

**NEW YORK STATE BAR ASSOCIATION TAX SECTION
REPORT ON DISQUALIFIED INVESTMENT CORPORATIONS
AS DEFINED IN SECTION 355(g)**

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New York State Bar Association Tax Section

Report on Disqualified Investment Corporations as Defined in Section 355(g)

I. Introduction

This report¹ discusses issues raised by section 355(g),² added to the Internal Revenue Code by the Tax Increase Prevention and Reconciliation Act of 2005³ (the “Report”). Generally, section 355(g) limits the amount of investment assets that each of the distributing corporation (“Distributing”) and controlled corporation (“Controlled”) may own immediately after a section 355 distribution in which a shareholder increases its interest to fifty percent or more in either corporation. If either corporation owns more than the proscribed amount of investment assets, such corporation is a “disqualified investment corporation” and section 355 will not apply to the transaction. While section 355(g) generally is straightforward in its application, it raises certain interpretative issues that create uncertainty for taxpayers. Because a failed section 355 transaction results in significant tax consequences to both Distributing and its shareholders, we respectfully submit these comments with suggestions to clarify the application of section 355(g). Except where noted, we believe the broad grant of regulatory authority in section 355(g)

¹ This Report was prepared by the co-chairs of the Corporations and Reorganizations committees, Karen Gilbreath Sowell, Jodi J. Schwartz, David R. Sicular, and Linda Z. Swartz. The principal drafter of this Report was Karen Gilbreath Sowell. Helpful comments were received from Peter C. Canellos, Patrick C. Gallagher, Brandon L. Hayes, Matthew O’Halloran, Deborah L. Paul, Michael L. Schler, and Willard B. Taylor.

² All “section” references are to the Internal Revenue Code of 1986, as amended (the “Code”).

³ P.L. 109-222 (May 16, 2006).

is sufficient to allow the Department of the Treasury (the “Treasury”) and the Internal Revenue Service (the “Service”) to make the recommended clarifications to, and interpretations of, the statutory language. While we recognize that Treasury and the Service have many competing priorities, a finite number of issues are raised by the statutory language on which guidance is critical as taxpayers undertake significant corporate redemptions needing certainty as to their qualification qualify under section 355.⁴

Part II of the Report is a background section describing section 355(g) and identifying some aspects of the new provision that are unclear or potentially problematic to apply. Part III details the Tax Section’s recommendations.

Our principal recommendations are as follows:

1. Define “investment assets” to exclude accounts receivable to the extent they are offset by accounts payable.
2. Confirm that investment assets held by Distributing that will be transferred to creditors or shareholders as part of the plan of distribution will not be taken into account as investment assets for purposes of section 355(g).
3. Provide that non-investment assets acquired with investment assets will not be treated as investment assets as long as the non-investment assets are related to the business conducted by that corporation.
4. For purposes of applying the rules related to 20-percent controlled subsidiaries and active partnerships, provide that Distributing or

⁴ Even if the Treasury and Service do not have the resources to initiate a regulations project to address the universe of issues, several of the recommendations contained herein could be addressed in the form of a published ruling or procedural statement.

Controlled will be treated as owning a ratable share of the assets of the subsidiary or partnership calculated by multiplying the percentage ownership in the subsidiary or partnership by the fair market value of each asset, taking into account tiered ownership.

5. Provide guidance regarding the interaction of section 355(g) with the device requirement.

II. Background

Section 355 provides that, when certain requirements are satisfied, Distributing can distribute the stock of Controlled without gain to Distributing or its shareholders. As part of the Code's first tax-free reorganization provisions, the predecessor provision of section 355 was enacted to permit the tax-free separation of one or more active businesses formally operated by a corporation or by a corporation and its subsidiary.⁵ That original provision was once repealed, and then later reinstated and significantly modified over time by adding requirements to protect against tax avoidance.⁶ Section 355(g) is one such requirement enacted (we believe) to address certain highly publicized transactions that involved the redemption of a shareholder's appreciated interest in Distributing with the stock of a controlled corporation that owned significant amounts of cash. While the legislative history to section 355(g) does not specifically state, it appears

⁵ Revenue Act of 1924, Pub. L. No. 68-176, § 203(c), 43 Stat. 253, 256-57 (1924).

