Section of Taxation

10th Floor
740 15th Street, N.W.
Washington, DC 20005-1022
202-662-8670
FAX: 202-662-8682
E-mail: tax@abanet.org

May 26, 2010

Hon. Douglas Shulman
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224

Re: Comments on Proposed Regulations Regarding the Active Trade or Business Requirement Under Section 355(b)

Dear Commissioner Shulman:

Enclosed are comments on proposed regulations regarding the active trade or business requirement under section 355(b). These comments represent the views of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association, and should not be construed as representing the policy of the American Bar Association.

Sincerely,

Stuart M. Lewis
Chair, Section of Taxation

Enclosure

cc: Michael F. Mundaca, Assistant Secretary (Tax Policy), Department of the Treasury
William Wilkins, Chief Counsel, Internal Revenue Service
Joshua Odintz, Acting Tax Legislative Counsel, Department of the Treasury
William Alexander, Associate Chief Counsel, Office of Associate Chief Counsel (Corporate), Internal Revenue Service

ABA SECTION OF TAXATION

COMMENTS ON PROPOSED REGULATIONS REGARDING THE ACTIVE TRADE OR BUSINESS REQUIREMENT UNDER SECTION 355(b)

These comments ("Comments") are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Steven Flanagan, Derek Cain, and Brandon Hayes of the Corporate Tax Committee of the Section of Taxation. Substantive contributions were made by Gerald Towne, Philip Levine, Marc Countryman, Mark Silverman, Lisa Zarlenga, Jasper Cummings, Michael Schler, and Julie Divola. The Comments were reviewed by Robert Woodward, Committee Chair. The Comments were further reviewed by John P. Barrie of the Section's Committee on Government Submissions and by Peter Blessing, Council Director for the Corporate Tax Committee.

Although the members of the Section of Taxation who participated in preparing these Comments have clients who might be affected by the federal income tax principles addressed by these Comments, no such member (or firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

Contacts: Steven Flanagan
Steven.flanagan@ey.com
202.327.8034

Derek Cain
Derek.Cain@us.pwc.com
202.414.1016

Brandon Hayes
Brandon.hayes@ey.com
202.327.6498

Date: May 26, 2010

EXECUTIVE SUMMARY

Overview

On May 7, 2007, the Department of the Treasury ("Treasury") and the Internal Revenue Service (the "Service") issued Proposed Regulations (the "Proposed Regulations")[1] to provide guidance regarding the application of the active trade or business (the "ATOB") requirement of section 355(b)[2] after the 2006 enactment of section 355(b)(3), which allows a corporation to rely on the business operations of lower-tier affiliates (referred to as the "separate affiliated group" or "SAG") for purposes of the ATOB requirement. The Regulations would apply to distributions that occur after the date that the Regulations are published as final in the Federal Register.

The enactment of section 355(b)(3) has created a number of issues for the application of section 355(b)(2) in certain situations. The Proposed Regulations address some of these issues, in particular with respect to the definition of "transaction in which no gain or loss was recognized" for purposes of section 355(b)(2)(C) and (D). The Proposed Regulations would also revise the "affiliate exception" of Regulation section 1.355-3(b)(4)(iii) by limiting its application to acquisitions made by a corporation from another member of the SAG. These Comments address these aspects of the Proposed Regulations. We expect to submit separate comments regarding whether the acquisition of additional stock of the controlled corporation once it has joined the SAG of the distributing corporation violates section 355(b)(2)(C) in the absence of the application of the expansion doctrine, which is addressed in Notice 2007-60,[3] and the implications of the Proposed Regulations on the section 355(a)(3) "hot stock" rules.

Summary of Recommendations

We recommend that Treasury and the Service issue the Proposed Regulations in final form as soon as possible. Further, we recommend (as discussed more fully below) that the final Regulations:

1. Replace the strict prohibition against the use of a corporation's assets to acquire a trade or business in a tax-free transaction as set forth in Proposed Regulation section 1.355-3(b)(4)(ii) with a facts and circumstances test implemented through the addition of device provisions under Regulation section 1.355-2(d); and

2. Retain the affiliate exception as currently set forth in Regulation section 1.355-3(b)(4)(iii).

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[1] 72 Fed. Reg. 26,012 (2007).
[2] References to a "section" are to a section of the Internal Revenue Code of 1986, as amended (the "Code"), unless otherwise indicated.
[3] 2007-2 C.B. 466.

COMMENTS

I. The Proposed Regulations

A. The SAG Rule

For a distribution to qualify as tax-free under section 355, both the distributing and the controlled corporations must be engaged in the active conduct of a trade or business immediately following the distribution. Pursuant to section 355(b)(2)(B), an ATOB is one that has been actively conducted throughout the five-year period ending on the date of the distribution. Prior to the enactment of the Tax Increase Prevention and Reconciliation Act of 2005 ("TIPRA"),[4] section 355(b)(2)(A) provided that a corporation would be treated as engaged in the active conduct of a trade or business if and only if (1) it is engaged in the active conduct of a trade or business, or (2) substantially all of its assets consist of stock and securities of a corporation controlled by it (immediately after the distribution) which is so engaged.[5] These tests often required corporate groups to engage in preliminary restructurings to place active businesses in the proper entities before making a section 355 distribution. As acknowledged in the Preamble to the Proposed Regulations,[6] section 355(b)(3) was enacted with the goal of eliminating the need for such elaborate restructuring prior to a distribution.

TIPRA suspended the "substantially all" test of former section 355(b)(2)(A) and added section 355(b)(3).[7] Accordingly, TIPRA provided that a corporation will be treated as meeting the requirement of section 355(b)(2)(A) if and only if such corporation is engaged in the active conduct of a trade or business.[8] Further, for purposes of determining whether such corporation is engaged in the active conduct of a trade or business, all members of the corporation's SAG will be treated as one corporation (the "SAG Rule").[9] A corporation's SAG is the affiliated group that would be determined under section 1504(a) if such corporation was the common parent and section 1504(b) did not apply.[10]

The Tax Technical Corrections Act of 2007 ("TTCA") permanently eliminated the "substantially all" language from section 355(b)(2)(A).[11] TTCA also added new subparagraphs (C) and (D) to section 355(b)(3).[12] Section 355(b)(3)(C) provides that if a

