Hon. Charles P. Rettig  
Commissioner  
Internal Revenue Service 
1111 Constitution Avenue, NW 
Washington, DC 20224

Re: Comments Regarding Application of the Active Trade or Business Requirement under Section 355(b)

Dear Commissioner Rettig:

Enclosed please find comments in response to statements by the Internal Revenue Service regarding the application of the active trade or business requirement under Section 355 of the Internal Revenue Code to businesses without income collection. These comments are submitted on behalf of the 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.

The Section of Taxation would be pleased to discuss these comments with you or your staff.

Sincerely,

Eric Solomon  
Chair, Section of Taxation

Enclosure

cc: Hon. David Kautter, Assistant Secretary (Tax Policy), Department of the Treasury  
Jeffrey Van Hove, Office of Tax Policy, Department of the Treasury  
Krishna P. Vallabhaneni, Tax Legislative Counsel, Department of the Treasury  
Colin Campbell, Attorney-Advisor, Department of the Treasury  
Hon. Michael Desmond, Chief Counsel, Internal Revenue Service  
William M. Paul, Deputy Chief Counsel (Technical), Internal Revenue Service  
Robert H. Wellen, Associate Chief Counsel (Corporate), Internal Revenue Service  
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Lola L. Johnson, Attorney Advisor, Office of Associate Chief Counsel (Corporate), Internal Revenue Service
Comments on the Service’s Statement Regarding Application of the Section 355 Active Trade or Business Requirement to Businesses Without Income Collection

These comments (“Comments”) are submitted on behalf of the American Bar Association Section of Taxation (the “Section”) and have not been approved by the House of Delegates or 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 Amie Colwell Breslow, Steve Fattman, Nicole Field, Philip Mammen, Eileen Marshall, Maury Passman, Amit Sachdeva, Rebecca Sager, Heather Sidwell, and Jay Singer. Significant contributions were made by Bill Alexander, Derek Cain, Bryan Collins, Jack Cummings, Elliott Freier, Scott Levine, Victor Penico, and Tom Wessel. The Comments have been reviewed by David Wheat, Council Director for the Corporate Tax and Affiliated & Related Corporations Committees and Lisa Zarlenka of the Section’s Committee on Government Submissions.

Although members of the Section may have clients who might be affected by the federal tax principles addressed by these Comments, no member who has been engaged by a client (or who is a member of a firm or other organization that has been engaged by a client) to make a government submission with respect to, or otherwise to influence the development or outcome of one or more specific issues addressed by, these Comments has participated in the preparation of the portion (or portions) of these Comments addressing those issues. Additionally, while the Section’s diverse membership includes government officials, no such official was involved in any part of the drafting or review of these Comments.

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Date: July 17, 2019
I. EXECUTIVE SUMMARY

These Comments are in response to two requests for information concerning the active trade or business requirement for section 355 distributions. On September 25, 2018, the Internal Revenue Service (the “Service”) issued a statement announcing that the Service and the Department of the Treasury (the “Treasury”) are considering issuing guidance regarding the active trade or business (“ATB”) requirement under section 355(b) (the “ATB Requirement”). Specifically, the September 2018 Statement indicates that Treasury and the Service are considering guidance addressing the potential qualification under section 355(b) of businesses that have not yet collected income but that are nevertheless engaged in entrepreneurial activity (“No-Income ATBs”) -- e.g., internal research and development (“R&D”), as distinguished from providing R&D services to unrelated customers. On May 6, 2019, the Service issued another statement in which it requested specific information to assist in identifying what types of No-Income ATBs should be treated as satisfying the ATB Requirement.

We commend Treasury and the Service for considering guidance and private letter rulings (“PLRs”) on this question. These Comments discuss the application of section 355(b) to such businesses and recommend, in response to the Statements, that:

1. Rev. Rul. 57-464 should be obsoleted, rather than merely suspended and,
assuming that our recommendation regarding the treatment of No-Income ATBs is adopted, Rev. Rul. 57-492\(^7\) should be obsoleted or revoked.

2. Guidance should be issued to clarify that a No-Income ATB can constitute a “trade or business” within the meaning of Regulation section 1.355-3(b)(2)(ii) if it engages in regular and continuing research and/or developmental (including product development) activities by managerial and operational employees with the intent to generate income or profit and incurs significant regular operational expenses. This guidance should clarify Rev. Rul. 82-219\(^8\) to the extent that such ruling suggests an interpretation of the term “ordinarily” in Regulation section 1.355-3(b)(2)(ii) that is narrower than required by the policy underlying the ATB Requirement and should interpret the phrase “collection of income” in Regulation section 1.355-3(b)(2)(ii) as referring to the collection of gross income.

3. Guidance should be issued that clarifies that the requirement of Regulation section 1.355-3(b)(2)(iii) can be satisfied by a No-Income ATB if the business activities consist of developing intellectual property for commercial use.

4. The Service’s PLR practice regarding No-Income ATBs should apply a flexible rule of reason that looks to whether the policy concerns underlying the ATB Requirement are satisfied.

II. DISCUSSION

A. Section 355(b) Background

Section 355 provides for non-recognition treatment with respect to corporate distributions of the stock of a controlled corporation if certain requirements are met. One of the requirements to qualify under section 355 is that both the distributing corporation and the controlled corporation must be engaged, immediately after the distribution, in the active conduct of a trade or business.\(^9\) For this purpose, a corporation is treated as engaged in the active conduct of a trade or business if, and only if, the corporation is engaged in the active conduct of a trade or business, and the trade or business has been actively conducted throughout the five-year period ending on the date of distribution.\(^10\)

This five-year requirement originated in the Internal Revenue Code of 1954, and it reflects Congressional reaction to prior law. In 1951 (after a 17-year hiatus), Congress reinstated

