

# SELECT ISSUES IN TAX-FREE DISTRIBUTIONS UNDER SECTION 355

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# Select Issues to be Discussed

- \* Section 355 – In General
- \* Section 355- Private Letter Ruling Process
- \* 2013 Developments from the IRS
  - \* Dual-Class Stock structures
  - \* North-South transactions
  - \* Leveraged Spin-offs
- \* The End of Section 355 Rulings?
  - \* Significant issues
- \* Tax Opinions in Section 355 Transactions

# Section 355 – In General

- \* Three primary forms for Section 355 transactions.
  - \* Spin-off: The distributing corporation (“Distributing”) distributes the stock of a controlled corporation (“Controlled”) *pro rata* to its shareholders.
  - \* Split-off: Distributing distributes the stock of Controlled to particular shareholders in exchange for their Distributing stock.
  - \* Split-up: Distributing distributes stock of Controlled corporations to its shareholders, followed by a liquidation of Distributing.
- \* There is also a “splint-off”, which combines a split-off with a spin-off.
  - \* See Revenue Ruling 2003-52.

# Section 355 – In General

- \* After the repeal of the “General Utilities” doctrine in the 1986 Tax Reform Act, Section 355 of the Code became the primary way to get assets out of corporate solution without federal income tax.
- \* Section 355 permits a tax-free distribution of the stock of Controlled to the shareholders of Distributing, provided that a number of statutory and non-statutory requirements are met.

# Section 355 – In General

- \* The statutory requirements include:
  - \* A distribution by Distributing to its shareholders with respect to their stock or to its securities holders in exchange for their securities of solely stock or securities of Controlled.
  - \* Not principally a device for the distribution of earnings and profits.
  - \* Active trades or businesses immediately after the distribution.
  - \* Distribution of all of Distributing's stock or securities in Controlled (or at least an amount constituting control and no principal purpose of avoiding federal income tax for retaining any Controlled stock or securities).

# Section 355 – In General

- \* The non-statutory requirements include:
  - \* Business purpose motivates the distribution in whole or substantial part.
  - \* Continuity of interest (“COI”).
    - \* Note that the Section 368 COI test does not apply.
  - \* Continuity of business enterprise (“COBE”).

# Section 355 – In General

- \* “Control” is based on Section 368(c) and depends on 80% or more of total combined voting power and 80% or more of all other classes of stock.
  - \* Revenue Ruling 59-259 interprets the control test to apply to each other class of nonvoting stock.
- \* The Section 368(c) control test differs from the Section 1504(a) affiliation test, which is based on 80% or more total voting power and 80% or more of total value.
- \* The most recent revenue proposal by the Obama administration would eliminate the Section 368(c) control test in favor of the affiliation test for transactions occurring after December 31, 2014.

# Section 355 – In General

- \* Even if the statutory and non-statutory requirements are met, other provisions may also result in taxability of a spin-off:
  - \* Specialized rules for certain purchases and acquisitions of distributing or controlled stock that can cause gain at the corporate level.
    - \* Section 355(d) and (e).
  - \* Other specialized rules for affiliated groups and disqualified investment corporations.
    - \* Section 355(f) and (g).

# Section 355 – In General

- \* Section 355 distributions of Controlled may be tax-free to Distributing under one of two Code provisions.
  - \* **Section 361(c).** Includes where Distributing forms Controlled as a new subsidiary in connection with the transaction and contributes the business being distributed, then nonrecognition at the corporate level is provided under Section 361(c) of the Code.
    - \* This is because the Distribution involves a “reorganization” – a “D/355” transaction.
  - \* **Section 355(c).** If Controlled is “old and cold”, then Distributing would be afforded nonrecognition treatment under Section 355(c) of the Code.

# Section 355 – In General

- \* Section 355(c) versus Section 361(c).
  - \* Whether there is a reorganization can affect the allocation of earnings and profits.
    - \* Treas. Reg. 1.1502-33(a) (reorganization) and Treas. Reg. 1.1502-33(b) (no reorganization).
  - \* A D/355 also implicates other rules that apply only in the reorganization context.
    - \* For example, when indebtedness of Controlled is distributed to holders of Distributing securities.
    - \* COBE under Section 355 versus COBE under Section 368?

