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## Business Transformations

### IRC 355: Understanding the Basics of a Tax-Free Spin-off

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One disadvantage of forming a Subchapter C corporation is the unfortunate reality of “double taxation.” The first level of taxation occurs when the business pays corporate income taxes on its profits. The second level occurs when the previously taxed profits are distributed to shareholders as dividends. Even if the corporation does not have sufficient cash flow and decides to distribute property that has appreciated in value to its shareholders, the tax is typically unavoidable. IRC 311(b) provides that when a corporation distributes property to a shareholder where the fair market value exceeds its tax basis, the gain shall be recognized to the distributing corporation.

One exception where a corporation is permitted to distribute appreciated property to its shareholders in a tax-free manner is via qualified spin-off under IRC 355. Provided a series of requirements are met, Section 355 can be an excellent option for corporations and their shareholders who are looking to restructure by providing a vehicle to do so tax-free in a type of transaction that otherwise would have created a taxable event. A Section 355 transaction, in its most basic form, involves a parent company (distributing) and a subsidiary of the parent (controlled), both of which are owned by the same shareholders, where the

parent corporation distributes the stock of its subsidiary up the chain to its shareholders. This results in the shareholders ultimately owning shares in two separate entities without surrendering or purchasing additional stock.

Numerous requirements must be met for a transaction to qualify as an IRC 355 spin-off. If met, the transaction will be tax-free to both the corporation and its shareholders. Another tax-related implication to consider in a qualifying spin-off is the treatment of preexisting tax attributes. Preexisting tax attributes (such as net operating losses, capital loss carryforwards, etc.) may remain with the parent or may be allocated between the parent and spun subsidiary, dependent upon the specifics of the restructuring. In addition, the earnings and profits (E&P) will be allocated between the parent and subsidiary pursuant to the applicable regulations and dependent on the details of the transaction. After a completed spin-off, the shareholders must allocate their prespin tax basis in the parent stock between the parent and subsidiary stock (postspin) based upon the relative fair market values of the two stocks. The shareholders’ total tax basis remains unchanged, but it is now bifurcated between two investments.

Numerous requirements, statutory and

nonstatutory, must be understood and met pursuant to Section 355. There are four statutory requirements: control, device restriction, active trade or business, and distribution. The control requirement states that the distributing corporation must be in “control” of the subsidiary prior to the distribution. Control is generally obtained when an entity possesses 80 percent or more of voting power. The device requirement focuses on the purpose of the transaction, and that it is not just a way to distribute earnings. It seeks to prohibit the distribution of E&P to shareholders at more favorable capital gain rates. When confirming this requirement, determination of the “device” will look to the nature, kind, amount, and use of the assets immediately after the transaction. The active trade or business requirement involves both the distributing entity and controlled subsidiary being engaged in the conduct of a trade or business immediately after the distribution. The last requirement looks at the distribution itself, and requires that all of the stock, or at least enough to have “control,” of the controlled subsidiary is what gets distributed.

There are three nonstatutory requirements that are not listed in Section 355, and they include business purpose, continuity of interest, and continuity of business

enterprise. The business purpose requirement requires that the transaction contains a valid corporate business purpose. This is to prevent shareholders from benefiting from the tax-free aspect of Section 355 if the transaction does not appear to be central to the business itself. The continuity of interest requirement relates to the shareholders of both the distributing and the controlled entities, and requires that the shareholders retain their interest in both corporations after the transaction. The final nonstatutory requirement, the continuity of business enterprise, relates to the

continuation of business operations that existed prior to the transaction. This seems to be the least critical, as the IRS has not specifically challenged this requirement in the past as long as the other criteria have been met.

Section 355 is a valuable tool, but it is not without substantial risk. The impact of a transaction that was intended to be an IRC 355 transaction but fails to meet the requirements can be catastrophic. It is extremely important to ensure that all of the requirements have been properly met, with contemporaneous documentation, before

implementation. And it is worth noting that there are even more complexities if foreign entities are involved. 

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