Alternatives to Section 355

ABA – Section of Taxation
Closely Held Business Committee

Hollywood, FL – January 19, 2006

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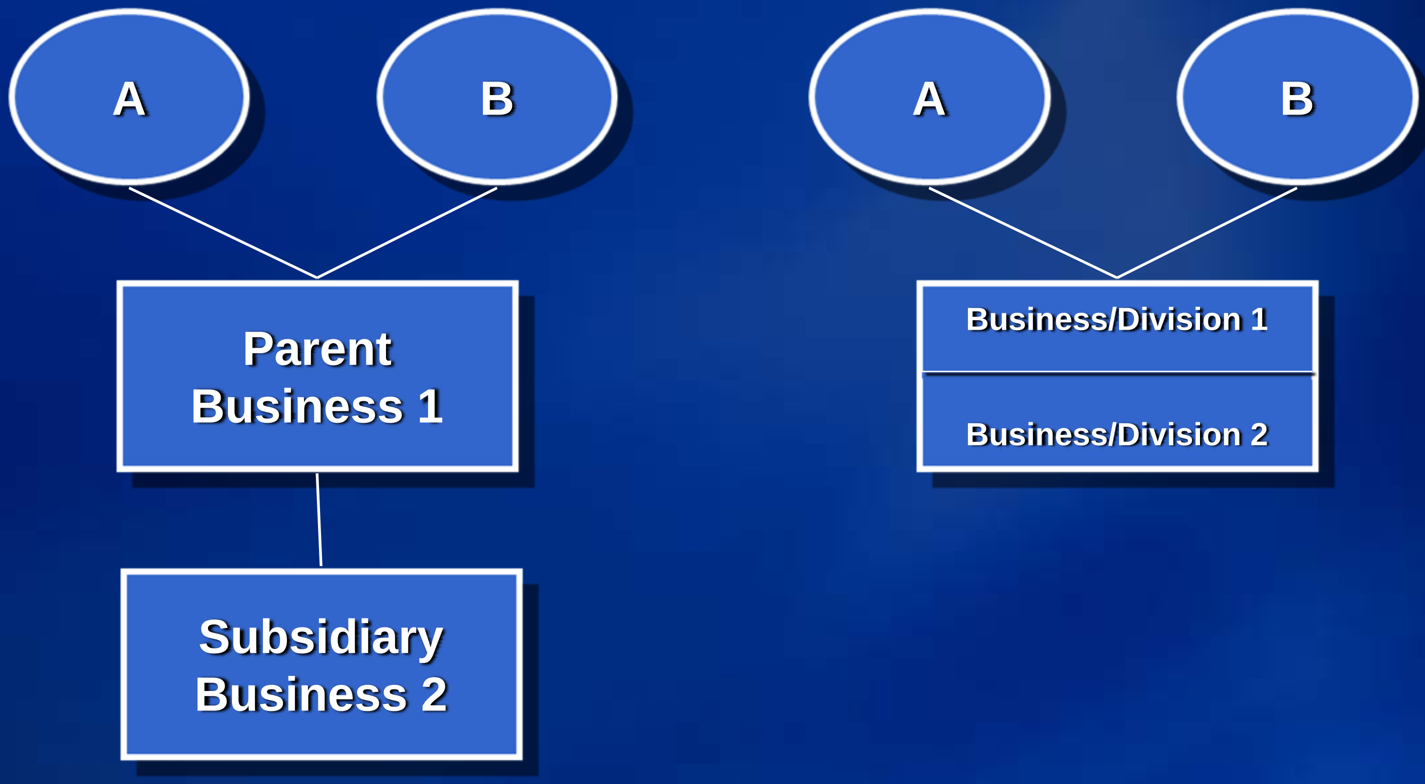
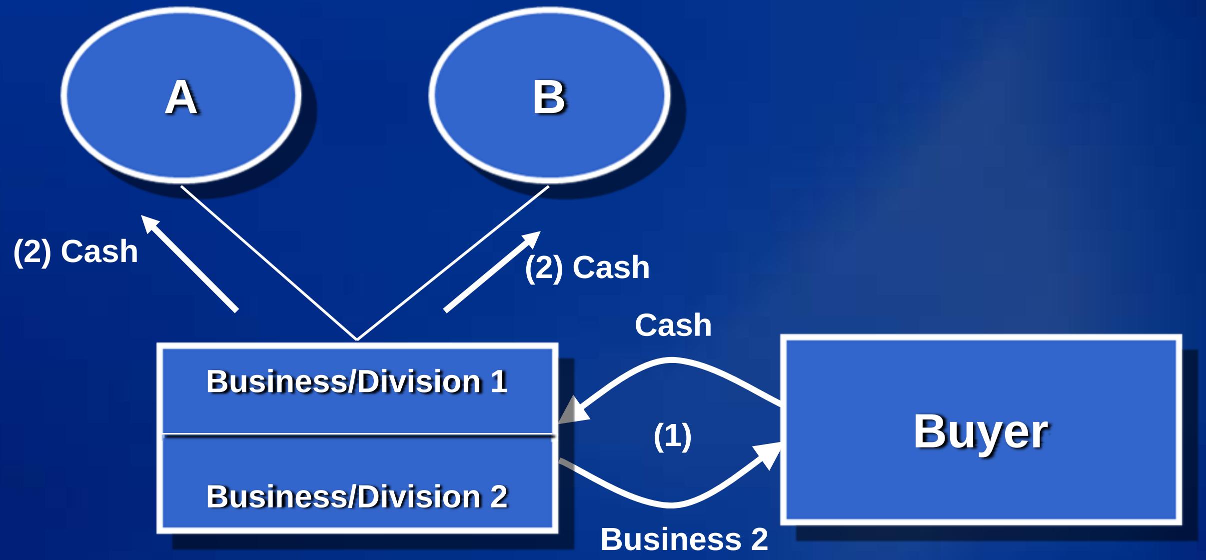
Typical Fact Patterns

Parent, a closely held corporation operating two businesses (the assets of which are appreciated), is considering a sale one of the businesses



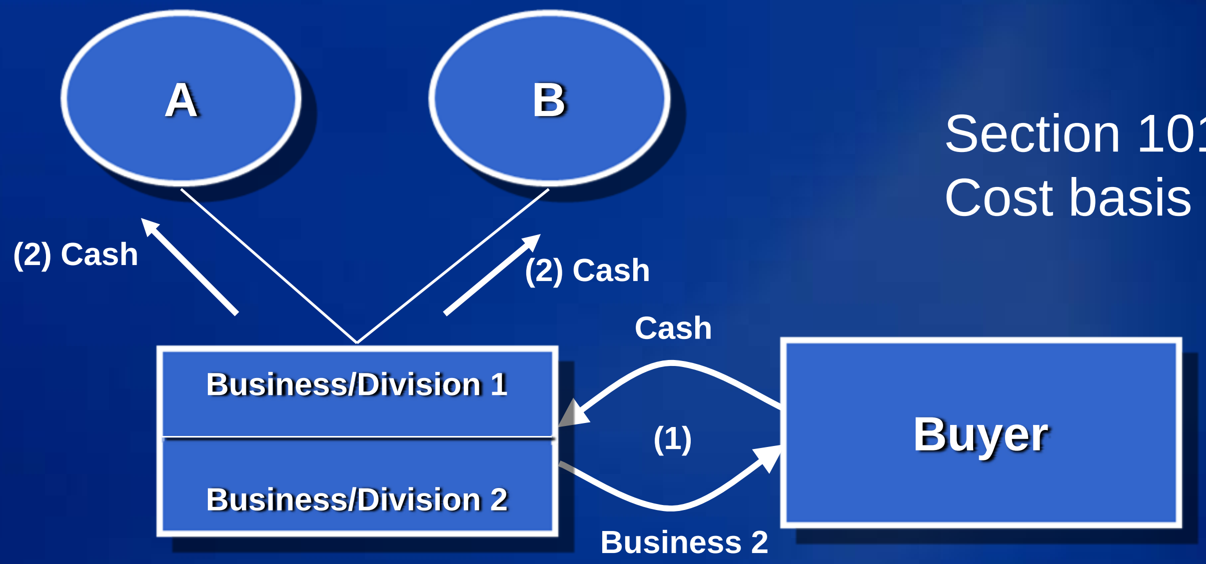
Sale of Business and Pro Rata Distribution of Proceeds



- Parent sells Business 2 assets to unrelated Buyer for cash in a taxable transaction and Parent distributes the cash proceeds of the sale pro rata to its shareholders

Sale of Business (Cont'd) Double Taxation

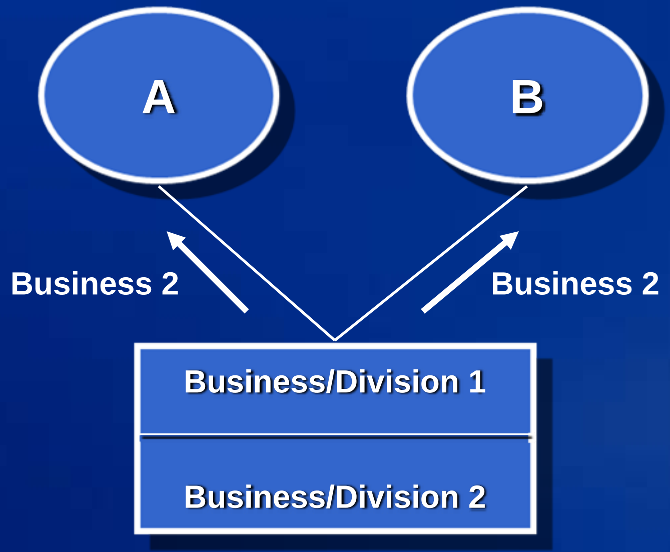
Section 301 – Dividend, basis recovery, or capital gain



Section 1012
Cost basis in assets

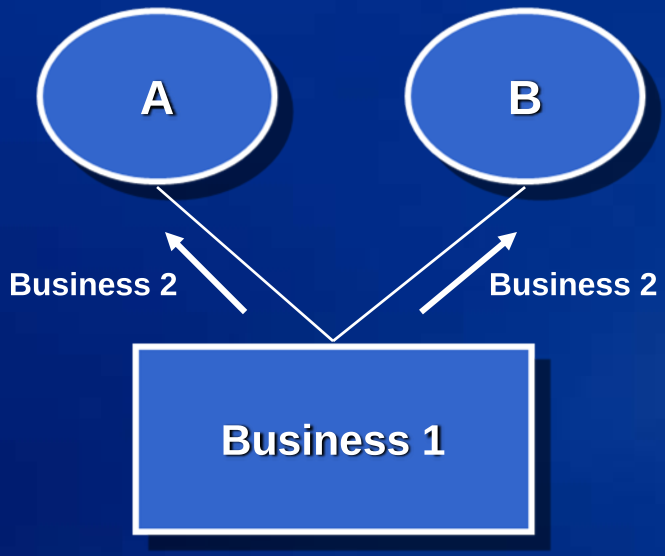
- *General Utilities* repeal – TRA 1986
- Section 1001 – gain or loss recognition
- May offset gains against losses if not 382 limited

