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Simplifying and Rationalizing the Spinoff Rules

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TABLE OF CONTENTS

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THE spinoff rules in § 355 and related sections are in many respects illogical, complex and uncertain. The rules disqualify some transactions that logically should be permitted, and permit other transactions that logically should be disqualified. Moreover, the complexities and uncertainties are so great that spinoff ruling requests are reported to represent more than half the workload of the entire IRS corporate division.[1] Congress, the Treasury Department and the IRS have devoted considerable attention to spinoffs in recent years, yet few would say that this has made the rules simpler, more rational or more certain.

There are several reasons for these problems. First, many of the spinoff rules were developed in an era when most corporations doing spinoffs were closely held and had simple corporate structures. Today spinoffs are often done by large, publicly traded corporations with complex corporate structures. In fact, in recent years, spinoffs have become a significant percentage of all public merger and acquisition activity.[2] Second, most of the spinoff rules were designed for the pre-1986 era. At that time, the concern was that spinoffs could improperly be used to convert shareholder-level dividend income into capital gain. The rules were not designed for the post-1986 era following the repeal of the *General Utilities*[3] doctrine. Now, the concern is that spinoffs can improperly be used to avoid corporate level capital gain on the distribution. Third, in light of *General Utilities* repeal, enormous pressure has been put on the spinoff rules because spinoffs are the principal remaining method for appreciated assets to leave a corporate group without gain recognition.

This article suggests revisions to the spinoff rules that are intended to eliminate unnecessary complexities and make the rules more consistent with their purpose. To be sure, the purpose of the spinoff rules is in the eye of the beholder, and different views of the purpose will lead to different proposals for reform. I believe the purpose of the rules is to allow a single preexisting corporation or corporate group to be divided into parts among its shareholders. The proposed revisions to the rules are intended to be consistent with that purpose.

The suggested changes to the spinoff rules are intended to be an integrated package. As compared to the present rules, some of the proposals

1. Jasper L. Cummings, Jr., *Landing on the Moon: IRS Chief Counsel's National Office*, 93 TAX NOTES 1899, 1904 (2001).

2. *See* Robert Frank, *More and More, Mergers of '90s Are Becoming Today's Spinoffs*, WALL ST. J., Feb. 6, 2002, at C1 (indicating that spinoffs constituted 20-35% of the total merger and acquisition market over the 1996-2001 period).

3. Gen. Utils. & Operating Co. v. Helvering, 296 U.S. 200 (1935). *See infra* Part III for further discussion of this issue.

are pro-taxpayer and some are anti-taxpayer. A selective adoption of some of the changes but not others could potentially leave the spinoff rules either too broad and thus open to abuse by taxpayers, or more restrictive than necessary in light of their intended purpose.

In this article, *P* is a parent corporation spinning off a subsidiary *S*.

I. REQUIREMENTS FOR A SPINOFF

Under § 355, if *P* distributes the stock of *S* to the *P* shareholders, and certain conditions are satisfied, then (1) *P* does not recognize gain or loss on the distribution,[4] and (2) the shareholders do not recognize gain or loss on receipt of the *S* stock.[5] The conditions include:

1. The distribution must have a corporate business purpose.[6]

2. The distribution cannot principally be a device for the distribution of the earnings and profits of *P* or *S*.[7]

3. The distribution must satisfy continuity of shareholder interest as to both *P* and *S*.[8]

4. *P* must control *S* immediately before the distribution.[9] Control for purposes of the spinoff rules means ownership of 80% of the voting stock and 80% of each class of nonvoting stock.[10]

5. *P* must distribute either all the stock it held in *S*, or else stock representing control where the retention of stock does not have a tax avoidance motive.[11]

6. Each of *P* and *S* must be engaged, immediately after the distribution, in the active conduct of a trade or business (or substantially all its assets must consist of stock of subsidiaries so engaged).[12]

7. The relevant trade or business of each of *P* and *S* must have been conducted for at least 5 years before the spinoff (although not necessarily by *P* and *S*),[13] cannot have been acquired by *P* or *S* within the 5-year period in a transaction in which any gain or loss was recognized,[14] and cannot have been held (at the time of the acquisition) by a corporation that was acquired by *P* or *S* within the 5-year period in a transaction in which any gain or loss was recognized.[15]

8. A corporate shareholder cannot have acquired control of *P* during the preceding 5-year period in a transaction in which any gain or loss was recognized.[16]

4. I.R.C. § 355(c)(1) (2002).
5. I.R.C. § 355(a)(1) (2002).
6. Treas. Reg. § 1.355-2(b) (as amended in 1989).
7. I.R.C. § 355(a)(1)(B) (2002); Treas. Reg. § 1.355-2(d) (2002).
8. Treas. Reg. § 1.355-2(c)(1) (2002).
9. I.R.C. § 355(a)(1)(A) (2002).
10. I.R.C. § 368(c) (2002).
11. I.R.C. § 355(a)(1)(D) (2002).
12. I.R.C. § 355(a)(1)(C), (b)(1), (b)(2)(A) (2002).
13. I.R.C. § 355(b)(2)(B) (2002).
14. I.R.C. § 355(b)(2)(C) (2002).
15. I.R.C. § 355(b)(2)(D) (2002).
16. *Id.*

Moreover, even if a distribution meets these requirements, it will not be tax-free to *P* (although it will remain tax-free to the *P* shareholders) if either of the following exists:

1. A person purchased *P* stock within 5 years preceding the distribution, and such stock either (1) represents 50% or more of the outstanding *P* stock after the distribution, or (2) caused the purchaser to receive 50% or more of the outstanding *S* stock in the distribution.[17]
2. The distribution is part of a plan or series of related transactions pursuant to which there is a 50% or greater change in ownership of *P* or *S*.[18]

In addition, § 368(a)(1)(D) provides for a "divisive D reorganization." This occurs when (1) *P* transfers part of its assets to a new or preexisting *S*, (2) *P* distributes *S* in a transaction qualifying under § 355, and (3) immediately after the distribution the preexisting shareholders of *P* control *S*. The result is tax-free treatment to both *P*[19] and the shareholders of *P*.[20] Thus, if *P* has a preexisting subsidiary *S*, and spins off *S* without making any further contributions to *S*, the spinoff is solely under § 355. If *P* contributes additional assets to *S*, or if *P* forms a new *S* and contributes assets to *S*, the transaction can qualify as a divisive D reorganization.

Finally, a "spinoff" refers to a pro rata distribution by *P* of the stock of *S* to all the *P* shareholders. A "splitoff" refers to *P*'s use of *S* stock to redeem a portion of the stock of *P* on a non-pro rata basis, so that some shareholders of *P* end up with an interest in *S* and other shareholders of *P* end up with an increased percentage interest in *P*. A "splitup" refers to the case where *P* has no assets other than stock in two or more subsidiaries (or *P* contributes any other assets to such subsidiaries) and *P* then liquidates, distributing the stock in its subsidiaries to its shareholders on either a pro rata or non-pro rata basis.

II. A BRIEF HISTORY OF SPINOFFS

Congress first adopted corporate reorganization provisions in the Revenue Act of 1918, and made major amendments in the Revenue Acts of 1921 and 1924. By 1924, divisive D reorganizations were permitted, whether they were in the form of spinoffs, splitoffs or splitups.[21] Distributions of these types that were not part of a reorganization were not permitted. However, this restriction was not very meaningful because *P* could spin off (or split off) a preexisting *S* by contributing the *S* stock to a

17. I.R.C. § 355(d) (2002).
18. I.R.C. § 355(e) (2002).
19. I.R.C. § 361(a) (2002) (relating to dropdown of assets and receipt of *S* stock); I.R.C. § 361(c) (relating to distribution of *S* stock).
20. I.R.C. § 355(a)(1), (a)(2)(C) (2002).
21. *See, e.g.*, H.R. Rep. No. 68-179, at 14 (1924) (stating that a "common type of reorganization" occurs when *P* transfers some of its assets to new *S* and distributes the stock of *S* as a dividend to its shareholders). For more details, see Charles S. Whitman III, *Draining the Serbonian Bog: A New Approach to Corporate Separations Under the 1954 Code*, 81 Harv. L. Rev. 1194, 1198-200 (1968).

newly formed company ("Newco") and then spinning off Newco. There were no statutory requirements for a reorganization, the only rule being that the distribution must be pursuant to a plan of reorganization.

The next major development occurred in 1932, when the Board of Tax Appeals decided *Gregory v. Helvering*.[22] There, the individual taxpayer owned all of *P*, and *P* held appreciated stock. *P* contributed the stock to a newly formed *S*, *P* spun off *S*, and *S* immediately liquidated. The taxpayer received the stock and immediately sold it. If the transaction qualified as a divisive D reorganization, the result was to convert dividend income into capital gain. The court upheld this result based on the literal language of the statute.

Congress considered this result abusive and, in the Revenue Act of 1934,[23] repealed the spinoff form of divisive D reorganization. This may have been an overreaction, because the Board of Tax Appeals decision was ultimately reversed by the Second Circuit.[24] The Supreme Court affirmed on the ground that the claimed result was inconsistent with the purpose of the statute and that the transaction was a "mere device."[25] Nevertheless, from 1934 to 1951 there was no spinoff form of divisive D reorganization in the Code. However, the splitup form of divisive D reorganization apparently remained permissible,[26] making the lack of a spinoff provision hardly a major obstacle to the well advised taxpayer.

The Revenue Act of 1951[27] amended the 1939 Code to restore the spinoff form of divisive D reorganization. However, this Act imposed new requirements that (1) *P* and *S* must have intended to continue the active conduct of a trade or business after the spinoff, and (2) *S* was not "used principally as a device for the distribution of earnings and profits."[28] These provisions were designed to prevent dividend-equivalent transactions, such as those in *Gregory*, from being done as spinoffs.

The 1954 Code[29] included § 355 in the same general form as it exists today. For the first time, a spinoff (or splitoff or splitup) was allowed outside the D reorganization context, so that a preexisting *S* could be distributed without any prior transfer of assets from *P* to *S*. In addition, regardless of the form of the transaction, the device test from 1951 was adopted, the active business test from 1951 was adopted and strengthened, the 5-year active business tests were added, and the control test was added.

No significant changes were made to the statute between 1954 and

22. Gregory v. Helvering, 27 B.T.A. 223 (1932).
23. Revenue Act of 1934, Ch. 277, § 112, 48 Stat. 680, 704-06 (1934).
24. Helvering v. Gregory, 69 F.2d 809 (2d Cir. 1934).
25. Gregory v. Helvering, 293 U.S. 465, 469 (1935).
26. Whitman, *supra* note 21, at 1201-02.
27. Revenue Act of 1951, Pub. L. No. 82-183, 65 Stat. 452, 493-94 (1951).
28. *Id.*
29. I.R.C. § 355 (1954) (amended 1954).

1987.[30] The Revenue Act of 1987 (the 1987 Act)[31] amended § 355(b)(2)(D) to disqualify a spinoff under § 355 if a corporation had acquired control of *P* within 5 years preceding the spinoff. The purpose of this provision was to prevent a corporation from purchasing 80% of *P* for cash, receiving stock of *S* in a spinoff in which the *S* stock would take a substituted basis, and then selling the *S* stock at little or no gain.

Subsequently, § 355(d) was adopted in 1990.[32] It applies, for example, when *X* buys 40% of *P* stock for cash and, after a period of time to meet continuity of interest, *P* splits off *S* by redeeming out all of the *P* stock held by *X*. *X* obtains a basis in the *S* stock equal to *X*'s cost for the *P* stock. *X* can eventually sell the *S* stock at a reduced gain reflecting this basis. A similar result would arise if *P* split off *S* by redeeming out all the non-*X* shareholders of *P*, in which case *X* would own 100% of the smaller *P* with a cost basis.

Finally, § 355(e) was adopted in 1997.[33] It was aimed at so-called *Morris Trust*[34] transactions where the spinoff of *S* is followed by a third party acquiring *P* (or sometimes *S*) in a tax-free reorganization. This section was particularly aimed at leveraged spinoff transactions that were the economic equivalents of cash sales of assets, where the spinoff rules resulted in no taxable gain to the "seller."[35] However, the section applies equally even in the absence of leverage.

III. THE ROLE OF SPINOFFS AFTER *GENERAL UTILITIES* REPEAL

In the Tax Reform Act of 1986[36] (the 1986 Act), Congress eliminated most of the methods for a corporate group to transfer assets outside the group without gain recognition. This set of amendments is generally referred to as the repeal of the *General Utilities* doctrine.[37] In fact, after the 1986 Act, the principal remaining method of achieving this result is under § 355 (or a divisive D reorganization). This has caused taxpayers to at-

30. However, extensive changes were made in the regulations and significant case law arose. *See* John W. Lee, *The Art of Regulation Drafting: Structured Discretionary Justice Under Section 355*, 44 TAX NOTES 1029 (1989).

31. Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, 101 Stat. 1330, 411-12 (1987).

32. Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, 104 Stat. 1338, 460-63 (1990).

33. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 1788, 914-16 (1997).

34. Comm'r v. Mary Archer W. Morris Trust, 367 F.2d 794 (4th Cir. 1966).

35. Suppose *P* had two divisions (*A* and *B*), each with a basis of $0 and value of $100. If *X* wanted to buy *B*, *P* would borrow $65, contribute the cash and *A* to new *S*, and spin off *S* to its shareholders. *X* would then acquire *P* (holding *B* and having $65 of debt) for $35 of *X* stock. *S* (holding *A* and $65 in cash, and renamed *P*) is in the same position as the old *P*, as if old *P* had sold *B* for $100 and paid $35 in tax. Likewise, *X* is in the same position as if it paid $100 ($65 in cash and $35 in stock) for *B*. However, no tax has been paid and the *B* assets do not have a stepped-up tax basis. The $35 in tax savings has gone to the old *P* shareholders in the form of *X* stock.

36. Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986).

37. *See* George K. Yin, *Taxing Corporate Liquidations (and Related Matters) After the Tax Reform Act of 1986*, 42 TAX L. REV. 575 (1987).

tempt to stretch § 355 to its limits, and has put much pressure on the requirements of § 355.

The most basic question is the proper role of § 355 after *General Utilities* repeal. This question has been much discussed,[38] and at one point the Treasury Department was reportedly considering whether repeal was appropriate.[39]

It might be thought that § 355 is consistent with *General Utilities* repeal because even though the *S* assets leave the *P* group, they remain in corporate solution and do not obtain a stepped up basis. As a result, the argument runs, there is no reason for *P* to recognize gain as a result of a spinoff. However, while a carryover basis in the *S* assets is necessary in order for § 355 to be consistent with *General Utilities* repeal, this factor alone is not sufficient. There are many reasons for this conclusion.

1. Before 1982, a corporation generally did not recognize gain when it used stock of a subsidiary to redeem stock held by a shareholder. This exception to the general recognition rule was mostly eliminated in 1982.[40] As a result, even before 1986, a corporation generally recognized gain on the distribution of stock of a subsidiary to its shareholders, even though the assets of the subsidiary retained a carryover basis. *General Utilities* repeal was intended to increase, rather than decrease, gain recognition to a corporation on a distribution. As a result, Congress could not have intended that a carryover basis of *S* assets would be sufficient for *P* to avoid gain on a distribution of *S* stock.

2. If carryover basis is the key, a corporation should be allowed to sell any of its assets for cash and not recognize gain, as long as the buyer elected a carryover basis for the assets. Congress has never gone this far, nor even seriously considered this result.

3. A well-respected ALI study in the early 1980s[41] considered far reaching reform of the corporate income tax. However, even that study did not suggest that a carryover asset basis should be sufficient to avoid gain recognition. Rather, the study suggested that a selling corporation should be permitted to avoid gain on asset sales only if (1) the assets represented all or a major portion of the corporation's assets, and (2) the corporation distributed the cash to its shareholders, resulting in immediate gain recognition at the shareholder level.[42] The purpose of the propo-

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38. *See, e.g.*, Michael L. Schultz, *The Evolution of Continuity of Interest,* General Utilities *Repeal and the Taxation of Corporate Acquisitions*, 80 TAXES 229 (2002); Jeffrey T. Sheffield & Herwig J. Schlunk, *Reconciling Spin-Offs with* General Utilities *Repeal*, 74 TAXES 941 (1996); Melissa C. McCann, *Section 355 in a Post-*General Utilities *World: The Victim of an Overreaction?*, 23 J. CORP. TAX'N 137 (1996); Karla W. Simon & Daniel L. Simmons, *The Future of Section 355*, 40 TAX NOTES 291 (1988); Eric M. Zolt, *The* General Utilities *Doctrine: Examining the Scope of Repeal*, 65 TAXES 419 (1987).

