

Recent Developments Concerning Section 355

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Key Changes to Section 355 Ruling Policy

- Rev. Proc. 2013-1 provides that the IRS will no longer provide rulings on an expedited basis except “when a factor outside a taxpayer’s control creates a real business need to obtain a letter ruling or determination letter before a certain date to avoid serious business consequences.”
- Rev. Proc. 2013-3 provides that the IRS will no longer rule on:
 - Section 355 distributions involving recapitalizations and certain stock issuances that could affect whether the control requirement is satisfied;
 - Section 355 distributions involving a distributing corporation’s distribution of stock or securities of a controlled corporation in exchange for, and in retirement of, any putative debt of the distributing corporation if such distributing corporation debt is issued in anticipation of the distribution; and
 - “North-South” transactions.

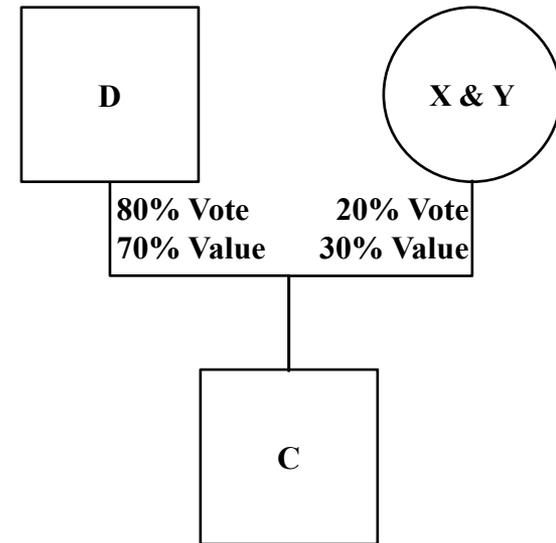
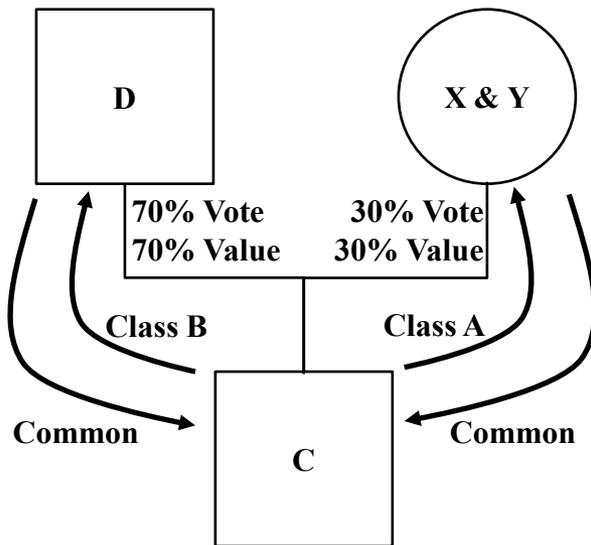
Recapitalizations



Section 355 Control Requirement

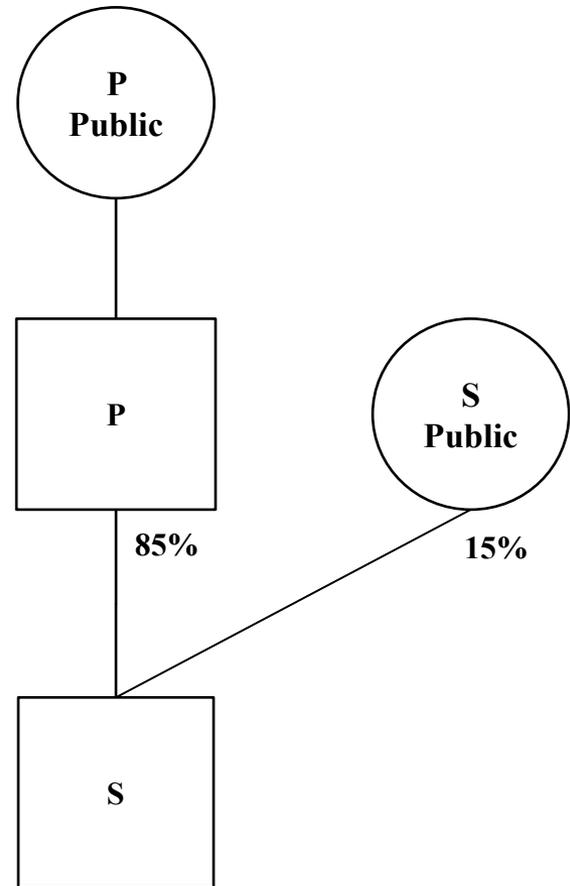
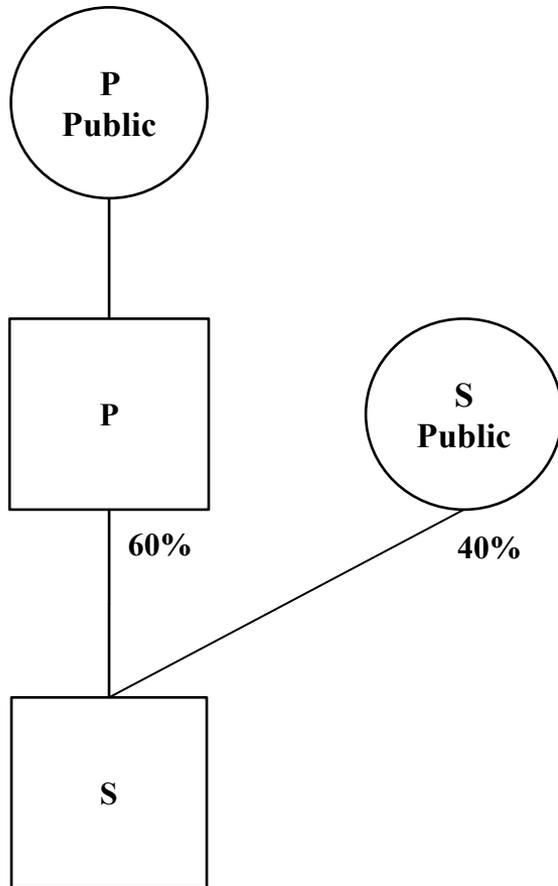
- For a spin-off to be tax-free, D must:
 - Control C (within the meaning of section 368(c)) immediately before the distribution; and
 - Distribute control of C.Sections 355(a)(1)(A); 355(a)(1)(D).
- Under section 368(c), “control” means ownership of:
 - Stock possessing 80% of the vote; and
 - 80% of each class of non-voting stock.Rev. Rul. 59-259.