\(^7\) 1957-2 C.B. 247.
\(^8\) 1982-2 C.B. 82.
\(^10\) I.R.C. § 355(b)(2)(A), (B).
tax-free treatment for qualifying spin-offs, provided the stock of the controlled corporation was distributed pursuant to a plan of reorganization.\footnote{Revenue Act of 1951, § 317, 65 Stat. 452, 493 (1951) (adding section 112(b)(11) of the Internal Revenue Code of 1939). See S. Rep. No. 82-781, at pp. 57-58 (Sept. 18, 1951) (“This section has been included in the bill because your committee believes that it is economically unsound to impede spin-offs which break-up businesses into a greater number of enterprises, when undertaken for legitimate business purposes.”).} Under the 1951 legislation, tax-free treatment was not available if it appeared that “any corporation which is a party to such reorganization was not intended to continue the active conduct of a trade or business after such reorganization.”\footnote{Section 112(b)(11) of the Internal Revenue Code of 1939, as amended by the Revenue Act of 1951, provided that “[i]f there is distributed, in pursuance of a plan of reorganization, to a shareholder of a corporation which is a party to the reorganization, stock (other than preferred stock) in another corporation which is a party to the reorganization, without the surrender by such shareholder of stock, no gain to the distributee from the receipt of such stock shall be recognized unless it appears that (A) any corporation which is a party to such reorganization was not intended to continue the active conduct of a trade or business after such reorganization, or (B) the corporation whose stock is distributed was used principally as a device for the distribution of earnings and profits to the shareholders of any corporation a party to the reorganization.”} Treasury interpreted this limitation to allow the distribution of a controlled corporation that held only cash and investment assets, provided there was a clear and definite plan for the controlled corporation to purchase a continuing business shortly after the distribution.\footnote{See Reg. 111, § 29.112(b)(11)-2, Exs. (2) and (3) (1953), as added by T.D. 5990, 18 Fed. Reg. 999 (1953).}

The House’s 1954 proposal would have permitted the separation of active and inactive businesses. For this purpose, an inactive corporation would have been one with more than ten percent of its income comprised of personal holding company income. In exchange for allowing the separation of an inactive corporation, the House proposal would have imbeded the inactive corporation with a ten-year taint, such that the disposition of its stock within ten years following its separation would have resulted in ordinary income for the shareholder to the full extent of the proceeds, and any amount received in a distribution from such corporation during the ten-year period would have been includible in the recipient shareholder’s income without regard to the amount of earnings and profits of such corporation.\footnote{See Reg. 111, § 29.112(b)(11)-2, Exs. (2) and (3) (1953), as added by T.D. 5990, 18 Fed. Reg. 999 (1953).} To avoid characterization as inactive, a corporation would have had to have been engaged in active business for five years prior to the separation, and to have maintained separate books.\footnote{H.R. Rep’t. No. 83-1337, at p. A-124.} The House proposal was met with
significant criticism in the Senate Finance Committee hearings, and was not advanced.\footnote{16} Instead, the Senate took a different approach, requiring both the distributing and controlled corporations to be engaged in an ATB immediately after the distribution, and requiring a business to have been conducted throughout the five-year pre-distribution period to qualify as an ATB.\footnote{17} The Senate’s approach was adopted in Conference, accompanied by an additional ATB restriction\footnote{18} and a gloss in the conference report regarding business expansion.\footnote{19}

Shortly after the 1954 enactment of section 355, Treasury published proposed regulations implementing the ATB Requirement.\footnote{20} The regulations were issued as final in 1955 (“1955 Regulations”).\footnote{21} In the 1955 Regulations, Treasury and the Service took the position that section 355 was not available for the vertical separation of a single business.\footnote{22} They also took the position that a division of a vertically-integrated business along functional lines, such as the separation of coal mining operations from the manufacture and sale of steel and steel products, was impermissible, on the basis that the activities “in connection with the coal mine do not constitute a trade or business, since such activities are not themselves independently producing income although a part of the business operated for profit.”\footnote{23} In contrast, Treasury and the Service took the view that a business could be separated horizontally, such as along geographical lines, with activities in different states treated as separate businesses. For example, a corporation that manufactured and sold steel containers for oil and oil products was viewed as being engaged

\footnote{16} See, e.g., Hearings Before the Committee on Finance, United States Senate, Eighty-Third Congress, Second Session, on H.R. 8300, Part I, at pp. 384-392 (Apr. 7 and 8, 1954) (written comments of the American Bar Association, Section of Taxation).

\footnote{17} S. Rep’t. No. 83-1622, at pp. 50-52 (June 18, 1954).


\footnote{19} \textit{Id.} at p. 38 (“It is the understanding of the managers on the part of the House, in agreeing to the active business requirements of section 355 and of section 346 (defining partial liquidations), that a trade or business which has been actively conducted throughout the 5-year period described in such sections will meet the requirements of such sections, even though such trade or business underwent change during such 5-year period, for example, by the addition of new, or the dropping of old, products, changes in production capacity, and the like, provided the changes are not of such a character as to constitute the acquisition of a new or different business.”).

\footnote{20} 19 Fed. Reg. 8,237, 8270-8271 (Dec. 11, 1954) (Prop. Reg. § 1.355-1(c)).


\footnote{22} Third sentence of former Reg. § 1.355-1(a) (1955) (“Section 355 does not apply to the division of a single business.”). \textit{See also} former Reg. § 1.355-1(d), Ex. 11 (1955) (a corporation that processed and sold meat products could not engage in a qualifying spin-off; “since the manufacturing and selling activities constitute only one integrated business, neither [distributing nor controlled] will be continuing the active conduct of a trade or business formerly conducted by [distributing].”); Rev. Rul. 58-54, 1958-1 C.B. 181, obsolete\textit{d}, Rev. Rul. 76-566, 1976-2 C.B. 450 (“Where a corporation is engaged in one particular trade or business, the manufacturing activities and the sales activities of that business do not constitute separate businesses. The manufacturing and selling operations constitute only an integrated business, as illustrated by example (11) of section 1.355-1(d) of the [1955 Regulations].”).