39. McCann, *supra* note 38, at 144.

40. *See* STAFF OF THE J. COMM. ON TAX'N, 97TH CONG., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982, at 129-31 (Comm. Print 1982).

41. AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT: SUBCHAPTER C, PROPOSALS ON CORPORATE ACQUISITIONS AND DISPOSITIONS (1982).

42. *Id.* at 72-75, 94-99.

sal was to avoid an immediate double tax as long as a current shareholder-level tax was paid. The goal was not to permit the avoidance of all current tax solely on account of the carryover asset basis.

4. The 1986 Act enacted new § 336(e). That section authorizes regulations to provide that, when *P* distributes the stock of *S*, an election can be made to treat the distribution as an asset disposition with no gain to *P* on the stock distribution. This provision demonstrates that Congress was aware that *P* might be taxed on the transfer of *S* stock outside the corporate group even though the *S* assets retained a carryover basis. In fact, in discussing the justification for § 336(e), the 1986 Blue Book explicitly recognizes that this is the appropriate result.[43] The solution was to allow an election to recognize gain on the assets, not to provide that a carryover asset basis was sufficient to avoid gain on the stock.

5. In the 1987 Act, Congress amended the Code in three respects to stop transactions that allowed assets to leave a corporate group without gain recognition to the group. The techniques were (a) mirror liquidations,[44] (b) a technique involving § 304 that produced an artificial increase in the stock basis of a subsidiary that was to be sold, and (c) as discussed above,[45] the purchase of 80% of the stock of a corporate parent followed by the parent's distribution of subsidiary stock in a spinoff.[46] Even though the assets retained a carryover basis in each case, the legislative history refers to these techniques as "tax avoidance."[47] Moreover, the legislative history makes clear that Congress rejected the concept that a carryover of the underlying asset basis was sufficient to prevent corporate-level gain recognition.[48]

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43. *See* STAFF OF J. COMM. ON TAX'N, 100TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 338 (Comm. Print 1987) [hereinafter 1986 Blue Book] ("Congress believed it was appropriate to conform the treatment of liquidating and nonliquidating sales or distributions and to require recognition when appreciated property, *including stock of a subsidiary*, is transferred to a corporate or individual recipient outside the economic unit of the selling or distributing affiliated group.") (emphasis added).

44. In a mirror liquidation, instead of corporation *X* directly buying the stock of corporation *P* for cash, (1) *X* would form a number of new wholly owned consolidated subsidiaries, (2) *X* would contribute the total purchase price for *P* to the new subsidiaries in a predetermined manner, (3) the new subsidiaries would each purchase a predetermined percentage of the stock of *P*, 100% in the aggregate, and (4) *P* would liquidate into the subsidiaries under § 332, relying on the former rule that for purposes of the 80% stock ownership test in § 332, ownership by consolidated subsidiaries was aggregated. As a result, each new subsidiary would own a portion of the *P* assets with a carryover basis, but *X* would own the stock of each subsidiary with a cost basis. *X* could then sell the stock of one or more subsidiaries with no taxable gain.

45. *See supra* Part II (discussion of the 1987 Act).

46. *See* H.R. REP. NO. 100-391, at 1080-84 (1987); H.R. CONF. REP. NO. 100-495, at 966-70 (1987).

47. H.R. REP. NO. 100-391, at 1080 (1987); H.R. CONF. REP. NO. 100-495, at 966 (1987).

48. [T]he statute specifically rejects the concept that recognition can be deferred merely because the underlying assets of the subsidiary do not obtain a stepped-up basis. This is because the potential for a corporate-level tax in the future, resulting from the low basis of the assets, is not the economic equivalent of a current tax on the appreciation at the time of the sale or distribution . . . . [Section 355] might be used to claim a stepped-up, fair

6. Congress subsequently thought it appropriate to adopt § 355(d) and (e). These sections impose corporate level gain in cases where assets leave the corporate group with a carryover basis. The legislative history of § 355(d) makes it clear that Congress thought § 355(d) transactions were inconsistent with *General Utilities* repeal.[49] The sections do not impose shareholder gain because Congress viewed the transactions in question as implicating *General Utilities* repeal but not the device test.

These consistent actions by Congress beginning with the 1986 Act demonstrate that Congress did not intend a carryover asset basis to be sufficient grounds to allow an asset to leave a corporate group without gain recognition. Nevertheless, throughout this period, Congress did not repeal § 355, despite the numerous opportunities. As a result, Congress clearly intended the core of § 355 to remain.

If carryover basis is not the key to the retention of § 355, what is the key? There is no clear answer in the legislative history to the 1986 Act. However, the 1986 Blue Book has the best explanation. It states that:

> Congress felt that the same policy rationale that justifies nonrecognition by the shareholder on receipt of the stock—namely, that the transfer merely effects a readjustment of the shareholder's continuing interest in the corporation in modified form and subject to certain statutory and other constraints—also justifies nonrecognition of gain (or loss) to the distributing corporation in this situation. Similarly, certain distributions pursuant to a plan of reorganization also are not subject to recognition.[50]

Thus, a spinoff is simply "a readjustment of the shareholder's continuing interest in the corporation,"[51] analogous to a reorganization. In other words, if merging two corporations together is tax free, dividing a corporation into parts should also be tax free. This explanation would support

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> market value basis when a subsidiary of an acquired corporation is distributed to the acquiring corporation. The committee believes that section 355 of the Code should generally prevent the use of that section to accomplish a sale of a recently distributed subsidiary (or its recently acquired parent) without corporate level tax, or effectively to accomplish a sale of a subsidiary to a significant shareholder by a distribution with respect to recently purchased stock.

H.R. Rep. No. 100-391, at 1081-83 (1987).

49. The Committee is concerned that some corporate taxpayers may attempt, under present-law rules governing divisive transactions, to dispose of subsidiaries in transactions that resemble sales . . . . The avoidance of corporate level tax is inconsistent with the repeal of the *General Utilities* doctrine . . . . The provisions for tax-free divisive transactions under section 355 were a limited exception to the repeal of the *General Utilities* doctrine, intended to permit historic shareholders to continue to carry on their historic corporate businesses in separate corporations. . . . The present-law provisions granting tax-free treatment at the corporate level are particularly troublesome because they may offer taxpayers an opportunity to avoid the general rule that corporate-level gain is recognized when an asset (including stock of a subsidiary) is disposed of.

H.R. Rep. No. 101-881, at 341 (1990).

50. 1986 Blue Book, *supra* note 43, at 337.

51. *Id.*

both a pro rata spinoff and a non-pro rata splitoff, and is consistent with the history of § 355. As noted above,[52] spinoffs entered the Code as a form of tax-free reorganization, and were subsequently considered to be a form of reorganization. This history provides strong support for the retention of § 355 after *General Utilities* repeal.

However, this is not to say that *General Utilities* repeal properly had no effect on the theory of spinoffs. Before that time, the principal concern was that spinoffs would be used to convert ordinary dividend income at the shareholder level into capital gain. Since 1986, a second major concern is that spinoffs should not be used to circumvent the purposes of *General Utilities* repeal. The purpose of the repeal is far from clear. At a minimum, Congress has shown its belief that a buyer of stock of corporation *X* should not be able to convert its stock basis into a stepped-up basis in stock of a corporation that holds only part of the *X* assets. This is so even if the underlying assets retain a carryover basis.

A broader Congressional intent regarding *General Utilities* repeal is demonstrated by the amendments to § 304 and § 355(e). The purpose of the § 304 amendment was to prohibit a historic owner of stock of a subsidiary from artificially increasing the basis of the stock before it was sold. Even more broadly, in § 355(e), Congress viewed a transaction as resembling a sale of assets if some of the assets in a corporate group leave the group, and economic ownership of those assets (or of the remaining assets) is transferred to one or more third parties.[53] If the group does not recognize a gain, the result is considered inconsistent with *General Utilities* repeal even if the assets retain a carryover basis. This issue is discussed further below.[54]

The foregoing discussion provides insight into the requirements that should be imposed for spinoffs.

1. Spinoffs generally should be subject to the requirements for tax-free reorganizations—the basis upon which they continue to exist.
2. Just as in the pre-1986 era, because spinoffs are inherently divisive, additional restrictions should be required for spinoffs in order to prevent them from converting shareholder dividend income into capital gain.
3. In light of *General Utilities* repeal, additional restrictions should be required for spinoffs to prevent them from being used improperly to avoid corporate level tax when assets leave the corporate group.

The remainder of this article considers the extent to which the spinoff rules should be modified in order to make them simpler in practice and more consistent with the purposes of § 355 following *General Utilities* repeal.

52. *See supra* Part II.

53. *See* STAFF OF J. COMM. ON TAX'N, 105TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN 1997, at 198 (Comm. Print 1997) ("In cases in which it is intended that new shareholders will acquire ownership of a business in connection with a spin-off, the transaction more closely resembles a corporate level disposition of the portion of the business that is acquired.").

54. *See infra* Part V.B.1.

IV. RECONSIDERING THE SPINOFF TESTS

A. Business Purpose

The Code does not expressly require that either a reorganization or a spinoff have a business purpose. The regulations adopt a business purpose test for both reorganizations[55] and spinoffs.[56] This is certainly appropriate to prevent transactions such as that in *Gregory v Helvering*. However, in contrast to the very general business purpose requirement for a reorganization, the requirements for a spinoff are quite strict. The business purpose must be a corporate business purpose[57] rather than a shareholder purpose. In addition, the purpose does not qualify if the desired result could have been achieved without a spinoff in a manner that is "neither impracticable nor unduly expensive."[58]

Under published guidelines issued for advance ruling purposes, a taxpayer will satisfy the business purpose test for a spinoff if its business purpose is on a list of approved purposes.[59] These purposes include the need to issue stock to employees of *P* or *S* that reflects solely the performance of the particular business, cost savings, the desire of *P* or *S* to do business with competitors of the other who are not willing to do business with an affiliate of a competitor, and "fit and focus."[60]

In reality, many spinoffs involving public corporations are planned in order to "enhance shareholder value."[61] Corporate management often believes that the market discounts the value of two disparate businesses that operate as divisions of a single corporate group, and that once the businesses are separated the aggregate stock price will increase. Regardless of the validity of this theory, this purpose is not on the approved list.

The IRS will consider ruling on business purposes not on the approved list.[62] However, as long as the IRS determines that an approved purpose motivates the spinoff "in substantial part," it will issue a ruling without regard to any other purposes for the spinoff.[63] Moreover, the IRS will not rule on the purpose of enhancing shareholder value, apparently because it is considered an impermissible shareholder purpose rather than a corporate business purpose. Rulings for other business purposes not on the approved list are also difficult to obtain.

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55. Treas. Reg. § 1.368-1(b) (as amended in 2001); *see also* Treas. Reg. § 1.368-1(c) (stating that a reorganization "must be an ordinary and necessary incident of the conduct of the enterprise," and the object cannot be "a preconceived plan having no business or corporate purpose"). *See* Boris I. Bittker & James S. Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 12.61[1] (7th ed. 2002).

56. Treas. Reg. § 1.355-2(b) (as amended in 1989).

57. Treas. Reg. § 1.355-2(b)(1).

58. Treas. Reg. § 1.355-2(b)(3).

59. Rev. Proc. 96-30, 1996-1 C.B. 696 app. A.

60. *Id.*

61. *See, e.g.*, Schultz, *supra* note 38, at 311 n.194.

62. Rev. Proc. 96-30, 1996-1 C.B. 696, app. A, § 1.

63. *Id.*

As a result, virtually all taxpayers asking for rulings try to satisfy an approved purpose without regard to any additional purposes that might exist. This forces taxpayers to do such things as the following:

1. offer more *P* or *S* stock than desired to employees after the spinoff in order to meet the IRS requirements for showing that issuing a sufficient amount of such stock was a valid business purpose for the spinoff;[64]

2. find a key employee of a division of *P* that threatens to quit unless granted options on stock that represents solely an interest in that division;[65]

3. obtain a letter from an investment banker stating that after the spinoff, *P* or *S* will be able to issue equity or borrow money more cheaply than the combined business could have;[66]

4. demonstrate an expected "significant cost savings" from the spinoff, generally a net savings over the three post-spinoff years equal to at least 1% of net income over the three pre-spinoff years;[67] or

5. when all else fails, demonstrate a fit and focus business purpose by demonstrating "management, systemic, or other problems that arise (or are exacerbated)" by the taxpayer's operation of different businesses within a single group.[68]

These requirements are, for the most part, divorced from reality. Issuing extra stock to employees after the spinoff may be the "price" of an IRS ruling, but is rarely the primary business purpose for the spinoff. Likewise, even if an executive of one division of *P* is unhappy about the incentives provided by options on stock representing all of *P*, this would not usually be a reason to quit and would seldom constitute the primary reason for a spinoff. Moreover, few corporations would do a spinoff for the minor cost savings that constitute a good business purpose under the guidelines. In fact, corporations often do not even make such calculations until after the spinoff has been decided upon and the time has come to obtain a ruling. Finally, even if the corporation's investment banker is willing to write a letter stating that debt or equity financing will be cheaper after the spinoff, the result is so uncertain that a corporation would not usually plan a spinoff primarily for that purpose.

The result of the guidelines is that a corporation's ability to obtain an IRS ruling may depend largely on the willingness of the corporation's investment banker to write supporting letters to the IRS that attempt to predict the unpredictable. These letters are heavily negotiated, and the corporation will often have decided upon the spinoff long before the negotiation of the letter.

This entire effort makes no sense for a number of reasons. First, as a practical matter, virtually every corporation wishing to do a spinoff can

64. *Id.* § 2.01(1)(b).
65. *Id.* § 2.01(1)(a).
66. *Id.* §§ 2.02(2), 2.03(2).
67. *Id.* § 2.04.
68. *Id.* § 2.05.

eventually satisfy the IRS concerning its business purpose. However, vast amounts of time and energy on the part of both the IRS and taxpayers are devoted to this effort. In the final analysis, the time and energy are completely nonproductive.

Second, in many cases everyone acknowledges that the primary reason for the spinoff is different than the approved purpose. Nevertheless, this is entirely permissible under the ruling guidelines as long as the approved purpose is a substantial purpose.[69]

Third, a major reason for the effort is the rule that attempting to increase the combined stock price of *P* and *S* is a shareholder level purpose and not a corporate business purpose. However, it is difficult to make this distinction. Every benefit to a corporation should logically increase the stock price and thus benefit its shareholders. Conversely, an increase in stock price demonstrates that the shareholders value a corporation more highly, and this increase in value is a corporate level benefit.

Finally, a purpose relating to the shareholder's personal situation should not be a valid business purpose. The regulations properly use "personal planning purposes of a shareholder" to illustrate this point.[70] For example, if producing tax savings for a shareholder was a valid business purpose, Mrs. Gregory would have had a good business purpose for her spinoff. The problem today is that the concept of shareholder level business purpose has been extended beyond this situation without logical justification.

Because the existing business purpose test is so illogical and nonproductive, it should be modified. One alternative would be to tighten the business purpose rule and require a fundamental and objective corporate reason for a spinoff. A permissible purpose might be to avoid regulatory restrictions on a major acquisition, or to solve a clearly demonstrated problem with competitors of *P* who do not want to deal with *S* as long as it is related to *P*. This approach would not allow spinoffs for relatively small projected cost savings, and would allow fit and focus spinoffs only in the most extreme cases.

An alternative approach would be to loosen the business purpose rule and adopt the same rule that presently exists for reorganizations. To the extent this new rule would allow spinoffs to be used for purposes inconsistent with the purpose of the spinoff rules, these problems would be solved directly.

The former approach of tightening the business purpose test could only be justified on the ground that in light of *General Utilities* repeal, good tax policy requires a significant cutback in "plain vanilla" spinoffs. However, there is no indication that Congress intended this result, and furthermore, this result would be inconsistent with the idea that spinoffs remain as a form of reorganization. As a result, the latter approach of

69. *Id.* § 1.
70. Treas. Reg. § 1.355-2(b)(2) (as amended in 1989).

loosening the business purpose requirement is far preferable. It would eliminate the complexity that exists today with no real disadvantages.