⁶ In 1934 Congress eliminated the spin-off provision out of concern that businesses were being distributed for tax-avoidance purposes. Congress reinstated the spin-off provision in the Revenue Act of 1951, Pub. L. No. 82-183, § 317, 65 Stat. 452, 493 (1951). As an example of the addition of requirements, the Internal Revenue Code of 1954, Pub. L. No. 83-591, § 355(b), 68A Stat. 3, 114 (1954), added the active trade or business requirement to section 355.

Congress determined that an additional requirement was considered necessary to address these “cash rich” redemption transactions.

A. Section 355(g) Generally

The Tax Increase Prevention and Reconciliation Act of 2005 added new subsection (g) providing that section 355 (and the portion of section 356 that relates to section 355) shall not apply to any distribution that is a part of a transaction if (i) either the Distributing or Controlled is a disqualified investment corporation immediately after the transaction, and (ii) any person that did not hold a 50% or greater interest (vote or value, determined using the attribution rules of section 318) immediately before the transaction holds such an interest immediately after the transaction in a disqualified investment corporation.⁷ It appears that both Distributing and Controlled must be tested under the disqualified investment corporation definition, regardless of whether its shareholder increases its interest to 50%. “Disqualified investment corporation” is defined as any distributing or controlled corporation if the aggregate fair market value of the investment assets of the corporation is, for distributions after the end of the one-year period beginning on May 17, 2006, two-thirds or more of the fair market value of all assets of the corporation, and for distributions within the one-year period beginning on May 17, 2006, three-fourths or more of the fair market value of all assets of the corporation.⁸ While not altogether clear, it appears that the ratio prescribed is made on the basis of gross assets and not taking into account liabilities. The time for making this determination is “immediately after the transaction” that involves the distribution of

⁷ Section 355(g)(1).

⁸ Section 355(g)(2)(A).

Controlled. Therefore, as a practical matter, taxpayers will need to provide for value fluctuations and changes in asset mix to ensure the ratio is satisfied. The broad reference to “transaction” would seem to make relevant other transactions that are related to the distribution of Controlled, although it is unclear what standard should be applied in making this step transaction analysis.

The term “investment assets” is defined by providing a non-exclusive list of assets that are considered investment in nature:⁹

- (ii) Cash,
- (iii) Any stock or securities in a corporation,
- (iv) Any interest in a partnership,
- (v) Any debt instrument or other evidence of indebtedness,
- (vi) Any option, forward or futures contract, notional principal contract, or derivative,
- (vii) Foreign currency, or
- (viii) Any similar asset.

There is no indication as to how the Treasury and Service are to communicate a conclusion that something is “similar” to the list of assets above.

Exceptions are provided for assets used in the active conduct of certain financial trades or businesses¹⁰ and for securities that are marked to market under section 475.¹¹ Further, exceptions are provided for stock or securities in a 20-percent controlled entity and interests in certain partnerships, each of which is described below. Where no specific

⁹ Section 355(g)(2)(B)(i).

¹⁰ Section 355(g)(2)(B)(ii).

¹¹ Section 355(g)(2)(B)(iii).

exception is provided, it appears that every asset in each category enumerated by Congress would be treated as an investment asset regardless of whether it is used in a trade or business.

B. 20-Percent Controlled Entity Exception

Section 355(g)(2)(B)(iv) carves out of the definition of investment assets any (1) stock or securities in, (2) any debt instrument or other evidence of indebtedness issued by, or (3) any option, forward or futures contract, notional principal contract or derivative issued by, a corporation that is a 20-percent controlled entity with respect to Distributing or Controlled (the “20-Percent Controlled Entity Exception”). For this purpose, a “20-percent controlled entity” is defined by reference to the affiliated group ownership requirement of section 1504(a)(2) (a voting power and value test), except using a 20 percent ownership standard instead of 80 percent, and not including preferred stock described in section 1504(a)(4).

Instead, Distributing or Controlled is treated as owning its ratable share of the assets of any 20-percent controlled corporation. No guidance is given as to how to determine the ratable share of assets. Interestingly, for purposes of the section 355(g) asset value tests, while liabilities are not taken into account generally by the statute and therefore the value of subsidiary assets attributed to Distributing or Controlled is determined on a gross basis, liabilities will decrease the value of a subsidiary that is not a 20 percent owned subsidiary by reducing the equity value of the subsidiary’s stock.