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4 Pub. L. No. 109-222, 120 Stat. 345 (2006).
5 For advance ruling purposes, the Service interpreted the reference in section 355(b)(2)(A) to "substantially all" of the corporation's assets as meaning at least 90% of the fair market value of a corporation's gross assets (*i.e*., assets undiminished by liabilities). Rev. Proc. 77-37, 1977-2 C.B. 568.
6 72 Fed. Reg. 26,012, 26,013-14 (2007).
7 Pub. L. No. 109-222, § 202, 120 Stat. 345 (2006).
8 *Id*. (former section 355(b)(3)(A)).
9 Pub. L. No. 109-222, § 202, 120 Stat. 345 (2006) (former section 355(b)(3)(B)).
10 *Id*. The provision enacted in TIPRA originally applied to distributions after May 17, 2006, the date of enactment, and on or before December 31, 2010. The Tax Relief and Health Care Act of 2006 removed the December 10, 2010, sunset clause in section 355(b)(3). Pub. L. No. 109-432, §410(a), 120 Stat. 2963 (2006).
11 Pub. L. No. 110-172, § 4(b)(1), 121 Stat. 2476 (2007).
12 Pub. L. No. 110-172, § 4(b)(2), 121 Stat. 2476 (2007).

corporation became 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, any trade or business conducted by such corporation (at the time that such corporation became such a member) will be treated for purposes of section 355(b)(2) as acquired in a transaction in which gain or loss was recognized in whole or in part. Section 355(b)(3)(D) grants Treasury the authority to prescribe such Regulations as are necessary or appropriate to carry out the purposes of section 355(b)(3), including Regulations that provide for the proper application of subparagraphs (B), (C), and (D) of section 355(b)(2), and modify the application of section 355(a)(3)(B), in connection with the application of section 355(b)(3).

The SAG Rule treats all SAG members as one corporation. Consistent with this rule, the separate existence of subsidiary SAG members is disregarded and all assets (and activities) owned (or performed) by SAG members are treated as owned (and performed) by the distributing or controlled corporation, as appropriate, for purposes of determining whether the ATOB requirement is satisfied. If one distributing SAG ("DSAG") or controlled SAG ("CSAG") member satisfies the ATOB requirement, then distributing or controlled, as appropriate, satisfies the ATOB requirement.

Because section 355(b)(3) treats SAG members as one corporation for purposes of section 355(b), it alters the application of section 355(b)(2)(C) and (D)[13] with respect to the acquisition of stock of a corporation that is or becomes a subsidiary SAG member. The Proposed Regulations treat a transaction that results in a corporation, including the controlled corporation, becoming a subsidiary SAG member as a direct acquisition of all of the assets (and activities) owned (and performed) by the acquired corporation at the time of the acquisition.[14] Such acquisition is tested under section 355(b)(2)(C), and not section 355(b)(2)(D).

Ultimately, the Proposed Regulations address three categories of provisions: (1) guidance regarding the new rules in section 355(b)(3); (2) interpretation and re-examination of the scope of section 355(b)(2)(C) and (D); and (3) coordination between these provisions. As detailed below, the Preamble to the Proposed Regulations explains that to harmonize section 355(b)(2) and (b)(3), it was necessary to take a purpose-based approach in interpreting and applying the provisions. As a result, the Proposed Regulations are not necessarily consistent with the literal language of section 355(b)(2)(C) and (D).

B. Acquisitions of a Trade or Business

Section 355(b)(2)(C) and (D) provides generally that a trade or business acquired, directly or indirectly, during the pre-distribution period will not satisfy the ATOB requirement unless it was acquired in a transaction in which no gain or loss was recognized. The Proposed Regulations preserve the general rule that the trade or business

[13] As discussed in paragraph II.A, *infra*, section 355(b)(2)(C) and (D) provides generally that a trade or business acquired, directly or indirectly, during the pre-distribution period in a transaction in which gain or loss was recognized, in whole or in part, will not satisfy the ATOB requirement.
[14] Prop. Reg. § 1.355-3(b)(1)(ii).

(or interest in a partnership engaged in a trade or business) relied on to meet the ATOB requirement for a corporate separation must not have been acquired by a member of either the DSAG or the CSAG during the five-year period ending on the date of the distribution (the pre-distribution period), unless it was acquired in a transaction in which no gain or loss was recognized.[15]

However, in an attempt to harmonize section 355(b)(2)(C) and (D) with section 355(b)(3), the Proposed Regulations apply a purpose-based interpretation of section 355(b)(2)(C) and (D) that is broader than the literal language of the statute. The Preamble to the Proposed Regulations explains that the common purpose of section 355(b)(2)(C) and (D) is to prevent the distributing corporation from using assets, rather than its stock or stock of a corporation in control of the distributing corporation, to acquire a new trade or business in anticipation of distributing the trade or business to its shareholders tax-free.[16] In addition, the Preamble explains that section 355 is intended to apply to separations of active trades or businesses with which the participants have an historic relationship.[17]

Consistent with these purposes, the Proposed Regulations provide certain exceptions from section 355(b)(2)(C) and (D) for acquisitions in which gain or loss is recognized.[18] Conversely, the Proposed Regulations apply section 355(b)(2)(C) and (D) to certain transactions in which no gain or loss is recognized. In that regard, Proposed Regulation section 1.355-3(b)(4)(ii) provides, in part:

> *Certain transactions treated as transactions in which gain or loss is recognized.* The common purpose of section 355(b)(2)(C) and (D) is to prevent the direct or indirect acquisition of the trade or business to be relied on by a corporation in exchange for assets in anticipation of a distribution to which section 355 would otherwise apply. Generally, if a DSAG member or controlled acquires the trade or business solely in exchange for distributing stock, distributing acquires control of controlled solely in exchange for distributing stock, or controlled acquires the trade or business from distributing solely in exchange for stock of controlled, in a transaction in which no gain or loss was recognized, the requirements of section 355(b)(2)(C) and (D) are satisfied. On the other hand, if the trade or

15 Prop. Reg. § 1.355-3(b)(4)(i)(A).
16 72 Fed. Reg. 26,012, 26,015 (2007).
17 *Id.*
18 The transactions in which recognized gain or loss is disregarded for section 355(b)(2)(C) and (D) purposes include: (i) an acquisition by the CSAG from the DSAG provided that the DSAG controls the controlled corporation immediately after the acquisition (Prop. Reg. § 1.355-3(b)(4)(iii)(A)); (ii) the payment of cash to shareholders for fractional shares, when the cash paid represents a mere rounding off of the fractional shares in the exchange and is not separately bargained for consideration (Prop. Reg. § 1.355-3(b)(4)(iii)(B)); (iii) taxable acquisitions from affiliates that are members of the same SAG immediately before and after the transfer (Prop. Reg. § 1.355-3(b)(1)(ii)); and (iv) acquisitions that expand a pre-existing business (Prop. Reg. § 1.355-3(b)(3)(ii)). In addition, direct or indirect acquisitions by a distributee corporation of control of the distributing corporation in one or more transactions in which gain or loss is recognized will not violate section 355(b)(2)(D) when the basis of the acquired distributing stock in the hands of the distributee corporation is determined in whole by reference to the transferor's basis (Prop. Reg. § 1.355-3(b)(4)(iii)(C)). This exception would apply only to a distribution by the distributing corporation and would not apply for purposes of any subsequent distribution by any distributee corporation.

