ALTERNATIVE TAX-FREE BUSINESS SEPARATIONS INVOLVING LIMITED LIABILITY COMPANIES

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Closely Held Businesses, Advanced Topics
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May 9, 2000
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I. INTRODUCTION

In recent years, tax-free business separations -- particularly "spin-offs" -- have become highly desirable to tax practitioners and have also become subject to increasing scrutiny from the Internal Revenue Service.[1] The spin-off – a term of art describing a particular kind of transaction under Section 355 of the Internal Revenue Code of 1986[2] – is used to achieve a wide variety of business purposes.[3] These business purposes include (1) creating an attractive structure for providing equity compensation to the key employees of a particular business; (2) improving the borrowing capacity of the resulting separate corporations; and (3) protecting corporate assets from liability that stems from high risk lines of business.[4] Under Section 355, a corporation that operates more than one business – either directly or through subsidiary corporations -- may separate those businesses by distributing to its shareholders stock and securities of a subsidiary.[5]

A spin-off can also be misused, however, to extract earnings and profits from corporate solution at capital gains rates; Section 355 thus places significant restrictions on when corporations can engage in tax-free spin-offs.[6] These statutory restrictions are supplemented by additional IRS regulations.[7] All of these restrictions result in a number of "hoops" through which a corporation must pass before tax-free treatment is given. A failure to meet these restrictions will result in double taxation (i.e., the transaction will be taxed at both the corporate

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[1] *See, generally*, Herbert N. Beller, *Tax-Free Corporate Separations Under Section 355*, 428 PLI/Tax 583, 591 (September 1998); *see also* Edward S. Adams and Arijit Mukherji, *Spin-Offs, Fiduciary Duty and the Law*, 68 Fordham L.Rev. 15, 15-16 (October 1999).
[2] I.R.C. § 355 (1999).
[3] Adams, *supra* Note 1, at 39-51.
[4] Candace A. Ridgway, 776-2nd T.M., *Corporate Separations*, A-1 (1999).
[5] *Id.*
[6] *Id.*
[7] Treas. Reg. §1.355-0, *et seq.*

and shareholder levels).[8]

With recent developments in limited liability company (LLC) law, a corporation may achieve three of the commonly asserted corporate business purposes – key employee, enhance borrowing position, and reduction of risk, -- for a Section 355 separation, while avoiding the onerous requirements imposed by Section 355. With the advent of the IRS' "check-the-box" regulations and state one-member LLC statutes, a corporation can achieve a similar tax result as it would under Section 355.[9] This "alternative spin-off", however, differs significantly from the traditional 355 form with respect to shareholder consequences.[10] Moreover, this alternative is not available for six of the most common business purposes.[11]

This paper compares a traditional Section 355 tax-free spin-off with the alternative LLC form, with an emphasis on the key employee, borrowing enhancement and risk reduction business purposes. This paper first discusses the "spin-off" concept, and the purposes that could motivate a spin-off. This paper next discusses Section 355 and the significant restrictions it imposes on spin-offs. This paper then discusses the recent changes in limited liability company law which provide an alternative means with which to accomplish certain business purposes associated with a Section 355 transaction. This paper then compares the consequences of the alternative LLC form and the traditional Section 355 spin-off.

II. TAX-FREE SEPARATIONS UNDER I.R.C. SECTION 355: AN OVERVIEW

A. Section 355 Separations Generally

Section 355 of the Internal Revenue Code of 1986 (the "Code") allows a tax-free separation of the ownership of two or more businesses, or the division of a single business into

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[8] Beller, *supra* Note 1, at 591.
[9] *See* Section V, *infra*.
[10] *See* Section VI(C), *infra*.
[11] *See* Section VI(B), *infra*.

two or more businesses separately owned.[12] This is accomplished by allowing a corporation (the "Distributing Corporation") to distribute the stock and/or securities of one or more corporations it controls (the "Controlled Corporation").[13] The Controlled Corporation may be a pre-existing subsidiary that already operates the business intended to be spun-off, or it can be newly created.[14] The Distributing Corporation can spin-off a division of a business, or can otherwise vertically divide a single business, by transferring the assets intended to be spun-off to a newly created Controlled Corporation and distributing the stock of the Controlled Corporation.[15]

B. Types of Section 355 Separations

Section 355 contemplates three types of tax-free separations: spin-offs, split-offs and split-ups[16].

1. Spin-Off

A spin-off is a pro rata distribution of Controlled Corporation's stock and/or securities to Distributing Corporation's shareholders.[17] In other words, the Distributing Corporation distributes the Controlled Corporation stock in proportion to the shareholders' Distributing Corporation stock.[18] None of the distributee-shareholders surrenders any stock in the Distributing Corporation.[19] Distributing Corporation's shareholders afterwards hold stock in two

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[12] I.R.C. § 355

[13] *Id.* Although the Section 355 (and commentary on Section 355) use the terms "Distributing Corporation" and "Controlled Corporation" in describing the spin-off transaction, the term "Controlled Corporation" is something of a misnomer. "Controlled Corporation" refers to the Distributing Corporation's control of its subsidiary prior to the spin-off. Once the spin-off occurs, however, the "Controlled Corporation" is not "controlled" by the Distributing Corporation at all. The Distributing Corporation divests itself of control in the Controlled Corporation. I.R.C. §§ 355(a)(1)(D)(i), (ii). A more appropriate term for the spun-off subsidiary would be the "Spun Corporation."

[14] Beller, *supra* Note 1, at 595.

[15] Louis Freeman and Thomas M. Stephens, *Section 355: Tax-Free Spin-Offs, Split-Offs, Split Ups Uses and Requirements*, 391 PLI/Tax 293, 299 (1996).

[16] *Id.* at 300; *see also* Beller, *supra* Note 1, at 595-596; Robert A. Rizzi, *Selected Issues in Spin-Offs, Split-Offs and Split-Ups*, 453 PLI/Tax 803, 809 (October-November 1999).

[17] Freeman, *supra* Note 15, at 300.

[18] *Id.*

[19] *Id.*

corporations, Distributing Corporation and Controlled Corporation.[20]

2. Split-Off

A split-off is a distribution of stock in exchange for stock of Distributing Corporation.[21] Each shareholder allowed to choose between retaining all Distributing stock or turning in some or all for Controlled Corporation stock.[22]

3. Split-Up

A split-up is the spin-off of two or more controlled subsidiaries, followed by Distributing Corporation's liquidation.[23]

C. How A Tax-Free Spin-Off Works

In order to demonstrate how a Section 355 spin-off works, assume that Corporation A, a corporation with five (5) shareholders, is engaged in computer manufacturing. Also assume that Corporation A owns a subsidiary, Corporation B, that produces and sells a line of frozen foods. Corporation A wishes to separate each business into a separate corporation. Under Section 355, assuming that Corporation A can meet the requirements, Corporation A can distribute the Corporation B stock to Corporation A's five shareholders in proportion to the shareholders' Corporation A stock. The shareholders then hold stock in Corporation A and Corporation B. This is the traditional spin-off. Corporation A is the Distributing Corporation, and Corporation B is the Controlled Corporation.

