ARTICLES

REFORM OF SECTION 355

BRET WELLS*

Section 355 is one of the most important provisions in U.S. corporate tax law because, after the 1986 Tax Reform Act, it remains the principle means of allowing for a tax-free spin-off and disposition of businesses in the publicly traded corporate context. Yet, the provision has received very limited scholarly attention. The Article addresses a gap in existing literature by addressing the normative goals of this provision and its deficiencies. Section 355 has had a curious and troubled history.

In 1986, Congress enacted major tax reform legislation, but section 355 was not reformed as part of the Tax Reform Act of 1986. In 2017, Congress again enacted major tax reform legislation, but similar to 1986, Congress did not reform section 355 either. In the intervening years from 1987 through 2016, section 355 was amended eleven times, making it the most amended provision in subchapter C during this period. The policy goals that motivated these amendments have been remarkably consistent, namely these reforms sought to ensure that section 355 did not provide taxpayers with an inappropriate device for circumventing the intended scope of Congress's repeal of the General Utilities *doctrine.*

In addition, Congress provided the Treasury Department with broad regulatory authority to ensure that its purpose in repealing the General Utilities

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doctrine would not be circumvented through any other provision of law (including section 355), and the Treasury Department has issued regulatory guidance in an effort to effectuate this goal. But, in like manner, the Treasury Department's proposed amendments to its section 355 regulations also have fallen short of the appropriate mark.

The result of these congressional amendments and of the Treasury Department's ongoing regulatory efforts is that section 355 has become needlessly complex and subjective. Section 355's needless subjectivity creates an administrative working law that is close to unfathomable to many experienced tax professionals. And yet, the added complexity and subjectivity does not forestall section 355 from affording tax-free treatment to corporate separations that are more akin to a disposition of an historic business to new shareholders. Seen in its proper context, section 355's nonrecognition treatment is justifiable only in the limited scenario of a corporate separation (motivated by business necessities) among historic shareholders who seek to continue their interest in the corporation's historic businesses, albeit in modified corporate form. The effectiveness of section 355 in providing a vehicle to side-step Congress's General Utilities *repeal is now widely understood and has caused some to laud section 355 as "the heartbeat of mergers and acquisition activity in the United States." In short, section 355 is a mess.*

But, why has section 355 become such a mess and what must be done to reform section 355? This Article seeks to answer both of these organizing questions and then sets forth a reform proposal that, if adopted, would finally allow section 355 to fulfill its core mission without creating an inappropriate means to avoid Congress's repeal of the General Utilities *doctrine.*

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INTRODUCTION

In 1986, Congress enacted major tax reform legislation, but section 355 was not reformed as part of the Tax Reform Act of 1986. In 2017, Congress again enacted major tax reform legislation, but similar to 1986, Congress did not amend section 355 in that reform effort either. However, in the intervening years from 1987 through 2016, section 355 was amended eleven times,[1] making it the most amended provision in subchapter C of the Internal Revenue Code during this period. The policy goals that motivated these amendments have been remarkably consistent; namely to ensure that section 355 did not provide taxpayers with an inappropriate device for circumventing the intended scope of

1. *See* Pub. L. No. 114-113, § 311(a), 129 Stat. 2242, 3090 (2015); Pub. L. No. 113-295, § 221(a)(50), 128 Stat. 4010, 4045 (2014); Pub. L. No. 110-172, § 4(b), 121 Stat. 2473, 2476 (2007); Pub. L. No. 109-432, § 410(a), 120 Stat. 2922, 2963 (2006); Pub. L. No. 109-222, §§ 202, 507(a), 120 Stat. 345, 348, 358–59 (2006); Pub. L. No. 105-206, § 6010(c)(2), 112 Stat. 685, 813 (1998); Pub. L. No. 105-34, §§ 1012(a)–(b)(1), 1014(c)–(d), 111 Stat. 788, 914, 916, 921 (1997); Pub. L. No. 104-188, § 1704(t)(31), 110 Stat. 1755, 1889 (1996); Pub. L. No. 101-508, §§ 11321(a), 11702(e)(2), 104 Stat. 1388, 1388-460, 1388-515 (1990); Pub. L. No. 100-647, § 2004(k)(1), 102 Stat. 3580, 3605 (1988); Pub. L. No. 100-203, § 10223(b), 101 Stat. 1330, 1330-411 (1987).

Congress's repeal of the *General Utilities*[2] doctrine. But, notwithstanding Congress's repeated efforts, section 355's scope has not been appropriately curtailed through these enactments.[3]

In addition, Congress provided the United States Treasury Department with broad regulatory authority to ensure that its purpose in repealing the *General Utilities* doctrine would not be circumvented through any other provision of law, including section 355,[4] and the Treasury Department has issued regulatory guidance in an effort to effectuate this goal.[5] Similar to Congress's failed efforts to curb the

2. Gen. Utils. & Operating Co. v. Helvering, 296 U.S. 200 (1935).

3. *See infra* Section I.B.

4. *See* I.R.C. § 337(d) (2012); *see also infra* note 77. Shortly after the 1986 Tax Reform Act, the son-of-mirror transaction was developed as a technique to circumvent the repeal of the *General Utilities* doctrine. Under the son-of-mirror technique, an acquiring company would acquire the stock of a target company at fair market value. The acquiring company would then cause the target company to distribute its wanted assets to the acquirer, thus generating gain within the acquirer's consolidated group and thereby increasing the acquirer's basis in the stock of the target by the amount of that gain. The acquirer then could sell the target's stock at a time when the target company held only unwanted assets. As a result, an artificial loss was created that approximated the amount of the previously recognized gain that occurred upon the distribution of the wanted assets out of the target. In response to the son-of-mirror technique, the Internal Revenue Service (IRS) stated that it would deny the intended tax benefits of the transaction with future regulations that would have retroactive effect. *See* I.R.S. Notice 87-14, 1987-1 C.B. 445; *see also* Treas. Reg. § 1.1502-20 (2008) (as amended by T.D. 8364, 1991-2 C.B. 43) (finalizing the loss disallowance rule in 1991); Rite Aid Corp. v. United States, 255 F.3d 1357, 1360 (Fed. Cir. 2001) (holding that the duplicated loss provisions of the loss disallowance rules were an invalid exercise of regulatory authority). *But see* I.R.S. Notice 2002-11, 2002-1 C.B. 526 (arguing that the finding of invalidity in "the *Rite Aid* opinion implicates only the loss duplication aspect of the loss disallowance regulation" and not the factors dealing with the son-of-mirror problem). In response to the *Rite Aid* decision, the IRS and Treasury Department promulgated two regulations to replace the loss disallowance rules. *See* T.D. 9187, 2005-1 C.B. 778 (adopting four temporary treasury regulations: Temp. Treas. Reg. § 1.337(d)-2T (2002); Temp. Treas. Reg. § 1.1502-35T (2003); Temp. Treas. Reg. § 1.1502-32T (2003); Temp. Treas. Reg. § 1.1502-21T (2010)); *see also* T.D. 9424, 2008-2 C.B. 1012 (adopting final unified rules for loss on subsidiary stock). For further discussion of the complicated final unified loss disallowance regulations, see David B. Friedel, *Final Loss Disallowance Rules: A New World Order*, 35 CORP. TAX'N 33 (2008); and Don A. Leatherman, *A Survey of § 1.1502-36*, *in* 29 THE CORPORATE TAX PRACTICE SERIES: STRATEGIES FOR ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, REORGANIZATIONS & RESTRUCTURINGS 451–57 (Louis S. Freeman ed., 2017).

5. *See, e.g.*, Guidance Under Section 355 Concerning Device and Active Trade or Business, 81 Fed. Reg. 46,004 (proposed July 15, 2016) (to be codified at 26 C.F.R. pt. 1).

scope of section 355, the Treasury Department's proposed amendments to its section 355 regulations have also fallen short.[6]

The result of these congressional amendments and of the Treasury Department's ongoing regulatory efforts is that section 355 has become needlessly complex and subjective. This creates an administrative working law that is close to unfathomable to many experienced tax professionals. Yet, the added complexity and subjectivity does not forestall section 355 from affording tax-free treatment to corporate separations that are more akin to a disposition of a historic business to new shareholders.[7]

Said differently, section 355's complexity and subjectivity facilitate its use as a device for historic businesses to be separated out of a common corporate ownership in a tax-free manner and transferred to new owners. Section 355, as currently constructed, allows historic shareholders to monetize their investment in historic businesses in a tax-free manner. The ability to use section 355 to achieve those results represents a significant deficiency because those outcomes inappropriately circumvent Congress's effort to repeal the *General Utilities* doctrine. Seen in its proper context, section 355's nonrecognition treatment is justifiable only in the limited scenario of a corporate separation—motivated by business necessities—among historic shareholders who seek to continue their interest in the corporation's historic businesses, albeit in modified corporate form.[8] The effectiveness of section 355 in providing a vehicle to side-step Congress's *General Utilities* repeal is now widely understood and has caused some to laud section 355 as "the beating heart of mergers and acquisitions activity in the United States."[9] In short, section 355 is a mess. But, why has section 355 become such a mess, and what must be done to reform section 355? The remainder of this Article seeks to answer both of these organizing questions.

To begin with, some of the discontinuity and complexity in section 355 is explained by the fact that it was forged in a period prior to the

6. *See infra* Section I.C.

7. *See* Treas. Reg. § 1.355-3(b)(3) (2001); Rev. Proc. 2017-52, 2017-41 I.R.B. 283.

8. *See* Treas. Reg. § 1.355-2(c)(1) (1989) (containing the continuity of shareholder interest standard as a long-existing provision within section 355). However, the subjectivity in applying this shareholder continuity test is in need of greater certainty and objectivity in terms of its application.

9. Jasper L. Cummings, Jr., *Spinning, Acquiring, and Disposing*, 158 TAX NOTES 101, 101 (2018).

repeal of the *General Utilities* doctrine.[10] In that prior era, the *General Utilities* doctrine generously allowed assets to leave corporate solution without corporate level gain.[11] However, the device test and the business purpose test that undergird section 355, forged in the *General Utilities* era, promote a shareholder level tax objective: ferret out corporate separations that constitute a device to bail out corporate earnings and profits in avoidance of the shareholder dividend tax. But even so, the original policy rationale that justified section 355's existence in that formative era, and the policy rationale that justifies its continued existence in the post-*General Utilities* era, has been remarkably constant. In Section I.A, this Article sets forth how section 355 evolved in the *General Utilities* era and then defends the proposition that section 355, at its core, was designed to afford nonrecognition treatment to corporate separations—motivated by business necessities—when those separations involve historic shareholders who seek to continue their interest in the corporation's historic businesses, albeit in modified corporate form. Corporate separations in that context are afforded nonrecognition treatment because those corporate separations do not represent a disposition of a historic business to new shareholders, nor do corporate separations in that context principally involve shifting the ownership of financial nonbusiness assets among the historic shareholders. Instead, corporate separations executed in that context are best described as merely a readjustment of the shareholders' continuing interest in the underlying historic businesses in modified corporate form. However, section 355 is overly broad and can apply beyond the scope of that core mission, and its overbreadth infringes on

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10. Gen. Utils. & Operating Co. v. Helvering, 296 U.S. 200, 206 (1935) (holding that a distribution of assets by a corporation to its shareholders did not constitute a sale or exchange of the distributed assets and accordingly the distributing corporation did not realize a taxable gain or loss from the distribution); *see* 1 BORIS I. BITTKER ET AL., FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 8.20, at 8–64 (7th ed. 2018) (explaining that the *General Utilities* doctrine was codified in the Internal Revenue Code of 1954 in old section 311(a)(2) as to non-liquidating distributions and in old section 336 with respect to liquidating distributions); *see also* H.R. REP. NO. 99-841, pt. 1, at 198 (1986); *infra* Section II.B, II.C (discussing the impact that the repeal of the *General Utilities* doctrine has had and normatively should have on circumscribing the scope of section 355).

11. *See* Edward S. Cohen et al., *Corporate Liquidations Under the Internal Revenue Code of 1954*, 55 COLUM. L. REV. 37, 37–55 (1955) (analyzing how Congress explicitly endorsed allowing appreciated corporate assets to leave corporate solution without corporate level tax and detailing how the 1954 Code attempted to provide certainty and taxpayer electivity in applying the *General Utilities* doctrine under prior law).

the scope of Congress's competing post-1986 goal of implementing a "strong form"[12] version of repeal of the *General Utilities* doctrine.

In Section I.B, this Article seeks to frame this tension by first demonstrating that Congress, in the post-1986 period, has been motivated by a "strong form" of *General Utilities* repeal. After laying that predicate, Section I.B then sets forth the case for why section 355 should not afford nonrecognition treatment to a disposition of a historic business to non-historic shareholders as doing so violates the goals of the "strong form" of *General Utilities* repeal. The analysis in Section I.B demonstrates that Congress's repeated amendments to section 355 are explainable only in terms of furthering a "strong form" version of *General Utilities* repeal, but the actual statutory amendments overly rely on subjective standards that inhibit their effectiveness. The analysis in Section I.B, therefore, lays the foundation for identifying the deficiencies within section 355 that impede the harmonization of section 355's scope with Congress's desired "strong form" of *General Utilities* repeal. The overbreadth in section 355's scope is objectionable because it allows taxpayers to utilize it as a device for transferring historic businesses in a tax-free manner to new shareholders in transactions that are more akin to a disposition. The enlistment of section 355's nonrecognition treatment for transactions that are more akin to a disposition causes section 355 to stray beyond its core mission and contravenes Congress's competing goal of wanting to implement a "strong form" version of *General Utilities* repeal. In Section I.C, this Article then sets forth the tentative steps that the Treasury Department has taken to implement the repeal of the *General Utilities* doctrine and how those actions have not been sufficient to address section 355's overbreadth.

In Part II, this Article sets forth how section 355 should be reformed to promote both its core mission and Congress's efforts to implement a "strong form" version of repeal of the *General Utilities* doctrine. Specifically, this Article argues that the device test should be reformulated so that section 355 would not be satisfied if more than fifty percent of the assets of either the distributing corporation or the controlled subsidiary are non-historic business assets. Moreover, as a further reform to the device test, this Article argues that the device test should not afford tax-free status to the releveraging aspects of a section

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12. Scholars for decades have used this well-known nomenclature. *See, e.g.*, Eric M. Zolt, *The* General Utilities *Doctrine: Examining the Scope of the Repeal*, 65 TAXES 819, 822 (1987) (referring to the alternatives views of the *General Utilities* repeal as "strong form" and "weak form").

355 transaction in situations where excessive leverage is shifted between the distributing corporation and the controlled corporation. Thus these releveraging techniques allow shareholders to monetize their interest in a historic business in a manner that is more akin to a disposition. These reforms of the device test are discussed in greater detail in Section II.A.

In addition to reformulating the device test, this Article argues that Congress should amend section 355(d) to require all corporate separations to satisfy an objective continuity of interest standard. Specifically, this Article proposes that a corporate separation would create corporate level gain if there were an ownership change within either five years prior to or two years after a section 355 transaction. This time period represents a synthesis of the testing periods that now exist in section 355(d) and section 355(e). Section 355(d) provides, in part, for a five-year pre-spin-off testing period. Moreover, section 355(e) provides, in part, for a post-spin-off continuity period of two years to assure that a corporate separation was motivated by the shareholders' desire to continue to own their historic interest until the transactions are old and cold.

In terms of applying this Article's prescriptive continuity of interest testing period, this Article proposes that the ownership change criteria set forth in section 382 should be utilized in lieu of the subjective criteria that undergirds existing sections 355(d) and section 355(e). In this regard, section 382 provides an objective set of criteria to determine an ownership change and sets forth an administrable rule that disregards ownership changes among less than five percent of shareholders. Thus, by relying on the objective criteria set forth in section 382 to determine whether sufficient historic shareholder continuity of interest exists throughout the testing period, this Article's proposal sets forth a clear rule that promotes the core mission of section 355 and does so in a manner that forestalls section 355's use as a means to circumvent Congress's repeal of the *General Utilities* doctrine. The contours of this repurposed, new section 355(d) are set forth in greater detail in Section II.B.

Once the new section 355(d) provisions set forth in this Article are adopted, the existing provisions of section 355(d) and section 355(e) could be eliminated as redundant. Moreover, once the device test—repurposed along the lines set forth in Section II.A—is concomitantly adopted, then section 355(g) and the subjective device test set forth in Treasury Regulation section 1.355-2(d) could be repealed. The refocused device test set forth in Section II.A seeks to differentiate

between those corporate separations that inappropriately circumvent Congress's intended repeal of the *General Utilities* doctrine from those corporate separations that are justified under the core mission of section 355. In contrast, the device test under current law, focuses on an obsolete shareholder bail out concern that no longer is relevant given the rate parity that exists for qualified dividends and long-term capital gains rates.

In combination, the section 355 reforms advocated in this Article seek to fully implement the "strong form" version of *General Utilities* repeal that Congress has attempted to enact in the post-1986 period by adopting objective and transparent rules that replace the subjective standards currently utilized by section 355's provisions.[13] The subjectivity that lies at the heart of section 355(d), section 355(e), and the current formulation of the device test, creates needless complexity and hinders the harmonization of section 355's scope with Congress's competing goal of implementing a "strong form" version of *General Utilities* repeal. Thus, this Article's reform proposals, if adopted, would provide much needed objectivity and transparency in the manner of section 355's application.

I. EVALUATION OF SECTION 355 AS CURRENTLY CONSTRUCTED

A. *Section 355 in the* General Utilities *Era*

To begin with, it must be understood that section 355's allowance for tax-free corporate separations is one of the longest standing aspects of subchapter C. From a historical perspective, it is helpful to consider *Rockefeller v. United States*,[14] as this was an important early case that came before the legislative adoption of section 355's predecessor. In 1911, John D. Rockefeller had lost a critical antitrust case,[15] which was followed by another loss in 1914 that required him to separate his monopolistic pipeline business into a separate corporation that was spun-off to the shareholders.[16] The Supreme Court eventually agreed with the Internal Revenue Service's (IRS) determination that Mr. Rockefeller and the other shareholders had received a taxable stock dividend upon their receipt of the stock of the spun-off controlled

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13. *See generally* Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557 (1992) (discussing the benefits of using rules instead of standards for resolving repetitive legal questions).

14. 257 U.S. 176 (1921).

15. *See* Standard Oil Co. v. United States, 221 U.S. 1 (1911).

16. *See* The Pipe Line Cases, 234 U.S. 548 (1914).

subsidiary even though the spin-off was legally compelled and even though the historic shareholders continued to own their investment in the same businesses, albeit in modified corporate form.[17] In 1918, Congress responded to the perceived harshness of the shareholder level taxable stock dividend result by enacting the predecessor to section 355.[18] In enacting section 355's predecessor, Congress was successful in alleviating its main concern to change the shareholder taxable stock dividend result.[19]

It is important in this context to also remember that the corporate level tax consequences of distributing appreciated property out of corporate solution was not a dominant policy concern prior to 1986. Yes, it is true that section 355's predecessor—and section 355 as currently envisioned—may provide nonrecognition treatment[20] at the corporate level for a qualifying section 355 distribution of appreciated stock in a controlled subsidiary. However, in the pre-1986 era, it was

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17. *Rockefeller*, 257 U.S. at 181–84; *accord* Cullinan v. Walker, 262 U.S. 134, 137–38 (1923) (holding that the shareholder had a gain equal to the difference in the value of the shares received and their basis in the stock of the liquidating distributing corporation); *see* United States v. Phellis, 257 U.S. 156, 165, 173–75 (1921) (finding on the same day as *Rockefeller*, that shareholders received a taxable stock dividend after the E.I. du Pont de Nemours Powder Company transferred all its assets to a new subsidiary, E.I. du Pont de Nemours & Co. in exchange for all of its stock plus debt instruments, and then E.I. du Pont de Nemours Powder Company transferred the stock in E.I. du Pont de Nemours & Co. to its shareholders).

