August 16, 2007

Recent Developments Related To Nontaxable Spinoffs

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In general, a corporation is required to recognize gain upon the distribution to its shareholders of appreciated property with a value in excess of basis, to the extent of the built-in gain. Depending on the circumstances, such a distribution will also generally result in either dividend income or the recognition of other gains attributable to built-in gain at the shareholder level.

Section 355 of the Internal Revenue Code ("IRC") is an important exception to this rule that permits a corporation ("D") to distribute to one or more of its shareholders the stock of another corporation ("C") controlled by D, without the recognition of gain either by D or its shareholders, if, among other requirements: the transaction is not used "principally as a device" for the distribution of earnings and profits of D; both C and D are engaged in the active conduct of a trade or business immediately after the distribution; that trade or business has been conducted for the past five years; and there is an appropriate business purpose.

Perhaps in part because of the importance of IRC §355 as essentially the sole means of dividing a corporate business without the recognition of gain, that provision has been amended several times in the last decade both for simplification and to limit perceived abuses, and these legislative changes have been accompanied by additional regulations and other guidance from the IRS. The more recent legislative changes include the addition of IRC §355(b)(3) in 2006 to attempt to simplify the key determination of whether the corporation making the distribution, and the corporation the stock of which was distributed, are each engaged in the active conduct of a trade or business.

With regard to administrative guidance, the IRS issued in June, 2007, Rev. Rul. 2007-42[1] to address a relatively narrow issue that frequently arises concerning the active conduct requirement: namely, the circumstances under which a corporation owning a partnership interest will be considered to be engaged in the active conduct of a trade or business by reason of a business conducted by the partnership.

More broadly, in May of this year a notice of proposed rulemaking[2] was issued with proposed regulations that address the active conduct of a trade or business requirement and specifically the integration of new section 355(b)(3) with other aspects of the active conduct requirement.

Most recently, IRS Notice 2007-60,[3] as issued earlier this month, states that the IRS will refrain, until the above-referenced proposed regulations are issued in final form, from applying changes made by Congress to IRC §355 in 2006 in a manner that would cause §355 not to apply in certain contexts, generally involving pre-spinoff acquisitions, that were considered consistent with the application of §355 before 2006 but that, by reason of the amendments made last year, may not continue to fit within the scope of §355.

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Attribution From Partnerships

A corporation may be considered to be engaged in the active conduct of a trade or business if it does not conduct such a trade or business directly but owns an interest in a partnership engaged in the active conduct of a trade or business. For example, in Rev. Rul. 92-17,[4] a corporate general partner of a limited partnership engaged in the active conduct of a trade or business (the ownership and operation of commercial office buildings) was considered to meet the active conduct requirement where (i) the corporation owned a 20% interest in the partnership and (ii) the officers of the corporation performed "active and substantial management functions" with respect to the partnership and supervised the employees of the partnership.

Rev. Rul. 2002-49[5] extended this concept of attribution of a trade or business in concluding that, where D and another corporation each owned a 20% interest in a member-managed limited liability company ("LLC") classified as a partnership for Federal tax purposes, and the two corporations jointly managed the business of the LLC, D was engaged in the active conduct of a trade or

business by reason of its interest in the LLC.

Neither of the published rulings discussed above, however, suggested that a corporation could be considered to meet the active conduct of a trade or business requirement solely by reason of ownership of an equity interest in a partnership engaged in the active conduct of a trade or business where the corporation and its officers did not have any role in managing the business of the partnership.

Rev. Rul. 2007-42

Rev. Rul. 2007-42 deals with two situations. In the first, a LLC classified as a partnership for Federal tax purposes owns several commercial office buildings that are leased to unrelated parties. Corporation D owns a one-third membership interest in the LLC.

The LLC provides services customary in connection with the rental of commercial office space to the tenants of the buildings. All management and operational functions with respect to the LLC's business are performed by its employees, and no services with respect to the business of the LLC are provided by D or the other members of the LLC.

D also owns all the stock of C, a corporation engaged in the active conduct of a trade or business unrelated to that of the LLC. It is proposed that D distribute the stock of C, for a valid business purpose, to the shareholders of D in a transaction intended to meet the requirements of §355.

The second situation described in the ruling is identical to the first except that D owns only a 20% membership interest in the LLC.

After briefly discussing the active conduct requirement as set forth in IRC §355 and the current regulations thereunder, the ruling observes that "the determination of whether a partner is considered to be engaged in the active conduct of a trade or business must be based on the requirements of §355 and the regulations thereunder taking into account the activities of the partner (if any), the partner's interest in the partnership, and the activities of the partnership."

After discussion of how this issue was addressed in Rev. Rul. 92-17 and Rev. Rul. 2002-49, the 2007 ruling then reviews the regulation addressing a somewhat similar issue under IRC §368 concerning the continuity of business enterprise ("COBE") requirement for nontaxable reorganizations.

Under the COBE requirement, the "issuing corporation" (that is, the corporation issuing stock in the reorganization transaction, together with its subsidiaries) must either continue the target corporation's historic business or use a significant portion of the historic business assets of the target in some business (Reg. §1.368-1(d)). For purposes of the COBE requirement, the issuing corporation will be treated as conducting the business of a partnership if the issuing corporation (i) owns an interest in the partnership representing a "significant interest" in that partnership business, or (ii) performs active and substantial management functions with respect to the partnership business.