As a result, the business purpose test for a spinoff should generally be the same test as for a reorganization under § 368.[71] A purely personal business purpose of the shareholder, such as saving taxes, should not be sufficient for a spinoff just as it would not be for a reorganization. However, enhancing shareholder value should expressly be valid.

Moreover, in the case of a widely held public corporation, subject to the exception below, the business purpose test should be applied so that it would rarely be an impediment to a spinoff. The board of directors has a fiduciary duty to the shareholders to act in the best interests of the shareholders, and the board should be presumed to be doing so in adopting a spinoff. Just as a reorganization involving public companies would rarely if ever be challenged on business purpose grounds, the same should be true of a spinoff.

However, one exception to the liberalized business purpose test is appropriate. Consider the situation where *P* satisfies this business purpose test, but the primary purpose of the distribution is to facilitate taxable sales of *P* or *S* stock by shareholders of *P*. Such a purpose is inconsistent with the concept that, after *General Utilities* repeal, a spinoff should represent a division of an existing business among its existing shareholders.

The continuity of interest rule as well as § 355(e) limit the ability of shareholders to sell *P* or *S* stock after a spinoff as part of the spinoff plan. However, neither rule would prevent a spinoff that has the purpose of facilitating a post-spinoff cash sale of less than 50% of the *P* or *S* stock.

The device test, discussed further below,[72] is also inadequate in this situation. The test is a vague balancing test, and has been interpreted to allow a distribution to qualify under § 355 even though the only purpose of the distribution was to facilitate a sale.[73] Moreover, the test is focused on shareholder-level issues rather than *General Utilities* repeal. For example, it does not generally apply to non-pro rata splitoffs, and a public *P* is a nondevice factor.

The simplest and most appropriate method of dealing with this issue would be an exception to the liberalized business purpose test. Under this approach, even if a distribution otherwise satisfies the business purpose test, it would automatically fail the test if the principal purpose of the distribution (or possibly "a" principal purpose of the distribution) was to facilitate taxable post-distribution sales of *P* or *S* stock by shareholders of *P*.

71. For a similar conclusion, see Schultz, *supra* note 38, at 311 n.194.
72. *See infra* Part IV.B.1.
73. *See* Pulliam v. Comm'r, 73 T.C.M. (CCH) 3052 (1997), *nonacq.*, 1998-2 C.B. 664. *See infra* note 87.

B. Device Test

1. *Background*

The device test has been in the statute since spinoffs were reinstated in 1951. The regulations state that a spinoff "presents a potential for tax avoidance by facilitating the avoidance of the dividend provisions of the Code through the subsequent sale or exchange of stock of one corporation and the retention of stock of another corporation."[74] The idea is that if the shareholders of *P* were to receive *S* stock in a spinoff and then sell their *S* (or *P*) stock for cash, they end up with *P* (or *S*) stock and cash. This is the same result as if *P* had sold the *S* (or *P*) assets and paid a cash dividend to the shareholders. This would no doubt be a device today, and the cases generally so hold.[75]

The device test is a facts and circumstances test.[76] Factors indicating a device are (1) a pro rata distribution of *S* stock,[77] (2) a sale of *P* or *S* stock after the distribution,[78] (3) assets of *P* or *S* not used in a 5-year trade or business,[79] or (4) a business of *P* or *S* (a so-called "secondary business") whose principal function is to serve the other business and which could be sold without adverse effect on the other business.[80] Regarding the sale of stock factor, the greater the amount of *P* or *S* stock sold by the shareholders, and the greater the level of negotiations for the sale before the spinoff, the more likely a device exists. A sale after the spinoff is evidence of a device even if the sale is not negotiated or agreed upon before the distribution.[81]

The factors evidencing lack of a device are a (1) corporate business purpose that outweighs any device factors,[82] (2) the fact that *P* stock is publicly traded and *P* has no greater-than-5% shareholder,[83] and (3) the fact that *P* shareholders are corporations that would be entitled to the dividends received deduction.[84]

A device is generally not considered to exist if *P* and *S* have no current or accumulated earnings and profits and the distribution would not create current earnings.[85] Nor is a device considered to exist in a splitoff where each shareholder would be entitled to capital gain treatment under § 302

74. Treas. Reg. § 1.355-2(d)(1) (as amended in 1989).

75. *See, e.g.*, S. Tulsa Pathology Lab., Inc. v. Comm'r, 118 T.C. 84 (2002) (device test applies where private *P* distributes *S* stock pro rata, and *S* shareholders sell all the *S* stock on the same day in a prearranged plan). *But see Pulliam*, 73 T.C.M. (CCH) 3052 (1997), discussed *infra* note 87.

76. Treas. Reg. § 1.355-2(d)(1).

77. Treas. Reg. § 1.355-2(d)(2)(ii).

78. Treas. Reg. § 1.355-2(d)(2)(iii).

79. Treas. Reg. § 1.355-2(d)(2)(iv)(B).

80. Treas. Reg. § 1.355-2(d)(2)(iv)(C).

81. Treas. Reg. § 1.355-2(d)(2)(iii).

82. Treas. Reg. § 1.355-2(d)(3)(ii).

83. Treas. Reg. § 1.355-2(d)(3)(iii).

84. Treas. Reg. § 1.355-2(d)(3)(iv).

85. Treas. Reg. § 1.355-2(d)(5)(ii).

if the distribution was taxable.[86]

2. *Reasons for Retaining the Test*

The device test is vague, and the court decisions interpreting it are sometimes difficult to defend based on the policies behind the test.[87] As a result, it could be argued that the test should be eliminated and replaced with more precise prohibitions. Nevertheless, the test should be retained for the following reasons:

a. The device test has been in the statute since the readoption of the spinoff rules in 1951. In fact, to the extent that splitups remained permissible between 1934 and 1951, *Gregory v. Helvering* imposed a device test during that period.

b. The device test serves a valuable function today in every pro rata spinoff. It strongly discourages (1) planned sales of stock after the distribution, (2) large amounts of nonbusiness assets in *P* or *S*, or (3) a weak business purpose for the distribution in comparison to other factors. These restrictions are appropriate and prevent transactions that are similar to dividends.

c. If the device test were eliminated, other more specific rules would be required to prevent dividend-like transactions. Such rules would increase the complexity of § 355 for all taxpayers, not only those who were close to the line. In that sense, the device test plays a role similar to an anti-abuse rule. Such a rule is a backstop that allows for simpler statutory requirements, without the need for the statute to foresee and prevent every possible specific method of abuse.

d. The need for the device test becomes even greater if the business purpose test is liberalized, as is suggested above.[88] Consider a corporation owned by a single individual where there is a minimal business purpose for a spinoff, but where in reality the principal purpose for the spinoff is truly personal to the shareholder (such as estate planning). The spinoff would likely be disallowed today under the device test, i.e., the pro rata distribution and the earnings in *P* would be device factors that would outweigh the weak corporate level business purpose. This is the correct result, because, if the primary purpose of the spinoff is purely personal to the shareholder, there is no policy reason for allowing § 355 to apply. In order to ensure this result, either the proposed business purpose rule could be modified to require a balancing of personal and corporate business purposes, or the device test could be retained for this purpose. The latter makes more sense.

e. It was recently argued that the active business requirement should

86. Treas. Reg. § 1.355-2(d)(5)(iv).

87. *See, e.g.*, *Pulliam*, 73 T.C.M. (CCH) 3052 (1997), *nonacq.*, 1998-2 C.B. 664 (*P* distributes *S* to *P*'s sole shareholder for the sole purpose of facilitating the sale of 49% of *S* to a key employee of *S*; held, the distribution was necessary for the sale to occur, and the business purpose for the sale overcame the device factor created by the planned sale).

88. *See supra* Part IV.A.

completely replace the device test.[89] Under this theory, if all the assets of *P* and *S* consist of 5-year active business assets, it should not matter that a significant number of shareholders plan to sell their *P* or *S* stock after the distribution. The reasoning is that a shareholder selling *P* or *S* stock is giving up an interest in real business assets, and a bailout only arises when the shareholder receives cash without a reduction in interest in operating assets. As a result, the argument runs, capital gain treatment is appropriate in this case. Likewise, there is no abuse, because if *P* had sold the assets and distributed the proceeds, the noncorporate shareholders would probably be entitled to capital gain treatment under the partial liquidation rules of § 302(b)(4).

However, this reasoning does not seem correct. The shareholder receives cash and a continuing interest in a smaller *P*, just as if *P* had sold the *S* business and distributed the cash as a dividend. Moreover, the reliance on § 302(b)(4) is questionable because that section presupposes that *P* paid tax on the sale of the business before distributing the sale proceeds in partial liquidation. The combination of § 355 to achieve tax-free treatment at the corporate level, along with the analogy to § 302(b)(4) to achieve capital gain treatment at the shareholder level, is too good to be true.

3. *Problems with the Test*

The foregoing reasons support the retention of the device test. However, this is not to say that the test should be left unchanged. In several respects, some of the device factors have tended to take on a life of their own, without regard to the logic of their application in any particular case. Moreover, in certain situations the device test is too narrow. These issues are discussed in the following sections.

a. The logic behind the device factor of a secondary business is unclear. A secondary business that can be sold seems to be no different than any other business held by *P* or *S* that can be sold. This factor should be eliminated.

b. More significantly, where *P* is a public corporation, the IRS ruling guidelines apply the device factor of stock sales by requiring *P* to represent that no 5% shareholder has a plan or intention to sell any stock in *P* or *S* after the distribution.[90] This rule makes sense when the 5% shareholder is part of the management of *P* and thus plays a role in planning the spinoff. It makes no sense, however, in the case of a passive investor such as a mutual fund. The management of *P* will have no idea whether a fund will even continue to hold its *P* stock until the time of the spinoff, let alone whether it will sell its *P* or *S* stock after the spinoff. The spinoff should not be tested as a device based on the undisclosed intent of such a fund.

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89. Schultz, *supra* note 38, at 311 n.194.
90. Rev. Proc. 96-30, 1996-1 C.B. 696, § 4.05(1)(a).

Moreover, because *P* cannot give the representation required by the IRS without obtaining a representation from the fund, the result is to put the fund in the position of having veto power over a spinoff. The fund will have no desire to be in this position. However, it will be justifiably concerned that a representation as required by the IRS could limit its future flexibility.

There is no logic to the validity of a spinoff depending on the intent of an independent shareholder such as a mutual fund. As a result, when *P* is publicly traded, the device factor relating to stock sales after the distribution should not apply to sales by nonmanagement shareholders of *P* who own less than 10% of *P*, unless a principal purpose of the distribution was to facilitate such sales. In practice, this will exclude sales by mutual funds in most instances.

c. Under the regulations, if *P* has a 5-year active trade or business, *P*'s purchase of another trade or business in the same line of business is treated as an expansion of the original business, and the entire combined business is treated as meeting the 5-year test.[91] This rule is known as the "business expansion doctrine."

As noted above, one device factor is the existence of assets that do not meet the 5-year trade or business test.[92] Thus, this device factor does not apply to assets that satisfy the business expansion doctrine even though they were acquired within the 5-year period. Moreover, this device factor does not apply to business expansion assets no matter how closely related the purchase of the assets is to the distribution. For example, *P* might use excess cash the day before the distribution to purchase assets in contemplation of the distribution.

In addition, there is no limit on the amount of assets that can be purchased under the business expansion doctrine. *P* cannot use excess cash during the 5-year period to acquire any non-expansion assets without having to overcome the device factor. It is illogical that the business expansion doctrine should be a complete exemption from the device factor regardless of the actual facts.[93]

Today, the business purpose test would impose a practical limit on the avoidance of the device test in this manner. However, if the business purpose test is liberalized as suggested above,[94] it will provide few if any

91. Treas. Reg. § 1.355-3(b)(3)(ii) (as amended in 1989).

92. Treas. Reg. § 1.355-2(d)(2)(iv)(B) (as amended in 1989).

93. *See also* Robert Willens, *Finessing the 'Active Business' Test of Section 355: IRS Concession Allows Taxpayers to Avoid the Five-Year Rule*, Daily Tax Report (BNA) No. 165, at J-1 (Aug. 26, 2002) (the business expansion doctrine is an "extraordinary concession" by the IRS, *id.* at J-2, and the doctrine "at the end of the day, allows the use of the Section 355 rules to avoid the tax on dividends." *Id.* at J-3.). *Cf.* Robert Willens, *Spinoffs of Recently Purchased Businesses—What will be the Impact of a Recent Tax Court Decision*, 84 J. TAX'N 32, 35 (1996) (the doctrine "represents a reasonable and measured response . . . on the grounds that a taxpayer that has acquired activities in a line of business similar or identical to the business it has historically conducted is invariably motivated by corporate objectives, rather than by a purpose to achieve a bailout of E&P").

94. *See supra* Part IV.A.

limits on these transactions. In fact, *P*'s ability to avoid the device test through the business expansion doctrine would be even more significant if the business expansion doctrine were tested on a group basis rather than on an individual company basis, as is suggested below.[95] Under this scenario, if *P* was engaged in business *B*, *P* could use its excess cash to buy the stock of a corporation engaged in business *B*, rather than directly buying the business *B* assets. The result would be the use of the cash to avoid the device test combined with the lack of corporate-level tax on an asset sale.

Consequently, when applying the device factor relating to assets that are not 5-year business assets, the business expansion doctrine should be disregarded. Under this rule, all assets purchased within the 5-year period would count as a negative factor, even if *P* is already in the same business. Of course, *P* would still be permitted to overcome the negative factor, e.g., in the case of a routine incremental expansion of an existing business, just as *P* is permitted to overcome the negative factor today when the business expansion doctrine does not apply.

d. The device test was adopted long before *General Utilities* repeal. As a result, the statute by its terms is limited to protecting the fisc against the avoidance of shareholder dividend taxes. Moreover, this is why the regulations have a specific exclusion for a non-pro rata splitoff, and why a public corporation without 5% shareholders is evidence of nondevice.

Thus, the statute by its terms does not prevent the use of § 355 to avoid *General Utilities* repeal. Likewise, the specific exclusions and factors in the regulations make it difficult if not impossible for the IRS to use the device test to enforce *General Utilities* repeal in the splitoff or public corporation context.

To be sure, Congress has enacted some specific provisions, such as § 355(d) and (e), to deal with the use of § 355 to avoid *General Utilities* repeal. However, in the absence of specific limiting provisions, there is little today to prevent such use. In fact, if the business purpose test is liberalized as suggested above,[96] taxpayers will have even greater ability to engage in spinoff transactions that are inconsistent with *General Utilities* repeal.

Some specific types of transactions that seem inconsistent with *General Utilities* repeal are discussed separately above[97] and below.[98] However, it is likely that creative tax lawyers will think of other transactions that violate the principles of *General Utilities* repeal but are not covered by any of the specific prohibitions of § 355.

One method of avoiding this problem would be to expand the device test to apply to distributions having the effect of avoiding the purposes of *General Utilities* repeal. Moreover, for this new prong of the test, the fact

95. *See infra* Part IV.D.4.
96. *See supra* Part IV.A.
97. *See supra* Part IV.A (final 4 paragraphs).
98. *See infra* Part IV.E.

that a distribution is non-pro rata and/or the fact that *P* is publicly traded would not be relevant.

This new prong of the device test would be a backstop to specific provisions of § 355 designed to enforce *General Utilities* repeal. In that regard, it would serve a role comparable to the existing device test, which is a backstop to specific provisions of § 355 designed to prevent the avoidance of dividend treatment to shareholders. Moreover, this expansion of the device test would promote simplification of the statute. Absent this provision, a series of additional detailed rules would be required in lieu of the more general device test. This is not in the interest of either taxpayers or the government.

However, there are a number of significant problems with this expansion of the device test. First, if a distribution fails the device test, § 355 does not apply, and the distribution is taxable at both the corporate and shareholder level. In contrast, as a policy matter, Congress has indicated by the enactment of § 355(d) and (e) that a distribution in violation of the principles of *General Utilities* repeal should be taxable only at the corporate level. Moreover, as a practical matter, if violation of the new device test resulted in tax at both the corporate and shareholder levels, the IRS could claim that an ordinary violation of § 355(d) or (e) also violated the device test and thus resulted in shareholder-level tax.

These problems could be solved by a separate device test solely for all *General Utilities* violations, with the penalty limited to corporate level tax. However, this would be extremely complex, and would inevitably lead to litigation over whether a transaction violated the existing as well as the new device tests.