18. Revenue Act of 1918, Pub. L. No. 65-254, § 202(b), 40 Stat. 1057, 1060 (1919). Congress modified the predecessor to section 355 in 1921 and 1924. *See* Revenue Act of 1924, Pub. L. No. 68-176, § 203(h)(1)(B), 43 Stat. 253, 257 (1924) (codifying section 355's predecessor as follows: "a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred"); Revenue Act of 1921, Pub. L. No. 67-98, § 202(c), 42 Stat. 227, 230 (1921).

19. *See* Peter C. Canellos, *The Section 355 Edifice: Spinoffs Past, Present, and Future*, 104 TAX NOTES 419, 420 (2004) ("[T]he basic outlines of section 355 were drawn to deal with a tax environment in which tax rates on dividends received by individuals greatly exceeded those on capital gains. The complex and strict requirements of section 355 derive from concerns over dividend avoidance, not the avoidance of gain recognition that is typically the concern in the reorganization area. This concern was most evident in the 'device' clause but also in the other provisions designed to assure that the spin-off was a true reorganization resulting from business needs (far beyond the business purpose test normally applied to corporate transactions), and involving a controlled subsidiary in an active business. The rate difference, of course, was eliminated in 2003, which calls into question the need for all the complex safeguards contained in section 355.").

20. *But see* I.R.C. § 355(d)(1) (2012) (specifying corporate level gain in certain situations); § 355(e)(1) (further specifying corporate level gain in certain situations).

possible to distribute appreciated property to shareholders in taxable transactions without incurring corporate level tax in reasonably available alternatives. Thus, even though section 355 generally affords nonrecognition treatment at the corporate level, distributions taxable at the shareholder level could be structured in the pre-1986 era without incurring corporate level taxation outside the context of section 355.[21] Therefore, the corporate level nonrecognition treatment provided by section 355's predecessor was not unique.

In this regard, the Supreme Court in *General Utilities* held that a corporation did not recognize gain as a result of its distribution of appreciated property to its shareholders.[22] Congress codified the *General Utilities* doctrine to allow for nonrecognition treatment at the corporate level for (1) distributions of appreciated property to its shareholders as nonliquidating dividends;[23] (2) liquidating or partially-liquidating distributions;[24] and (3) sales of appreciated assets made in connection with qualifying liquidating distributions.[25] This nonrecognition treatment, at the corporate level, for distributions of appreciated assets out of the corporate solution was so significant that it was widely identified as one of the "seven basic decisions or principles" of the pre-1986 corporate tax law.[26] Thus, although section 355 provided nonrecognition treatment at the corporate level to the distributee corporation, that result was not meaningfully divergent from the tax results obtainable via reasonably available alternative transactions due to the broad scope of the *General Utilities* doctrine.

Consequently, section 355, in its formative period, was principally concerned with the shareholder level tax consequences of a corporate separation rather than focused on the corporate-level consequences of a corporate separation. Thus, the purpose of section 355 was to discern

21. *See* Esmark, Inc. v. Comm'r, 90 T.C. 171, 181–82, 185, 199–200 (1988), *aff'd*, 886 F.2d 1318 (7th Cir. 1989).

22. Gen. Utils. & Operating Co. v. Helvering, 296 U.S. 200, 206 (1935).

23. Internal Revenue Code of 1954, Pub. L. No. 83-591, § 311, 68A Stat. 93, 94–95 (1954). The legislative history makes clear that the intent of this provision was to codify the rule development in the Supreme Court's decision in *General Utilities*. *See* S. REP. NO. 83-1622, at 46–47 (1954) (explicitly referencing the desire to codify the *General Utilities* doctrine with an exception for distributions of LIFO inventory and an exception for a distribution of property with a liability in excess of its tax basis); H.R. REP. NO. 83-1337, at 37–38 (1954) (expressing the desire to codify the *General Utilities* doctrine with the same exceptions expressed in the Senate report).

24. Internal Revenue Code of 1954, Pub. L. No. 83-591, § 336, 68A Stat. 93, 106 (1954).

25. *Id.* § 337, 68A Stat. at 106–07.

26. *See* Robert Charles Clark, *The Morphogenesis of Subchapter C: An Essay in Statutory Evolution and Reform*, 87 YALE L.J. 90, 96–97, 130 (1977).

which business separations were, in substance, a device for shareholders to bail out earnings and profits at capital gains rates, and which corporate separations should instead be afforded nonrecognition treatment because the corporate separation represented a readjustment of the historic shareholder's continuing interest, in modified corporate form, in historic businesses.[27]

Here is where the landmark case of *Gregory v. Helvering*[28] enters the dialogue. *Gregory* stands on the other side of the spectrum from *Rockefeller* and has forever altered section 355's development. The facts are well understood. Ms. Gregory, in 1928, owned all the stock of United Mortgage Corp., which in turn owned a stock investment in Monitor Securities Corp. (Monitor).[29] A simple distribution of the Monitor shares to Ms. Gregory would have been a taxable dividend.[30] So, instead of engaging in a transaction that took that form, United Mortgage Corp. formed a new corporation, Averill, and transferred its Monitor shares to Averill.[31] Shortly thereafter, United Mortgage Corp. distributed all of the Averill shares to Ms. Gregory in a transaction that the taxpayer claimed was a tax-free spin-off under section 355's predecessor.[32] Averill then was liquidated, making Mrs. Gregory the direct owner of the Monitor Shares.[33] Under the *General Utilities* doctrine, the Averill liquidation did not create a corporate level taxable event, and Ms. Gregory asserted that she was entitled to capital gains treatment on the exchange of her Averill stock for the Monitor stock since she acquired the Monitor stock as part of a taxable liquidation of Averill.[34] Ms. Gregory won at the lower court level in a 1932 decision by the Board of Tax Appeals.[35] In response to the tax planning utilized here, Congress prospectively repealed section 355's

27. For an excellent analysis of section 355 in its early years, see Charles S. Whitman, III, *Draining the Serbonian Bog: A New Approach to Corporate Separations under the 1954 Code*, 81 HARV. L. REV. 1194, 1238 (1968), which provides a thorough review of the historical development and legislative history of the early years of section 355.

28. 293 U.S. 465 (1935).

29. *Id.* at 467.

30. *Id.*

31. *Id.*

32. *Id.*

33. *Id.*

34. *Id.*

35. Gregory v. Comm'r, 27 B.T.A. 223, 226 (1932).

predecessor that purportedly had allowed Ms. Gregory to receive the Averill stock in a tax-free spin-off transaction.[36]

After this draconian congressional response, the Second Circuit,[37] and then the Supreme Court,[38] held for the government in the subsequent appeals, thus reversing the taxpayer victory in *Gregory*. The Court held that Ms. Gregory had, in substance, received a taxable stock dividend distribution of the Averill stock from United Mortgage Corp. under the following rationale:

> [p]utting aside, then, the question of motive in respect of taxation altogether, and fixing the character of the proceeding by what actually occurred, what do we find? Simply an operation having no business or corporate purpose—a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganize a business or any part of a business, but to transfer a parcel of corporate shares to the petitioner.[39]

In response to the Court's holding, when Congress restored nonrecognition treatment for spin-offs through its reenactment of section 355's predecessor in 1951, it added two new requirements to the statute to address the tax planning technique highlighted by *Gregory*.[40] First, Congress required that the distributing corporation and the controlled corporation must conduct a historic active trade or business, thus attacking the fact that Averill's sole activity consisted of owning only a passive investment in Monitor's stock.[41] Second, Congress provided that the spin-off transaction must not be used principally as a device for the distribution of earnings and profits to the distributing corporation's

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36. *See* Revenue Act of 1934, Pub. L. No. 73-216, § 112, 48 Stat. 680, 704–06 (1934); *see also* Donald L. Cordes, *The Device of Divisive Reorganizations: An Analysis of Section 355(a)(1)(B) and Its Relation to Section 368(a)(1)(D) and the Doctrines of "Continuity of Interest" and "Business Purpose,"* 10 U. KAN. L. REV. 21, 23 (1961) ("The reason for this action [repealing Section 355's predecessor in 1934] was because the spin-off provisions were often utilized by taxpayers as a means of avoiding taxes. A fairly common tactic was for a corporation to transfer certain liquid assets, or passive investments, to a new corporation and distribute the stock to the shareholders. The shareholders would then liquidate the new corporation and receive what was in essence a dividend, but taxable, however, only at capital gain rates.").

37. Helvering v. Gregory, 69 F.2d 809, 811 (2d Cir. 1934).

38. *Gregory*, 293 U.S. at 470.

39. *Id.* at 469.

40. *See* Internal Revenue Code of 1951, Pub. L. No. 82-183, § 317, 65 Stat. 452, 493 (1951).

41. *See* I.R.C. § 355(b) (2012); *see also* Revenue Act of 1951, Pub. L. No. 82-183, § 317, 65 Stat. 452, 493 (1951).

shareholders;[42] thus, in effect, codifying the substance-over-form device test that was employed by the Court in *Gregory*.[43]

Seen in its historical context, the addition of the device test and the historic active trade or business requirement, in combination, represent congressional attempts to prevent the tax planning set forth in *Gregory*, while still allowing tax-free readjustments where the historic shareholders maintained a continuing shareholder interest in historic businesses, albeit in modified corporate form.[44] But, instead of providing objective tests for distinguishing between qualifying and nonqualifying transactions, Congress instead adopted a subjective business purpose test and a subjective device test.

Obviously, the device test was codified into section 355's predecessor prior to the repeal of the *General Utilities* doctrine.[45] Again, in that era,

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42. *See* I.R.C. § 355(a)(1)(B). This provision was added in section 317 of the Revenue Act of 1951, 65 Stat. at 493–94.

43. In 1954, Congress expanded the applicability of these requirements so that they also applied to split-offs and split-ups. *See* I.R.C. § 368(a)(1)(D) (requiring that a section 368(a)(1)(D) reorganization include a distribution of stock that satisfies either section 354(b), section 355, or section 356).

44. *Gregory*, 293 U.S. at 469; *see also* H.R. REP. NO. 68-179, at 16 (1924) ("This is a common type of reorganization, and clearly should be included within the reorganization provisions of the statute."); 65 CONG. REC. 2429 (1924) (statement of Rep. Green) (stating that a usual form of reorganization is splitting one corporation into two or more corporations). In this regard, existing Treasury regulations mirror this purpose. *Compare* Treas. Reg. § 1.355-2(b)(1) (2016) (stating that the business purpose requirement provides "nonrecognition treatment only to distributions that are incident to readjustments of corporate structures required by business exigencies and that effect only readjustments of continuing interests in property under modified corporate forms"), *with* Treas. Reg. § 1.368-1(b) ("The purpose of the reorganization provisions of the Code is to except from the general rule certain specifically described exchanges incident to such readjustments of corporate structures made in one of the particular ways specified in the Code, as are required by business exigencies and which effect only a readjustment of continuing interest in property under modified corporate forms. Requisite to a reorganization under the Internal Revenue Code are a continuity of the business enterprise through the issuing corporation under the modified corporate form . . . ."). Noted scholars have continued to point to this principal as the core feature for section 355. *See, e.g.*, Karla W. Simon & Daniel L. Simmons, *The Future of Section 355*, 40 TAX NOTES 291 (1988); George K. Yin, *Taxing Corporate Divisions*, 56 SMU L. REV. 289, 297 (2003). For an excellent analysis of this historical development of section 355 exemplifying the argument that the IRS's restriction of the device test to only the shareholder level rate concern was not inevitable given the legislative history, see Whitman, *supra* note 27, at 1238.

45. The final repeal of the *General Utilities* doctrine occurred in 1986, but the correct understanding of its historical evolution is that the doctrine diminished incrementally over many decades, culminating in its final repeal in 1986. Congress and the courts created numerous exceptions to the *General Utilities* doctrine. *See* STAFF OF J. COMM. ON TAX'N, 97TH

assets leaving corporate solution without corporate level taxation were not a significant policy concern. Thus, the focus of the device test was directed towards bail out techniques that would circumvent shareholder dividend taxation.[46] Furthermore, the device test focused on only a special subset of corporate separations that failed to demonstrate a continuity of shareholder interest, namely those transactions that facilitated a shareholder effort to bail out corporate earnings and profits in a manner that avoided the shareholder dividend tax. In fact, consistent with this historical context, existing Treasury Department regulations articulated the contours of the device test by focusing on whether a distribution represents a bail out of earnings and profits, or instead, represents a corporate separation that is motivated by business exigencies of historic active businesses among historic shareholders.[47]

CONG., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982 129–30 (Comm. Print 1982). In fact, even when section 311 was first enacted in 1954, the section already contained several exceptions to the *General Utilities* doctrine for LIFO Inventory and property in which a liability exceeded its basis. *See* Internal Revenue Code of 1954, Pub. L. No. 83-591, §§ 311(b)–(c), 68A Stat. 3, 94–95 (1954). In 1969, section 311 was amended so that corporations using appreciated property to redeem their own stock, where the fair market value of the property exceeded the adjusted basis, were also excluded from non-recognition treatment. Tax Reform Act of 1969, Pub. L. No. 91-172, § 905(a), 83 Stat. 487, 713–14 (1969) (codified as amended at I.R.C. § 311). In 1982, the Tax Equity and Fiscal Responsibility Act added subsection (e), which designated certain definitions and special rules which were required to be complied with to receive non-recognition treatment. Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 223(a)(2), 96 Stat 324, 483–84 (codified as amended at I.R.C. § 311). Theses definitions and special rules included the required use of qualified stock, which was defined as a stock holding period. *Id.* Section 311(e) also applied section 318 attribution rules to stock holding requirement. *Id.* Finally, section 311(e)(2)(A) added the requirements that (1) distributions must be made to qualified stock, (2) the assets must be related to a qualified business, (3) the non-business assets must not have been contributed through a section 351 contribution to capital within the last five years, and (4) more than fifty percent of the controlled corporation must be distributed. *Id.* § 223(e)(2)(A).

46. This artificial restriction of the device test has been criticized even prior to the repeal of the *General Utilities* doctrine. *See* Whitman, *supra* note 27, at 1238 ("By tying the device clause of section 355 to sections 302 and 346, the IRS seems to be extending the grant of favorable [section 355] treatment further than Congress intended.").

47. *See* Treas. Reg. § 1.355-2(d) (2016) (stating that a spin-off facilitates avoiding dividend provisions of the Code through selling or exchanging one corporation's stock and retaining stock in another). Device factors include: pro rata distribution; subsequent sale of the controlled subsidiary's stock by the shareholders; assets of the distributing corporation or the controlled subsidiary that are not used in a five-year trade or business; or the business of either the distributing corporation or the controlled corporation represents a secondary business whose principal function is to serve the other business and which could be sold without adverse effect on the other business. *See* Treas. Reg. § 1.355-2(d)(2)(ii)–(iv). In recognition of the bail out

This formulation of the device test promoted the shareholder level policy concern of that era, but focusing on these considerations caused section 355 to differentiate between corporate separations that represent a device for shareholders to access corporate earnings and profits at capital gains rates, instead of solely focusing on the core original question: did a corporate separation solely represent a readjustment of historic businesses among historic shareholders or was section 355 being used as a device for some other purpose?[48] Thus, the device test, as it evolved in the *General Utilities* era, shifted attention away from the issue of whether a transaction represented merely a readjustment of interest in historic businesses among historic shareholders to instead focus on whether a particular disposition allowed historic shareholders to bail out earnings and profits at capital

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concern, a distribution is ordinarily considered not to have been used principally as a device if, in the absence of section 355, the distribution would be a redemption to which section 302(a) or section 303(a) would have applied or if the distributing corporation had no earnings and profits. *See* Treas. Reg. § 1.355-2(d)(5)(ii)–(iv). Historically, the IRS has articulated that sale or exchange treatment presumptively precludes the finding of a device. *See, e.g.*, Rev. Rul. 71-383, 1971-2 C.B. 180–81 (holding that "if the distribution were considered taxable, it would not result in dividend income to the two shareholders receiving Y stock because the exchange of their X stock as to each would have been a substantially disproportionate redemption under section 302(b)(2) of the Code and thus would have been treated as a distribution in part or full payment in exchange for such stock under section 302(a) of the Code. Consequently, the transaction is not a device to distribute earnings and profits (that is, to convert dividend income into capital gains)"); Rev. Rul. 64-102, 1964-1 C.B. 138 (stating that "there can be no device to distribute earnings and profits because of the non pro rata distribution"). The extant case law has repeatedly applied the device test to protect the shareholder rate differential and prevent a bail out of corporate earnings and profits at capital gains rates, which is a shareholder level policy question that does not have a continuing role today. *See, e.g.*, Rafferty v. Comm'r, 452 F.2d 767, 770 (1st Cir. 1971) (discussing the effects of distribution of controlled corporations); Comm'r v. Wilson, 353 F.2d 184, 186 (9th Cir. 1965) (examining distribution on taxpayers as a dividend paid for by the corporation); Gada v. United States, 460 F. Supp. 859, 864 (D. Conn. 1978) (defining distribution as corporate "spin off" of shareholders to the subsidiary); S. Tulsa Pathology Lab., Inc. v. Comm'r, 118 T.C. 84, 93–94 (2002) (holding that the device test applies where a private distributing corporation distributes a controlled subsidiary pro rata and the shareholders sold all the controlled subsidiary's stock in a prearranged plan that same day).

48. For an excellent analysis of the early evolution of the judicially created continuity of shareholder interest doctrine and the framing of the *Gregory* decision as part of the development of the continuity of interest doctrine, see David F. Shores, *Reexamining Continuity of Shareholder Interest in Corporate Divisions*, 18 VA. TAX REV. 473, 482–83 (1999); David F. Shores, *Reexamining Continuity of Shareholder Interest in Corporate Reorganizations*, 17 VA. TAX REV. 419, 452 (1998) [hereinafter *Corporate Reorganizations*].

gains rates.[49] Again, in an era where the *General Utilities* doctrine allowed easy distribution of appreciated property out of corporate solution without corporate level tax,[50] it is not surprising that the device test did not focus on protecting the corporate tax base, but instead focused on protecting the shareholder dividend tax rate differential.[51]

Currently, section 1(h)(11) provides that qualified dividends received by individual shareholders generally are taxed at the same rate as long-term capital gains,[52] and the American Taxpayer Relief Act of 2012 made this tax rate parity permanent.[53] Thus, unlike most of the U.S. income tax history, individuals now are entitled to receive the same preferential tax rate for qualified dividends as long-term capital gains. Consequently, the historic shareholder level concern that underlies the device test is no longer a relevant policy concern.[54]

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49. *See Corporate Reorganizations*, *supra* note 48, at 423.

50. Protecting the corporate tax base from distributing appreciated assets out of corporate solution was not a significant policy concern in section 355's formative period, as the *General Utilities* doctrine made that opportunity available in a broad range of contexts. *See* Simon & Simmons, *supra* note 44, at 292 (summarizing the disconnect between the policy concerns during section 355's formative period and today to explain that the main question in the current tax environment is "whether stock acquisitions and dispositions that fit within the literal language of section 355 ought to be permitted when their principal purpose is avoidance of the corporate tax on asset appreciation").

51. *See* Canellos, *supra* note 19, at 420 (stating that the "basic outlines of section 355 were drawn to deal with a tax environment in which tax rates on dividends received by individuals greatly exceeded those on capital gains. The complex and strict requirements of section 355 derive from concerns over dividend avoidance, not the avoidance of gain recognition that is typically the concern in the reorganization area. This concern was most evident in the 'device' clause but also in the other provisions designed to assure that the spin-off was a true reorganization"); *see also* Simon & Simmons, *supra* note 44, at 293–94 ("Without a capital gain preference, the underlying historic purpose behind the 'device' restriction and the active trade or business requirements of section 355 largely disappears.").

