

New York State Bar Association Tax Section

**Report on Temporary Regulations
Regarding the Hot Stock Rules Under Section 355(a)(3)(B)**

October 2, 2009

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**NEW YORK STATE BAR ASSOCIATION
TAX SECTION**

**Report on Temporary Regulations
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Under Section 355(a)(3)(B)¹**

I. INTRODUCTION

This report (the “Report”) of the New York State Bar Association Tax Section (the “NYSBA Tax Section”) comments on temporary regulations (the “Temporary Regulations”)² issued by the Internal Revenue Service (the “IRS”) and the U.S. Department of Treasury (“Treasury”) in respect of Section 355(a)(3)(B),³ which are commonly referred to as the “hot stock” rules. The IRS and Treasury issued the Temporary Regulations in response to the amendments to the active trade or business rules of Section 355(b)(3) effected by the Tax Technical Corrections Act of 2007 (the “Technical Corrections Act”),⁴ which direct Treasury to prescribe regulations as are necessary or appropriate to carry out the purposes of the amendments to the active trade or business rules and to modify the application of the hot stock rules in connection with the application of Section 355(b)(3).⁵

¹ The principal drafter of this report was Peter F. G. Schuur, with substantial assistance from Jonathan Macke. Helpful comments were received from John P. Barrie, Gary B. Mandel, Erika W. Nijenhuis, Jodi J. Schwartz and David R. Sicular.

² Temp. Treas. Reg. § 1.355-2T.

³ Except as otherwise provided herein, “Section” references are to the Internal Revenue Code of 1986, as amended (the “Code”), and references to Regulations are to the Treasury Regulations promulgated thereunder.

⁴ Pub. L. No. 110-172, § 4(b) (2007).

⁵ I.R.C. § 355(b)(3)(D).

This Report is divided into five parts. The remainder of this Part I summarizes the hot stock rules and other aspects of Section 355 that are relevant to the application of the hot stock rules. Part II summarizes our specific comments and recommendations regarding the Temporary Regulations. Part III is a brief review of the historical development of Section 355(a)(3)(B) and Section 355(b)(3). Part IV contains a discussion of the hot stock rules and our recommendations, and responds to questions that the IRS and Treasury raised in the preamble of the Temporary Regulations.

Section 355 generally allows a corporation (“Distributing”) to distribute stock of a corporation that it controls (“Controlled”) to its stockholders in a transaction in which gain or loss is not recognized to Distributing and its shareholders. For purposes of Section 355, “control” has the meaning given to it in Section 368(c) (“Section 368(c) control”).⁶ Section 355 includes a number of provisions that are intended to prevent a corporation from bailing out corporate earnings by facilitating the post-spin sale of stock of Distributing or Controlled in a capital gains transaction. For example, under Section 355(a)(1)(B), the distribution of the stock of Controlled must not be used principally as a device for the distribution of the earnings and profits of Distributing or Controlled.⁷

Like the device rules, Section 355(a)(3)(B) is an anti-bailout provision, which is designed to prevent Distributing from converting liquid assets into additional shares of Controlled that can be distributed without recognizing gain or loss under Section 355.⁸

⁶ Under Section 368(c), the term “control” means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.

⁷ See also Treas. Reg. § 1.355-2(d).

⁸ See generally *Dunn Trust v. Commissioner*, 86 T.C. 745, 755 (1986), *acq. in result*, AOD 1997-07; BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS, ¶11.10[1] (7th Ed. 2006) (“The purpose of this restriction is to prevent the distributing corporation from investing its excess funds in additional stock of the controlled corporation as a prelude to a tax-free distribution.”).

Under Section 355(a)(3)(B), even if a distribution of stock of Controlled satisfies the other requirements of Section 355, stock of Controlled that Distributing acquired by reason of any transaction: (i) which occurs within the five-year period preceding the distribution (the “pre-distribution period”), and (ii) in which gain or loss is recognized, in whole or in part, will not be treated as stock of Controlled that is permitted to be distributed without recognizing gain or loss, but as “boot”, the distribution of which is taxable to both Distributing and its shareholders.

Section 355(a)(3)(B) does not by its terms prevent Distributing from contributing cash or other liquid assets to Controlled in consideration for Controlled stock in a transaction in which no gain or loss is recognized, and then distributing the cash-rich stock. However, Section 355 imposes separate limits on loading up Distributing or Controlled with excess cash or liquid assets, including the device rules, which, among other things, provide that the existence of assets that are not used in a qualifying trade or business, including but not limited to cash and other liquid assets that are not related to the reasonable needs of the business, are evidence that the spin-off is principally a device for the distribution of earnings and profits.⁹ In addition, Section 355(g), which is designed to restrict so-called “cash-rich split-offs”, provides that Section 355 is not applicable to any distribution if: (i) either Distribution or Controlled is, immediately after the transaction, a “disqualified investment corporation” and (ii) any person holds, immediately after the transaction, a 50-percent or greater interest in any disqualified

⁹ Treas. Reg. § 1.355-2(d)(2)(iv)(B). In addition to the device rules, the IRS will not ordinarily issue a ruling or determination letter regarding whether the active trade or business requirement of Section 355(b) is met if Distributing acquired control of Controlled through the contribution of cash, or other liquid or inactive assets, in a non-recognition transaction under Section 351(a) or Section 368(a)(1)(D). Rev. Proc. 2009-3, 2009-1 I.R.B. 107.

investment corporation, and did not hold such interest immediately before the transaction.¹⁰

The active trade or business rules of Section 355(b) also fulfill an anti-bailout function by restricting the tax-free separation of a recently acquired business under Section 355.¹¹ Section 355(b) requires that each of Distributing and Controlled be engaged in the active conduct of a trade or business immediately after the distribution and the trade or business has been actively conducted throughout the pre-distribution period.¹² Generally, under Section 355(b)(2)(C), a trade or business will not satisfy the active trade or business requirement if the trade or business is acquired during the pre-distribution period in a transaction in which gain or loss is recognized. Under Section 355(b)(2)(D), a trade or business generally will not satisfy the active trade or business requirement if Section 368(c) control of the corporation conducting the trade or business is acquired by Distributing or by a distributee corporation, directly or through one or more corporations, during the pre-distribution period in a transaction in which gain or loss is recognized.

Under the “expansion doctrine,” a trade or business that is acquired in a transaction during the pre-distribution period in which gain or loss is recognized will nevertheless be treated as a qualifying active trade or business for purposes of Section 355(b) if the acquired trade or business is in the same line of business as an existing trade or business that the purchaser has actively conducted throughout the pre-distribution period.¹³ For purposes of Section 355(b), the newly acquired expansion business will

¹⁰ I.R.C. § 355(g)(1). For purposes of Section 355(g), a “disqualified investment corporation” generally means a corporation if the fair market value of the corporation’s investment assets is equal to two-thirds or more of the fair market value of all of the corporation’s assets. I.R.C. § 355(g)(2).

¹¹ *See also* I.R.C. § 355(a)(1)(C).

¹² I.R.C. § 355(a)(1)(C), (b).

¹³ Treas. Reg. § 1.355-3(b)(3)(ii).

itself be treated as having been actively conducted by the purchaser during the pre-distribution period.¹⁴

Pursuant to Section 355(b)(3), which was introduced by the Tax Increase Prevention and Reconciliation Act of 2005 (“TIPRA”)¹⁵ and modified by the Technical Corrections Act, for purposes of determining whether Distributing or Controlled is engaged in an active trade or business, all members of Distributing or Controlled’s “separate affiliate group” (“SAG”) are treated as one corporation. Section 355(b)(3)(B) defines SAG, with respect to any corporation, as the affiliated group which would be determined under Section 1504(a) if the corporation were the common parent and Section 1504(b) did not apply (“Section 1504(a) control”),¹⁶ and in this Report we refer to the separate affiliated group of Distributing as the “DSAG” and the separate affiliated group of Controlled as the “CSAG”.

Although the active trade or business rules of Section 355(b)(3) do not by their terms apply to Section 355(a)(3)(B), Section 355(b)(3)(D) directs Treasury to prescribe regulations as are necessary or appropriate to carry out the purposes of the Technical Correction Act’s changes to Section 335(b)(3), including regulations which provide for the proper application of Section 355(b)(2)(C) and (b)(2)(D) and modify the application of Section 355(a)(3)(B) in connection with the application of Section 355(b)(3). Pursuant to that grant of authority, Treasury issued the proposed regulations regarding the active

¹⁴ *Id.*; *see also* Rev. Rul. 2003-18, 2003-1 C.B. 467 (purchase of brand Y automobile dealership by an existing dealer of brand X automobiles treated as an expansion); Rev. Rul. 2003-38, 2003-1 C.B. 811 (creation of website by an existing retail store treated as an expansion).