Distribution of Assets – Pro Rata



Parent distributes Business 2 to shareholders

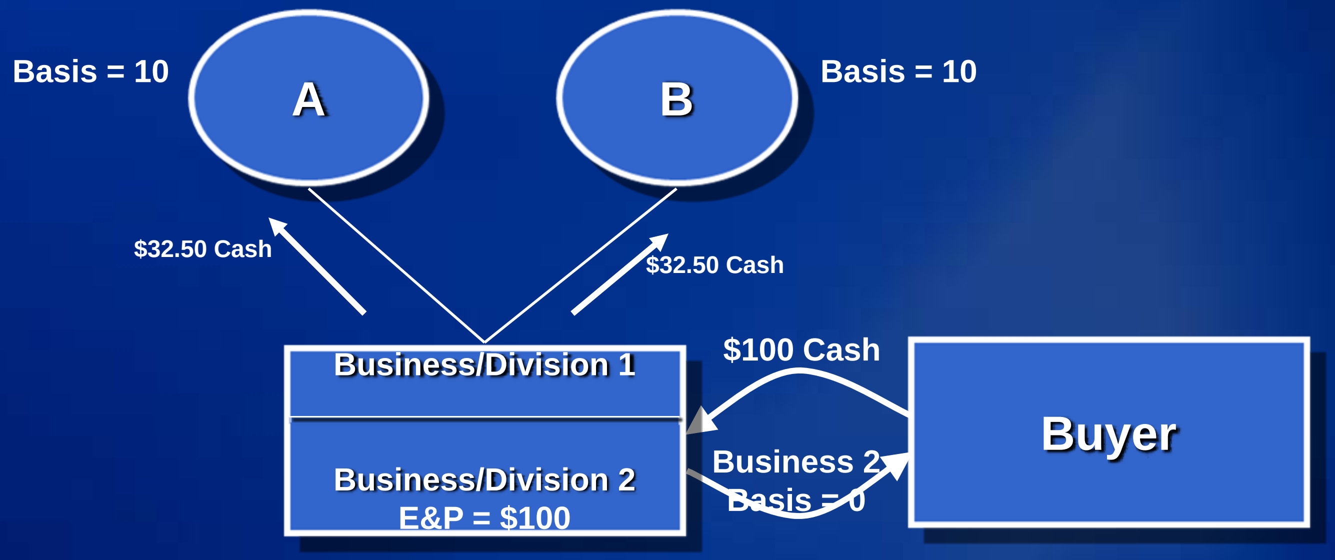
Distribution of Assets (Cont'd)
Double Taxation



Section 301 – Dividend, return of basis, or capital gain

- *General Utilities* repeal – TRA 1986
- Section 311(b) – gain (but not loss) recognition
- May offset gains against losses if not 382 limited

Partial Liquidations Under Section 302(b)(4)



- Without Section 302(b)(4) – corporate level tax of $35 ($100 x 35%) and shareholder level tax of $9.75 ($65 x 15%)
- With Section 302(b)(4) – same corporate level tax but reduced shareholder level tax (basis offset)

Partial Liquidations Under Section 302(b)(4) (Cont'd)

- Section 302(b)(4) versus (b)(2) and (b)(3)
  - Test is made at corporate instead of shareholder level
  - No requirement that shareholder's entire interest be redeemed or that distribution be disproportionate – may be pro rata
- Section 302(b)(4) requirements - Distribution made in redemption of stock treated as sale/exchange if:
  - Shareholder is not a corporation;
  - Distribution made pursuant to a plan and occurs within the taxable year of plan or next year; and
  - Corporate contraction occurs

Partial Liquidations Under Section 302(b)(4) (Cont'd)

- Corporate Contraction
  - Judicially developed concept - facts and circumstances test
  - Distribution results from genuine contraction of the corporate business. Regs. section 1.346-1(a)
  - Substantial reduction in activities performed by corporation should occur due to contraction
  - Sale of division and distribution of proceeds should usually qualify
  - Sale of subsidiary stock is not a contraction by parent. Rev. Rul. 79-184
    - But sub can liquidate and parent sell the assets and be deemed to contract. Rev. Rul. 75-223

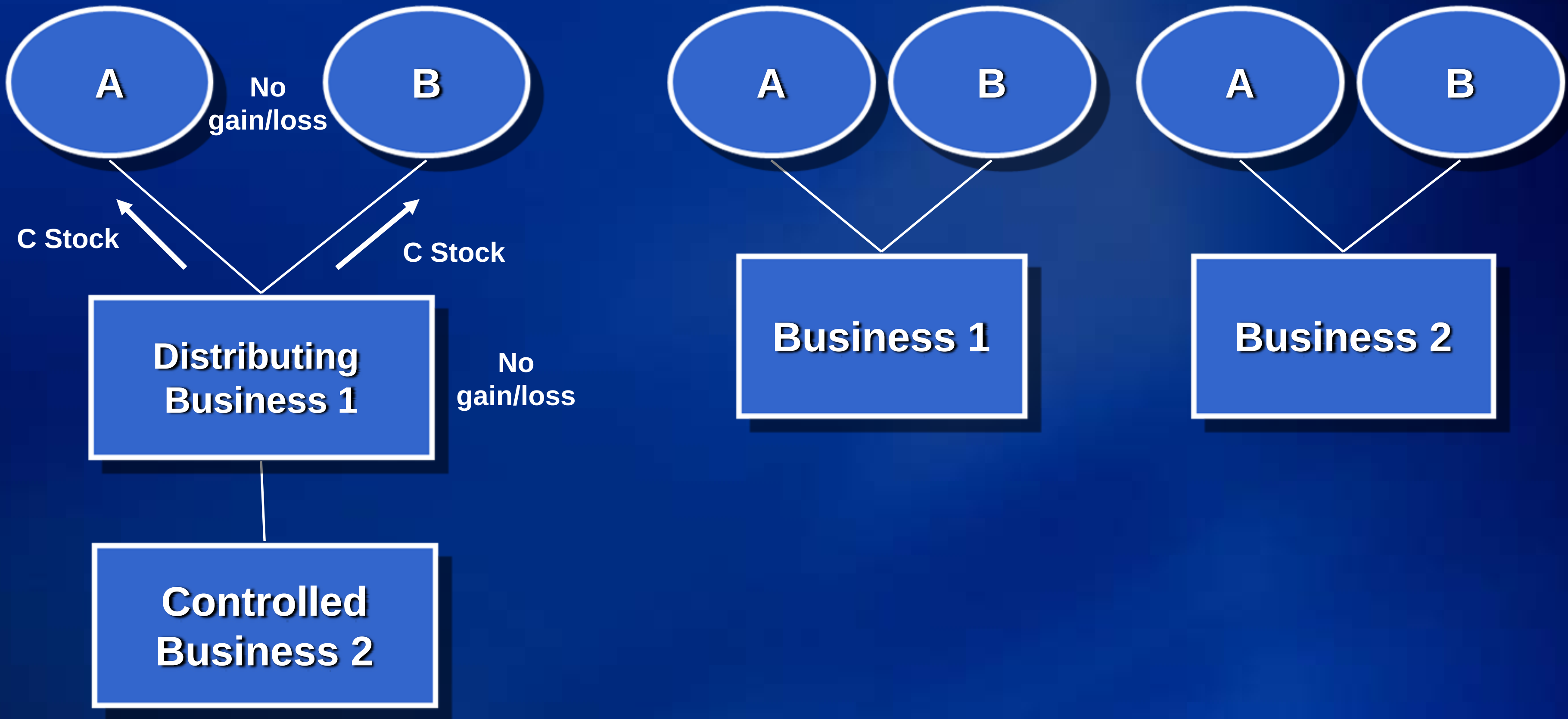
Partial Liquidations Under Section 302(b)(4) (Cont'd)

- Safe Harbor. Section 302(e)(2)
  - Qualifying contraction deemed to occur if:
    - Distributing corporation essentially meets the Section 355 test of conducting at least two qualified trades or businesses for at least five years and sells one of these businesses and distributes the proceeds (or distributes the assets of the business)

Section 355
Advantages and Limitations

Section 355

General rule -- Permits one corporation to distribute the stock of a controlled corporation without any tax at either the corporate or the shareholder levels



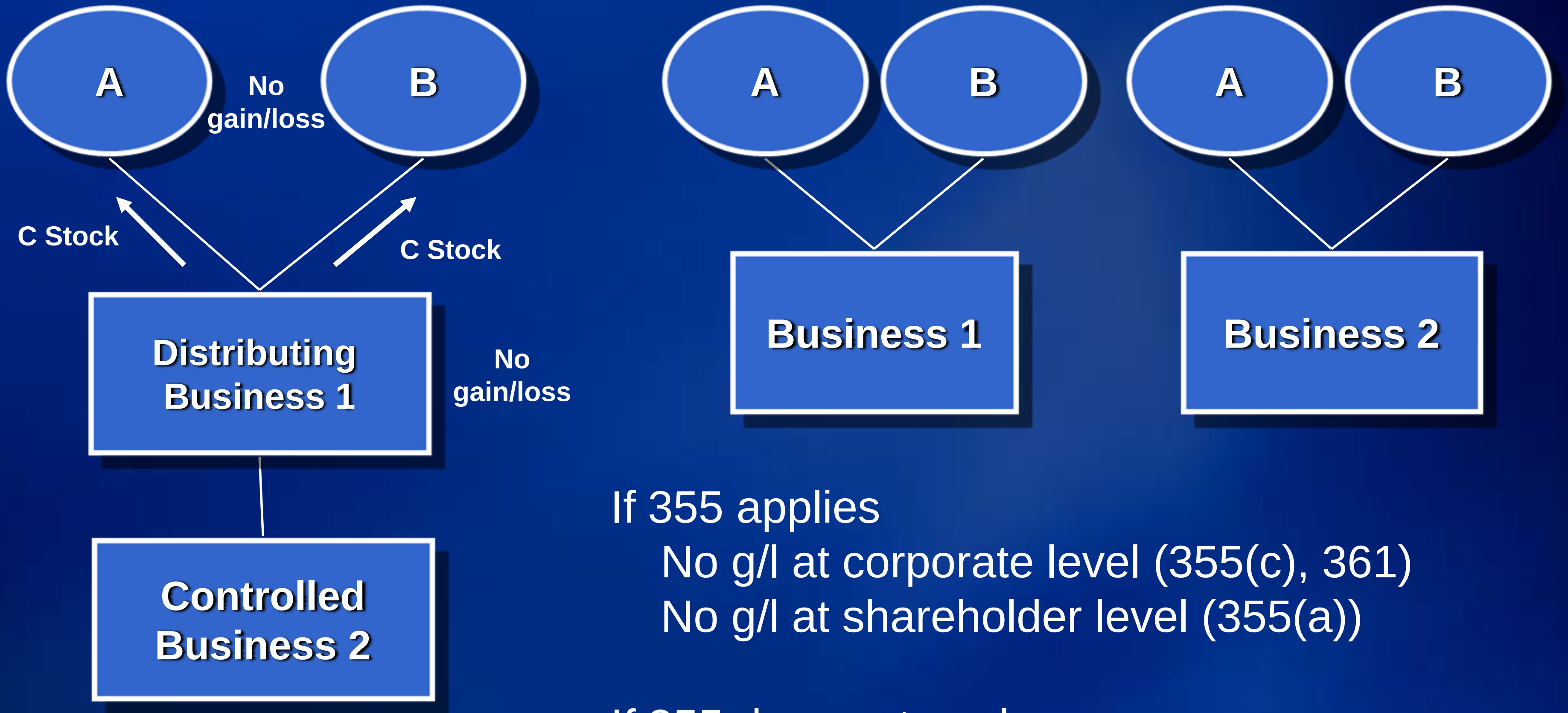
Current Law and Issues

- *General Utilities* Repeal - 1986 TRA eliminated the ability of a corporation to distribute appreciated property free of tax
- Hence, perhaps the biggest issue now is the attempted use of divisive reorganizations to avoid a corporate-level tax
- Assets <u>must</u> stay in corporate form in a divisive reorganization, but a variety of anti-abuse hurdles also must be cleared