52. *See* BORIS I. BITTKER ET AL., FEDERAL INCOME TAXATION OF INDIVIDUALS ¶ 9.13 (3d ed. 2010).

53. I.R.C. § 1(h)(11)(A) (2012). Section 1(h) first applied for 2003. *See* Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, § 302, 117 Stat. 752, 760, 764 (2003). The provision initially applied only for the years 2003 through 2008, but Congress extended its life twice. *See* Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, § 102(a), 124 Stat. 3296, 3298 (2010); Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109-222, § 102, 120 Stat. 345, 346 (2006). In 2013, Congress made the provision permanent. American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, § 102, 126 Stat. 2313, 2318 (2013).

54. Although other noted commentators have proposed other reforms, it is widely recognized that the device test was impacted by an extinct shareholder tax rate

Moreover, unlike the prior era where the *General Utilities* doctrine allowed easy escape of appreciated assets out of corporate solution without incurring corporate level gains, the current era—as indicated in the next two sections—instead is concerned with protecting against efforts to avoid Congress's repeal of the *General Utilities* doctrine. Thus, the key question now, is whether a corporate separation is motivated by a business purpose to separate historic businesses between historic shareholders, or whether the corporate separation is being used as a device to avoid the intended scope of the repeal of the *General Utilities* doctrine. The device test needs to be repurposed for the modern era, and the continuity of interest standard and the testing periods of sections 355(d) and (e) need to be rationalized in order to fulfill Congress's goal in its repeal of the *General Utilities* doctrine.[55] In Section I.B and Section I.C, this Article addresses the scope of Congress's intended repeal of the *General Utilities* doctrine so that the appropriate scope of section 355's limited exception to that *General Utilities* repeal can be properly framed. Thus, the analysis in Section I.B and Section I.C lays the foundation for the reform proposals set forth in Part II.

B. *Congress's Intended Scope of its* General Utilities *Repeal*

Before addressing how section 355 should be reformed, it is necessary to properly frame the fundamental shift that occurred in 1986 due to the repeal of the *General Utilities* doctrine, as section 355 cannot be properly positioned until Congress's goal in its *General Utilities* repeal is clear. The ability to distribute appreciated assets out of corporate solution without incurring corporate level tax is exactly what Congress decided was in need of fundamental reform in 1986.[56]

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concern and as such does not adequately address today's era. *See* Michael L. Schler, *Simplifying and Rationalizing the Spinoff Rules*, 56 SMU L. REV. 239, 252 (2003) ("The device test . . . is also inadequate in this situation. The test is a vague balancing test . . . . Moreover, the test is focused on shareholder-level issues rather than *General Utilities* repeal."); *see also* Canellos, *supra* note 19, at 420 ("The rate difference . . . was eliminated in 2003, which calls into question the need for all the complex safeguards contained in section 355.").

55. This parity of rates and grappling with the implications of rate parity on the device test was explored early on by others. *See, e.g.*, Joshua D. Blank, *The Device Test in a Unified Rate Regime*, 102 TAX NOTES 513, 518–20 (2004).

56. *See* H.R. REP. NO. 99-426, at 282 (1985) ("[T]he *General Utilities* rule tends to undermine the corporate income tax. Under normally applicable tax principles, nonrecognition of gain is available only if the transferee takes a carryover basis in the transferred property, thus assuring that a tax will eventually be collected on the appreciation. Where the *General Utilities* rule applies, assets generally are permitted to

In the end, Congress endorsed business tax reform that supported the classic view of corporations[57] by repealing the last vestiges of the *General Utilities* doctrine.[58] The intent of that major tax reform effort was to ensure that built-in gain property, residing in corporate solution, would be subject to corporate level taxation when and if such property were disposed of.[59] Thus, a corporation could no longer distribute appreciated corporate assets without incurring a corporate level tax, and Congress also authorized the Treasury Department to issue regulations to ensure that companies would not circumvent the purpose behind the repeal of the *General Utilities* doctrine.[60]

The question of when a spin-off represents an inappropriate circumvention of Congress's repeal of the *General Utilities* doctrine has been a point of continual discussion in the literature.[61] So, any analysis

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leave corporate solution and to take a stepped-up basis in the hands of the transferee without the imposition of a corporate level tax. Thus, the effect of the rule is to grant a permanent exemption from the corporate income tax."); *id.* at 282 n.28 ("The price of this basis step up is, at most, a single, shareholder-level capital gains tax (and perhaps recapture, tax benefit, and other similar amounts). In some cases, moreover, payment of the capital gains tax is deferred because the shareholder's gain is reported under the installment method."). For contemporaneous statements in favor of retaining the *General Utilities* doctrine, see Walter J. Blum, *Behind the* General Utilities *Doctrine, or Why Does the General Have so Much Support from the Troops*, 62 TAXES 292, 293–95 (1984); Bernard Wolfman et al., *Taxing Corporate Distributions of Appreciated Property: Repeal of the* General Utilities *Doctrine, Relief Measures and Entity Reclassification Proposals*, 22 SAN DIEGO L. REV. 77, 83–85 (1985); *see also Reform of Corporate Taxation: Hearing before the S. Comm. on Finance*, 98th Cong. 148–49 (1983) (statement of John S. Nolan).

57. *See* Don Leatherman, *The Scope of the* General Utilities *Repeal*, 91 TAXES 235, 237 (2013). Calls for the repeal of the *General Utilities* doctrine began almost at the time of its codification. *See, e.g.*, H. COMM. ON WAYS AND MEANS, 86TH CONG., A PROPOSED NEW TREATMENT FOR CORPORATE DISTRIBUTIONS AND SALES IN LIQUIDATION 1643, 1649–50 (Comm. Print 1959) (authored by James B. Lewis).

58. *See* Tax Reform Act of 1986, Pub. L. No. 99-514, § 631(a), 100 Stat. 2085, 2269 (1986) (amending I.R.C. §§ 311(b)(2) and 336(a)).

59. H.R. REP. NO. 99-841, at 204 (1986) (Conf. Rep.), *as reprinted in* 1986 U.S.C.C.A.N. 4075, 4292 ("The repeal of the *General Utilities* doctrine is designed to require the corporate level recognition of gain on a corporation's sale or distribution of appreciated property, irrespective of whether it occurs in a liquidating or nonliquidating context."); *see also* George K. Yin, General Utilities *Repeal: Is Tax Reform Really Going to Pass it by?*, 31 TAX NOTES 1111, 1112 (1986) (proposing the repeal of the *General Utilities* doctrine, which later became law in 1986 with the enactment of sections 336, 337, and 338 of the Internal Revenue Code).

60. *See* I.R.C. § 336(d)(1)(A) (1988).

61. There are rich scholarly discussions of section 355 where various reform proposals have been set forth and are worthy of serious consideration. *See, e.g.*, Herbert N. Beller, *Tax-Free Corporate Separations: The Tug of War Continues*, U. S. CAL. L. CTR. TAX INST. § 200 (1992); Canellos, *supra* note 19, at 423; J. William Dantzler Jr., *Spinoffs: Still*

of the appropriate scope of section 355 must begin with this organization question: How should section 355's continued existence be harmonized with Congress's over-arching goal of repealing the *General Utilities* doctrine? As part of its decision to repeal the *General Utilities* doctrine, Congress had to address the appropriate scope of section 355 both in 1986 and in subsequent legislation. Unfortunately, in 1986, Congress initially chose to leave section 355 unchanged. This was a missed opportunity. However, the legislative history in the Tax Reform Act of 1986 indicates why Congress believed section 355 should remain in the tax law, and thus represents a good place to start to understand how Congress rationalized section 355's continued existence in the post-*General Utilities* era:

> Congress felt that the same policy rationale that justifies nonrecognition by the shareholder on receipt of the stock—namely, that the transfer merely effects a readjustment of the shareholder's continuing interest in the corporation in modified form and subject to certain statutory and other constraints—also justifies nonrecognition of gain (or loss) to the distributing corporation in this situation.[62]

With the benefit of hindsight, Congress's failure to reform section 355 in 1986 was a mistake, and the subsequent statutory amendments to section 355 in the post-1986 era demonstrate that Congress has recognized that section 355's statutory provisions must be harmonized with its larger effort to repeal the *General Utilities* doctrine. But, even so, the above justification for retaining section 355 is instructive:

Remarkably Tax Friendly, 129 TAX NOTES 683, 683 (2010); Melissa C. McCann, *Section 355 in a Post-*General Utilities *World: The Victim of an Overreaction?*, 23 J. CORP. TAX'N 137 (1996); Schler, *supra* note 54, at 240; Daniel M. Schneider, *Internal Revenue Code § 355 Before and After the Tax Reform Act of 1986: A Study in the Regulation of Corporate Tax Bailouts*, 39 OKLA. L. REV. 567, 569 (1986); Michael L. Schultz, *The Evolution of the Continuity of Interest Test,* General Utilities *Repeal and the Taxation of Corporate Acquisitions*, 80 TAXES 229, 229 (2002); Jeffrey T. Sheffield & Herwig J. Schlunk, *Reconciling Spin-Offs with* General Utilities *Repeal*, 74 TAXES 941, 941 (1996); Simon & Simmons, *supra* note 44, at 291; Lewis R. Steinberg, *Selected Issues in the Taxation of Section 355 Transactions*, 51 TAX LAW. 7, 7–8 (1997); George K. Yin, *A Different Approach to the Taxation of Corporate Distributions: Theory and Implementation of a Uniform Corporate-Level Distributions Tax*, 78 GEO. L.J. 1837, 1924 (1990) ("In sum, the traditional focus of the device clause has been not on testing whether there has been a constructive withdrawal of corporate earnings (and contribution of new capital), but rather on the character of those earnings in the hands of the distributee, once withdrawn."); Yin, *supra* note 44, at 289–90; Zolt, *supra* note 12, at 819.

62. STAFF OF THE J. COMM. ON TAX'N, 99TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 337 (Comm. Print 1987).

Congress believed that a readjustment of the continuing interest of historic shareholders in historic businesses should be afforded nonrecognition treatment.[63] But, after giving a shout-out for that core fact pattern that deserved nonrecognition treatment in the post-*General Utilities* era, Congress did not seek to revisit whether section 355, in its then existing statutory construct, might afford nonrecognition treatment to transactions that resembled a disposition of a business to new shareholders in contravention of the intended scope of its *General Utilities* repeal.[64]

Since Congress did not resolve the question of how to harmonize section 355 with its broader effort to repeal the *General Utilities* doctrine in 1986, a rich debate has ensued about the appropriate scope of Congress's *General Utilities* repeal.[65] A "weak form" of *General Utilities* repeal holds that Congress's repeal of the *General Utilities* doctrine is fulfilled as long as assets remain with a carryover basis in corporate solution so that corporate level taxation is deferred, but not permanently avoided.[66] In contrast, a "strong form" of *General Utilities* repeal holds that Congress did not intend nonrecognition treatment for assets that are transferred to new shareholders who are outside of the historic economic group.[67] Section 355 lies at the heart of this debate, and the fact that Congress did not reexamine section 355's scope left this debate unresolved in 1986.

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63. *Id.*

64. It is inexplicable that Congress did not take up this challenge because significant scholarship at the time was devoted to the notion of whether and to what extent section 355's scope should be expanded or curtailed as part of the repeal of the *General Utilities* doctrine. *See, e.g.*, FEDERAL INCOME TAX PROJECT—SUBCHAPTER C: PROPOSALS ON CORPORATE ACQUISITIONS AND DISPOSITIONS 104 (AM. LAW INST. 1982); Peter L. Faber et al., *Income Taxation of Corporations Making Distributions with Respect to Their Stock*, 37 TAX LAW. 625, 626 (1984) (discussing the recommendations of the *General Utilities* Task Force); Edward J. Hawkins, *A Discussion of the Repeal of* General Utilities, 37 TAX LAW. 641, 644–45 (1984); John S. Nolan, *Taxing Corporate Distributions of Appreciated Property: Repeal of the* General Utilities *Doctrine and Relief Measures*, 22 SAN DIEGO L. REV. 97, 97 (1985); Bernard Wolfman, *Corporate Distributions of Appreciation Property: The Case for Repeal of the* General Utilities *Doctrine*, 22 SAN DIEGO L. REV. 81, 85–87 (1985).

65. *See* Zolt, *supra* note 12, at 832 (demonstrating multiple interpretations of the scope of the *General Utilities* repeal and Congress's failure to solve the matter in 1986).

66. *See* FEDERAL INCOME TAX PROJECT—SUBCHAPTER C, *supra* note 64, at 116–17 (advancing the view that the exception includes a "transfer of assets in which basis carries over to the corporate transferee").

67. *See* Zolt, *supra* note 12, at 822 (listing a presently used rubric of the competing "strong form" and "weak form" versions of Congress's *General Utilities* repeal).

However, this debate needs to incorporate what can and should be gleaned from Congress's repeated amendments to section 355 over the intervening period from 1987 through 2016. Both the statutory amendments to section 355 since 1986, and the legislative history from the numerous amendments from 1987 to 2016, demonstrate that Congress had a steadfast desire to enact a "strong form" of repeal despite a lack of clarity from Congress during the 1986 repeal.[68] Yet, even though Congress's legislative amendments and the accompanying legislative history demonstrate an effort to enact a "strong form" of *General Utilities* repeal, the statutory amendments failed to fulfill Congress's stated "strong form" policy goals. The discontinuity that exists between the explicit "strong form" version of Congress's *General Utilities* repeal that motivated Congress's passage of these amendments, contrasted with the ineffectiveness of the actual statutory amendments in achieving those "strong form" goals, has caused section 355 to evolve in a chaotic fashion.[69]

The initial category of transactions that caused Congress to believe that section 355 could be used as a means to circumvent its efforts to repeal the *General Utilities* doctrine involved an acquirer corporation that purchased stock of a target corporation and then caused the target corporation to distribute its low-basis assets to the purchasing corporation via the distribution of a subsidiary's stock, which held those appreciated assets. In Revenue Ruling 74-5,[70] the IRS ruled that an acquiring corporation that had purchased stock in a distributing corporation two years prior to the spin-off of a controlled subsidiary's stock could constitute a historic shareholder, and thus could qualify for section 355 treatment even though the shareholder had not owned

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68. *See id.* at 822–23 (showing that Congress did not resolve the question in 1986 as to whether it endorsed a "strong form" or "weak form" of its efforts to repeal the *General Utilities* doctrine).

69. Although the literature suggests divergent prescriptions on how to reform section 355, the authors broadly agree that section 355 needs fundamental reform. *See* Schler, *supra* note 54, at 240 ("The spinoff rules in [section] 355 and related sections are in many respects illogical, complex and uncertain. The rules disqualify some transactions that logically should be permitted and permit other transactions that logically should be disqualified. Moreover, the complexities and uncertainties are so great that spinoff ruling requests are reported to represent more than half the workload of the entire IRS corporate division. Congress, the Treasury Department, and the IRS have devoted considerable attention to spinoffs in recent years, yet few would say that this has made the rules simpler, more rational or more certain.").

70. Rev. Rul. 74-5, 1974-1 C.B. 82 (as made obsolete by Rev. Rul. 89-37, 1989-1 C.B. 107).

stock in the distributing corporation for five years.[71] This ruling provided a pathway for a corporate purchaser to acquire stock in a target corporation and then break-up and sell the target corporation's ownership structure[72] without incurring corporate level taxation.

This transaction is not objectionable under a "weak form" of *General Utilities* repeal as the assets held in corporate solution retain a carryover basis. However, this transaction is objectionable under a "strong form" of *General Utilities* repeal because historic assets are being transferred outside the economic group to new shareholders without incurring corporate level taxation. Thus, this transaction created an early acid test for determining the correct form (a "weak form" or "strong form") of *General Utilities* repeal that Congress intended, and Congress quickly responded by asserting that section 355's usage in this context was inconsistent with its repeal of the *General Utilities* doctrine as it inappropriately allowed a new shareholder (an acquiring corporation) to obtain ownership of a historic business without the corporation incurring corporate level taxation on the disposition.[73] This outcome was seen as analogous to the results sought by the so-called mirror transactions that were being lauded as a means for corporate purchasers to acquire target assets from a target corporation without incurrence of corporate level gain.[74] Thus, Congress was forced to immediately recognize that the efficacy of its *General Utilities* repeal in 1986 was hamstrung by a variety of tax provisions that pre-dated its *General Utilities* repeal and still provided a pathway for bust-up transactions where a target corporation's assets could be transferred to a new acquirer without incurrence of corporate level taxation.

Thus, in 1987, Congress decided to address the so-called mirror transaction[75] by amending section 337(c), and, at the same time, it addressed the so-called cousin-of-mirror transaction[76] by enacting section

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71. *Id.*

72. The acquiring corporation would be able to allocate its cost basis in the target corporation's stock to the stock in the controlled subsidiary and the retained stock in the target corporation based on their relative fair market value per section 358.

73. Rev. Rul. 89-37, 1989-1 C.B. 107–08.

74. *See* Lee A. Sheppard, *Mirror Transactions Go Forward*, 35 TAX NOTES 1057, 1057 (1987); Lee A. Sheppard, *Room Full of Mirrors: Enforcing* General Utilities *Repeal*, 33 TAX NOTES 281, 281 (1986).

75. For a more detailed explanation of this transaction and its implications with respect to the repeal of the *General Utilities* doctrine, see Zolt, *supra* note 12, at 825–27.

76. For a more detailed explanation of the cousin-of-mirror transaction and its implications with respect to the repeal of the *General Utilities* doctrine, see Lynne A.

304(b)(4). During this same period, the Treasury Department utilized its regulatory authority under the consolidated return regulations to address the son-of-mirrors technique.[77] It was in this larger context that Congress decided that section 355 must also be reformulated so that it did not provide an inappropriate means to circumvent Congress's intended

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Schewe, *Consolidated Return Regs. Duck Many Issues Involving Application of Section 304*, 77 J. TAX'N 162, 163 (1992).

77. The son-of-mirror transaction involved a situation in which an acquiring company would acquire the stock of a target company at fair market value. After the acquisition, the acquiring company would cause the target company to distribute its wanted assets to the acquirer, thus generating gain within the acquirer's consolidated group. The transaction increased the acquirer's basis in the stock of the target by the amount of that gain. The acquirer then could sell the target's stock at a time when the target company held only unwanted assets. As a result, an artificial loss was created that approximated the amount of the previously recognized gain that occurred upon the distribution of the wanted assets out of the target. The IRS immediately responded to the son-of-mirror technique by issuing I.R.S. Notice 87-14, 1987-1 C.B. 445, stating that it would deny the intended tax benefits of a son-of-mirror type transaction by future regulations that would have retroactive effect. On September 19, 1991, the IRS and Treasury Department published Treasury Regulation § 1.1502-20 (the loss disallowance rule). T.D. 8364, 1991-2 C.B. 43–44. On July 6, 2001, in Rite Aid Corp. v. United States, 255 F.3d 1357, 1360 (Fed. Cir. 2001), the Court held that the duplicated loss provisions of the loss disallowance rules were an invalid exercise of regulatory authority. Because only the loss duplication provision of Treasury Regulation § 1.1502-20 was at issue in *Rite Aid*, the IRS believes that the finding of invalidity applied only to that factor and not to the factors dealing with the son-of-mirror problem. *See* I.R.S. Notice 2002-11, 2002-1 C.B. 526 ("It is the Service's position that the *Rite Aid* opinion implicates only the loss duplication aspect of the loss disallowance regulation . . . ."). In response to the *Rite Aid* decision, the IRS and Treasury Department promulgated two regulations to replace the loss disallowance rules. The first, Temporary Treasury Regulation § 1.337(d)-2T (2002) (temporary *General Utilities* regulation), was published on March 12, 2002, to address the circumvention of *General Utilities* repeal. *See* T.D. 8984, 2002-1 C.B. 668. The second, Temporary Treasury Regulation § 1.1502-35T (2003), was published on March 14, 2003, to address the inappropriate duplication of loss. *See* T.D. 9048, 2003-1 C.B. 645. T.D. 9048 also included certain related provisions promulgated under Temporary Treasury Regulation § 1.1502-21T (2010) and Temporary Treasury Regulation § 1.1502-32T (2003). *Id.* On March 3, 2005, the temporary regulation was adopted without substantive change as final Treasury Regulation § 1.337(d)-2T (2005). *See* T.D. 9187, 2005-1 C.B. 778. On September 17, 2008, the IRS and Treasury Department issued final unified rules for loss on subsidiary stock through Treasury Regulation § 1.1502-36 (2008). *See* T.D. 9424, 2008-2 C.B. 1012. For a discussion of the final unified loss disallowance regulations that now represent the end of this sordid tale, see Friedel, *supra* note 4, at 33 ("To call these final rules complicated would be a great understatement."). For a thorough analysis of the final regulations, see Leatherman, *supra* note 4. For a detailed analysis of the evolution of the consolidated loss disallowance regulations and the need for such regulations in order to prevent circumvention of Congress's *General Utilities* repeal, see Leatherman, *supra* note 57, at 237.

scope of its repeal of the *General Utilities* doctrine.[78] This larger context is instructive in understanding the over-arching "strong form" repeal efforts that motivated all of these reforms and simultaneously guided the reform efforts with respect to section 355.