¹⁵ Pub. L. No. 109-222 (2006).

¹⁶ Section 1504(a) control generally requires that Distributing possess at least 80% of the total voting power and 80% of the total value of the stock of Controlled.

trade or business requirement (the “Proposed ATB Regulations”)¹⁷ and the Temporary Regulations.

As a general matter, the Temporary Regulations implement Section 355(b)(3)(D)’s directive to modify the application of the hot stock rules in connection with the application of Section 355(b)(3) by treating the DSAG as a single corporation for purposes of the hot stock rules and by providing that stock of Controlled that any member of the DSAG acquires during the pre-distribution period in a taxable transaction generally constitutes hot stock.¹⁸ The Temporary Regulations also include a broad new exception from the hot stock rules, pursuant to which Section 355(a)(3)(B) does not apply to an acquisition of Controlled stock if Controlled is a DSAG member at any time after the acquisition, but prior to the Section 355 distribution.¹⁹ As a result, under the Temporary Regulations the hot stock rules apply only in the limited case where Distributing has Section 368(c) control but does not have Section 1504(a) control at any time after the acquisition. As a corollary to treating the DSAG as a single corporation for purposes of Section 355(a)(3)(B), the Temporary Regulations provide that the hot stock rules do not apply to an acquisition of stock of Controlled from another member of the DSAG, or to an acquisition of stock of Controlled from another member of the acquiring corporation’s affiliated group.²⁰

As described in the preamble, the Temporary Regulations’ approach resolves conflicts that would otherwise arise as a result of the application of Section 355(a)(3)(B)

¹⁷ Prop. Treas. Reg. § 1.355-3, 72 Fed. Reg. 26012 (May 8, 2007).

¹⁸ Temp. Treas. Reg. § 1.355-2T(g)(1). For purposes of the Temporary Regulations, the term “taxable transaction” means “a transaction in which gain or loss was recognized in whole or in part.” Temp. Treas. Reg. § 1.355-2T(g)(4)(i).

¹⁹ Temp. Treas. Reg. § 1.355-2T(g)(2)(i).

²⁰ Temp. Treas. Reg. § 1.355-2T(g)(1), (g)(2)(ii). As discussed in greater detail below, the affiliate exception will automatically sunset if Treasury finalized the Proposed ATB Regulations in their current form.

to stock of Controlled that Distributing acquired in a recognition transaction during the pre-distribution period if Controlled's trade or business satisfies the active trade or business requirement of Section 355(b) because the business is treated as an expansion of an existing trade or business or because Controlled became a member of the DSAG in a transaction in which no gain or loss is recognized under Section 355(b)(2)(C) and the Proposed ATB Regulations.²¹

II. SUMMARY OF RECOMMENDATIONS

We commend the IRS and Treasury for the Temporary Regulations, which we believe appropriately balance the concerns that underlie Section 355(a)(3)(B) and the other protections afforded against earnings and profits bailout under Section 355, and the changes to Section 355(b) effected by TIPRA and the Technical Corrections Act. The following is a brief summary of our comments and recommendations regarding the Temporary Regulations.

1. We concur with the IRS's and Treasury's conclusion that the hot stock rules should not apply to an acquisition of Controlled stock if Controlled is a member of the DSAG at any time after the acquisition, but prior to the distribution of Controlled. Part IV.A.

2. We agree that transfers of Controlled stock within the DSAG should be disregarded for purposes of the hot stock rules. Part IV.B.

3. We believe that the current law exception for transfers of Controlled stock among affiliated group members from application of the hot stock rules should not be eliminated, at least as it applies to transfers among domestic affiliates. For example, we

²¹ T.D. 9435, 2009-4 I.R.B. 333 (2009) (hereinafter "Preamble").

believe an affiliate transfer exception is appropriate if the transferor is a domestic affiliate that held the Controlled stock throughout the pre-distribution period or if the transferor acquired the Controlled stock during the pre-distribution period in a transaction in which no gain or loss is recognized. The final regulations should also include the exception for cash for fractional shares in proposed Treasury Regulations Section 1.355-3(b)(4)(iii).

Part IV.B.

4. We believe that Section 355(a)(3)(B) should not apply to indirect acquisitions of Controlled stock except in certain limited circumstances, and that bailout concerns raised by indirect acquisitions are adequately policed by other provisions within Section 355. For these reasons, we recommend that the IRS and Treasury confirm that the hot stock rules do not reach indirect acquisitions of Controlled stock, except in the case of an indirect acquisition entered into with a principal purpose of avoiding the hot stock rules. Part IV.C.

5. For reasons similar to those pertaining to indirect acquisitions of Controlled stock, we recommend that the IRS and Treasury issue guidance that confirms that acquisitions by predecessors are outside the reach of the hot stock rules, except for (i) transactions entered into with a principal purpose of avoiding the hot stock rules and (ii) transactions in which the predecessor corporation was a member of Distributing's affiliated group, if the predecessor acquired the Controlled stock in a recognition transaction during the pre-distribution period. Part IV.D.

6. We believe that the Tax Court reached the correct result in *Dunn Trust v. Commissioner* and that reconciling Section 355(a)(3)(B) and Section 355(b) should not include extending the reach of the hot stock rules to apply to stock held by Controlled ("real" Controlled issues). Whether a subsidiary of Controlled is in fact the "real" Controlled due to reliance on the subsidiary's business in order to meet the requirements of Section 355(b) is more appropriately addressed within the confines of the active trade or business regime. Part IV.E.

7. We recommend that the IRS and Treasury follow the approach adopted in Revenue Ruling 78-442 and exclude issuances of Controlled stock from the ambit of the hot stock rules. Part IV.F.

8. We do not recommend that the IRS and Treasury adopt disguised acquisition rules applicable to the redemption by Controlled of its stock using cash or other assets provided by Distributing. A redemption that is, in substance, an acquisition of Controlled stock by Distributing should be subject to Section 355(a)(3)(B) under existing step transaction and substance over form principles. Part IV.G.

III. DEVELOPMENT OF THE HOT STOCK AND ACTIVE TRADE OR BUSINESS RULES

A. 1954 Legislative History.

The hot stock rules were introduced in the Senate version of Section 355(a)(3) of the 1954 Code²² in order to prevent the conversion of excess, liquid funds into additional Controlled stock that Distributing could distribute on a tax-free basis.²³ The final version of the 1954 Code enacted by Congress treats as taxable boot any “stock of a controlled corporation acquired by reason of any transaction which occurs within 5 years of the distribution of such stock, and in which gain or loss was recognized in whole or in part.”²⁴ The final version of Section 355(a)(3) expanded the scope of the original Senate proposal, which would have applied only to stock acquired by a distributing corporation

²² See S. REP. NO. 83-1622 (1954).

²³ See *supra* note 8.

²⁴ I.R.C. § 355(a)(3) (1954) (emphasis supplied).

within 5 years of its distribution, in a transaction in which gain or loss was recognized in whole or in part.²⁵

The Conference Committee Report (“1954 Conference Report”) states that the Senate proposal was modified “to make certain that, in addition to treating stock of a controlled corporation purchased directly by the distributing corporation as ‘other property,’ similar treatment will be given such stock if it is purchased within 5 years through the use of a controlled corporation or of a corporation which, prior to a ‘downstairs merger’, was in control of the distributing corporation.”²⁶ The 1954 Conference Report gives two examples of “by reason of” acquisitions: (i) Distributing causes a subsidiary to acquire stock of Controlled during the pre-distribution period in a recognition transaction and thereafter Distributing acquires the Controlled stock through a liquidation of the subsidiary in which no gain or loss is recognized under Section 332 and (ii) a parent corporation purchases stock of Controlled and then merges into Distributing in a tax-free merger.²⁷ The examples illustrate that Congress intended the final “acquired by reason of any transaction” language of Section 355(a)(3) to prevent Distributing from avoiding the application of the hot stock rules simply by having a related party acquire the Controlled stock in a recognition transaction and then transfer the Controlled stock to Distributing in a non-recognition transaction.

B. TIPRA and Technical Corrections Act Amendments to Section 355.

In 2006, TIPRA amended the active trade or business rules of Section 355(b) by adding Section 355(b)(3), which treats all members of a corporation’s SAG as a single corporation for purposes of determining whether the distributing corporation and the

²⁵ 1954 Conference Report, at 38.; S. REP. NO. 83-1622 (1954).

²⁶ 1954 Conference Report, at 38.