D. Tax Consequences of Section 355

In the absence of Section 355, if the fair market value of the Controlled Corporation's stock were to exceed the adjusted basis in the hands of the Distributing Corporation, Section

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[20] Beller, *supra* Note 1, at 17.
[21] *Id.*
[22] *Id.* A split-off is usually used in closely-held context to separate business among feuding owners or ownership groups. *Id.* at 301.

311(b) would mandate that the Distributing Corporation recognize a gain equivalent to the appreciation of the distributed stock.[24] In addition, the shareholders of the Distributing Corporation would have to include in their gross income the fair market value of the stock, which would be taxable as a dividend to the extent of earnings and profits.[25] Section 355, however, provides shelter from immediate double taxation, provided certain requirements are met.[26]

1. Nonrecognition

If Section 355's requirements are met, no gain or loss is recognized to and no amount shall be includable in the income of shareholders or security holders.[27] Additionally, no gain or loss shall be recognized to a corporation on any Section 355 distribution.[28]

2. Stock Basis

The basis of stock or securities received in a Section 355 transaction is determined under I.R.C. Section 358 with reference to the basis of stock or securities of the Distributing Corporation surrendered (or, in the case of a spin-off, deemed surrendered).[29] In a spin-off, the distributee-shareholder's prior basis in the stock of the Distributing Corporation is allocated on a relative fair market value basis to the Distributing and Controlled Corporation shares such shareholder ends up holding.[30] Stock basis may be adjusted by the amount of gain the

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[24] I.R.C. § 311(b); *see also* Adams, *supra* Note 1, at 19. Section 311(b) requires a corporation distributing appreciated property to a shareholder to recognize a gain "as if such property were sold to the distributee at fair market value." I.R.C. §311(b).

[25] I.R.C. §61(a)(7); §§ 301, 316 & 317(a); *see also* Adams, *supra* Note 1, at 19.

[26] I.R.C. §355; *see also* Adams, *supra* Note 1, at 19. For a discussion of Section 355's requirements, see Section III, *infra.*

[27] I.R.C. §355(a)(1)

[28] I.R.C. §355(c)(1)

[29] I.R.C. §§ 358(b)(2), (c)

[30] *Id.* If the distributee ends up with shares in only one corporation (e.g., in a split-up or a split-off in which all of such shareholder's Distributing Corporation shares are surrendered), the shareholder's basis in the new Controlled Corporation shares is the same as such shareholder's basis in the surrendered Distributing Corporation shares. *Id.*

shareholder recognizes and by the value of taxable property the shareholder receives.[31]

E. Uses for Tax Free Spin-Offs

Spin-offs may be undertaken to achieve a wide variety of business objectives.[32]

1. Provide Equity Compensation to a Key Employee

A corporation may employ a spin-off to create an attractive structure for providing equity compensation to the key employees of a particular business.[33] In fact, one of the most commonly asserted reasons for doing a spin-off is to enable existing or prospective "key employees" to obtain a direct equity interest in the particular business in which they work.[34] The expectation is that the employee will be better motivated to maximize the performance of his or her corporate duties.[35]

2. Enhance Borrowing Capacity

A spin-off may also be useful to improve the borrowing capacity of the resulting separate corporations.[36] Borrowing capacity is improved where a lender is willing to give more favorable treatment to one or both corporations than it would to a larger corporation.[37]

3. Risk Reduction Among Lines of Business

Risk reduction/asset protection is another common purpose that may motivate a corporation to engage in a spin-off.[38] One line of a corporation's business may, at times, place

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[31] I.R.C. § 358(a). New section 358(g) grants the Treasury broad regulatory authority to prescribe regulations which require basis adjustments in connection with intra-group Section 355 transactions. I.R.C. § 358(g); *see also* Beller, *supra* Note 1, at 691. This new section was prompted by Congress' concern that affiliated groups could manipulate their outside bases through the use of tax-free intragroup spin-offs. *Id.* Congress was also concerned that intragroup spin-offs occurring within a consolidated group could have the effect of avoiding the excess loss account recapture provisions under the consolidated return regulations. *Id.*

[32] Ridgway, *supra* Note 4, at A-1.

[33] *Id.*

[34] Beller, *supra*, Note 1 at 637.

[35] *Id.*

[36] Ridgway, *supra* Note 4, at A-1.

[37] *Id.*

[38] Adams, *supra* Note 1, at 30.

its other lines of business at risk.[39] For example, a reputable financial services firm's image and stock price can be damaged if a particular division incurs large losses or over-exposes itself to certain liabilities, even though the overall health of the firm is strong.[40] Similarly, a company may find that a certain line of business carries potential environmental or other tort liabilities that make its shareholders uncomfortable.[41] In such situations, spin-offs are a possible solution.[42]

4. Other Common Business Purposes

A spin-off can also be used to reduce non-federal taxes[43], or to reduce regulatory costs.[44] Regulatory costs are reduced because the spin-off of a regulated subsidiary frees the Distributing Corporation from the substantial administrative expense and time required by state and/or federal licensing procedures.[45] Spin-offs can resolve shareholder conflicts in closely-held corporations by separating the shareholders' business interests (i.e. a split-off or split-up).[46] Management operating conflicts resulting from housing disparate businesses under the same roof can be accomplished through a spin-off (the "fit and focus" rationale).[47] The theory behind "fit and focus" is that a corporation may not efficiently conduct those lines of business which are separate from the corporation's core business.[48] A spin-off of the non-core business(es) thus allows those lines to be run more efficiently.[49]

A spin-off may also be utilized to enhance capital investment in the corporation.[50] In the

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[39] *Id.*
[40] *Id.*
[41] *Id.*
[42] *Id.*
[43] Ridgway, *supra* Note 4, at A-1.
[44] *Id.*
[45] Beller, *supra* Note 1, at 648; *see also* Rev. Rul. 88-33, 1988-1 C.B. 115 (spin-off of regulated subsidiary freed Distributing Corporation "from the substantial continuing administrative expense and time" required by state licensing procedures).
[46] Ridgway, *supra*, 1, at A-1.
[47] *Id.*; *see also* Beller, *supra* Note 1, at 650; Adams, *supra* Note 1, at 44-46.
[48] Beller, *supra* Note 1, at 650.
[49] *Id.*
[50] Adams, *supra* Note 1, at 41-42.

publicly-held context, a corporation with a subsidiary may use a spin-off to position one or both of the corporations for a public offering of stock or debt securities. The issuer-corporation can usually obtain a higher stock price from the separation, because two separate corporations result, and investors typically prefer to own stock in a parent corporation rather than in a controlled subsidiary.[51]

A spin-off can also enhance a corporation's access to equity in the closely held context.[52] It might be easier for a parent corporation in need of additional capital to attract new investors if an undesirable subsidiary is spun-off.[53] For example, investors may be deterred from investing in a computer software company because the company carries significant long-term debt in a wholly-owned real estate subsidiary. In such a case, a spin-off is useful to separate the two businesses and thereby stimulate investment in the software company.