# Section 355 – In General

- \* Tax stakes for a qualifying distribution.
  - \* Very high – if the distribution does not qualify under Section 355, then it would be a taxable distribution of stock by Distributing to its shareholders.
    - \* Potential for taxable gain at the Distributing level.
    - \* Potential for taxable dividend to Distributing's shareholders.
    - \* No step-up in inside basis of Controlled's assets.
      - \* Section 336(e) regulations can mitigate the potential negative consequences.

# Section 355 – Private Letter Ruling Process

- \* Taxpayers (especially public companies) typically would seek a private letter ruling (PLR) from the Internal Revenue Service (IRS) because of the high stakes.
- \* The PLR would rule on the qualification under Section 355 of the distribution of Controlled's stock by Distributing to its shareholders, but would expressly note that certain issues were not being ruled on.

# Section 355 – Private Letter Ruling Process

- \* Typical rulings include:
  - \* Tax-free nature of the distribution under Section 355 to Distributing and its shareholders.
  - \* Tax basis and holding period of shareholders in Distributing and Controlled stock.
  - \* Fractional shares.
  - \* Treatment of payments made by the parties in connection with distribution agreements.
  - \* Earnings and profits allocation.
  - \* Retained Controlled stock.

# Section 355 – Private Letter Ruling Process

- \* The PLR is still subject to verification by the field that the facts submitted by and representations made by the taxpayer were accurate.
- \* If the taxpayer cannot substantiate the facts and representations, the PLR may be of little benefit.

# Section 355 – Private Letter Ruling Process

- \* The IRS has published guidelines for submitting Section 355 PLR requests.
  - \* Revenue Procedure 96-30 provides a very detailed set of facts to be provided to the IRS and a number of representations that the IRS expects taxpayers to make.
  - \* Revenue Procedure 96-30 was modified by Revenue Procedure 2003-48, in which the IRS indicated that it would not longer rule on business purpose, device and whether there was a “plan” under Section 355(e).

# Section 355 – Private Letter Ruling Process

- \* Following the publication of Revenue Procedure 2003-48, the IRS published a number of revenue rulings under Section 355.
  - \* See, e.g., Revenue Ruling 2003-74, Revenue Ruling 2003-75, and Revenue Ruling 2004-23.
  - \* These rulings provide guidance on a number of issues that are relevant in a spin-off.
    - \* Types of business purposes for a spin-off.
    - \* Overlapping board members.
    - \* Continued agreements between Distributing and Controlled.
    - \* The existence of a greater-than-5% shareholder.

# Section 355 – Private Letter Ruling Process

- \* In recent years, the IRS also had been issuing PLRs that provided taxpayer favorable conclusions in a number of areas.
  - \* Dual-Class Stock structures.
  - \* North-South transactions.
  - \* Leveraged Spin-offs.
- \* Ruling guidelines established that the IRS would issue PLRs where there were “significant issues” in a Section 355 transaction. See, e.g., Revenue Procedure 2012-3.

# Section 355 – Private Letter Ruling Process

- \* Dual-Class Stock Structure.
  - \* The existence of tax control using high-vote/low-vote stock structures (“Dual-Class Stock structures”) that were unwound after the spin-off.
    - \* Revenue Ruling 69-407 and a “permanent realignment” of voting control.
    - \* Unwinding of the Dual-Class Stock structure was possible right after the distribution so long as it was not pre-wired.

# Section 355 – Private Letter Ruling Process

- \* **Dual-Class Stock Structure Example.** In advance of a carve-out IPO, Distributing recapitalizes the stock of Controlled into a low-vote (Class A) and high-vote (Class B) stock structure. Distributing issues the public shares of Class A stock that have 30% of the value of Controlled's stock, but only 10% of the voting power. Even though Distributing and Controlled are not eligible to file a consolidated return (Section 1504 requires 80% vote/80% value), Distributing has Section 368(c) tax control of Controlled. Distributing subsequently distributes its Class B stock of Controlled to its shareholders. The Controlled shareholders vote, immediately after the distribution, to unwind the Dual-Class Stock structure.

# Section 355 – Private Letter Ruling Process

- \* North-South Transactions.
  - \* The movement of assets between a shareholder, Distributing and/or Controlled in connection with the spin-off (a “North-South” transaction).
    - \* The issue is whether there is a sale or exchange occurring or a tax-free distribution.
    - \* The IRS has ruled that the movement of assets “south” to Distributing and the movement of assets “north” from Controlled were not integrated transactions provided that there was not a regulatory, legal, contractual, or economic compulsion or requirement to make part or all of the contribution as part of the distribution.