> business is acquired in exchange for assets of distributing (other than stock of a corporation in control of distributing used in a reorganization) the requirements of section 355(b)(2)(C) and (D) are generally not satisfied. For example, acquisitions by controlled (while controlled by distributing) from an unrelated party made in exchange for controlled stock have the effect of an indirect acquisition by distributing in exchange for distributing's assets. Such acquisitions violate the purpose of section 355(b)(2)(C) even if no gain or loss is recognized.

If the DSAG or CSAG acquires a trade or business, an interest in a partnership engaged in a trade or business, or stock of a corporation engaged in a trade or business in exchange for assets of the DSAG in a transaction in which no gain or loss is recognized, such acquisition would nevertheless be treated as one in which gain or loss is recognized. Specifically, Proposed Regulation section 1.355-3(b)(4)(ii)(A) provides, in part:

> *Certain tax-free acquisitions made in exchange for assets*. An acquisition paid for in whole or in part, directly or indirectly, with assets of the DSAG will be treated as an acquisition in which gain or loss is recognized even if no gain or loss is actually recognized. Acquisitions described in this paragraph (b)(4)(ii)(A) include for example, a transaction in which [(a)] the DSAG or CSAG acquires stock of a corporation engaged in the trade or business to be relied on by transferring assets not constituting the trade or business to be relied on to such corporation in exchange for stock of such corporation, [(b)] the DSAG or CSAG acquires an interest in a partnership engaged in the trade or business to be relied on by contributing assets not constituting the trade or business to be relied on to the partnership, [(c)] the DSAG or CSAG acquires stock of a corporation engaged in the trade or business in an exchange to which section 304(a)(1) applies, or [(d)] distributing acquires a trade or business in exchange for its stock and assets in a transaction in which no loss is recognized by virtue of section 351(b).[19]

Finally, tax-free acquisitions using the stock of SAG subsidiaries can result in a section 355(b)(2)(C) or (D) violation under Proposed Regulation section 1.355-3(b)(4)(iv)(E), which provides that:

> *Acquisitions involving the issuance of subsidiary stock*. If a SAG directly or indirectly owns stock of a subsidiary (including a subsidiary SAG member) and the subsidiary directly or indirectly acquires a trade or business, an interest in a partnership engaged in a trade or business, or stock of a corporation engaged in a trade or business from a person other than such SAG in exchange for stock of

[19] However, the assumption by the DSAG or CSAG of liabilities of a transferor would not, in and of itself, be treated as the payment for assets if such assumption is not treated as the payment of money or other property under any other applicable provision. In addition, an acquisition in which no gain or loss is recognized consisting of a pro rata distribution to which section 355 applies (to the extent the stock with respect to which the distribution is made was not acquired during the pre-distribution period in a transaction in which gain or loss was recognized), a distribution from a partnership that is explicitly excluded by Proposed Regulation section 1.355-3(b)(4)(ii)(B), a reorganization described in section 368(a)(1)(E) or (F), and an exchange to which section 1036 applies, are not acquisitions described in Proposed Regulation section 1.355-3(b)(4)(ii)(A).

> such subsidiary in a transaction in which no gain or loss is recognized (the acquisition), solely for purposes of applying this paragraph (b)(4) with respect to the trade or business, partnership interest, or stock acquired by the subsidiary in the acquisition, the subsidiary's stock directly or indirectly owned by the SAG immediately after the acquisition is treated as acquired at the time of the acquisition in a transaction in which gain or loss is recognized.

C. Limited Affiliate Exception

Regulation section 1.355-3(b)(4)(iii) provides that acquisitions of an ATOB by one member of an affiliated group[20] from another group member are disregarded in applying section 355(b)(2)(C) and (D), even if gain or loss is recognized.[21] The Proposed Regulations would limit this special treatment to transfers in which the assets (or activities) are transferred among SAG members (as opposed to members of the larger affiliated group). Thus, non-SAG member affiliates of the distributing or controlled corporations would be treated in the same manner as unrelated persons for purposes of applying section 355(b)(2)(C) and (D).

Notice 2007-60[22] provides transition relief to taxpayers applying Regulation section 1.355-3(b)(4)(iii) to certain transactions. Specifically, the Notice provides that, notwithstanding the changes made to the section 355(b) ATOB requirement as the result of the enactment of section 355(b)(3) and the issuance of Proposed Regulations that question the continuing vitality of Regulation section 1.355-3(b)(4)(iii), the Service will not challenge, with respect to distributions effected on or before the date of publication in the Federal Register of Temporary or final Regulations modifying Regulation section 1.355-3(b)(4)(iii), the continued applicability of that Regulation (taking into account amendments made to section 355(b)(2)(D) in 1987 and in 1988), which generally applies to distributions on or before December 15, 1987, but which has been administratively applied by the Service to distributions occurring after that date.[23]

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[20] For this purpose, the term "affiliated group" means an affiliated group as defined in section 1504(a) (without regard to section 1504(b)), except the term "stock" includes nonvoting stock described in section 1504(a)(4). Reg. § 1.355-3(b)(4)(iv).

[21] Although Regulation section 1.355-3(b)(4) generally is applicable to distributions on or before December 15, 1987, the Service has applied it administratively to distributions occurring after that date, consistent with the amendments to section 355(b)(2)(D) in 1987 and 1988. *See* Notice 2007-60, 2007-2 C.B. 466; *see also* Pub. L. No. 100-203, 101 Stat. 1330-411 (1987); Pub. L. No. 100-647, 102 Stat. 3580, 3605 (1988).

[22] 2007-2 C.B. 466.

[23] Notice 2007-60 also provides that the Service will not challenge the acquisition by the distributing corporation or its SAG of additional stock of the controlled corporation as a violation of section 355(b)(2)(C) with respect to the controlled corporation for distributions effected on or before the date on which the Proposed Regulations are published as Temporary or final Regulations in the Federal Register, provided that the transaction satisfies the requirements of section 355(b)(2)(D) as in effect before the enactment of section 355(b)(3) in 2006.