C. Active Partnership Exception

Section 355(g)(2)(B)(v) carves out of the definition of investment assets any interest in a partnership, or any debt instrument or other evidence of indebtedness issued

by the partnership, if one or more of the trades or businesses of the partnership would satisfy the active business requirement of section 355(b), without regard to whether the active business has been conducted for five years (the “Active Partnership Exception”). If this exception applies, Distributing or Controlled is treated as owning its ratable share of the assets of such partnership. No explanation is given why the exception for partnerships depends upon whether the partnership’s business satisfies the active business test of section 355(b) instead of a simple ownership test as in the case of the 20-Percent Controlled Entity Exception. The active business requirement for partnership look-through treatment creates uncertainty for taxpayers, because the determination of whether a business is active for section 355 purposes can be a difficult and complex analysis as it is dependent on a variety of facts and circumstances, and the conclusion may be elusive. The law is by no means clear and continues to evolve.¹²

D. Regulatory Authority

Section 355(g)(5) provides the Treasury general authority to issue guidance to carry out the purposes of the provision and prevent its avoidance. In addition, Congress identified specific issues for which the Treasury shall prescribe guidance:

- a. The use of related persons, intermediaries, pass-thru entities, options, or other arrangements,
- b. The treatment of assets unrelated to the trade or business of a corporation as investment assets if, prior to the distribution, investment assets were used to acquire such unrelated assets,

¹² Proposed regulations (REG-123365-03) issued in May 2007 provide proposed guidance on new subsection 355(b)(3), as added by the Tax Increase Prevention and Reconciliation Act of 2005, and modify the active business rules as they apply in the context of partnerships.

- c. In appropriate cases, excluding from the application of the provision a distribution that does not have the character of a redemption which would be treated as a sale or exchange under section 302, and
- d. Modifying the application of the attribution rules applied for purposes of the provision.

There is no elaboration on these specific grants of authority in the legislative history. Thus, it is unclear what Congress had in mind, if anything, when it referred to these items as potentially preventing the avoidance of the provision. As the Treasury has the authority to issue regulations on a retroactive basis under its authority of section 7805(b) to prevent abuse, taxpayers may face uncertainty as they attempt to comply with the statute.

III. Discussion of Issues and Recommendations

Because of the potentially devastating tax consequences if section 355(g) is not properly complied with, and the importance of consistent application of the rules by taxpayers and Service agents, this report identifies several issues raised by section 355(g) for which guidance would be helpful.

A. Investment Assets

A clear understanding of what is considered an investment asset and how to measure that asset is critical to compliance with the statute. We recommend clarifying the definitions of certain categories of investment assets to include only assets that truly represent investment assets at the disposal of the applicable corporation and its shareholder(s).

1. Netting of accounts receivable and accounts payable. It appears that the definition of disqualified investment corporation is based upon the gross value of investment assets and ignores all liabilities. At the same time, under the literal language of the Code, it appears that all accounts receivable are treated as investment assets, regardless of their amount or whether they are associated with a business.¹³ Because accounts payable and accounts receivable are a part of the normal operations of a business and are short-term in nature, we recommend that guidance be issued to provide that accounts receivable and accounts payable should offset one another, resulting in an investment asset only to the extent that the receivables exceed the payables.¹⁴ To prevent improper planning related to such an exception, the payables level of the corporation could be measured based on an average balance for a period of years. The adoption of this proposal would alleviate pressures on valuations created by normal fluctuations in balances in these accounts.¹⁵

We also note that the gross asset calculation in section 355(g) creates an incentive for well advised taxpayers to use cash or other investment assets to satisfy accounts payable or other indebtedness prior to the distribution. Adoption of the foregoing netting proposal may reduce the need for taxpayers to take this step.

¹³ Accounts receivable are treated as investment assets under the category of “any debt instrument or other evidence of indebtedness”.

¹⁴ *Cf.* Notice 88-22, 1988-1 C.B. 489 (a trade or service receivable, derived from sales or services provided in the ordinary course of a trade or business which produce nonpassive income, is treated as a nonpassive asset for purposes of the asset test of the passive foreign investment company provisions).

¹⁵ Because accounts receivable appear to be included in one of the categories of investment assets provided in the statute, a determination would be required whether the Treasury has authority to adopt such a netting proposal based upon the regulatory authority afforded by Congress.