\footnote{23} Former Reg. § 1.355-1(d), Ex. (12) (1955). \textit{See also} Rev. Rul. 56-287, 1956-1 C.B. 186, obsoleted, Rev. Rul. 76-566, 1976-2 C.B. 450 (corporation that owned and operated a bus service was unable to spin-off its buses and other transportation equipment, even though it intended to engage extensively in the general business of leasing buses and equipment to various independent small bus operators); Rev. Rul. 58-54, 1958-1 C.B. 181 (soft drink bottling and distributing business was unable to spin-off its distributing operations).
in a separate ATB in each state in which it operated.\textsuperscript{24} Initially, this may have been viewed as favorable to taxpayers, because it allowed a division of a single business otherwise precluded under the 1955 Regulations; however, the Service’s view was also unnecessarily restrictive in that it allowed the Service to argue that a geographically concentrated group of activities did not constitute a qualifying ATB unless those activities had been conducted in that geographic space throughout the five-year pre-distribution period.\textsuperscript{25}

The regulatory prohibition against dividing a single business was not well received by the courts, and the portion of the 1955 Regulations that articulated this position was held to be invalid in a reviewed Tax Court opinion four years after its promulgation.\textsuperscript{26} The Service briefly maintained its position,\textsuperscript{27} but after losing the second appellate decision\textsuperscript{28} on the issue, it reversed course and announced that it would allow the division of a single business notwithstanding its 1955 Regulations.\textsuperscript{29} Similarly, the geographic distinction quickly proved untenable, and was rejected in \textit{Lockwood}.\textsuperscript{30} In addition, the court in \textit{Rafferty} – in a decision won by the Service – expressed significant doubt on the correctness of the 1955 Regulations in light of their overbreadth and the judicial rejection of their single-business requirement.\textsuperscript{31}

The Service had more litigating success in the context of owner-occupied real estate, in which the judicial opinions describe real estate operations that were largely tangential, generated

\begin{itemize}
\item \textsuperscript{24} Former Reg. § 1.355-1(d), Exs. (13) and (14) (1955). See also former Reg. § 1.355-1(d), Exs. (8) and (9) (1955) (a corporation that manufactured and sold ice cream from a plant in one state and that opened up a plant in a second state could not qualify the second plant as an ATB because it was viewed as a new ATB that had not been in existence for the requisite five-year pre-distribution period).
\item \textsuperscript{25} Former Reg. § 1.355-1(d), Ex. (9) (1955) (a men’s clothing store in a downtown area was viewed as a separate trade or business from the suburban store where the two stores were managed and operated independently) and Ex. (15) (corporation that manufactured electrical products in different states); Rev. Rul. 56-227, 1956-1 C.B. 183, obsoleted, Rev. Rul. 80-367, 1980-2 C.B. 386 (domestic corporation engaged in general contracting and construction business in various locations throughout the United States was unable to spin-off a newly organized foreign corporation formed to undertake a new venture in a new territory in a different country, notwithstanding that the formation of and transfer of assets to the new corporation was not in pursuance of a plan having as one of its principal purposes the avoidance of tax under section 367).
\item \textsuperscript{27} The Service issued a non-acquiescence to the Tax Court decision in \textit{Coady}, 1960-2 C.B. 8, and to the Sixth Circuit’s affirmance. Rev. Rul. 61-198, 1961-2 C.B. 61.
\item \textsuperscript{28} \textit{United States v. Marett}, 325 F.2d 28 (5th Cir. 1963). Example 5 in the current regulations, Reg. § 1.355-3(c), Ex. (5), is based on \textit{Marett}. T.D. 8238, 54 Fed. Reg. at 288.
\item \textsuperscript{29} Rev. Rul. 64-147, 1964-1 C.B. 136, revoking Rev. Rul. 61-198.
\item \textsuperscript{30} \textit{Estate of Thorval J. Lockwood v. Commissioner}, 350 F.2d 712 (8th Cir. 1965), rev’g., 23 T.C.M. 1233 (1964).
\item \textsuperscript{31} \textit{Rafferty v. Commissioner}, 452 F.2d 767, 772 (1st Cir. 1971) ("The correctness of [former Reg. § 1.355-1(c) and the examples in former Reg. § 1.355-1(d)] is questionable in view of the rejection of the separate business requirement…. Moreover, we find that the [1955 Regulations] in this area are so broadly drawn that they may in some instances defeat the congressional purpose behind the enactment of § 355.").
\end{itemize}
little income, and presented significant device concerns. Significantly, however, in the _E Ward King_ appeal decided four months after _Rafferty_, the Service lost a real estate case in which the appellate court criticized the 1955 Regulations. In sum, several of the positions the Service had taken in the 1955 Regulations were significantly undermined by the court decisions in _Coady_, _Marett_, _Lockwood_, _Rafferty_, and _E. Ward King_.

In response to these judicial developments, Treasury and the Service issued proposed regulations in 1977 to replace the 1955 Regulations, and published the regulations as final in 1989 (“1989 Regulations”).

The rationale of the courts that addressed the 1955 Regulations is relevant to the No-Income ATB issue considered by these Comments. In the reviewed Tax Court opinion in _Coady_, the court stated:

> A careful reading of the definition of the active conduct of a trade or business contained in subsection (b)(2) indicates that its function is also to prevent the tax-free separation of active and inactive assets into active and inactive corporate entities.

The First Circuit in _Rafferty_ summarized the gravamen of an ATB:

> It is our view that in order to be an active trade or business under § 355 a corporation must engage in entrepreneurial endeavors of such a nature and to such an extent as to

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32 _Isabel A. Elliott v. Commissioner_, 32 T.C. 283 (1959); _Theodore F. Appleby v. Commissioner_, 35 T.C. 755 (1961), aff’d per curiam, 296 F.2d 925 (3d Cir. 1962) (“As stated in the opinion of the Elliott case, supra, ‘we do not think a mere passive receipt of income from the use of property which is used in the principal trade or business and which is only incidental to, or an incidental use of a part of property used primarily in, the principal business would constitute the active conduct of a trade or business within the meaning of section 355(b) of the Code, whether or not such use of property might constitute a trade or business within the meaning of other sections of the Code.’”); _Bonsall v. Commissioner_, 317 F.2d 61, 65 (2d Cir. 1963) (“The continuing rental to Armstrong Cork Co. which provided most of the rental income appeared to be an accommodation to a large supplier of the floor-covering business and thus an adjunct to it, rather than indicative of an independent business, for the Tax Court found that the premises were let at less than fair rental value over the five-year period. Finally, no separate records of rental income and expenses were kept. . . . The Tax Court was plainly justified in concluding that the small amount of rental activity was merely an incidental part of the sole business of the corporation- wholesale floor-coverings. . . . It is clear that careful scrutiny of purported ‘real-estate rental’ businesses is necessary to prevent evasion of the purposes of the statute. The possibility of the shareholders abstracting accumulated earnings at capital gains rates is present whenever a corporation owns its own factory or office building. Under taxpayers’ interpretation, all that need be done is to transfer the building to a new corporation and distribute the stock received in return.”).