II. Background

A. Legislative History of Section 355(b)(2)(C) and (D)

Section 355(b)(2)(C) and (D) was added to the Code in 1954. The Conference Report provided that section 355(b)(2)(C) and (D) was designed to prevent the avoidance of the five-year ATOB requirement.[24] Specifically, the Conference Report explains that section 355(b)(2)(D) was added to prevent avoidance of the ATOB requirement, for example, under the following circumstances:

> The stock of corporation A which owned all of the stock of a subsidiary which was conducting an active business was purchased by corporation B. Before such purchase, corporation B owned only one active business but had cash and other liquid assets. It desired to distribute the active business under section 355(a). Without the amendment, it might be held that corporation B could merge "downstairs" with corporation A, and A could meet the test of section 355(b)(1) by reference to the business formerly held by corporation B and its own business even though one of the businesses had, in effect, been purchased less than 5 years prior to the distribution.[25]

The current version of section 355(b)(2)(C) remains relatively unchanged from the 1954 Code. Prior to 1987, section 355(b)(2)(D) provided that a business acquired in a taxable transaction could qualify as a five-year ATOB only if it was not acquired directly (or through one or more corporations) by another corporation within the proscribed five-year period. Following the repeal of the *General Utilities*[26] doctrine, section 355(b)(2)(D) was modified by section 10223(b) of the Revenue Act of 1987[27] and section 2004(k)(1) of the Technical and Miscellaneous Revenue Act of 1988.[28] The revised language took the repeal of the *General Utilities* doctrine into account by prohibiting distributee corporations from acquiring control of a corporation through "mirror" type transactions within the five-year period.

B. Traditional Application of Section 355(b)(2)(C) and (D)

1. Policy Based Exceptions to Statutory Language

Although the language of section 355(b)(2)(C) and (D) is unambiguous, there are several authorities supporting the position that the plain language of the statute may be disregarded when the application of the statute would be inconsistent with the policy concerns behind section 355(b)(2)(C) and (D). The Second Circuit first addressed this issue in *Commissioner v. Gordon*.[29] In this case, the distributing corporation contributed a qualifying five-year ATOB to the controlled corporation, and in connection with the

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[24] H.R. REP. No. 83-2543 (1954) (Conf. Rep.).
[25] H.R. REP. No. 83-2543, at 37-38 (1954) (Conf. Rep.).
[26] *General Utilities & Operating Co. v. Helvering*, 296 U.S. 200 (1935).
[27] Pub. L. No. 100-203, 101 Stat. 1330.
[28] Pub. L. No. 100-647, 102 Stat. 3342.
[29] 382 F.2d 499 (2d Cir. 1967), *rev'd on other grounds,* 391 U.S. 83 (1968).

contribution, the controlled corporation assumed an amount of liabilities from the distributing corporation in excess of its basis in the transferred assets, resulting in the recognition of gain under section 357(c). In reviewing the application of section 355(b)(2)(C) to the distribution, the court stated:

> The theory underlying 355(b), the active business requirement, is the prevention of the temporary investment of liquid assets in a new business in preparation for a 355(a) division. The primary danger envisioned by the draftsmen of this Section was the creation of the new business and the safeguard was the five-year provision. . . . The second danger was that instead of creating a new business, the corporation would purchase one which had been in existence for over five years and then distribute its stock in place of a dividend. . . . We think that the draftsmen of Section 355 intended these subsections [355(b)(2)(C) and (D)] to apply only to the bringing of new assets within the combined corporate shells of the distributing and the controlled corporations. Therefore, it is irrelevant in this case whether gain was recognized on the intercorporate transfer.[30]

Based on the foregoing rationale, the court held that the transaction did not violate section 355(b) because no liquid assets were temporarily invested in a business, notwithstanding the fact that gain was recognized in the transaction.[31]

Consistent with the court's holding in *Gordon*, the Service has routinely ruled that section 355(b)(2)(C) and (D) does not apply to similar gain recognition transactions in which the gain recognized is not the subject of the policy underlying the statute. For example, in Rev. Rul. 69-461,[32] applying former section 355(b)(2)(D), the Service ruled that there was no violation when a distributing corporation acquired the controlled corporation from a subsidiary of the distributing corporation as a dividend because this was not the type of transaction to which section 355(b)(2)(D) was intended to apply.

The Service reached a similar conclusion in Rev. Rul. 74-5.[33] In the ruling, P purchases X stock which owned Y for five years. Within the five-year period of the purchase, X distributes Y to P, which then distributes Y to P shareholders. The Service ruled that the first spin satisfied section 355(b)(2)(D). However, the second spin did not

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30 382 F.2d at 507.

31 Consistent with *Gordon*, in Rev. Rul. 78-442, 1978-2 C.B. 143, the Service held that an internal restructuring transaction is not the type of transaction to which section 355(b)(2)(C) was meant to apply even though gain was recognized as a result of the transaction. Corporation X actively conducted two businesses for more the five years, and transferred the assets of one business to a newly formed corporation Y in exchange for Y stock and Y's assumption of the liabilities associated with the transferred business. Immediately thereafter, X distributed all of the stock of Y to its shareholders. Because the total amount of the liabilities assumed by Y exceeded X's adjusted basis in the transferred assets on the date of the contribution, X recognized gain pursuant to section 357(c) to the extent of the excess. The Service stated that the rules of section 355(b)(2)(C) are intended to prevent the acquisition of a trade or business by the distributing or controlled corporation from an outside party in a taxable transaction within five years of a section 355 distribution and that such rules should not apply to an acquisition of a trade or business by the controlled corporation from the distributing corporation. Consequently, the Service ruled that the distribution satisfied the requirements of section 355(b)(2)(C).

32 1969-2 C.B. 52.

33 1974-1 C.B. 82.

satisfy section 355(b)(2)(D) because P used cash to purchase the ATOB of Y within the five-year period. The first spin satisfied the requirements of section 355 notwithstanding that it violated the literal words of former section 355(b)(2)(D) because it "is not the type of transaction to which section 355(b)(2)(D) is directed since P is merely the shareholder receiving the distributions and not the distributing or controlled corporation."[34]

In addition to the foregoing rulings, as discussed above, Treasury and the Service promulgated Regulation section 1.355-3(b)(4)(iii), a regulatory exception to the general "no gain or loss" rule in section 355(b)(2)(C) and (D). This Regulation states:

> A direct or indirect acquisition of a trade or business by one member of an affiliated group from another member of the group is not the type of transaction to which section 355(b)(2)(C) and (D) is intended to apply. Therefore, in applying section 355(b)(2)(C) or (D), such an acquisition, even though taxable, shall be disregarded.[35]

The *Gordon* decision, the existing final Regulations, and the Service's guidance, discussed above, established a clear principle that the plain language of section 355(b)(2)(C) and (D) may be disregarded (in each case to the advantage of the taxpayer) when the gain or loss transaction at issue did not represent a potential abuse that these subsections were intended to prevent.

In 2002, the Service determined that an acquisition of an active trade or business violated section 355(b)(2)(C) notwithstanding that the acquisition qualified as a nonrecognition transaction under the Code. In Situation 2 of Rev. Rul. 2002-49,[36] the Service ruled that section 355(b)(2)(C) was considered violated by a transaction in which a distributing corporation acquired an interest in a limited liability company treated as a partnership in exchange for a contribution of appreciated securities. Notwithstanding that the distributing corporation transferred assets to a partnership in a nonrecognition transaction under section 721, the Service ruled that section 355(b) was not satisfied and the distributing corporation could not rely on the active business conducted by the partnership.