Rev. Rul. 69-407



- The ruling concludes that respecting D as controlling C as a result of the recapitalization is appropriate because the recapitalization “resulted in a *permanent realignment of voting control.*”

IPO Carve-Outs



Section 355: Recaps Into and Out of Control

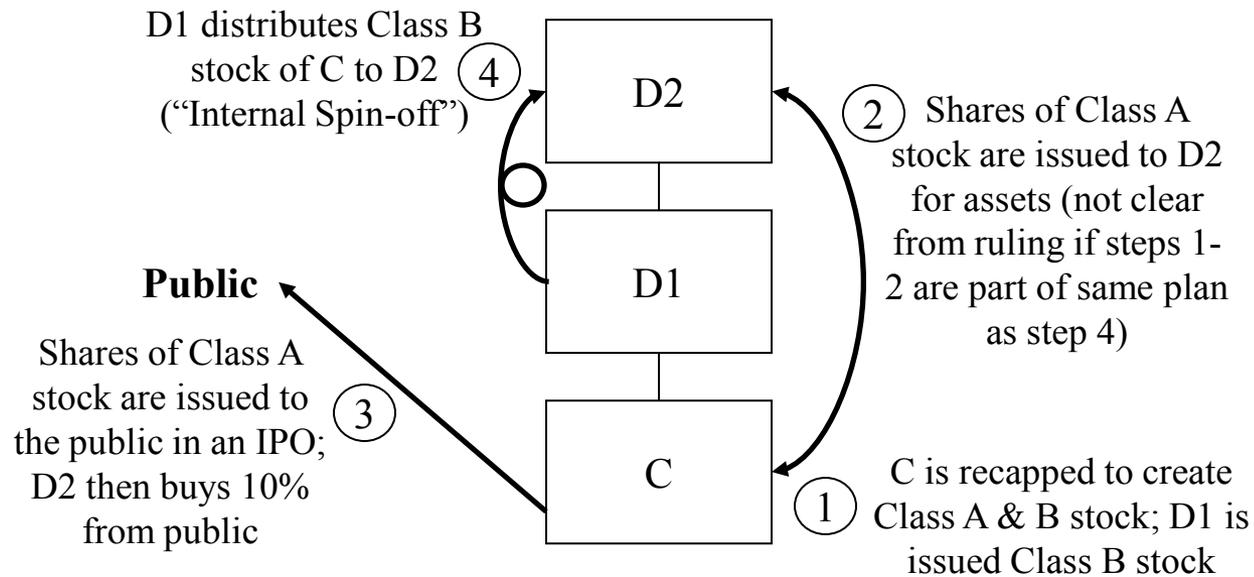
Date of Ruling/Spin	Date of Supplemental Ruling Request	Date Supplemental Ruling Published	Supplemental Ruling Number
3/25/99	6/28/01	<u>9/28/01</u>	200139011
6/2/99	10/8/03	1/16/04	200403041
<u>8/30/02</u>	8/19/03	11/21/03	200347013

Section 355: Recaps Into and Out of Control

- Rev. Proc. 2003-48 stated CC:Corp. would not issue supplemental rulings on spin-offs due to change of circumstances (did not apply to 3 rulings cited above, because sought before effective date).
 - What is scope of “change of circumstances”?
 - Around 2005 CC:Corp stopped requiring representations of no plan to undo dual vote structure.
- In 2008 Wessel, Pari and D’Avino added to their treatise:
 - “The authors understand that the Service will rule favorably if, following the distribution, the taxpayer expects that the board of directors of controlled will consider whether to unwind the dual class structure as long as it is subject to an independent shareholder vote.”
p. 417
- PLR 200837027 stated that “in connection with the resolutions to be submitted to the Controlled shareholders at the next regularly scheduled annual shareholders’ meeting of Controlled or at a special shareholders’ meeting of Controlled,” shareholders could vote to approve a resolution to undo a recapitalization into control consummated in connection with the spin-off addressed by the ruling. Later rulings involving recaps into control included similar language in representations.

PLR 201007050

Recap into Control for Spin-off Followed by Unwind



Step 5: D2 offers to exchange its Class A stock in C for D2 stock owned by the D2 shareholders (“Exchange Offer” resulting in an “External Split-off” to the D2 shareholders). Offer provides that, if the conditions to the Exchange Offer are met, then D2 will convert the Class B stock received in the Internal Spin-off to Class A stock (the “Unwind”) prior to consummation of the Exchange Offer/External Split-off.