In this regard, in June of 1987, the Joint Committee on Taxation provided a comprehensive report to the House Ways and Means Committee that set forth areas where the Tax Reform Act of 1986 was in need of technical corrections including the following potential reform:

> Arguments for the proposals
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> 5. The rules permitting tax-free distributions of corporate stock were intended to apply in cases where there was a mere readjustment of a shareholder's continuing interest in a corporation in modified form. This rationale is not present where the shareholder has recently acquired its interest in the distributing corporation through a taxable acquisition, or where the shareholder sells the distributed stock without having held it for a substantial period of time.
>
> Possible Proposals
>
> 6. Permit nonrecognition in a divisive distribution of corporate stock only if the stock distributed is directly or indirectly owned by the distributee shareholders for a specified period of time (e.g., 5 years) before or after the distribution.[79]

The Joint Committee on Taxation's observations on section 355 are instructive on multiple levels. First, the Joint Committee on Taxation clearly believed that the *General Utilities* repeal was the general rule and that dispositions of historic businesses to new shareholders was intended to be taxable at the corporate level after Congress had repealed the *General Utilities* doctrine.[80] Second, the Joint Committee on Taxation envisioned section 355 as a narrow exception to the broader *General Utilities* repeal.[81] In this regard, section 355 was limited to allowing historic shareholders to separate their continuing investment in historic businesses in a modified corporate form.[82] And

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78. Leatherman, *supra* note 57, at 241.

79. STAFF OF THE J. COMM. ON TAX'N & STAFF OF THE COMM. ON WAYS AND MEANS, 100TH CONG., DESCRIPTION OF POSSIBLE OPTIONS TO INCREASE REVENUES PREPARED FOR THE COMMITTEE ON WAYS AND MEANS 172–73 (Comm. Print 1987).

80. *See id.* at 171–72.

81. *See id.* at 172 ("[T]he distribution must not be a device for the distribution of earnings and profits.").

82. *See id.* ("For example, a new shareholder who recently acquired the distributing corporation in a taxable transaction could still receive a qualified section 355 stock distribution.").

third, the Joint Committee on Taxation envisioned that section 355 should only apply to historic shareholders who owned their investment for a significant period of time before and after the corporate separation.[83] Thus, the Joint Committee on Taxation set forth the parameters for a "strong form" of *General Utilities* repeal.

But, in 1987, Congress only acted in part on the Joint Committee on Taxation's recommendations while whole-heartedly endorsing the "strong form" policy formulation. Specifically, Congress amended section 355(b)(2)(D) to disqualify from section 355 any treatment of a distribution of stock in a controlled subsidiary to a shareholder who had acquired control of the distributing corporation within five years of the spin-off.[84] This legislation is grounded upon a "strong form" of *General Utilities* repeal that the Joint Committee on Taxation had enumerated earlier that year. Congress clarified in this legislation that the tax-free spin-off of a controlled subsidiary to a new acquiring shareholder was akin to a sale of the controlled subsidiary as the following legislative history makes plain:

> The committee believes that the requirements of section 355 of the Code should generally prevent the use of that section to accomplish a sale of recently distributed subsidiary (or its recently acquired parent) without corporate level tax, or effectively to accomplish a sale of a subsidiary to any significant shareholder by a distribution with respect to recently purchased stock.[85]

Thus, the normative policy concern that motivated Congress to amend section 355 in 1987 was a situation where a historic active business was being transferred to a non-historic shareholder. Section 355's application in this context was seen as inconsistent with the repeal of the *General Utilities* doctrine as it allowed a disposition of a historic business to a new shareholder without incurring corporate level tax on the disposition.[86] Congress saw this outcome as

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83. *Id.* at 173.

84. *See* Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, § 10223(c), 101 Stat. 1330, 1330-411–12 (1987).

85. H.R. REP. NO. 100-391, at 1083 (1987), *as reprinted in* 1987 U.S.C.C.A.N. 2313–378, 2313–697. For a further discussion of the policy implications of this congressional action, see Schler, *supra* note 54, at 246–47.

86. *See* The legislative Congress explicitly rejected mere carryover of basis as a sufficient goal for Section 355 in the following statement when it amended Section 355(b)(2)(D). H.R. REP. NO. 100-391, at 1081–83 ("[Tlhe statute specifically rejects the concept that recognition can be deferred merely because the underlying assets of the subsidiary do not obtain a stepped-up basis. This is because the potential for a corporate-level tax in the future, resulting from the low basis of the assets, is not the

inconsistent with its *General Utilities* repeal even though the corporate assets retained a carryover basis at the corporate level. Thus, this legislative enactment indicates that Congress fundamentally had rejected a "weak form" of *General Utilities* repeal. Congress was comfortable with section 355 affording nonrecognition treatment to corporate separations of historic active businesses among the historic shareholders. However, with that said, Congress also did not want section 355 to be used as an inappropriate device for circumventing the intended scope of its *General Utilities* repeal. And, in this context, Congress enacted section 355(b)(2)(D) to promote a "strong form" of *General Utilities* repeal and articulated its desire for a "strong form" version of *General Utilities* repeal as its justification for adopting this amendment to section 355.

A second key aspect of section 355(b)(2)(D)'s enactment was Congress's desire to have an objective pre-transaction continuity of interest period. In this regard, in the context of a transaction that was akin to a disposition, Congress explicitly provided in section 355(b)(2)(D) that the shareholder who obtained control must be a shareholder for five years prior to the section 355 transaction in order to be considered a historic shareholder.[87] Thus, Congress decided to clarify the testing period by setting forth a predetermined and objective five year time period in lieu of relying on the subjective "old and cold" analysis[88] that had been employed.

Congress should be commended for responding so quickly and for clarifying its intentions in terms of the scope of its *General Utilities* repeal, but even so, the resulting statutory amendment failed to

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economic equivalent of a current tax on the appreciation at the time of the sale or distribution . . . . [Section 355] might be used to claim a stepped-up, fair market value basis when a subsidiary of an acquired corporation is distributed to the acquiring corporation. The committee believes that section 355 of the Code should generally prevent the use of that section to accomplish a sale of a recently distributed subsidiary (or its recently acquired parent) without corporate level tax, or effectively to accomplish a sale of a subsidiary to a significant shareholder by a distribution with respect to recently purchased stock."); *see also* Omnibus Budget Reconciliation Act of 1987, § 10223(b)–(c), 101 Stat. at 1330-411–12; Schler, *supra* note 54, at 246–47 (discussing further the policy implications of the amendment to section 355).

87. *See* I.R.C. § 355(b)(2)(D) (2012).

88. Prior to this date, the continuity of interest standard was expressed as a subjective standard. *See* Treas. Reg. § 1.355-3(c) (2002). And, the IRS had held that two years was sufficient for purposes of meeting this test. *See* Rev. Rul. 74-5, 1974-1 C.B. 82–83. With the enactment of section 355(b)(2)(D), transactions that had been described as a disposition now required the corporate purchaser to be a five-year historic shareholder to avail itself of Section 355. *See* Rev. Rul. 89-37, 1989-1 C.B. 107.

implement the full breadth of the Joint Committee on Taxation's original recommendations for how to implement a "strong form" of repeal of the *General Utilities* doctrine.[89] Again, Congress clearly saw that section 355 should not provide a tax advantage for a bust-up transaction that resembled a disposition of a historic business to new shareholders because a transaction in that context is more akin to a disposition. The legislative history accompanying this 1987 reform explicitly endorsed a "strong form" version of *General Utilities* repeal.

Even though the policy rationale that motivated Congress's 1987 reform effort can be correctly gleaned from a normative perspective, the statutory amendment to section 355 that Congress enacted in 1987 was clearly too narrowly tailored to effectuate its stated "strong form" policy goals. In this regard, Congress's amendment to section 355(b)(2)(D) did not provide for any post-transaction continuity requirement as envisioned by the 1987 Joint Committee on Taxation proposal.[90] Moreover, although Congress's 1987 section 355(b)(2)(D) amendment did apply a five year testing period, that five-year testing period only applied to a purchasing shareholder—like the one posited in Revenue Ruling 74-5—that obtained control, as defined in section 368(c), through a taxable purchase of the distributing corporation's stock.[91] In other words, the amendments to section 355(b)(2)(D) did not prevent section 355 from applying to a purchasing corporation that acquired less than eighty percent of the stock of a target corporation and then subsequently exchanged the target stock for stock in a controlled subsidiary two years later in a section 355 distribution.[92] Thus, the amendment to section 355(b)(2)(D) sought to restrict the tax-free spin-off of a controlled subsidiary to a non-historic shareholder, but section 355(b)(2)(D), as drafted, was underinclusive in terms of meeting that policy goal. The obvious planning technique, therefore, was for the acquiring corporation to acquire a less than eighty percent interest in the target corporation and then spin-off a controlled subsidiary to the new shareholder thereafter.

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89. *See* I.R.C. § 355(b)(2)(D).

90. *See id.*

91. *See* Rev. Rul. 89-37, 1989-1 C.B. 107 (discussing rationale for the 1987 amendments and that the amendment of section 355(b)(2)(D) was explicitly designed to reverse the holding of Revenue Ruling 74-5).

92. *See* Alan S. Kaden & Richard A. Wolfe, *Spin-Offs, Split-Offs, and Split-Ups: A Detailed Analysis of Section 355*, 44 TAX NOTES 565, 575 (1989); Michael L. Schler, *Avoiding the Technical Requirements of New Section 355*, 38 TAX NOTES 417, 417–18 (1988).

Thus, the 1987 enactment of section 355(b)(2)(D) provides an interesting juxtaposition. On the one hand, Congress expressed in its 1987 legislative history a clear desire to limit the scope of section 355 so that a new purchasing corporation could not use it to distribute a controlled subsidiary out of the target corporation without corporate level gain because this technique circumvented the intended scope of Congress's repeal of the *General Utilities* doctrine.[93] Moreover, Congress sought to provide an objective five year pre-transaction historic shareholder test that would apply in the context of a disposition described in section 355(b)(2)(D)—a policy prescription premised on an effort to promote a "strong form" *General Utilities* repeal, as no change would have been necessitated by a "weak form" of *General Utilities* repeal given that assets would have remained with a carryover basis in corporate solution. But, even with these additions, the statutory language that Congress enacted to amend section 355(b)(2)(D) did not restrict its application to dispositions to all new shareholders but only restricted its application with respect to those new shareholders that acquired eighty percent of the target corporation's stock before the section 355 spin-off.[94] Thus, Congress's underinclusive response in 1987 left significant opportunities for new purchasers to acquire an interest in a target corporation and then bust-up that corporation via a distribution of a controlled subsidiary in transactions that resembled a disposition and yet did not technically run afoul of the amendments to section 355(b)(2)(D). As the following discussion will confirm, the need for further legislative amendments since the 1987 amendment indicates that Congress recognizes that its amendment to section 355(b)(2)(D) in 1987 was underinclusive in terms of achieving a "strong form" version of *General Utilities* repeal.[95]

As a result, in 1990, Congress returned to its desire to right-size section 355's scope so that it did not provide an inappropriate means to circumvent its repeal of the *General Utilities* doctrine. The legislative

93. *See* Rev. Rul. 89-37, 1989-1 C.B. 107 (discussing the rationale for the 1987 amendments and the reversal of Revenue Ruling 74-5).

94. Congress amended I.R.C. section 355(b)(3) in 2006 to make it easier for holding company structures to qualify for the active trade or business test. *See* Pub. L. No. 109-432, 120 Stat. 2963 (2006). This aspect of section 355's evolution is beyond the scope of this Article and addressed elsewhere. *See, e.g.*, Jasper L. Cummings, Jr., *The New Section 355(b) Active Trade or Business Proposed Regulations*, 107 J. TAX'N 74 (2007). For the regulations that implement these rules, see T.D. 9435, 73 Fed. Reg. 75,946 (Dec. 15, 2008).

95. *See* H.R. REP. NO. 101-881, at 340–41 (1990).

history in its 1990 amendment to section 355 is remarkably similar in terms of stating Congress's overall desired "strong form" version of its *General Utilities* repeal as the following excerpt indicates:

> The Committee is concerned that some corporate taxpayers may attempt, under present-law rules governing divisive transactions, to dispose of subsidiaries in transactions that resemble sales . . . . The avoidance of corporate level tax is inconsistent with the repeal of the *General Utilities* doctrine . . . . The provisions for tax-free divisive transactions under section 355 were a limited exception to the repeal of the *General Utilities* doctrine, intended to permit historic shareholders to continue to carry on their historic corporate businesses in separate corporations . . . . The present-law provisions granting tax-free treatment at the corporate level are particularly troublesome because they may offer taxpayers an opportunity to avoid the general rule that corporate-level gain is recognized when an asset (including stock of a subsidiary) is disposed of.[96]

The legislative history could not be more clear in terms of supporting a "strong form" of *General Utilities* repeal. This 1990 legislative history clearly expresses the belief that section 355 is "a limited exception" to the broad intended scope of Congress's repeal of the *General Utilities* doctrine. This 1990 legislative history also asserted that the limited nonrecognition exception provided by section 355 was intended "to permit historic shareholders to continue to carry on their historic corporate businesses in separate corporations."[97] The above legislative history clarifies that Congress was comfortable with affording nonrecognition treatment under section 355 for a corporate separation of historic businesses between historic shareholders, but Congress did not want the nonrecognition treatment afforded under section 355 to extend to transactions that resemble a disposition of a historic business to new shareholders outside the historic economic group.[98] Moreover, Congress also reiterated its desire to utilize a five-year pre-section 355 transaction testing period for situations that resembled a disposition. Thus, Congress was motivated by a desire to

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96. *Id.* In enacting section 355(d), Congress also consciously refused to allow nonrecognition treatment for carryover basis transactions. In addition, the above excerpt makes clear that Congress was searching for a means to differentiate between a corporate separation of historic businesses among historic shareholders and a corporate separation that allowed businesses to transfer to new owners in violation with the intended repeal of the *General Utilities* doctrine. For a further discussion of the policy implications of this congressional action, see Schler, *supra* note 54, at 247.

97. *See* H.R. REP. NO. 101-881, at 341.

98. *See id.*

ferret out transactions that resembled a disposition and utilized an objective five-year pre-transaction time frame to determine historic shareholders in lieu of the more subjective "old and cold" standard.[99]

However, just as it had done in 1987, Congress adopted an amendment to section 355 that yet again was too narrow to achieve its explicitly stated "strong form" policy goal. Specifically, Congress added a new section 355(d), which provided that a corporate level (but not a shareholder level) recognition event would occur on a distribution of subsidiary stock in a section 355 transaction if after the distribution, a shareholder holds a fifty percent or greater interest in the distributing corporation or in a distributed subsidiary due to a stock interest that was acquired "by purchase" within five years of the section 355 transaction.[100] Under a "weak form" of *General Utilities* repeal, section 355(d) would not have been necessary as assets remain in corporate solution with a carryover basis. But, under a "strong form" of *General Utilities* repeal, section 355(d) is justifiable exactly because historic business assets are being transferred to new shareholders outside of the historic economic group in a transaction that avoids corporate level taxation with respect to the disposition.

The policy implications of section 355(d)'s adoption cannot be more clear: Congress wanted to effectuate a "strong form" of *General Utilities* repeal such that historic assets that are disposed to new shareholders would not avoid corporate level taxation. However, this provision does not specify any post-separation continuity requirement. As a further defect, section 355(d) does not solely rely on whether a spin-off occurred as part of a fifty percent or more ownership change to a new shareholder. Yes, section 355(d) looks to whether there has been a fifty percent or greater ownership change within five years prior to the section 355 transaction, but then it limits section 355(d)'s applicability to only those ownership changes that occur "by purchase" within that five-year period. In other words, section 355(d) does not restrict corporate level nonrecognition treatment for a new shareholder who acquires stock in a tax-free manner.[101] The statute provides its own list of new shareholder stock acquisitions that are not treated as having arisen "by purchase,"[102] and also gives the Treasury Department authority to provide further exceptions to the "by purchase"

99. *See* I.R.C. § 368(a)(1)(D) (2012).

100. Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, § 11321, 104 Stat. 1388, 1388–460–63 (1990).

101. *See* I.R.C. § 355(d)(3)–(5).

102. *See* § 355(d)(3).

designation.[103] Additionally, the Treasury Department has provided further instances when a new shareholder can acquire stock and not be viewed as having acquired that stock "by purchase."[104] By not simply looking at whether or not a corporate separation under the auspices of section 355 resulted in a historic business being transferred to non-historic—or non-five year—shareholders regardless of how that new shareholder acquired its interest, Congress missed a golden opportunity to provide a straightforward rule that would have prevented section 355's application if the corporate separation effectuated a transfer of a historic business to a non-historic shareholder.

After section 355(d)'s enactment, a distributing corporation could still spin-off a subsidiary that contained an "unwanted business" to its historic shareholders and then the historic shareholders could exchange their stock in the distributing corporation for stock in an acquiring corporation in a qualifying tax-free reorganization. In this situation, the pre-merger spin-off transaction could side-step the amendments to section 355(d) if the acquiring corporation acquired stock in either the distributing corporation or in the controlled subsidiary by a means other than "by purchase." This could be accomplished via an acquisitive tax-free reorganization as that form of acquisition was not "by purchase" within the meaning of section 355(d).[105] Thus, a corporate separation could qualify by reason of nonrecognition treatment at the corporate level by reason of section 355 even though that corporate separation is coupled with an acquisitive reorganization where a historic businesses is transferred to a new shareholder group. This technique of engaging in a pre-merger spin-off of a subsidiary followed by a subsequent acquisitive reorganization of the distributing corporation by the unrelated acquiring corporation is commonly referred to as a "*Morris Trust*" transaction.[106] Moreover, a reverse-*Morris Trust* transaction was also authorized under the pre-1997 law as long as the controlled subsidiary's

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103. *See* § 355(d)(9)(B).

104. *See* Treas. Reg. § 1.355-6(D) (2018).

105. For an in-depth analysis of section 355(d)'s scope, see Mark J. Silverman et al., *The Proposed Section 355(d) Regulations: Narrowing the Scope of an Overly Broad Statute*, 26 J. CORP. TAX'N 269 (2000).