The result in Rev. Rul. 2002-49 represented something of a departure from the Service's prior guidance.[37] For example, in Rev. Rul. 71-593,[38] shareholders A and B

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[34] *Id*. In a later ruling that applied the revised section 355(b)(2)(D) to similar facts, the Service's analysis of the first spin was obsoleted. *See* Rev. Rul. 89-37, 1989-1 C.B. 107.

[35] Reg. § 1.355-3(b)(4)(iii). As noted above, in Notice 2007-60 the Service stated that it "will not challenge the applicability of the rule stated in § 1.355-3(b)(4)(iii) to distributions effected on or before the date of publication in the Federal Register of temporary or final regulations modifying the rule stated in § 1.355-3(b)(4)(iii)." 2007-2 C.B. 466. This suggests that the Service understands that the Proposed Regulations are a departure from a widely accepted administrative practice.

[36] 2002-2 C.B. 288.

[37] Note that the last sentence of Regulation section 1.355-3(b)(4)(i) provides that, "[a] trade or business acquired, directly or indirectly, within the five-year period ending on the date of the distribution in a transaction in which the basis of the assets acquired was not determined in whole or in part by reference to the transferor's basis does not qualify under section 355(b)(2), even though no gain or loss was recognized by the transferor." Presumably, this provision applies to otherwise taxable transactions in which gain or

each owned 50% of the stock of corporation X. Shareholder A also owned 25% of the stock of corporation Y, with corporation X owning the remaining 75% of the Y stock. In order to separate the ownership of X and Y, the parties agreed to a split-off transaction in which A would exchange its X stock for the Y stock held by X. To equalize the value of the X stock to be surrendered by A and the Y stock to be received by A, X transferred some of its assets (which are not identified as operating or liquid assets) to Y in exchange for additional shares of Y stock, increasing X's ownership percentage of Y to 90%. The Service ruled that this acquisition of control did not violate section 355(b)(2)(D) because no gain or loss was recognized in the asset-for-stock exchange. The conclusion of this ruling is inconsistent with the result in Situation 2 of Rev. Rul. 2002-49, as well as the Proposed Regulations, because the distributing corporation used its assets to acquire control of the controlled corporation, which had its own active business for purposes of section 355(b).

2. Traditional Statements of Policy Underlying Section 355(b)(2)(C) and (D)

The Proposed Regulations depart from the language of the statute by providing that section 355(b)(2)(C) and (D) may be violated even when a corporation uses assets to acquire an ATOB in a tax-free transaction. As such, a transaction that might otherwise qualify for full non-recognition treatment would be recharacterized as a taxable transaction solely for the purpose of applying section 355(b)(2)(C) and (D). Moreover, the Proposed Regulations arguably would modify current law by providing that the use of any non-ATOB assets, not just cash or liquid assets, to acquire an ATOB may result in a violation of section 355(b)(2)(C) or (D).

Although not entirely clear, the weight of current authorities suggests that section 355(b)(2)(C) and (D) is violated when *excess funds or liquid* assets are used to acquire an ATOB from an *outside party* in a taxable transaction. Arguably, the focus on excess funds or liquid assets is because liquid assets typically are used by a corporation to distribute a dividend to its shareholders and are the property that the government has typically been concerned about with respect to a bailout of earnings and profits. This view is consistent with the example in the 1954 Conference Report explaining that section 355(b)(2)(D) was added to prevent a corporation that had only one ATOB, but which also had cash and other liquid assets, from using the liquid assets to acquire a second ATOB for purposes of facilitating a section 355 distribution.[39] According to one

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loss is not recognized for some reason. For example, these transactions might include an otherwise taxable transaction in which the selling party is a tax-exempt organization or the selling party does not recognize gain or loss because the amount realized by the taxpayer is equal to the adjusted tax basis of the transferred property. In such cases, the basis of the acquired assets is not determined in whole or in part by reference to the transferor's basis. Contrast this with a "nonrecognition" transaction in which gain or loss recognition is deferred by a specific Code section (*e.g.*, section 354) and in which the basis of the transferred property is a "carryover" basis under section 362. The final sentence of Regulation section 1.355-3(b)(4)(i) is arguably concerned with the former type of transaction rather than the latter. *See* GCM 35,633 (Jan. 23, 1974) (stating "[a]ll indications are that the principal purpose of [section 355(b)(2)(C)] was to exclude a business that was acquired in a purchase transaction").

[38] 1971-2 C.B. 181.

[39] H.R. REP. No. 83-2543, at 37-38 (1954) (Conf. Rep.).

group of commentators, section 355(b)(2)(C) "is apparently intended to prevent temporary purchases of going businesses as a method of distributing liquid assets to shareholders. Accordingly, the test has the general purpose of differentiating between acquisitions for cash or other liquid assets, which will not qualify, and acquisitions for stock, which will qualify."[40] Another commentator states that the purpose of section 355(b)(2)(C)

> is to prevent a [d]istributing corporation from, first, using excess cash to acquire a business; and then, later, spinning it off to its shareholders. The concern that this provision deals with is best explained in the context of closely held corporations. There, it would be relatively easy to understand that the alternative to this transaction would be the dividend of the cash to the shareholder(s), followed by a purchase of a target. Thus, this provision is . . . a back stop to the device clause.[41]

Several pieces of judicial and administrative guidance apply this view. For example, in *Gordon*,[42] the Second Circuit reviewed the policies underlying section 355(b)(2)(C) in addressing whether the recognition of gain under section 357(c) violated section 355(b). As noted above, the court expressly stated that the theory behind the active business requirement is the prevention of the temporary investment of liquid assets in a new business in preparation for a section 355 distribution.

Moreover, the Service has made a number of affirmative statements in rulings that section 355(b)(2)(C) and (D) is aimed at preventing the use of a corporation's excess funds or liquid assets to acquire a business for a distribution to its shareholders. For example, in Rev. Rul. 74-5,[43] discussed above in paragraph II.B.1, P purchases X stock which owned Y for five years. Within the five-year period of the purchase, X distributes Y to P, which then distributes Y to P shareholders. Under former section 355(b)(2)(D), the first distribution satisfies 355(b)(2)(D), but the second distribution does not, because P used cash to indirectly purchase the ATOB of Y within the five-year period. In so ruling, the Service states that "[t]he purpose of section 355(b)(2)(D) . . . is to prevent a distributing corporation from accumulating *excess funds* to purchase the stock of a corporation having an active business and immediately distributing such stock to its shareholders."[44]

Additionally, in Rev. Rul. 69-461, the Service states that section 355(b)(2)(D) was "intended to prevent the acquisition of stock of a corporation conducting an active

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[40] Edwin S. Cohen et al., *The Internal Revenue Code of 1954: Corporate Distributions, Organizations and Reorganizations*, 68 HARV. L. REV. 393, 430 (1955).