Step 6: Conditions are met, and Unwind and External Split-off are consummated.

Step 7: D2 contributes assets to D1 (North-South issue). Rep: Internal Spin-off not conditional on contribution.

PLR 201007050 (cont'd)

- The IRS concludes: “the Unwind will not cause the Internal Spin-off to fail to satisfy the control immediately before requirement of section 355(a)(1)(A).” *Cf.* Rev. Rul. 98-27.
- The taxpayer represented that immediately after the Internal Spin-off, there would be “no legally binding obligation to change the capital structure or the Charter of Controlled” and “no legally binding obligation to proceed with the remainder of the Proposed Transaction.”
 - Compare to prior PLRs requiring no plan or intention.
- Consummation of the Exchange Offer/External Split-off was conditioned upon a minimum level of participation in the Exchange Offer.
 - The exchange ratio for the Exchange Offer was set at a level intended to encourage the D2 shareholders to tender their D2 stock.
- Does “economic substance” under section 7701(o) affect the analysis? (Is tax benefit “clearly consistent” with the statute and policies?)

Taxpayer Reform Act of 1997

- Added section 355(e) and section 368(a)(2)(H) to the Code.
- In general, these provisions turned off the application of the step transaction doctrine with respect to transactions following spin-offs for purposes of determining whether a distribution qualifies under section 355.
 - Section 368(a)(2)(H)(ii) provides that, in the case of a transaction with respect to which the requirements of section 355 (or so much of section 356 as relates to section 355) are met, the fact that the shareholders of the distributing corporation dispose of part or all of the distributed stock, or the fact that the corporation whose stock was distributed issues additional stock, shall not be taken into account.
 - Section 355(e) generally imposes a corporate level (but not shareholder level tax) if, pursuant to a plan, one or more persons acquire directly or indirectly stock representing a 50-percent or greater interest in D or C.
- Rev. Rul. 98-27 revoked Rev. Rul. 96-30 and acknowledged that step transaction principles no longer applied with respect to transactions engaged in by D or C following a spin-off.

Taxpayer Reform Act of 1997

- Rev. Rul. 2003-79 turned off the step transaction doctrine with respect to “born to die” transactions and quoted the following legislative history to section 355(e) and section 368(a)(2)(H):

The . . . bill does not change the present-law requirement under section 355 that the distributing corporation must distribute 80 percent of the voting power and 80 percent of each other class of stock of the controlled corporation. It is expected that this requirement will be applied by the Internal Revenue Service taking account of the provisions of the proposal regarding plans that permit certain types of planned restructuring of the distributing corporation following the distribution, and to treat similar restructurings of the controlled corporation in a similar manner. Thus, the 80-percent control requirement is expected to be administered in a manner that would prevent the tax-free spin-off of a less-than-80-percent controlled subsidiary, but would not generally impose additional restrictions on post-distribution restructurings of the controlled corporation if such restrictions would not apply to the distributing corporation.

H.R. Rep. No. 105-220, at 529-30 (1997); 1997-4 C.B. 1457, at 1999-2000.

Rev. Proc. 2013-3 No Rule

- Rev. Proc. 2013-3 provides that, until the IRS resolves the issue, it will no longer rule on:
 - Whether a corporation is a “controlled corporation” within the meaning of section 355(a)(1)(A) if, in anticipation of a distribution of the stock of the corporation, a distributing corporation acquires putative control of the controlled corporation (directly or through one or more corporations) in any transaction (including a recapitalization) in which stock or securities were exchanged for stock having a greater voting power than the stock or securities relinquished in the exchange, or if, in anticipation of a distribution of the stock of the putative controlled corporation, such corporation issues stock to another person having different voting power per share than the stock held by the distributing corporation.