The final commonly asserted purpose for a spin-off is to tailor either the Distributing Corporation or the Controlled Corporation to participate in a tax-free reorganization.[54] This usually involves spinning off unwanted assets prior to merger or acquisition.[55]

F. Congressional and IRS Scrutiny of Section 355 Separations

Despite the many uses of Section 355 separations – particularly spin-offs, the potential misuse of separations to extract earnings and profits from corporate solution has made such transactions subject to continuing Congressional scrutiny.[56]

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[51] Freeman, *supra* Note 15, at 371.
[52] Adams, *supra* Note 1, at 42-43.
[53] *Id.*
[54] Ridgway, *supra* Note 4, at A-1.
[55] *Id.*
[56] Adams, *supra* Note 1, at 18. Section 203(c) of the Revenue Act of 1924 first gave nonrecognition treatment to spin-offs when it provided that if there was a distribution of stock or securities to a shareholder pursuant to a plan of reorganization without the surrender of stock or securities by the shareholder, no gain would be recognized by the shareholder from the receipt of such stock. *Id.* This provision granted a blanket exemption that served as a device to avoid the tax on dividend income, an exemption that remained until the landmark case of *Gregory v. Helvering*, 293 U.S. 465(1935), promulgated the business purpose test. *Id.* In *Gregory*, the taxpayer attempted to extract assets (stock in another corporation) to a newly organized subsidiary, which was dissolved immediately thereafter and the

Additionally, the IRS increased its scrutiny of tax-free spin-offs, due to the repeal of the *General Utilities* Doctrine in 1986.[57] In *General Utilities & Operating Co. v. Helvering*,[58] the U.S. Supreme Court held that a corporation distributing property to its shareholders derived no taxable gain, since the distribution was not a sale and assets were not used to discharge indebtedness.[59] The Court's holding became known as the *General Utilities* doctrine.[60]

Congress repealed the doctrine in 1986 with the enactment of I.R.C. Section 311, which provides that a corporation's distribution of appreciated property to its shareholders results in taxable gain to the corporation.[61] Thus, since the repeal of the *General Utilities* doctrine, Section 355 transactions -- particularly spin-offs -- have been the principal means of splitting up existing corporate structures on a tax-free basis.[62]

Because Section 355 is, except in certain situations, the only means left for a corporation to distribute appreciated property to its shareholders without the corporation recognizing taxable gain, the IRS heavily scrutinizes Section 355 separations.[63]

III. TRADITIONAL SPIN-OFFS: REQUIREMENTS

Section 355 and the Treasury Department's regulations under Section 355 contain six

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assets distributed to the taxpayer. *Id.* In ruling against the taxpayer, the Supreme Court stated that although the transaction was in full compliance with the letter of the spin-off statute, it was devoid of any business purpose and was thus indistinguishable from an ordinary dividend. *Id.* Even before the *Gregory* case reached the Supreme Court, Congress enacted the Revenue Act of 1934, which treated spin-offs as ordinary distributions to be taxed as dividends. *Id.* After several proposals to reinstate the spin-off as a vehicle for a tax-free reorganization, Congress finally amended the Internal Revenue Code in 1951 to provide a tax-free spin-off under Section 112(b)(11) but incorporated the device test into the provision to deter tax avoidance practices. *Id.* Through the 1954 amendments, Congress loosened restrictions on the types of spin-offs qualifying for tax-free status, but tightened the requirements for qualification. Ridgway, *supra* Note 4, at A-2. Section 112(b)(11) was finally replaced in 1954 by the far more elaborate provisions of Section 355, which now appear as amended in 1986. Adams, *supra* Note 1, at 19.

[57] Ridgway, *supra* Note 4, at A-2.

[58] 296 U.S. 200 (1935).

[59] *Id.*

[60] Beller, *supra* Note 1, at 591; *see also* Freeman, *supra* Note 15, at 301; Rizzi, *supra* Note 16, at 809; Adams, *supra* Note 1, at 18-19.

[61] I.R.C. § 311(b) (1999).

[62] Beller, *supra* Note 1, at 591; *see also* Freeman, *supra* Note 15, at 301; Rizzi, *supra* Note 16, at 809; Adams, *supra* Note 1, at 18-19.

requirements for spin-off to qualify for tax-free treatment.

A. Control

First the Distributing Corporation must control the Controlled Corporation immediately before the transaction.[64] Control is determined under I.R.C. §368(c), which requires that the distributing corporation hold stock constituting 80% of the total combined voting power of all classes of stock entitled to vote and 80% of the total number of shares of all other classes (which has been interpreted to mean 80%) of each non-voting class).[65]

B. Distribution of All Stock and/or Securities of Controlled

Second, the Distributing Corporation must distribute all of the stock of and securities of the Controlled Corporation or, if the IRS is satisfied that no tax avoidance motive exists, a lesser amount which at least constitutes control of the Controlled Corporation.[66]

C. Device

Third, the transaction may not be used principally as a device for the distribution of earnings and profits of either the Distributing or Controlled Corporation.[67] Evidence of device includes: (1) a substantially pro rata distribution;[68] (2) a subsequent sale of stock of either Distributing or Controlled after distribution;[69] (3) the exchange of assets not used in a trade or

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[63] *Id.*
[64] I.R.C. § 355(a)(1)(A)
[65] I.R.C. §368(c). An additional control requirement imposed when the transaction involves a "D" reorganization. *Id.* A "D" reorganization is a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor, or one or more shareholders (including persons who were shareholders immediately before the transfer), or any combination thereof, is in control of the corporation to which the assets are transferred; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under [I.R.C.] § 354, 355, or 356. I.R.C. § 368(a)(1)(D). In a "D" reorganization, either the Distributing Corporation or its shareholders, or some combination, must control the Controlled Corporation immediately after the transaction. §368(c).
[66] I.R.C. § 355(a)(1)(D)(i), (ii)
[67] *Id.* §355(a)(1)(B)
[68] Treas. Reg. § 355-2(d)(2)(ii)
[69] *Id.* §1.355-2(d)(2)(iii). The greater the amount of stock sold or the shorter the period between distribution and sale, the greater the evidence of device. *Id.* The IRS' concern is that the spin-off may be part of a plan or intention on the part of the corporation's shareholders to sell either their Distributing or Controlled Corporation stock after the

business satisfying active business requirement, particularly cash and liquid assets;[70] (4) either of the businesses involved in the spin-off is a "secondary business" -- one whose principal function is to serve the business of the other corporation -- remains so after the distribution, and can be sold without adversely affecting the business of the other corporation.[71]

Evidence of device does not necessarily mean transaction will be treated as device, and strong business purpose can overcome evidences of device.[72] The primary evidence of non-device is a corporate business purpose.[73] To determine the business purpose, three factors are to be examined. The first factor is the importance of achieving the purpose to success of business.[74] The second factor is the extent the purpose is prompted by persons/circumstances outside control of corporation.[75] The third and final factor is the immediacy of the conditions prompting transaction.[76]

Other non-device evidence includes (1) whether the Distributing Corporation publicly traded and widely held;[77] and (3) whether the distribution is made to domestic corporate shareholders.[78]

D. Active Trade or Business

Fourth, both the Distributing and Controlled Corporations must be engaged in the active conduct of a trade or business immediately after the transaction.[79] Both Distributing and Controlled must have been actively conducted throughout 5-year period ending on date of

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transaction. Freeman, *supra* Note 15, at 333. Such a concern is not present where the corporation's stock is publicly traded and the selling shareholders are not officers, directors or greater than 1% shareholders. *Id.*

[70] *Id.* §1.355-2(d)(2)(iv)(B).

