

Transition Relief Regarding the Active Trade or Business Requirement for Certain Transactions

Notice 2007-60

This Notice provides transition relief to taxpayers applying § 1.355-3(b)(4)(iii) of the Income Tax Regulations and § 355(b)(2)(C) and (D) of the Internal Revenue Code to certain transactions described in this Notice.

SECTION 1. BACKGROUND

Section 355 sets forth the requirements of a tax-free distribution by a corporation of stock of a controlled subsidiary. Section 355(b) conditions the tax-free status of the distribution on the trade or business activities of the relevant corporations and the manner in which those activities were acquired. Generally, § 355(b)(2)(A) provides that a corporation shall be treated as engaged in the active conduct of a trade or business if and only if it is engaged in the active conduct of a trade or business. Section 355(b)(2)(B) requires that the trade or business have been actively conducted throughout the five-year period ending on the date of the distribution (pre-distribution period). Section 355(b)(2)(C) provides that the trade or business must not have been acquired in a transaction in which gain or loss was recognized, in whole or in part, within the pre-distribution period. Section 355(b)(2)(D) provides that control (as defined in § 368(c)) of a corporation which (at the time of acquisition of control) was conducting the trade or business must not have been directly or indirectly acquired by any distributee corporation or by the distributing corporation during the pre-distribution period in a transaction in which gain or loss was recognized, in whole or in part.

SECTION 2. APPLICABILITY OF § 1.355-3(b)(4)(iii)

Section 1.355-3(b)(4)(iii) provides an exception to the general no gain or loss rule in § 355(b)(2)(C) and (D), stating that “[a] direct or indirect acquisition of a trade or business by one member of an affiliated group from another member of the group is not the type of transaction to which section 355(b)(2)(C) and (D) is intended to apply. Therefore, in applying section 355(b)(2)(C) or (D), such an acquisition, even though taxable, shall be disregarded.” While § 1.355-3(b)(4) is generally applicable to distributions on or before December 15, 1987, the IRS has applied it administratively to distributions occurring after that date, consistent with the amendments to § 355(b)(2)(D) in 1987 and 1988. See Public Law 100-203 (101 Stat. 1330, 1330-411 (1987)) and Public Law 100-647 (102 Stat. 3342, 3605 (1988)).

Section 355(b) was amended again on May 17, 2006. See Section 202 of the Tax Increase Prevention and Reconciliation Act of 2005, Public Law 109-222 (120 Stat. 345, 348) and Section 410 of division A of the Tax Relief and Health Care Act of 2006, Public Law 109-432 (120 Stat. 2922, 2963). This amendment added § 355(b)(3), which provides that a corporation shall be treated as meeting the requirement of § 355(b)(2)(A) if and only if such corporation is engaged in the active conduct of a trade or business. Section 355(b)(3)(B) provides that for purposes of § 355(b)(3)(A) (and, consequently, § 355(b)(2)(A)), all members of such corporation’s separate affiliated group (SAG) shall be treated as one corporation.

The IRS and Treasury Department have interpreted § 355(b)(3) as calling into question whether the regulation quoted above appropriately reflects the statute as amended in 2006. See Notice of Proposed Rulemaking, Guidance Regarding the Active Trade or Business Requirement Under Section 355(b), 72 Fed. Reg. 26012 (No.

88) (May 8, 2007) (proposing to modify § 1.355-3) (NPRM). However, consistent with past administrative practice, the IRS will not challenge the applicability of the rule stated in § 1.355-3(b)(4)(iii) to distributions effected on or before the date of publication in the Federal Register of temporary or final regulations modifying the rule stated in § 1.355-3(b)(4)(iii).

SECTION 3. CERTAIN ACQUISITIONS OF ADDITIONAL STOCK OF THE CONTROLLED CORPORATION

Section 355(b)(2)(C) by its terms applies to asset acquisitions while § 355(b)(2)(D) applies to stock acquisitions. The IRS and Treasury Department have interpreted § 355(b)(3) as modifying the applicability of § 355(b)(2)(C) and (D). Section 355(b)(3) essentially treats a stock acquisition that results in the acquired corporation becoming a subsidiary member of the acquiring corporation's SAG as an asset acquisition for purposes of § 355(b). See NPRM. Accordingly, the IRS and Treasury Department have concluded that such a stock acquisition is subject to § 355(b)(2)(C) regardless of whether it results in an acquisition of control that would otherwise be subject to § 355(b)(2)(D). See NPRM.

Acquisitions of stock of the controlled corporation that result in the controlled corporation becoming a member of the distributing corporation's SAG are treated as asset acquisitions that are subject to § 355(b)(2)(C) regardless of whether the distributing corporation already controlled the controlled corporation. Specifically, such an acquisition could violate § 355(b)(2)(C) notwithstanding the fact that it would not violate § 355(b)(2)(D) because there was no acquisition of control.

For example, assume that for more than five years, corporations D and C have each engaged in the active conduct of a trade or business. The trades or businesses are not in the same line of business. Throughout this period, D has owned stock of C constituting control (as defined in § 368(c)) but not meeting the requirements of § 1504(a)(2). In year 6, D purchases for cash the remainder of the C stock from an unrelated party. The purchase of the additional C stock does not violate § 355(b)(2)(D) because D already owned stock of C constituting control. However, because after the purchase D owns stock of C meeting the requirements of § 1504(a)(2), C becomes a member of D's SAG, and D and C are treated as one corporation for purposes of the active trade or business requirement. Accordingly, for § 355(b) purposes, D has acquired the assets of C in a transaction in which gain or loss was recognized in violation of § 355(b)(2)(C).

Taxpayers may not have anticipated that such acquisitions of additional stock of the controlled corporation would adversely impact the controlled corporation's ability to satisfy the active trade or business requirement. Accordingly, the IRS will not challenge the distributing corporation's (or its SAG's) acquisition of additional stock of the controlled corporation as a violation of § 355(b)(2)(C) with respect to the controlled corporation in the case of distributions effected on or before the date the proposed regulations in the NPRM are published as temporary or final regulations in the Federal Register, provided that the transaction satisfies the requirements of § 355(b)(2)(D) as in effect before the enactment of § 355(b)(3).

SECTION 4. COMMENTS

The IRS welcomes comments on whether similar treatment would be appropriate with respect to any other potential effects of the recent amendments to § 355(b).

Comments may be forwarded in the manner provided in the NPRM.

SECTION 5. DRAFTING INFORMATION

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