Leveraged Spin-Offs

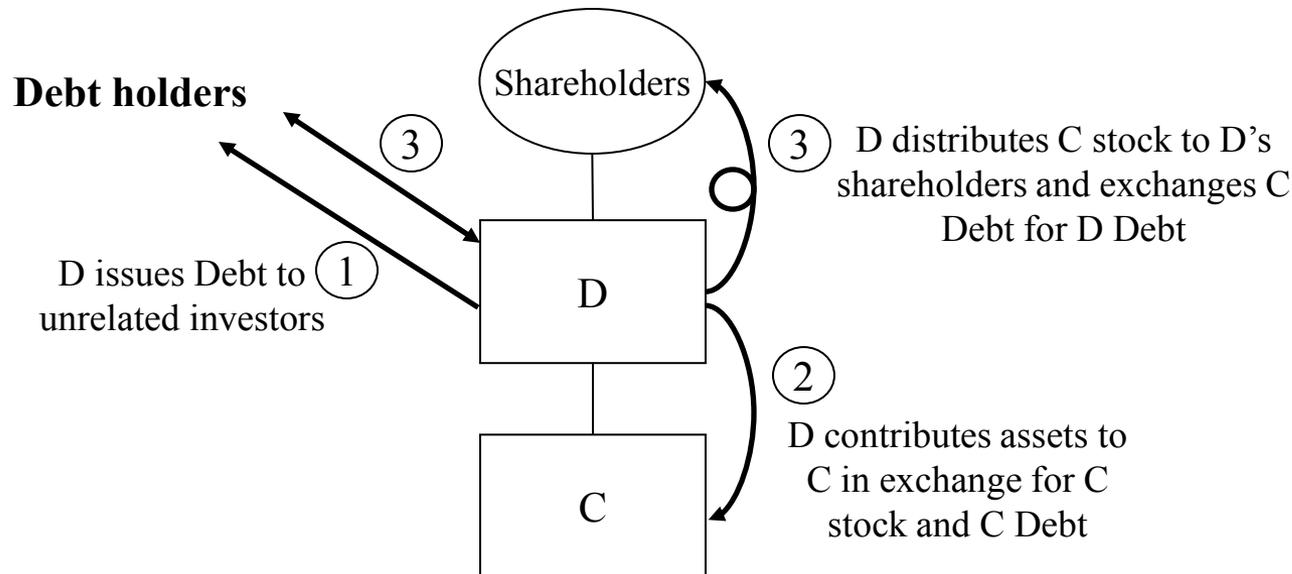


Repayment of Distributing Debt in Section 355 Spin-Offs

- To allocate debt between D and C in a D/355 spin-off transaction, D may transfer property to C in exchange for a combination of C stock and debt (or debt securities).
 - Typically, an investment banker will buy up D debt on the market and exchange the D debt for C securities.
- Section 361(a): General rule
 - No gain or loss shall be recognized to a corporation if such corporation is a party to a reorganization and exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation a party to the reorganization.
- Section 361(b): If other property (“boot,” i.e., not stock or securities) is received, then gain is generally recognized if the property is not distributed to the shareholders.
 - Section 361(b)(3): If, in a D/355 spin-off transaction, a distribution of boot to D is used to pay creditors of D, then no gain is recognized to the extent the value of the boot does not exceed the basis of the assets contributed to C in the reorganization.
- Section 361(c)(3): Any transfer of qualified property, including C securities, by D to its creditors in connection with the reorganization shall be treated as a distribution to its shareholders pursuant to the plan of reorganization.

PLR 201029007

Repayment of Distributing Debt in 355 Spin-off



- The IRS concluded that D will not recognize gain or loss on the transfer of C Debt under section 361(c) (with certain exceptions).
- The taxpayer represented that D Debt exchanged for C Debt “will not exceed the daily average outstanding third party indebtedness of D for the 365-day period ending” at the close of the last business day before D’s Board directed management to pursue the distribution.
- Compare to prior rulings requiring D Debt to be “old and cold”. *See* PLRs 200716024, 200345050, 200137011.

PLR 201029007 (cont'd)

- The ruling provides that D Debt will be issued to investors at least *g* days prior to distribution. The ruling does not specify when D and the investors will agree to the exchange of C Debt for D Debt.
- *Compare* PLR 201032017:
 - The Investment Banks acquired D debt (either by direct issuance or on secondary markets) at least *ii* days prior to date of exchange (assumed to be 14 days based on PLR 200802009).
 - An Exchange Agreement was entered into by the Investment Banks and D no sooner than *jj* days after the Investment Banks acquired the debt (assumed to be five days based on PLR 200802009).
 - It was anticipated that the Investment Banks would sell the C debt they received in the debt exchange.

Rev. Proc. 2013-3 No Rule

- Rev. Proc. 2013-3 provides that, until the IRS resolves the issue, it will no longer rule on:
 - Whether either section 355 or section 361 applies to a distributing corporation's distribution of stock or securities of a controlled corporation in exchange for, and in retirement of, any putative debt of the distributing corporation if such distributing corporation debt is issued *in anticipation of* the distribution.

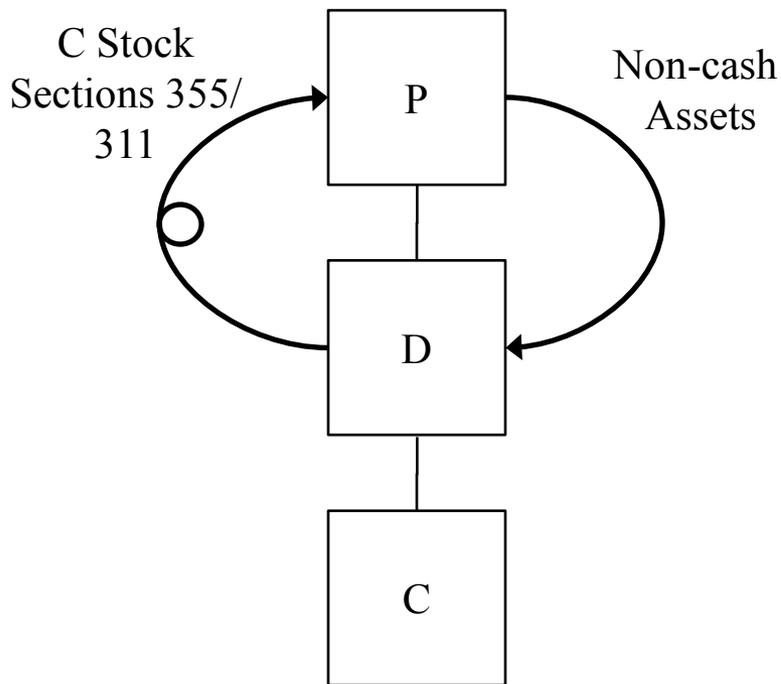
Proposed Legislation

- The Senate version of the 2012 Highway Bill proposed to change section 361 to treat C securities and non-qualified preferred stock as “other property.”
- The final legislation did not include this provision.