106. The transaction takes its name from the transaction that was blessed in Commissioner v. Mary Archer W. Morris Trust, 367 F.2d 794 (4th Cir. 1966). Further IRS regulations have expounded the *Morris Trust* technique and defined what constitutes an adequate business purpose for engaging in a pre-merger spin-off. *See, e.g.*, Rev. Rul. 68-603, 1968-2 C.B. 148; Rev. Rul. 70-434, 1970-2 C.B. 83; Rev. Rul. 78-251, 1978-1 C.B. 89; Rev. Proc. 96-30, 1996-1 C.B. 696, 712.

post spin-off merger was approved in a subsequent vote after the spin-off of the controlled subsidiary that was not contingent as to its acceptance or occurrence at the time of the spin-off.[107]

Several high-profile transactions occurred after section 355(d)'s enactment that demonstrate its deficiencies in fulfilling a "strong form" version of *General Utilities* repeal, but none was more influential in galvanizing the discussion than Viacom's corporate separation and disposition of its cable business to a new owner, TCI.[108] By way of background, Viacom International, a subsidiary of Viacom, historically had conducted several businesses including a cable business, and TCI wanted to acquire only the cable business.[109] In a leveraged reverse-*Morris Trust* transaction, Viacom International borrowed $1.7 billion[110] and then transferred all of its non-cable historic business assets and the $1.7 billion of cash proceeds to a new subsidiary (Viacom Services) that it spun-off to its parent, Viacom.[111] Thus, after this first series of steps, Viacom International had additional infused debt of $1.7 billion and only the historic cable business.[112] Viacom then split-off Viacom International to certain shareholders in exchange for their Viacom stock.[113] The Viacom International shareholders then agreed to exchange their Viacom International stock for nonvoting preferred stock, while TCI invested $350 million into Viacom International for all of its common stock.[114] The IRS ruled that the Viacom Services spin-off and the subsequent Viacom International split-off both qualified for section 355 treatment even though these corporate separations facilitated the disposition of the Viacom cable business in a tax-free

107. *See* Rev. Rul. 98-27, 1998-1 C.B. 1159 (stating that the IRS would not apply a *Court Holdings* or step transaction doctrine to determine continuity if the outcome of public shareholder vote was uncertain at the time of the spin-off of the controlled subsidiary); Rev. Rul. 98-44, 1988-2 C.B. 315 (obsoleting earlier rulings that would have resequenced the steps to disqualify section 355 from applying in a reverse-*Morris Trust* fact pattern where the controlled subsidiary was first the subject of a spin-off followed by a subsequent merger of the controlled subsidiary for purposes of disqualifying the spin-off from receiving section 355 treatment).

108. For a historical debate and competing views on the contours of the *Morris Trust* transaction, compare George K. Yin, Morris Trust, *Sec. 355(e), and the Future Taxation of Corporate Acquisitions*, 80 TAX NOTES 375, 376, 378 (1998), with Schler, *supra* note 54, at 240–41.

109. *Viacom sells cable system to TCI*, UPI (July 25, 1995), https://www.upi.com/Archives/1995/07/25/Viacom-sells-cable-system-to-TCI/1859806644800.

110. *See* TCI Pacific Communications, Inc., (Form S-4/A) at 28–29 (June 19, 1996).

111. *Id.* at 25–33.

112. *Id.* at 32–33.

113. *Id.* at 47.

114. *Id.*

manner to a new shareholder, namely TCI, in a transaction that resembled a disposition.[115] The added debt infused into Viacom International followed by the split-off of Viacom International at a time when Viacom International only held the historic cable business allowed the Viacom shareholders to keep Viacom Services with $1.7 billion of loan proceeds and allowed TCI to acquire control of Viacom International, which had the cable businesses and $1.7 billion of new debt. Thus, the transaction economically resulted in Viacom's historic cable business being disposed of to a non-historic shareholder—namely, TCI—with the Viacom shareholders retaining Viacom Services and $1.7 billion of loan proceeds, which monetized their interest in the cable business all under the auspices of section 355.

Viacom's successful leveraged *Morris Trust* transaction created immediate reaction in the press,[116] and the success of this transaction called into question the efficaciousness of the IRS's assertion that it would apply a *Court Holdings* analysis to an overall plan where a section 355 spin-off was coupled with a subsequent acquisition.[117]

None of these transactions are objectionable under a "weak form" of *General Utilities* repeal as corporate assets retain a carryover basis at

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115. *See id.* at 25–33, 112–13 (providing the transaction steps including the leveraging aspects of the transaction including an additional $1.7 billion of new debt and then states that the transaction received a private letter ruling from the IRS stating that the transaction qualified for section 355 treatment). The private ruling that appears to have favorably ruled on this transaction appears to have been I.R.S. Priv. Ltr. Rul. 96-37-043 (June 17, 1996).

116. *See, e.g.*, Lee A. Sheppard, *Aliens Kidnap IRS Lawyers: Inexplicable Viacom Ruling*, 96 TAX NOTES 129-6 (1996).

117. *See* Rev. Rul. 96-30, 4.05, 1996-1 C.B. 36 ("[T]he management of the distributing corporation, to its best knowledge, is not aware of any plan or intention on the part of any particular remaining shareholder or security holder of the distributing corporation to sell, exchange, transfer by gift, or otherwise dispose of any stock in, or securities of, either the distributing or controlled corporation after the transaction"); Lee A. Sheppard, *IRS Rules in Favor of Viacom, Ignoring Its Own Guidance*, 71 TAX NOTES 1728 (June 24, 1996). For a helpful review of the historic transactions, see Richard L. Reinhold, *Section 355(e): How We Got Here and Where We Are*, 82 TAX NOTES 1485, 1485–89 (1999). A similar leveraged spin-off was announced in early 1997 involving General Motors $3.9 billion leveraged spin-off of its Hughes Aircraft subsidiary, and another high-profile leveraged spin-off occurred involving Capital Cities transfer of ABC to a new leveraged subsidiary that was eventually acquired by Disney while Capital Cities was later merged into Knight Ridder. *See* General Motors Corp. (Form S-4/A) at 89–91 (Oct. 17, 1997) (stating that the IRS had issued a private letter ruling stating that the spin-off of Hughes Defense qualified for Section 355 treatment). The IRS confirmed that the leveraged spin-off qualified as tax-free under section 355. *See* I.R.S. Priv. Ltr. Rul. 98-02-048 (July 11, 1997); *see also* Reinhold, *supra* note 117, at 1490.

the corporate level. However, these transactions are objectionable under a "strong form" of *General Utilities* repeal because these transactions allow section 355 to be used as a means to effectuate a leveraged tax-free disposition of a historic business to non-historic shareholders while avoiding corporate level taxation. The combination of the leveraging of a controlled subsidiary or of the distributing corporation prior to a corporate separation that qualifies for section 355 treatment followed by the acquisition of one of the separated corporations by a new economic group in an acquisitive tax-free reorganization allows the former shareholders to transfer a historic business to new shareholders, to retain financial assets for a substantial portion of the value of the transferred corporation, and to do so in avoidance of any corporate level taxation. A corporate separation in this context resembles a disposition, and the re-leveraging aspect of the transaction allows historic shareholders to partially monetize or cash-out of their investment in a historic business. Thus, section 355's applicability in this context constitutes a device for historic shareholders to monetize, or cash-out, of their interest in the historic business assets in a tax-free manner.

The above results that are obtainable under section 355(d) provide an interesting juxtaposition. On the one hand, Congress enacted a provision that can only be understood in terms of a "strong form" of *General Utilities* repeal. In fact, the legislative history accompanying the enactment of section 355(d) Congress explicitly endorsed a "strong form" version of *General Utilities* repeal and explicitly stated that nonrecognition treatment should not be given for corporate separations of historic businesses to non-historic shareholders. But, instead of enacting a statutory amendment that clearly and comprehensively denied section 355 treatment for any ownership change that occurred during the five years prior to the section 355 transaction, and instead of affording a bright-line post-transaction continuity period, section 355(d) only requires corporate level gain if there is a new shareholder who acquires their new stock ownership "by purchase" within the five-year period preceding the section 355 transaction.[118] Further, section 355(d) did not address the tax-free monetization techniques that allowed a historic shareholder to cash-out of their interest in a historic business in a tax-free manner under the rubric of section 355.

118. *See* I.R.C. § 355(d)(3)–(5) (2012).

In response to these transactions and section 355(d)'s objective failure to effectuate a "strong form" of *General Utilities* repeal, Congress should have amended section 355(d) to provide that corporate level gain should arise for any section 355 transaction that occurs whenever there has been a fifty percent ownership change in either the distributing corporation or the distributed subsidiary regardless of whether that ownership change occurred "by purchase" or otherwise. In addition, Congress should have provided that the excess leveraging aspects of these corporate separations should create a deemed taxable stock dividend to the extent that the shareholders have "cashed-out" of their proportionate interest in historic business assets.

But, instead of either of these responses, Congress chose to enact a new section 355(e) that again was underinclusive in terms of addressing Congress's now familiar "strong form" policy goal that has guided its *General Utilities* repeal efforts in the post-1986 period. Before looking at the actual scope of section 355(e), it is informative to look at the legislative policy goals that were set forth as the motivation for Congress's enactment of new section 355(e) as those policy goals help to evaluate the intended scope of the repeal of the *General Utilities* doctrine. In this regard, the 1997 House Report makes clear that section 355, "was intended to permit the tax-free division of existing business arrangements among existing shareholders" only. [119] It was not intended to allow nonrecognition treatment for the transfer of historic businesses to non-historic shareholders through any means that resemble a disposition.[120]

Thus, the legislative history in 1997, consistent with the legislative history in 1987 and 1990, stated emphatically that section 355's intended scope was to allow a limited nonrecognition exception for a corporate separation of historic businesses among historic shareholders. The 1997 House Report contrasts that limited context with Congress's broader *General Utilities* repeal effort that sought to prevent nonrecognition treatment for corporate separations that

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119. *See* S. REP. NO. 105-33, at 139–40 (1997); H.R. REP. NO. 105-148, at 462 (1997); J. COMM. ON TAX'N, 105TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN 1997 198 (Comm. Print 1997). The Conference Report states a similar understanding of section 355 in terms of not allowing a corporate separation to non-historic shareholders. In their view, section 355 provides an exception to this rule for certain "spin-off" type distributions of stock of a controlled corporation. It applies to acquisitions and dispositions of stock of the distributing corporation or the controlled corporation prior and subsequent to a distribution. *See, e.g.*, H.R. REP. NO. 105-220, at 527 (1997).

120. S. REP. NO. 105-33, at 139–40 (1997).

facilitate the transfer of a historic business to new shareholders, which the legislative history characterized as a transaction that "more closely resembles a corporate level disposition."[121] Thus, the legislative history represents a full-throated and clear endorsement of the "strong form" of *General Utilities* repeal.

Yet, after giving due regard to Congress's explicit endorsement of a "strong form" version of *General Utilities* repeal as its rationale for section 355(e)'s enactment, one must then recognize the disconnect that exists between the "strong form" policy goals set forth in the legislative history to section 355(e) and the actual substantive legislation that Congress enacted. In this regard, section 355(e) provides that the distributing corporation must recognize corporate level gain but no shareholder level gain is required for any spin-off that effectuates a fifty percent or greater ownership change to new shareholders that arise "pursuant to a plan or series of related transactions."[122] Thus, section 355(e) does attempt to determine whether non-historic shareholders acquire a more than fifty percent interest in either the distributing corporation or the controlled corporation and endorses the goal of not allowing section 355 to be used to circumvent the repeal of the *General Utilities* doctrine. Moreover, in an improvement over section 355(d), section 355(e) does not seek to determine a non-historic shareholder's status by whether or not a new shareholder acquired its interest "by purchase."[123] Thus, on its face, section 355(e) is premised on effectuating a "strong form" of *General Utilities* repeal.

In addition, as a further improvement over prior legislative efforts, section 355(e) sets forth a post-separation continuity testing period of two years,[124] thus providing for a bright-line post-continuity requirement as envisioned in the 1987 Joint Committee on Taxation's

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121. H.R. REP. NO. 105-148, at 462 (1997).

122. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1012, 111 Stat. 1788, 914–16 (1997); *see also* H.R. REP. NO. 105-148, at 462–63. A number of public deals have sought to avoid section 355(e)'s application by ensuring that the distributing corporation's shareholders maintain more than fifty percent of the stock of the distributed corporation and the distributing corporation after the spin-off any and a subsequent acquisitive reorganization after the spin-off. *See, e.g.*, Hewlett Packard Enter. Co. (Form 8-K) 1 (May 24, 2016) (disclosing spin-off of its computer service business to Everett and then Computer Science Corporation acquires less than fifty percent ownership of Everett in a subsequent reverse *Morris Trust* transaction where the Hewlett Packard shareholders retained more than fifty percent of the stock of Everett).

123. *Compare* I.R.C. §§ 355(e)(2)(A), (e)(3)(A) (2012), *with* § 355(d)(3).

124. *See* § 355(e)(2)(B).

recommendation. In transactions that Congress believed could represent a disposition, it specifically added a two-year post-section 355 separation testing period. Again, an explicit post-transaction continuity of interest testing period furthers the goal of ensuring that a corporate separation only represents a readjustment of the continuing interest of historic shareholders in the historic business. These prescriptions harken back to a desire to effectuate a "strong form" of *General Utilities* repeal.

Nevertheless, notwithstanding these improvements over section 355(d), section 355(e) has its own unique set of deficiencies in terms of implementing Congress's effort to implement a "strong form" of *General Utilities* repeal. First, section 355(e) uses a different time period for purposes of determining a historic shareholder than does section 355(b)(2)(D) and section 355(d): namely a period that commences two years before and ends two years after the section 355 spin-off. Second, section 355(e) only targets a corporate separation that effectuates an ownership change of either the distributing corporation or the controlled corporation as part of a "plan or series of related transactions."[125]

The determination of whether a subsequent ownership change and an earlier section 355 corporate separation are part of a prohibited "plan or series of related transactions" has become a subjective quagmire. Treasury regulations set forth a list of nonexclusive factors that tend to show the existence or nonexistence of a prohibited "plan or series of related transactions" at the time of the section 355 transaction.[126] The Treasury Department regulations require a factual determination of whether the ownership change and accompanying section 355 transaction are part of a common plan or arrangement and seek to identify, among other things, whether "substantial negotiations" for an acquisition occurred during the two year period ending on the date of the spin-off distribution.[127] And, these regulations provide specific safe harbors and operating rules.[128]

Revenue Ruling 2005-65[129] is a helpful ruling to demonstrate the downgrade that has occurred. In this ruling, the IRS considered a situation where a controlled subsidiary's spin-off was publicly announced for valid business reasons prior to the commencement of discussions with an acquiring corporation. After the spin-off had been announced but before it had been consummated, the distributing

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125. *See id.*
126. Treas. Reg. § 1.355-7(b)(3) (2018).
127. § 1.355-7(b)(2).
128. § 1.355-7(b)(4).
129. Rev. Rul. 2005-65, 2005-2 C.B. 684, 685.

corporation began negotiations and agreed to be acquired by an acquiring corporation in an acquisitive reorganization where the acquirer's shareholders would obtain fifty-five percent of the stock in the resulting combined company. Thus, Revenue Ruling 2005-65 posits a situation where new shareholders receive a historic business within two years of a section 355 transaction. Moreover, the acquisitive reorganization that involved the distributing corporation was agreed to prior to the spin-off of the controlled subsidiary. Thus, a historic business is posited to be transferred in a tax-free manner to new shareholders in a transaction that is akin to a disposition. Yet, the IRS ruled that the spin-off, which facilitated the ultimate disposition of the distributing corporation, was entitled to section 355 nonrecognition treatment because the section 355 transaction was publicly announced *prior* to any actual negotiations with the acquiring corporation with the consequence that no prohibited "plan (or series of transactions)" existed at the time of the initial section 355 transaction's announcement.[130] Revenue Ruling 2005-65, therefore, provides a well understood roadmap for how one can transfer a historic business to new shareholders in a transaction that resembles a disposition but avoids running afoul of section 355(e).[131]

Revenue Ruling 2005-65 may be correctly decided in terms of interpreting section 355(e)'s provisions as statutorily enacted, but the result obtained under this revenue ruling is objectionable because it allows section 355 to be used as an inappropriate device for circumventing

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130. *Id.*

131. *See* Alcoa Inc., Tax Matters Agreement (Form 8-K) 26 (Oct. 31, 2016) (showing that the distributing corporation and the controlled subsidiary had the following representation and restriction after a spin-off: "during the period beginning two years before the Distribution Date and ending on the Distribution Date, there was no 'agreement, understanding, arrangement, substantial negotiations or discussions' (as such terms are defined in Treasury Regulations Section 1.355-7(h)) by any one or more officers or directors of any member of the UpstreamCo Group or by any other person or persons with the implicit or explicit permission of one or more of such officers or directors regarding an acquisition of all or a significant portion of the UpstreamCo Capital Stock (and any predecessor)"; *see also* Yum China Holdings, Inc., Tax Matters Agreement (Form 8-K) 22 (Oct. 31, 2016) (providing in section 7.03 of a tax separation agreement that the controlled subsidiary, after its spin-off, will not engage in any issuance of stock that would not satisfy the safe harbors of Reg. § 1.355-7(d)(8) or (9)); Versum Materials, Inc., Tax Matters Agreement (Form 8-K) 5, 16, 17 (Sept. 29, 2016) (showing a tax separation agreement in section 4.3 restricts the controlled subsidiary that will be spun-off from having a fifty percent ownership change unless the acquisition of the controlled meets the safe harbors to section 355(e) for public companies provided in Treas. Reg. § 1.355-7(d)(8) and (9)).

Congress's "strong form" version of repeal of the *General Utilities* doctrine. From a normative perspective, section 355 treatment should be denied if a corporate separation allows a historic business to be transferred to new shareholders within section 355(e)'s two-year testing period. Instead of a straightforward approach, section 355(e) provides an escape hatch to section 355(e)'s application for a transaction that transfers a historic business to non-historic shareholders that occur within the prescribed section 355(e) testing period as long as the corporate separation was not part of a common "plan or series of related transactions," even though a disposition to new shareholders occurred in that testing period. This subjective "plan or series of transactions" analysis creates planning opportunities and subjectivity in applying section 355(e) that undercuts the policy of restricting section 355's application to only corporate separations of historic businesses among historic shareholders that actually maintain their interest in the distributing corporation and the controlled subsidiary for the entire testing period.

Section 355(e) provides yet another interesting juxtaposition. On the one hand, section 355(e)'s statutory provisions make sense only in the context of a "strong form" of *General Utilities* repeal, and in fact, the legislative history accompanying section 355(e)'s adoption explains section 355(e) in terms of ensuring that section 355 treatment should not afford nonrecognition treatment to corporate separations of historic businesses to non-historic shareholders. The legislative history then further states that section 355 was intended to be a "limited exception" that should not apply when either the distributing corporation or the controlled corporation are transferred to new shareholders as that scenario more closely resembles a "disposition" and not simply a readjustment of the historic shareholder's continuing interest in the historic businesses.[132] Furthermore, "[i]n cases in which it is intended that new shareholders will acquire ownership of a business in connection with a spin-off, the transaction more closely resembles a corporate level disposition of the portion of the business that is acquired."[133] These statements represent a clear endorsement of a "strong form" version for defining the scope of Congress's *General Utilities* repeal. Yet the actual statutory language of section 355(e) conditions its application on a subjective determination of whether a

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132. *See* H.R. REP. NO. 105-148, at 462 (1997) (describing the similarities of new shareholders acquiring a business with a corporate level disposition); *see also* STAFF OF THE J. COMM. ON TAX'N, 105TH CONG., GENERAL EXPLANATION OF THE TAX LEGISLATION ENACTED IN 1997 198 (Comm. Print 1997) (quoting same language).

133. H.R. REP. NO. 105-148, at 462; S. REP. NO. 105-33, at 139–40 (1997).

prohibited "plan or series of related transactions" exists.[134] This condition precedent limits the efficacy and certainty of section 355(e)'s statutorily prescribed two-year continuity of interest testing period even in the context where section 355 is facilitating a disposition of a historic business to non-historic shareholders within that prescribed testing period. Instead of conditioning section 355(e)'s applicability on a subjective determination of whether a prohibited "plan or series of related transactions" existed, Congress should have simply stated that a corporate separation does not qualify for section 355 treatment if the effect of the transaction is to transfer the ownership of the distributing corporation or the controlled subsidiary to non-historic shareholders within a specified timeframe as originally suggested by the Joint Committee on Taxation in 1987.