[71] *Id.* §1.355-2(d)(2)(iv)(C).

[72] *Id.* §1.355-2(d)(3).

[73] *Id.* §1.355-2(d)(3)(ii). This business purpose is separate from the independent business purpose. *Id.*, §1.355-2(b)(1). The independent business purposed is discussed at Section III(F), *infra*.

[74] Treas. Reg. §1.355-2(d)(3)(ii)(A).

[75] *Id.* §1.355-2(d)(3)(ii)(B)

[76] *Id.* §1.355-2(d)(3)(ii)(C)

[77] *Id.* §1.355-2(d)(3)(iii).

[78] *Id.* §1.355-2(d)(3)(iv).

distribution.[80] Changes in the trade or business during the 5-year period will be disregarded unless the changes are of such a character as to constitute the acquisition of a new or different business.[81] Acquisitions within 5-year period treated as expansion and treated as actively conducted for 5-year period if acquired business is one in the same line of business.[82] "Trade or Business" means a specific group of activities carried on by the corporation for the purpose of earning income or profit.[83] "Active" means the corporation itself must perform active and substantial management and operational functions.[84] This is a facts and circumstances test.[85]

E. Continuity of Interest

Fifth, there must be continuity of interest of proprietary ownership and business enterprise.[86] One or more persons who were owners of the enterprise (directly or indirectly) prior to the transaction continue to own, in the aggregate, an amount of stock establishing a continuity of interest in each of the modified corporate forms in which the enterprise is conducted after the transaction.[87] Continuity must be met for each post-exchange corporations.[88] Each shareholder does not, however, need to own an interest in each corporation.[89] Shareholders usually have to hold on to stock for 2 years following distribution to meet this requirement.[90] Essentially, this requirement prevents addition of new shareholders in course of spin-off.[91]

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[79] I.R.C. §355(b)(1)(A); Treas. Reg. §1.355-3(a)(1).
[80] I.R.C. §355(b)(2)(A), (B).
[81] Treas. Reg. §1.355-3(b)(3)(ii).
[82] Freeman, *supra* Note 15, at 325.
[83] Treas. Reg. §1.355-3(b)(2)(ii).
[84] Rev. Rul. 88-19, 1988-1 C.B. 114.
[85] *Id.*
[86] Treas. Reg. §1.355-2(c)(1).
[87] *Id.*
[88] Freeman, *supra* Note 15, at 342.
[89] *Id.*
[90] *Id.*

F. Independent Corporate Business Purpose

Sixth, there must be a valid corporate business purpose for the distribution.[92] This requirement receives the most scrutiny from the IRS, especially after *General Utilities* repeal in 1986).[93] This requirement's purpose is to "provide 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."[94] "Business exigencies" connotates a greater urgency that merely having a reason for the transaction.[95] If a corporate business purpose can be achieved through a nontaxable transaction that does not involve the distribution of stock of a controlled corporation and which is neither impractical nor unduly expensive, then the separation is not carried out for that corporate business purpose.[96] A corporation contemplating a spin-off typically requests an IRS private letter ruling approving the corporate business purpose.[97] In Revenue Procedure 96-30[98], the IRS has provided guidance to corporations on what business purposes and what proof will result in a favorable private letter ruling.

IV. REVENUE PROCEDURE 96-30: REQUIREMENTS FOR VALID BUSINESS PURPOSE

Appendix A to Rev. Proc. 96-30 lists nine explicit acceptable (although non-exclusive) corporate business purposes which the IRS deems acceptable.[99] In addition, Appendix A lists the

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[91] *Id.*
[92] Treas. Reg. §1.355-2(b)(1).
[93] Beller, *supra* Note 1, at 591; *see also* Freeman, *supra* Note 15, at 302.
[94] Treas. Reg. §1.355-2(b)(1)
[95] *Id.*
[96] *Id.* §1.355-2(b)(3).
[97] Freeman, *supra* Note 15, at 350.
[98] 1996-1 C.B. 696.
[99] Appendix A, Rev. Proc. 96-30, 1996-1 C.B. 696. Other acceptable purposes not mentioned in Rev. Proc 96-30 but approved by the IRS in private letter rulings include: (1)avoidance of regulatory burdens; (2) reduction of non-federal taxes; (3) compliance with law (i.e., court-ordered split-up); (4) avoiding a hostile takeover; (5) labor problems; (6) resolution of shareholder differences; (7) enhance profitability; and (8) enhance shareholder value. *See generally,* Beller, *supra* Note 1, at 670-676.

types of documentation required to show each purpose.[100] Of the acceptable purposes specified, three purposes -- key employee, enhance borrowing position, and risk reduction -- can be accomplished through the alternative form.[101] The discussion of documentation requirements will thus be limited to these three purposes.

A. Key Employee

The IRS recognizes providing equity compensation to a key employee as a valid corporate business purpose.[102] In order to obtain a favorable letter ruling on this purpose, the corporation must make three showings. First, the corporation must show that the transfer will accomplish a real and substantial corporate business purpose; namely, the corporation must explain why it is necessary to give its employee(s) equity interest in the type and amount proposed.[103] Second, the corporation must show that a significant percentage (by value) of voting stock will be transferred to the employee(s) within one (1) year of the distribution.[104] Such a showing is not required if it would be prohibitively expensive for the employee(s) to purchase such a significant amount.[105] Third, the corporation must show that the objective to be accomplished by stock transfer cannot be accomplished by an alternative nontaxable transaction that is not unduly expensive.[106]

B. Enhance Borrowing Position

The IRS also accepts as a valid business purpose for a spin-off a corporation's desire to

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[100] Appendix A, Rev. Proc. 96-30, 1996-1 C.B. 696.
[101] The remaining six acceptable purposes listed in Appendix A – enhance stock offering, fit and focus, competition, cost savings, facilitating an acquisition of the Distributing Corporation, and facilitating an acquisition by Distributing or Controlled – cannot be accomplished through the alternative form. See Section V(B), *infra*.
[102] Rev. Proc. 96-30, 1996-1 C.B. 696, Appendix A, § 2.01
[103] *Id.* § 2.01(1).
[104] *Id.* § 2.01(2).
[105] *Id.*
[106] *Id.* § 2.01(3). An interesting note is that the IRS specifically references the use of an LLC in this context. *Id.*

enhance its borrowing position and facilitate access to non-equity financing.[107] In order to obtain a favorable letter ruling on this purpose, the corporation must make four showings. First, the corporation must show that either the Distributing Corporation or the Controlled Corporation needs to raise substantial amount of capital in near future to fund business needs.[108] Second, the corporation must show that the proposed separation will enable the corporation to borrow significantly more money or borrow on significantly better financial terms.[109] Expert analysis and support is required to make this showing.[110] Third, the corporation must show that the funds raised in borrowing will be used to meet corporate business needs.[111] Fourth, the corporation must show that borrowing will be completed within one year of distribution.[112]