Types of Divisive Reorganizations

- Spin-Off (dividend) – pro rata distribution; shareholders do not surrender stock
- Split-Off (redemption) – some shareholders surrender stock
- Split-Up (liquidation) – distribution of two or more controlled corporations' stock in liquidation of distributing corporation

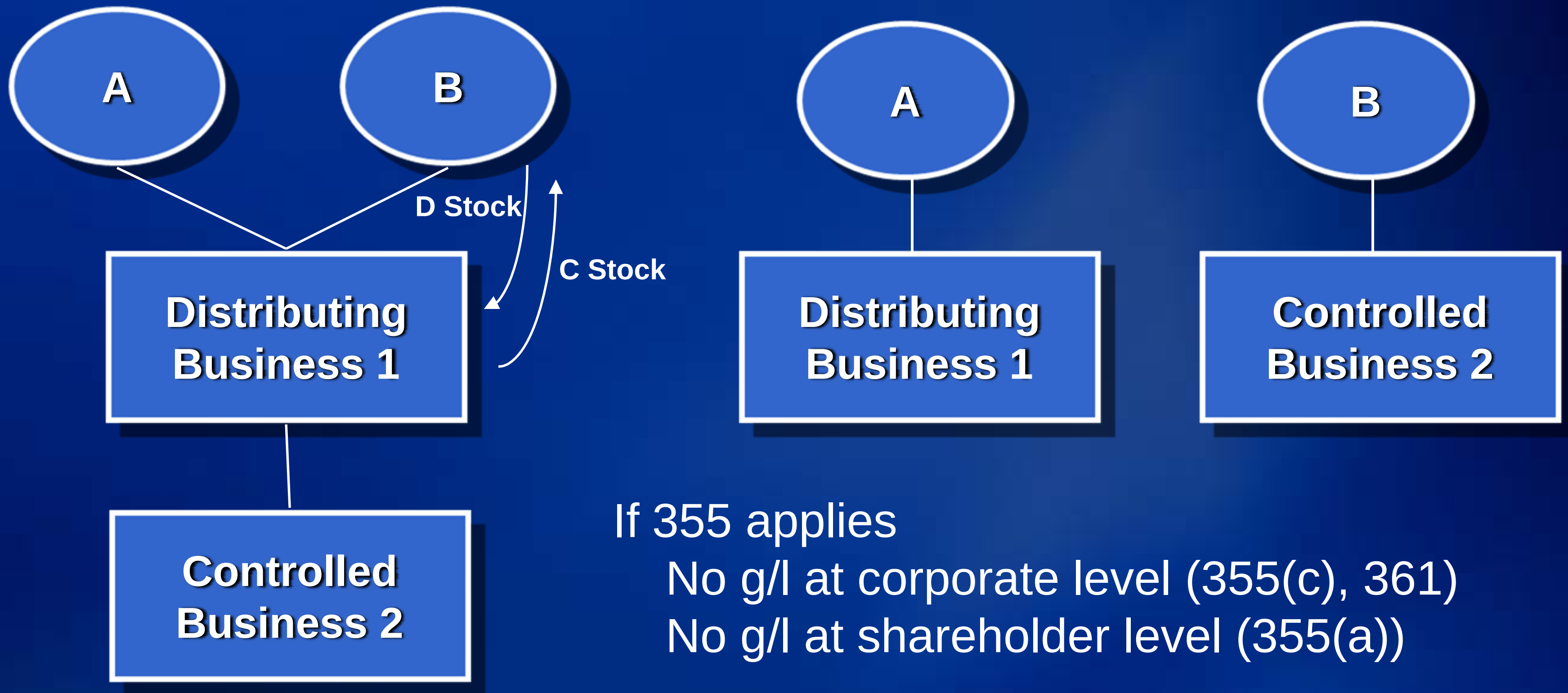
Spin Off (Dividend)



If 355 applies
- No g/l at corporate level (355(c), 361)
- No g/l at shareholder level (355(a))

If 355 does not apply
- Distributing corporation – 311(b) gain
- Shareholder – 301 distribution

Split-Off (Redemption)



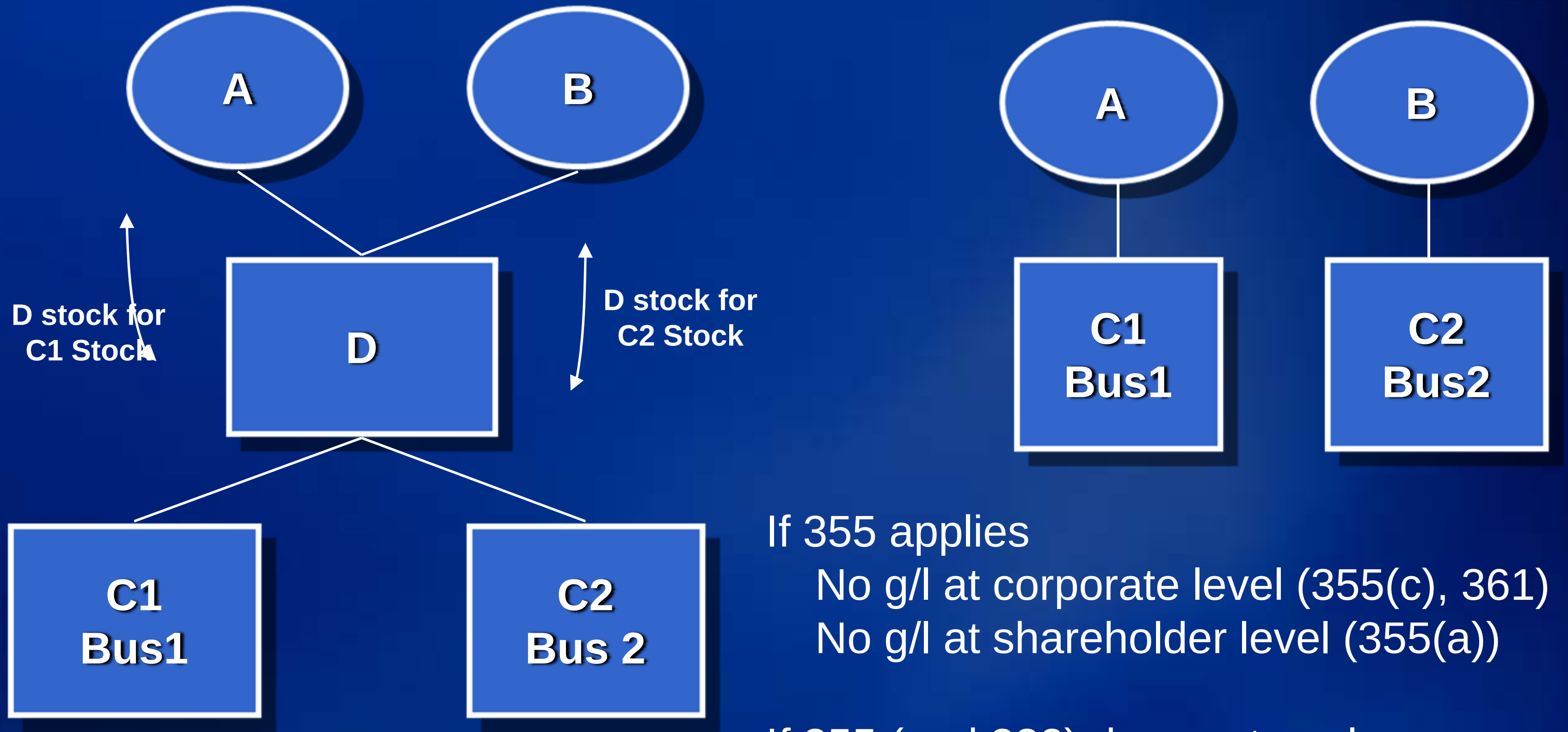
If 355 applies

- No g/l at corporate level (355(c), 361)
- No g/l at shareholder level (355(a))

If 355 does not apply

- Distributing corporation – 311(b) gain
- Shareholder – 302 gain

Split-Up (Liquidation)



If 355 applies
- No g/l at corporate level (355(c), 361)
- No g/l at shareholder level (355(a))

If 355 (and 332) does not apply
- Liquidating corp. – 336 gain/loss
- Shareholder – 331gain/loss
- May also qualify as an acquisitive (D) reorganization

Section 355 Requirements

I. Section 355(a) Statutory Requirements

- Control Immediately Before
- Distribution of Stock and Securities Constituting Control
- Not a Device for Distribution of E&P
- Distributing & Controlled Engaged in a 5-year Active Trade or Bus
- Not a cash-rich split-off (new rule)

II. Section 355(a) Nonstatutory Requirements

- Business Purpose
- Continuity of Shareholder Interest
- Continuity of Business Enterprise

III. Special Corporate-Level Requirements

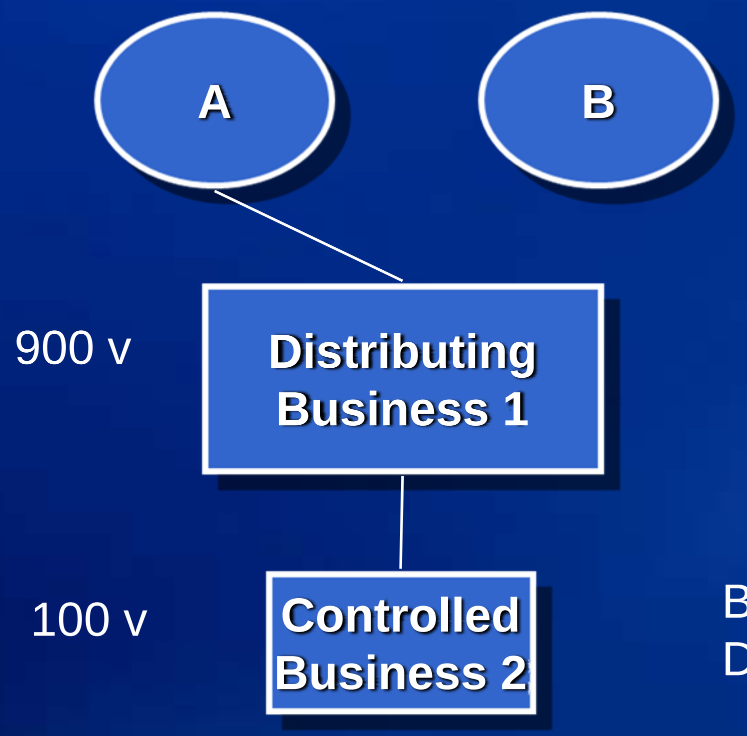
- Section 355(d)
- Section 355(e)