North-South Transactions



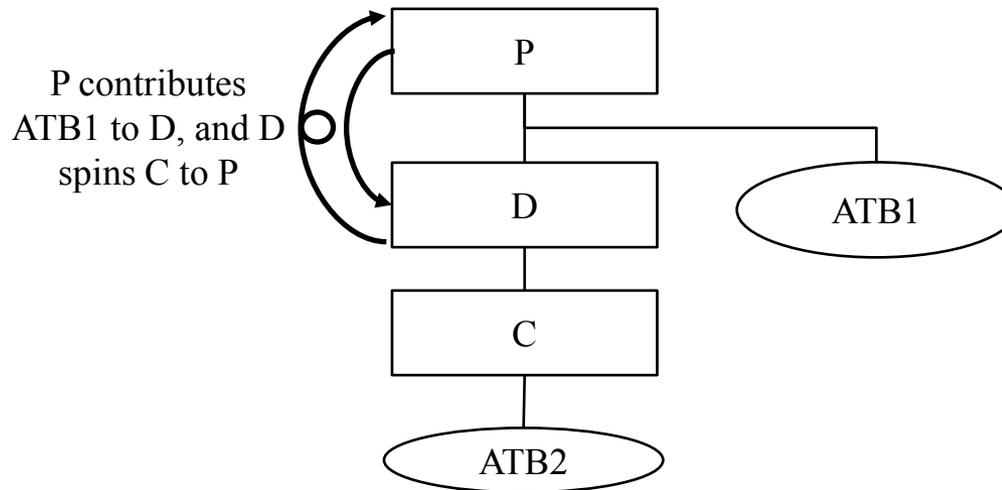
North-South Variation: Transfers Between Shareholder and Distributing



•**Facts:** P owns all of the stock of D, which owns all of the stock of C (FMV=\$100). P contributes non-cash assets to D, and D spins-off C stock to D in a transaction that either does or does not qualify under section 355 (in each case, disregarding the contribution).

- Alternative A: Suppose the assets P contributes are contributed so that D can satisfy its debt covenants.
- Alternative B: Suppose there is no legal or economic compulsion for P to contribute assets to D and the assets have FMV of (a) \$10, (b) \$100, or (c) \$110.
- Alternative C: Suppose the assets P contributes are necessary for D to satisfy the active trade or business requirement of section 355 and D would recognize a large gain if the transaction were to fail to satisfy section 355.
- Alternative D: Suppose (a) the contribution precedes the distribution, (b) the distribution precedes the contribution, or (c) the contribution and distribution are simultaneous.
- Alternative E: Suppose there is (a) documentation characterizing the contribution and distribution as an exchange or (b) no such documentation.
- Alternative F: Suppose P is an individual, rather than a corporation.

North-South Transactions (cont'd)



- PLR 201033007: P contributes ATB1 (the active business to be relied on by D in subsequent spin-off) to D. D then distributes C to P. Are the contribution and distribution considered to be an exchange under “North-South” principles?
- The taxpayer represented: “There is no regulatory, legal, or economic compulsion or requirement that the Asset Contributions be made as a condition of the Internal Distribution. The fact that the value of Distributing 1 will decrease as a result of the Internal Distribution was not a consideration in the decision to contribute property to Distributing 1. The Internal Distribution is not contingent on there being contributed to Distributing 1 assets having a specified (or roughly specified) value.” *See also* PLRs 201034005, 201030005, 201007050. *See generally* Treas. Reg. section 1.301-1(l).
- What if D’s distribution to P was a split-off? Does it matter whether the shares redeemed include the D shares issued (or deemed issued) in the contribution by P?
- Other North-South rulings: 201014048 (F reorganization into Newco and subsequent redemption of some Newco shares in exchange for a Newco note, treated as separate); PLR 201047016 (above).

North-South Transactions (cont'd)

- In two more recent private letter rulings (PLR 201136009 and 201106004) the IRS apparently expanded its policy on “North-South” transfers in the section 355 context to transfers between D and C.
- In PLR 201202007, the IRS apparently extended non-exchange treatment beyond a section 355 stock distribution to a section 301 stock distribution (the representation covers the issue although there is no specific ruling on the issue).

Rev. Proc. 2013-3 No Rule

- Rev. Proc. 2013-3 provides that, until the IRS resolves the issue, it will no longer rule on:
 - Whether transfers of stock, money, or property by a person to a corporation and transfers of stock, money, or property by that corporation to that person (or a person related to such person) in what are ostensibly two separate transactions (so-called “north-south” transactions), at least one of which is a distribution with respect to the corporation’s stock, a contribution to the corporation’s capital, or an acquisition of stock, are respected as separate transactions for Federal income tax purposes.

Active Trade or Business - Goodwill

Active Trade or Business Regulations – SAG Rules

- In May 2006, section 355(b)(3) was added to the Code.
- Section 355(b)(3) permits D or C to satisfy the ATB requirement through the activities of members of its separate affiliated group, or “SAG.”
- In May 2007, Prop. Reg. section 1.355-3 was issued to update the ATB regulations to reflect the SAG rules.
- These regulations address certain issues created by the SAG rules including:
 - The application of section 355(b)(2)(C) to sales of stock between SAGs.
 - The location of an ATB that has assets in multiple members of the group.
- Status?