[41] James M. Lynch, *Tax Free Spin Offs Under Section 355*, 839 PLI/Tax 503, 546-47 (2008); *see also*, Jasper L. Cummings, Jr., *The New Section 355(b) Active Trade or Business Proposed Regulations*, 107 J. TAX'N 74, 86 (Aug. 2007) (stating "indeed, the [active trade or business] requirement appears to have been intended to bolster the device requirement").

[42] Discussed in paragraph II.B.1, *supra*.

[43] 1974-1 C.B. 82.

[44] *Id.* (emphasis added) (citing H.R. Rep. No. 2543, 83rd Cong., 2d Sess. 37 (1954)); *see also* GCM 35,476 (Sept. 13, 1973) (stating "[t]he purpose of [section] 355(b) . . . is the prevention of the temporary investment of liquid assets in a new business by an existing corporation").

trade or business in a taxable transaction from a party not within the direct or indirect control of the distributing corporation."[45] The ruling concludes that section 355(b)(2)(D) was designed to prevent the distributing corporation from accumulating *excess funds* to purchase the stock of an active business and immediately distributing such stock to its shareholders. The Service made a number of similar statements in General Counsel Memoranda addressing the policy underlying section 355(b).[46] These authorities support the position that section 355(b)(2)(C) and (D) is concerned only with preventing a corporation from using the provisions of section 355 as a means of distributing accumulated excess funds or liquid assets to its shareholders.[47]

III. General Comments

In reconsidering the interpretation of section 355(b)(2)(C) and (D) in the Proposed Regulations, it appears that the Service and Treasury sought to identify the ultimate purpose of those provisions and to carry out that purpose in a pure and consistent manner. It seems that the Service and Treasury's theory was (at least in part) that section 355(b)(2)(C) and (D) prohibit gain or loss acquisitions not because such transactions are inherently violative of section 355 policy, but rather because of the type of consideration that must be involved. The legislative history indicates that Congress wanted to ensure that section 355 could not be utilized to effectuate a dividend distribution in a tax-free manner. Accordingly, section 355 had to prevent taxpayers from being able to purchase a new business that could either be spun-off to the corporation's shareholders or used to facilitate the spin-off of an existing business to the corporation's shareholders. This typically would be accomplished using cash or liquid assets, but at a basic level any "unspinable" asset (*i.e.*, any non-ATOB asset) presents this conversion concern. In contrast, the stock of the distributing corporation is distinguishable because the distributing corporation generally could issue its own stock to

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[45] 1969-2 C.B. 52.

[46] *See, e.g.*, GCM 39,264 (July 23, 1984) (applying former section 355(b)(2)(D) and stating "This provision seeks to prevent a corporation from investing its surplus funds in a new business and spinning it off, in preparation for a sale of the business by the shareholders, a scheme that would have the same economic effect as the distribution of money. . . . We agree that the legislative history of section 355(b)(2)(D) allows it to be liberally construed in conformity with congressional intent."); GCM 35,633 (Jan. 23, 1974) (citing *Gordon* for the proposition that section 355(b) is designed to prevent temporary investment of liquid assets); GCM 35,476 (Sept. 13, 1973) (stating "[t]he purpose of [section] 355(b) . . . is the prevention of the temporary investment of liquid assets in a new business by an existing corporation").

[47] However, certain authorities interpreting the policy of section 355(b) do not specifically focus on the nature of the assets used to acquire the subject trade or business or include a broader category of assets. *See, e.g.,* Rev. Rul. 57-144, 1957-1 C.B. 123 (holding that the taxable redemption of a minority shareholder of the controlled corporation, which allowed the distributing corporation to gain control of the controlled corporation within the five-year period preceding a purported section 355 transaction, violated section 355(b)(2)(D)); *McLaulin v. Commissioner*, 115 T.C. 255 (2000), *aff'd* 276 F.3d 1269 (11th Cir. 2001) (finding that a redemption by the controlled corporation of a minority shareholder that allowed the distributing corporation to acquire the requisite control violated section 355(b)(2)(D) when the distributing corporation funded the redemption by way of a loan to the controlled corporation); Rev. Proc. 2009-3, 2009-1 I.R.B. 107 (providing that the Service will ordinarily not rule when the distributing corporation acquires control of the controlled corporation by transferring "cash or other liquid or *inactive assets*" to the controlled corporation in a nonrecognition transaction).

its shareholders without raising the same dividend concerns. As such, stock of the distributing corporation does not present the same conversion concerns as other assets. Accordingly, it seems that generally only the stock of the distributing corporation would be acceptable consideration.[48]

If one accepts this premise, then it is logical to conclude that to carry out the ultimate purpose of section 355(b)(2)(C) and (D), the Regulations must prohibit any acquisition in which assets of the distributing corporation are used as consideration (regardless of whether gain or loss is actually recognized). If the distributing corporation were to acquire the stock of a corporation engaged in an ATOB from an existing nonaffiliated shareholder in exchange for assets, gain or loss (including $0) would be recognized, and section 355(b)(2)(C) or (D) would prohibit the acquisition. However, if the distributing corporation were to acquire newly issued stock of a corporation engaged in an ATOB in exchange for assets, it is possible that no gain or loss would be recognized. Similarly, if the distributing corporation contributed an ATOB (ATB1) to a partnership that had a its own qualifying ATOB (ATB2) in exchange for a 50% partnership interest, and the partnership subsequently sold ATB1 for cash, the distributing corporation would have acquired an interest in a qualifying ATOB (ATB2) in a transaction in which it recognized no gain or loss, but still managed to convert its historic ATOB into liquid assets. Notwithstanding that the taxpayer does not recognize gain or loss, such transactions might be viewed as sufficiently similar to the acquisition from an existing nonaffiliated shareholder, and thus violative of the purposes of section 355(b)(2)(C) and (D) if not the literal language. Similar results might be achieved without the recognition of gain or loss if the distributing corporation were to acquire newly issued stock of a corporation engaged in an ATOB by causing a subsidiary that owns assets to merge into the target corporation, or to have the target corporation merge into the subsidiary corporation in exchange for stock of the subsidiary corporation.

Each of these transactions result in the distributing corporation acquiring stock of a corporation engaged in an ATOB by exchanging assets. The Service and Treasury seem to have designed the Proposed Regulations to produce a consistent ATOB result in each of these situations regardless of the form, and regardless of whether gain or loss is recognized. However, we believe it is unclear that this theory is the precise basis for section 355(b)(2)(C) and (D). Additionally, we believe that the pure application of this theory may prohibit legitimate business transactions that are in no way violative of any section 355 policy. Consequently, we believe that the Proposed Regulations prohibit far more than what Congress appears to have intended.