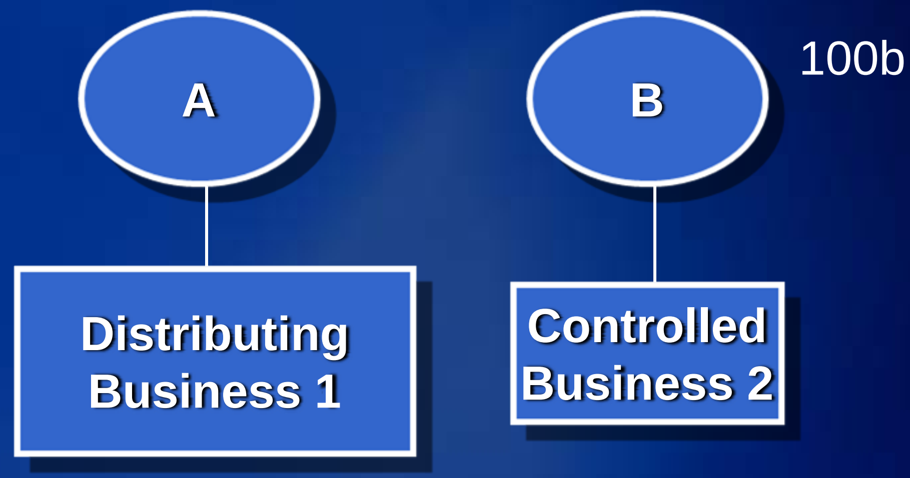
Section 355(d) and (e)

Both require recognition of corporate-level gain in circumstances when section 355 is used to change ownership of D or C

Transaction still generally tax-free at shareholder level

Section 355(d) – The Perceived Evil





B buys D stock from other shldr for $100
D redeems B’s stock with C stock in section 355 split-off

B’s basis in C will be $100 exchange basis
Viewed as tax-free disposition where purchaser gets high basis

Section 355(d)

- IF: Disqualified distribution – Then D recognizes gain
- Disqualified Distribution
  - Any distribution if - immediately after the distribution

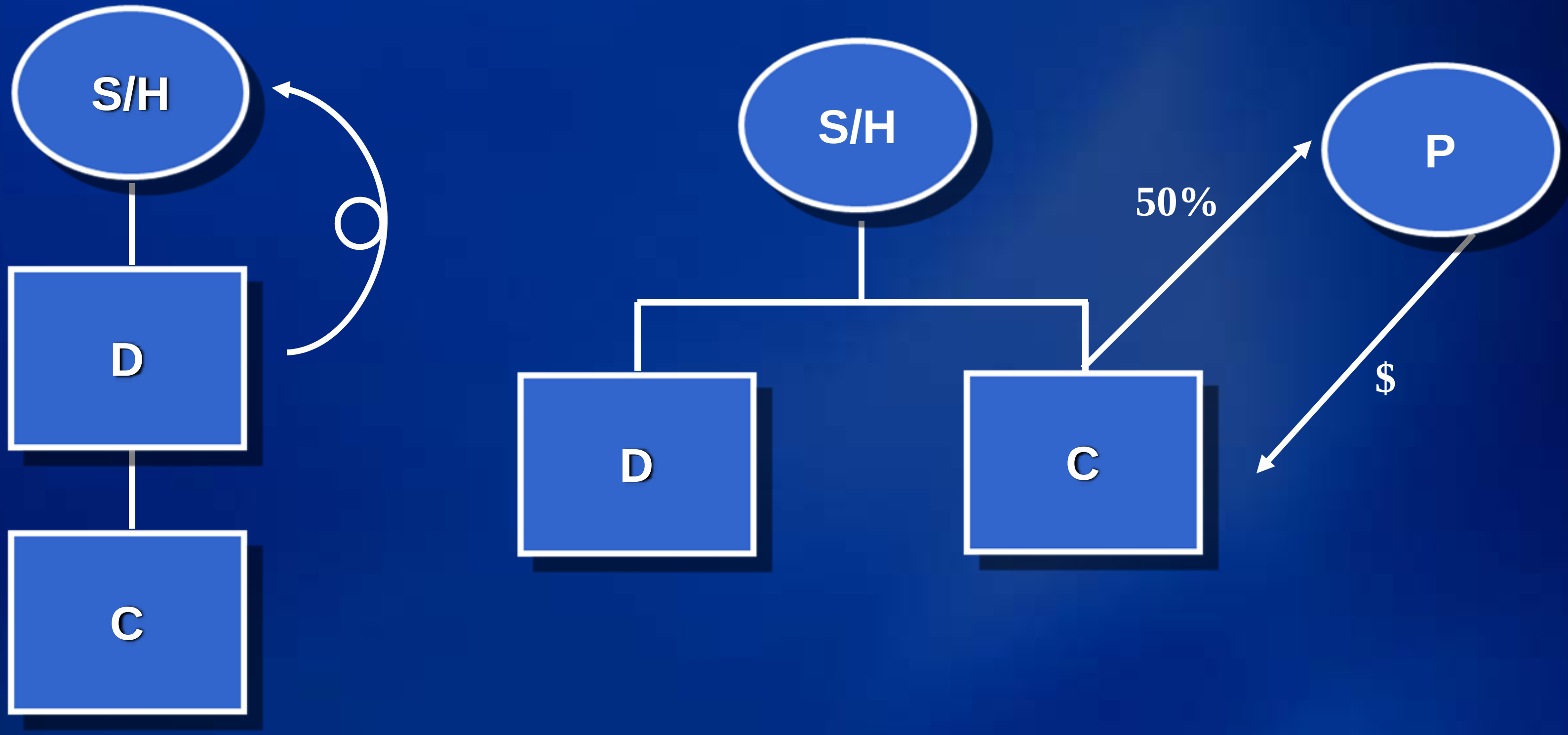
    Any Person holds Disqualified Stock in D or C which constitutes a 50 percent or greater interest
- Disqualified Stock
  - Any D stock or C stock acquired by Purchase within five years of the distribution OR
  - Any C stock received with respect to Disqualified D Stock

Section 355(e)

IF the distribution is "part of a plan (or series of related transactions)" pursuant to which one or more persons acquire, directly or indirectly, 50 percent or more of the stock of either D or C.

THEN D recognizes gain on distribution of C stock

Example: Post-Distribution IPO



Section 355(e) -- Part of a Plan (or series of related transactions)

- Statutory Presumption

    4 years centered on distribution date

- Final Regulations

    Nine safe harbors

    Otherwise, facts and circumstances (lists non-exclusive factors)

    Post-distribution acquisitions: Plan requires AUASN re acquisition w/in 2-year period preceding distribution

Section 355 Alternatives

Why Use Section 355 Alternative?

- Fails section 355 requirements

  e.g. - fail five-year active trade/business test

  e.g. - Section 355(g) applies

- Good 355 but Distributing recognizes gain due to either Section 355(d) or Section 355(e) will apply

Section 355 Alternative #1: Tracking Stock

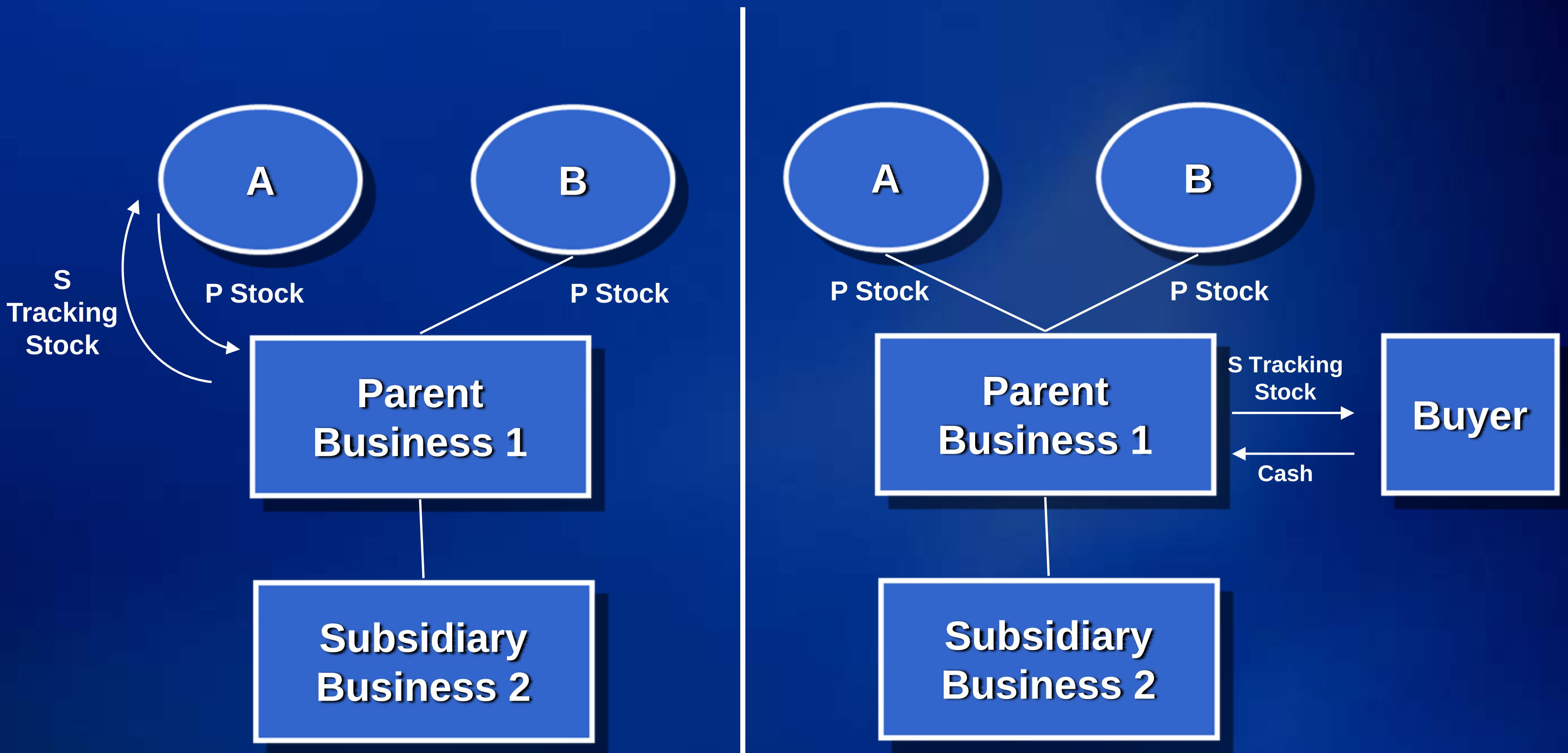
- New class of stock created and distributed to P shareholders
- Designated so stock should be considered to be P stock but tracks value of S
  - Stock's dividends and liquidation proceeds tied to S, may also control management of S
- Should be no tax upon distribution and receipt of tracking stock
- Pro-rata or non-pro-rata distribution of tracking stock

Tracking Stock (Cont'd)

- Desire to sell S but cannot qualify for Section 355 spin-off OR Section 355(d) or Section 355(e) will apply

- Buyer contributes $ to P in exchange for tracking stock which tracks value and performance of S

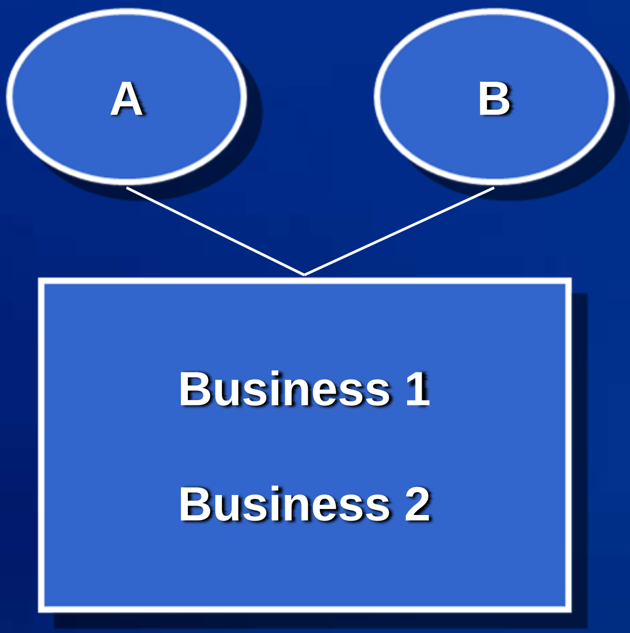
Tracking Stock - Examples



Tracking Stock (Cont'd)

- IRS "no-rule" policy – but see PLR 200645015
- Little guidance that exists on taxation of tracking stock implies IRS will treat stock as P stock if designed correctly
- Tracking stocks not well received by financial markets
- Better solution for closely held business where Section 355 cannot be used?