²⁷ *Id.* Diagrams illustrating the two examples are set out in Exhibit A.

controlled corporation satisfy the active trade or business requirement.²⁸ According to the House Committee Report, the amendment was intended to simplify planning for corporate groups that use holding company structures, and in particular to eliminate the need for elaborate pre-spin internal restructurings to place active businesses in the proper entities to satisfy the active trade or business requirement.²⁹ The TIPRA amendment to Section 355(b) did not provide for corresponding changes to the hot stock rules, and the legislative history also is silent on this issue.

Unlike TIPRA, the Technical Corrections Act's further amendment to Section 355(b) expressly provided for corresponding changes to the hot stock rules. In relation to the active trade or business rules, the Technical Corrections Act clarified that, for purposes of determining whether a corporation satisfies the active trade or business requirement of Section 355(b)(2)(A), if a corporation becomes a member of a SAG in one or more transactions in which gain or loss was recognized in whole or in part, then any trade or business conducted by the acquired corporation is treated as acquired in a transaction in which gain or loss is recognized in whole or in part for purposes of Section 355(b)(2).³⁰ As a result, in a transaction in which a corporation becomes a member of a SAG in one or more recognition transactions, there is a potential overlap between the active trade or business test, which treats that transaction as an asset acquisition, and the hot stock rules, which could apply by reference to the acquisition of the corporation's stock.

However, the Technical Corrections Act also amended Section 355(b)(3)(D) to instruct Treasury to prescribe regulations that provide for the proper application of Sections 355(b)(2)(B), (C) and (D) in the case of any corporation that is tested for active business under the SAG rule and to prescribe regulations that "modify the application of

²⁸ TIPRA, § 202.

²⁹ H.R. REP. NO.109-304, at 53-54 (2005).

³⁰ Technical Corrections Act, § 4(b)(2).

[Section 355(a)(3)(B)], in connection with the application of [Section 355(b)(3)]” (emphasis supplied).³¹ In its explanation of the Technical Corrections Act, the Joint Committee on Taxation provides additional color on the application of Section 355(b)(3) to Sections 355(b)(2)(B), (C) and (D), specifying both that if a corporation becomes a member of a SAG as a result of one or more transactions in which gain or loss was recognized in whole or in part, the acquisition of the SAG member’s stock is treated as an asset acquisition which is subject to the provisions of Section 355(b)(2)(C) and that the resulting deemed asset acquisition may qualify as an expansion of an existing trade or business.³² However, the Joint Committee explanation of the hot stock coordination rule is limited to a statement to the effect that Treasury Regulations should modify the application of Section 355(a)(3)(B) in a manner consistent with the purposes of the changes to Section 355(b)(3).³³

C. *Dunn Trust Case.*

The development of the hot stock rules also has been shaped by *Dunn Trust v. Commissioner*, in which the Tax Court held that Section 355(a)(3)(B) did not apply to AT&T’s distribution of stock of Pacific Telesis Group (“PacTel”), a Bell regional holding company, even though the distribution constituted an indirect distribution of recently acquired stock of Pacific Telephone and Telegraph Company, a Bell operating company (“Pacific”), that AT&T contributed to PacTel in anticipation of the spin-off.³⁴ During the pre-distribution period, AT&T in effect acquired a portion of the stock of Pacific in a recognition transaction and then contributed the stock of Pacific and certain other Bell operating companies to PacTel in exchange for PacTel stock in a transaction in

³¹ *Id.*

³² Joint Committee on Taxation, *Description of The Tax Technical Corrections Act of 2007, As Passed By the House of Representatives*, at 5 (JCX-119-07), December 18, 2007 (hereinafter “Technical Corrections Act Bluebook”).

³³ *Id.* at 5.

³⁴ *Dunn Trust*, 86 T.C. 745.

which no gain or loss was recognized.³⁵ The IRS asserted that the distribution of PacTel stock should be treated as an indirect distribution of the recently acquired Pacific stock and therefore the portion of the PacTel stock equal to the fair market value of the recently acquired Pacific stock should be treated as boot under Section 355(a)(3)(B).³⁶ The IRS asserted, alternatively, that: (i) the “by reason of any transaction” language of Section 355(a)(3)(B) is sufficiently broad to encompass PacTel stock that AT&T acquired by reason of the contribution of the recently acquired Pacific stock to PacTel or (ii) the overall statutory framework of Section 355 requires Pacific, as part of PacTel, be treated as a Controlled for purposes of Section 355(a)(3)(B).³⁷

In response to the first argument, the Tax Court held that Section 355(a)(3)(B) should be read literally and should apply only if Distributing acquires stock of Controlled itself in a recognition transaction during the pre-distribution period.³⁸ The distribution of the PacTel shares by AT&T was outside the scope of Section 355(a)(3)(B) because the stock of PacTel was not acquired in a recognition transaction (the Pacific stock was).³⁹ The Tax Court also declined to accept the IRS’s second argument that Pacific was the “real” Controlled for purposes of Section 355(a)(3)(B).⁴⁰ The Tax Court noted that, unlike Section 355(b), which has look-through provisions for purposes of determining whether Distributing and Controlled are engaged in an active trade or business, neither Section 355(a)(3)(B) nor its legislative history suggest that a look-through rule should apply for purposes of the hot stock rules.⁴¹ The Tax Court also found that the principles of Section 355(a)(3)(B) were not offended by AT&T’s distribution of the PacTel stock because the Pacific stock remained in corporate solution after the spin-off and therefore

³⁵ *Id.* at 746-50.

³⁶ *Id.* at 750-51.

³⁷ *Id.* at 751.

³⁸ *Id.* at 753.

³⁹ *Id.*

⁴⁰ *Id.* at 754.

⁴¹ *Id.*

AT&T did not bail out earnings.⁴² The Tax Court’s holding in *Dunn Trust* therefore rejects a broad reading of the “by reason” language of Section 355(a)(3)(B) and adopts a narrow interpretation of the statute that limits the application of Section 355(a)(3)(B) to stock of Controlled. That is, under *Dunn Trust*, the relevant inquiry is whether the actual stock distributed was acquired by Distributing, directly or in certain multiple-step transactions, in a recognition transaction within the pre-distribution period.

IV. DISCUSSION

A. *Reconciliation of Hot Stock and Active Trade or Business Rules.*

The Temporary Regulations implement the Technical Corrections Act’s mandate to reconcile the hot stock rules with the SAG regime that applies for purposes of the active trade or business rules by: (i) treating the DSAG as a single corporation for purposes of Section 355(a)(3)(B), so that stock of Controlled that any member of the DSAG acquires during the pre-distribution period in a recognition transaction generally is treated as boot and (ii) providing a broad exception from the hot stock rules that applies if Controlled is a member of the DSAG at any time after the acquisition but prior to the spin-off.⁴³ Consistent with treating the DSAG as a single corporation, the Temporary Regulations also provide that the hot stock rules do not apply to an acquisition of Controlled stock by one member of the DSAG from another member of the DSAG.⁴⁴ As a result, under the Temporary Regulations, the acquisition of Controlled stock by Distributing (or any other member of the DSAG) during the recognition period is never a problem under Section 355(a)(3)(B) if Distributing (or any other member of the DSAG)

⁴² *Id.* at 756. The Tax Court explained that if the IRS wanted to challenge the type of transactions involved in *Dunn Trust* as an attempt to bail out earnings and profits, then it could challenge such transactions as a “device” under Section 355(a)(1)(B). *Id.* at 757.

⁴³ Temp. Treas. Reg. § 1.355-2T(g)(1), (2)(i).

⁴⁴ Temp. Treas. Reg. § 1.355-2T(g)(1).

acquires sufficient stock so that Distributing has Section 1504(a) control of Controlled at any time after the acquisition but prior to the spin-off. Section 355(a)(3)(B)'s scope is therefore, in general, limited to acquisitions of Controlled stock during the pre-distribution period by Distributing (or any other member of the DSAG) if Controlled is not a member of the DSAG at any time after the acquisition and Distributing has only Section 368(c) control of Controlled at the time of the spin-off. For the reasons described below, we believe the Temporary Regulations' approach strikes a sensible balance in reconciling the purposes of the hot stock and the active trade or business rules.

Very generally, in considering the proper scope of the Temporary Regulations, we took into account two main considerations. One is that, as described above, assuming the continued viability of *Dunn Trust*, the potential application of the hot stock rules is in any event relatively narrow. The other is that, conversely, the active trade or business test post-TIPRA and Technical Corrections Act applies very broadly. In addition, as described elsewhere, there are many other Section 355 rules that police potential abuses.