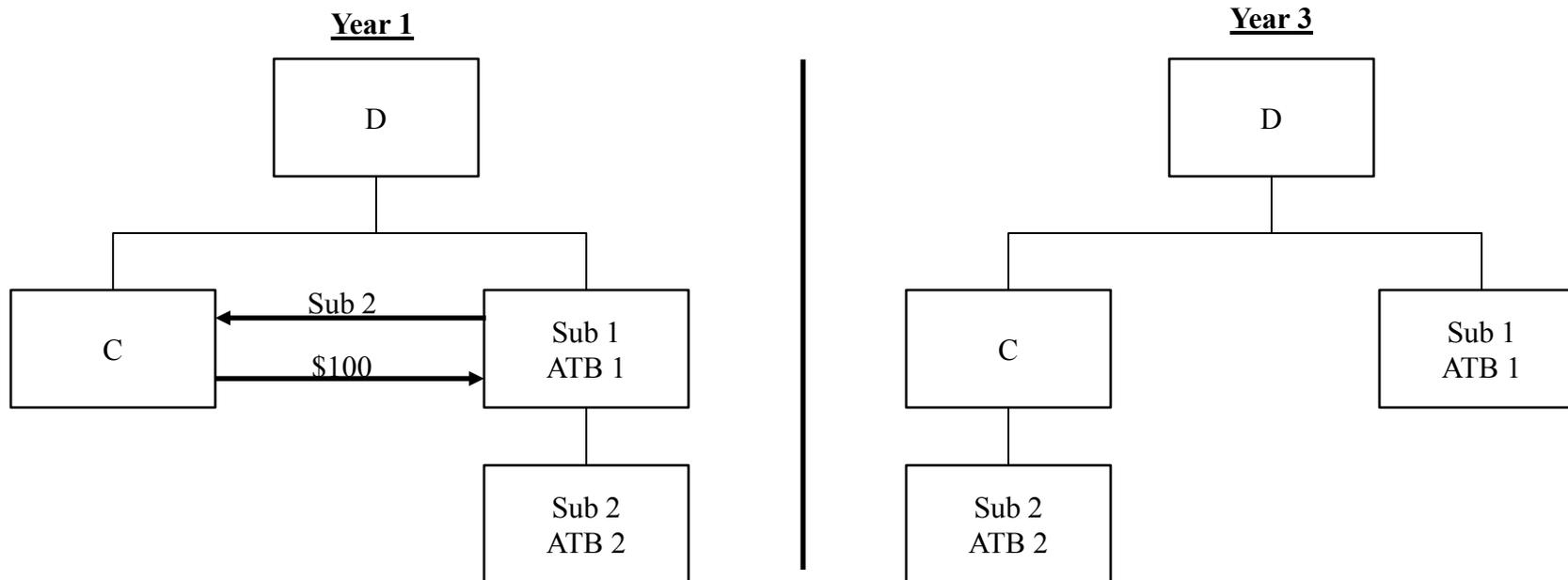
Active Trade or Business Regulations - Goodwill

- Prop. Treas. Reg. section 1.355-3(b)(2)(iii) states: “A corporation will not be treated as engaged in the active conduct of a trade or business unless it (or its SAG, or a partnership from which the trade or business assets and activities are attributed) is the principal owner of the goodwill and significant assets of the trade or business for Federal income tax purposes.”
- Subsequent to the issuance of the proposed active trade or business regulations, the IRS generally required a representation regarding goodwill in connection with the issuance of a private letter ruling such as the following:
 - Neither Business A nor control of an entity conducting this business will have been acquired during the five-year period ending on the date of the Distribution in a transaction in which gain or loss was recognized (or treated as recognized) in whole or in part, except for transactions that have expanded Business A. Throughout the five-year period ending on the date of the Distribution, Distributing has been the principal owner of the goodwill and significant assets of Business A and will continue to be the principal owner following the Distribution.
- Recently, a number of private letter rulings seem to lack the goodwill representations. *See, e.g.*, PLR 201245020, PLR 201233016, PLR 201216027.
- Do taxpayers need to make the goodwill representation to obtain private letter rulings in the section 355 context?

Active Trade or Business – Affiliated Group Sales



Affiliated Group Sales



- D, C, Sub 1, and Sub 2 file a consolidated return.
- In year 1, Sub 1 sells all of the stock of Sub 2 to C for \$100.
- In year 3, D would like to distribute all of the stock of C to its shareholders in a section 355 distribution.
- D relies on Sub 1's ATB 1 to satisfy the ATB requirement.
- Can C rely on Sub 2's ATB 2 to satisfy ATB in year 3?

Affiliated Group Sales

- Current Treas. Reg. section 1.355-3(b)(4)(iii) provides that, for purposes of transactions engaged in prior to December 15, 1987, sections 355(b)(2)(C) and 355(b)(2)(D) do not apply to an acquisition of an ATB by one member of an affiliated group from another member of an affiliated group.
- Prop. Treas. Reg. section 1.355-3 provides that sections 355(b)(2)(C) and 355(b)(2)(D) do not apply to an acquisition of an ATB by one member of a SAG from another member of a SAG. However, they do not extend this rule to sales between affiliates that are not members of the same SAG.
- Notice 2007-60 provides that, for certain limited purposes, taxpayers may continue to rely upon Treas. Reg. section 1.355-3(b)(4)(iii) until temporary or final SAG ATB regulations are published.