C. Reduction of Risk

The IRS allows a corporation to engage in a tax-free spin-off where the corporation's business purpose is to reduce risks or liabilities.[113] The corporation must make three showings. First, the corporation must address the nature and magnitude of purported risks, including a history of claims or an analysis of similar businesses.[114] Second, the corporation must describe whether the existing assets and insurance of the business are sufficient to meet reasonably anticipated claims.[115] Finally, the corporation must describe whether, under existing law, the distribution will significantly enhance the protection of the other businesses and whether an alternative nontaxable transaction would provide similar protection.[116]

Essentially, the IRS takes the position that Section 355 is a remaining "loophole" after

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[107] *Id.* § 2.03
[108] *Id.* § 2.03(1).
[109] *Id.* § 2.03(2).
[110] *Id.*
[111] *Id.* § 2.03(3).
[112] *Id.* § 2.03(4).
[113] *Id.* § 2.09
[114] *Id.* § 2.09(1)
[115] *Id.* § 2.09(2)

General Utilities repeal, and it is the IRS' job to close the loophole by making it difficult to use Section 355. The IRS accomplishes this objective through the onerous reporting requirements demanded in exchange for a favorable letter ruling. If a corporation chooses not to obtain a letter ruling in advance of the spin-off, the corporation risks double taxation.[117]

As a result of the IRS' posture towards Section 355, a corporation with a legitimate business purpose must either (1) meet the IRS' onerous documentation requirements necessary to obtain favorable private letter ruling; (2) forego a private letter ruling and risk double taxation treatment if the IRS subsequently disapproves of the spin-off transaction; or (3) forego the spin-off altogether. The IRS' requirements thus have a "chilling effect" on Section 355 transactions.

IV. "ALTERNATIVE" TAX-FREE SPIN-OFFS: THE ROLE OF LIMITED LIABILITY COMPANIES

Two recent developments in limited liability company ("LLC") law make an "alternative tax-free spin-off" possible: (1) the "check-the-box" regulations; and (2) state one-member LLC statutes.[118]

A. Check-the-Box Regulations

The "Check-the-box" regulations, adopted in January 1, 1997 specify that unless an election is made, a one-member LLC is disregarded for federal tax purposes.[119] If the one member is a corporation, the LLC is treated as a division of the corporation.[120]

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[116] *Id.* § 2.09(3)

[117] *See* discussion at Section II(D), *infra.*

[118] Mark J. Silverman, Lisa M. Zarlenga and Derek E. Cain, *Use of Limited Liability Companies in Corporate Transactions*, 449 PLI/Tax 239, 292-293 (October-November 1999)(discussing mechanics of spin-off with one-member LLCs).

[119] Treas. Reg. §301.7701-3(b)(ii). This approach has, and should have, nothing to do with efforts to pierce the veil of a one-member LLC. Daniel S. Kleinberger and Carter G. Bishop, *Limited Liability Companies: Tax and Business Law*, Cumulative Supplement No. 2, S6-11 (1999). Tax classification has never been a factor in piercing analysis. *Id.*

The one-member LLC is similarly disregarded for state tax purposes where the state adopts the federal tax classification rules.[121] To date, all states have so adopted except for Arkansas (domestic LLCs taxed as partnerships), Michigan (LLCs subject to single business tax and members subject to tax on LLC income), Mississippi (one-member LLC not disregarded for corporate franchise tax), Nevada (no state income tax), New Hampshire (federal adoption only with regards to multi-member LLCs), Pennsylvania (statute unclear whether one-member LLC is disregarded), South Dakota (no state income tax), Texas (LLCs subject to corporate franchise tax, and Wyoming (no state income tax).[122]

B. State One-Member LLC Statutes

Following the check-the-box regulations, most states amended their LLC statutes and now permit one-member LLCs.[123] Only Massachusetts, South Dakota, and the District of

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[120] *Id.* Prior to January 1, 1997, the entity classification regulations, referred to as the Kintner Regulations, applied a four-factor test for determining whether an entity was classified as a corporation or a partnership for Federal tax purposes. A business entity was classified as a corporation if it had more than two of the following corporate characteristics: (1) limited liability; (2) centralization of management; (3) free transferability of interests and (4) continuity of life. Old Treas. Reg. §301.7701-2.

[121] Bruce P. Ely and Christopher R. Grissom, *State Tax Treatment of Limited Liability Companies and Registered Limited Liability Partnerships*, ALI-ABA Course of Study Representing the Growing Business: Tax, Corporate, Securities and Accounting Issues (March 18-20, 1999).

[122] *Id.*

[123] (Statutes permitting single-member LLCs) Ala. Code § 10-12-9 (1999); Alaska Stat. § 10.50.155(a)(1)(B)(2)(1999); Ariz. Rev. Stat. § 29-601.8(a)(1999); Cal. Corp. Code § 17050(b) (1999); Colo. Rev. Stat. § 7-80-203 (1999); Conn. Gen. Stat. § 34-101(9)(1999); Del. Code tit. 6, § 18-101(6)(1999); Fla. Stat. § 608.405(1999); Ga. Code Ann. § 14-11-101(12) (1999); Haw. Rev. Stat. § 428-202 (1999); Idaho Code § 53-603 (1999); Ill. Comp. Stat. §180/5-1 (1999); Ind. Code § 23-18-11 (1999); Iowa Code §490A.102.13 (1999); 1999 Kansas Laws ch. 119, §2(f) (1998); Ky. Rev. Stat. § 275.020 (1999); La. Rev. Stat. § 12:1301(A)(10)(1999); Me. Rev. Stat. tit. 31, § 621 (1999); Md. Code, Corps. & Ass'ns. § 4A-202(a)(1999); Mich. Comp. Laws § 450.450(1999); Minn. Stat. § 322B.11 (1999); Miss. Code § 79-29-103(h); Mo. Stat. § §347.015 (1999); Mont. Code § 35-8-201 (1999); Neb. Rev. Stat. § 21-2605 (1999); Nev. Rev. Stat. § 86.151.3 (1999); N.H. Rev. Stat. § 304-C:1(V) (1999); N.J. Stat. § 42:2B-2 (1999); N.M. Stat. § 53-19-7 (1999); N.Y. Ltd. Liab. Comp. Law § 102(m) (1999); N.C. Gen. Stat. § 57C-2-20(a) (1999); N.D. Cent. Code § 10-32-06 (1999); Ohio Rev. Code § 1705.04(A) (1999); Okla. Stat. tit. 18, § 2001.12 (1999); Or. Rev. Stat. § 63.001(13) (1999); 15 Pa. Cons. Stat. § 8912 (1999); R.I. Gen. Laws § 7-16-2(m) (1999); S.C. Code § 33-44-202 (1999); Tex. Rev. Civ. Stat. art. 1528n, §401(A) (1999); Utah Code § 48-2b-103(2)(a) (1999); Vt. Stat. tit. 11, § 3022 (1999); Va. Code Ann. § 13-1.1010 (1999); Wash. Rev. Code § 25.15.270 (1999); W. Va. Code § 31B-2-202 (1999); Wis. Stat. § 183.0201 (1999); Wyo. Stat. § 17-15-144(d).