In analyzing the Temporary Regulations' approach, we considered two main alternatives for implementing Section 355(b)(3)(D)'s directive to modify the application of Section 355(a)(3)(B) in connection with the application of Section 355(b)(3):

- (1) providing a more limited exception, solely for transfers of Controlled stock between DSAG members; and
- (2) providing a broad exception for all taxable stock acquisitions by a DSAG member if Controlled is a member of the DSAG after the acquisition (the approach of the Temporary Regulations).

An exception from Section 355(a)(3)(B) that applies to intra-DSAG transfers only would effect a limited reconciliation of the Section 355(b) SAG rules and the Section

355(a)(3)(B) rules, while preserving the application of the hot stock rules in relation to stock acquired from outside of the DSAG. Carving out intra-DSAG transfers from the hot stock rules is consistent with the structure of Section 355(b)(3), which treats the SAG as a single corporation. This is similar to the approach that we recommended in our Report on Proposed Regulations Regarding the Active Trade or Business Requirement Under Section 355(b), and we agree with Treasury and the IRS that any reconciliation of Section 355(b)(3)'s SAG rules and Section 355(a)(3)(B) should include an exception for intra-DSAG transfers.⁴⁵

The Temporary Regulations' approach of providing an exception for all taxable stock acquisitions by a DSAG member if Controlled is a member of the DSAG after the acquisition goes well beyond the approach that we recommended in our report on the proposed active trade or business regulations. As discussed below, there is a technical justification for limiting the application of the hot stock rules to avoid conflict with the deemed asset purchase framework of Section 355(b)(3)(C). However, it is difficult to conclude from the legislative history to TIPRA or the Technical Corrections Act that Congress had any particular expectations as to how the hot stock rules would be reconciled with the TIPRA and Technical Corrections Act changes to Section 355(b). Therefore, the Temporary Regulations' narrowing of the hot stock rules ultimately should rest on a policy determination that Section 355's many and somewhat overlapping protections sufficiently protect earnings bailout so that the application of Section 355(a)(3)(B) can be limited to spin-offs when Controlled is not a member of the DSAG at any time prior to the distribution (i.e., when Distributing has 368(c) control, but not Section 1504(a) control, of Controlled).

⁴⁵ See NYSBA Tax Section, Report on Proposed Regulations Regarding the Active Trade or Business Requirement Under Section 355(b) (Report No. 1142, Jan. 11, 2008), available at www.nysba.org (Sections/Committees, Tax Section, Tax Section Reports/Tax Section Reports 2008). This report was drafted prior to the enactment of the Technical Corrections Act. The acquisition of Controlled stock from an affiliate that is not a member of the DSAG is more complex, as discussed in Part IV.B., below.

As described in the preamble to the Temporary Regulations, as a technical matter, a limited exception from Section 355(a)(3)(B) that applies only to intra-DSAG transfers would conflict with the Technical Corrections Act changes to Section 355(b)(3), which adopt a deemed asset purchase framework for taxable stock acquisitions that result in a corporation becoming a member of the SAG. In particular, Section 355(b)(3)(C) provides that, if a corporation becomes a member of a SAG as a result of one or more transactions in which gain or loss was recognized, any trade or business conducted by the corporation will be treated as acquired in a transaction in which gain or loss is recognized for purposes of Section 355(b)(2).⁴⁶ In addition, the legislative history to the Technical Corrections Act contemplates that the expansion doctrine will be available with respect to a deemed acquisition of a trade or business resulting from a stock acquisition pursuant to which the target joins the SAG.⁴⁷ Taken together, the deemed asset purchase framework that applies when Controlled joins the DSAG and the application of the expansion doctrine allow the DSAG to acquire Section 1504(a) control of Controlled in a recognition transaction, but for a trade or business of Controlled nevertheless to qualify as an expansion of an existing trade or business of the DSAG.

Under an approach to reconciling the hot stock rules and Section 355(b)(3) that exempts only intra-DSAG transactions, if Distributing acquires Section 1504(a) control of Controlled in one or more recognition transactions during the pre-distribution period but Controlled's business satisfies the active trade or business requirement by virtue of the expansion doctrine, the Controlled stock would be treated as hot stock under Section 355(a)(3)(B) notwithstanding the applicability of the expansion doctrine. In contrast, under *Dunn Trust* the purchase of stock of a target corporation other than Controlled in a recognition transaction that is deemed to be an asset purchase under Section 355(b)(3) and that also is treated as an expansion of an existing trade or business under the expansion doctrine generally would not cause a subsequent spin-off of Controlled with

⁴⁶ I.R.C. § 355(b)(3)(C); *see also* Prop. Treas. Reg. § 1.355-3(b)(1)(ii).

⁴⁷ Technical Corrections Act Bluebook, at 5.

target as a subsidiary of Controlled to be subject to the hot stock rules.⁴⁸ Limiting the application of the expansion doctrine in the case of an acquisition of Controlled through the hot stock rules seems somewhat arbitrary and inconsistent with the deemed asset purchase framework of the Section 355(b)(3)(C) rules and the statement in the Technical Corrections Act legislative history that the expansion doctrine should be available in the deemed asset purchase context, and also cuts against the purpose of the TIPRA changes to Section 355(b)(3) of reducing the need for complex pre-spin restructurings.

The Temporary Regulations narrow substantially the applicability of the hot stock rules to instances where Distributing (or the DSAG) has Section 368(c) control of Controlled, but does not acquire Section 1504(a) control. We believe this approach recognizes appropriately that the numerous anti-bailout protections afforded by Section 355, including the active trade or business rules, the device rules and the cash-rich split-off rules described in Part I above, afford sufficient protection against earnings bailout so that the hot stock rules can be narrowed to cover spin-offs of a Controlled with respect to which the DSAG has Section 368(c) control but does not have Section 1504(a) control.⁴⁹

B. Transfers Among DSAG Members and Members of Affiliated Groups.

We believe that the Temporary Regulations appropriately treat the DSAG as a single corporation for purposes of Section 355(a)(3)(B) and disregard transfers of Controlled stock between DSAG members.⁵⁰ Treating the DSAG as a single corporation for purposes of the hot stock rules is consistent with Section 355(b)(3), which treats all

⁴⁸ See, e.g., *Dunn Trust v. Commissioner*, 86 T.C. 745 (1986).

⁴⁹ The definition of “control” for purposes of Section 368(c) allows Controlled to issue low voting stock with a value substantially in excess of 20% of Controlled’s stock to non-DSAG members while remaining within the DSAG’s Section 368(c) control. We believe that in general a spin off of a Controlled that is not a member of the DSAG at any time following the acquisition of controlled stock is more susceptible to manipulation and therefore appropriately falls within the scope of the hot stock rules.

⁵⁰ See Temp. Treas. Reg. § 1.355-2T(g)(1).

members of the SAG as a single corporation for purposes of determining whether the corporation is engaged in an active trade or business, and with the Proposed ATB Regulations, which generally extend that treatment to the application of Section 355(b)(2)(B) and (b)(2)(C). The Temporary Regulations also provide that Section 355(a)(3)(B) does not apply to an acquisition of stock of the controlled corporation described in Regulations Section 1.355-3(b)(4)(iii).⁵¹ Under the current Regulations, this cross-reference in effect provides that an acquisition of stock from a member of a Section 1504(a) affiliated group is not subject to the hot stock rules, which is the same result that applied prior to issuance of the Temporary Regulations.⁵² However, if the Proposed ATB Regulations are finalized in their current form, the affiliated group exception will be eliminated and replaced by an exception that applies only to acquisitions by the CSAG from the DSAG and an exception for cash for fractional shares.⁵³

We do not believe that the legislative directive in Section 355(b)(3)(D) to modify the application of the hot stock rules in connection with Section 355(b)(3) requires Treasury to eliminate the present law exception from Section 355(a)(3)(B) for transfers among affiliated group members, at least as it applies to transfers among domestic affiliates.⁵⁴ In the case of the active trade or business rules, the TIPRA changes to Section 355(b)(3) limit the universe of permitted intra-group transfers to the SAG, so that the acquisition of stock of a target from an affiliate that is not a member of the SAG in a

⁵¹ Temp. Treas. Reg. § 1.355-2T(g)(2)(ii).

⁵² See Temp. Treas. Reg. § 1.355-2T(g)(5), Ex. 4 (Controlled stock that Distributing acquires from a member of its affiliated group which is not a member of the DSAG is not hot stock). The exception from Section 355(a)(3)(B) for affiliate transfers was formerly included in Regulations Section 1.355-2(g), which was removed when the Temporary Regulations were issued. Regulations Section 1.355-3(b)(4)(iii) generally defines “affiliated group” by reference to Section 1504(a), without regard to Section 1504(b).