Predecessor/Successor Rules and Prop.
Treas. Reg. 1.355-8

Section 355(e) Successor

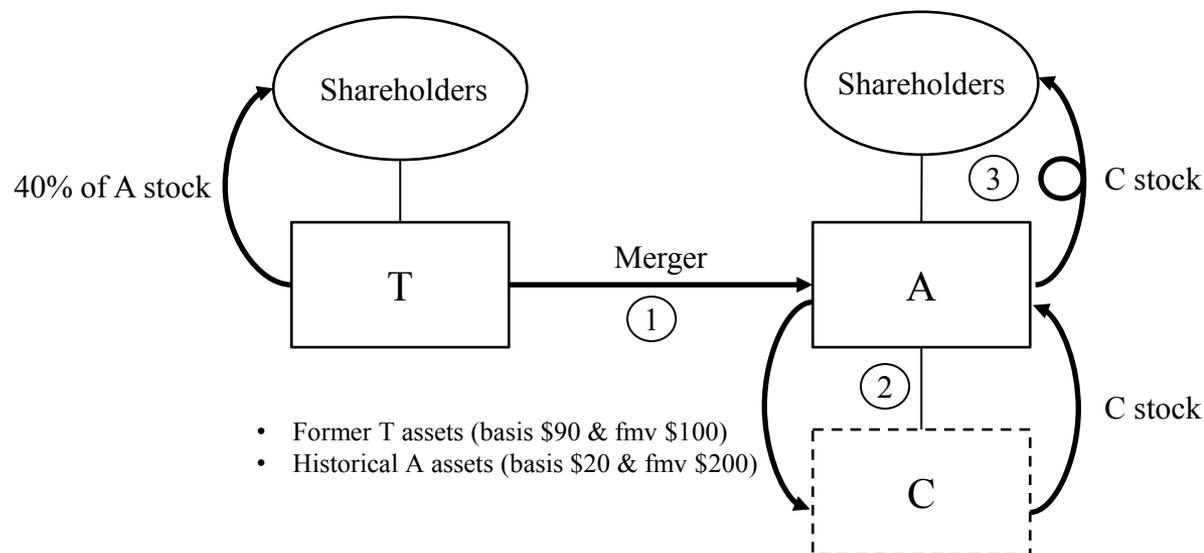
- Section 355(e)(3)(B) refers to a successor in a reorganization described in sections 368(a)(1)(A), (C), and (D).
- Section 355(e)(4)(D) states that, for purposes of section 355(e), any reference to a controlled corporation or a distributing corporation shall include a reference to any predecessor or successor of such corporation.
- Unlike section 355(e)(3)(B), which refers to a successor in a section 368(a)(1)(A), (C), and (D) reorganization involving an asset transfer, section 355(e)(4)(D) provides no definition of the term successor.
- Prop. Treas. Reg. section 1.355-8, which was issued in 2004, states that a successor of D or C, respectively, is a corporation to which D or C transfers property after the distribution in a transaction to which section 381 applies (a successor transaction).
 - A predecessor of D is a corporation (the first corporation) that before the distribution transfers property to D in a transaction to which section 381 applies (the combining transfer), but only if certain requirements are satisfied.
 - A corporation is a predecessor of C if, before the distribution, it transfers property to C in a transaction to which section 381 applies.
- Thus, in the absence of a section 381(a) transaction, there can be neither a successor nor a predecessor for purposes of section 355(e) under the proposed regulations. The preamble to the proposed regulations requested comments.

Section 355(e) Successor

Prop. Treas. Reg. section 1.355-8(e)(2) provides that:

- If a distribution and acquisitions of stock that in the aggregate represent a 50-percent or greater interest in a predecessor of D are part of a plan,
- The amount of gain recognized by D by reason of section 355(e) as a result of the acquisitions shall not exceed the amount of gain, if any, that the predecessor of D would have recognized if:
 - immediately before the distribution, the predecessor of D had transferred the property that was transferred to C in the separating transfer and stock of C that the predecessor of D transferred to D in the combining transfer to a newly-formed, wholly-owned corporation in exchange solely for stock of such corporation in an exchange to which section 351 applied, and
 - then sold the stock of that corporation to an unrelated person in exchange for cash equal to its fair market value.

Section 355(e) Successor



- T merges into A, with T shareholders receiving 40 percent of the stock of A.
- Pursuant to a plan, A contributes (a) former T assets with a basis of \$90 and a fair market value of \$100 and (b) historical A assets with a basis of \$20 and a fair market value of \$200 to C and distributes the stock of C to its shareholders.
- Assume the transaction satisfies the requirements of section 355 (other than potentially section 355(e)); does A recognize gain on the distribution of the C stock and, if so, how much gain?
- What is the IRS ruling policy regarding section 355(e) successor issues?
- What is the status of the successor regulations?

REIT Spin-Offs



History of REIT Spin-Offs: Before 2001

- In Rev. Rul. 73-236, D spun off its sales business and assets as a separate entity, retaining its property rental business and assets. Immediately after the distribution, D elected REIT status.
 - At the time, section 856(d)(3) prevented entities from qualifying as REITs if they provided services to tenants or managed/operated property.
 - IRS concluded that, under section 856(d)(3), a REIT could not satisfy the active trade or business requirement of section 355(b)(1).

Rev. Rul. 2001-29

- The Tax Reform Act of 1986 amended section 856(d)(2)(C) to operate in conjunction with Treas. Reg. section 1.512(b)-1(c)(5), allowing REITs to provide services usually or customarily rendered in the ordinary course of renting property.
- Rev. Rul. 2001-29 concluded that REITs could now satisfy the active trade or business requirement of section 355(b)(1).
 - Rev. Rul. 73-236 was obsoleted.
- Rev. Rul. 2001-29 cautioned that “the obsolescence of Rev. Rul. 73-236 does not imply a view whether a distribution of stock involving a REIT election by the distributing or controlled corporation would otherwise satisfy the requirements of section 355, including the business purpose requirement.”