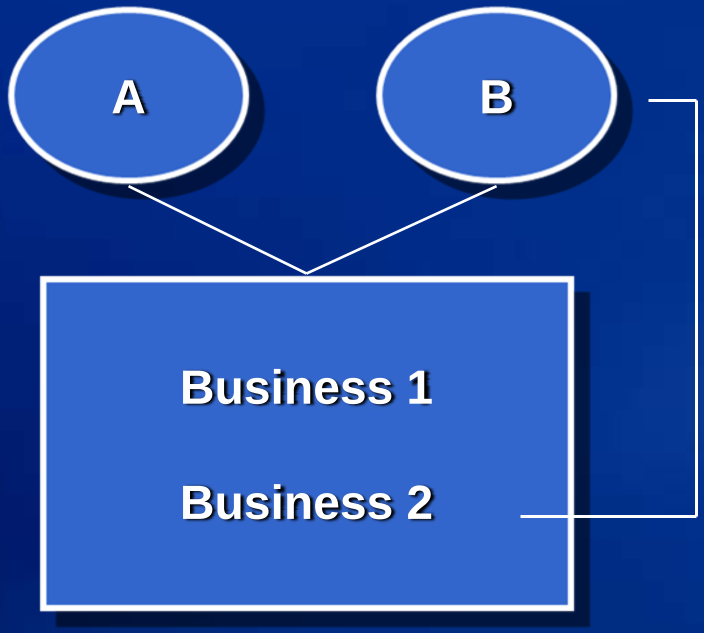
Section 355 Alternative #2: Lease Business/Contractual Arrangement



Business 1 – Pharm business
- Patents – 10 years left
- Manufacturing facility
- Management, manuf and sales employees

P “leases” Business 1 to B:
- B has “use” of business for term
- B pays P “rental” payments

Lease Business/Contractual Arrangement MANY issues



Formation of partnership?

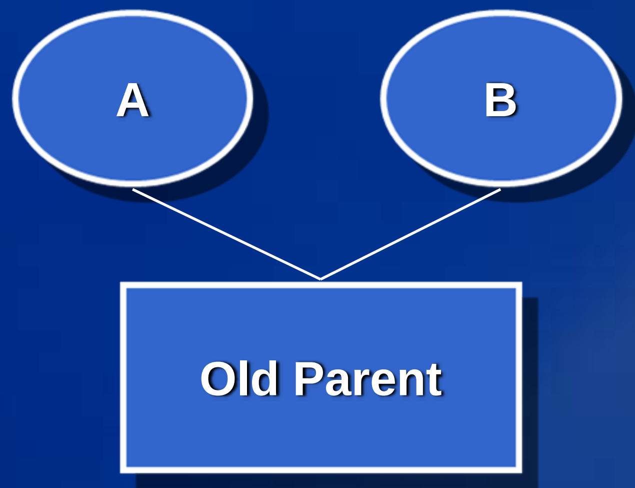
Lease v. sale v. distribution
must be retention of rights to be a lease

- term of lease vs. life of business
- transferred vs retained rights

Valuations are critical

Employment arrangements?

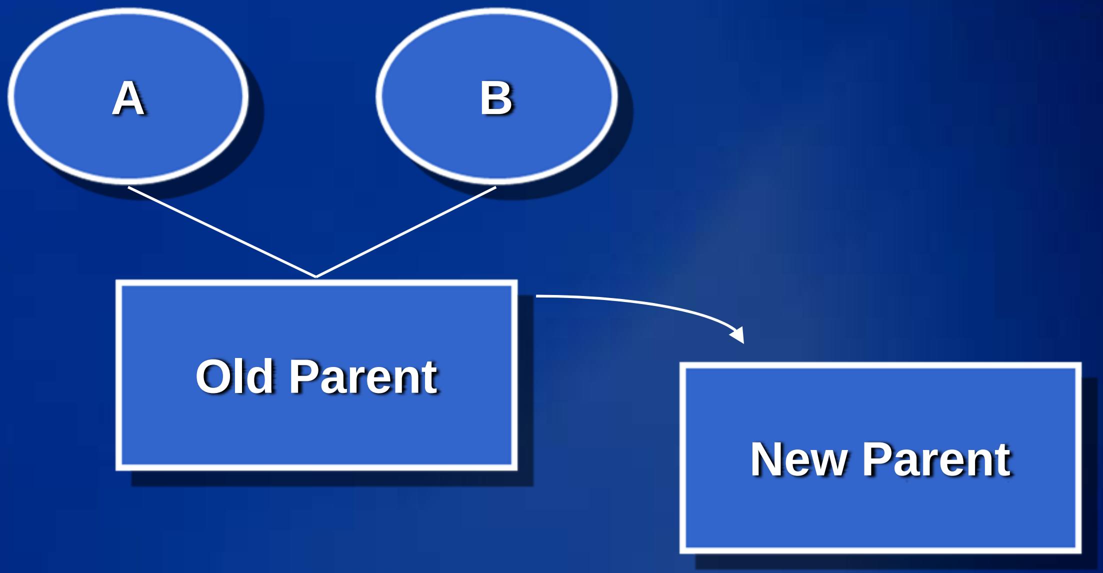
Section 355 Alternative #3: Risk Segregation/“F” Reorganization



- Old Parent, an S corporation, directly conducts a chemicals operations (Chemicals Operations)

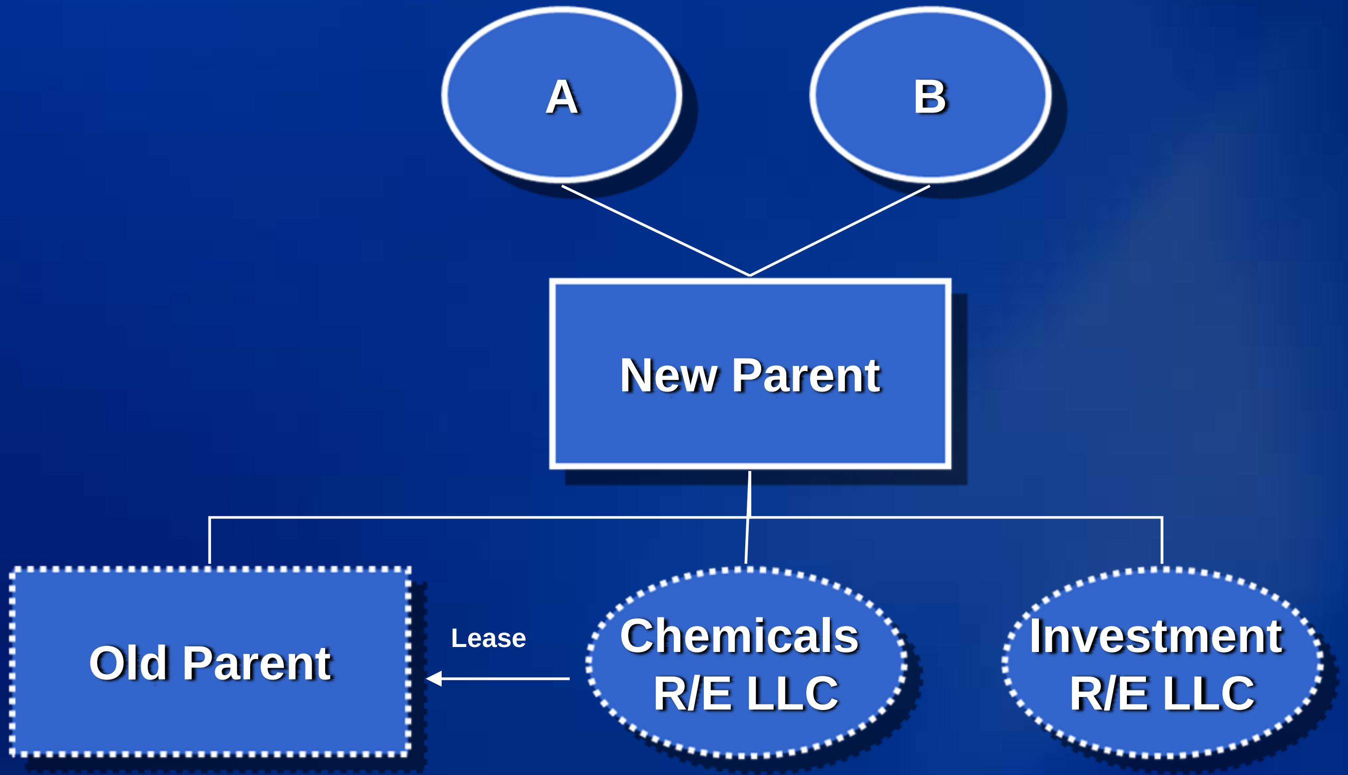
- Old Parent also directly owns real estate used in connection with the Chemicals Operations (Chemicals R/E) as well as real estate leased to unrelated parties (Investment R/E)

Risk Segregation - Steps 1 and 2



1) Old Parent shareholders transfer all of their Old Parent stock to newly formed corporation, New Parent, solely in exchange for New Parent common stock
2) New Parent makes an S corporation election and makes a qualified subchapter S subsidiary election for Old Parent. As a result, Old Parent is treated as a disregarded entity for federal income tax purposes (*i.e.*, is treated as having liquidated into New Parent)

Risk Segregation - Steps 3 through 5



3) New Parent forms Chemicals R/E LLC and Investment R/E LLC
4) Old Parent transfers the Chemicals R/E to Chemicals R/E LLC and the Investment R/E to Investment R/E LLC
5) Chemicals R/E LLC leases the Chemicals R/E to Old Parent for use in its operations

Risk Segregation

- Designed to isolate historic and future liabilities associated with the Chemicals Operations in Old Parent.