Columbia retain a two-member requirement.[124] Additionally, while Tennessee permits a one-member LLC, the statute specifies that the members must be individuals.[125]

A corporation is permitted to wholly own a one-member LLC.[126] If a particular state does not allow one-member LLCs, a corporation may organize its wholly-owned LLC in a state which does allow one-member LLCs and then qualify the LLC in the states where it does business.[127]

C. Performing an Alternative Tax-Free Spin Off

The alternative spin-off requires three steps. First, the Parent Corporation[128] organizes a one-member LLC ("Single Member LLC") with the Parent Corporation as the sole member.[129] Second, the Single Member LLC does not elect corporate tax treatment under the "check-the-box" regulations, thus giving the Single Member LLC a default tax classification status of a "disregarded entity."[130] Third, the Parent Corporation then "drops down" the assets from the line of business to be separated into the LLC in exchange for a one hundred percent (100%) membership interest in the LLC.

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[124] D.C. Code § 29-1301(16) (1999); Mass. Gen. Laws ch. 156C §2; S.D. Cod. Laws § 47-34-4.1;
[125] Tenn. Stat. § 48-203-102.
[126] I.R.C. § 7701(a)(1).
[127] Michael J. Grave, *Continuing Adventures of Disregarded Entities*, 439 PLI/Tax 579, 585 (June 1999). A one-member LLC's shield should not be in danger of piercing in the jurisdictions that still maintain a two-member requirement for its domestic LLCs, for two reasons. Kleinberger and Bishop, *supra* Note 119, at S6-11. First, these jurisdictions' enabling statutes expressly defer to the law of a foreign LLC's state of organization on questions pertaining to the personal liability of members as members. *Id.* Second, principles of choice of law and comity mandate such deference unless the foreign state's rule interferes with some fundamental public policy of the forum state. *Id.*
[128] For purposes of clarity, the designations "Parent Corporation" and "Single Member LLC" will supplant the "Distributing Corporation" and "Controlled Corporation" terminology used in the traditional spin-off context.
[129] It should also be noted that, if the Parent Corporation is an subchapter S corporation, each of the three business purposes discussed at Section VI(B), *infra*, which can be accomplished with a one-member LLC could also be accomplished with a qualified subchapter S corporation subsidiary ("QSSS"). Silverman, *supra* Note 118, at 255. A QSSS – a subsidiary which is owned at least 80% by an S corporation – is not treated as a separate corporation. I.R.C. § 1361(b)(3)(A). All of the QSSS' assets, liabilities, and items of income, deduction and credit are treated as those of its owner. *Id.*; *see also* Silverman, *supra* Note 118, at 255.
[130] Treas. Reg. §301.7701-3(b)(ii).

D. Split-Offs and Split-Ups with Limited Liability Companies

While limited liability companies provide an alternative means to accomplish certain business purposes motivating a tax-free spin-off, no such alternatives exist for performing split-offs and split-ups.

The split-off is typically used to break up a business among a group of conflicting shareholders.[131] Any alternative Section 355 separation involving a one-member LLC will keep the entire business of the Parent Corporation under one-roof, and will not result in a distribution of stock or securities of the Single-Member LLC. The shareholder conflict thus cannot be resolved with the alternative.

If the split-off is desired for reasons other than the resolution of a shareholder conflict, an "imperfect alternative" does exist. For example, assume that the Parent Corporation operates two lines of business and has two shareholders. Shareholder A wishes to manage Business 1 and Shareholder B wishes to manage Business 2. The shareholders could, in that case, agree to do an alternative spin-off as described above, dropping the assets of each business into two single-member LLCs. The shareholders could then agree that each shareholder will manage the business of one LLC, with the Parent Corporation's ownership structure left unaffected.

The split-up, which involves multiple spin-offs followed by the liquidation of the Distributing Corporation, is impossible in the LLC context. The liquidation of the corporation to its shareholders will, be a taxable event.[132]

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[131] *See* Freeman, *supra* Note 15, at 301.
[132] *See* I.R.C. § 302.

VI. CONSEQUENCES OF THE ALTERNATIVE TAX-FREE SPIN-OFF

A. Parent Corporation's Tax Treatment

Like the traditional spin-off, the alternative form results in no tax to the Parent Corporation or its shareholders.[133] The alternative form's tax-free treatment, however, does not flow from Section 355, but instead from the Single Member LLC's disregarded status.[134] The transfer of assets to a disregarded entity from its sole owner is not a taxable event.[135] The transfer from the Parent Corporation to the Single Member LLC is no different than a transfer from the Parent Corporation to one of its divisions.[136]

B. Business Purposes Which Can Be Achieved Through the Alternative Spin-Off

The alternative spin-off can be used to accomplish three of the most commonly asserted business purposes for a spin-off: (1) providing equity compensation to key employees; (2) enhancing a corporation's borrowing position; and (3) reducing risk and protecting corporate assets from high-risk business areas.

1. Providing Equity Compensation to Key Employees

The alternative spin-off can be utilized to provide equity compensation to a key employee (or employees) using a two-step process. First, the Parent Corporation consummates an alternative spin-off transaction, dropping the assets of the business in which the key employee ("Employee") is involved into the Single Member LLC.[137] Second, the Employee receives a membership interest in the LLC.

When the key employee becomes a member of the LLC, however, the LLC's default

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[133] Treas. Reg. § 7701-3(b)(ii).
[134] *Id.*
[135] *Id.*
[136] *Id.*
[137] If the Parent Corporation is an S corporation and chooses to use a QSSS instead of a one-member LLC as its disregarded entity, the Parent Corporation must not provide equity interests exceeding an aggregate amount of 20%; a higher percentage will cause the QSSS to lose its qualified status. I.R.C. § 1361(b).

classification changes.[138] Once the LLC increases its membership from one to two, its default classification automatically changes to a partnership.[139] In Revenue Ruling 99-5[140], the IRS addressed the tax consequences of adding a new member to a one-member LLC.[141]

a. Revenue Ruling 99-5, Situation 2

Situation 2 of Rev. Rul. 99-5, in which the LLC admits a person as a new, additional member in exchange for the person contributing capital or services to the LLC is applicable in the key employee context.[142] When the employee becomes an additional owner (along with Distributing Corporation), a tax partnership is created and that tax partnership became the deemed owner of the LLC's assets.[143] Under Rev.Rul. 99-5, the Distributing Corporation is treated as contributing all the assets of the previously disregarded entity to the newly created partnership in exchange for a partnership interest.[144] The Employee, on the other hand, contributes either money or services.

b. Tax Consequences of Classification Change.