33 _E. Ward King v. Commissioner_, 458 F.2d 245, 249 (6th Cir. 1972) (“We decline to rest our determination upon [the 1955 Regulations], and instead rely upon the language of the statute itself and its legislative history. This conclusion makes it unnecessary to pass upon the applicability of the regulations to the factual situation here present, but we express some reservation in this regard.”).


36 _Coady_, 33 T.C. at 777.
qualitatively distinguish its operations from mere investments. Moreover, there should be objective indicia of such corporate operations.37

The current ATB regulations were explicitly promulgated to adhere to Coady and Marett,38 and should be interpreted in a manner consistent with these cases. Moreover, the Service has articulated the purposes underlying the ATB requirement as “the prevention of the temporary investment of liquid assets in a new business by an existing corporation in order to distribute the stock of the new business to the shareholders of the existing corporation in a ‘spin-off’ or other tax-free corporate division.”39 Thus, the ATB requirement is properly viewed as a “backstop” to the nondevice requirement of section 355(a)(1)(B)40 and the term “trade or business” should be defined by reference to the underlying policy.41

B. Current Law and Administrative Practice

As suggested by the Statements, guidance is needed to clarify whether a business can satisfy the ATB Requirement in various circumstances if entrepreneurial activities, as opposed to investment or other non-business activities, take place with the purpose of earning income in the future, but no (gross) income has yet been collected. The main issue considered here is whether the absence of the collection of gross income should prevent a business from satisfying the ATB Requirement.

37 Rafferty, 452 F.2d at 772.
38 Proposed Amendment to the Regulations, 42 Fed. Reg. at 3867.
39 G.C.M. 35476 (Sept. 13, 1973) (considering Rev. Rul. 74-5, 1974-1 C.B. 82) (revoked on other grounds, G.C.M. 39100 (Dec. 21, 1983)). See also Commissioner v. Gordon, 382 F.2d 499, 506-507 (2d Cir. 1967), rev’d. on other grounds, 391 U.S. 83 (1968) (“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 reasoning is that if the new business must be operated for at least five years, there will be little incentive to use this device for tax avoidance purposes. 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. To safeguard against this possibility, subsections (b)(2)(C) and (D) prohibit acquisition of a trade or business, or of a corporation, in a transaction in which gain or loss was recognized.”); G.C.M. 35633 (Jan. 23, 1974) (considering Rev. Rul. 78-442, 1978-2 C.B. 143) (“Absent § 355(b), it would be possible to effect a ‘bail-out’ of the earnings and profits of the distributing corporation….”) (footnote omitted); Guidance Regarding the Active Trade or Business Requirement Under Section 355(b), REG-123365-03, 72 Fed. Reg. 26,012, 26,013 (May 8, 2007) (“2007 Proposed ATB Regulations”) (the ATB “requirement, in tandem with the device prohibition and business purpose requirement, limits a corporation’s ability to convert dividend income into capital gain through the use of a section 355 distribution.”).
40 See GCM 37968 (June 1, 1979) (Tax Legislative Counsel Memorandum attached to the GCM states that “new regulations under section 355 [will] focus on the device clause of section 355(a)(1)(B), and ... make the active trade or business requirement of section 355(b) a backstop to the device clause”). See also 2007 Proposed ATB Regulations at 26,015 (“Section 355 contemplates that a tax-free separation shall involve only the separation of assets attributable to the carrying on of an active business.” S. Rep. No. 83-1622, at 50 (1954). The active trade or business requirement is intended to ensure that only these types of separations qualify under section 355. Further, it operates as an additional safeguard to the device prohibition (a prohibition against disguised dividends) in section 355(a)(1)(B).”). If nothing else, the preamble to the 2007 Proposed ATB Regulations offers strong support for administering section 355(b) in accordance with its underlying purpose.
As noted above, section 355(b) requires both the distributing corporation and the controlled corporation to be engaged in an ATB immediately after the distribution, and that such business(es) have been actively conducted for the five years immediately preceding the distribution. For this purpose, section 355 does not define the term “trade or business.” Regulations under section 355(b) provide that a corporation shall be treated as engaged in a trade or business immediately after the distribution “if a specific group of activities are being carried on by the corporation for the purpose of earning income or profit, and the activities included in such group include every operation that forms a part of, or a step in, the process of earning income or profit. Such group of activities ordinarily must include the collection of income and the payment of expenses.”

We are aware of few authorities addressing the scope of the “ordinarily” standard in Regulation section 1.355-3(b)(2)(ii). In one such authority, Rev. Rul. 82-219, Y corporation manufactured equipment specifically designed for an unrelated company, Z. In January 1980, Z unexpectedly went bankrupt and cancelled further orders from Y. Although Y’s engineers subsequently redesigned its product, and its employees actively searched for customers, no customers were found until January 1981. During that year, Y sold no equipment. Y shut its plant down and substantially reduced its employees, although it continued to employ individuals

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42 Note that the Regulation does not indicate that the ATB Requirement is failed where this particular set of conditions is not satisfied.