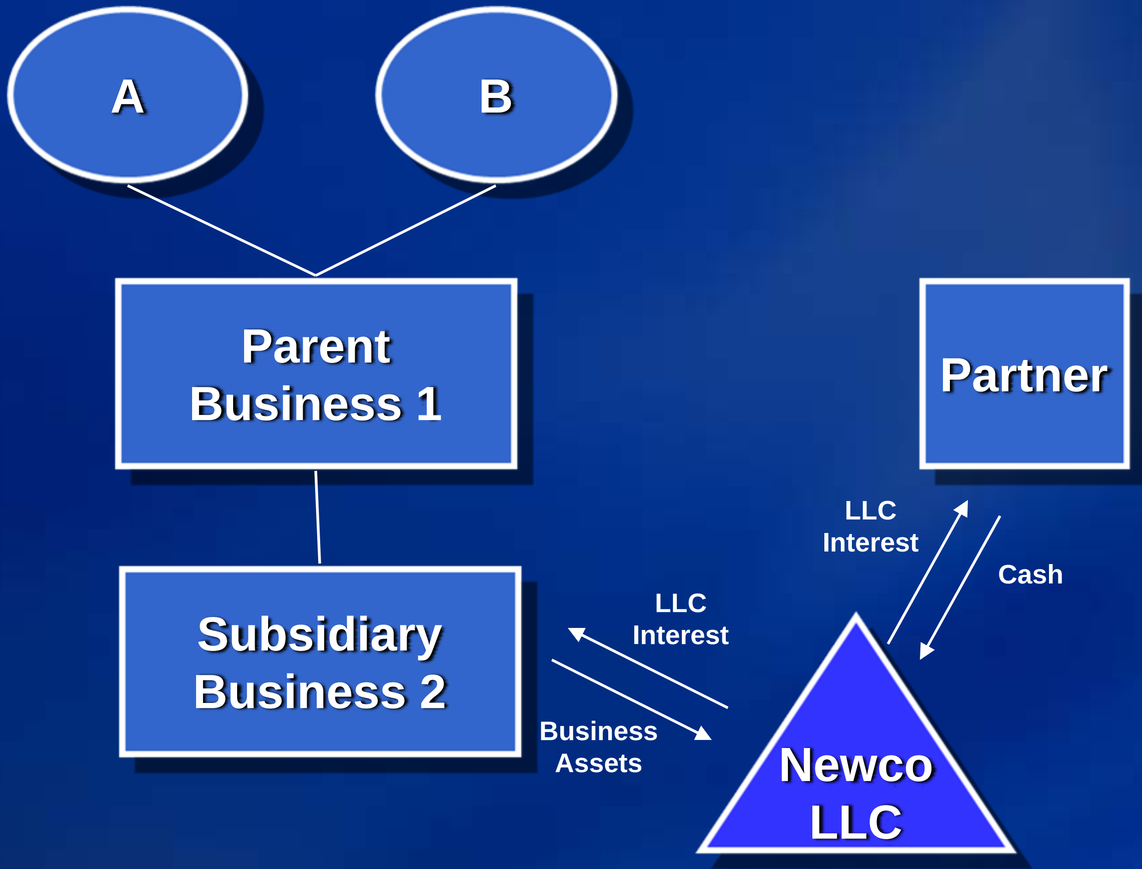
- The transaction should qualify as a tax-free “F” reorganization.
  - As a result of the deemed liquidation of Old Parent, New Parent’s acquisition of Old Parent stock is ignored, and New Parent is treated as acquiring the assets of Old Parent. See, e.g., Rev. Rul. 2001-46, 2001-2 C.B. 321.
  - New Parent’s deemed asset acquisition should be viewed as a “mere change in identity, form, or place of organization” of Old Parent. Section 368(a)(1)(F). See, e.g. PLR 200701017 (Oct. 6, 2006).

- Because Old Parent and the newly formed LLCs should be disregarded for federal income tax purposes, the transfer of the Chemicals R/E and the Investment R/E (as well as the lease of the Chemicals R/E) should be disregarded for federal income tax purposes.

- Would this transaction adversely effect a subsequent spin-off? Reg. Section 1.355-2(b)(3).

Section 355 Alternative #4: Use of LLC/Partnership

- Without Section 355 Spin Off



Use of LLC/Partnership (Cont'd)

- Nonrecognition on formation.
  - A transfer of property to a partnership in exchange for a partnership interest is generally nontaxable for both the partner and the partnership. Section 721(a)

- Certain Exceptions to Nonrecognition:
  - Investment company rule. Section 721(b)
  - Liability shift in excess of basis. Sections 731(a), 752(b)
  - Capital interest issued in exchange for services (past or future)
  - Disguised sale. Section 707(a)(2)(B)

Use of LLC/Partnership (Cont'd) Liquidating Distributions

- Generally no gain or loss on a distribution to the partner unless cash exceeds basis. Section 731(a)

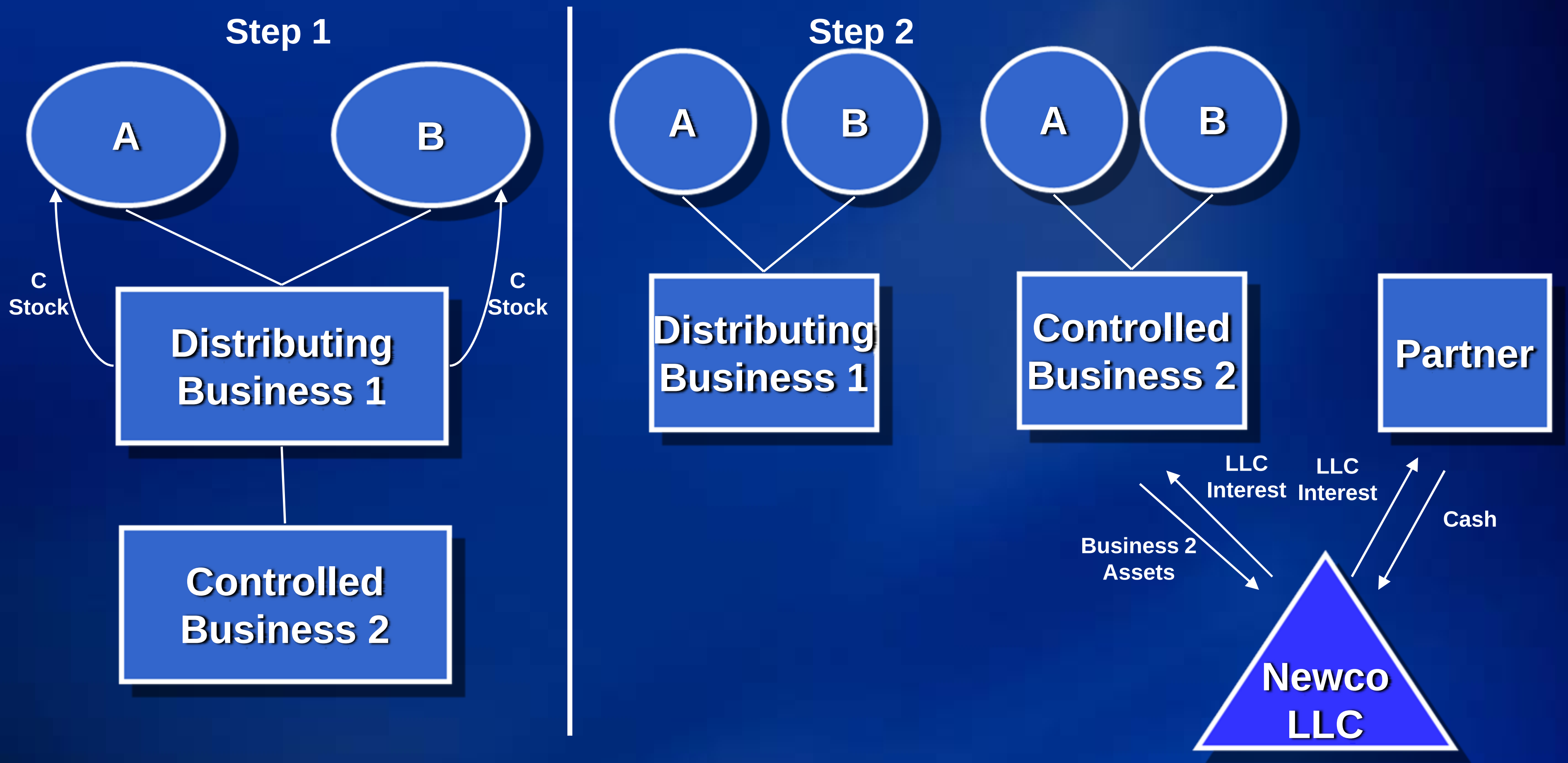
- Certain Exceptions to Nonrecognition Treatment:
  - Mixing Bowl Rules – Sections 704(c)(1)(B) & 737
  - Disproportionate distribution of Hot Assets – Section 751(b)

Use of LLC/Partnership (Cont'd) Anti-Abuse Rules

- Transaction must satisfy business purpose, economic substance.
- Must also satisfy partnership anti-abuse rule:
  - Abuse of subchapter K – tax avoidance and inconsistent with intent of subchapter K.
  - Abuse of entity – IRS can treat partnership as aggregate of partners unless (i) the a Code or reg provision clearly prescribes entity treatment and (ii) the tax results are clearly contemplated by that provision.
  - Reg. section 1.701-2.

Use of LLC/Partnership

- With Section 355 Spin Off

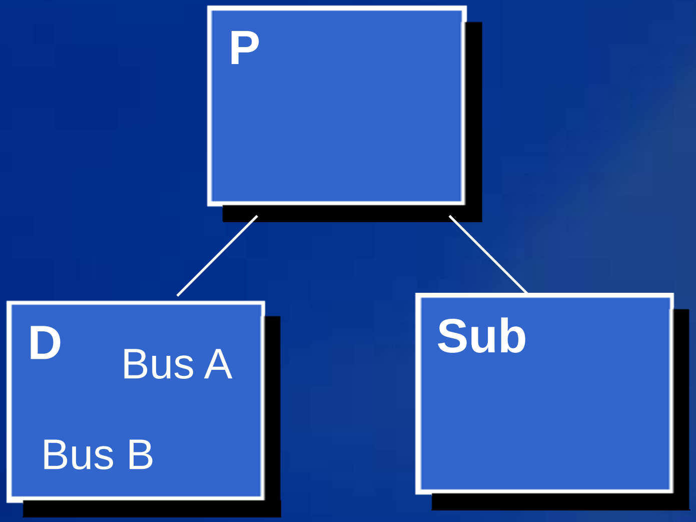


Use of LLC/Partnership (Cont'd)

- Active Trade or Business Requirement
  - Reliance on the business conducted by Newco LLC. Rev. Ruls. 92-17, 1992-1 C.B. 142 (20% GP interest), and 2002-49, 2002-2 C.B. 288 (joint/equal management).
  - Controlled must perform active and substantial management activities with respect to the Newco LLC business.

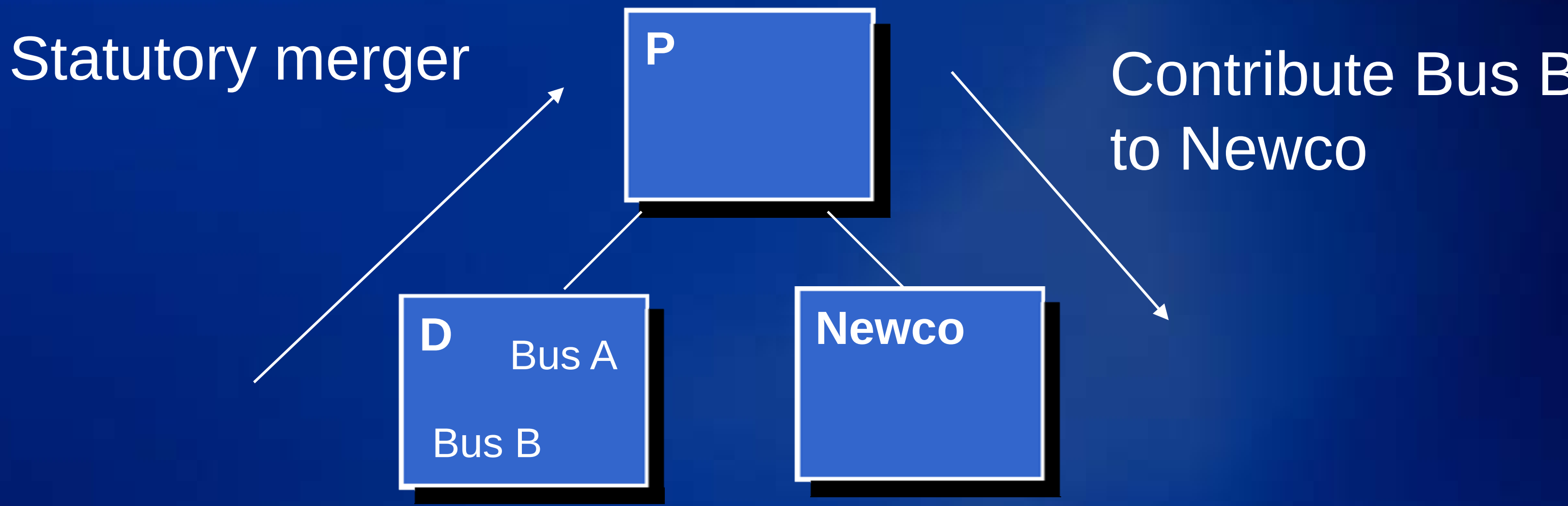
- Section 355(e)
  - Applies to direct or indirect stock acquisitions of Distributing or Controlled
  - Successor Rule--Prop. Reg. section 1.355-8 (limiting "successors" to <u>corporations</u> acquiring assets in a Section 381 transaction; other transfers under study).