In 2005, Congress became concerned about so-called "cash rich" split-offs that occur as part of a fifty percent or greater ownership change.[135] When either the distributing corporation or the controlled subsidiary has more than two-thirds of its value attributable to investment assets, and when a shareholder obtains a fifty percent or greater interest in a disqualified investment corporation as a result of the corporate separation, then the corporate separation is denied nonrecognition treatment under section 355(g).[136] Thus, if a substantial majority of the value of a corporation after a corporate separation relates to non-historic business assets, then the principle reason for the spin-off is attributable to factors other than separating the historic business between historic shareholders. Section 355(g) is consistent with Congress's goal of not allowing section 355 to represent a device for circumventing the repeal of the *General Utilities* doctrine. However, section 355(g) has several deficiencies. First, section 355(g)

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134. Reinhold, *supra* note 117, at 1492, 1496.

135. Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109-222, § 507, 120 Stat. 345, 358–59 (2006). For a further analysis of cash rich spin-offs, see Robert S. Bernstein, *Janus Capital Group's cash rich split-off*, 30 CORP. TAX'N 39 (2003); *see also* Lee Sheppard, *NYSBA Considers 'Cash Wreck' in Spinoffs*, 114 TAX NOTES 507 (2007); Robert Willens, *Can STI Efficiently 'Monetize' Its KO Stake?*, 120 TAX NOTES 601, 602 (2008); Robert Willens, *Does the* Tribune *Decision Endanger Cash-Rich Split-offs?*, 109 TAX NOTES 547, 548 (2005); Robert Willens, *Endgame May Be in Sight for Untangling Ties of Liberty Media, News Corp.*, 194 DAILY TAX REP. J-1 (2006); Robert Willens, *Ending Entanglements Through a 'Cash-Rich' Split Off*, 126 TAX NOTES 243 (2010); Robert Willens, *Liberty Media Will Engage in 'Cash-Rich' Split-Offs*, 42 DAILY TAX REP. 41, 43–44 (2007); Robert Willens, *Weyerhaeuser Blazes New Trails in Spinoff Techniques*, 115 TAX NOTES 497 (2007); Robert Willens, *Windstream Will Split Off Its Yellow Pages Business*, 114 TAX NOTES 573 (2007).

136. *See* I.R.C. § 355(g)(2)(A)(i) (2012).

does not apply if the transaction represents a spin-off where no shareholder group increases its proportionate interest in the disqualified investment by fifty percent or more.[137] Second, the tainted investment asset threshold is "a relatively high level . . . so that only super cash-rich split-offs need fear this provision."[138] Instead of this high threshold, Congress should have restricted section 355's application to only corporate separations that involve principally historic business assets.

In 2015, Congress again became concerned about section 355's usage in the context where a controlled subsidiary is distributed in a section 355 transaction and either the distributing corporation or the controlled subsidiary subsequently elect real estate investment trust (REIT) status. The combination of a tax-free corporate separation under section 355 coupled with a REIT election with respect to one of the corporations involved in the section 355 transaction allows assets to permanently leave corporate solution after the subsequent REIT election without incurring corporate level tax.[139] Initially, the IRS had issued favorable section 355 rulings for the "spin-REIT" transaction, finding that a controlled subsidiary's real estate activities could satisfy the active trade or business standard of section 355 through its real estate management activities and once distributed could elect REIT status.[140] In 2015, the Treasury Department reversed its course and stated that it now had concerns about a section 355 spin-off that is followed by either the distributing corporation or the controlled subsidiary making a REIT election after the

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137. *Id.*

138. *See* BITTKER ET AL., *supra* note 10, at ¶11.02[2][f].

139. I.R.S. Notice 2015-59, 2015-40 C.B. 459.

140. *See, e.g.*, I.R.S. Priv. Ltr. Rul. 12-73-348 (Sept. 13, 2013) (describing the process a company took to meet REIT status). Apparently, at least fifteen REIT spin-offs were concluded between 2010 and 2015 including a large transaction involving Darden Restaurants and a significant transaction involving Hilton Hotels. *See* Robert Rizzi, *30 Years' War:* General Utilities *Repeal and Efforts to Enforce It*, 43 J. CORP. TAX'N 23 (2016). For representative disclosures of publicly announced Spin-REIT transactions, see Park Hotels & Resorts Inc., Current Report (Form 8-K) 2–3 (Jan. 2, 2017) (disclosing section 355 spin-off of Hilton real estate properties into a separate company); Vornado Realty Trust, Current Report (Form 8-K) 8 (Oct. 31, 2016) (setting forth intent to spin-off JBG Smith in a qualifying section 355 transaction followed by JBG Smith electing REIT status); MSG Spinco, Inc., Current Report (Form 8-K) 157 (Sept. 16, 2015) (announcing a section 355 spin-off a controlled subsidiary that would own all of the Madison Square Garden sports and entertainment segments).

spin-off.[141] Shortly thereafter, on December 18, 2015, Congress enacted section 355(h) and section 856(c)(8).[142]

Under section 355(h), a REIT generally will be ineligible to participate in a tax-free spin-off as either the distributing corporation or controlled corporation unless those corporations were already REITs or the corporate separation would be subjected to corporate level taxation.[143] In addition, if a corporation is a party to a section 355 transaction, then that corporation is not eligible to make a REIT election for ten years from the date of the section 355 transaction.[144] Even with the passage of section 355(h), the Treasury Department was concerned that this statutory provision, by itself, did not fully protect against the ability of taxpayers to combine a section 355 transaction with a subsequent REIT or RIC election.[145] Thus, in order to protect against an inappropriate circumvention of Congress's repeal of the *General Utilities* doctrine, the Treasury Department issued regulations on June 7, 2016 that would cause a corporation that merged into a REIT within ten years of its participation in a section 355 transaction must recognize all of the corporate-level built-in gain at the time of its REIT conversion.[146] The Treasury Department arguably could have solved this recalibration of Section 355 with its very broad delegated authority, but it left it to Congress to make statutory changes to recalibrate Section 355. But, the Treasury Department, albeit late in doing so, has started to use its original legislative grant of authority to now independently reform Section 355 as more fully discussed in the next section.

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141. *See* I.R.S. Notice 2015-59, 2015-40 C.B. 459 (describing the Treasury Department's concerns around the section 335 spin-offs); *see also* Rev. Proc. 2015-43, 2015-40 C.B. 467, 468 (describing how the IRS similarly announced that it would no longer provide a favorable ruling under section 355 with respect to transactions where either the distributing corporation or the controlled corporation elected REIT or RIC status after the section 355 transaction and that transaction).

142. Consolidated Appropriations Act, 2016, Pub. L. No. 114-113, Div. Q, 129 Stat. 2242, 3040 (2015).

143. *Id.* at 3090.

144. *Id.* at 3090–91.

145. *See* Certain Transfers of Property to Regulated Investment Companies [RICs] and Real Estate Investment Trusts [REITs]; Correction, 81 Fed. Reg. 41,800 (proposed June 28, 2016) (to be codified at 26 C.F.R. pt. 1) (imposing a tax on transactions where property of a C corporation converts to the property of an REIT).

146. Treas. Reg. § 1.337(d)-7T(f) (2017).

C. *Treasury Department's Use of its Delegated Authority to Recalibrate the Device Test to Address* General Utilities *Repeal*

Although Congress has sought to repeatedly amend section 355, it should be understood that the Treasury Department has long held sufficient authority to reform section 355. In 1986, Congress gave the Treasury Department broad authority to ensure that its purpose in repealing the *General Utilities* doctrine would not be circumvented through any other provision of law, including section 355.[147] In 1989, the Treasury Department substantially expanded its regulatory guidance under section 355, but those regulations did not include any guidance under its authority to prevent the circumvention of the repeal of the *General Utilities* doctrine under section 3337(d) because the IRS was still developing its position with respect to those matters.[148] In addition, in 1990, Congress, in its legislative history to section 355(d)'s enactment, reminded the Treasury Department that it had broad regulatory authority that it should independently use to ensure that the intended scope of its repeal of the *General Utilities* doctrine was not circumvented even when Congress concurrently tries to address the same concern statutorily;[149] the Treasury Department has recently endorsed this broad grant of authority in the section 355 context.[150] Thus, regardless of Congress's legislative enactments, the Treasury Department has broad authority to restrict section 355's scope to ensure that it is not used as a means to circumvent Congress's *General*

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147. *See* I.R.C. § 337(d) (2012) (outlining the authority the Secretary of the Treasury shall have to carry out sections of the Tax Reform Act of 1986).

148. *See* General Utilities Repeal, 54 Fed. Reg. 289 (Jan. 5, 1989) (stating that "[t]he Internal Revenue Service is developing regulations under section 337(d) of the Code that will relate to the distribution of stock, or stock and securities, of a controlled corporation. New § 1.355-6 is revised for this purpose").

149. *See* H.R. REP. NO. 101-881, at 342 (1990) ("The bill [that enacted section 355(d)] is not intended to limit in any way the continuing Treasury Department authority to issue regulations to prevent the avoidance of the repeal of the *General Utilities* doctrine through any provision of law or regulations, including section 355."); *see also* I.R.C. § 337(d)(1) (showing the broad grant of regulatory authority to implement Congress's desire to repeal the *General Utilities* doctrine).

150. *See* I.R.C. § 337(d); *see also* General Utilities Repeal, 81 Fed. Reg. 45,963, 46,009 (proposed July 15, 2016) (stating that "the Treasury Department and the IRS are concerned that certain taxpayers may be interpreting the current regulations under sections 337(d) and 355 in a manner allowing tax-free distributions motivated in whole or substantial part by a purpose of avoiding corporate-level taxation of built-in gain in investment or nonbusiness assets"); I.R.S. Notice 2015-59, 2015-40 C.B. 459 (observing that taxpayers may attempt to use section 355 distributions in ways that are inconsistent with the purpose of the *General Utilities* repeal).

Utilities repeal. But, notwithstanding this longstanding authority, the Treasury Department has been slow to act in the section 355 context.[151] Nevertheless, in 2016, the Treasury Department became much more active in terms of utilizing its regulatory authority to address taxpayer efforts to utilize section 355 to circumvent Congress's *General Utilities* repeal, and so 2016 may represent a turning-point year. In this regard, the 2016 proposed Treasury Department regulations provide that the existence of nonbusiness assets and disproportionate allocation of nonbusiness assets in the corporate separation can represent an evidence of device.[152] Thus, these regulations signal that the Treasury Department has started to reformulate the device test so that it focuses on the corporate level (*General Utilities* repeal) concerns of whether or not a corporate separation represents a device for inappropriately circumventing Congress's repeal of the *General Utilities* doctrine.[153] This Article's reform proposals with respect to refocusing the device test on corporate level concerns, as set forth in Section II.A, are consistent with the Treasury Department's reformulation of the device test to focus that standard on the goals of ensuring the "strong form" of *General Utilities* repeal.

The impetus for these 2016 proposed regulations appears to have been the highly publicized potential spin-off by Yahoo of a subsidiary that would own the Yahoo investment in Alibaba stock.[154] In this proposed spin-off, substantially all of the market value of the controlled subsidiary would be attributable to a passive investment in Alibaba stock, not the de minimis active trade or business that Yahoo would transfer into that controlled subsidiary.

Historically, the IRS had interpreted section 355(b)'s active trade or business requirement as being satisfied regardless of the size of the historic active trade or business assets in comparison to the nonbusiness assets held by each of the distributing corporation or the

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151. *See* Annette Ahlers, *Section 355 Guidance: More Clarity and New Tests on Device, Active Trade or Business and Distribution of Control*, JDSUPRA (July 20, 2016), https://www.jdsupra.com/legalnews/section-355-guidance-more-clarity-and-22310 (describing the limitations and shortages in resources to manage responses to section 355 inquiries).

152. *See* Comments Regarding Device, 81 Fed. Reg. 46,008 (July 15, 2016) (describing the factors used to determine the evidence of device).

153. *See supra* note 150 (discussing how the Treasury Department in 2016 issued regulations under section 337(d) to further circumscribe the so-called "spin-REIT" technique).

154. *See* Marie Sapirie & Amy S. Elliott, *New Device Test Included in Proposed Hot Dog Stand Regs*, 152 TAX NOTES 326, 327 (2016) (describing a tax-free spin-off plan by Yahoo Inc.).

controlled corporation.[155] For ruling purposes, the IRS had previously required that the controlled corporation's active trade or business assets either must represent at least five percent of the total assets of the newly separated entity or must not be "de minimis" under a facts and circumstances analysis,[156] but this ruling guideline was eliminated in 2003.[157] The proposed Yahoo spin-off raised this question: Would Ms. Gregory have won in front of Judge Learned Hand or in front of Justice Sullivan if she had ensured that the Averill corporation had owned an actively run hot dog stand in addition to the Monitor stock investment?[158]

In a reversal of its ruling practice, after the announcement of the proposed Yahoo spin-off of its Alibaba investment, the IRS announced that it may have policy concerns with a spin-off transaction that involves a controlled subsidiary with a relatively small active trade or business and a relatively large amount of investment assets.[159] Concurrently with this announcement, the IRS reinstituted its no-rule policy with respect to spin-off transactions where the active trade or business assets represent less than five percent of the controlled corporation's assets and also indicated that it would not rule in situations where (1) the fair market value of the investment assets is two-thirds or more of the value of the gross assets, (2) the fair market value of the active trade or business assets is less than ten percent of the value of the investment assets, and (3) the ratio of the fair market value of the investment assets to the value of the gross assets is three or more times greater than the comparable ratio of the other corporation.[160] Furthermore, in proposed regulations issued in July 2016, the Treasury Department

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155. *See, e.g.*, Treas. Reg. § 1.355-3(b)(2)(iii) (2016) (stating that "[g]enerally, the corporation is required itself to perform active and substantial management and operational functions" and that this determination would be made based on an analysis "from all the facts and circumstances"); *see also* Rev. Rul. 73-234, 1973-1 C.B. 180 (finding that the corporation itself directly performs active and substantial management and operational functions due two employees and that this was sufficient to find that the corporation was engaged in the active conduct of a trade or business).

156. *See* Rev. Proc. 96-43, 1996-2 C.B. 330 (describing the process of establishing active trade requirement of section 355(b)).

157. *See* Rev. Proc. 2003-48, 2003-2 C.B. 86, 87 (noting when a letter ruling will not be issued on whether active business requirements are met).

158. *See* Amy S. Elliott, *Does Size Matter? Getting to Will on a Hot Dog Stand ATB*, 148 TAX NOTES 128, 132 (2015) (describing the growing number of transactions regarding ATB issues).

159. *See* I.R.S. Notice 2015-59, 2015-40 C.B. 459 (stating that the IRS is studying this issue); Rev. Proc. 2015-3, 2015-1 C.B. 129, 133 (adding two specific issues in the section 355 context in which the IRS will not rule).

160. *See* Rev. Proc. 2015-43, 2015-2 C.B. 467, 468 (noting three new situations where the IRS will not rule).

stated that it would revise its existing regulations to provide that the distributing corporation and the controlled corporation must each hold active trade or business assets that comprised at least five percent or more of their total assets.[161] The Treasury Department explained that a corporate separation must involve an economically significant amount of active business assets in order for nonrecognition treatment to be consistent with congressional intent, case law, and the underlying purpose of the reorganization provisions and circumvents Congress's desire to repeal the *General Utilities* doctrine.[162] Consequently, the Treasury Department concluded that existing section 355 regulations should provide more objective guidance regarding the device factors where a corporate separation involves predominantly non-historic or nonbusiness assets.[163] Thus, it now appears that the Treasury Department finally has riveted its attention on the question of how the device test and the active business test should be refocused on the corporate level policy concern of Congress's repeal of the *General Utilities* doctrine.[164] The Treasury Department should be commended for asserting that the device test should be used to promote a "strong form" of *General Utilities* repeal and for recognizing that corporate separations that involve substantial nonbusiness assets or a disproportionate separation of nonbusiness assets can inappropriately circumvent the repeal of the *General Utilities* doctrine.

The proposed regulations, however, fall far short of achieving the laudable expressed goal of providing for a "strong form" of *General Utilities* repeal. First, the proposed regulations state that the ownership of nonbusiness assets by the distributing corporation and/or the controlled corporation is evidence of a device, but the weight afforded to this new device factor is determined largely on a facts and

161. *See* Minimum Percentage of Five-Year Active-Business Assets, 81 Fed. Reg. 46,018 (July 15, 2016) (adding § 1.355-9 as a proposed regulation).

162. *See* Comments Regarding Active Business, 81 Fed. Reg. 46,008 (July 15 2016) (describing the divergence from congressional intent by allowing section 355(b) to be met through insignificant active businesses); *see also* Sapirie & Elliott, *supra* note 154, at 326 (showing an early reaction to these new proposed regulations).

163. *See* Supplementary Information, 81 Fed. Reg. 46,005, 46,008 (July 15, 2016) (showing the Treasury Department's determination that regulations should be clearer for determining device factors).

164. *See* Amy S. Elliott, *Will New Spinoffs Require* General Utilities *Repeal Compliance?*, 151 TAX NOTES 879, 879–80 (2016) (quoting Robert Wellen, IRS associate chief counsel, stating that the IRS is concerned with so-called hot dog stand fact patterns and wants to issue guidance but are still working through the issues).

circumstance basis.[165] The proposed regulations then state that the larger the percentage of nonbusiness assets in either corporation, the stronger the evidence of a device.[166] In contrast, if neither the distributing corporation nor the controlled corporation has nonbusiness assets that comprise twenty percent or more of its total assets, the ownership of nonbusiness assets ordinarily would not be evidence of a device.[167] In addition, a difference in the nonbusiness asset percentages for the distributing corporation and the controlled corporation ordinarily would not be evidence of a device if such difference is less than ten percentage points.[168] Finally, the proposed regulations then provide a "per se device" standard.[169]

Thus, an interesting juxtaposition can be seen when one compares the actual regulatory enactment with the policy goals set forth in the preamble that motivated these proposed regulations. In this regard, the preamble indicates that nonbusiness assets can represent a device, but the proposed regulations do not foreclose a section 355 treatment where either or both the distributing corporation or the controlled corporation have a majority (fifty-one percent) of their assets as nonbusiness assets.[170] The proposed regulations will not ordinary treat this situation as a device—even if substantially all of the assets of both the distributing corporation and the controlled corporation are nonbusiness assets—as long as the percentage of nonbusiness assets is within ten percentage points of the assets of the distributing corporation and the controlled corporation.[171] In addition, because the device test still focuses on spin-offs, some practitioners have already

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165. § 1.355-2 Limitations, 81 Fed. Reg. 46,014 (July 15, 2016).

166. *Id.*

167. *Id.*

168. *Id.*

169. The proposed regulations provide that a per se device exists if either the distributing corporation or the controlled corporation has nonbusiness assets that comprise two-thirds or more of its total assets; one corporation has nonbusiness assets comprising two-thirds or more of its total assets but less than four-fifths of its total assets and the other corporation has nonbusiness assets that comprise less than three-tenths of its total assets; one corporation has nonbusiness assets comprising four-fifths or more of its total assets but less than nine-tenths of its total assets and the other corporation has nonbusiness assets that comprise two-fifths or less of its total assets; or one corporation has nonbusiness assets comprising nine-tenths or more of its total assets and the other corporation has nonbusiness assets that comprise less than half of its total assets. *See* Guidance Under Section 355 Concerning Device and Active Trade or Business, 81 Fed. Reg. 46,004, 46,017.

170. *See id.* at 46,016.