43 Reg. § 1.355-3(b)(2)(ii) (emphasis added). This definition has been in the Regulations since 1955. Note that these Comments are based on the authorities under and policy underlying section 355(b). Except as indicated below, we generally do not attempt to analogize to other Code provisions. The Code contains dozens of references to the “active conduct of a trade or business” or an “active trade or business” and hundreds of references to a “trade or business.” However, there is no single, unifying definition of a “trade or business.” Instead, the phrase is interpreted based on context and the purposes of the relevant Code provision. Compare, e.g., Reg. § 1.197-2(e)(1) (providing that a single asset may constitute a trade or business) with Reg. § 1.989(a)-1(c) (defining a “trade or business” by reference to income producing activities similar to Reg. §1.355-3(b)(2)(ii), but also providing that related expenses must be deductible under section 162 or 212). As noted by the Supreme Court in Groetzinger, 480 U.S. at 27, “the difficulty rests in the Code's wide utilization in various contexts of the term "trade or business," in the absence of an all-purpose definition by statute or regulation, and in our concern that an attempt judicially to formulate and impose a test for all situations would be counterproductive, unhelpful, and even somewhat precarious for the overall integrity of the Code.” Even under a single Code provision, the analysis from case to case may depend on the type of activity conducted. See, e.g., Snyder v. U.S., 674 F.2d 1359 (10th Cir. 1982) (trade or business of writing may begin under section 162 prior to producing a book); Francis v. Commissioner, 36 T.C.M. 704 (1977) (no trade or business under section 162 until apartment complex open and producing income); Boris Semion Maximoff v. Commissioner, 53 T.C.M. 423 (1987) (experimental activity may constitute a trade or business without generating any income). Nevertheless, we think the Tax Court’s comment in Maximoff is worth emphasizing here because it is addressing a type of activity, research and development, coupled with the absence of income, which is a key fact pattern contemplated by the Statement. In concluding that the taxpayer was engaged in a trade or business, the court noted that “[w]hile no income was generated from this project, this factor is not determinative. Experimental activity may yield little, if any, return during the developmental stages although it has the potential of producing significant income. Petitioner was involved in the activity of inventing with continuity and regularity during the taxable year in issue as well as subsequently through at least the time of trial. Accordingly, we find petitioner was engaged in a trade or business pursuant to section 162.”
to maintain its plant in anticipation of future sales. Thus, Y incurred expenses but generated no income for one year.

Concluding that a 1982 spin-off of Y by its parent corporation X satisfied the ATB requirement, the ruling stated:

Y has incurred expenses and engaged in substantial managerial and operational activities representative of the active conduct of a trade or business for each of the 5 years preceding the date of the distribution of the Y stock, but it has collected income for only 4 of the preceding 5 years, since no manufacturing receipts were received by it in 1980. The use of the word "ordinarily" in section 1.355-1(c) of the regulations indicates that there are exceptional situations where, based upon all the facts and circumstances, there is no concurrent receipt of income and payment of expenses which, nevertheless, will constitute an active trade or business within the meaning of section 355(b) of the Code. Y’s failure to receive manufacturing receipts during 1980 was unforeseen and caused by events outside of its control. Y took all reasonable steps to secure manufacturing receipts by redesigning its limited use product and actively seeking new customers for such product, and shortly thereafter began to again receive manufacturing receipts from its business. These extraordinary facts, when coupled with Y’s activities before January, 1980, and after January, 1981, indicate that Y was engaged in the active conduct of a trade or business within the meaning of section 355(b) for the 5-year period preceding the date of the distribution of its stock by X.44

Rev. Rul. 82-219 might be read to suggest that the Service would allow a No-Income Business to satisfy the ATB Requirement only in narrow or “extraordinary” circumstances, particularly if the business is in the midst of a lengthy R&D phase.45 In addition, until the recent issuance of the Statements and Rev. Rul. 2019-09,46 described below, there was concern that the Service might not apply the term “ordinarily” in Regulation section 1.355-3(b)(2)(ii) in a fashion consistent with the policies underlying the ATB Requirement.47 The Statements, which appear

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44 Other business interruption authorities do not attempt to interpret the meaning of “ordinarily.” See Rev. Rul. 57-126, 1957-1 C.B. 123 (ATB Requirement met even though crop freezes caused citrus business not to have income for most of the five-year period; taxpayer maintained the separate identity of its citrus business during the dormant period, and subsequently resumed full scale operations); Spheeris v. Commissioner, 461 F.2d 271 (7th Cir. 1972) (holding that a fire-damaged, non-income producing commercial building with no lease or construction agreements, permit application, or bookkeeping records is not an ATB because the taxpayer lacked the requisite intent to resume the business – “there was never an actual plan to reactivate the property during the four years after the fire”). Relatedly, the Service has issued a number of PLRs involving business interruptions. See, e.g., PLR 200323001 (Mar. 11, 2003) (D’s one-year cessation of its 20-year-old farming operation and lease of its farm pending the probate of its shareholder’s estate, the division of the farming assets between D and C, and the split-off, held not inconsistent with continued conduct of an ATB).

45 As noted below, this narrow view of the “ordinarily” standard is inconsistent with the recommendation made by these Comments.


47 In our experience, the Service, within the last 15-20 years, generally has required in its PLR practice that the business have generated gross income in each of the five years preceding the spin-off, absent a business interruption. However, the Service has shown some willingness to consider a more flexible application of the “collection of income” element in the context of nascent businesses engaged in R&D. In that context, the Service has been willing to entertain arguments that the receipt of payments such as government research grants and milestone payments under research collaboration agreements in the pharmaceutical context constitute income collection within the
to reflect the Service’s experience with ruling requests and taxpayer inquiries, announced that Treasury and the Service are considering issuing guidance regarding the application of the ATB Requirement to businesses that have yet to collect income.48 According to the September 2018 Statement:

[T]he IRS has observed a significant rise in entrepreneurial ventures whose activities consist of research and development in lengthy phases. During these phases, the ventures often collect no income or negligible income but nonetheless incur significant financial expenditures and perform day-to-day operational and managerial functions that historically have evidenced an ‘active’ business. For instance, a venture in the pharmaceutical or technology field might engage in research to develop new products with the purpose of earning income in the future from sales or licenses. The venture might even forgo current income opportunities to obtain increased future income by developing products on its own. The nature and duration of the research phases is often dictated by regulatory agencies, which require complex review processes that can span multiple years and cost millions of dollars.49

The September 2018 Statement indicates that potential guidance might address whether a business can qualify as an ATB “if entrepreneurial activities, as opposed to investment or other non-business activities, take place with the purpose of earning income in the future, but no income has yet been collected.”

In informal public comments, the Associate Chief Counsel (Corporate) has noted the following factors as being relevant to the determination of whether such a business satisfies the ATB Requirement:

1. Regular, continuing research and related activities by a significant number of full-time management and operational employees;

2. Regular, continuing expenses for research and related activities;

3. Significant progress toward developing an income-producing product;

4. Holding out that the business is available to enter into an income producing arrangement;

5. An actual offer or expression of interest made or received by the business to enter into an income producing arrangement; and

meaning of Reg. § 1.355-3(b)(2)(ii). However, the revenue procedure for section 355 PLRs, Rev. Proc. 2017-52, 2017-41 I.R.B. 283, does not clearly address the issue considered here. The revenue procedure generally states that the taxpayer must submit a table showing the amounts of gross income earned and salaries and wages paid to employees during each of the past five years for each active business. See id., at §3.03(3)(b). Over the past two years, we understand that the Service has considered PLR requests in which, for some potentially relevant period, the business did not collect or does not expect to collect gross income.