We acknowledge that the authorities cited above support a departure from the plain language of section 355(b)(2)(C) and (D) when appropriate from a policy perspective, albeit the weight of such authorities support departures that provide a favorable result to the taxpayer. Furthermore, we agree with the general proposition that an acquisition of an ATOB may, in certain limited circumstances, be inconsistent with the policy concerns of section 355(b)(2)(C) and (D) even when non-liquid assets are used

[48] Stock of a corporation in control of the distributing corporation seems also to be acceptable consideration provided it was not a pre-existing asset of the distributing corporation.

to acquire such active business in a completely tax-free transaction. However, we do not believe that section 355(b)(3) and the policy reasons for its enactment, as discussed above, warrant the expansive and mechanical approach adopted by the Proposed Regulations, particularly when that approach is contrary to the plain language of the statute.

Instead, because section 355(b)(2)(C) and (D) is properly characterized as a backstop to the device limitation of section 355(a)(1)(B),[49] we believe that a better methodology for addressing these potentially abusive transactions is to adopt a facts and circumstances approach that would be implemented through the "device" limitation of section 355(a)(1)(B) and Regulation section 1.355-2(d). We believe that the device provisions outlined below will prohibit those transactions that are inconsistent with section 355 policy as traditionally interpreted by the Service, while permitting those legitimate business transactions that do not violate such policy concerns.

IV. Recommendation Concerning Tax-free Acquisitions

We recommend that the final Regulations provide for the replacement of the strict prohibition against the use of a corporation's assets to acquire an ATOB set forth in Proposed Regulation section 1.355-3(b)(4)(ii) with a facts and circumstances test implemented through the addition of device provisions to the existing Regulations under Regulation section 1.355-2(d). Specifically, we recommended the following modifications:

1. Delete Proposed Regulation section 1.355-3(b)(4)(ii) and (iv)(E).

2. In Proposed Regulation section 1.355-3(b)(4)(i), cross reference the device rules proposed below.

3. Add to the general rule with respect to device under Regulation section 1.355-2(d)(1) the following language:

   Generally, a device does not include a transaction in which a DSAG member or controlled corporation acquires a trade or business solely in exchange for the distributing corporation's stock, the distributing corporation acquires control of the controlled corporation solely in exchange for distributing corporation stock, or the controlled corporation acquires the trade or business from the distributing corporation solely in exchange for stock of the controlled corporation, in a transaction in which no gain or loss was recognized. On the other hand, as provided by paragraph (d)(v)(A) of this section, unless otherwise qualifying as an expansion of a pre-existing trade or business, a device may include an otherwise tax-free transaction if the trade or business relied on to satisfy section 355(b) is

[49] Arguably, in this context, the concern of section 355(b)(2)(C) and (D) is purely with the potential for a bailout of earnings and profits, not *General Utilities* repeal (discussed above). Because there is no gain or loss recognized in the transaction absent operation of the Proposed Regulations, there is no potential for a "mirror" type transaction.

acquired in exchange for assets of the distributing corporation (other than stock of a corporation in control of the distributing corporation used in a reorganization) in anticipation of a distribution that would otherwise qualify under section 355. In addition, paragraph (d)(v)(B) of this section provides that a device may include an otherwise tax-free transaction if a substantial portion of the assets used to acquire the trade or business consists of "investment assets" of the distributing or controlled corporation.

4. Add the following new device factor under Regulation section 1.355-2(d):

    (v) *Certain tax-free acquisitions made in exchange for distributing corporation's assets.* – (A) In general. – Unless otherwise qualifying as an expansion of a pre-existing trade or business, a transaction described in this paragraph (d)(v)(A) in which the DSAG or CSAG acquires (whether directly or through a subsidiary or partnership) a trade or business, an interest in a partnership engaged in a trade or business, or stock of a corporation engaged in a trade or business in exchange for assets of the DSAG in a transaction in which gain or loss is not recognized is evidence of device if such acquisition is in anticipation of a distribution that would otherwise qualify under section 355. Acquisitions described in this paragraph (d)(v)(A) are:[50]

        1. Distributing corporation's acquisition of a trade or business in exchange for its stock and assets in a transaction in which no loss is recognized by virtue of section 351(b);

        2. An acquisition of a trade or business by the DSAG or CSAG as a result of a distribution from a partnership unless the acquisition consists of a pro rata distribution from a partnership of stock or an interest in a lower-tier partnership (provided that the distributee partner did not acquire the interest in the distributing partnership in anticipation of the distribution by the partnership in a transaction in which gain or loss was recognized in whole or in part);[51]

        3. The DSAG or CSAG acquires stock of a corporation engaged in the trade or business to be relied on by transferring assets not constituting the trade or business to be relied on to such corporation in exchange for stock of such corporation;

[50] Proposed Regulation section 1.355-3(b)(4)(ii)(A), includes a transaction whereby the DSAG or CSAG acquires stock of a corporation engaged in the trade or business in an exchange to which section 304(a)(1) applies. We do not believe that such a transaction gives rise to device potential to the extent the property received results in the receipt of a dividend under section 301(c)(1). In that case, there is no potential for the bailout of earnings and profits of either the acquiring or issuing corporation.

[51] We do not fully appreciate the policy concerns that necessitated the requirement that the distribution from the partnership be pro-rata, but such concerns are beyond the scope of these Comments.

4. The DSAG or CSAG acquires an interest in a partnership engaged in the trade or business to be relied on by contributing assets not constituting the trade or business to be relied on to the partnership in exchange for an interest of such partnership; or

5. If a SAG member directly or indirectly acquires a trade or business, an interest in a partnership engaged in a trade or business, or stock of a corporation engaged in a trade or business from a person other than another member of such SAG in exchange for stock of such SAG member.[52]

(B) *Investment assets used to make an acquisition.* -- Generally, for acquisitions described in paragraph (d)(v)(A)(3) through (5) of this section, the greater the amount of assets that consist of "investment assets" in the total quantum of assets transferred, of a subsidiary merged into target, or of a subsidiary into which target is merged, the stronger the evidence of device. However, for this purpose, assets should not be considered "investment assets"[53] if held as an integral part of the conduct of a trade or business.[54]

1. An acquisition described in paragraph (d)(v)(A)(3) through (5) of this section is a device if more than two-thirds of the fair market value of the gross assets in the total quantum of assets transferred, of a subsidiary merged into target, or of a subsidiary into which target is merged, consist of "investment assets".[55]

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[52] We recommend that consideration also be given to the adoption of a specific rule to prevent a swap of an interest in a pre-existing five-year active trade or business for an interest in a new active trade or business.