Second, if the device test was expanded to cover all *General Utilities* problems, difficult issues would arise as to how the new test would interact with existing § 355(d) and (e). For example, if a transaction was generally within the scope of those provisions but avoided the specific application of those provisions, questions would arise as to when and under what circumstances the new device test would apply.

Third, the new device test would necessarily be very open-ended, as is the existing test. However, the existing test has been in the law for many years and taxpayers generally have learned to live with it. The new test would raise innumerable questions and would create uncertainties about numerous types of transactions. As a practical matter, in many cases where a taxpayer today can rely on an opinion of counsel for a spinoff, an advance ruling from the IRS would be necessary. The IRS would no doubt also have great difficulty in determining the intended scope of the new test.

As a result, the device test should not presently be expanded to cover all transactions that are inconsistent with the purposes of *General Utilities* repeal. Rather, Congress and the Treasury Department[99] should continue the practice of adopting specific statutory or regulatory provisions to deal with specific situations as they arise.[100] Further, if these more specific actions turn out to be inadequate, an expansion of the device test could be reconsidered.

C. Control Test

The control test is primarily relevant under § 355 because *P* is required to distribute control of *S*. As noted above,[101] control is defined as 80% of the voting stock and 80% of each class of nonvoting stock.

This definition of control allows *P* to control *S* (and spin off *S*) even though *P* might own a relatively small percentage of the common equity of *S*. For example, suppose *P* owns all eight shares of a class of common stock of *S* having ten votes per share, and the public has for many years owned twenty shares of a class of common stock of *S* having one vote per share. *P* controls *S* and can spin off *S* even though it has only about 28% of the economic ownership of *S*. Similarly, if *P* begins with 100% ownership of *S*, *S* can issue a large amount of low-vote stock for cash to the public. As long as *P* keeps 80% of the voting power (to maintain control) and more than 50% of the total equity (to avoid § 355(e)), *P* can immediately spin off *S* even though its economic interest in *S* may have been diluted to well below 80%.

Alternatively, suppose *P* owns all the voting common stock of *S*, but *S* has a very small class of nonvoting common or preferred stock held by third parties. *P* has most of the economic ownership in *S*. However, *P* does not control *S* (and thus cannot spin off *S*) because it does not have 80% of the nonvoting stock.

If § 355 is intended to allow a single corporation (or equivalent corporate group) to break apart, these examples illustrate that the existing control test is both too broad and too narrow. On the one hand, *P*'s voting control of *S* should be necessary but not sufficient for a spinoff, and *P* should also be required to own most of the economic interests in *S*. On the other hand, a spinoff should be allowed even if *S* has a small amount of nonvoting stock none of which is owned by *P*.

Thus, a more appropriate test for control under § 355 would be the consolidated return test under § 1504(a)(2). This test requires ownership of 80% of the total vote and 80% of the total value of all outstanding stock. The exceptions to consolidation based on the status of a subsidiary corporation,[102] such as a foreign corporation, should not be applicable under this test.

99. The Treasury Department has broad authority to issue regulations to enforce *General Utilities* repeal. I.R.C. § 337(d) (2002).

100. See *infra* Part IV.E.4 for an example of a specific rule designed to deal with a specific *General Utilities* issue.

101. *See supra* Part I.

102. I.R.C. § 1504(b) (2002).

For consolidated return purposes, § 1504(a)(4) disregards straight nonvoting preferred stock. As a result, *P* can consolidate with *S* if *P* owns all the common stock of *S*, even if *S* has a very large amount of nonvoting preferred stock held by third parties. Consider whether this exception should apply for purposes of the spinoff rules. From the point of view of the holder of common stock, preferred stock is similar to debt. Therefore, the outstanding preferred stock should not detract from *P*'s control of *S*. Moreover, outstanding preferred stock does not prevent the filing of consolidated returns, and if two corporations are sufficiently united to file a consolidated return, logically they are sufficiently united for *P* to spin off *S*. Finally, there is an advantage to avoiding a proliferation of different tests for control.

On the other hand, a holder of *S* preferred stock is in fact an equity holder of *S* and takes equity risks in *S*. Thus, it can be argued that if a large amount of *S* preferred stock is held by third parties, a spinoff of *S* differs from the division of a single corporation. Moreover, if preferred stock does not count, *P* could extract virtually unlimited amounts of cash from *S* prior to a spinoff by having *S* issue preferred stock and then moving the cash proceeds to *P* prior to the spinoff.

On balance, the § 1504(a)(4) rule disregarding preferred stock should apply, and any concern about the extraction of cash from *S* should be dealt with separately. As a result, the control test should be the same as the stock ownership test for consolidation.

A similar proposal was made by the Treasury Department in the past for reorganizations and § 351, as well as spinoffs.[103] However, it received mixed reviews from bar associations,[104] in part because of the reduced flexibility it would provide to taxpayers under § 355. No action has been taken by Congress.

The control test applies under § 355 not only in determining whether *P* controls *S*, but for a variety of other purposes, such as in applying the trade or business tests to *S* and its controlled subsidiaries. The § 1504 test is appropriate for these other purposes also.

103. *See* STAFF OF J. COMM. ON TAX'N, 106TH CONG., DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2001 BUDGET PROPOSAL, at 363-66 (Comm. Print 2000) [hereinafter 2001 Budget Proposal]; STAFF OF J. COMM. ON TAX'N, 106TH CONG., DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2000 BUDGET PROPOSAL, at 220-22 (1999) [hereinafter 2000 Budget Proposal].

104. Am. Bar Ass'n Section of Tax'n, *Comments on Proposed Change to Section 368(c) Definition of Corporate Control*, 83 TAX NOTES 1357, 1360, 1364 (1999); Letter from Harold Handler, Chair, N.Y. State Bar Ass'n, Tax Section, to the Honorable Jonathan Talisman, Deputy Assistant Sec'y, Tax Policy, Dep't of the Treasury (July 8, 1999), *reprinted in* 1999 TAX NOTES TODAY 135-28 (1999) (supporting the proposal but noting that a significant minority disagreed).

D. Active Trade or Business Test

1. Background

Section 355(b) requires that immediately after a distribution, both *P* and *S* be engaged in the active conduct of a trade or business. A business qualifies only if it has been conducted for 5 years and was not acquired in a taxable transaction during that period. A business that meets this test is referred to as a qualifying business. *P* or *S* can meet the trade or business test either by directly conducting a qualifying business, or by having substantially all of its assets consist of stock in controlled subsidiaries (not acquired in taxable transactions within 5 years) that conduct qualifying businesses. A subsidiary that meets this test is referred to as a qualifying subsidiary.

Two IRS ruling guidelines are important for purposes of these tests. First, for a corporation to meet the trade or business test by engaging in its own business, the value of the gross assets of the business must generally represent at least 5% of the total gross assets of the corporation (referred to as the 5% test).[105] Second, for a corporation to meet the test on the ground that substantially all its assets consist of stock in qualifying subsidiaries, such stock must represent at least 90% of the net assets and 70% of the gross assets of the corporation (referred to as the 90%/70% test).[106]

The trade or business test was first enacted in 1951 without the 5-year rule. Its purpose was apparently to be an anti-abuse rule to be applied in conjunction with the device test.[107] The 5-year rule was adopted in 1954. Under this rule, for example, a subsidiary of *P* is not a qualifying subsidiary if it was purchased within the preceding 5 years. The purpose of this rule "is to prevent a distributing corporation from accumulating excess funds to purchase the stock of a corporation having an active business and immediately distributing such stock to its stockholders."[108]

Note that the active business test is directly related to the device test in that the device factors include the existence of assets not used in a 5-year business. Thus, the use of funds within the 5-year period to acquire a business directly or indirectly, and the distribution of the business so purchased, is considered to be similar to a dividend paid by *P* to its shareholders.

The trade or business rules raise difficult practical and policy issues. These are discussed next.

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105. Rev. Proc. 2002-3, 2002-1 I.R.B. 117, § 4.01(31). The IRS "may rule" in other cases where the taxpayer can establish that the trade or business is not *de minimis* compared with the other assets or activities of the corporation and its subsidiaries.

106. Rev. Proc. 77-37, 1977-2 C.B. 568.

107. S. Rep. No. 82-781, at 58 (1951), *reprinted in* 1951-2 C.B. 458, 499.

108. Rev. Rul. 74-5, 1974-1 C.B. 82.

2. Applying the Test to a Corporate Group

A major problem with the trade or business test is that *P* and *S* must meet the test on an individual corporate basis, not a group basis. This leads to enormous complexities. Moreover, there is no logical reason for the test to be applied separately to *P* and *S* if spinoffs are viewed as a means to allow the division of a corporate group.

For example, assume *S* will directly engage in a qualifying business after the spinoff. However, suppose that after the spinoff *P*'s only assets will be the stock of two subsidiaries, *S1* (a qualifying subsidiary) and *S2* (purchased within 5 years and thus not a qualifying subsidiary). Assume *S1* and *S2* are of equal size. *P* fails the trade or business test, because it does not engage in a business directly, and after the distribution only half of its assets consist of stock in qualifying subsidiaries. Likewise, *P* would fail the trade or business test if, immediately before the spinoff, it contributed the stock of *S1* to *S2*. The reason is that *S2* directly engages in a nonqualifying business, and so substantially all of the *S2* assets do not consist of either qualifying assets or stock of a qualifying subsidiary. Thus *S2* is a nonqualifying subsidiary of *P*.

On the other hand, *P* would satisfy the trade or business test if, immediately before the spinoff, (1) it liquidated *S1* into *P* so that *P* would be directly engaged in a qualifying business; (2) it contributed the stock of *S2* to *S1*, or merged *S2* into *S1*, so that substantially all of *P*'s assets consisted of stock in a corporation (*S1*) which is engaged in a qualifying business and which had not been purchased within 5 years; or (3) it merged *S1* into *S2*, so that substantially all of *P*'s assets consisted of stock in a corporation (*S2*) engaged in a qualifying business which business was contributed to the corporation after the purchase of the corporation.[109]

There is no good policy reason why *P* should satisfy the trade or business test in some of these situations but not the others. The policy justification for a spinoff has nothing to do with where in a particular corporate group the qualifying or nonqualifying assets are located. Good business reasons typically exist for the particular corporate structure of a group, and it is completely arbitrary that the particular structure should affect the qualification of a spinoff.

Consider, for example, a typical case where *P* is a holding company and does not directly own any significant trade or business. *P* might have first tier subsidiaries that were purchased within the preceding 5 years. Alternatively, *P* might have some nonbusiness assets. Even though *P* has substantial qualifying subsidiaries, these nonqualifying subsidiaries and/or nonbusiness assets could easily cause *P* to fail the 90%/70% test.

The only choices for *P* in this situation are (1) to transfer the stock of the nonqualifying subsidiaries, and any nonbusiness assets, to qualifying

109. Alternative (3) is permissible even though *P* had purchased the *S2* stock within the 5 preceding years. Although a trade or business held by *S2* at the time of the purchase is disqualified, *see* I.R.C. § 355(b)(2)(D) (2002) (initial parenthetical), a qualifying business contributed to *S2* after the purchase remains qualified.

subsidiaries, or (2) to engage in its own qualifying business. The latter alternative may be difficult because of the 5% test. *P*'s gross assets would include the value of all of its subsidiaries, meaning that it would have to engage in a significant business in order to meet the test.

The restructuring of a group that is necessary to meet the trade or business requirements for *P* can take an enormous amount of time and effort. Moreover, from *P*'s point of view, the restructuring makes no business sense and is done solely to satisfy the statutory requirement. From the IRS's point of view, it may spend much time and effort in determining whether *P*, on a stand-alone basis, is engaged in a sufficiently large trade or business. None of this activity is useful in any way, and there is no policy of § 355 that is being carried out.

As a result, the trade or business test should be applied on a group-wide basis. That is, *P* and its direct and indirect controlled subsidiaries after the spinoff would be treated as a single corporation, and *S* and its controlled subsidiaries would be treated as a single corporation. This proposal was advanced in bills introduced by Senator Breaux[110] and has passed both houses of Congress in legislation that was later vetoed by the President.[111] It has also been supported by the Treasury Department,[112] the Staff of the Joint Committee on Taxation,[113] and at least one bar association.[114]

An additional issue is whether a U.S. group should be able to look through to a foreign subsidiary to establish its qualifying trade or business. For example, suppose that after a distribution *P*'s only assets are a nonqualifying domestic subsidiary and a qualifying foreign subsidiary. Should *P* be considered to meet the trade or business test? If the answer is yes, then the proposal would allow spinoffs that could not readily be accomplished today even through restructuring.

This result is reasonable. If *P*'s only post-spinoff asset is stock in a qualifying foreign subsidiary, the spinoff would be allowed even today, because § 355 currently makes no distinction between domestic and foreign subsidiaries. It follows that disqualified domestic assets of *P* should not prevent a spinoff even if the *P* group's qualifying business is held by a foreign subsidiary. As a result, *P* and all its controlled subsidiaries, including foreign subsidiaries, should be treated as a single corporation for

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110. S. 2538, 105th Cong. (1998); S. 1158, 107th Cong. (2001).

111. *See* H.R. CONF. REP. NO. 106-289, at 483-85 (1999).

112. 2001 Budget Proposal, *supra* note 103, at 221-23; 2000 Budget Proposal, *supra* note 103, at 144-45.

113. STAFF OF THE J. COMM. ON TAX'N, 107TH CONG., STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION, PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986, at 251 (Comm. Print 2001).

114. *See* Letter from Steven C. Todrys, Chair, N.Y. State Bar Ass'n, Tax Section, to the Honorable John Breaux, U.S. Senator from Louisiana (Jan. 12, 1999), *reprinted in* 1999 TAX NOTES TODAY 10-41 (1999).

this purpose.[115]

Note that the proposal to apply the trade or business test on a group basis is most supportable if the proposed new control test[116] is also adopted. The existing control test permits *P* to control a subsidiary even though *P* owns a relatively small economic interest in it. In that situation, it is much less clear that the subsidiary should be combined with *P* under the group trade or business test in determining whether *P* should be permitted to spin off *S*.

3. *Permitted Nonbusiness Assets*

The trade or business test under § 355 requires only that *P* and *S* be engaged in the active conduct of a qualifying business immediately after the spinoff. There is no statutory limit on the amount of nonbusiness assets that *P* or *S* can hold. The only practical minimums are the device test and the 5% test. However, the 5% test is only an IRS ruling guideline that by its terms is subject to exceptions. Moreover, a taxpayer not desiring an IRS ruling can rely on the literal language of the statute and take the position that any business (no matter how small in absolute terms or as a percentage of the total assets) is sufficient.

Moreover, a spinoff at a time when *P* or *S* holds a large amount of nonbusiness assets is very similar to a cash dividend to the shareholders. If the nonbusiness assets are appreciated securities, the result of the spinoff is the avoidance of both capital gains tax at the *P* level as well as (in the case of a pro rata spinoff) dividend tax at the shareholder level.

The device test is not adequate to police these transactions. The test is very vague, does not apply to splitoffs, and does not generally apply to public corporations because of the nondevice factor. Moreover, there is no policy reason that such a low proportion of business assets should be permissible as a statutory matter, even aside from the device test.

At present, the 5% test ameliorates the unfairness of applying the trade or business test on an entity-by-entity basis. In fact, the 5% test is heavily relied upon by large public corporations which fit squarely within the purposes of § 355 but which have difficulty meeting the trade or business test on a separate entity basis. If, however, the trade or business test were modified to apply on a groupwide basis, as proposed above,[117] there would be little remaining justification for permitting a low threshold of business assets.

Thus, the required percentage of qualifying assets should substantially exceed 5%. The percentage, however, should not be too high. Just as today, "bad" assets for this purpose would include any business assets acquired by *P* in taxable transactions within the preceding 5 years (unless

115. S. 2538, 105th Cong. (1998) and S. 1158, 107th Cong. (2001) excluded foreign corporations for this purpose. However, the sources cited *supra* notes 111-14 included or supported the inclusion of foreign corporations.
116. *See supra* Part IV.C.
117. *See supra* Part IV.D.2.

the business expansion doctrine applies), as well as stock in any less-than-80% owned subsidiaries.