171. *See id.*

indicated that the market may well utilize split-off transactions to avoid the applicability of the new device test whenever substantial nonbusiness assets are being distributed as part of the corporate separation.[172] Even though the Treasury Department's proposed regulations are a step in the right direction, the regulatory response has failed to fulfill the goals of the repeal of the *General Utilities* doctrine. The new guidance only focuses on spin-offs and does not categorically prevent section 355 from being used in a corporate separation where the majority of assets of either the distributing corporation or the controlled corporation are nonbusiness assets. Thus, the Treasury Department's proposed regulations fall short of circumscribing section 355's scope so that it cannot be used to circumvent Congress's repeal of the *General Utilities* doctrine.

II. REFORM OF SECTION 355

Congress's policy rationale for its amendments to section 355 in the post-1986 era has been remarkably consistent in its stated preference for a "strong form" version of repeal of the *General Utilities* doctrine. Congress has expressed a continuing concern about corporate dispositions of corporate assets to new owners in transactions that are akin to a sale but avoid corporate level taxation. Congress has rightfully attempted to ensure that the nonrecognition provisions of section 355 remain limited to the circumstance where the corporate separation merely serves to readjust the continuing interest of historic shareholders in historic active business assets. The amendments to section 355 since 1986 can be framed and understood in the context of furthering that policy goal so that the direction of the law in the section 355 context is now apparent in terms of advancing towards the normative goal of a "strong form" of *General Utilities* repeal.

Notwithstanding the clarity of understanding the direction of the reform efforts to section 355 and how those efforts have moved the existing law closer to the normative goals of a "strong form" of *General Utilities* repeal, the outcome of these multiple congressional enactments is that a patchwork of provisions now exist that provide needless complexity and fail to provide a unified approach for determining whether a corporate separation represents simply a readjustment of ownership of historic businesses among historic shareholders who intend to continue their investment in the historic

172. *See* Laura Davison, *Tax-Free Spinoffs Would Be More Difficult Under IRS Proposal*, DAILY TAX REP. (2016).

businesses, albeit in modified corporate form. Section 355, as currently constructed, overly relies on subjective standards and has created an informal administrative working law that is not transparently understood except by those who are deeply involved in the ruling process.[173] And, these subjective standards provide inappropriate opportunities to utilize section 355 as a means for historic shareholders to monetize—or cash-out—of their proportionate interest in historic business assets and/or to transfer a historic business to non-historic shareholders in a tax-free manner. Section 355, therefore, provides inappropriate planning opportunities for circumventing Congress's repeal of the *General Utilities* doctrine. The Treasury Department's recent efforts to reformulate the device test, albeit laudable, also have fallen far short of implementing a "strong form" of *General Utilities* repeal. Thus, it is now time for Congress and the Treasury Department to reassess their efforts in the 1987 to 2016 time period and seek to rationalize their efforts so that the normative goals of a "strong form" of *General Utilities* repeal and needed simplification can be achieved.

The Article urges reform in two directions. First, the Treasury Department should continue to refocus the device test[174] so that it addresses today's corporate level policy goal of preventing appreciated assets from leaving a corporation's tax base in transactions that inappropriately circumvent the scope of Congress's "strong form" version of repeal of the *General Utilities* doctrine. In this regard, the device test should be reformed so that it more objectively differentiates between non-objectionable corporate separations that represent a mere readjustment of the continuing interest of historic shareholders in historic business assets from objectionable corporate separations that are more akin to a disposition or a monetization of a shareholder's interest in a historic business. This Article's proposed reform of the device test is set forth in Section II.A below. Once the device test is refocused in the manner set forth in this Article, section 355(g) and

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173. *See* Schler, *supra* note 54, at 240 (ascertaining that the spin-off rules of section 355 are "illogical, complex and uncertain").

174. Others have also argued that the device test should be refocused to promote the goals of *General Utilities* repeal, and thus this Article follows a long line of other scholars. For example, Professor Yin has found that corporate division also gives taxpayers an opportunity for corporate-level tax advantages unseen before the transaction. The smaller corporate structures allow for a tax-free divisive transaction, which enables the possibility of corporate assets without corporate tax. Yin, *supra* note 44, at 294; *see also* Schler, *supra* note 54, at 240 (highlighting that "the concern is that spinoffs can improperly be used to avoid corporate level capital gain on the distribution").

the subjective device factors set forth in existing Treasury Regulation's section 1.355-2(d) can be eliminated as obsolete.

In addition, Congress identified non-historic shareholders in conflicting ways in section 355(b)(2)(D), section 355(d), and section 355(e). Those conflicting provisions also use subjective tests that frustrate their transparent application and afford taxpayers an opportunity to utilize section 355 to circumvent Congress's expressly stated "strong form" version of *General Utilities* repeal. Thus, in Section III.B, this Article argues that section 355(d) and section 355(e) should be repealed and proposes that a harmonized testing period should be set forth in a new section 355(d). Under the new section 355(d) as envisioned in this Article, section 355(d) would provide a unified ownership change standard that borrows heavily from the objective standards set forth in section 382. This aspect of the reform proposal is set forth in Section II.B. below. In combination, the reforms set forth in this Part II seek to fulfill Congress's oft-repeated "strong form" version of *General Utilities* repeal and seeks to do so in a manner that utilizes clear rules and eliminates the subjective standards that currently inhibit the effectiveness of Congress's prior reform efforts.

A. *Reformation of the Device Test*

1. *The device test should deny section 355 treatment unless more than fifty percent of the value of both the distributing corporation and the controlled subsidiary is attributable to historic active trade or business assets*

The Treasury Department already has the authority it needs in order to reformulate the device test to promote the corporate level policy goal of effectuating a "strong form" of *General Utilities* repeal, and in fact, the Treasury Department has started the process of doing so.[175] Existing Treasury Department regulations state that section 355 should not apply to a transaction used principally as a device for the distribution of the earnings and profits of the distributing corporation, the controlled corporation, or both.[176] To this extent, the existing final Treasury regulations are not objectionable. However, the Treasury Department regulations then seek to employ a subjective facts and circumstance analysis to implement this mandate.

In contrast to the approach taken in the existing regulations, this Article contends that the Treasury Department should set forth in its

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175. *See supra* Section II.C.
176. *See* Treas. Reg. § 1.355-2(d)(1) (2011).

regulations that the device test is satisfied only if a majority of the total assets of both the distributing corporation and the controlled corporation constitute active historic trade or business assets.[177] Congress's core policy goal in section 355 is to allow tax-free corporate divisions that principally involve a separation of historic businesses among historic shareholders, like the fact pattern in *Rockefeller*.[178] Viewed with that transaction in mind, a distribution should only qualify for section 355 treatment if, and only if, the fair market value of the historic active trade or business assets of each of the distributing corporation and of the controlled corporation—judged after the section 355 spin-off, split-off, or split-up—represents at least fifty percent of the total asset value of each of the distributing corporation and the controlled corporation.

If at least fifty percent of the total assets of either the distributing corporation or the controlled subsidiary were not historic active business assets after the corporate division, then the transaction should run afoul of the device test because the corporate separation principally serves as a device to separate non-active assets out of common corporate solution in avoidance of the intended scope of Congress's repeal of the *General Utilities* doctrine. In the post-*General Utilities* era, a tax-free corporate distribution should not be allowed under section 355 unless the principal assets in both the distributing corporation and the controlled corporation are historic active business assets. When a majority of assets in either the distributing corporation or the controlled subsidiary are not historic active business assets, then the IRS should presume that the principal reason for the corporate separation was to serve as a device to separate non-historic activities in a manner that circumvents Congress's efforts to repeal the *General Utilities* doctrine. Certainly, some could argue that a lower threshold might be justifiable.[179] However, the benefit of the fifty percent historic

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177. This aspect of this Article's reform proposal was advanced as a potential reform proposal more than a decade ago. *See* Schler, *supra* note 54, at 264–65 (stating that "the required percentage of qualifying [active trade or business assets] should substantially exceed 5%[;] the percentage, however, should not be too high . . . . One reasonable possibility would be to have the required percentage for qualifying assets set at 50%"). In that prior reform proposal, it was argued that this percentage could be waived in appropriate circumstances, but that nuance is not adopted in this Article's reform proposal. This proposal has been separately advanced elsewhere as well. *See* Canellos, *supra* note 19.

178. Rockefeller v. United States, 257 U.S. 176, 180–83 (1921).

179. *Cf.* Treas. Reg. § 1.368-2(k)(2) (2007) (setting forth that a one-third interest in a partnership is to be considered sufficient interest in historic business assets in Example 8).

business asset threshold set forth in this Article is that it requires a majority of the financial value of both the distributing corporation and the controlled subsidiary to be attributable to historic business assets. Thus, on its face, the principal consequence of the corporate separation was simply to divide historic business assets among historic shareholders and was not to separate out nonbusiness assets or to achieve a different purpose. The following Example 1 sets forth the contours of this proposed reformulated (corporate level focused) device test.

a. Example #1: substantial nonbusiness assets

Distributing corporation is only owned by historic shareholders and owns two active trades or businesses that have been conducted for five years as described in section 355(b): Business A (worth $8 million) and Business B (worth $8 million). Distributing corporation also owns nonactive trade or business assets worth $12 million. In order to further a legitimate business purpose, the distributing corporation forms a new controlled subsidiary, transfers Business A and $6 million of the nonactive assets to the controlled subsidiary, and distributes all of the stock of the controlled subsidiary to its shareholders.

This transaction meets the device test under the reform proposal set forth in this Article. What is relevant to the device test is that the historic active trade or business assets of both the distributing corporation and the controlled corporation account for more than fifty percent of the total asset value of each corporation after the spin-off,[180] so this corporate division did not have a principal purpose of separating out non-historic business assets. Rather, since more than half of the total asset value of each of the distributing corporation and the controlled subsidiary remains attributable to historic active trade or business assets, the purpose for this corporate separation was not principally a device to distribute nonbusiness assets to shareholders but instead principally served to separate two historic active businesses amongst the historic shareholders.

This example provides a clear case for when section 355 is not being utilized principally as a device simply to inappropriately separate nonbusiness assets out of common corporate solution in avoidance of

180. The "Distributing Corporation" and the "Controlled Subsidiary" each have total assets of $14 million. As to each of them, $8 million of the asset value is attributable to historic business assets. Thus, more than fifty percent of the fair value of the assets of each of the Distributing Corporation and the Controlled Subsidiary are from historic business assets.

corporate level taxation. Here, each of the distributing corporation and the controlled subsidiary have historic active trade or business assets that comprise more than fifty percent of the total asset value of each corporation after the corporate separation. Even assuming a valid business purpose and assuming the other requirements of section 355 are satisfied, the distribution of the controlled subsidiary's stock by the distributing corporation should be afforded section 355 treatment because the objective facts demonstrate that over half of the total asset value for each of the distributing corporation and the controlled corporation is in fact attributable to historic active business assets. Therefore, the stock distribution principally related to separating historic businesses and did not principally serve as a device to separate non-historic business assets.

However, if the facts were altered such that all of the investment assets stayed with the distributing corporation or all of the investment assets had been transferred to the controlled subsidiary, then this revised fact pattern would have caused this Article's articulation of the device test to be failed because now the shareholders are receiving stock in one of the corporations that has more than fifty percent of its total asset value derived from nonbusiness assets.[181] In this situation, this corporate division serves principally—not entirely, but principally—as a device to divide nonbusiness assets out of the combined corporation without incurring corporate level taxation. In this revised fact pattern, the distribution does not qualify for section 355 treatment because both the distributing corporation and the controlled subsidiary must have more than fifty percent of their total asset value attributable to historic business assets. As this example demonstrates, the reform proposal set forth in this Article provides objective certainty by making it clear that a corporate separation cannot be done tax-free under section 355 if more than fifty percent of the assets of either the distributing corporation or the controlled corporation are nonbusiness assets. In contrast, the Treasury Department's proposed 2016 regulations do not categorically foreclose this outcome. In fact, a corporate separation can involve ninety-five percent non-active assets and still the corporate separation would not be considered a device that was principally motivated to

181. Now, the value of the corporation that retained all of the nonbusiness assets (whether the distributing corporation or the controlled subsidiary) is $20 million comprised of non-historic business assets of $12 million and historic business assets of $8 million. Thus, less than fifty percent of the fair value of the assets of the corporation that retained all of the financial assets would relate to historic business assets.

separate appreciated nonbusiness assets in certain fact patterns under the 2016 proposed regulations. In addition, the proposed 2016 Treasury Department regulations require a subjective weighing of factors that hinders their transparent application and afford planning opportunities that frustrate the efficacy of those proposed 2016 regulations from achieving the normative policy goals that motivated their issuance in the first place.

2. The device test should deny nonrecognition treatment for stock if shareholders receive excessive value due to disproportionate leverage in either the distributing corporation or the controlled subsidiary

Even where a corporate separation involves historic active business assets that comprise more than fifty percent of the total assets of both the distributing corporation and the controlled corporation, the use of section 355 can allow monetization opportunities for shareholders to cash-out of their proportionate interest in the corporation's aggregate historic assets through leveraged spin-offs exemplified by the *Morris Trust* transaction. Current law affords nonrecognition treatment at the shareholder level even though these re-leveraging techniques represent a cashing-out of the shareholder's proportionate interest in the aggregate historic assets. Section 355 should not provide a tax-free means for one group of shareholders to monetize—or cash-out—of their investment in historic business assets while allowing another group of shareholders to enhance their proportionate interest in the historic business assets as this usage of section 355 represents a device for disguising what should be a taxable stock dividend under section 305 to the shareholders.[182]

So, to deal with this concern, this Article proposes that the shareholders of either the distributing corporation or the controlled corporation, whichever the case may be, must recognize a taxable stock dividend as part of an otherwise qualifying section 355 transaction if the effect of the section 355 transaction is to cause the other corporation to have "excess leverage" immediately after the spin-off. For this purpose, excess leverage would mean a debt-to-equity ratio that exceeded 120%

182. *See* Treas. Reg. § 1.355-2(d)(2)(iv)(B) (2011) (stating that differing ratios in financial assets between the distributing corporation and the controlled corporation does not wholly preclude evidence of a device). Proposed regulations issued in 2016 provide further objectivity but are still far more lenient than those in this proposal, which isolates the taxable dividend impact of the transaction in a more targeted manner. *See* Guidance Under Section 355 Concerning Device and Active Trade or Business, 81 Fed. Reg. 46,004, 46,009 (July 15, 2016) (to be codified as 26 C.F.R. pt. 1).

of the average debt-to-equity ratio of the corporate affiliated group that existed before the section 355 transaction.

Again, section 355 should afford nonrecognition treatment to the extent it divides historic businesses amongst its historic shareholders. But, if the parties bolt-on to the corporate separation a re-leveraging of the corporate affiliates as part of the section 355 transaction, then the stock associated with the monetization benefit should be treated as a taxable stock dividend under section 305(c) that trumps section 355(a)'s applicability. The following Example 2 sets forth this Article's proposal for how to reform section 355 so that it does not supplant a taxable stock dividend result under section 305 in a situation where section 355 transaction involves re-leveraging as part of the transaction:

a. Example #2: nonrecogition treatment due to disproportionate leveraging

The facts are the same as in Example 1 except now assume that the corporation has $7 million of debt and so has a debt-equity ratio of thirty-three percent before the spin-off.[183] In the spin-off, the distributing corporation takes Business A, half of the non-active assets ($6 million of the $12 million nonbusiness assets), and all of the $7 million debt. The controlled subsidiary obtains Business B, half of the non-active assets ($6 million of the $12 million of nonbusiness assets), and no debt.

The distributing corporation and the controlled subsidiary each conduct active trade or businesses that account for more than fifty percent of their total assets, and these corporations are each owned by historic shareholders after the spin-off. Thus, the spin-off in this example does not violate the device test and otherwise qualifies for section 355 treatment. However, even though the corporate division otherwise qualifies for section 355 treatment, the corporate division in this example was used as a means to shift excess leverage because the distributing corporation has a debt-to-equity ratio of fifty percent (assets of $14 million, debt of $7 million and equity of $7 million) whereas the distributing corporation had a pre-separation debt-to-equity threshold of forty percent (i.e., 33% x 120% limit). In this situation, the amount of its excess leverage above a forty percent debt-to-equity threshold, or $3 million, represents a taxable stock dividend under section 305 to the shareholders of the controlled corporation

183. Assets of $28 million (Business A of $8 million; Business B of $8 million; and nonbusiness assets of $12 million) and debt of $7 million implies equity of $21 million for a debt-to-equity ratio of seven to twenty-one or thirty-three percent.

who shifted excessive leverage away from their investment and in effect cashed-out of their investment in those corporate assets.

The effect of the disproportionate leverage that exceeded the 120% threshold is that it allowed shareholders of the controlled subsidiary to disproportionately increase their equity in the controlled corporation's underlying business assets. Outside of section 355, a disproportionate stock distribution that increases the proportionate interest of some shareholders implicates section 305(b) and section 305(c), and section 355 should not turn-off that result. Accordingly, this re-leveraging aspect of the transaction should be treated as a taxable stock dividend to the benefitted shareholders who shifted their proportionate interest in the debt away from their investment with respect to the relatively underleveraged corporation. If the entire leverage were transferred to the controlled subsidiary, then the distributing corporation's shareholders would be the ones that are the recipient of the deemed taxable stock dividend as they would have obtained an enhanced ownership in the historic business assets through a monetized disposition of their interest in the historic assets that were split-off in the controlled subsidiary.

Once these reforms are enacted, Congress could consider repealing section 355(g) as the policy goals for its original adoption would now have been addressed more comprehensively under this Article's reformulated device test.

B. New Section 355(d) and the Continuity of Interest Test

Fundamentally, section 355(b)(2)(D), section 355(d), and section 355(e) each attempt to ensure that the corporate division is afforded tax-free treatment under section 355 when a corporate separation occurs among historic shareholders who maintain a continuing interest in the distributing corporation and the controlled corporation in modified corporate form.[184] Each of these provisions determine "continuity" by prescribing a statutorily mandated continuity testing period. But, even though these provisions seek to set forth a statutorily based continuity of interest testing period, the ownership change criteria used in section 355(b)(2)(D), section 355(d), and section 355(e) provides needless complexity that should be harmonized into

184. *See* Treas. Reg. § 1.355-2(c)(1) (stating that "[s]ection 355 applies to a separation that effects only a readjustment of continuing interests in the property of the distributing and controlled corporations").

a coherent ownership change standard that removes the idiosyncrasies of the various provisions.

Congress has repeatedly stated that section 355 should not apply to corporate separations that are more akin to a disposition of historic business assets to non-historic shareholders, and these repeated legislative amendments demonstrate a consistent desire to enact a "strong form" of *General Utilities* repeal.[185] Moreover, where a transaction resembles a disposition, Congress has repeatedly endorsed the usage of objective testing periods to determine historic shareholders five years prior to a section 355 transaction under section 355(b)(2)(D) and section 355(d) and a two-year post-transaction continuity period under section 355(e). These aspects of current law are incorporated into this Article's new section 355(d), which provides for a five-year pre-transaction testing period and a two-year post-transaction testing period.

Yet, even though current law utilizes objective time periods under section 355(b)(2)(D), section 355(d), and section 355(e), those provisions ultimately condition the applicability of those provisions on either the acquisition of section 368(c) control, a subjective "by purchase" transaction, or on a "plan or series of related transactions" criteria that each in their own way limit the effectiveness of those statutorily prescribed testing periods. The restrictive and/or subjective criteria used in these provisions is ironic because Congress has successfully enacted a cohesive and unified ownership change regime in section 382 to address an analogous concern, namely the trafficking in net operating losses to non-historic shareholders. Section 382 provides a unified approach for differentiating between historic and non-historic shareholders, and section 382 accomplishes this task by using an objective testing period that shuns subjective criteria.[186] Thus, in a very real sense, Congress's duplicative efforts to define the identity of non-historic shareholders in section 355(b)(2)(D), section 355(d), and section 355(e) represent an effort to reinvent an already existing wheel and does so in a haphazard and subjective manner.