Section 355 Alternative #5: Intra-Group Upstream Reorganizations



Goal – Move Business A or B out of D into P or Sub

Section 355 Alternative #5: Intra-Group Upstream Reorganizations

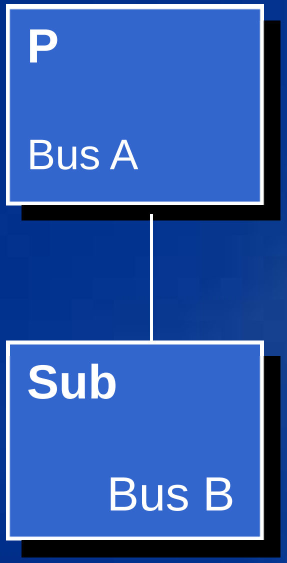


Rev. Rul. 69-617

Upstream transaction – 368(a)(1)(A)

Contribution – 368(a)(2)(C)

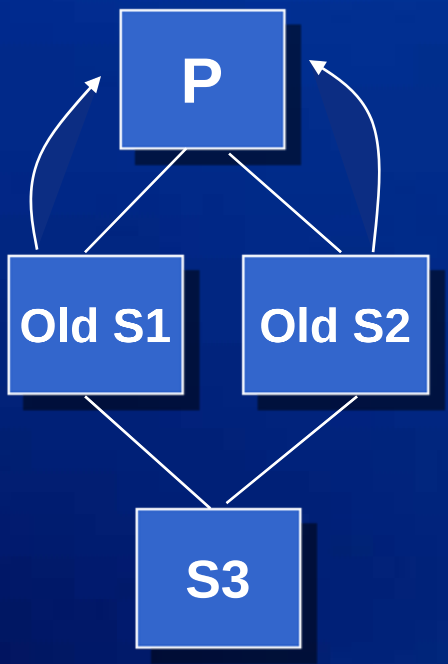
Section 355 Alternative #5: Intra-Group Upstream Reorganizations



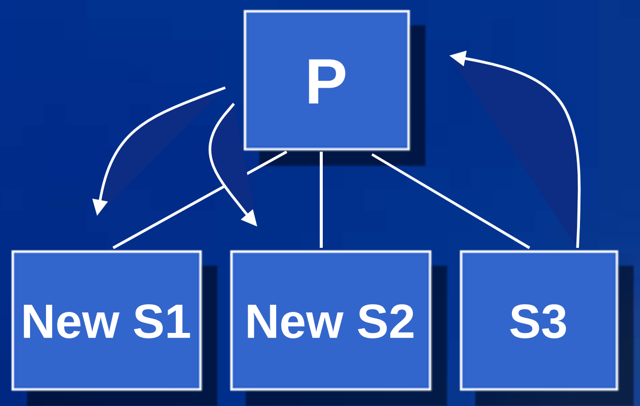
Economic effect of distribution of Business A

Tax-free reorganization

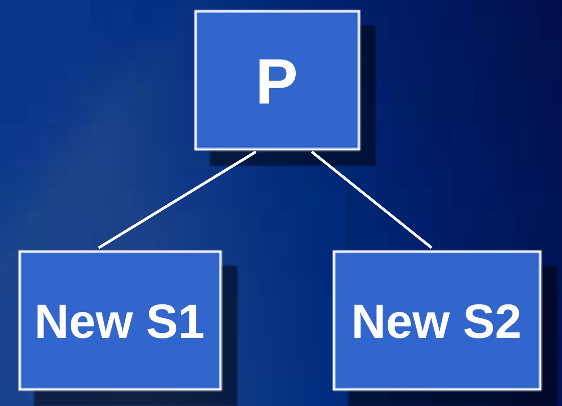
Section 355 Alternative #5:
Service has blessed transaction in PLRs



- Old S1, S2 merge into P.



- P contributes old sub operating assets to new subs and S3 liquidates.



- Mergers of old S1 and S2 are Type A reorganizations; merger of S3 qualifies under §332. PLR 200250024.
- Distribution of S3 would not have qualified under §355. Compare Rev. Rul 77-191.

•See also PLR 200028027, PLR 200300025 (no L/R doctrine application)

Questions?

Section 355 Transactions that Resemble Corporate-Level Sales

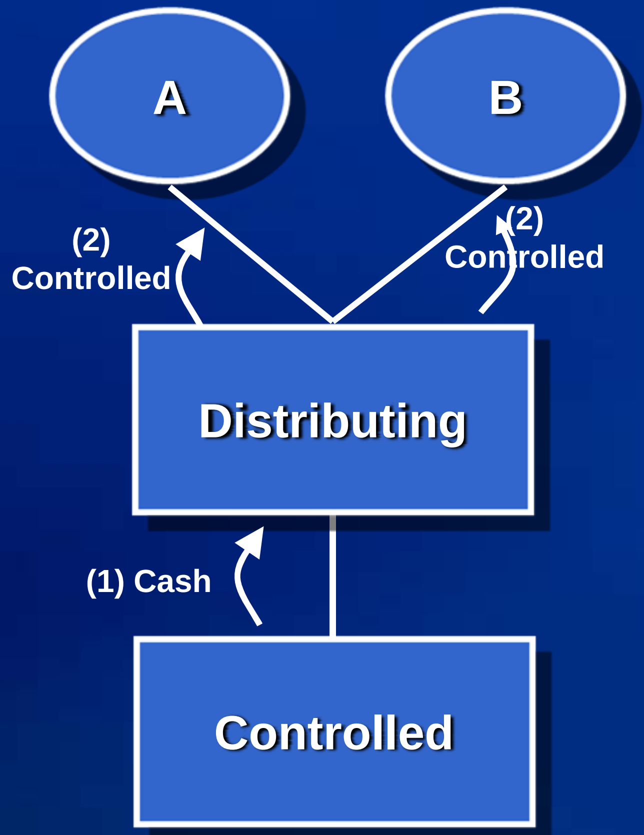
Bootstrap Dispositions/Monetizing Strategies

- Assumes can meet requirements of Section 355

- Divisive transactions can be structured to provide cash to Distributing without triggering gain recognition. The Code provides three ways to handle these "bootstrap" dispositions:

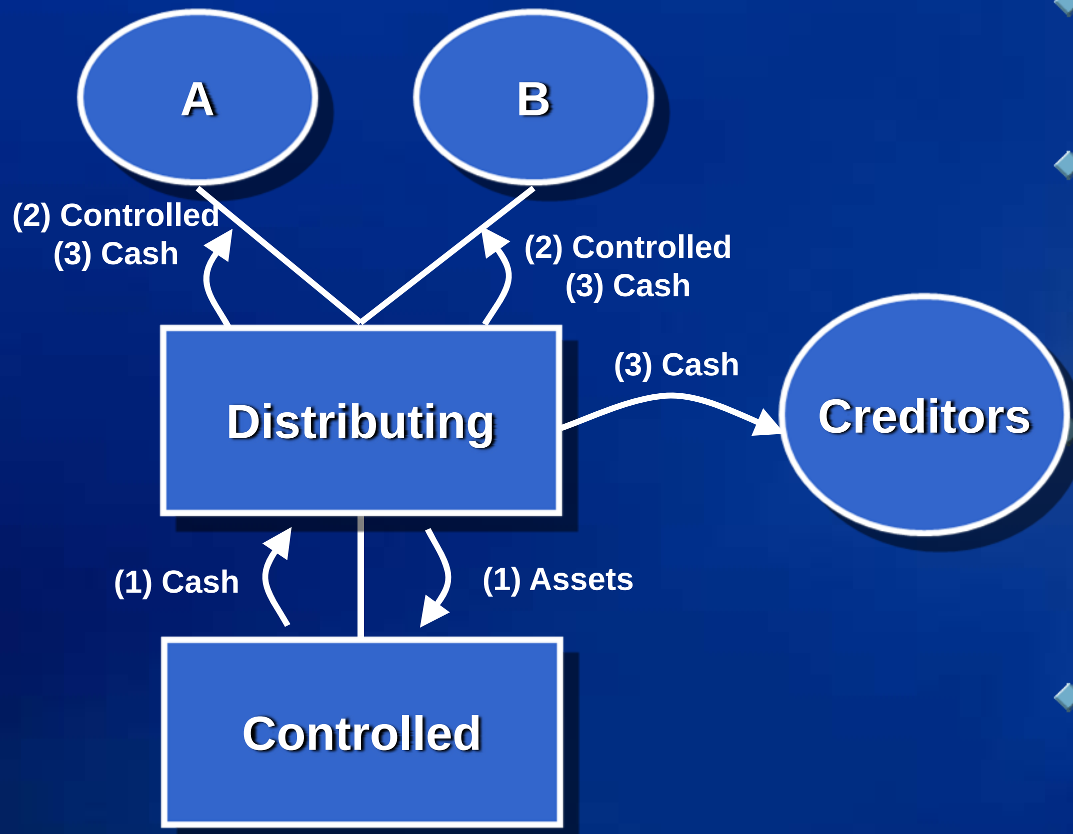
1. Cash payment from Controlled to Distributing
2. Assumption by Controlled of Distributing liabilities
3. Exchange of Controlled securities for Distributing securities/debt

Bootstrap Dispositions: Cash Payment from Controlled to Distributing



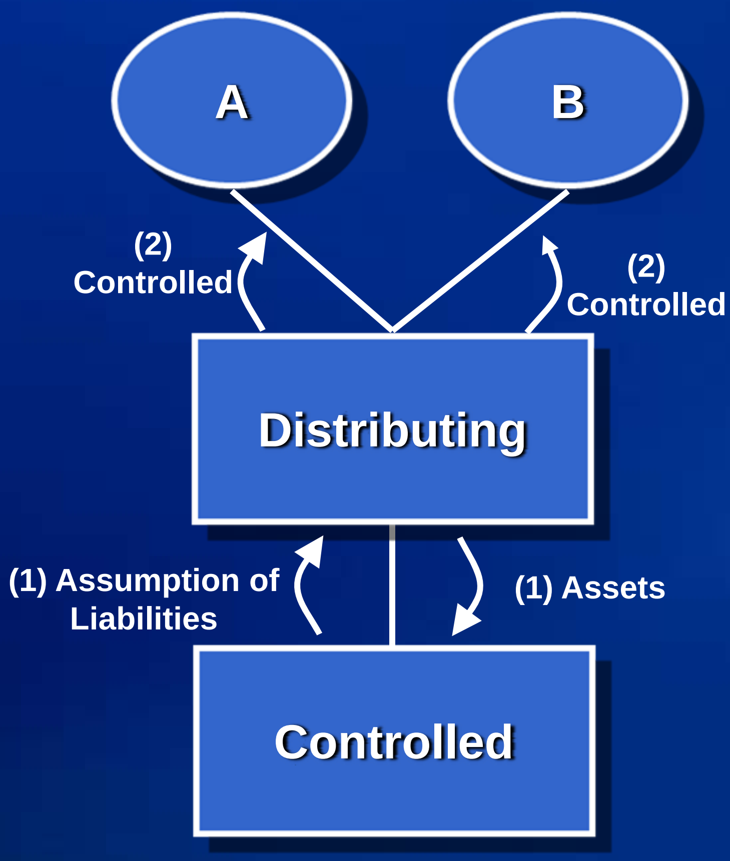
- Suppose pre-existing Controlled pays cash to Distributing, and then Distributing distributes the stock of Controlled to the Distributing shareholders in a transaction qualifying under §355.
- Non-Consolidated—Section 301, dividend, return of basis, or capital gain. DRD for dividend. But see Section 1059.
- Consolidated—No income to Distributing if distribution does not exceed Controlled stock basis. Otherwise, ELA triggered upon the spin. Reg. section 1.1502-19.