There is no effect from the entity conversion.[145] The Parent Corporation experiences no recognition event from the contribution.[146]

I.R.C. Section 722 governs the members' basis in their respective membership interests.[147] The Parent Corporation's basis equals basis in assets "contributed" to tax partnership.[148] The Employee's basis depends on the nature of the Employee's partnership

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[138] Treas. Reg. § 301.7701-3(b)(1)(i).
[139] *Id.*
[140] 1999-5 I.R.B. 1.
[141] *Id.*
[142] *Id.*
[143] *Id.*
[144] *Id.*
[145] *Id.*
[146] I.R.C. §721(a).
[147] *Id.* §722.
[148] *Id.*

interest.[149] The LLC's basis in its assets equals basis of the Parent Corporation in the assets prior to the contribution.[150] The Parent Corporation's holding period for its partnership interest includes its holding period in the contributed assets.[151] The Employee's holding period begins on the day that Employee becomes a member of the LLC.[152] The LLC's holding period in the contributed assets includes the Parent Corporation's holding period.[153]

2. Enhance Borrowing Position

The alternative spin-off can be used to enhance the corporation's borrowing position, subject to certain limitations. The Parent Corporation itself cannot enhance its own borrowing position, because it will still own all of the assets pre-and post- "spin-off." Borrowing enhancement can occur, however, at the LLC level.

For example, assume that the Parent Corporation has two lines of business. One line of business is in an area of financial risk. The Parent Corporation forms two LLCs (LLC1 and LLC2) and drops the riskier business into LLC2, and the non-risk business into LLC1. Under state LLC law, LLC1 provides a full shield to the Parent Corporation for LLC1's liabilities.[154]

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[149] Rev. Proc. 93-27, 1993-2 C.B. 343. If the Employee receives a capital interest (defined as an interest that would give the Employee a share of the proceeds if the partnership's assets were sold at fair market value and then the proceeds were distributed in a complete liquidation of the partnership), such receipt is taxable as compensation. *Id.* Thus, the Employee's basis in the interest would be equal to the amount the Employee is taxed upon. I.R.C. § 1016. If, however, the Employee receives a profits interest (defined as any partnership interest other than a capital interest), the IRS will not treat such receipt as a taxable event (and thus the Employee will have a basis of zero), provided that: (1) the profits interest does not relate to a substantially certain and predictable stream of income from partnership assets, such as high-quality debt securities or a high-quality net lease; (2) the Employee holds the partnership interest for more than two years after receipt; and (3) the profits interest is not an interest in a "publicly traded partnership" within the meaning of section 7704(b) of the Internal Revenue Code. Rev. Proc. 93-27, 1993-2 C.B. 343-344.

[150] I.R.C. § 723.

[151] *Id.* §1231.

[152] Rev. Rul. 99-5, 1999-5 I.R.B. 1.

[153] *Id.*

[154] *See*, e.g. Uniform Limited Liability Company Act, § 303(a) ("the debts, obligations, and liabilities of a limited liability company, whether arising in contract, tort, or otherwise, are solely the debts, obligations, and liabilities of the company. A member or manager is not personally liable for a debt, obligation, or liability of the company solely by reason of being or acting as a member or manager.")

Similarly, LLC2 provides a full shield to the Parent Corporation for LLC2's liabilities.[155] LLC1 is, in turn, shielded from LLC2's liabilities. This arrangement should enhance LLC1's borrowing position with a third party lender. The segregation of LLC2's potential liabilities allows the Parent Corporation to personally guarantee any loan to LLC1 without having to worry about the Parent Corporation's assets being at the mercy of LLC2's creditors. Provided that each LLC adheres to corporate formalities (as provided under state law), it seems unlikely for any "piercing" of the shields of LLC1 and LLC2 against the Parent Corporation.[156]

3. *Reduction of Risk*

Reduction of risk is possible with the alternative spin-off. Perhaps the simplest area in which one member LLC's can be of importance is in the creation of "firewalls."[157] That is, the compartmentalization of various discrete economic activities in separate LLC "boxes" to limit the exposure of each type of economic activity has to liabilities that might arise in other areas of the business.[158] Every new economic venture, no matter how small, entails some degree of risk.[159] LLCs can be used to encapsulate those risks.[160] Note, however, that only future liabilities can be shielded.[161] The Parent Corporation will remain liable for past liabilities, just as

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[155] *Id.*

[156] In at least one memorandum, the IRS ruled that it could not levy against an individual's wholly owned LLC in order to satisfy the individual's tax obligations, even though the entity is disregarded for federal tax purposes. ILM 199930013 (April 18, 1999); *see also* Internal Revenue Service, *IRS Can't Levy Against One-Member LLC*, Tax Notes Today (August 2, 1999). The ruling was based on the fact that the individual does not own the LLC property pursuant to state law. *Id.* The IRS stated that "we do not believe that it is inconsistent to disregard an LLC entity for purposes of determining federal tax liability, but to recognize the LLC as a valid entity for determining what property the taxpayer has an ownership interest in under state law. *Id.* The memorandum contained a discussion about "piercing" the LLC veil if the one-member LLC is being used to evade the payment of taxes. *Id.* Additionally, the IRS held that it can determine whether or not the LLC is being used to evade taxes on a case-by-case basis and, if necessary, pierce the LLC veil. *Id.* This ruling should not pose problems for the alternative spin-off, since no taxes are being evaded. *Id.* The IRS' primary concern with Section 355 transactions – that shareholders may extract earnings and profits from the corporation at capital gains rates – is not at issue in the alternative spin-off. *Id.*

[157] Stuart Levine, et al., *One Member LLCs: Planning with Little Boxes*, SE30 ALI-ABA 437, 441 (October 7, 1999).

[158] *Id.*

[159] *Id.*

[160] *Id.*

[161] *See* ULLCA, § 301(a) (LLC shield extends to liability of company; no reference to members' past individual

it would in a traditional spin-off.

C. Business Purposes Which Cannot Be Achieved Through the Alternative Spin-Off

The alternative spin-off cannot accomplish all of the commonly asserted business purposes associated with a spin-off. Section 355 thus remains the only means to accomplish these business purposes.

1. Enhance Stock Offering

The alternative spin-off cannot be used to enhance a stock offering. A limited liability company cannot engage in a public offering of membership interests without subjecting itself to corporate tax classification.[162] If the Single Member LLC sells membership interests to the public, the LLC will thus be reclassified as a "publicly traded partnership" which is taxed as a corporation.[163]

2. Cost Savings

The alternative spin-off is not available to achieve cost savings to the corporation. Costs savings are achieved in the traditional spin-off when the corporation separates the business that involves significant administrative and regulatory expenses.[164] Under the alternative spin-off, the corporation does not divest itself of any business. The corporation

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liabilities).

[162] I.R.C. §7704 (1999).