One reasonable possibility would be to have the required percentage for qualifying assets set at 50%. (The percentage is assumed to be 50% for purposes of the discussion below.) Nonabusive cases, however, might well arise where the actual percentage of qualified assets is less than 50%. Thus, a waiver of the percentage should be available based on an advance ruling from the IRS to the taxpayer indicating that the distribution would not violate the purposes of the active trade or business test. The ruling would take into account the device test as well as *General Utilities* repeal since the trade or business test would be a backstop for both.[118]

4. The Business Expansion Doctrine

As discussed above,[119] under the business expansion doctrine, if *P* has an active 5-year business and purchases another trade or business in the same line of business, the entire combined business is treated as meeting the 5-year test.[120] The purchased portion of the business can then be spun off at any time.[121]

The business expansion doctrine applies at present on a corporation by corporation basis, as do all the active business tests. For example, if *P* has a qualifying business, a purchase by *S* of assets in the same business will result in the acquisition of a nonqualifying business as to *S*, although a purchase of the same assets by *P* would be considered a business expansion as to *P*.

Moreover, the IRS reportedly treats an acquisition by *P* as a business expansion of a *P* business only if the acquired assets actually "touch" *P*.[122] In other words, if *P* is in business *X*, a direct acquisition of additional *X* assets by *P* would qualify, but a purchase by *P* of stock of a corporation holding those assets would not qualify. Thus, *P* could buy some additional *X* assets, immediately drop them into new *S*, and then spin off *S*. However, if *P* bought the stock of *S* with *S* holding those assets *P* could not immediately spin off *S*.

The scope of the "touching" rule is not clear. For example, suppose that in the above example, *P* were to buy the stock of *S* and then liquidate *S* into *P*. At that point, the new *X* assets would be in *P*. It is not clear whether this would be sufficient touching so that the new assets would count as 5-year assets for purposes of a spinoff shortly thereafter.

Note that the touching rule is analogous to the existing application of the trade or business test on a corporation by corporation basis. The

118. *See infra* Part IV.E. (discussing the connection between the trade or business test and *General Utilities* repeal).

119. *See supra* Part IV.B.3.c.

120. Treas. Reg. § 1.355-3(b)(3)(ii) (as amended in 1989).

121. *See, e.g.*, Treas. Reg. § 1.355-3(c) ex. 8.

122. *See, e.g.*, MARTIN D. GINSBURG & JACK S. LEVIN, MERGERS, ACQUISITIONS AND BUYOUTS ¶ 1004.2.1.3 (2002) (expressing uncertainty about the IRS position in a number of situations not involving "touching").

touching rule, however, makes no more sense than such application of the trade or business test.[123] Thus, if the trade or business test is changed to apply on a group basis, the business expansion doctrine should likewise apply on a group basis. The result would be that a stock acquisition could be a permissible business expansion.

E. Active Businesses Held for Less than Five Years

1. *Background*

In two situations, assets held by the *P* group are treated as qualifying assets even though they have been held by the group for less than 5 years at the time of the distribution. The assets in question are those acquired either under the business expansion doctrine or in a tax-free manner. *P* can avoid the purposes of *General Utilities* repeal, as well as the purposes of the proposed 50% active trade or business test, by acquiring these assets and (1) spinning them off, or (2) using them as qualifying assets that permit the spinoff of other assets.

This problem is not solved by the device test, either as it exists today or as expanded to cover business expansion assets.[124] The reason is that the device test does not deal with *General Utilities* issues, does not apply to assets acquired in a tax free manner, does not apply to splitoffs, and generally does not apply to public corporations because of the nondevice factor. Moreover, although the existing business purpose test restricts these transactions, the proposed liberalized test would be far less restrictive. The following discussion of the two situations assumes adoption of the proposed business purpose test.

2. *Business Expansion Doctrine*

Under the business expansion doctrine, if *P* has a qualifying business, *P* can buy any amount of assets used in the same business from third parties for the purpose of spinning off those purchased assets (or for the purpose of spinning off the existing *P* assets). The purchase price can come from either existing or borrowed funds. The size of the existing business as compared to the newly purchased business is irrelevant, as is the lack of any operational relationship between the businesses.

Likewise, if *P* is a 20% managing partner in a partnership that has an active business, and the 5-year tests are met, *P* is considered to be engaged in a qualifying business. *P* can purchase the remaining 80% ownership interest in the partnership for cash, allowing the entire business to be considered a 5-year business of *P*, and (assuming *P* has a separate qualifying business) *P* can then immediately spin off that entire business.[125]

In fact, under current law, *P* could apparently buy a group of assets, 5% of which happen to overlap with any one of *P*'s qualifying businesses,

123. *Id.*
124. *See supra* Part IV.B.3.c.
125. Rev. Rul. 2002-49, 2002-32 I.R.B. 288.

and then immediately drop down all of the acquired assets to new *S* and spin off *S*. *S* would then be considered to have a qualifying business that met the 5% test. If the business expansion doctrine were modified to apply on a group basis, as long as an unrelated *S* owned the requisite percentage of qualifying assets, *P* might be able to buy the stock of *S* and shortly thereafter spin off all or part of the *S* assets.[126]

3. *Tax-Free Acquisitions*

Similar issues arise when *P* acquires a business in a tax-free manner within the 5 years preceding the distribution. The business is a qualifying business, assuming it has been conducted for a total of 5 years including the pre-acquisition period. A permissible acquisition under this rule would necessarily be made by *P* entirely for *P* stock. As a result, there is no device issue because cash of *P* is not being used to acquire an asset.

An acquisition of this type, however, raises significant issues in light of *General Utilities* repeal. For example, suppose *P* owns 60% of *S*'s only outstanding class of common stock. Today, *S* can recapitalize its stock into high-vote stock held by *P* and low-vote stock held by the minority shareholders, with *P* ending up with at least 80% of the vote of *S*. *P* has acquired control of *S* in a tax-free manner and can spin off *S* the next day (or else *P* can spin off other assets and use the *S* business as its own active business). This result is improper if the purpose of the spinoff rules is to allow the division of a preexisting corporate group.

This transaction would not work if the definition of control proposed above[127] were adopted. Nevertheless, even under the proposed definition, other tax-free spinoffs would still be permitted that are inconsistent with *General Utilities* repeal. Consider the following examples, which assume that *P* and *S* each has a qualifying business and that there is no 50% change of ownership of *P* or *S* under § 355(e).

> (a) *P* owns 60% of *S*. *P* acquires the remaining 40% of *S* for *P* stock in a "B" reorganization. *P* could not immediately spin off *S* under the reorganization rules. *P*, however, achieves a similar result by spinning off all of its other assets the next day, leaving *S* as its sole qualifying subsidiary.
>
> (b) *P* owns 60% of *S*. *P* contributes sufficient cash or assets to *S* in exchange for *S* stock so as to bring *P*'s ownership in *S* to 80%. *P* then immediately spins off *S* (or all of *P*'s non-*S* assets) in a divisive D reorganization.
>
> (c) *P* owns 100% of *S*. *P* acquires all the stock of *T* in a "B" reorganization. *P* immediately spins off *S* and keeps *T* as a qualifying subsidiary. *P* may or may not have other assets. It is not clear that this transaction is taxable to *P* under § 355(e), despite the more than

126. *See infra* Part IV.E.3 (discussing the possible application of I.R.C. § 355(e) to this situation).

127. *See supra* Part IV.C.

50% change in ownership of *T*.[128]

4. *Conclusions*

In both of these situations involving acquisitions of assets within the 5-year period, the spinoff is achieving far more than the division of a preexisting corporate group. As a result, the transactions in question violate the principles of *General Utilities* repeal. Moreover, because the assets acquired in both situations are qualifying assets, the result is an end run around the proposed 50% trade or business test. No matter how many nonqualifying assets the *P* group held before a spinoff, *P* could always acquire sufficient qualifying assets in either manner before the distribution to permit *P* and *S* to each satisfy the 50% test after the distribution.

There is no good solution to the problem raised by acquisitions of this type. One possibility is to consider all assets that enter the group in any manner within the 5-year period before the distribution as nonqualifying assets under the proposed 50% test. This approach, however, has a number of problems. First, it is overbroad. In many cases, the assets in question might be acquired in the ordinary course of business and should be good rather than bad assets under the 50% test. Moreover, the proposed approach would mean that *P*'s acquisition of assets could preclude a subsequent spinoff even though a spinoff before the asset acquisition would be permissible.[129] This makes no sense.

Second, a reverse acquisition rule would be needed. For example, suppose the *X* corporate group is worth $100, the *Y* corporate group is worth $400, and *X* acquires *Y* in exchange for 80% of the outstanding *X* stock. Instead of *X* being treated as having 80% bad assets (the *Y* assets) under the trade or business test, the combined group should be treated as the *Y* group with 20% bad assets (the *X* assets).

Third, this approach does not deal with newly created groups. For example, if *P* spins off *S*, does the new *S* group not have any qualifying assets for 5 years? Does it matter whether *S* was preexisting or was formed in a divisive D reorganization? What if *P* owns all the *S* stock and sells 30%, creating a new *S* group? These questions are difficult and would raise additional complexities. As a result, treating all acquired assets as bad assets for purposes of the 50% test has many problems. Thus, assets acquired by the *P* group in a tax-free manner or as business expansion assets should continue to count as good assets under the test.

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128. I.R.C. § 355(e) (2002) requires a 50% change in ownership of *P* or *S*, but the 50% change of ownership occurs in *T*. The theory for the application of § 355(e) is that *T* is a predecessor of *P* under § 355(e)(4)(D). This, however, is by no means clear. *See* GINSBURG & LEVIN, *supra* note 122, ¶ 1010 ex. 2, at 10-102 (this fact pattern "does not . . . . implicate" I.R.C. § 355(e)); Mark J. Silverman et al., *'Spin-Offs': The New Anti-Morris Trust and Intragroup Spin Provisions*, 78 TAX NOTES 329, 341 (1998).

129. For example, suppose *P* and *S* each held only qualifying assets of $100. *P* then acquires additional assets of $200, not to be spun off, either as business expansion assets (with borrowed funds) or on a tax-free basis. *P* would fail the 50% test after the spinoff of *S*, even though *P* would satisfy the test if the spinoff had occurred before the acquisition.

Another possible approach would be to interpret or expand § 355(e) to cover most of these cases based on the change of ownership of the business acquired by *P* within the 5-year period. This approach, however, could not cover business expansion assets purchased for cash, and any attempt to cover most tax-free acquisitions within the 5-year period would be vastly overbroad. Any mechanical rule would have similar problems.

The only reasonable alternative appears to be the adoption of a facts and circumstances test. Such a test would be similar to the device test, but it would be far more narrowly focused. It would be applicable to all § 355 distributions, including splitoffs and distributions by public corporations.

One possibility for such a test would be the following: *P* would be taxed on a distribution if (a) during the 5-year period before a distribution, the *P* group acquired assets from outside the group that are qualifying assets under the proposed 50% trade or business test; (b) after the distribution those assets represent more than a specified portion (e.g., 20% or 25%) of the then-value of the assets of *P* or *S*; (c) *P* would be taxable on the distribution under the usual rules if the assets in question were not qualifying assets under the 50% test; and (d) based on all the facts and circumstances, the tax-free treatment of *P* was inconsistent with the purposes of *General Utilities* repeal or the 50% trade or business test. The ultimate facts and circumstances determination would be based on the connection between the acquisition and the distribution, as in the existing device test. Shareholders of *P* would not be affected by the test.

The test has technical problems. For example, it would allow *P* to acquire appreciated assets on a tax-free basis, and then spin off existing unappreciated assets with no taxable gain. Moreover, if all the assets of the *P* and *S* groups were qualifying assets, acquisitions by *P* before the distribution could allow each group to almost double in size without triggering clause (c) of the test. However, this latter issue would also arise if *P* acquired new nonqualifying assets for cash. Therefore, the problem lies with the 50% trade or business test rather than this test.

More fundamentally, the adoption of a new test of this type is far from ideal. Recent history with § 355(d) and (e) has demonstrated that a new test leads to periods of great turmoil until the test is clarified. The test, however, is not proposed in a vacuum, but rather in conjunction with a series of other proposals. It is difficult to see how those other proposals, particularly the liberalization of the business purpose test, can be implemented without either this type of test or a broader device test that applies to *General Utilities* repeal. Otherwise, almost any mixing and matching of assets between unrelated parties before a spinoff would be permissible. The likely result would be an explosion of these types of transactions.

Moreover, the proposed test is far preferable to a more general device test for the reasons discussed above.[130] The proposed test will likely apply to relatively few corporations, certainly far fewer than will benefit from the liberalization of the business purpose test. Thus, the net effect should be a great simplification of spinoff practice, even though some taxpayers will face additional complexity. In addition, the proposed test is not likely to prevent many transactions that could be done today, since most transactions it would prevent would probably fail the current business purpose test. As a result, the proposed test should be viewed as the best option in a series of poor alternatives.

V. TAXATION OF THE DISTRIBUTING CORPORATION

A. Section 355(d)

As discussed above,[131] § 355(d) is aimed at situations where a buyer (*X*) buys stock of *P* and, following a spinoff, *X*'s cost basis in the *P* stock is allocated directly to stock in a business representing only a portion of the overall *P* business. The result is similar to a mirror liquidation. As a result, § 355(d) is generally considered to be an appropriate response to *General Utilities* repeal.

Section 355(d) contains some technical rules that would impose tax on *P* in situations that clearly go beyond the purposes of the section. The final regulations,[132] however, eliminated this overbreadth and are generally considered reasonable.[133] As a result, no change is needed in § 355(d).

B. Section 355(e)

1. *The Statute*

Section 355(e) is controversial because it stops *Morris Trust* transactions that contain no element of the basis shifting that is the key to a mirror liquidation. The legislative history of § 355(e) states that:

> The Committee believes that section 355 was intended to permit the tax-free division of existing business arrangements among existing shareholders. In cases in which it is intended that new shareholders will acquire ownership of a business in connection with a spin-off, the transaction more closely resembles a corporate level disposition of the portion of the business that is sold.[134]

Assume *P* spins off *S* as part of a plan where *X* will immediately thereafter acquire *S* for *X* stock representing less than 50% of *X*. Under § 355(e), *P* is deemed to have made a taxable disposition of the *S* stock.

130. *See supra* Part IV.B.3.d.
131. *See supra* Part I.
132. Treas. Reg. § 1.355-6 (as amended in 2001).
133. *See, e.g.*, Sharon C. Mendelson, *Section 355(d) Final Regulations Appropriately Limit Expansive Statute*, 14 J. TAX'N FIN. INSTS. 31 (2001).
134. H.R. REP. NO. 105-148, at 213 (1997); S. REP. NO. 105-33, at 139-40 (1997).

Note that *P* would clearly be taxed if it had engaged in an economically identical transaction, namely selling the *S* stock to *X* for *X* stock, and paying a dividend of the *X* stock. The reasoning in favor of § 355(e), however, is not that a taxpayer should be taxed whenever an alternative transaction reaching the same result would be taxable. Rather, the focus of § 355(e) is on *General Utilities* repeal, not on a complete recharacterization of the transaction by changing the order of the steps. Thus, the section only taxes *P*, and not also the *P* shareholders as would be the case in the alternative transaction.

The theory behind § 355(e) is that the combination of the spinoff and the planned shift of ownership of *S* after the spinoff is in substance a transfer by *P* of *S* to *X* that should be taxed following *General Utilities* repeal. In other words, the *S* stock has left the *P* corporate solution, and the economic ownership of *S* has left the *P* shareholder group. As a result, after *General Utilities* repeal, *P* should be taxed on the appreciation in the *S* stock.

The argument in favor of § 355(e) is strengthened in some situations by the fact that the tax-free treatment of *P* is inconsistent with general tax principles. This is most clear where the *P* shareholders, at the moment they receive the *S* stock, have a binding contract to transfer it to *X*. In that case, the *P* shareholders have no separate indicia of ownership of the *S* stock, and their transitory ownership of *S* stock should not be respected for tax purposes.[135] Even in the absence of a binding contract at the time of the distribution, *Court Holding Co.*[136] or step transaction principles[137] might apply to treat *P* as the transferor of the *S* stock.