The examples in the regulations under IRC §368 concerning the COBE requirement further indicate that a 33-1/3% interest in a partnership is viewed as a significant interest in a partnership for these purposes.

Rev. Rul. 2007-42 concludes that, in the first situation described above, D is engaged in the active conduct of a trade or business for purposes of §355 because D owns a significant interest in the LLC and the LLC performs activities constituting an active trade or business.

In the second situation described above, where D owns only a 20% interest in the LLC, the ruling concludes that such an interest is not a significant interest for these purposes. Because D neither holds a significant interest in the LLC nor performs active and substantial management functions (through its officers, other employees, or otherwise) for the LLC, D is not considered to be engaged in the active conduct of a trade or business for purposes of §355.

Rev. Rul. 2007-42 further states that Rev. Rul. 92-17 is modified to the extent it indicated that a partner must perform management functions in order for the partner to be viewed as engaged in the active conduct of a trade or business of the partnership.

In the context of a corporate partner with no involvement in the business of the partnership, it might be questioned why a 33-1/3% interest in a partnership engaged in the active conduct of a trade or business will be viewed as a significant interest for purposes of §355 but a 20% interest in a similar partnership will not be viewed as significant, regardless of the relative values of the 20% and 33-1/3% interests or of the extent of the assets of the two partnerships. As a planning matter, the ruling may cause corporations considering a spinoff or other distribution under §355 to prefer to hold a relative large percentage interest in a smaller partnership rather than a smaller percentage interest of equal or greater value in a larger partnership.

"Active Conduct" Proposal

The main thrust of the proposed regulations issued in May is to address the requirements of IRC §355(b)(3) as added in 2006. Under that provision, in determining whether or not the active conduct requirement is met, each of (i) D and all the corporations that would be part of the same affiliated group as D under the standards of IRC §1504(a) if D were the common parent (the D "separate affiliated group"), and (ii) the C separate affiliated group, is treated as one corporation.[6]

The proposed regulations also address the impact of §355(b)(3) on other rules in §355(b) relating to the acquisition of a trade or business less than five years before a distribution, and the topic addressed in part by the rulings discussed above – namely, whether a corporation will be considered to be engaged in the active conduct of a trade or business by reason of the attribution of trade or business activities from a partnership in which the corporation owns an interest.

Although §355(b)(3) was intended to simplify the process of planning and implementing a distribution intended to qualify under §355, the integration of §355(b)(3) with the other rules of

§355(b) may cause a corporate group to fail to meet the active conduct requirement in circumstances where that requirement would have been met under §355(b) and the regulations thereunder prior to 2006. Accordingly, the IRS issued Notice 2007-60 to provide transitional relief in two specific contexts described in the notice.

For example, notwithstanding the general rule that a trade or business acquired by the distributing or controlled corporation in a taxable transaction less than five years before a distribution cannot be counted in determining whether the active conduct test is met, it was reasonably clear prior to the 2006 amendments that the recognition of gain or loss by reason of the transfer of a business by one member of an affiliated group to another would be disregarded for these purposes.[7]

In one fairly typical spinoff situation to which this rule might be relevant, the common parent of an affiliated group filing a consolidated return ("P") owns various first tier subsidiaries, including a corporation ("D") owning another corporation ("C") that P wishes to dispose of through a series of distributions of the stock of C, first by D to P and then by P to its shareholders. If C purchased from P, or from a subsidiary of P not owned directly or indirectly from D, a five-year active trade or business in a taxable transaction less than five years before the distributions, it appeared, at least prior to 2006, that C might rely on that business to meet the active conduct requirement notwithstanding that C acquired the business in a taxable transaction within five years before the distributions.

Under §355(b)(3) as interpreted by the proposed regulations, however, a taxable acquisition of a business by a member of the C separate affiliated group, from P or from another member of the affiliated group of which C and D are members but that is not part of either the C or D separate affiliated groups, less than five years before the distribution may preclude satisfaction of the active conduct requirement through reliance on the acquired business, even though the business was acquired from another member of the same affiliated group as the distributing corporation and may have been conducted by members of the group for many years preceding the distribution.[8]

Notice 2007-60 also indicates that the acquisition of additional stock of a controlled corporation in a taxable transaction less than five years before a distribution of the stock of that corporation may adversely affect the ability of the controlled corporation to satisfy the active conduct of a trade or business requirement, in circumstances where such an acquisition would not have precluded meeting the active conduct requirement prior to the 2006 amendments.

The notice states that, with respect to distributions effected before the publication of the proposed regulations as either final or temporary regulations, the IRS will not (under specified circumstances) challenge the applicability of the specific pre-2006 rules referred to in the notice relating to the active conduct of a trade or business requirement.

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[1] 2007-28 IRB 44.
[2] REG-123365-03 (May 8, 2007).
[3] 2007-35 IRB __.
[4] 1992-1 C.B. 142.
[5] 2002-2 C.B. 288.
[6] The separate affiliated group is determined without regard to IRC §1504(b), which excludes certain corporations from an affiliated group for other purposes.
[7] See Reg. §1.355-3(b)(4)(iii) and IRS Notice 2007-60, §2.
[8] See REG-123365-03, Background and Explanation of Provisions, Part G.

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