48 See supra note 2.

49 September 2018 Statement, supra note 2.
6. Similarly situated businesses have entered into income producing arrangements with
research that has progressed to a similar level as the taxpayer’s research.\footnote{See, e.g., Emily L. Foster, "‘Guideposts’ Revealed for R&D-Intensive Business Spinoffs," 2018 TNT 196-2 (Oct. 10, 2018) (quoting or paraphrasing Robert Wellen). This list of factors is referred to herein as the “Factors List.” The Service subsequently issued the May 2019 Statement requesting a wide range of additional information regarding No-Income ATBs. See May 2019 Statement, supra note 2. These questions may be best answered by reference to specific industries or taxpayers. Thus, absent comments from industry groups, we believe the Service will learn about these businesses through ruling requests.}

As noted above, the Service also recently issued Rev. Rul. 2019-09.\footnote{2019-14 I.R.B. 925.} Rev. Rul. 2019-09, which does not contain a fact pattern, suspends Rev. Rul. 57-464\footnote{1957-2 C.B. 244.} and Rev. Rul. 57-492\footnote{1957-2 C.B. 247.} pending the completion of the study described in the Statements. Rev. Rul. 2019-09 states that those rulings “could be interpreted as requiring income generation for a business to qualify as an ATB.”

In Rev. Rul. 57-464, a corporation separated its manufacturing business from its rental real estate business. The real estate consisted of three residences (one of which was occupied by the sister-in-law of the corporation’s president, apparently rent-free, and one of which was rented by employees of the corporation) and a small office building. The ruling concludes that the real estate business’s “net income was negligible after deductions for depreciation and other expenses. These properties were acquired either as an investment or as a convenience to the employees of the manufacturing business.”\footnote{1957-2 C.B. 244 (emphasis added).} The ruling adds that “as in Example (4) of section 1.355-1(d) of the [former] regulations, such rental activity was only incidental to the manufacturing business.”\footnote{Id.}

We believe that Rev. Rul. 57-464 is out of step with the Service’s ruling position (even before Rev. Rul. 2019-09) and current law. First, the Service’s most recent guidance on whether the relevant measure under the ATB Requirement is gross or net income indicates that the appropriate measure is gross income.\footnote{See Reg. 1.355-3(b)(2)(iv) (requiring the performance of significant services with respect to the operation and management of property). In this regard, Rev. Rul. 57-464 is not needed to illustrate the Service’s views about the circumstances under which a real estate business will satisfy the ATB Requirement.} In addition, Rev. Rul. 57-464 does not focus to any extent on whether services are provided by the corporation in connection with the renting of the properties.\footnote{See Rev. Proc. 2017-52, 2017-41 I.R.B. 283, 284 (requiring a table showing amounts of “gross income”).} Furthermore, the analysis of the ruling, in concluding that the rental activity was incidental to the corporation’s manufacturing business, appears to be an application of the long repudiated position that the ATB requirement may not be satisfied by the division of a single
business.\textsuperscript{58} In the wake of the Statements, we believe it was prudent to suspend Rev. Rul. 57-464. To the extent that the revenue ruling’s analysis depended on the magnitude of the corporation’s net income, it is understandable that Treasury and the Service viewed suspension of the ruling as necessary or helpful to issuing PLRs blessing the absence of gross income. In any case, for the reasons described above, it is difficult to see how Rev. Rul. 57-464 would survive the study described in the Statements, no matter how the government handles the No-Income ATB question. We recommend that Rev. Rul. 57-464 be obsoleted.

The other ruling suspended by Rev. Rul. 2019-09, Rev. Rul. 57-492, involved a corporation that for over 20 years was engaged in refining, transporting, and marketing petroleum products. In 1947, the corporation began activities related to oil exploration. It negotiated for mineral rights and began geological and geophysical work in 1948 and 1949. The corporation obtained permits in February 1951 and began drilling exploratory wells in 1953 and 1954, when it discovered oil in commercial quantities. During this period (\textit{i.e.}, 1947-1954), the corporation had incurred substantial expenditures for exploration and drilling activities. Oil was discovered in commercial quantities in 1954. The corporation later transferred the oil exploration and production assets to a new corporation and distributed the stock of the new corporation to its shareholders.\textsuperscript{59} The ruling concluded that the controlled corporation failed the ATB Requirement.

The ruling stated that:

\begin{quote}
“\text{\textquoteleft}\text{\textquoteright}such activities were preliminary steps, either required by law or dictated by prudent business considerations to investigate, inspect and appraise the prospective venture in order to determine if it should be continued or abandoned. This is further borne out by the fact that, prior to February, 1951, the old corporation was forestalled from engaging in active exploration by operation of law, since the mineral rights were not acquired by the old corporation until that time.”\textsuperscript{60}
\end{quote}

The ruling explained that section 355:

\begin{itemize}
  \item The ruling cites former Reg. § 1.355-1(c), Ex. (4) (1955). In that example, a corporation conducted a banking business on one-and-a-half floors of its two-story building, and leased the other half for storage. The rental activity was not considered an active business because it was “incidental” to the banking business. (The incidental activity rule, \textit{i.e.}, the rule forbidding the division of a single business, was formally removed from the Regulations in 1989.) The facts in Example 4 of the 1955 Regulations are substantially similar to Example 13 of the current Regulations. However, the current Example 13’s analysis is based on the fact that the lessee, rather than the lessor, would repair and maintain its portion of the building and pay property taxes and insurance. Moreover, current Example 13 notes that “this example does not address the question of whether the activities of \text{\textit{Z}} with respect to the building prior to the separation would constitute the active conduct of a trade or business.” \textit{Compare}, \textit{e.g.}, Reg. § 1.355-3(c), Exs. (9) and (10). Example 9 concludes that the activities of a research department could be regarded as an active trade or business, even though prior to the distribution, the research department was not independently producing income. Similarly, Example 10 concludes that a corporation that processed and sold meat products could separate the sales function from the processing function and regard the processing function as an active trade or business, despite the fact that the processing function did not have any customers prior to the distribution.
  \item The ruling does not state the year in which the distribution occurred.
  \item 1957-2 C.B. 247.
\end{itemize}
“contemplates that an active business ordinarily includes the collection of income as well as the payment of expenses. Before oil was discovered in commercial quantities in 1954, the venture here involved did not include any income producing activity or any source of income. If the venture had been discontinued any time prior to such discovery of oil, the old corporation would never have been engaged in producing oil. Furthermore, prior to the discovery in 1954 of oil in commercial quantities, the exploration and producing activities conducted by the old corporation were not themselves independently producing income, nor did they contain for the past five years, all of the elements necessary to produce income.”