Finally, after the decision in *Cumberland Public Service*,[138] there was a "shadowy and artificial" distinction between the situations when a corporation's distribution of assets to shareholders, followed by a shareholder sale of the assets, would or would not be respected.[139] Shortly thereafter, Congress eliminated the significance of the distinction by adopting

135. In *Esmark v. Comm'r*, 90 T.C. 171 (1988), *aff'd*, 886 F.2d 1318 (7th Cir. 1989), corporation *X* purchased *P* stock on the market and was required to transfer that stock to *P* in exchange for all the *S* stock. *P*'s transfer of *S* stock to *X* would be tax free to *P* only if *X*'s ownership of *P* stock was respected notwithstanding its transitory nature. The court followed the form and upheld the tax-free treatment of *P*. This case appears inconsistent with general principles of tax ownership. In any event, there is no policy reason that such transitory ownership should be respected.

136. Court Holding Co. v. Comm'r, 324 U.S. 331 (1945). *See* Rev. Rul. 96-30, 1996-1 C.B. 36 (indicating that the application of the case to a *Morris Trust* transaction depends on all the facts and circumstances, but not applying the case to the facts in question).

137. The step transaction doctrine is notoriously vague and uncertain. It has been said to apply if the "steps are in substance integrated, interdependent, and focused toward a particular result." Penrod v. Comm'r, 88 T.C. 1415, 1428 (1987). The alternative formulations of the test ask whether there is a "binding commitment" to do the second step at the time of the first, whether "the steps are so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series," or whether "a series of formally separate steps are really prearranged parts of a single transaction intended from the outset to reach the ultimate result." *Id.* at 1429-30.

138. United States v. Cumberland Pub. Serv. Co., 338 U.S. 451 (1950).

139. *Id.* at 454-55.

§ 337.[140] Section 355(e) can be viewed as Congress's attempt to eliminate an equally artificial distinction between a corporate sale on the one hand, and a corporate distribution followed by a shareholder sale on the other hand.

For these reasons, particularly the inconsistency of *Morris Trust* transactions with *General Utilities* repeal, I believe § 355(e) reaches the correct policy result.[141] This, however, is far from a majority view among those writing on the subject.[142] Moreover, § 355(e) clearly has theoretical imperfections. Most notably, *P* is taxed on the distribution of *S* even if *P* rather than *S* has the subsequent change of ownership. Conceptually, if *P* has the change in ownership, *S* should be treated as if it had disposed of the *P* assets to the acquiring corporation. This imperfection in § 355(e) will result in overtaxation (or undertaxation) in the case where *P* has the change of ownership if the appreciation in the *P* assets is less (or more) than the appreciation on the *S* assets.

This imperfection, however, is not limited to § 355(e). Section 355(b)(2)(D) and 355(d) has the same problem. For example, if *X* buys 60% of *P* and *P* then splits off *S* in redemption of the other shareholders, *S* should have a gain on the disposition of *P*. More significantly, the same imperfection has always existed under the device and continuity of interest tests. Even if those tests are violated because of subsequent sales of *P* stock rather than *S* stock, *P* is taxed on the appreciation in *S* stock, and shareholders are treated as receiving a dividend of *S* stock rather than *P* stock.[143]

As a result, fixing this flaw in § 355(e) would logically require a rather fundamental change in these other provisions as well. Difficult issues would arise, including the consequences if both *P* and *S* had changes of ownership. The approach now taken by all of these provisions is to follow the form of the distribution and to always tax *P* on the appreciation in *S*. This is a reasonable simplification, although not theoretically correct.

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140. *See* BITTKER & EUSTICE, *supra* note 55, ¶ 10.05[5][a].

141. *Cf.* George K. Yin, *Morris Trust, Sec. 355(e), and the Future Taxation of Corp. Acquisitions*, 80 TAX NOTES 375 (1998) (arguing that I.R.C. § 355(e) has elements of a mandatory I.R.C. § 338 election because gain is triggered as a result of the change of stock ownership of *P* or *S*); Michael L. Schler, *Yes to Section 355(e), No to Mandatory Section 338*, 80 TAX NOTES 733 (1998) (letter to the editor) (agreeing with the theory expressed in the text in favor of I.R.C. § 355(e), but claiming that I.R.C. § 355(e) has nothing to do with mandatory I.R.C. § 338 because I.R.C. § 355(e) requires a double trigger, i.e., not only a change in ownership of *P* or *S* but also a spinoff of *S*). This correspondence continued with George K. Yin, *Is Section 355(e) a Stalking-Horse for Mandatory Section 338?*, 80 TAX NOTES 865 (1998) (letter to the editor), and Michael L. Schler, *The Section 355(e) Debate: Round 4*, 80 TAX NOTES 971 (1998) (letter to the editor).

142. *See, e.g.*, Peter C. Canellos, *A Tax Practitioner's Perspective on Substance, Form and Business Purpose in Structuring Business Transactions and in Tax Shelters*, 54 SMU L. REV. 47, 63-64 (2001); Richard L. Reinhold, *Section 355(e): How We Got Here and Where We Are*, 82 TAX NOTES 1485, 1493 (1999); *Report No. 906, Report on Section 355* (N.Y. State Bar Ass'n Tax Section) July 2, 1997, *reprinted in* 97 TAX NOTES TODAY 132-36 (1997) [hereinafter NYSBA Section 355(e) Report].

143. *See* Sheffield & Schlunk, *supra* note 38, at 950.

Moving beyond this imperfection in § 355(e), the adoption of § 355(e) has itself resulted in simplification of § 355 in two respects. First, § 355(e) was designed to prevent leveraged *Morris Trust* transactions that are the equivalent of cash sales of assets with no tax to *P* or *S*.[144] These transactions are universally considered abusive.[145] Absent § 355(e), a far more complex provision would be necessary to stop them. In fact, the difficulty of drafting such a provision may well have led to the existing version of § 355(e).

Second, when § 355(e) was adopted, there were many more restrictions on a post-spinoff acquisition of *S* than on a post-spinoff acquisition of *P*. For example, a preexisting commitment by a third party to acquire *S* after the spinoff may have been viewed as causing *P* to fail to control *S* at the time of the distribution of *S*.[146]

Congress indicated in the legislative history of the Revenue Act of 1997[147] and the Internal Revenue Service Restructuring and Reform Act of 1998[148] a desire to equalize the types of post-spinoff restructurings that were permissible for *P* and *S*. Based on this legislative history, the IRS announced that it would not apply step transaction principles to determine whether *P* met the control test for *S* before the distribution notwithstanding any post-distribution acquisition or restructuring of *S*.[149]

This principle is extremely broad. For example, *P* can apparently drop assets to a newly formed *S* and spin off *S*, and (pursuant to a binding contract) *S* can then merge into *T* in a tax-free "A" reorganization. Congress clearly intended § 355 to apply in this case.[150] This is quite extraordinary, since under general tax principles the existence of *S* is transitory, and both *P* and the *P* shareholders would be subject to tax. It is difficult to justify this result as a policy matter,[151] even though *P* could spin off all of its assets other than the *S* assets in question and then be acquired in a tax-free reorganization.

The distribution of transitory *S*, however, will be taxable to *P* under § 355(e) if the *P* shareholders end up with no more than a 50% economic interest in *S*. This limitation is the only possible justification of the result

144. *See supra* Part II (final paragraph).

145. *See, e.g.*, NYSBA Section 355(e) Report, *supra* note 142.

146. *See, e.g.*, Rev. Rul. 96-30, 1996-1 C.B. 36. The issue would not arise for a second-step acquisition of *P* because such an acquisition would not call into question *P*'s prior control of *S*.

147. H.R. CONF. REP. NO. 105-220, at 529-30 (1997).

148. Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, 112 Stat. 685; *see* S. REP. NO. 105-174, at 175-76 (1998), *reprinted in* 1998-3 C.B. 711-12. *See also* STAFF OF J. COMM. ON TAX'N, 105TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN 1998, at 189-91 (Comm. Print 1998) [hereinafter 1998 Blue Book].

149. Rev. Rul. 98-27, 1998-1 C.B. 1159.

150. *See* S. REP. NO. 105-174, at 175-76 (1998); 1998 Blue Book, *supra* note 148, at 190.

151. *See* Richard W. Bailine, *The Vindication of Mrs. Gregory and Sundry Other Items*, 29 J. CORP. TAX'N, July/Aug. 2002, at 31 (criticizing a private letter ruling that takes the same position).

in the preceding paragraph. As a result, the simplification of § 355 can be attributed in part to the moderating influence of § 355(e).

To conclude, § 355(e) should remain in the Code. The underlying policy is correct, and it permits simplification of other aspects of § 355. While in theory the amount of gain recognized on a spinoff should depend upon whether *P* or *S* has a change of ownership after the spinoff, the more precise rule would lead to much additional unnecessary complexity.

2. *The Regulations*

Consider next the level of a "plan or series of related transactions" that should be required to trigger § 355(e). This has been the subject of considerable controversy. I (along with many others) criticized the original proposed regulations as being much too broad in their concept of a plan.[152] An interim set of temporary regulations was relatively balanced.[153] The current regulations, however, have gone too far in the opposite direction and exclude from the plan concept certain transactions that would normally be considered a plan. They state that § 355(e) can apply to a distribution followed by an acquisition only if *P* (or *S*) and the particular third party acquirer had "an agreement, understanding, arrangement, or substantial negotiations" for the acquisition by the date of the distribution.[154] "Substantial negotiations" generally exist only if there is discussion of "significant economic terms."[155]

This rule exempts many post-spinoff acquisitions from § 355(e) that are within the plain meaning of the statute, i.e., they fit within the ordinary meaning of "plan or series of related transactions." Moreover, many of these acquisitions should be covered in light of the purpose of § 355(e), as expressed in the legislative history, to tax *P* on transactions that are more like sales than divisions of a preexisting business.[156] Finally, the regulations require more of a preexisting agreement in order for § 355(e) to apply as opposed to the rather loose standard for pre-spinoff negotiations that might trigger the device test.[157]

For example, under the regulations, § 355(e) would not apply even if, by the time of the spinoff, *P* and *X* had "insubstantial" discussions for a post-spinoff acquisition of *S* and the parties believed it was very likely that negotiations would be successful after the spinoff. In fact, any amount of discussions concerning the noneconomic terms of the acquisition are permitted before the spinoff. These terms include management

152. *See* Michael L. Schler, *The Meaning of a 'Plan' Under Section 355(e)*, 85 TAX NOTES 913 and 85 TAX NOTES 1051 (1999).
153. T.D. 8960, 2001-2 C.B. 176.
154. Treas. Reg. § 1.355-7T(b)(2), (h) (as amended in 2002).
155. Treas. Reg. § 1.355-7T(h).
156. See Schler, *supra* note 152, at 921-22 for a discussion of legislative history.
157. "Substantial evidence of device" will "ordinarily" exist if "a sale or exchange was discussed by the buyer and the seller before the distribution and was reasonably to be anticipated by both parties." Treas. Reg. § 1.355-2(d)(2)(iii)(D) (as amended in 1989).

issues, which are often the most contentious. Apparently it would even be permissible for *P* to solicit acquisition proposals (with offer prices) from potential acquirers prior to the distribution, as long as *P* did not respond to the proposals until after the distribution. Moreover, it is irrelevant that the expected success of the negotiations might be a motive for the spinoff.

As another example, suppose *P* agreed with *X* that after *P*'s spinoff of *S*, *X* would acquire *P*, and the parties acknowledged that § 355(e) would apply. After the spinoff is announced, however, *Y* makes a higher offer for *P* and, without any discussions between *P* and *Y* before the spinoff, *Y* ultimately succeeds in the acquisition. Under the regulations, § 355(e) does not apply because *Y*'s acquisition of *P* is not "similar" to *X*'s proposed acquisition of *P*.[158] This result is not justified by the policies behind § 355(e), since *P* had agreed to be acquired by the time of the spinoff, and only the name of the acquirer was a surprise. Moreover, the result is an unlevel playing field because only *X* is subject to § 355(e), and thus any competing bidder is at an advantage.

In addition, under the IRS guidelines, a valid business purpose for a spinoff is to facilitate a tax-free combination of *P* or *S* with another corporation.[159] If that is the purpose of a spinoff, it is difficult to see why the spinoff and combination should not be viewed as a single plan. This problem would be exacerbated under the proposed loosening of the business purpose requirement.

Finally, § 355(e) would not apply to the examples in the preceding paragraphs even if they involved a leveraged spinoff. It is especially difficult to justify the nonapplication of the section in these cases, since these were the clearly abusive cases at which § 355(e) was most directly aimed.

Thus, the regulations should be modified to expand the definition of "plan" to cover the situations discussed herein. It should be noted that even some who generally support the new regulations have expressed doubt about the full scope of the exemption from § 355(e) contained in the regulations.[160]

C. Cash Received From the Distributed Subsidiary

In a spinoff, *P* often wishes to receive cash from *S*, or to have *S* assume liabilities of *P*. The existing rules for these transactions are illogical in certain respects, and depend upon whether the transaction is a pure § 355 distribution or is a divisive D reorganization.

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158. Treas. Reg. § 1.355-7T(h)(8).

159. Rev. Proc. 96-30, 1996-1 C.B. 696 app. A., §§ 2.07, 2.08.

160. *See* Letter from Samuel A. Dimon to Pamela F. Olson and Charles O. Rossotti (Oct. 28, 2002), (N.Y. State Bar Ass'n Tax Section, Rep. No. 1020), *available at* http://www.nysba.org/taxreports. *But see* Mark J. Silverman & Lisa M. Zarlenga, *Fourth Time's a Charm: New Anti-Morris Trust Regs Provide Helpful Guidance*, 96 Tax Notes 983 (2002); Robert Willens, *IRS Revises the 'Plan' Concept in the 355(e) Temp. Regs. to Infuse More Practicality*, 97 J. Tax'n 6, 19 (2002).

1. Section 355 Distributions

Consider first a pure § 355 distribution. *S* can pay a cash dividend to *P* or assume liabilities of *P*. Assuming *P* and *S* file a consolidated return, the dividend or debt assumption will reduce *P*'s basis in *S*.[161] This will not matter as long as the dividend and debt assumption do not exceed *P*'s basis in *S*, because this basis becomes irrelevant after the spinoff. However, to the extent the dividend and debt assumption exceed *P*'s basis in *S*, *P* will have an excess loss account (negative basis) in *S*, and this amount will be treated as taxable gain at the time of the spinoff.[162]

These rules raise a number of issues. First, suppose *S* issues new equity to third parties consistent with *P*'s retention of control of *S*. *S* then pays the proceeds to *P* as a dividend, and *P* spins off *S*. Subject to the basis limitation, *P* will not be taxed on the cash received even though the result is economically identical to a sale by *P* of a portion of its preexisting *S* stock to the third parties. This result may not be correct as a policy matter. The same issue arises, however, if *P* does not spin off *S*. Therefore, the issue is not a spinoff issue.

Second, *P* may have debt that is not assumable as a legal matter, but that *P* desires economically to shift to *S*. The same economic result can be achieved, subject to the basis limitation, if *S* borrows directly and pays a dividend to *P*, and *P* uses the proceeds to pay down its own debt. Thus, *S*'s ability to pay cash dividends to *P*, up to the basis limitation, is necessary to permit the equivalent of debt assumptions. This fact is relevant for the discussion of divisive D reorganizations below.[163]

Third, the basis limitation puts a great premium on the form of the spinoff. Suppose *P* and *S* each has an active business worth $100, and *P* has a $0 basis in *S*. If *S* borrowed $50 and distributed the cash to *P*, and then *P* spun off *S*, *P* would have $50 of gain. If instead *P* borrowed $50, retained the liability, contributed the $50 in cash and the entire *P* business to Newco, and then spun off Newco, *P* would have no tax. The two transactions have the same economic result, but very different tax results.

It might be argued that the disparity in the preceding paragraph should be eliminated, just as Congress eliminated the distinctions in post-acquisition restructurings of *P* and *S*.[164] These disparities, however, could only be avoided with a rule that, in the case of a spinoff, cash can be arbitrarily moved between *P* and *S* without regard to *P*'s basis in *S*.

Moreover, the issue is more pervasive since exactly the same disparities arise under § 357(c) in a divisive D reorganization. Suppose *P* holds only business *A* with liabilities in excess of its basis, and business *B* without liabilities in excess of its basis. *P* will recognize § 357(c) gain if it contributes business *A* to *S* and spins off *S*, but not if it contributes business *B* to *S* and spins off *S*. As a result, it would be impossible to eliminate all

161. Treas. Reg. § 1.1502-32 (as amended in 2002).
162. Treas. Reg. § 1.1502-19 (as amended in 1997).
163. *See infra* Part V.C.2.
164. *See supra* Part V.B.1.

disparities of the type under discussion without freely allowing the shifting of debt as well as cash between *P* and *S* prior to a spinoff.

