Taking the Spin Off Income

by Benjamin M. Willis

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In this article, Willis analyzes section 355 and whether income is needed to satisfy the active conduct of a trade or business requirement.

Section 355(b) describes the active conduct of a trade or business (ATB) requirement. The IRS is studying whether income is needed to satisfy this requirement. Other than describing various limitations and specific look-through rules, section 355(b) does very little to define trade or business and does not mention income. Section 355(b), however, concludes with a broad grant of regulatory authority. The legislative history indicates the ATB requirement ensured enough time to "produce a product," which we know can take years and can result in losses rather than income.[1]

The ATB requirement was created under the Revenue Act of 1951 through section 112(b)(11)(A), which required that any corporation that is a party to the divisive reorganization "continue the active conduct of a trade or business."[2] Congress explained in the 1951 legislative history of the ATB requirement that "when a spin-off corporation does not stay in business *long enough to produce a product* or render any service, it is patent that it amounts to a tax avoidance scheme"[3] (emphasis added). Thus, presumably if a corporation does "stay in business long enough to produce a product," such as the medical therapies of a pharmaceutical company, for example, the requirement should be met because the business is active even though it hasn't produced income yet.

Under Rev. Rul. 2019-9, 2019-14 IRB 1, issued March 21, the IRS won't apply two 1957 revenue rulings that "could be interpreted as requiring income" to qualify as an ATB while it studies the need for income and substitute guidelines[4] for the many companies with active business that have no income. Bob Wellen explained[5] six factors the

[1] 50 *Cong. Rec.* Vol. 97 (1951), reprinted in Jacob S. Seidman, *Seidman's Legislative History of Federal Income and Excess Profits Tax Laws, 1953-1939*, at 1561 (1954) (remarks of Sen. Humphrey: "But when a spin-off corporation does not stay in business long enough *to produce a product or render any service*, it is patent that it amounts to a tax avoidance scheme" (emphasis added).).

[2] The Revenue Act of 1951 added section 112(b)(11) to the 1939 code. Congress provided an ATB requirement and a device restriction that limited the qualification of tax-free spinoffs made under reorganizations in section 112(g)(1)(D) of the 1939 code. Section 112(b)(11) provided that "if there is distributed, in pursuance of a plan of reorganization, to a shareholder of a corporation which is a party to the reorganization, stock (other than preferred stock) in another corporation which is a party to the reorganization, without the surrender by such shareholder of stock, no gain to the distributee from the receipt of such stock shall be recognized unless it appears that (A) any corporation which is a party to such reorganization was not intended *to continue the active conduct of a trade or business* after such reorganization, or (B) the corporation whose stock is distributed was used principally as a device for the distribution of earnings and profits to the shareholders of any corporation a party to the reorganization" (emphasis added). Under section 112(g)(1)(D) of the 1939 code the term "reorganization" included "(D) 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 shareholders or both are in control of the corporation to which the assets are transferred."

[3] *Supra* note 1.

[4] Emily L. Foster, "Spinoff Rules for No-Income Businesses Could Apply Broadly," *Tax Notes*, Feb. 4, 2019, p. 550.

[5] Foster, "'Guideposts' Revealed for R&D-Intensive Business Spinoffs," *Tax Notes*, Oct. 15, 2018, p. 385.

IRS is considering as substitutes for the provision in reg. section 1.355-3(b)(2)(ii) that "activities *ordinarily* must include the collection of income" (emphasis added) including progress toward developing an income-producing product. Legislative history supports this as a reasonable expectation for businesses in the product development stage.

Where Did the Concern Come From?

Indeed, there is conflicting guidance on the need to qualify under the ATB requirement. Let's begin with the regulatory definition. Under reg. section 1.355-3(b)(2)(ii), a trade or business is defined as a specific group of activities carried on for the purpose of earning income or profit. Under the regulations those activities ordinarily must include the collection of income. Thus, while income is a strong indicator an ATB exists, the word "ordinarily," meaning normally, confirms that the collection is not needed for every activity to constitute an ATB.

While the plain language seems clear, additional guidance seemed to suggest income was necessary. Rev. Rul. 57-492, 1957-2 C.B. 247, found no ATB for oil activities that produced no income, and Rev. Rul. 57-464, 1957-2 C.B. 244, found no ATB when net rental income was incidental to the tested business.[6] However, a third revenue ruling from 1957 allows for more flexibility than those two.