# Section 355 – Private Letter Ruling Process

- \* **North-South Transaction Example.** The parent (“Parent”) of Distributing contributes Business A to Distributing and Distributing distributes Controlled stock to Parent. If the transactions are treated as separate, then the transaction results in a tax-free spin-off. If the transactions are treated as an exchange, then Parent may be taxed on the contribution of the Business A assets to Distributing, and Distributing may be taxed on the Distribution of Controlled stock.

# Section 355 – Private Letter Ruling Process

- \* Leveraged Spin-offs.
  - \* The retirement of Distributing liabilities using Controlled stock or securities in connection with the spin-off (a “Leveraged Spin-off”).
    - \* The reorganization rules permit this to be accomplished on a tax-free basis.
    - \* This contrasts with the excess loss account rules that are implicated if Controlled borrowed funds and distributed cash to Distributing and the potential application of Section 357(c) if Controlled assumed Distributing liabilities.

# Section 355 – Private Letter Ruling Process

- \* **Leveraged Spin-off Example.**

- \* Distributing contributes Business A to Controlled in exchange for stock and securities of Controlled. Distributing issues short-term debt to an investment bank in exchange for cash before a planned distribution of Controlled stock and securities. In the distribution, shareholders of Distributing receive a *pro rata* distribution of Controlled stock and investment bank receives Controlled securities in exchange for its Distributing debt. Distributing retains the cash from the debt issuance, but its related debt has been retired using the Controlled securities.

# 2013 Developments from the IRS

- \* In January 2013, the Internal Revenue Service published its annual “no-rule” revenue procedure.
- \* Revenue Procedure 2013-3 expanded the no-rule areas under Section 355 to cover certain Dual-Class Stock structures, North-South transactions, and Leveraged Spin-offs.
- \* The suspension of rulings in this area, pending the outcome of a study by the Treasury Department, had an immediate effect on taxpayers.
- \* For example, taxpayers effecting a “carve-out IPO” of a subsidiary followed by a later distribution now had to forgo using Dual Class Stock structures if they wanted a PLR.
  - \* This was the case even if they were willing to leave the high-vote/low-vote stock in place for a period of time.

# 2013 Developments from the IRS

- \* IRS representatives spent a good portion of late winter/spring 2013 discussing the new no-rule areas.
- \* Then in late spring, rumors began to circulate that the IRS would suspend issuing rulings under Section 355 in an even broader manner.

# 2013 Developments from the IRS

- \* This came to fruition with the publication of Revenue Procedure 2013-32, which announced that the IRS would not issue PLRs on the qualification of a distribution under Section 355, subject to an August 23, 2013, grandfather date.
  - \* Many taxpayers scrambled to submit their PLR requests to the IRS before the deadline in order to obtain a PLR.
- \* The IRS stated that it would only rule on a “significant issue” presented in a Section 355 distribution or on a significant issue presented under a Code section that addresses the federal income tax consequences of a transaction that qualifies as a Section 355 distribution.
  - \* The no-rule position also applies to transactions under Sections 332, 351, 368 and 1036.

# 2013 Developments from the IRS

- \* Qualification under Section 355 will not be ruled on even if the transaction presents a significant issue and even if the transaction is an integral part of a larger transaction that involves other issues upon which the IRS will rule.
- \* An example in this revenue procedure of an area in which the IRS would still potentially rule if there were a “significant issue” is the application of the continuity of business enterprise rules of Treas. Reg. 1.368-1(d).

# The End of Section 355 Rulings?

- \* Revenue Procedure 2014-3 incorporates the recent no-rule position changes for Section 355 transactions.
- \* The IRS will not rule on:
  - \* Whether a transaction qualifies under Section 355 (and other Code provisions) for nonrecognition treatment;
  - \* Whether the transaction constitutes a corporate reorganization within the meaning of Section 368; and
  - \* Whether various tax consequences (such as nonrecognition and basis) result from the application of that section.
- \* The IRS will rule on:
  - \* Significant issues presented in a Section 355 transaction.
  - \* One or more significant issues under the Code sections that address the tax consequences (such as nonrecognition and basis) that result from the qualification of a transaction Section 355.