In any event, *P*'s receipt of a dividend from *S* (or *S*'s assumption of *P* debt) in excess of *P*'s basis in *S* is similar to a taxable disposition of *S* at a gain. *P*'s failure to recognize gain in this case is inconsistent with *General Utilities* repeal. As a result, the basis limitation is correct,[165] notwithstanding the disparities that are created.[166]

2. *Divisive D Reorganizations*

Consider now divisive D reorganizations. Section 361(b) deals with cases in which *P* receives cash as well as stock from *S* in exchange for assets transferred to *S*. If *P* retains the cash, it is treated as taxable boot.[167] This means that the first dollars of retained cash are taxable to the extent of *P*'s gain on the contribution of assets to *S*. However, *P* is not taxed on the receipt of the cash if it distributes the cash to its shareholders or creditors as part of the plan of reorganization.[168]

Section 361(b) was substantially revised as part of technical corrections legislation in 1986 and 1988.[169] Before that time, boot received by *P* and distributed to creditors of *P* would have been taxed to *P*.[170] However, the legislative history of the amendments does not focus on divisive D reorganizations.[171]

Several aspects of these rules merit comment. First, contrary to these rules, *P* should be able to receive cash from *S* to the extent of *P*'s basis in *S* without the recognition of gain, even if *P* does not distribute the cash to its shareholders or creditors. In other words, retained cash should be treated first as basis recovery rather than boot.

There are several reasons for this conclusion. It conforms the result of a cash distribution to *P* in a divisive D reorganization to the result under

165. *But see* Sheffield & Schlunk, *supra* note 38, at 960 (suggesting that I.R.C. § 357(c) (2002) might justifiably be scrapped in the spin-off context).

166. The basis limitation might not apply today in one situation where the parties file consolidated returns. Suppose *P* has a positive basis in *S*, *S* owns all of *T*, and *T* borrows cash in excess of *S*'s basis and distributes the cash to *S*. *S* has an excess loss account in *T*. Treas. Reg. § 1.1502-19. Suppose *S* spins off *T* to *P*, and *P* spins off *T*. Logically such excess loss account should be taxable to *P* or *S*, since it represents cash received by the *P/S* group from *T* in excess of its basis. Under § 1.1502-19(g) ex. 3, however, the excess loss account disappears without any gain recognition. It is not clear whether the anti-abuse rule in § 1.1502-19(e)(3) would apply in this case. This result should be changed for the reasons stated in the text. Note that if I.R.C. § 355(e) applies to the second spinoff, then § 355(f) would cause the distribution of *T* to *P* to be a dividend rather than a spinoff, and so this problem would not arise.

167. I.R.C. § 361(b)(1)(B) (2002).

168. I.R.C. § 361(b)(1)(A), (b)(3) (2002).

169. *See* BITTKER & EUSTICE, *supra* note 55, ¶ 12.42[2].

170. *Id.* ¶ 12.42[1][b]; H.R. REP. NO. 100-795, at 372 (1988) [hereinafter 1988 House Report]; S. REP. NO. 100-445, at 393 (1988) [hereinafter 1988 Senate Report].

171. STAFF OF THE J. COMM. ON TAX'N, 100TH CONG., EXPLANATION OF TECHNICAL CORRECTIONS TO THE TAX REFORM ACT OF 1984 AND OTHER RECENT TAX LEGISLATION, at 26-27 (Comm. Print 1987) [hereinafter 1986 Technical Corrections Blue Book]; 1988 House Report, *supra* note 170, at 372; 1988 Senate Report, *supra* note 170, at 393.

§ 355. Moreover, *P* could achieve the same result if (a) *P* borrowed against the assets up to the asset basis and then contributed the assets subject to the debt,[172] or (b) *P* made a § 351 asset contribution to *S*, *S* later paid a "separate" dividend to *P*, and *P* then spun off *S* under § 355. Finally, the proposed rule would eliminate much unproductive structuring that now takes place in divisive D reorganizations in order to avoid assets moving "down" from corporation *X* to *Y* at the same time cash is moving "up" from *Y* to *X*. Note also that the proposed rule is not entirely new, but rather is an extension of the existing consolidated return regulations.[173]

Second, suppose the cash received by *P* exceeds *P*'s basis in *S*, and *P* retains the cash. *P* should have taxable gain to the extent of the excess, just as under § 355. The same should be true if liabilities assumed by *S* exceed *P*'s basis in *S*. In both cases, *P* has a cash profit on the disposition of *S* that should be taxed. This is so notwithstanding the fact that *P* could avoid the gain through the spinoff of the non-*S* assets in an economically equivalent transaction.[174]

Third, suppose the cash received by *P* exceeds *P*'s basis in *S*, and *P* distributes the cash to creditors of *P*. Section 361(b) allows tax-free treatment to *P* without any basis limitation. Thus, if *P* and *S* do not file consolidated returns, *P* does not have taxable gain. If *P* and *S* file consolidated returns, the better view is that the consolidated return regulations cause *P* to have taxable gain on the excess of cash over basis.[175] There is no direct authority on this point, however.

P's distribution of the cash to its creditors is no justification for *P*'s lack of gain recognition when *P* receives cash from *S* in excess of its basis in *S*. The rule in § 361(b) makes sense in the typical case of a nondivisive reorganization where *P* goes out of existence. Here, however, *P* continues to exist. When *P* uses the cash to pay its debt, *P*'s relief from liability is economically identical to an assumption of *P*'s liability by *S*, where the

172. In this case, I.R.C. § 357(b) would potentially apply to treat the liabilities assumed by *S* as taxable boot. That provision applies if the principal purpose of the borrowing and debt assumption was tax avoidance or not a bona fide business purpose. The provision is not likely to apply if *P* waits a reasonable period of time between the borrowing and contribution, or if *S* ends up with a reasonable amount of debt on its books, particularly if the effect is equivalent to an assumption of preexisting *P* debt. Rev. Rul. 79-258, 1979-2 C.B. 143.

173. In an intra-group reorganization, boot otherwise taxable under I.R.C. § 356 (2002), as well as liabilities over basis otherwise taxable under I.R.C. § 357(c) (2002), are instead treated as separate dividends. Treas. Reg. § 1.1502-13(f)(3) (as amended in 2000); Treas. Reg. § 1.1502 -80(d)(1) (as amended in 1997). However, these regulations do not apply if, as part of the same plan, the transferor or transferee leaves the consolidated group, as would be the case in a divisive D reorganization.

174. See *supra* Part V.B.1. for a discussion on this point.

175. Under I.R.C. § 358(a)(1) (2002), *P*'s basis in *S* would be reduced by cash received from *S* to which I.R.C. § 361 (2002) applied. Under Treas. Reg. § 1.1502-19(a)(2)(i) (as amended in 1997), when a negative adjustment is made to *P*'s basis in *S* under "the consolidated return regulations and other rules of law," the excess of such adjustment over *P*'s basis is an excess loss account. The excess loss account would be triggered on the distribution.

basis limitation applies. Likewise, *P*'s payment of its debt is economically similar to *P*'s retention of the cash, most obviously if the debt is short term debt or is otherwise close to its maturity date. Moreover, in contrast to *P*'s distribution of cash to its stockholders, *P*'s distribution of cash to its creditors will not be taxable to them.

As a result, *P*'s use of the cash to pay down its debt should not preclude *P* from being taxed on the receipt of the cash in excess of basis. The Clinton Administration proposed a basis limitation to § 361(b) for the use of cash to pay creditors in a divisive D reorganizations.[176] However, no such limitation has been adopted.

Finally, suppose *P* receives cash in excess of its basis in *S* and distributes the cash to *P* stockholders. It may be argued that *P* should be taxed on the excess cash in this situation as well, since *P* has extracted cash from *S* and used the cash for the benefit of its stockholders. However, the nontaxability of *P* in this situation is long standing. Moreover, the *P* stockholders will be subject to tax on the cash. In the case where the cash is distributed pro rata with the *S* stock, the result is no different than if *S* had paid a dividend after the distribution. As a result, present law should not be changed in this situation.[177]

In conclusion, in a divisive D reorganization, (1) distributions from *S* to *P*, or assumptions of *P* liability by *S*, should be treated as separate from the contribution of assets to *S*; (2) such distributions should not be taxable to the extent of *P*'s stock basis in *S*; and (3) any excess distribution should be taxable to *P* to the extent the cash is retained by *P* or distributed to creditors of *P*. These rules would apply whether or not a consolidated return is filed.

D. Distribution of Subsidiary Stock to Creditors

Under § 355(c), *P* is not taxed on the distribution of appreciated stock of *S* in exchange for debt securities of *P*. An earlier version of this rule was first added to the Code in 1988,[178] and there is no explanation for the rule in the legislative history.[179] However, *P* receives an economic benefit when its liabilities are reduced. Moreover, this benefit arises when *P* transfers *S* stock outside the *P* group.[180] It is inconsistent with *General*

176. 2001 Budget Proposal, *supra* note 103, at 376-78.

177. Under the consolidated return rules discussed above, *P* would have an excess loss account in the *S* stock for cash received in excess of its basis even if the cash was distributed to *P* shareholders. Such excess would be taxed to *P* on the distribution of *S*. This rule is long standing and has nothing to do with *P*'s use of the cash. It probably should not be changed because of the complexities that would arise from a change.

178. Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 1018(d)(5)(C), 102 Stat. 3342, 3580. Further technical corrections were made in the Revenue Reconciliation Act of 1990, Pub. L. No. 101-508, § 11,321(a), 104 Stat. 1388, 460-63.

179. 1988 House Report, *supra* note 170, at 373; 1988 Senate Report, *supra* note 170, at 394; H.R. Rep. No. 101-894 pt.2A (1990); H.R. Conf. Rep. No. 101-964, at 1141-42 (1990).

180. Note that I.R.C. § 355(e) would not apply to such a transfer of *S* stock because that section disregards stock transferred to preexisting security holders of *P*. I.R.C. § 355(e)(3)(A)(ii) (2002). However, the continuity of interest rule requires sufficient *S* stock to be held by former equity holders of *P*, and *S* stock distributed to *P* security holders

Utilities repeal for *P* to avoid gain recognition when *S* stock leaves the *P* group to benefit *P* in this manner.[181] This issue would become particularly significant with the liberalization of the business purpose test. As a result, as part of the overall package, § 355(c) should be modified to cause gain recognition in this case.

Consider next a divisive D reorganization. Under general principles, *P* would recognize taxable gain on the distribution of appreciated property to its creditors as part of the reorganization.[182] Under § 361(c)(3), however, no gain is recognized to *P* on its distribution of *S* stock to its creditors in a divisive D reorganization. The creditors in this case need not even hold securities of *P*.[183] Recent private rulings have illustrated the application of § 361(c)(3).[184]

As noted above, § 361 was substantially revised in 1986 and 1988.[185] Before that time, *S* stock distributed to creditors of *P* would have been treated as disposed of by *P* in a taxable transaction.[186] However, the legislative history of the amendments does not focus on divisive D reorganizations.[187]

Section 361(c)(3) makes sense in the typical case where *P* is going out of existence, since *P* is merely a conduit for an acquiring corporation. However, when *P* remains in existence, there is no more justification for this result than for the tax free treatment of *P* under § 355(c) when *P* uses *S* stock to redeem its securities. In fact, because the debt redeemed by *P* under § 361(c)(3) need not even be a security, the result to *P* can be even more inconsistent with *General Utilities* repeal than the result that arises under § 355. Again, this issue would become particularly significant with the liberalization of the business purpose test. As a result, as part of the overall package, § 361(c)(3) should be amended to require *P* to recognize gain on *S* stock distributed to any creditor of *P*.[188]

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would not count towards this requirement. *See* Lewis R. Steinberg, *Selected Issues in the Taxation of Section 355 Transactions*, 51 TAX LAW. 7, 8-10 (1997).

181. I.R.C. § 355(c) also provides tax-free treatment to *P* if it transfers *S* securities to holders of *P* securities. However, if *P* received the securities as a dividend or as boot in a § 351 transaction, *P* would generally have a basis in the securities approximately equal to their face amount. I.R.C. § 351 (2002). Moreover, the receipt of the securities would have either been taxable to *P* or reduced *P*'s basis in the *S* stock.

182. *See, e.g.*, Rev. Rul. 70-271, 1970-1 C.B. 166.

183. Note that I.R.C. § 368(a)(1)(D) requires that former shareholders of *P* have 80% control of *S* immediately after the distribution.

184. Priv. Ltr. Rul. 2001-25-011 (Mar. 14, 2001); Priv. Ltr. Rul. 2001-37-011 (June 4, 2001) (both allowing *P*'s investment banker to buy debt of *P* (commercial paper in at least one case) that was then redeemed for *S* stock as part of a divisive D reorganization); *see* Jodi J. Schwartz, *When You Assume . . . Rearranging Liabilities in Corporate Reorganizations*, THE TAX CLUB, at 46-48 (Nov. 19, 2001) (on file with author); Robert Willens, *Lucent's Spin-Off of Agere Systems Breaks New Ground*, 2 MERGERS & ACQUISITIONS, Sept. 2001, at 3, 7-8.

185. BITTKER & EUSTICE, *supra* note 55, ¶ 12.42[1], [2].

186. *Id.* ¶ 12.42[2][b] n.678; Rev. Rul. 70-271, 1970-1 C.B. 166.

187. 1988 House Report, *supra* note 170, at 372; 1988 Senate Report, *supra* note 170, at 393; 1986 Technical Corrections Blue Book, *supra* note 171, at 26-27.

188. I.R.C. § 361(c) (2002) also contains a technical flaw that should be fixed. Suppose *S* is a preexisting subsidiary of *P*, *P* contributes additional assets to *S* for additional stock of

VI. SECTION 336(e)

As noted above,[189] § 336(e) authorizes regulations to provide that if *P* owns 80% of *S*, and *P* distributes the *S* stock, then an election may be made to treat the distribution as an asset disposition, with no gain or loss recognized on the stock distribution. For example, if *P* spins off *S* and the transaction does not qualify under § 355, *S* would have gain on its assets, instead of *P* having gain on the *S* stock. The result would be a stepped up asset basis. The shareholders of *P* would continue to be treated as receiving the *S* stock in a taxable transaction.

This result is much fairer than at present, where *P* recognizes gain on the *S* stock without any step up in the basis of the underlying *S* assets. Regulations should be adopted, or the statute amended, to allow the election contemplated by § 336(e).[190]

Note that the election should not be available if the distribution qualifies under § 355 but is taxable to *P* under § 355(d) or (e). In such a case, the *P* shareholders are not taxed on the receipt of the *S* stock. A stepped up asset basis is justified by analogizing the transaction to a taxable distribution of assets by *P* to the shareholders. The analogy does not arise, however, in the absence of gain recognition to the shareholders.

VII. OTHER ISSUES

A number of other more technical issues under § 355 also lead to considerable and unnecessary uncertainties. Many of these could be dealt with by the Treasury Department and IRS, and would not require legislation. These issues include:

(1) the proper allocation of earnings and profits between *P* and *S* in a § 355 transaction;[191]

(2) the proper treatment of employees of *P* and *S* who have their former stock options on *P* stock converted into options on both *P* and *S* stock after the spinoff;[192]

(3) the application of the active trade or business test when *P* or *S* is a partner of a partnership engaged in an active business;[193]

S, and *P* spins off *S* to the *P* shareholders. Section 361(c) literally only protects *P* from gain on the distribution of stock received by *P* in the reorganization. *See* I.R.C. § 361(c)(2)(B)(ii). Also, I.R.C. § 355(c)(1) (2002) does not apply because all the *S* stock is distributed in the plan of reorganization. Thus, nothing literally protects *P* from gain on the distribution of its preexisting stock in *S*. This result is clearly not intended and is not followed by the IRS, but it has not been fixed despite having been pointed out many years ago. *See* James S. Eustice, *Section 361 Redux*, 44 TAX NOTES 443, 444 (1989).

189. *See supra* Part III.

190. *See* Yin, *supra* note 37, at 652-57 (discussing issues that would arise in drafting regulations under I.R.C. § 336(e)).

191. *See* Treas. Reg. § 1.312-10 (as amended in 1960); Bryan P. Collins et al., *Allocation of E&P in a Spin-Off by a Consolidated Group*, 28 CORP. TAX'N, Nov./Dec. 2001, at 11.