2. Transitory investment assets. It is common in section 355 transactions for Controlled to distribute its stock, securities or cash to Distributing for Distributing to use to pay its creditors or distribute to its shareholders under section 361. It is not always the case that such equity, debt or cash is transferred by Distributing before the section 355 stock distribution has occurred. Because the transfer of these investment assets by Distributing is part of the transaction that includes the distribution and any such assets will not be held by either Distributing or Controlled after the transaction has concluded, we recommend that these assets not be counted as assets of Distributing or Controlled for section 355(g) purposes and that this conclusion be confirmed in formal guidance.

3. Investment assets used to acquire non-investment assets, etc. The role of the step transaction doctrine in the application of section 355(g) is not clear. There is, however, a specific grant of regulatory authority in section 355(g)(5)(A)(ii) to treat “assets unrelated to the trade or business of a corporation as investment assets, if prior to the distribution, investment assets were used to acquire such unrelated assets”. When the acquired non-investment assets are not related to the currently conducted business, there is a clear suggestion that the purchase was made in order to satisfy the section 355(g) test and not for any real business reason. Thus, consistent with the direction of the specific grant of authority, we recommend that such assets should continue to be treated as investment assets. If, however, it can be established that the new assets were not purchased as part of a plan including the stock distribution, we do not believe any further analysis should be necessary and such assets should be respected as non-investment assets.

A similar set of issues is presented in the case of non-investment assets that are sold after the stock distribution for cash or other investment assets. Because the statute measures the asset composition “immediately after the transaction”, we believe that any such sales that are part of the plan including the distribution should be taken into account as part of the transaction.

In either of the above cases, a standard similar to that provided in section 355(e) and developed in Treas. Reg. § 1.355-7 could be used to determine whether any sales or purchases are related to the distribution.

We further recommend providing a rule that non-investment assets acquired with investment assets will not be treated as investment assets for purposes of section 355(g) if the assets are related to the business that is already being conducted by that corporation.¹⁶ This recommendation appears to be consistent with Congress’ intent as the specific regulatory grant cited above addresses only acquisitions of assets not related to the currently conducted business.

B. Applying the 20 Percent Controlled Entity and Active Partnership

Exceptions

When the 20 Percent Controlled Entity Exception or the Active Partnership Exception applies to treat a portion of the assets held by the subsidiary or partnership as assets of Distributing or Controlled, it is unclear how to determine such corporation’s “ratable share” of each of the assets. As most assets are not severable in nature, guidance would be helpful for taxpayers to make the appropriate calculations. We recommend that

¹⁶ This should include non-investment assets attributed to the acquiring corporation as a result of the Controlled Entity Exception or the Active Partnership Exception, where the entity or the assets were purchased prior to the distribution.

the ratable share calculation be made on the simple basis of multiplying the percentage ownership in the subsidiary or partnership, by value, by the fair market value of each asset, with the result that the assets attributed to Distributing or Controlled reflect exactly the asset composition of the underlying subsidiary or partnership.¹⁷

A second issue concerning the 20 Percent Controlled Entity is application of the 20 percent threshold to an interest in a corporate subsidiary owned through other (corporate or partnership) entities. For example, assume Controlled owns 60 percent of a corporate subsidiary (S1) that owns 25 percent of another corporate subsidiary (S2), with the balance of each subsidiary owned by unrelated parties. Clearly, Controlled would take into account its ratable 60 percent share of S1's assets. It is not clear, however, whether S2 would be treated as a 20 percent indirectly owned subsidiary. Controlled could be viewed as owning indirectly 15 percent of S2 (60 percent of 25 percent), or it could be viewed as owning indirectly 25 percent as long as S1 and any other intermediary entity satisfies the 20 Percent Controlled Entity Exception or the Active Partnership Exception.¹⁸ Taking into account the purpose of the statute and the relevance of the exercise of determining what assets are held by Controlled in this case, we believe that the former methodology is appropriate – that is, when determining indirect ownership, the focus should be on what value Controlled has a direct or indirect legal claim to. Of course, this analysis is not perfect because it does not take into account that Controlled's

¹⁷ Where the corporate or partnership subsidiary has multiple classes of equity interests outstanding, ratable share could be determined based on the value and assets Distributing or Controlled would receive if the subsidiary sold its assets for fair market value and liquidated.