An Exaggerated Concern

In Rev. Rul. 57-126, 1957-1 C.B. 123, a series of disastrous freezes led to a substantial portion of a corporation's fruit being severely damaged, preventing it from earning income from its fresh fruit business for several years. The IRS concluded that because the corporation "maintained the separate identity of the fresh fruit division" and ultimately resumed business, it met the ATB requirement. In short, the requirement was met because the corporation didn't give up on what looked like a failing fruit business. The court in *Spheeris*[7] found that the ATB requirement was not met when no income was generated after a fire destroyed the business because, unlike in Rev. Rul. 57-126, the owner gave up on trying to continue the business.[8]

Further, Rev. Rul. 82-219, 1982-2 C.B. 82, provided a familiar argument: "The use of the word 'ordinarily' in section 1.355-1(c) of the regulations indicates that there are exceptional situations where, based upon all the facts and circumstances, there is no concurrent receipt of income and payment of expenses which, nevertheless, will constitute an active trade or business within the meaning of section 355(b) of the Code." With that rationale, the IRS determined that a one-year interruption of income from the loss of the only customer did not prevent active business status. But by extension, there is no rationale in the ruling that would have prevented satisfying the ATB requirement had the period been longer. Thus, case law and guidance support looking at section 355's general definition of ATB — a specified group of activities carried on for the purpose of earning income or profit.

An Active Analogy

In TAM 200914021, the IRS ruled that a taxpayer could deduct as an ordinary loss under section 165(g)(3) the worthless stock of a wholly owned foreign subsidiary that never had any gross receipts. While the statute could appear to require gross receipts for an ordinary — as opposed to capital — loss they are not required for a subsidiary to conduct an active business. The IRS properly looked to the legislative history in determining the meaning and purpose of the

[6] *See also* Rev. Proc. 2017-52, 2017-41 IRB 283, which requires a table showing gross income for each of the preceding five years be submitted with a ruling request.

[7] *Spheeris v. Commissioner*, 461 F.2d 271 (7th Cir. 1972).

[8] *Id*. at 275 ("The previous rental business at the Wells Street location was discontinued, unlike the fresh fruit marketing association considered in Rev. Rul. 57-126, 1957-1 C.B. 123, on which petitioner relies, where the supply of fruit was almost wiped out by natural disasters in 1949 and 1951 and the existing physical plant, formerly used only in the fruit business, was largely used for a cotton pressing operation, while the fruit business was relatively dormant for five years. Yet the separate identity of the fresh fruit division was maintained and constituted the active conduct of a business during these lean years, and full scale operation was later resumed, at which time the cotton pressing business was transferred to a new corporation in exchange for its stock which was distributed to the members of the association. *There was no question of discontinuing the fruit business*, but only of adding other operations to use the facilities made available by the temporary shortage of fruit" (emphasis added).).

active gross receipts test. The IRS explained its holding in TAM 200914021:

> Shortly after its enactment, section 23(g)(4) was amended by Congress to provide that certain rents and interest earned by an operating company were to be treated as operating income, rather than passive income, in applying the gross income test. See Pub. L. No. 235, section 112(a), 58 Stat. 21, 35 (1944); S. Rep. No. 91-1530, 91st Cong., 2d Sess. 2 (1970), 1971-1 C.B. 617, 618; S. Rep. No. 77-1631, 77th Cong., 2d Sess. 46 (1942), 1942-2 C.B 504, 543; 90 Cong. Rec. S121-122 (daily ed. Jan. 12, 1944) (statement of Sen. Davis). In introducing the amendment, Senator Davis noted that Congress' intent in enacting the gross income test was to permit the loss as an ordinary loss only when the subsidiary was an operating company as opposed to an investment or holding company. The intent of the change, as explained by Senator Davis, was to exclude certain rents and interest derived by a company that was solely an operating company from the scope of passive income in accordance with the intent of Congress. The rent and interest from the sources described were viewed as "incidental to the operating activities of the company" and as arising from a "direct result of its activities as *an operating company*." 90 Cong. Rec. S at 122. [Emphasis added.]

The IRS concluded that the numerical gross receipts test of section 165(g)(3)(B) "should not be applied to deny operating company classification to a truly operating company (with no disqualifying passive income) that just happens to have no gross receipts." In short, if an active operating business is conducted gross receipts are not needed to confirm the subsidiary is not an investment or holding company. Section 355(b) also looks for an active operating business.

Active Businesses Can Lose Money

As explained in Rev. Rul. 2019-9, consideration is being given to "whether a business can qualify as an ATB if entrepreneurial activities, as opposed to investment or other non-business activities, take place with the purpose of earning income in the future, but no income has yet been collected." Many active businesses take years to generate a profit, and as the legislative history to the ATB requirement provides, producing a product can indeed be a business that evidences a goal of earning income, even though it may take many years for that goal to be reached.

There are even investment fund strategies based on acquiring companies that bleed red (generate losses) as long-term holds expected to become profitable eventually. Some profits are certainly worth waiting out research and development phases exceeding five years. A successful vaccine takes roughly 10 years to go from preclinical stages to distribution. While 10 years may seem like a long time to invest in an active business generating no income, it may also seem like a short investment of time if a cure for cancer is on the horizon. ■