# The End of Section 355 Rulings?

- \* Revenue Procedure 2014-3 also should be consulted regarding the IRS's ruling policy in other areas applicable to PLRs under Section 355.
- \* For example, the no-rule policy with respect to integrated transactions.
- \* As another example, Dual-Class Stock structures and Leveraged Spin-offs remain under study.
  - \* While these appear to be “significant issues” for taxpayers under Section 355, a PLR is not available.

# The End of Section 355 Rulings?

- \* Note that, as the scope of the no-rule policy expanded, the IRS made changes to the definition of a significant issue.

# The End of Section 355 Rulings?

- \* **Revenue Procedure 2013-3**

**“SIGNIFICANT ISSUE:** A significant issue is an issue of law that meets the three following tests: (1) the issue is not clearly and adequately addressed by a statute, regulation, decision of a court, tax treaty, revenue ruling, revenue procedure, notice, or other authority published in the Internal Revenue Bulletin; (2) the resolution of the issue is not essentially free from doubt; and (3) the issue is legally significant and germane to determining the major tax consequences of the transaction. An issue of law will be considered not clearly and adequately addressed by the authorities above, and its resolution will not be essentially free from doubt when, because of concern over a legal issue (as opposed to a factual issue), taxpayer’s counsel is unable to render an unqualified opinion on what the tax consequences of the transaction will be.”

# The End of Section 355 Rulings?

- \* **Revenue Procedure 2013-32**

“(3) For purposes of this revenue procedure, a significant issue is an issue of law the resolution of which is not essentially free from doubt and that is germane to determining the tax consequences of the transaction. An issue the resolution of which is not essentially free from doubt under one Code section may nevertheless not be germane to determining the tax consequences of the transaction if, for instance, another Code section provides the same consequences as the first Code section. For example, the Service may decline to rule on an issue under section 368 with respect to an upstream merger of a wholly owned subsidiary into its shareholder if qualification of the transaction under section 332 is essentially free from doubt and it is essentially free from doubt that the tax consequences of section 332 qualification would be the same as the tax consequences that would result if the transaction constituted a reorganization within the meaning of section 368. In such an overlap case, the taxpayer must explain why the issue is germane to determining its tax consequences.”

# The End of Section 355 Rulings?

- \* **Revenue Procedure 2014-3**

**“SIGNIFICANT ISSUE:** A significant issue is an issue of law the resolution of which is not essentially free from doubt and that is germane to determining the tax consequences of the transaction. A change of circumstances arising after a transaction ordinarily does not present a significant issue with respect to the transaction.”

# The End of Section 355 Rulings?

- \* Guidance as to what constitutes a “significant issue” under Section 355 has not been provided, leaving tax practitioners uncertain as to when a PLR on a significant issue may be obtained.
- \* In cases when the IRS has been questioned on whether a particular issue might be considered “significant” for these purposes, the IRS has not been able to confirm in advance whether a PLR would be available.
- \* See Cummings, “Spinoff Auditing, Opinions, and Rulings,” Tax Notes (January 6, 2014).

# The End of Section 355 Rulings?

- \* So, where does that leave taxpayers?
  - \* Unless grandfathered in under the current rules, taxpayers generally will not be able to obtain a PLR on the qualification of a transaction under Section 355.
  - \* This will deprive taxpayers of the primary form of comfort that had been available that a distribution was tax-free.
  - \* However, tax counsel had previously been opining on the areas in which the IRS would not rule (business purpose, device and Section 355(e) plan).
  - \* It is expected that tax counsel will undertake a greater role in issuing opinions with respect to Section 355 transactions.

# Tax Opinions in Section 355 Transactions

- \* Broader tax opinions for Section 355 transactions are likely to become standard.
- \* These tax opinions will rely on the same types of information and representations that taxpayers have been providing to the IRS in connection with Section 355 PLR requests.
- \* Without the availability of a PLR, tax counsel will have to address issues raised by the three no-rule items in Revenue Procedure 2013-3.

# Tax Opinions in Section 355 Transactions

- \* In recent public appearances, IRS officials have indicated that:
  - \* The IRS does not expect to issue guidance on North-South transactions soon.
  - \* The IRS has indicated that it would likely interpret the Leveraged Spin-off no-rule to apply to debt issued at some point during the planning stages of a spin-off.
- \* What about recapitalizations into control of a subsidiary? How long before the structure can safely be unwound?
  - \* Two years? Five years?
  - \* Revenue Ruling 69-407.
- \* The long-term impact of the IRS's ruling policy continues to develop.

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