⁵³ Prop. Treas. Reg. § 1.355-3(b)(4)(iii). We support the proposed exception for cash for fractional shares, which we view as a rule of convenience.

⁵⁴ We have not considered the implication of expanding this concept to transfers among foreign affiliates or between foreign and domestic affiliates, which were permitted by the prior regulations.

recognition transaction generally is treated as a taxable acquisition for purposes of the active trade or business rules.⁵⁵ However, the hot stock rules, which are intended to prevent Distributing from bailing out liquid assets to its shareholders in the form of stock of Controlled, serve a different purpose than the active trade or business rules. The undesirable bailout potential may not be present if the cash or liquid assets that Distributing used to acquire the stock of Controlled is retained by a member of the acquiring corporation's affiliated group.⁵⁶ For example, we believe that a DSAG member's acquisition of Controlled stock from a domestic affiliate that is not a member of the DSAG in a transaction in which gain or loss is recognized should not be subject to Section 355(a)(3)(B) if the transferor member of the affiliated group held the Controlled stock throughout the pre-distribution period, or if the transferor member of the affiliated group acquired the Controlled stock during the pre-distribution period in a transaction in which no gain or loss was recognized.

As a technical matter, if the affiliated group exception is retained in whole or in part, the IRS and Treasury will need to amend the Temporary Regulations' cross-reference to Regulations Section 1.355-3(b)(4)(iii) and (iv) prior to, or in connection with, the finalization of the Proposed ATB Regulations which, as discussed above, would otherwise eliminate the affiliated group exception.⁵⁷

C. Indirect Acquisitions.

The IRS and Treasury have requested comments on the extent to which Section 355(a)(3)(B) should apply to stock of Controlled that is held by a target corporation if the

⁵⁵ TIPRA, § 202.

⁵⁶ *Cf.* Treas. Reg. § 1.355-2(d)(3)(iv) (the fact that stock of Controlled is distributed to one or more domestic corporate shareholders is evidence of nondevice).

⁵⁷ *Cf.* Temp. Treas. Reg. § 1.355-2T(g)(5) Ex. 4 (illustrating the exception for acquisitions of Controlled stock from an affiliate).

target corporation becomes a member of the DSAG during the pre-distribution period in a transaction in which gain or loss is recognized.⁵⁸ Similar considerations apply to a target corporation that acquires Controlled stock during the pre-distribution period in a transaction in which gain or loss is recognized if the target corporation subsequently becomes a member of the DSAG in a transaction in which no gain or loss is recognized.⁵⁹

Under the deemed asset acquisition framework of the Proposed ATB Regulations, if the target corporation joins the DSAG in a recognition transaction, the DSAG is treated as acquiring the assets of the target indirectly, in a recognition transaction for purposes of Section 355(b)(2)(C).⁶⁰ We considered whether a similar indirect acquisition rule should apply for purposes of Section 355(a)(3)(B) whereby the DSAG's acquisition of target stock in a recognition transaction would be treated as the acquisition by the DSAG in a recognition transaction of a proportionate share of target's Controlled stock if target joins the DSAG before the spin-off of target. In the absence of an indirect acquisition rule, target could subsequently transfer the Controlled stock that it holds to Distributing in an intra-DSAG transaction that is disregarded under the Temporary Regulations.⁶¹ An indirect acquisition rule would be consistent with the anti-bailout purpose of the hot stock rules because it would prevent the DSAG from using liquid assets to acquire a target corporation with Controlled stock embedded in it.

Nevertheless, on balance, we believe that Section 355(a)(3)(B) generally should not apply to indirect acquisitions of Controlled stock. First, as a general matter, we believe that the hot stock rules should be somewhat narrowly interpreted, in view of the overlapping limitations on using liquid assets to acquire Controlled stock imposed by the

⁵⁸ Preamble, § 4.A.

⁵⁹ Preamble, § 4.A. Diagrams illustrating two indirect acquisitions are set out in Exhibit A.

⁶⁰ Prop. Treas. Reg. § 1.355-3(b)(1)(ii), (b)(4)(i)(A).

⁶¹ Temp. Treas. Reg. § 1.355-2T(g)(1).

device rules, the active trade or business rules and the hot stock rules.⁶² Second, unlike Section 355(b)(2)(D), Section 355(a)(3)(B) does not expressly refer to indirect stock acquisitions. Although the “by reason of” in Section 355(a)(3)(B) can be read to support an indirect acquisition rule that would apply to the transactions described in the preamble to the Temporary Regulations, Congress’ stated concern was limited to capturing predecessor acquisitions by affiliates that are subsequently combined with Distributing in a non-recognition transaction (e.g., a taxable acquisition of Controlled stock by a parent corporation that merges into Distributing or by a corporation that liquidates into Distributing).⁶³ In addition, the legislative history to TIPRA and the Technical Corrections Act changes, which were generally intended to simplify matters for taxpayers by eliminating the need for complex pre-spin restructurings, does not indicate that Congress envisioned expanding Section 355(a)(3)(B) to cover indirect acquisitions in order to align the hot stock rules with Section 355(b)(3). The *Dunn Trust* case, discussed in Part III.C above, also suggests that the hot stock rule should be read narrowly in the case of indirect acquisitions because the Tax Court rejected the IRS’s argument that Section 355(a)(3)(B)’s “by reason of” language is broad enough to reach stock of a target corporation that Distributing holds indirectly through Controlled.⁶⁴ Finally, we believe the bailout potential of converting excess earnings into stock of Controlled is likely to be more attenuated in the case of indirect acquisitions because the DSAG’s assets are used to acquire the stock of target, rather than stock of Controlled.

As a result, we recommend that the IRS and Treasury confirm that Section 355(a)(3)(B) generally does not apply to indirect acquisitions. However, we believe it would be appropriate and consistent with the DSAG framework of the Temporary Regulations to treat as hot stock any Controlled stock that the DSAG indirectly acquires

⁶² An indirect acquisition of Controlled stock during the pre-distribution period may also bring Section 355(d), which expressly applies to indirect acquisitions, into play. I.R.C. § 355(d)(8)(B).

⁶³ 1954 Conference Report, at 38.

⁶⁴ *Dunn Trust*, 86 T.C. at 751.

as a result of the acquisition of target corporation stock in a recognition transaction if: (i) the target corporation acquired the Controlled stock during the pre-distribution period in a transaction in which gain or loss is recognized and (ii) a principal purpose of the DSAG's acquisition of the target corporation or the target's acquisition of the Controlled stock is to avoid the application of the hot stock rules.

An indirect acquisition of Controlled stock that results from a target corporation's acquisition of Controlled stock during the pre-distribution period in a recognition transaction, followed by the DSAG's acquisition of Section 1504(a) control of the target corporation stock in a non-recognition transaction, is a more difficult case since it resembles more closely the predecessor acquisition examples identified in the 1954 Conference Report. However, as in the case of indirect acquisitions of Controlled stock attributable to the acquisition of target corporation stock in a recognition transaction, we believe that the "by reason of" language in Section 355(a)(3)(B) generally should not be extended to indirect acquisitions of Controlled stock that are attributable to a target corporation joining the DSAG in a non-recognition transaction. We also note that, under the Proposed ATB Regulations, Distributing generally will not be able to rely on Controlled's trade or business if the target corporation acquired the Controlled stock in a recognition transaction during the pre-distribution period.⁶⁵

As in the case of an indirect acquisition through a recognition transaction, an anti-abuse rule could apply to an indirect acquisition if a principal purpose of the DSAG's acquisition of the target corporation or the target's acquisition of the Controlled stock is to avoid the application of the hot stock rules.

⁶⁵ See Prop. Treas. Reg. § 1.355-3(b)(4)(i)(A).

D. Predecessor Acquisitions.

The IRS and Treasury have requested comments on whether additional guidance should be issued that treats the DSAG as making any acquisition made by a predecessor of a DSAG member.⁶⁶ For this purpose, a predecessor would be defined as a corporation the assets of which are acquired in a transaction that is subject to Section 381(a).⁶⁷ As drafted, the Temporary Regulations generally capture predecessor acquisitions if the predecessor corporation is a member of the DSAG at the time it acquires the Controlled stock in a recognition transaction because the Temporary Regulations treat all members of the DSAG as a single corporation.⁶⁸ As a result, the Temporary Regulations already cover some of the concerns described in the 1954 legislative history in relation to acquisitions of Controlled stock by controlling corporations or controlled corporations that are subsequently merged or liquidated into Distributing. For example, the acquisition of Controlled stock in a recognition transaction by a member of the DSAG followed by a merger or liquidation of the DSAG member into Distributing is subject to Section 355(a)(3)(B) under the Temporary Regulations. Predecessor acquisitions are covered by the Proposed ATB Regulations, which treat a corporation as including any predecessor corporation that transfers its assets to the corporation in a transaction to which Section 381 applies.⁶⁹

However, we believe that the purpose of Section 355(b)(2)(C) and (b)(2)(D), to prevent the direct or indirect acquisition of a trade or business to be relied on for purposes of Section 355(b) in exchange for assets, is broader than Section 355(a)(3)(B), which applies to stock of a Controlled that Distributing acquires “by reason” of a recognition transaction during the pre-distribution period. We also believe that there is less of a need

⁶⁶ Preamble, § 4.A.