¹⁸ The latter methodology is used for continuity of business enterprise purposes, when assessing whether to attribute a subsidiary's assets to the issuing corporation. Interestingly, however, when assessing whether to attribute a partnership's assets to the issuing corporation where there are tiered partnerships, the former methodology is used. *See* Treas. Reg. § 1.368-1(d).

legal rights may not be specific to the assets that are treated as “owned” by it for section 355(g) purposes and any liabilities in the subsidiary are not taken into account. Nonetheless, it seems that applying the indirect test on this basis is the best alternative.

C. Interaction of Section 355(g) with the Device Requirement

The legislative history does not explain the role of section 355(g) in analyzing non-pro rata section 355 distributions and, therefore, it is unclear how section 355(g) interrelates with the other section 355 requirements. It appears that section 355(g) was intended to provide the standard for the amount of investment assets that is considered acceptable. The amount of investment assets is also relevant in analyzing the requirement that the transaction is not a device for the distribution of earnings and profits. Generally, the determination of whether a distribution is a device will be based on all of the facts and circumstances, including, but not limited to, the presence of device factors and non-device factors specified in Treas. Reg. § 1.355-2(d). The regulations consider the nature and use of the assets in each of the Distributing and Controlled as evidence of device.¹⁹ Specifically, this device factor looks to the ratio for each corporation of the value of the assets not used in a trade or business with the value of the assets that are used in an active trade or business. There is stronger evidence of device if the value of the assets not used in an active trade or business is substantially higher in comparison to the value of the assets used in an active trade or business. Furthermore, the nature of the non-active trade or business assets is relevant. However, the regulations specifically provide that a difference in the ratio of active to non-active business assets is ordinarily not evidence of device if the distribution is not pro rata among the shareholders of

¹⁹ Treas. Reg. §1.355-2(d)(2)(iv)(B).

Distributing and such difference is attributable to a need to equalize the value of the stock distributed and the value of the stock or securities exchanged by the distributee.²⁰

Because of their seemingly similar inquiries, it would be helpful for the Treasury and the Service to provide guidance regarding the interaction of section 355(g) and the device requirement. Further, because the function and application of the device requirement itself is unclear generally under current law, basic guidance on these aspects of the device requirement also would be valuable.

²⁰ Treas. Reg. §1.355-2(d)(2)(iv)(B). We note the Service has been consistent in its published guidance, as well as its private letter rulings, in applying the device restriction consistent with the regulatory principle that excepts non-pro-rata distributions involving even significant disparities between active and non active assets where such disparity exists to equalize the values of the companies. *See* Rev. Rul. 64-102, 1964-1 C.B. 136 (cash contribution of approximately 54% of the value of the Controlled stock was not a device, because if the transaction had been taxable to the shareholders, the exchange would have been in complete redemption of all of their stock resulting in capital gain treatment); Rev. Rul. 71-383, 1971-2 C.B. 180 (extends the equalization of value rationale of Rev. Rul. 64-102 to situations where the split off, if taxable, would have qualified for capital gain treatment under the substantially disproportionate test of section 302(b)(2)). *See also* private letter rulings that have permitted various forms of contributions, debt forgiveness, debt assumptions, and transfers to achieve value equalization in non-pro rata distributions. PLR 200037033 (June 15, 2000) (to equalize the value, Distributing retained a larger portion of cash and accounts receivable); PLR 200022032 (Mar. 3, 2000) (to equalize values, Controlled distributed a branch to Distributing, as Controlled assumed certain liabilities and Distributing contributed certain assets to Controlled); PLR 199953032 (Sept. 27, 1999) (to equalize values, Distributing transferred cash, a promissory note, real property, notes receivable, accrued interest receivable and advances payable to Controlled); PLR 199909031 (Dec. 3, 1998) (to equalize values, Distributing transferred cash and notes receivable to Controlled); and PLR 9422051 (Mar. 9, 1994) (to equalize values, Distributing contributed cash to Controlled). *See also Athanasios v. Commissioner*, 69 T.C.M. 1902 (Feb. 15, 1995) (significant capital contribution to Controlled did not result in the transaction being viewed as principally a device for the distribution of earnings and profits because the equalization was necessary to effectuate a split-off).