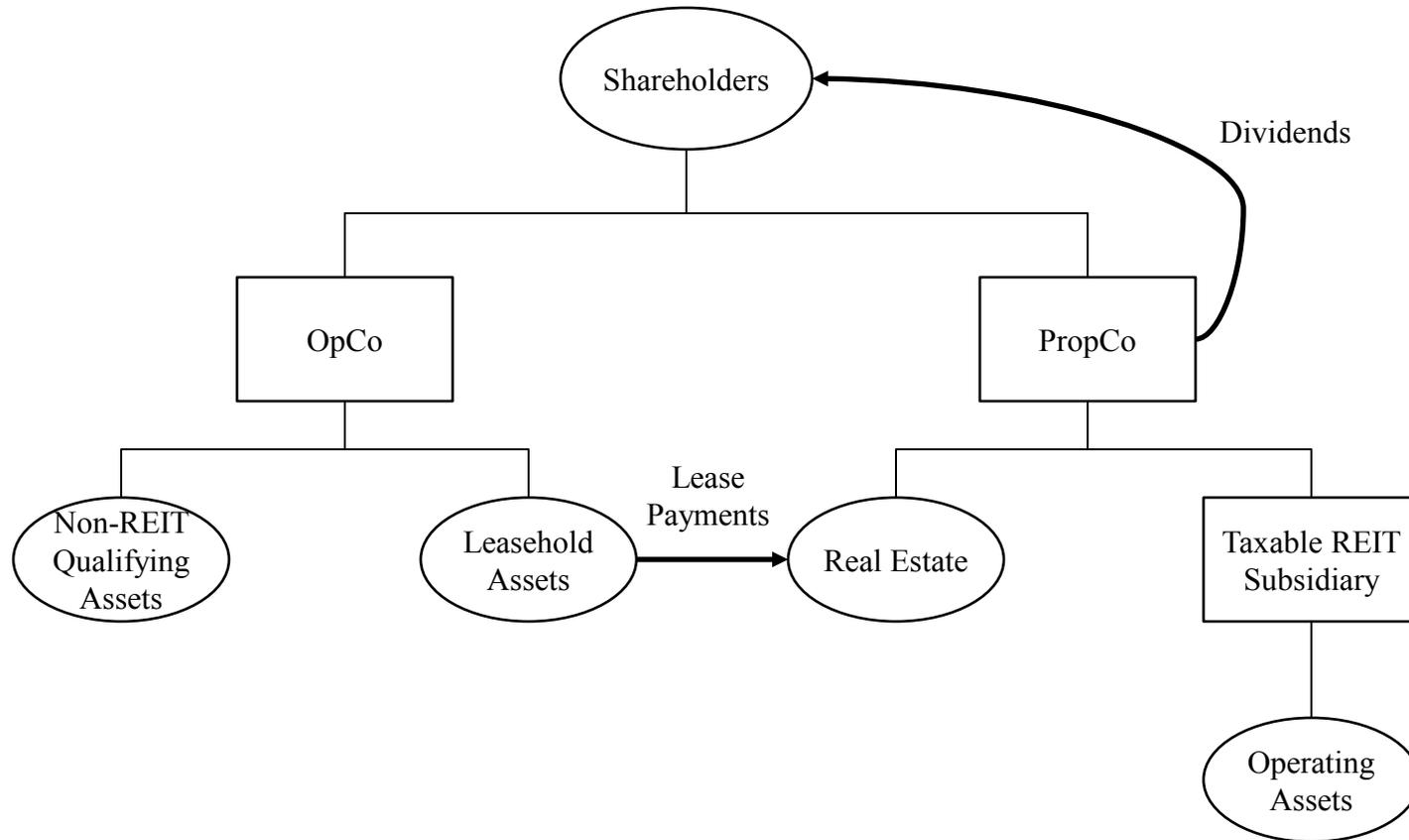
REIT Spin-Offs and Business Purpose

- Under Treas. Reg. section 1.355-2(b)(2), obtaining favorable federal tax treatment is not a valid business purpose for a section 355 distribution.
- Treas. Reg. section 1.355-3(b)(2)(iii) provides that the IRS will “carefully scrutinize” separations of owner-occupied real estate for business purpose.
- REITs are permitted to deduct, at the corporate level, any income distributed as dividends, effectively eliminating one level of tax.
 - Is the goal of obtaining REIT status for D or C an impermissible business purpose?
 - Is intent to elect REIT status following a spin-off evidence of device?
 - The IRS will no longer rule on what constitutes a valid business purpose.
 - The IRS’s Section 355 Committee has accepted a representation stating that a spin-off’s business purpose is to increase C’s value to investors by electing REIT status for C.
 - In PLR 200932018, the IRS granted tax-free treatment to the spin-off of newly-formed C, followed by the merger of C with and into a REIT, with the surviving REIT continuing to operate as such.
 - The IRS may be sympathetic to spin-offs where D owns a substantial amount of real estate, wants to separate the real estate from its other businesses due to regulatory constraints, but is not able to effect the separation unless C can compete in the marketplace as a REIT.

Recent REIT Spin-Off PLR

- In its 8K filed November 16, 2012, OpCo announced that it will contribute all of its real estate assets to newly-formed PropCo, then distribute PropCo to OpCo's shareholders.
- As part of the same plan, PropCo will elect to be a REIT, distribute its historical subchapter C E&P in a taxable dividend, and lease the majority of its real estate back to OpCo.
- To comply with REIT income rules that apply section 318 attribution, shareholders will reduce their indirect interest in PropCo to under 10% as part of the spin-off.
- In the 8K, OpCo disclosed that it had obtained a PLR relating to “the tax treatment of the separation and the qualification of PropCo as a REIT.”
 - This PLR has not yet been released.
- This planning strategy, the “McREIT,” had not been previously tested in a PLR.

Post-Spin-Off Structure



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