⁶⁷ *Id.*

⁶⁸ Temp. Treas. Reg. § 1.355-2T(g)(1).

⁶⁹ Prop. Treas. Reg. § 1.355-3(b)(iv)(A).

for Section 355(a)(3)(B) to have the same reach as Section 355(b) because the acquisition of Controlled stock by a predecessor corporation, must in any event pass muster under the Proposed ATB Regulations (and the proposed regulations under Section 355(e)), assuming they are finalized in their current form.⁷⁰ As in the case of indirect acquisitions, an anti-abuse rule could apply to predecessor acquisitions where a principal purpose of the predecessor's acquisition of the Controlled stock or the subsequent Section 381(a) transaction is to avoid the application of the hot stock rules. Therefore, we do not believe that Section 355(a)(3)(B) should be expanded to capture predecessors that were not affiliated with the DSAG prior to the Section 381 transaction, and the final Regulations should confirm this point.

However, in light of the examples in the 1954 Conference Report, we believe it would be appropriate to treat the DSAG as acquiring Controlled stock in a recognition transaction if the predecessor was a member of Distributing's affiliated group and the predecessor acquired the Controlled stock in a recognition transaction during the pre-distribution period. As a result, Distributing would not be able to avoid the application of the hot stock rules by acquiring the stock of Controlled through a non-DSAG parent corporation that subsequently merges into Distributing.

E. Which Entity is the Real Controlled?

The IRS and Treasury have asked whether Distributing's indirect ownership, through Controlled, of stock of a target corporation that would be treated as boot under Section 355(a)(3)(B) if Distributing directly held the target stock should cause a portion of the stock of Controlled to be treated as boot under Section 355(a)(3)(B).⁷¹ The preamble to the Temporary Regulations states that the IRS and Treasury are considering a rule that would provide that the target corporation should be treated as the "real"

⁷⁰ See Prop. Treas. Regs. §1.355-8(a).

⁷¹ Preamble, § 4.A.

Controlled in these circumstances if the CSAG would not satisfy the active trade or business requirement of Section 355(b) without taking into account the trade or business conducted by target in these circumstances. For the reasons set out below, we believe that Section 355(a)(3)(B) should not be extended to cover indirectly held stock of a target corporation.

Under the Temporary Regulations, issues as to which entity is the “real” Controlled may arise in relation to Section 355(a)(3)(B) if Distributing or another member of the DSAG acquires stock of a target corporation in a recognition transaction during the pre-distribution period and then transfers the target stock to Controlled in a non-recognition transaction, if Controlled is not a member of the DSAG at any time prior to the spin-off, but the target corporation is a member of the CSAG.⁷² Under the Proposed ATB Regulations, the CSAG would not be able to rely on target’s trade or business for purposes of Section 355(b) if Section 1504(a) control of the target corporation is not acquired through qualifying non-recognition transactions, unless the expansion doctrine applies. Similar issues may arise if Controlled is not a member of the DSAG and: (i) the CSAG acquires Section 1504(a) control of a target corporation in a transaction in which gain or loss is recognized but the target corporation’s business is treated as a qualifying active trade or business under the expansion doctrine, (ii) the CSAG acquires stock of the target corporation in a recognition transaction during the pre-distribution period but the CSAG holds old and cold Section 1504(a) control of the target corporation or (iii) the CSAG acquires Section 1504(a) control of the target corporation in a qualifying non-recognition transaction under Section 355(b)(2)(C) and the Proposed ATB Regulations. In each of these three cases, under Section 355(b)(3) and the Proposed ATB Regulations, the CSAG may rely on an active trade or business conducted by the target corporation for purposes of Section 355(b) even though a portion of the stock of

⁷² A diagram illustrating a which entity is the “real” Controlled example is set out in Exhibit A.

target was acquired during the pre-distribution period in a transaction in which gain or loss was recognized.⁷³

We believe that in the cases described above, Section 355(a)(3)(B) should not apply to a distribution of Controlled stock that is also an indirect distribution of stock of the target corporation because: (i) the DSAG has not acquired any Controlled stock in a taxable transaction and (ii) extending the application of Section 355(a)(3)(B) to the acquisition of target stock is not required by the TIPRA and Technical Corrections Act changes to Section 355(b).

The statutory language of Section 355(a)(3)(B) applies to Controlled stock that Distributing acquired by reason of any transaction during the pre-distribution period in which gain or loss was recognized.⁷⁴ As discussed above, the 1954 legislative history indicates that the “by reason of” language is intended to pick up cases in which the stock of Controlled is acquired by an affiliate in a transaction in which gain or loss is recognized and thereafter the stock is transferred to Distributing in a non-recognition transaction such as a merger or liquidation.⁷⁵ There is no indication in the statute or the legislative history that stock that Distributing does not hold directly should be treated as hot stock.

The question of which entity is the real Controlled was at issue in the *Dunn Trust* case, discussed in Part III.C above, in which the Tax Court declined to read the “by reason” of language of Section 355(a)(3)(B) to cover stock of Pacific that AT&T (Distributing) acquired in a recognition transaction and then contributed to PacTel (Controlled). We believe that Section 355(b)(3)(D)’s mandate to modify the application

⁷³ See Prop. Treas. Reg. § 1.355-3(b)(4).

⁷⁴ Note that, unlike Section 355(a)(3)(B), Section 355(b)(2)(D) specifically addresses indirect acquisitions.

⁷⁵ See 1954 Conference Report; see also *Dunn Trust*, 86 T.C. 745.

of Section 355(a)(3)(B) in connection with the Technical Corrections Act changes to Section 355(b)(3) does not warrant a reversal of the *Dunn Trust* case. More generally, we believe that concerns regarding which entity is the “real” Controlled in circumstances in which the CSAG or DSAG is relying on a particular target corporation to satisfy the active trade or business test are more appropriately dealt with in the Regulations under Section 355(b).

F. Issuances of Controlled Stock to Distributing in a Taxable Transaction.

In certain circumstances Controlled may issue stock to Distributing in a taxable transaction. For example, Distributing may acquire Controlled stock in connection with a Section 351 transaction where Section 357(c) applies to the issuance of Controlled stock. Distributing may also acquire Controlled stock from Controlled in a taxable transaction that does not satisfy the requirements of Section 351, such as a transaction in which Distributing acquires stock of Controlled for cash in a transaction that is not part of a larger Section 351 transaction.

We agree with the IRS and Treasury that, consistent with the holding of Revenue Ruling 78-442,⁷⁶ stock of Controlled that Distributing acquires in a taxable transaction should not be treated as hot stock.⁷⁷ An issuance of Controlled stock to Distributing in a recognition transaction should not be treated in a different manner for purposes of Section 355(a)(3)(B) than Distributing’s contribution of cash or other liquid assets to Controlled prior to the spin-off in a non-recognition transaction, which is not proscribed by the hot stock rules. Section 355(a)(3)(B) is designed to prevent Distributing from converting cash or other liquid assets, the distribution of which to shareholders would otherwise be treated as a taxable distribution, into additional stock of Controlled that can be distributed without the recognition of gain or loss under Section 355. “A bailout, like

⁷⁶ 1978-2 C.B. 143.