Bootstrap Dispositions: Cash Payment from Newco-Controlled to Distributing



- Suppose Distributing contributes assets including an active trade/business to newly formed Controlled corporation
- Distributing receives both Controlled stock and cash; Then Distributing distributes Controlled to the Distributing shareholders in a transaction qualifying under §§355 <u>and</u> 368(a)(1)(D)
- In order for cash to be received tax-free, Distributing must use cash received from Controlled to pay Distributing creditors or shareholders (§361(b))
- In addition, if cash is distributed to creditors, cash must not exceed Distributing's basis in the contributed assets reduced by the amount of any liabilities assumed (§ 361(b)(3), last sentence, enacted in 2004)

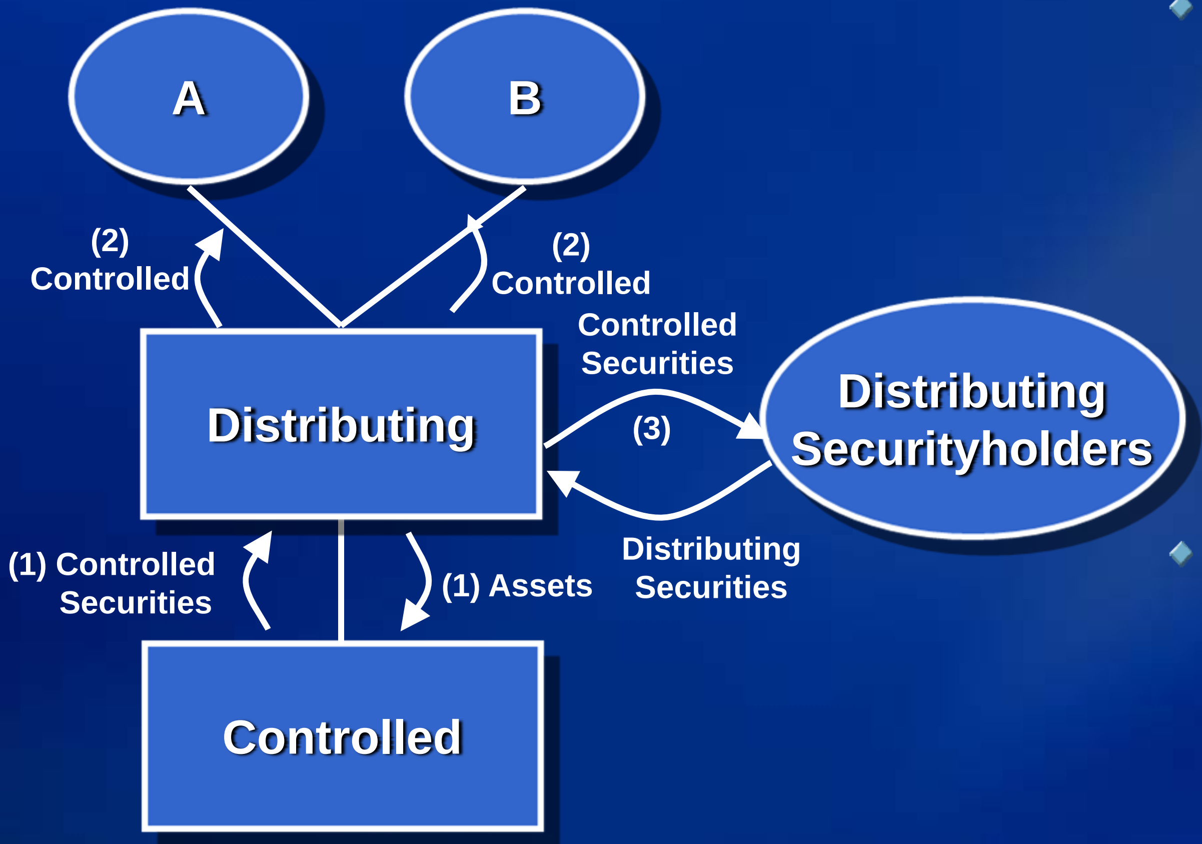
Bootstrap Dispositions: Assumption of Liabilities



- Suppose that Distributing contributes certain assets to Controlled, Controlled assumes liabilities of Distributing and then Distributing distributes the stock of Controlled in a transaction qualifying under §§355 and 368(a)(1)(D)

- In order for the assumption of liabilities to be tax-free to Distributing, the amount of liabilities assumed must not exceed Distributing's basis in the contributed assets (§ 357(c))

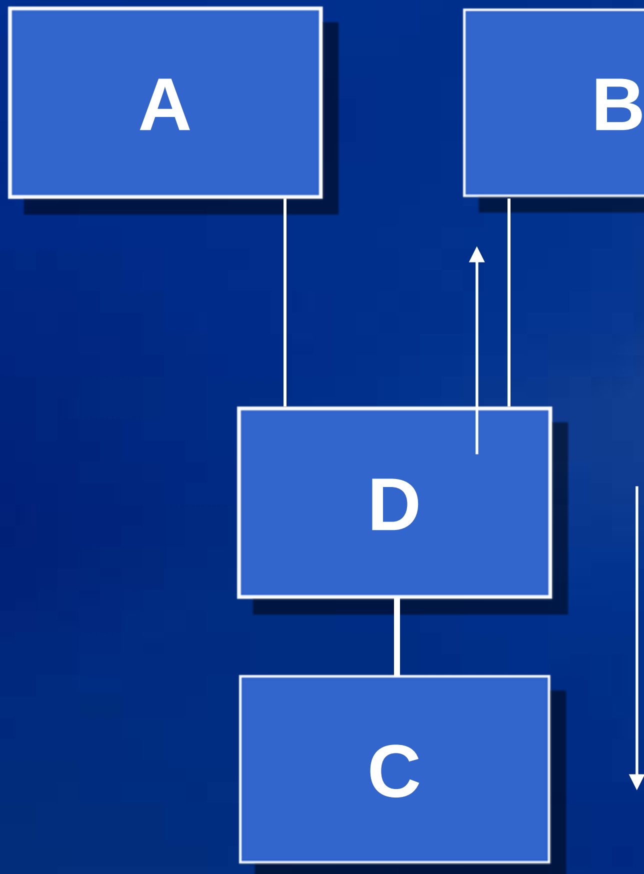
Bootstrap Dispositions: Use of Controlled Securities



- Suppose Distributing contributes certain assets to Controlled, Controlled issues Controlled securities to Distributing and then Distributing distributes the stock of Controlled to Controlled shareholders and Distributing uses the Controlled securities to either pay off existing security or debt holders
- Transaction is tax free to Distributing (§361) and (provided no "excess principal amount" is received by the Distributing security holders) to the Distributing security holders (§355(a)(1))
- No basis limitation applies to Distributing's receipt of the Controlled securities

Section 355 Transactions that Resemble Sales at the Shareholder Level

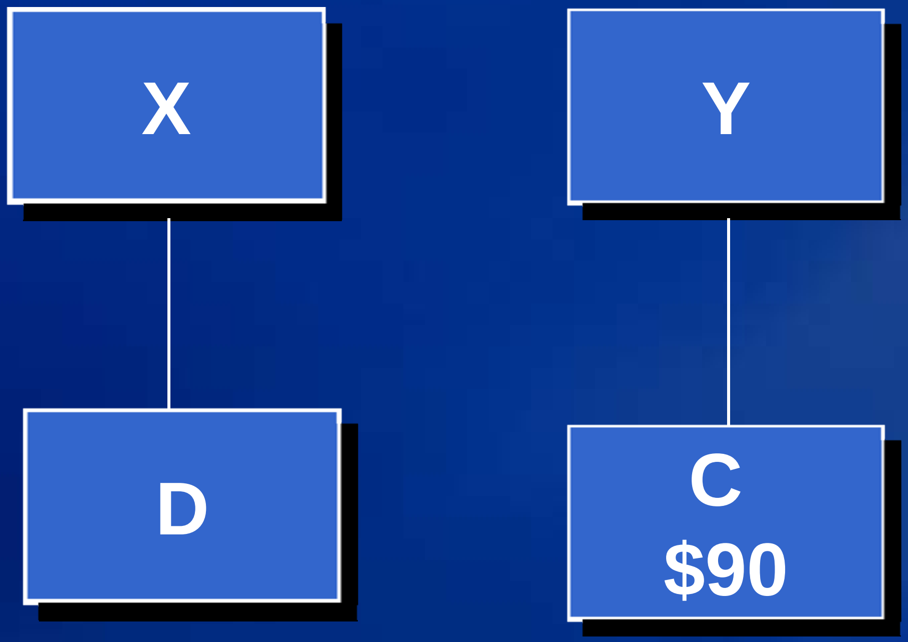
Cash-Rich Split-Offs



(2) D distributes all of C stock to Y in redemption of all of Y's D stock

(1) Transfer:
$10 fmv ATorB
$90 cash

Cash-Rich Split-Offs



$10 ATorB
$90 cash

C could liquidate in section 332

Functional equivalent of redemption by D of $90 of Y's stock

TIPRA 2005 (Signed May 17, 2006) New Section 355(g)

Section 355 will not apply IF

(A) Immediately after the transaction, either D or C is a Disqualified Investment Corporation (“DIC”), AND

(B) immediately after the transaction, any person owns a 50 percent (vote or value, applying section 318 attribution) or greater interest in any DIC, but only if such person did not hold such an interest in such corporation immediately before the transaction

New section 355(g)
Disqualified Investment Corporation

For distributions between May 17, 2006 and May 16, 2007

- D or C if 3/4 of the fmv of all of its assets constitutes Investment Assets

For distributions after May 16, 2007

- D or C if 2/3 of the fmv of all of its assets constitutes Investment Assets

Investment Assets

- Cash, stock or securities, partnership interests, debt, options, forward or futures contract, notional principal contract, derivative, foreign currency, or any similar asset

- Exception for certain assets used in financial trade or business

Questions?