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August 15, 2002

Active Trade or Business Requirements for Nontaxable Spin Offs—Rev. Rul. 2002-49

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When a corporation distributes property to its shareholders, the distributees ordinarily report the distribution as income. If the value of the property is greater than its tax basis, the distributing corporation will recognize gain as well.

If, however, the requirements of Internal Revenue Code ("Code") section 355 are met, a corporation may distribute the stock of a corporation which it controls to the shareholders of the distributing corporation without the recognition of gain by either the distributing corporation or its shareholders.

One of the requirements of section 355 is that each of the distributing corporation and the controlled corporation be engaged, immediately after the distribution, in the active conduct of a trade or business.

A corporation is generally treated as engaged in the active conduct of a trade or business only if (1) the trade or business was actively conducted, though not necessarily by the corporation, throughout the 5-year period ending on the date of the distribution and (2) the trade or business was not acquired within that period by the corporation in a transaction in which gain or loss was recognized in whole or in part.

In some circumstances, a corporation will be considered to be actively engaged in a trade or business conducted by a corporate subsidiary, if the subsidiary itself meets these requirements.

There have been numerous unresolved issues concerning the application of these "active business" requirements where the distributing or controlled corporation does not own a qualifying business directly or though a controlled corporate subsidiary, but owns an interest in a partnership (or other entity classified as a partnership for income tax purposes) that is engaged in an active business. Revenue Ruling 2002-49, published by the IRS this month, contains some good news and some not-so-good news for corporations seeking to meet the active business requirement on the basis of ownership of an interest in a limited liability company classified as a partnership for Federal tax purposes.

Facts

The ruling describes two situations. In Situation 1, a member-managed limited liability company classified as a partnership for Federal tax purposes ("the LLC") owns several commercial office buildings leased to third parties.

The LLC provides upkeep and maintenance services for the office buildings, collects rent, manages relationships with existing tenants, advertises for new tenants, and continuously seeks to acquire additional rental properties.

Initially, two corporations, "D" and "X", each own a 20 percent interest in the profits and capital of the LLC, and one or more other persons own the balance of the interests in the LLC. D and X jointly manage the LLC and have equal control over management decisions.

The officers of D and X perform "active and substantial management functions" with respect to the LLC, including joint decision-making with respect to significant decisions regarding the purchase, sale, renovation, and refinancing of property by the LLC. Those officers also participate in the supervision, direction and control of the employees of the LLC. The other members of the LLC do not participate in the management or operations of the LLC.

Not less than two years after the establishment of the LLC with the business and ownership structure described above, D purchases all of the other interests in the LLC, and the LLC accordingly becomes an entity that for tax purposes is disregarded as an entity separate from D. After the purchase, D's officers continue the activities and functions conducted by them before the purchase, and the employees of the LLC continue the activities and functions conducted by them before the purchase.

Three years after the purchase of the other members' interests, D causes the transfer of 40% (by value) of the rental properties formerly owned by the LLC to C, a newly formed and wholly owned subsidiary of D, and distributes

the stock of C pro rata to the shareholders of D in a transaction intended to meet the requirements of Code section 355.

Situation 2 in the ruling is identical to Situation 1 as described above except that D, instead of owning a 20% interest in the LLC for at least 5 years before the distribution, acquires its initial interest in the LLC 4 years before the spinoff by contributing appreciated securities to the LLC in exchange for an interest in the LLC, in a (nontaxable) transaction described in Code section 721.

Discussion

In an earlier ruling (Rev. Rul. 92-17, 1992-1 C.B. 142), the IRS had concluded that a corporation that was the general partner of a limited partnership engaged in commercial real estate rental activities, and that retained that interest after distributing the stock of a subsidiary engaged in an unrelated business, met the active business requirement of Code section 355(b), where the general partner held a 20% interest in, and its officers performed active and substantial management functions for, the partnership.

Consistently with the 1992 ruling, the IRS ruled in Rev. Rul. 2002-49 that the active business requirement was met in Situation 1, making clear that the circumstances that (1) the distributing corporation was a member of a limited liability company, rather than the general partner of a partnership, and (2) during part of the five-year period preceding the spinoff, shared managerial control and responsibilities with another member, did not prevent the active business requirement from being met.

The discussion in Rev. Rul. 2002-49 also makes clear that the active business requirement would have been met in the circumstances described in Situation 1 of the ruling, even if D had not bought out the interests of the other members in the third year preceding the spinoff.