[53] For this purpose, we suggest consideration of whether the "investment asset" definition used for purposes of section 355(g) or section 351(e) is appropriate for the purposes of this rule. We recommend that the final Regulations adopt an anti-abuse rule designed to prevent the taxpayer from using "investment assets" to acquire assets not described as "investment assets" with a principal purpose to circumvent these rules.

[54] *See, e.g.*, H.R. REP. NO. 99-841, II-190 (1986) (Conf. Rep.) (providing in relevant part that with respect to whether the value of a loss corporation is reduced under section 382(l)(4) as a result of holding substantial "nonbusiness assets," the term "nonbusiness assets" includes any asset held for investment, including cash and marketable stock or securities, but not if held as an integral part of the conduct of a trade or business).

[55] This provision is intended to treat as a device (not just evidence of device) any transaction described therein. As an alternative to this rule, we suggest that Treasury and the Service consider replacing Proposed Regulation section 1.355-3(b)(4)(ii) and (iv)(E) with a rule that provides that an otherwise tax-free acquisition of an active trade or business is treated as a gain or loss transaction if more than two-thirds of the fair market value of the gross assets in the package of assets transferred, of a subsidiary merged into a target, or of a subsidiary into which a target is merged, consist of "investment assets." This new provision would then cross reference the device rules proposed herein for situations in which more than one-third, but not more than two-thirds, of the fair market value of the gross assets in the package of assets transferred, of assets of a subsidiary merged into target, or into which target is merged, consist of "investment assets."

2. An acquisition described in paragraph (d)(v)(A)(3) through (5) of this section is substantial evidence of device if more than one-third, but less than two-thirds, of the fair market value of the gross assets in the total quantum of assets transferred, of a subsidiary merged into target, or of a subsidiary into which target is merged, consist of "investment assets."

(C) *Acquisition in anticipation of a distribution.* – The determination of whether an acquisition described in paragraph (d)(v)(A) of this section was made in anticipation of a distribution that would otherwise qualify under section 355 will be made from all of the facts and circumstances. Generally, the shorter the period of time between the acquisition and the distribution, the stronger the evidence of device. For example, an acquisition that occurs during the 12-month period immediately prior to the distribution is substantial evidence of device. However, an acquisition shall not be considered evidence of device if:

(i) There was an identifiable, unexpected change in market or business conditions occurring after the acquisition that resulted in the distribution that was otherwise unexpected at the time of the acquisition; or

(ii) During the 12-month period prior to the acquisition, there were no discussions by the DSAG or CSAG (or a related party) with an investment banker or outside advisor regarding the distribution or similar distribution.

V. Recommendation Concerning Retention of the Affiliate Exception

As discussed above, section 355(b)(2)(C) and (D) is designed to prevent the importation of new assets into the economic unit. Both the case law and the Regulations recognize that the affiliated group is a single economic unit. Specifically, the affiliate exception under Regulation section 1.355-3(b)(4)(iii) generally provides that acquisitions by one member of an affiliated group from another group member are disregarded in applying section 355(b)(2)(C) and (D), even if gain or loss is recognized. The Proposed Regulations would limit this special treatment to transfers in which the assets (or activities) are transferred among SAG members (as opposed to members of the larger affiliated group).[56] Thus, non-SAG member affiliates of the distributing or controlled corporation would be treated in the same manner as unrelated persons for purposes of applying section 355(b)(2)(C) and (D).

The Preamble to the Proposed Regulations suggests that Congress, by adopting section 355(b)(3), intended to draw a tight circle around the SAG for all purposes of section 355(b).[57] As explained in the Preamble, because section 355(b)(3) provides, in

[56] *See* Prop. Reg. § 1.355-3(b)(4)(iii).
[57] *See* 72 Fed. Reg. 26,012, 26,015 (2007).

effect, that all members of the SAG are treated as one corporation in determining whether the trade or business test is satisfied, a transfer of trade or business assets (or activities) among SAG members is disregarded and not treated as an acquisition for purposes of section 355(b)(2)(C) or (D). The Preamble states that the SAG rule implies a corollary, which is that the SAG should not be able to acquire trade or business assets (or activities) from outside the SAG in a transaction in which gain or loss is recognized.

We do not believe that the enactment of section 355(b)(3) necessitates a limitation of the affiliate exception to the SAG. As discussed above, prior to the enactment of section 355(b)(3), the active trade or business test often required corporate groups to engage in restructurings to place a trade or business in the proper entity before making a section 355 distribution. As acknowledged in the Preamble to the Proposed Regulations, section 355(b)(3) was enacted with the goal of eliminating the need for such elaborate restructuring prior to a distribution.[58] Rather than promoting the underlying policy of section 355(b)(3), the proposed limitation of the affiliate exception would again require complex restructurings within the affiliated group to satisfy the ATOB requirement of section 355(b).

For example, assume that P, a higher-tier affiliate of the distributing corporation owns all of the stock of S and the distributing corporation, and the distributing corporation owns all of the stock of the controlled corporation. Only S and the controlled corporation own a five-year ATOB but the distributing corporation wishes to distribute the controlled corporation in a transaction that qualifies under section 355. Under the current affiliate exception, the distributing corporation could directly acquire the ATOB of S in a taxable transaction without violating section 355(b)(2)(C), thereby allowing the distribution of the controlled corporation to qualify under section 355. Under the Proposed Regulations, the distributing corporation's acquisition of S's ATOB in this manner would not satisfy section 355(b)(2)(C) because S is not a member of the DSAG. The Preamble to the Proposed Regulations explains, however, that notwithstanding the limitation to the affiliate exception, the requirements of section 355(b)(2)(C) would be satisfied if P purchases S's ATOB and contributes it to the distributing corporation solely in exchange for the distributing corporation's stock in a transaction in which no gain or loss is recognized.[59] Accordingly, what would require only one step under the current affiliate exception would require two steps under the Proposed Regulations.

Because the proposed limitation to the affiliate exception would again require complex restructurings to satisfy the ATOB test, and without clear legislative intent otherwise, we recommend that the final Regulations retain the affiliate exception without limitation.[60]

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[58] *See id*. at 26,013-14.

[59] *See id*. at 26,023.

[60] We acknowledge that avoidance of the repeal if the *General Utilities* doctrine might still be a concern under the affiliate exception. For example, a distributing corporation could purchase an affiliate (T) outside the DSAG and then have T distribute a controlled corporation to the distributing corporation, thereby resulting in a stepped-up basis in the stock of the controlled corporation without T having recognized gain. This concern, however, is otherwise addressed by section 355(d), which would require gain recognition by

T on the distribution. Similarly, an acquisition by a distributee corporation from within the larger affiliated group should not be an issue.