The continuity of shareholder interest concerns in section 355 necessitate a determination of the identity of historic shareholders, and the methodology for identifying historic shareholders has already been thoughtfully addressed in section 382's comprehensive

185. Sheffield & Schlunk, *supra* note 61, at 946 (noting Congress's repeated attempts to reconcile section 355 and the *General Utilities* repeal).

186. I.R.C. § 382(i)(1) (2012) (defining the testing period to a strict three-year period).

ownership change regime. When Congress enacted section 382, it attempted to grapple with the continuity of interest problem in a comprehensive manner with objective criteria, and so section 355(d) and section 355(e) should not adopt their own unique ownership change tests that utilize subjective factors but should instead rely on the section 382 ownership change regime. Thus, in this respect, this Article's reform proposal appears to be consistent with an earlier call by Professor Yin to incorporate section 382 concepts into section 355.[187]

In contrast with how Congress defines ownership changes in section 382 with objective tests, the section 355 modifications since 1986 have occurred in a piecemeal fashion, and so the existing statute utilizes inconsistent testing periods, inconsistent tests of shareholders, and inconsistent application of intent standards. It is time for Congress to eliminate section 355(d) and section 355(e) and replace them with the following new unified ownership change standard that borrows heavily from the section 382 construct.

C. New Section 355(d)

1. Section 355 ownership change rule

The five-year historic shareholders of the distributing corporation must own fifty percent or more of both the distributing corporation and the controlled subsidiary for a period that begins five years before the section 355 transaction[188] and ends two years after the section 355 transaction.[189] To determine whether an ownership change has occurred during this seven year testing period, the principles of section 382 will be utilized with the following modifications: (1) the ownership change among historic shareholders that arises solely as a result of the section 355 distribution will be ignored; and (2) the testing period for determining an ownership change under section 355 will be a seven-year period that commenced five years before the section 355 transaction and ends two years after the section 355 transaction.

187. *See* Yin, *supra* note 44, at 296–301 (grappling with the ownership change implications and the leveraging aspects, although appearing to suggest a reformulation of section 355 so that it is designed to better protect against inappropriate avoidance of the *General Utilities* repeal by incorporating principles enunciated in section 382).

188. *See* I.R.C. § 355(d)(3)(A) (omitting the "by purchase" restriction).

189. *See* § 355(e)(2)(B) (omitting the condition set forth in the last class of the provision, which provides an exception for transactions that were not pursuant to a plan).

2. Consequences of failing continuity of shareholder interest

If an ownership change occurs with respect to either the distributing corporation or the controlled corporation, then the effect of such an ownership change will be that the entity that experiences the ownership change (whether the distributing corporation or the controlled subsidiary) must recognize in the tax year of the ownership change the entire amount of the corporate level net unrealized built-in gain (the NUBIG)[190] that existed at the time of the section 355 distribution.[191]

The above proposal sets forth a comprehensive rule, providing that the historic five-year shareholders of the distributing corporation must continue to own at least fifty percent of the stock in the distributing corporation and in the controlled subsidiary for at least two years after the qualifying section 355 transaction. Section 382 does not employ subjective standards such as a "plan or series of transactions" inquiry or a "by purchase" inquiry. Instead, section 382 utilizes a robust set of rules to determine owner shifts and equity structure shifts and possesses a reasonable rule on how to handle transactions among less than five percent shareholders. Through it all, section 382 defines and determines the existence of an ownership change using objective criteria, and these criteria are administrable and have had the benefit of existing for several decades. Instead of trying to recreate another ownership change regime within section 355 in a hodgepodge fashion, Congress should simply graft the ownership change standard that is already well developed in section 382 and apply that criteria to the testing period set forth for section 355.[192] Except for one minor exception noted in the following paragraph, section 355's core goals

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190. *See* § 382(h)(1)(A) (clarifying NUBIG at the time of the section 355 transaction). This approach is similar to the result afforded for a subsequent conversion of corporation to REIT status within ten years of its being involved in a Section 355 transaction except that the testing period is not as onerous. *See* Treas. Reg. § 1.337(d)-7(d)(2)(B)(iii).

191. For earlier proposals that appear similar to this proposal, see Simon & Simmons, *supra* note 44, at 297 (arguing that distributes of the controlled corporation stock could be required to hold the stock for a period, such as five years, after the distribution, to address the avoidance of corporate level taxes on asset appreciation); *see also* STAFF OF J. COMM. ON TAX'N, 100TH CONG., DESCRIPTION OF POSSIBLE OPTIONS TO INCREASE REVENUES PREPARED FOR THE COMM. ON WAYS AND MEANS, at 172 (Comm. Print 1987) (setting forth this same recommendation). Another variation is set forth by Professors Simon and Simmons, who have written that tainting provisions for stock received from distribution under section by shareholder distributees, either for a set period or forever. *See* Simon & Simmons, *supra* note 44, at 294.

192. *See* Yin, *supra* note 108, at 375 (similarly considering the reform proposed in this Article).

can be met by utilizing the ownership change analysis set forth in section 382 and can do so in a manner that provides more objective certainty and rationality than currently exists in the ad hoc framework provided in section 355(d) and section 355(e).

However, notwithstanding the versatility of section 382's ownership change criteria to handle the policy goals of section 355 as a general matter, I readily admit that an owner shift that arises solely as a result of a split-off to historic shareholders should not be treated as an owner shift for purposes of determining an ownership change under section 355.

In this regard, for purposes of section 382, a five percent shareholder of the distributing corporation is treated as a five percent shareholder of its wholly owned subsidiary,[193] and so a spin-off of the controlled subsidiary, by itself, does not cause an owner shift of either the distributing corporation or the controlled subsidiary as the spin-off causes the shareholders to actually own the stock of the controlled subsidiary that they already are deemed to own proportionately.[194]

In contrast, a qualifying section 355 transaction that represents a split-off can in fact create an owner shift under section 382 if the effect of the split-off transaction is to increase the proportionate interest of the shareholders in either the distributing corporation or the controlled subsidiary. Treating a split-off as an owner shift is appropriate under section 382 as doing so furthers the policy objective of restricting the trafficking of loss corporations between any five percent shareholders. But, section 355 is not interested in barring a division of the controlled subsidiary to a subset of the historic shareholders. In fact, section 355 contemplates that a split-off transaction can occur and is legislatively sanctioned,[195] and so it is at this point where the continuity of shareholder interest analysis of an owner shift under section 355 should diverge from the analysis of an owner shift under section 382. Example 3, which is almost identical to an example set forth in the 1986 legislative history to section 382,[196] serves to demonstrate the singular proposed change to the section 382 analysis that would be employed in the section 355 context.

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193. *See* I.R.C. § 382(c)(4)(E) (2012). This solution was briefly discussed in Simon & Simmons, *supra* 44, at 297 (stating that "the holding period requirement could be applied only to five percent or greater shareholders, with the public aggregated as under section 382").

194. *See* H.R. REP. NO. 99-841, at 181 (1986) (Conf. Rep.) (illustrating that no ownership change occurred in Example 17).

195. *See* Treas. Reg. § 1.335-1(b) (2011).

196. H.R. REP. NO. 99-841, at 176.

a. Example #3

Distributing corporation is owned by two unrelated historic shareholders: A (sixty percent) and C (forty percent). A controlled subsidiary is a wholly owned subsidiary of the distributing corporation and is therefore deemed to be owned by A and C in the same proportions as their interest in the distributing corporation. The distributing corporation distributes all of the controlled subsidiary to A in exchange for all of A's stock in the distributing corporation a section 355 transaction.

Under the general operation of section 382, there has been an ownership change of the distributing corporation because the percentage of the distributing corporation's stock owned by C (100 percent) has increased by more than fifty percentage points over the lowest percentage of the distributing corporation's stock owned by C at any time during the testing period (forty percent prior to the distribution of the controlled subsidiary's stock).[197] There has not been an ownership change under section 382 with respect to the controlled subsidiary, however, because the percentage of the stock in the controlled subsidiary owned by A (100 percent) has not increased by more than fifty percentage points over the lowest percentage of stock owned by A at any time during the testing period (sixty percent), after application of the attribution rules.[198] However, in this example, both the shareholders (shareholder A and C) who experienced an owner shift within the meaning of section 382(g)(2) did so solely as a result of a qualifying section 355 transaction, and both Shareholder A and Shareholder C represent historic (five-year) shareholders of the distributing corporation. As a result, the impact of the owner shift as to A and C is ignored for purposes of the ownership change analysis under section 355.

This Article sets forth an administrable rule that achieves appropriate outcomes for a transaction that is afforded section 355 treatment. But, suppose that an ownership change occurs with respect to either the distributing corporation or the controlled subsidiary within two years after the section 355 transaction. How would this Article's proposed reform address the context where the two-year post-section 355 transaction continuity test were not satisfied? The following Example 4 illustrates the application of this aspect of the Article's reform proposal.

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197. *See id.*
198. *See id.*

b. Example #4

The distributing corporation has three shareholders: historic shareholder A (fifty percent), historic shareholder B (thirty percent), and shareholder C (twenty percent) who acquired its interest three years before the section 355 transaction posited in this example. The distributing corporation distributes the controlled subsidiary to B and C in exchange for all of their interest in the distributing corporation such that B and C each own sixty percent and forty percent, respectively, of the controlled subsidiary. One year after the section 355 transaction, the controlled subsidiary acquires another company in a tax-free reorganization where D becomes a new shareholder in the controlled subsidiary. The resulting ownership percentages in the controlled corporation become as follows: B (forty-eight percent), C (thirty-two percent), and D (twenty percent).

The controlled subsidiary experienced an owner shift of forty percent when C, the non-historic shareholder,[199] increased its interest from zero to forty percent in the controlled subsidiary in the five years preceding and including the section 355 transaction, but at that point there had not been an ownership change as there was not a more than fifty-point increase in the interest of a five percent shareholder during the testing period. If there had been an ownership change at that time, then the section 355 transaction would have been taxable at the corporate level and at the shareholder level. Since there was not an ownership change at that time, the section 355 transaction provided nonrecognition treatment in the year of that transaction. However, during the testing period but after the section 355 transaction, D becomes a twenty percent shareholder in the controlled corporation and creates another twenty-point owner shift, and so now the controlled corporation has experienced an ownership change during the testing period because non-historic five percent shareholders have experienced a greater than fifty-point increase of their interest over the lowest percentage of stock owned during the testing period. Thus, on the date of the ownership change, the controlled subsidiary must recognize all of its net unrealized built-in gain that existed at the time

199. *See* Rev. Rul. 74-5, 1974-1 C.B. 82 (contrasting the static five-year, pre-transaction testing period set forth in this Article's reform proposal). In addition, the reform proposal set forth in this Article does not condition the application of new section 355(d) on whether shareholder C acquired its interest "by purchase" or through a "plan or series of related transactions." I.R.C. § 355(e)(2)(B) (2012).

of the section 355 transaction and will be afforded a fair market value basis in all of its corporate assets.[200]

One criticism of the above proposal is that it could create a significant corporate level tax consequence due to the shareholder ownership changes that occur during the testing period but were not contemplated at the time of the section 355 transaction.[201] This same criticism could be leveled against section 382's limitation of corporate level tax attributes due to a shareholder ownership change, but in the section 382 context, Congress has chosen objective tests and in part handled this criticism by ignoring owner shifts among less than five percent shareholders. Furthermore, after the financial crisis of 2008, it has become an accepted technique[202] to use poison pill stock plans to prevent ownership changes that could negatively impact a corporation's tax attributes, and the Delaware courts have upheld these plans as a reasonable exercise of the director's business judgment.[203] Thus, a public corporation and its board of directors could take affirmative steps at the time of a section 355 transaction to ensure that the bright-line post-transaction continuity of interest requirement will be satisfied during the two-year post-spin-off testing period set forth in this Article,[204] and if the company chooses to not do

200. *See* I.R.S. Notice 2003-65, 2003-2 C.B. 747.

201. *See* Simon & Simmons, *supra* note 44, at 299 (arguing for the use of a five-year before and after rule, which would have the same intended affect and would follow the same continuity rules under section 382).

202. *See, e.g.*, Am. Int'l Grp., Inc., Proxy Statement (Schedule 14A), at 75 (Apr. 4, 2011); Citigroup, Inc., Proxy Statement (Schedule 14A), at 111–12 (Mar. 12, 2010); J.C. Penney Co., Proxy Statement (Schedule 14A), at 67 (Mar. 21, 2014); Ford Motor Co., Proxy Statement (Schedule 14A), at 73 (Apr. 1, 2010); Ford Motor Co., Proxy Statement (Schedule 14A), at 90 (Mar. 28, 2013).

203. *See* Selectica, Inc. v. Versata Enters., Inc., No. 4241-VCN, 2010 WL 703062, at *25 (Del. Ch. Feb. 26, 2010) (upholding the board of director's business judgment to adopt a poison pill rights plans that prevented an ownership change within the meaning of section 382 so as to preserve the loss corporation's net operating loss tax attributes).

204. Public deals already provide post-spin-off restrictions to ensure that spin-offs satisfy the requirements of section 355 under current law. *See, e.g.*, Hewlett Packard Enter. Co., Current Report (Form 8-K) 2 (May 24, 2016) (disclosing spin-off of its computer service business to Everett and then Computer Science Corporation, which would acquire less than 50% ownership of Everett in a subsequent reverse *Morris Trust* transaction, and continuing post-transaction covenants as to ensure qualification for section 355 treatment); Tenneco Inc., Current Report (Form 8-K) 2 (Apr. 10, 2018) (including a stand-still agreement applicable to the distributed corporation and its shareholders for one year after the spin-off); Park Hotels & Resorts Inc., Current Report (Form 8-K) 3 (Jan. 2, 2017) (restricting parties in the spin-off transaction from

so, or chooses to later rescind such a poison pill plan, then this outcome demonstrates that section 355 did in fact operate as a device to facilitate the disposition of appreciated assets out of corporate solution to new owners in violation of the goals of section 355.

In a recent revenue procedure, the IRS provided more certainty with respect to whether the control test of section 368(c) is satisfied when the voting interest in the controlled subsidiary is altered prior to a section 355 spin-off and then the altered voting structure is unwound after the spin-off.[205] In Revenue Procedures 2016-40, the IRS indicated that altering the voting interest in the controlled subsidiary prior to the spin-off so that section 368(c) control exists prior to the spin-off will be respected if the voting structure is not unwound within two years after the section 355 transaction.[206] The announcement of a clear post-spin-off two-year test has been reported as having the following positive, normative effect.[207]

This Article's objective post-transaction two-year continuity testing period requirement is analogous to the continuity test set forth in Revenue Procedure 2016-40. Like Revenue Procedure 2016-40 has done in its context, the adoption of a bright-line two-year continuity test for determining historic shareholders for purposes of section 355 provides a transparent rule that draws upon the objective standards that already exists in section 382.

A continuity test that relies on objective standards reduces the opportunities for gamesmanship that plague subjective standards, and as a result an objective post-continuity testing period better fulfills Congress's "strong form" of *General Utilities* repeal that it has repeatedly sought to implement.[208] If one were to start from scratch, the above

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reframing for two years so to not impact the tax-free status of the spin-off transaction under section 355).

205. *See* Laura Davison, *IRS Adds Certainty for Unwinding Control After Spinoff*, DAILY TAX REP. (2016) (stating that the certainty "is probably considered a win for taxpayers and IRS").

206. *See* Rev. Proc. 2016-40, § 4.01, 2016-32 C.B. 228, 229.

207. The clear two year test "enables . . . tax lawyers to do what [they] rarely get to do, which is actually give [their] clients a clear answer to a question they ask . . . . Now [tax lawyers] can say, 'wait two years.'" *See* Amy S. Elliott, *Guidelines Placed on Control Workarounds for Spinoffs*, TAX NOTES (2016) (quoting Jay M. Singer of McDermott Will & Emery LLP).

208. Even if differential rates for qualified dividends and long-term capital gains were restored for individual taxpayers, this objective continuity test would still promote the goals of the historic device test. Thus, the approach advocated herein is broad enough to cover the historic bail out concerns as well as holistically address more generally an effort to use section 355 to effectuate a disposition of historic businesses to new owners.

continuity of interest rule would simultaneously achieve the goal of affording nonrecognition treatment to transactions like the *Rockefeller* fact pattern where historic shareholders separated historic businesses into separate corporations but then maintained their investment in those businesses, albeit in modified corporate form. But at the same time, this Article's objective testing period would provide strong protections against efforts to utilize section 355 to dispose of historic businesses to new owners or to afford opportunities for shareholders to monetize or cash-out of their investments in historic businesses on a tax-free basis. Given the administrative convenience benefits of objective tests, given that Congress already has enacted objective ownership testing criteria under section 382 that could be relied upon in the section 355 context, and given that taxpayers have the ability to take appropriate steps to comply with this bright-line standard, the adoption of an objective continuity of interest testing period in section 355 (in lieu of the subjective intent and facts and circumstances standards that section 355 currently employs) represents a substantial improvement over current law. An objective standard can better implement Congress's "strong form" version of *General Utilities* repeal while transparently allowing section 355 to fulfill its core mission: namely, afford tax-free treatment in the limited context of a corporate separation that merely represents a rearrangement of historic assets among historic shareholders who desire to continue their interest in modified corporate form.[209]

CONCLUSION

Congress started down the path to fundamental corporate tax reform with the Tax Reform Act of 1986, but it failed to harmonize section 355's scope with its broader effort to repeal the *General Utilities* doctrine at that time. Moreover, section 355 has been hampered by its antiquated shareholder level bail out focus. Now that a concern over a bail out of earnings and profits at capital gains rates is no longer a critical policy goal, section 355 should be rethought in terms of the policy goals that matter for the post-*General Utilities* repeal era.

Congress has repeatedly amended section 355 in the years after 1986 in an attempt to harmonize section 355's application with its "strong form" version of *General Utilities* repeal, but these efforts have failed to fulfill Congress's "strong form" policy goals. The Treasury Department has been given regulatory authority to ensure that section 355 does not

209. *See* Treas. Reg. § 1.355-2(c)(1) (2011).

provide taxpayers with an inappropriate device to circumvent Congress's repeal of the *General Utilities* doctrine. However, the Treasury Department's extant regulatory actions have also been underinclusive. It is long past time to reform section 355 so that its scope of application is harmonized with Congress's clearly articulated "strong form" version of *General Utilities* repeal.

The legislative history in the post-1986 period makes clear that section 355 was intended to be a limited exception that should be restricted to corporate separations of historic business assets among historic shareholders. Section 355 was never intended to be the "beating heart of mergers and acquisitions activity in the United States."[210] The fact that section 355 serves as a means to afford nonrecognition treatment to transactions that are more akin to a disposition simply demonstrates that section 355 has strayed away from its core mission and has become a device for circumventing Congress's desired repeal of the *General Utilities* doctrine.

Comprehensive section 355 reform is long past due: it is time to bring section 355 back into alignment with its core mission and to address its overbreadth. Section 355 should not afford nonrecognition treatment to corporate separations that are more akin to a disposition as doing so allows assets to be transferred out of corporate solution to a new shareholder economic group without the recognition of corporate level gain. That outcome represents a circumvention of the "strong form" version of repeal of the *General Utilities* doctrine that Congress has repeatedly endorsed in the post-1986 era.

The reforms advocated in this Article, if adopted, would remove a significant amount of the complexity and subjectivity that exists within section 355 and would harmonize section 355 with Congress's desired repeal of the *General Utilities* doctrine. Section 355 in its present form places too much reliance on subjective standards, and this over-reliance on subjective standards has had the further consequence of creating needless complexity. Thus, Congress and the Treasury Department should once again return to section 355 and finally harmonize its scope with its larger *General Utilities* repeal efforts.

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210. Cummings, *supra* note 9.