The ruling further concludes that the purchase of the interests of the other members would not prevent the active business requirement from being met. The purchase was potentially troublesome because of the rule that the active business requirement cannot be met through a trade or business acquired within the five-year period preceding the spinoff in a transaction in which gain or loss is recognized.

Under IRS rulings, a purchase by one limited liability company member of the other members' interests is generally treated, from the perspective of the purchaser, as if the entity made a liquidating distribution of all its assets to the members and the purchaser then purchased the other members' interests in those assets. That construct would suggest that, in Situation 1, D acquired the assets of the business in a transaction in which gain was recognized in part (by the other members).

In support of the conclusion that the active business requirement was nonetheless satisfied, the ruling refers to regulations under Code section 355 which generally provide that, if there is an expansion of a taxpayer's existing 5-year business or the acquisition of another business in the same line of business as the existing business, the entire business (including the expanded or acquired component) is treated as part of a business conducted throughout the entire 5-year period, unless the purchase or other acquisition effects a change of such a character as to constitute the acquisition of a new or different business. In the present case, D was considered to be engaged in the trade or business of the LLC even before the purchase of the other members' interests, so it appears appropriate to treat D after that purchase as continuing the same business.

In the second situation described in the ruling, D first acquired an interest in the LLC 4 years before the spinoff through a contribution of appreciated securities in exchange for an interest in the LLC, in a transaction in which no gain was recognized to D, the LLC, or the other members of the LLC under Code section 721(a).

The ruling notes that, if D had instead directly acquired the business represented by the interest in the LLC in exchange for the appreciated securities, that would have been a transaction in which gain or loss was recognized. "Therefore," the ruling concludes, D should be viewed as have acquired the business represented by the interest in the LLC less than 5 years before the spinoff in a transaction in which gain or loss was recognized; and, accordingly, the subsequent distribution by D failed to satisfy the active business requirement.

Observations

In Situation 1, the specification that the LLC is a *member-managed* limited liability company is noteworthy. The operating agreements for many limited liability companies provide for management by managers appointed by the members pursuant to the LLC agreement, rather than for management by members.

It seems hard to justify a different result in Situation 1, for example, if the operating agreement of the entity had provided that the LLC would be managed not by its members but rather by appointed managers, assuming that some of those managers were officers of D. Nonetheless, some caution would appear to be warranted in relying on the ruling in situations where a limited liability company is managed by managers rather than by its members.

With regard to Situation 2, would the IRS have ruled differently if D had contributed cash, or securities with a basis greater than or equal to fair market value, or other property? Even under the IRS reconstruction of the transaction in which the interest was acquired, D would not generally recognize gain or loss in using cash, for example, to acquire the underlying business.

One would expect, however, that the IRS would conclude that the same result would apply in all of these situations with respect to Code section 355, since in any such situation the owner of the business would, if the IRS characterization of the transaction for purposes of Code section 355(b) is followed, be disposing of the business in a transaction in which gain or loss would generally be recognized. Nonetheless,

the significance in Situation 2 of the circumstance that D contributed appreciated securities is not made clear.

More generally, however, it is not surprising that the IRS sought to reach the result that Situation 2 failed to meet the requirements of Code section 355. The IRS may legitimately be concerned that corporations not otherwise meeting the active business requirement would, on the basis of the ruling in Situation 1, be encouraged to acquire a 20% interest in a partnership or limited liability company with a qualifying business through a contribution to that entity of cash or other property in anticipation of a distribution of stock, in an attempt to cause an otherwise nonqualifying spinoff to qualify as a nontaxable distribution under Code section 355.

It is difficult, however, to reconcile the stated rationale for the conclusion in Situation 2 with the statutory language. Although the transaction in which the interest was acquired could have been effected in a taxable manner, the fact that the transaction actually effected was nontaxable appears to make inapplicable the rule that a business acquired within 5 years before the distribution in a transaction in which gain or loss was recognized is not a qualifying business for purposes of the active business requirement. However, the IRS has other tools, such as the "device" test under Code section 355 and the "aggregate" theory of partnership taxation and the "aggregate" theory of partnership taxation, that may be available to prevent this sort of end run.

On the whole, the ruling appears to be a potentially favorable development for any corporation doing business through partnerships or limited liability companies that may be considering a spinoff or other distribution of stock in a transaction intended to qualify under Code section 355, notwithstanding that the ruling leaves unresolved many of the long-standing issues in this area.

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