Thus, the ruling appears to rest on two grounds. First the venture did not, until 1954, consist of activities that would produce income independently of the distributing corporation’s other business, which was active. The ruling is obsolete to this extent because it is based on the portion of the 1955 Regulations that has since been repealed. Second, the venture did not result in the collection of income for all five years preceding the distribution. That rationale is consistent with our understanding of how the government generally applied the “collection of income” standard prior to the Statements. Although the recommendation of these Comments is based largely on our understanding of R&D intensive businesses and businesses that go through lengthy periods developing products, processes, or systems, as well as high-tech start-up businesses, the principle underlying our recommendation is consistent with treating the entrepreneurial activities described in Rev. Rul. 57-492 (including prior to the discovery of oil in commercial quantities) as an ATB. Assuming that the Government agrees, Rev. Rul. 57-492 should either be obsoleted as no longer consistent with the Service’s views post-Rev. Rul. 2019-09 or revoked upon the issuance of further guidance.

The final authority that we are aware of that may bear on the questions considered here is Regulation section 1.355-3(b)(2)(iv)(B), which provides that “[t]he active conduct of a trade or business does not include . . . (B) The ownership or operation (including leasing) of real or personal property used in a trade or business, unless the owner performs significant services with respect to the operation or management of the property.” One might ask whether this limitation applies to businesses that do not collect income but that engage solely in activities directed at developing intellectual property for commercial use. Should such activities be treated as “services with respect to the operation or management of the property”? If such activities are entrepreneurial (i.e., engaged in with a view to providing products or services to customers at a profit), then the limitation should not prevent a business engaged in R&D with such a profit motive from constituting an ATB.

C. New Guidance

As suggested by the Statements, since the issuance of the 1955 Regulations, it has become more common for companies to consider spin-offs of businesses that have been engaged

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61 Id.

62 Reg. § 1.355-3(b)(2)(iv)(B) (emphasis added). Curiously, the other limitations in current Regulation section 1.355-3(b)(2)(iv) were located under the definition of “trade or business” in the 1955 Regulations. This particular limitation, however, was added in 1989.
in significant, active, and resource-intensive R&D over a period prior to the generation of revenues or profits. For example, a technology-related business may be conducted in corporate form to develop intellectual property, and it may take a period of years to reach the point where the technology can be commercially exploited. During this period, the corporate venture may employ a significant number of technology professionals, including scientists and engineers, to develop the technology. In addition, the corporate business venture may employ persons to perform various business-related functions (executive, managerial, bookkeeping, finance and treasury, human resources, in-house legal, real estate, procurement, maintenance, etc.). This may involve the expenditure of considerable resources to support these activities, often funded through multiple rounds of angel and venture capital financing.

Whatever may be said about these business ventures, they often will exhibit all of the aspects of an ATB other than the collection of gross income or profit. At the same time, these business ventures do not bear indicia of a corporate bail-out, nor do they implicate the inactive business concerns that motivated the Senate’s rejection of the 1954 House proposal or pre-1954 law. In this regard, note that the Regulations under section 355(a)(1)(B), the device prohibition, look to the following factors as evidence of device: (i) the spin-off is pro rata, (ii) the spin-off is followed by a sale or exchange of the stock of distributing or controlled, (iii) distributing or controlled owns assets not used in an ATB, and (iv) distributing or controlled is engaged in a secondary business that can be sold without adversely affecting the business of the other corporation.63 Frequently, the only factor present in the case of the potential separation of a No-Income ATB is the pro rata nature of the distribution. In addition, under the current Regulations, a compelling business purpose to separate and distribute (as described further below) is frequently strong evidence of nondevice.64 Finally, the device statute merely prohibits a distribution from having as its principal purpose the bail-out of earnings and profits of either distributing or controlled. In light of the underlying policy of the ATB Requirement (i.e., that it is intended to be an additional safeguard against a device), the Government should have relatively few concerns issuing guidance under the ATB Requirement addressing the separation a No-Income ATB.

Regarding the business purpose to separate a No-Income ATB, many of these business ventures find it critical to secure financing to sustain their business operations, and on occasion it may be important to separate aspects of the technology under development so that potential funding sources can specifically devote their funding to a particular group of activities without risk that the funding may be diverted to other activities. This critical business need invokes the rationale of the 1951 Congress that reinstated the tax-free spin-off transaction, in that it is economically unsound to impede the separation of business into a greater number of enterprises when undertaken for legitimate business purposes.

63 Reg. § 1.355-2(d)(2).
64 Reg. § 1.355-2(d)(3)(ii). In addition, to the extent that the corporation in question has no current or accumulated earnings and profits or assets whose distribution would give rise to current earnings and profits, the distribution ordinarily is not a device. Reg. § 1.355-2(d)(5)(ii).
D. Recommendation

To this end, we recommend that in administering the ATB requirement, Treasury and the Service interpret and apply the phrase “ordinarily must include the collection of income” flexibly, consistent with the direction of the Statements, to allow a group of activities that exhibits all of the attributes of an ATB other than the collection of gross income to qualify as an ATB for purposes of section 355(b). In such cases, where a corporation is engaged in substantial activities directed at developing a commercially viable product or service for sale in an ongoing business, the policy concerns underlying the ATB Requirement are satisfied. Accordingly, we recommend that Treasury and the Service issue guidance that would provide that such a corporation can satisfy the ATB Requirement. For example, Treasury and the Service could issue sub-regulatory guidance in the form of a revenue ruling addressing a typical fact pattern. Specifically, Treasury and the Service should consider guidance containing the simple fact patterns and conclusions illustrated below.