192. *See* Rev. Rul. 2002-1, 2002-2 I.R.B. 268 (covering the simplest cases but not the more typical and complex situations).

193. Numerous issues remain besides those recently resolved in Rev. Rul. 2002-49, 2002-32 I.R.B. 288. *See* GINSBURG & LEVIN, *supra* note 122, ¶ 1004.5; Letter from Samuel

(4) confirmation that the liquidation/reincorporation doctrine does not apply when *S* merges upstream into *P* in an I.R.C. § 332 liquidation, and *P* then drops some of the *S* assets into Newco and spins off Newco;[194] and

(5) when *P* is taxed on its distribution of *S* stock, and the *P* and *S* stock is publicly traded, clarification of the proper method to determine the value of the *S* stock in calculating *P*'s gain.[195]

VIII. CONCLUSIONS

The principal proposals made herein, which are intended as a single package, may be summarized as follows:

1. The business purpose test would be liberalized so as to be the same as the test for a reorganization. A purely shareholder purpose would continue to be prohibited, but enhancing shareholder value would be a valid purpose. As an exception to this rule, however, a distribution would automatically fail the business purpose test if the principal purpose (or possibly "a" principal purpose) of the distribution were to facilitate taxable post-distribution sales of *P* or *S* stock by shareholders of *P*.

2. The device test would generally be retained in its present form but would be modified as follows:

(a) The secondary business factor in the regulations would be eliminated.

(b) When *P* is publicly traded, the device factor relating to stock sales after the distribution would not apply to sales by nonmanagement shareholders owning less than 10% of *P*, unless facilitating such sales was a principal purpose of the distribution.

Dimon to Pamela Olson and Charles O. Rossotti (Apr. 19, 2002) (N.Y. State Bar Ass'n Tax Section, Rep. No. 1009), *available at* http://www.nysba.org/taxreports; Mark J. Silverman & Steven B. Teplinsky, Letter to Pamela F. Olson, Acting Assistant Secretary of the Treasury (Tax Policy), May 17, 2002, *reprinted in* 96 TAX NOTES 157 (2002).

194. This fact pattern often occurs in separating out the assets of a group that are to be spun off. If the liquidation/reincorporation doctrine applied, *S* would have taxable gain because it would be deemed to have distributed only a portion of its assets to *P*. However, the IRS will now rule that § 332 applies to a liquidation of *S* into *P* followed by a dropdown of some of the former *S* assets to Newco, as long as Newco is not an "alter ego" of *S*. Rev. Proc. 2002-3, 2002-1 I.R.B. 117, § 4.01(24). That condition would virtually always be satisfied. Moreover, after the spinoff the assets end up in a corporation owned directly by the *P* shareholders, which is more consistent with a complete liquidation of *S* than with a liquidation/reincorporation of *S*.

195. *See* Pope & Talbot, Inc. v. Comm'r, 104 T.C. 574 (1995), *aff'd*, 162 F.3d 1236 (1999) (*P* transfers property to a new partnership and transfers partnership units to its shareholders in a taxable § 311 distribution; held, amount of taxable gain to *P* on distribution is based on price a third party would pay to *P* for all the partnership property, even though this is different than the trading price of the partnership units which determines the amount of the taxable dividend to the *P* shareholders); S. Tulsa Pathology Lab., Inc. v. Comm'r, 118 T.C. 84 (2002) (*P* creates *S* and distributes *S* stock in purported divisive D reorganization, and *S* shareholders sell all the *S* stock the same day in a prearranged sale; held, the device test applies, and *P* has taxable gain based on the actual sale price of the *S* stock, distinguishing *Pope & Talbot*); Tech. Adv. Mem. 200239001 (Jan. 22, 2002) (applying *Pope & Talbot* to a deemed dividend of partnership interests).

(c) In applying the device factor relating to assets that are not 5-year business assets, assets acquired within 5 years under the business expansion doctrine would be treated as not being 5-year assets.

3. The control test would be changed to be the same test as the § 1504 test for consolidation (80% vote and value), without regard to the exclusion for foreign subsidiaries. Straight nonvoting preferred stock would be disregarded, as under § 1504.

4. The active trade or business test would apply to the *P* controlled group as a whole and the *S* controlled group as a whole after the distribution, rather than to *P* and *S* as separate corporations. The business expansion doctrine would likewise apply on a group basis.

5. In applying the active trade or business test to the *P* group and the *S* group immediately after the distribution, a significant percentage (possibly 50%) of the assets of each group would be required to be active trade or business assets that meet the existing 5-year tests. The 50% threshold would be waived if the taxpayer received an advance ruling from the IRS stating that the distribution did not violate the purposes of the active trade or business test.

6. A new rule would tax *P* on a distribution if: (a) during the 5-year period before the distribution, the *P* group acquired assets from outside the group that are qualifying assets under the proposed 50% trade or business test; (b) after the distribution those assets represent more than a specified portion (e.g., 20% or 25%) of the then-value of the assets of *P* or *S*; (c) *P* would be taxable on the distribution under the usual rules if the assets in question were not qualifying assets under the 50% test; and (d) based on all the facts and circumstance relating to the acquisition and distribution, the tax-free treatment of *P* was inconsistent with the purposes of *General Utilities* repeal or the 50% trade or business test.

7. Section 355(d) and (e) would be retained as they are. The regulations under § 355(e) would be modified to expand the definition of "plan or series of related transactions" in certain respects.

8. In a divisive D reorganization, (a) distributions from *S* to *P*, or assumptions of *P* liability by *S*, would be treated as separate from the contribution of assets to *S*; (b) such distributions would not be taxable to the extent of *P*'s stock basis in *S*; and (c) any excess distribution would be taxable to *P* to the extent the cash is retained by *P* or distributed to creditors of *P*.

9. In a § 355 transaction or divisive D reorganization, *P*'s use of *S* stock to redeem any debt of *P* would be a taxable disposition of the *S* stock, regardless of whether the debt was a security.

10. If a distribution of *S* stock would be taxable to both *P* and its shareholders, the parties could elect under § 336(e) to have *S* treated as selling its assets and receiving a stepped up asset basis.

It might be questioned whether the spinoff rules would be any simpler if all of these reforms were enacted. In truth, the relevant sections might not have fewer words than today. However, taxpayers dealing with spinoffs would have a much easier time and the IRS would save an enormous amount of effort in processing private letter rulings. Moreover, the requirements of spinoffs would be much more focused on the relevant policies. As a result, the remaining efforts by both taxpayers, the Treasury Department and the IRS would be much more focused on legitimate issues rather than arbitrary rules. In this sense, the spinoff rules would be simpler.

IX. PROFESSOR YIN'S COMMENTARY

Professor Yin has provided an extremely insightful and thoughtful commentary on the foregoing discussion.[196] He correctly points out the difficulty of reforming § 355 in the absence of broader reform of the stock and asset acquisition rules of the Code. However, if piecemeal reform is to occur, he generally agrees with the foregoing proposals concerning business purpose, active trade or business, control, and § 336(e).

In addition, Professor Yin believes that the key to a permissible spinoff is that the taxpayer not take advantage of the spinoff and dispose of part but not all of the combined *P* business. Consequently, Professor Yin would eliminate the continuity of interest test, "most or all" of the device test,[197] and § 355(d). In their place, he would adopt a new and greatly expanded version of § 355(e) (referred to as expanded § 355(e)). Violation of expanded § 355(e) would cause a distribution not to qualify under § 355, resulting in both corporate and shareholder-level tax.

Expanded § 355(e) would be violated if there was more than a specified change of ownership of *P* or *S*, possibly 50%, within a specified period of time before or after the distribution. Expanded § 355(e) would be triggered by both taxable and nontaxable changes of ownership of *P* or *S*, thus retaining the existing prohibition on *Morris Trust* transactions.[198] Most significantly, expanded § 355(e) would be triggered without regard to whether the change of ownership was pursuant to a plan involving the distribution. Rather, there would be an "irrebuttable presumption"[199] that a change of ownership within the specified time period was part of the same plan as the distribution.

In addition, Professor Yin acknowledges the need, in the absence of the device test, to prevent planned dispositions of *P* or *S* stock that are too small to trigger expanded § 355(e). He suggests a rule that any disposition (whether taxable or tax-free and even an "insignificant amount") of *P* or *S* stock planned at the time of the distribution would disqualify the entire distribution at both the corporate and shareholder levels.

196. George K. Yin, *Taxing Corporate Divisions*, 56 SMU L. Rev. 289 (2003) [hereinafter Yin commentary].

197. *Id.* at 298.

198. I am extremely pleased that Professor Yin has now joined the half dozen people, *id.* at 300, that agree with the policy behind I.R.C. § 355(e) to prevent *Morris Trust* transactions. His thoughtful explanation for his current view will hopefully increase the size of our group by at least a few hundred percent.

199. Yin commentary, *supra* note 196, at 296.

In response, no one could claim that the existing rules in the Code concerning taxable and tax-free corporate stock and asset acquisitions are logical, consistent, or represent a uniform policy theme. However, these rules have been in place since the beginning of the income tax and are likely to remain so for the foreseeable future. This is due to the unpredictable consequences of new rules, the lack of a political constituency for fundamental reform, and the certainty that taxpayers would strongly object to "reforms" that would necessarily eliminate many existing structuring alternatives.

As a result, the practical choice is between incremental reform of Subchapter C or no reform at all. (The same could be said for much of the Code.) Professor Yin is clearly correct that the results of incremental reform will be imperfect but still worthwhile.

Turn now to Professor Yin's proposals for incremental reform. As an initial matter, I believe his expanded § 355(e) would not permit a great amount of simplification. I believe it would still be necessary to retain § 355(d),[200] some of my new proposed restrictions,[201] and part of the device test.[202]

More significantly, three rules contained in Professor Yin's expanded § 355(e) would change long-standing rules for spinoffs and would cause considerable practical difficulties. These rules are discussed in turn below.

Consider first the rule that violation of expanded § 355(e) would trigger shareholder as well as corporate-level tax. This may be correct as a theoretical matter. It is also necessary if expanded § 355(e) is to replace the device test. However, the proposed rule would reverse the 35-year old *Morris Trust* decision as it relates to shareholder taxation, an issue not affected by *General Utilities* repeal. Moreover, for whatever reason, Congress declined to go this far in 1986.

In addition, I believe Professor Yin greatly underestimates the practical significance of this change.[203] For example, suppose there is little or no gain to *P* on the distribution of *S* stock. Existing § 355(e) would not prevent the spinoff but expanded § 355(e) would do so. Alternatively, sup-

200. Professor Yin suggests that I.R.C. § 355(d) would be unnecessary because expanded I.R.C. § 355(e) would apply to changes in ownership occurring for an appropriate time period before and after a distribution. *Id.* at 299. However, any shortening of the 5-year pre-distribution period for I.R.C. § 355(d) transactions would greatly undercut the purposes of that section. On the other hand, a 10-year tainted period under expanded I.R.C. § 355(e), i.e., from 5 years before the distribution until 5 years after the distribution, would be far in excess of a period that could be justified for a *per se* rule of taxability.

201. For example, expanded I.R.C. § 355(e) might not cover certain acquisitions followed by spinoffs, e.g. example (c) in Part IV.E.3. If not, the rule described in Part IV.E.4 would still be necessary.

202. The device test would be needed for situations that do not involve a disposition of stock and thus do not trigger even expanded I.R.C. § 355(e). For example, suppose *P* is closely held, there is minimal business purpose for the spinoff, 49% of the assets of *S* after the spinoff are cash equivalents, and the shareholders are willing to wait several years to sell *S*. For another example, see the fact pattern discussed in Part IV.B.2.d.

203. *See* Yin commentary, *supra* note 196, at 301.

pose there was significant corporate level gain but the parties believed existing or expanded § 355(e) was unlikely to apply. The parties might be willing to risk corporate-level tax under existing or expanded § 355(e), but not shareholder-level tax under expanded § 355(e). This is especially true if public shareholders are involved. Thus, the shareholder-level tax under expanded § 355(e) could have significant effects in discouraging spinoffs.

Second, consider the rule that expanded § 355(e) would be triggered by any fifty percent change in ownership of *P* or *S* during the relevant time period, regardless of the existence of a plan. This rule is analogous to existing § 355(d), which is a per se rule that does not depend upon the existence of a plan. It is also analogous to a few other Code provisions that automatically treat a transaction as taxable if certain other events occur within a specified period, regardless of the existence of a plan.[204] This rule may also be justified, as Professor Yin states, by the policy that a taxpayer should not be able to obtain the tax benefits of both a spinoff and a post-spinoff disposition of the stock of *P* or *S*, even in the absence of a plan.

However, it is very unusual for the Code to take away the tax-free nature of a transaction solely because of the occurrence of a subsequent transaction that was not planned at the time of the first transaction. Moreover, this aspect of Professor Yin's proposal would squarely reverse the spinoff rules that have existed since the 1920s. At no time has an unplanned taxable or tax-free disposition of *P* or *S* stock following a distribution caused the distribution to fail to qualify as tax-free, either because of the device test or for any other reason.

Moreover, as a practical matter, in the case of a publicly held *P*, this proposal would severely restrict the ability of a board of directors to engage in transactions that would otherwise be in the best interest of the shareholders. After a change of ownership of *P*, it would severely limit the ability of *P* or its acquirer to spin off *S* for unexpected business reasons. After a spinoff of *S*, it would severely limit the ability of *P* or *S* to take advantage of unexpected opportunities to issue stock, to make tax-free acquisitions, or to be acquired on a taxable or tax-free basis. Likewise, following a spinoff of *S*, it would severely limit the ability of potential acquirers to acquire *P* or *S* on a taxable or tax-free basis.

Moreover, the proposal would allow any *P* to create a complete defense to any hostile takeover. *P* could drop down most of its assets to *S* and spin off *S*, thus in effect immunizing both *P* and *S* from a takeover for the length of the § 355(e) period. There is no good policy reason for *P* to be able to use expanded § 355(e) as a tax shield in this manner.

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204. *See, e.g.*, I.R.C. § 704(c)(1)(B) (gain to contributing partner if contributed property is distributed to another partner within 7 years of the contribution); I.R.C. § 737 (gain to contributing partner that receives other property from the partnership within 7 years of the contribution); Treas. Reg. § 1.367(a)-8(b)(3) (gain to U.S. transferor if transferee foreign corporation disposes of transferred property within 5 years of the transfer).

Third, consider the rule that expanded § 355(e) would apply if there was a plan at the time of the distribution for any future taxable or tax-free change of stock ownership of *P* or *S*, no matter how small. It is difficult to see a strong policy argument for this result. Moreover, this proposal would reverse the spinoff rules that have existed since the 1920s.

This proposal would also have very severe practical effects. Many spinoffs today involve a plan to issue a relatively small amount of *P* or *S* stock after the spinoff. Even more significantly, suppose a distribution was in fact followed by any taxable or tax-free issuance or disposition of *P* or *S* stock. The IRS could claim that a plan existed at the time of the distribution and thus the distribution was fully taxable at both the corporate and shareholder levels. Even if there was not in fact a plan, *P* or *S* might have great difficulty in proving this negative. As a result, any stock issuance or disposition following a spinoff would cause enormous risks to both *P* and the *P* shareholders. Few corporations would be willing to engage in any spinoff under these circumstances.

To conclude, these three rules contained in expanded § 355(e) would each reverse principles of the spinoff rules that have existed at least for decades, and in some cases since the beginning of the income tax. Moreover, each would cause enormous practical difficulties for taxpayers. The combined effect of these rules would be almost the equivalent of the outright repeal of § 355, at least for public corporations. It should be emphasized that no particular event has occurred in recent years that has increased the justification for these rules as a policy matter.

Professor Yin may be right that these rules are theoretically correct. These rules might also be appropriate in the context of overall reform of the stock and asset acquisition rules of the Code. (An evaluation of these propositions is beyond the scope of this article.) However, in recent decades Congress has done little more than tinker with § 355 and has implicitly approved of many of the policies that would be changed by these rules. I view my proposals in the same way that Professor Yin views my proposals, namely as a continuation of this incremental tinkering with an imperfect statute.

In contrast, Professor Yin's proposals are much more far-reaching (and restrictive). It does not seem appropriate to adopt them, or consider adopting them, except in the context of much broader reform of the stock and asset acquisition rules of the Code.