⁷⁷ See Preamble, § 4.B.

a dividend, by definition requires a distribution out of corporate solution.”⁷⁸ Contributing cash or other liquid assets to Controlled in a taxable transaction is fundamentally different than using the same liquid assets to acquire additional shares of Controlled prior to a spin-off of the Controlled shares. In the former case, the cash remains within corporate solution and will be taxed under the normal dividend rules upon distribution. In the latter case, Distributing converts cash into Controlled stock that, absent the application of Section 355(a)(3)(B), could be distributed on a non-recognition basis and thereafter could be sold by the shareholders of Distributing in a capital gains transaction. We believe that concerns about transfers of excess liquid assets to Controlled are appropriately addressed by the device rules and by the limitations in Section 355(g) on “cash rich split-offs” involving disqualified investment corporations. In addition, the IRS will not ordinarily issue a ruling or determination letter regarding whether the active trade or business requirement is met if Distributing acquired control of Controlled through the contribution of cash, or other liquid or inactive assets, in a non-recognition transaction under Section 351(a) or Section 368(a)(1)(D).⁷⁹

G. Redemptions of Controlled Stock; Disguised Use of Distributing Cash to Acquire the Controlled Stock.

The IRS and Treasury have requested comments regarding the effect of pre-spin redemptions of Controlled stock for purposes of Section 355(a)(3)(B).⁸⁰ We agree with the IRS and Treasury that a redemption of Controlled stock generally should not cause any portion of Distributing’s shares of Controlled to be treated as hot stock.⁸¹ Section 355(a)(3)(B) applies to Controlled stock that is acquired by Distributing by reason of a transaction in which gain or loss is recognized within the pre-distribution period. In the

⁷⁸ *Dunn Trust*, 86 T.C. at 756.

⁷⁹ Rev. Proc. 2009-3, 2009-1 I.R.B. 107.

⁸⁰ Preamble, § 4.C.

⁸¹ *See id.*

case of a redemption, Distributing does not acquire any stock of Controlled. In addition, ignoring redemptions for purposes of Section 355(a)(3)(B) is consistent with the purpose of the hot stock rules to prevent Distributing from bailing out earnings in the form of recently acquired Controlled stock that shareholders can dispose of in capital gain transactions. In the case of a redemption, the cash or assets that Controlled uses to redeem its stock have not been converted to additional Controlled stock that is distributed to Distributing's shareholders in a spin-off. Instead, the proceeds of the redemption are distributed to the Controlled's shareholders in a taxable distribution or disposition, as determined under Section 302, and Distributing's shareholders receive a smaller Controlled in the subsequent spin-off.

As described in the preamble to the Temporary Regulations, a taxable redemption of Controlled stock is treated as a taxable acquisition of Controlled stock for purposes of Section 355(b)(2)(D).⁸² However, as Treasury and the IRS recognize in the preamble, the statutory reach of Section 355(b)(2)(D), which permits pre-distribution period acquisitions of stock only if control of the target is acquired by reason of a transaction in which gain or loss was not recognized, is broader than that of the hot stock rules, which apply to Controlled stock that Distributing acquires by reason of one or more transactions in which gain or loss is recognized.⁸³

We agree with the IRS and Treasury that Section 355(a)(3)(B) should apply to a transaction that is structured as a redemption of Controlled stock from a shareholder other than Distributing but that is, in substance, an acquisition of the Controlled stock by Distributing.⁸⁴ This result is consistent with Revenue Ruling 75-360,⁸⁵ which provides

⁸² Preamble, § 4.C. *See also* *McLaulin v. Commissioner*, 276 F.3d 1269 (11th Cir. 2001); Rev. Rul. 57-144, 1957-1 C.B. 123; Prop. Treas. Reg. § 1.355-3.

⁸³ Preamble, § 4.C.

⁸⁴ *See id.*

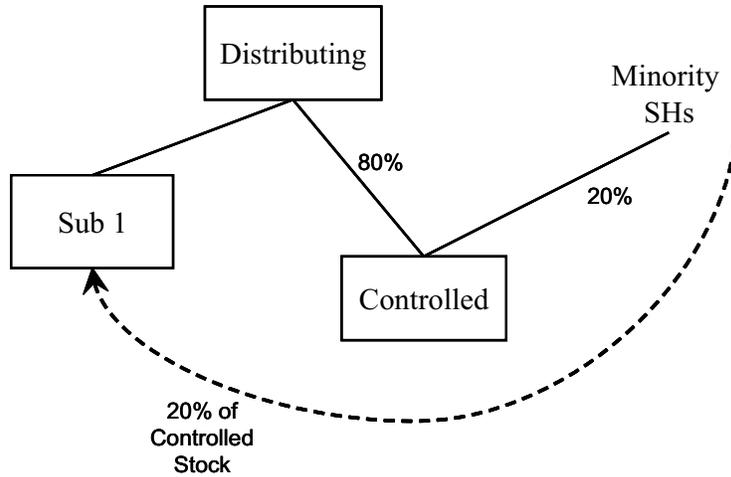
⁸⁵ 1975-2 C.B. 110.

that the acquisition of target stock is not solely in consideration for voting stock within the meaning of Section 368(a)(1)(B) if a purported pre-sale redemption was funded with short-term borrowing that was replaced with cash contributed by the acquiring corporation following the acquisition constituted an integrated transaction. However, in view of the substantial complexity associated with implementing workable disguised acquisition regulations, we do not recommend introducing shareholder-to-shareholder disguised acquisition rules to Section 355(a)(3)(B). Instead, a redemption that is a disguised acquisition by Distributing should be treated as an acquisition for purposes of the hot stock rules under existing step transaction and substance over form principles.

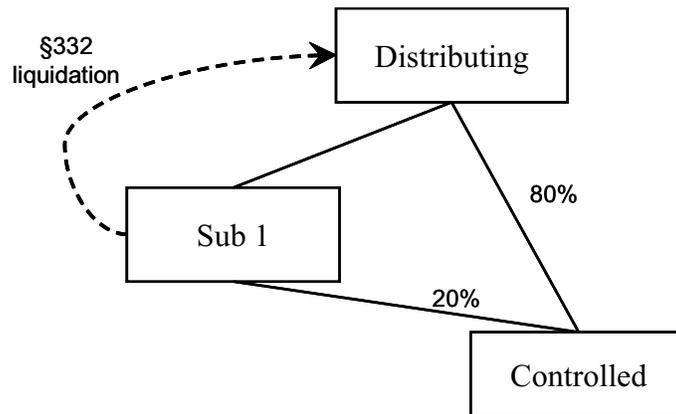
Exhibit A

1954 Conference Report Example 1

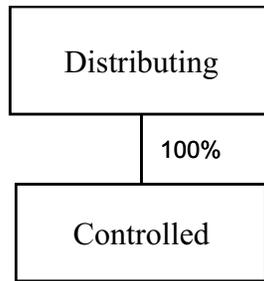
Step 1 Distributing causes Sub 1 to acquire 20% of Controlled's stock in a recognition transaction during the pre-distribution period. Distributing has held the other 80% of Controlled's stock for more than 5 years.



Step 2 Distributing acquires the 20% of Controlled that is now held by Sub 1 through a Section 332 liquidation of Sub 1, a non-recognition transaction.



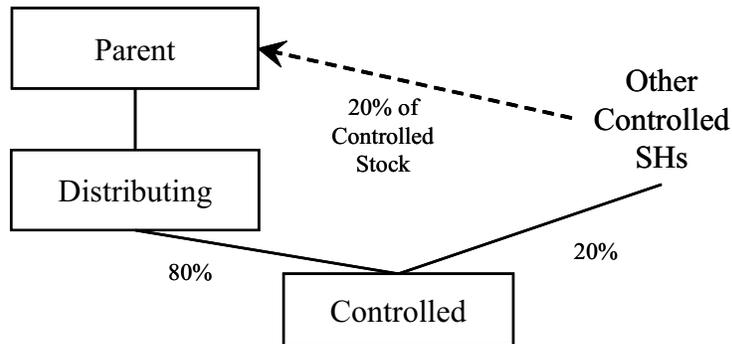
Pre-Spin Result



1954 Conference Report Example 2

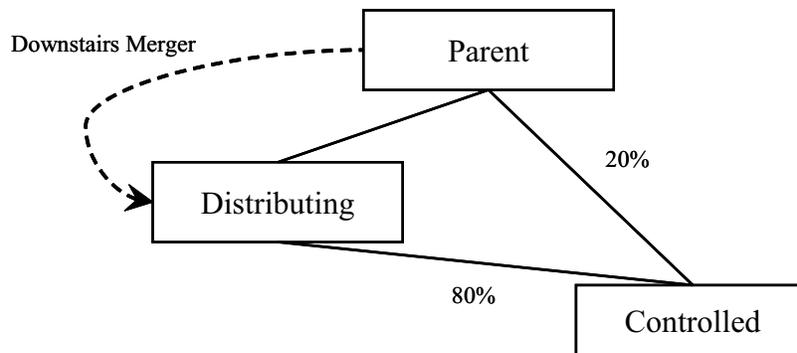
Step 1

Parent acquires 20% of Controlled's stock in a recognition transaction during the pre-distribution period. Distributing has held the other 80% of Controlled's stock for more than 5 years.