The examples below are intended to illustrate circumstances under which taxpayers engaged in certain research-intensive entrepreneurial activities can satisfy the ATB Requirement without having collected gross income or profit for the five years preceding a distribution and/or without collecting income or profit during the time period contemplated by the phrase “immediately after the distribution.” Such taxpayers should not be required to collect gross income or generate profit to satisfy the requirement of Regulation section 1.355-3(b)(2)(ii) if they have engaged in regular and continuing research and/or developmental activities (including product research) by managerial and operational employees with an intent to earn gross income or a profit and incurred significant expenses in so doing. In addition, the requirement of Regulation section 1.355-3(b)(2)(iv)(B), that a business that consists of owning and operating personal property perform “significant services with respect to the operation and management of the property[,]” should be satisfied if the business has engaged in significant internal activity (i.e., not as a service to customers) doing R&D with respect to intellectual property.

Example 1. Biopharmaceutical Business

Corporation X conducts businesses in the biomedical and biopharmaceutical fields. X has conducted an active biomedical business for 30 years and entered the biopharmaceutical business more than five years ago when it formed corporation Y, a wholly owned subsidiary. For at least five years, X has invested significant resources in Y and has employed scientists, researchers, and support professionals at operational and managerial levels with the intention of developing and exploiting a commercially viable drug compound. Throughout that period, Y has been engaged in pre-clinical, clinical trials, and discovery research with respect to certain chemical compounds and has paid operational and managerial expenses such as salaries and R&D costs. Y plans to continue the clinical trials and other research activity related to developing the drug compound.

65 I.R.C. § 355(b)(1).
For non-Federal tax business purposes, X will separate the biopharmaceutical business from its biomedical business by distributing all of the Y stock to its shareholders. Y will fund its operations through capital on hand and new financing. As of the date of the distribution, Y’s biopharmaceutical business has not collected gross income or profit. Moreover, Y has not received final regulatory approval to market its drug for commercial use. Such approval is not certain or imminent.

Notwithstanding that Y has not collected gross income, Y is engaged in the active conduct of a trade or business. For five years, Y has engaged in regular and continuing research and/or developmental activity through managerial and operational employees with the intent to generate income or profit. Such activity has resulted in significant, regular operational expenses over the five-year period. Accordingly, Y satisfies the requirements of section 355(b).

Example 2. Software and Search Engine

Corporation A has been engaged in the development of word processing software for at least five years and in the development of a search engine for legal research for one year. Individuals M and N are the founders of A and its majority shareholders. M and N have worked full time at least five years developing the software and for one year developing the search engine. In addition, throughout such respective periods, A has employed five individuals in each activity who are developing the products for commercial use. These individuals, whose only activity is the full-time development of the respective products, have been supervised by M and N. As needed, A hires attorneys, accountants, and other professionals to provide necessary non-technology services, and A also incurs routine general and administrative business expenses. Neither A’s software nor its search engine business has collected gross income or profit. All of A’s activities are undertaken with the intent to commercialize the two products, although the timeframe for bringing the products to market is unclear due to the need to perfect the technology and the changing marketplace. Assume that the search engine business is an expansion of the word processing business under the principles of Rev. Rul. 2003-38.6

Unrelated investor, Z, wishes to invest in the search engine technology but not the software. In order to facilitate Z’s investment, A decides to separate the two development activities by transferring the search engine assets and activities (e.g., the intellectual property rights, the five employees, and the business plan) to a newly formed corporation, B, in exchange for all of B’s stock, and to distribute B’s stock to its shareholders.

Notwithstanding that neither business has generated gross income or profit, A has been engaged in the active conduct of a trade or business. For five years, A has engaged in regular and continuing research and/or developmental activity through managerial and operational employees with the intent to generate income or profit. Such activity has resulted in significant, regular operational expenses over the five-year period. Accordingly, A and B satisfy the requirements of section 355(b).

6 2003-1 C.B. 811.
In addition to these examples, we believe that outside of the R&D context the Service’s ruling practice similarly should not require a corporation to have collected gross income or profit in each of (or, in some cases, any of) the five years preceding the distribution where the Service is confident that the policy underlying the ATB Requirement is not offended. In addition, given the importance of policy in the longstanding administration of section 355(b), our view of the Factor List is that factors 3, 4, 5, and 6 are not necessary to establish that activities constitute a trade or business because their presence is not necessary to the effectuation of that policy. Indeed, Factors 3, 4, 5, and 6 could frustrate policy by injecting unnecessary uncertainty around the moment in time when such factors can be viewed as having been satisfied, if such is necessary to determine when a trade or business has commenced for purposes of the five-year rule. In this regard, we note that the requisite entrepreneurial intent manifests itself in different ways throughout the life of a business. The activities and operational focus of the business changes depending on the stage in which the business exists. Accordingly, we recommend that Treasury and the Service take a flexible approach with respect to the types of activities that the guidance takes into account, guided by the policies underlying section 355 and the ATB requirement.

67 Although the ruling does not indicate the business in which the taxpayer is engaged, PLR 201920008 (Feb. 15, 2019) is a step in the right direction. In PLR 201920008, the Service issued a transactional ruling notwithstanding that after the distribution, once “Controlled ceases providing Services to Distributing, Controlled may not generate revenue, but it will continue to seek to generate future revenue through future Events.”

68 Note that the types of activities that we believe will satisfy this requirement are broad in scope and include activities that go beyond those illustrated in the examples above. The terms “research” and “development” are not intended to be limited to the type of activity necessary to qualify under section 41 or section 174. Similarly, we believe that the governing principle (that entrepreneurial activity is the key to an active business) is not limited to a particular industry or to a particular type of activity. For example, some businesses require extended periods of time to develop a new product or a new system or process. Such businesses are not limited to those in the pharmaceutical or high-tech industries referred to in the Statements or in our examples above. But such developmental activities seem equally as entrepreneurial. In that regard, we agree with the Statements that the guidance recommended here should also indicate that the governing principle underlying the guidance is not limited to a specific industry.