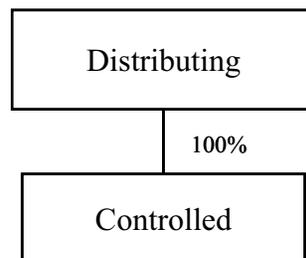


Step 2

Distributing acquires 20% of Controlled's stock from Parent pursuant to a downstairs merger of Parent into Distributing, a nonrecognition transaction.

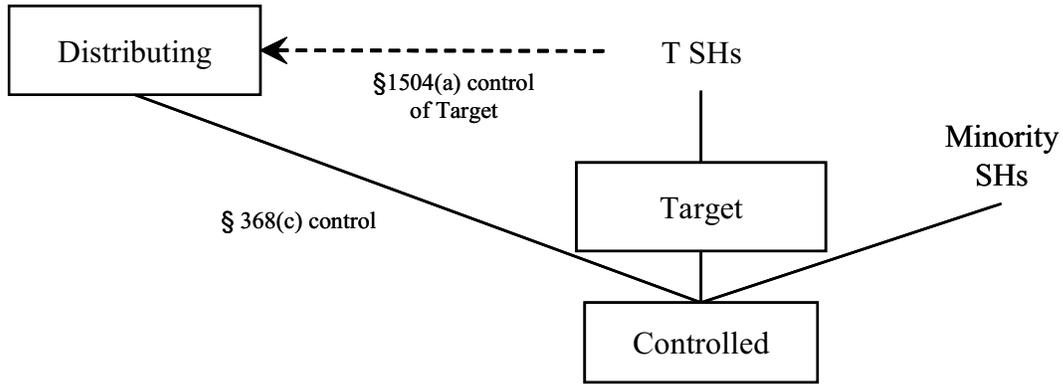


Pre-Spin Result

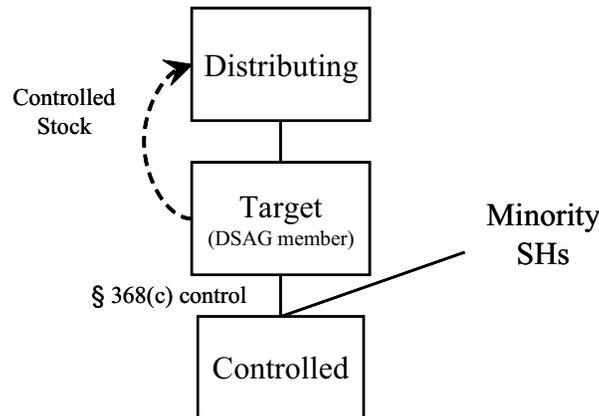


Indirect Acquisition: Distributing Acquires Target in Recognition Transaction

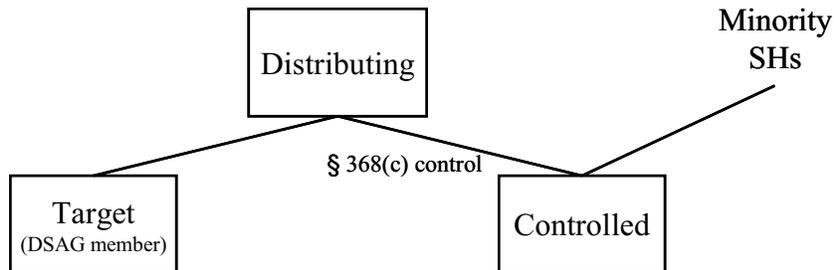
Step 1 Distributing acquires Section 1504(a) control of Target in a recognition transaction during the pre-distribution period. Target holds all or a portion of Controlled's stock.



Step 2 Distributing acquires the Controlled stock from Target in a transaction that is disregarded because Target is a member of the DSAG.

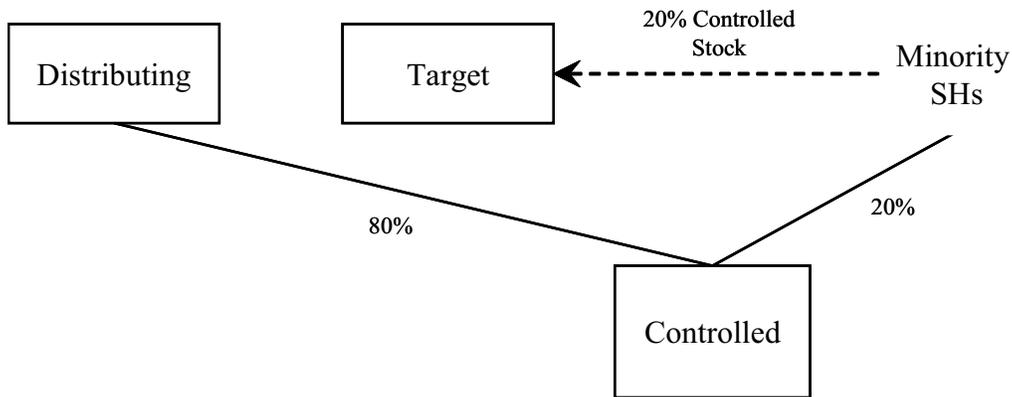


Pre-Spin Result

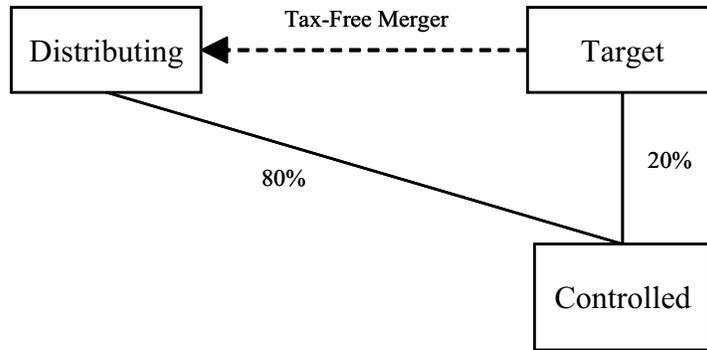


Indirect Acquisition: Distributing Acquires Target in a Non-recognition Transaction

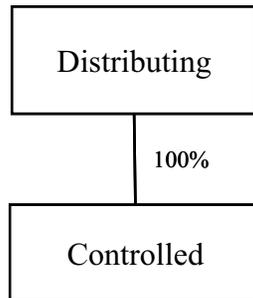
Step 1 Target acquires all or a portion of Controlled's stock in a recognition transaction during the pre-distribution period.



Step 2 Target merges into Distributing in a non-recognition transaction.

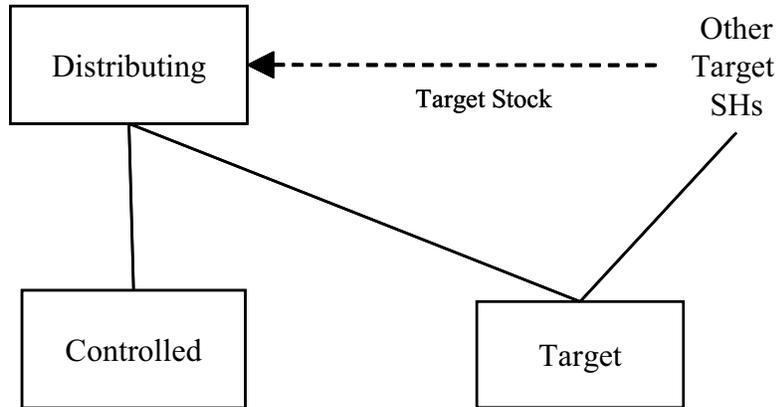


Pre-Spin Result

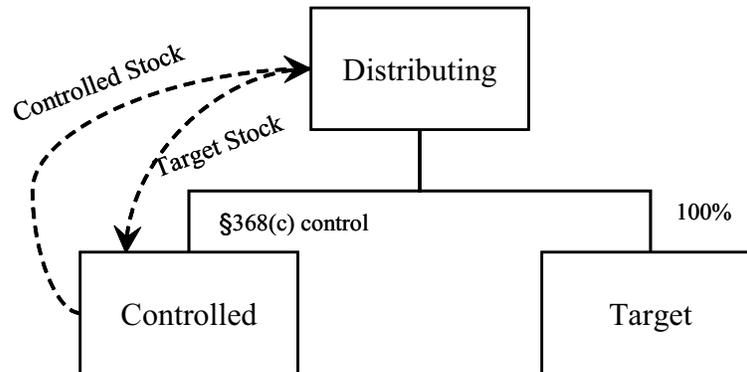


Which Entity is the “Real” Controlled

Step 1 Distributing acquires minority interest in Target in a recognition transaction.



Step 2 Distributing contributes 100% of the Target stock to Controlled in exchange for Controlled stock in a non-recognition transaction.



Pre-Spin Result