[163] *Id.* While the alternative spin-off cannot be used to position either Distributing or Controlled for an IPO, the alternative can be used to obtain more beneficial tax consequences for an IPO in certain circumstances. Christopher Barton, *Much Ado About a Nothing: The Taxation of Disregarded Entities*, 97 TNT 125-98, ¶ 28 (June 30, 1997). If Distributing sells the one-member Controlled LLC's membership interests to the public in an IPO, the LLC is immediately reclassified as a corporation because the membership interests become publicly traded. *Id.* The transaction should therefore be recast as a sale of assets to the public followed by the public's contribution of assets to a newly formed corporation ("NewCo"). *Id.* Any interest retained by Distributing would be treated as contributed as part of an overall Section 351 exchange. *Id.* This sequence of events causes an IPO of more than 80 percent of NewCo's interests to avoid the anti-churning rules of I.R.C. §197, giving NewCo an amortizable basis in its goodwill and going concern value for federal income tax purposes while avoiding having to amortize these intangibles for financial accounting purposes. *Id.* The anti-churning rules prevent the transferee from amortizing goodwill or going concern value when the intangibles are acquired from a related party. *Id.* The relationship requirement in the anti-churning rules is tested immediately before the sale or exchange. *Id.*

[164] *See* Section II(E)(4), *infra*.

will thus be required to meet regulatory requirements for the Single Member LLC.

3. Fit and Focus

Similarly, the alternative spin-off is not available to achieve "fit and focus." Like the cost savings theory, the "fit and focus" rationale depends upon the corporation's divestiture of non-core businesses.[165] In the alternative spin-off, the corporation would not be completely out of the non-core business.

4. Competition

The alternative spin-off is also not available to alleviate concerns over competition. This business purpose, like cost savings and fit and focus, requires the corporation to divest itself of some of its assets. In this case, the required divestiture is the competing business. Under the alternative spin-off, however, the corporation still owns this competing business. The business is merely conducted by the Parent Corporation's wholly-owned LLC.

5. Facilitating an Acquisition of/by Parent/Distributing Corporation or Controlled Corporation

The alternative spin-off is also not useful to position either the Parent Corporation or the Single-Member LLC to participate in an acquisition. The Parent Corporation does not "spin-off" unwanted assets into a separate entity in the alternative spin-off. Rather, the assets are dropped down into the Parent Corporation's wholly-owned LLC. In other words, the Parent Corporation still owns the unwanted assets. Such a transaction does not position the Parent Corporation to be acquired by an unrelated corporation. Similarly, any "acquisition" of the Single Member LLC will simply be treated as an acquisition of some of the Parent Corporation's assets, which is a taxable exchange.[166]

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[165] *See* Section II(E)(4), *supra*.

D. Differences in Shareholder Consequences

The primary difference between the traditional and alternative spin-off forms lies in the consequences to the Distributing/Parent Corporation's shareholders. In the traditional spin-off, Distributing Corporation's shareholders own stock in both Distributing and Controlled after the spin-off.[167] Ownership in two separate corporations gives the shareholders voting rights with respect to each corporation.[168]

In the alternative spin-off, however, the Parent Corporation's shareholders do not own any part of the Single Member LLC.[169] The Parent Corporation is the sole member.[170] The shareholders hold only their Parent Corporation stock that they held prior to the "spin-off." This difference in ownership structure results in differences in corporate governance structure, and differences in the shareholders' economic rights.

1. Differences in Governance Structure

In the traditional spin-off, the shareholders vote directly on issues pertaining to each of the Distributing and Controlled Corporations.[171] This is due to the fact that the shareholders hold stock in both corporations.

In the alternative spin-off, however, the Parent Corporation (i.e., the Parent Corporation's officers) makes decisions for the Single Member LLC as its sole member.[172] The Parent Corporation's shareholders only to the extent that the shareholders could remove a director of the

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[166] I.R.C. §1001 (1999).
[167] See Section II(B)(1), *supra*.
[168] *See, e.g.*, Revised Model Business Corporation Act, § 7.21 (subject to certain exceptions, each outstanding share of stock in corporation entitled to one vote on each matter voted on at a shareholders' meeting).
[169] See Section V(C), *supra*.
[170] *Id.*
[171] RMBCA, § 7.21.
[172] *See* ULLCA, § 403(a)(2)(except as provided otherwise, any matter relating to the business of the company may be decided by a majority of the members).

Parent Corporation if the shareholders disapprove of such director's actions.[173]

2. Differences in Shareholders' Economic Rights

In the traditional spin-off, the Distributing Corporation's shareholders own stock in each of Distributing and Controlled and thus have right to receive dividends from both.[174] In the alternative, however, the shareholders do not have any economic rights vis-à-vis the Single Member LLC, because the shareholders do not have a direct ownership interest in the Single Member LLC.[175]

VII. THE IRS' WILLINGNESS TO ALLOW THE USE OF DISREGARDED ENTITIES IN CORPORATE TRANSACTIONS

The consequences of being a "disregarded entity" are not fully described in the regulations.[176] The regulations provide only that "if the entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner."[177] To date, the IRS has made no direct ruling on whether a disregarded entity will be truly disregarded if used in Section 355-type transactions.[178]

The IRS would likely approve of the use of disregarded entities in corporate transactions such as the alternative spin-off, for two reasons. First, the IRS made a limited number of clarifications regarding other uses of disregarded entities indicate that the disregarded entity is indeed disregarded as an entity separate from its owner. Second, the IRS' primary vehicle for recharacterizing corporate transactions – the step transaction doctrine – is inapplicable in the

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[173] RMBCA § 8.08 (providing for removal of directors by shareholder vote). Parent Corporation's shareholders could not, however, remove the Parent Corporation's officers under the RMBCA. RMBCA § 8.43 (providing for officer removal by the corporation's board of directors).
[174] RMBCA CITE
[175] The Parent Corporation shareholders may benefit from the Single Member LLC to the extent that the business of the Single Member LLC enhances the profitability of the Parent Corporation so that the Parent Corporation must declare a dividend in order to avoid the accumulated earnings tax. I.R.C. §§ 531-537 (1999).
[176] Barton, *supra* Note 163, at ¶ 4.
[177] Treas. Reg. § 301.7701-2(a); *see also* Barton, *supra* Note 163, at ¶ 4.
[178] Barton, *supra* Note 163, at ¶ 4.

disregarded entity context.

A. IRS Rulings Related to Disregarded Entities

1. Employment Taxes

In Notice 99-6, issued on January 19, 1999, the IRS requested comments on the payment of employment taxes for employees of disregarded entities.[179] The IRS also announced a temporary two-prong elective classification scheme for the payment of such taxes.[180] Under the scheme, payment can be made in one of two ways. First, the disregarded entity can calculate, report, and pay all employment tax obligations with respect to employees of its wholly owned disregarded entity, as though the employees of the disregarded entity are employed directly by the owner. Second, the disregarded entity and its owner can separately calculate, report, and pay all employment tax obligations by each state law entity with respect to each entity's employees under its own name and taxpayer identification number.[181] With this method, however, the owner retains ultimate responsibility for the employment tax obligations incurred with respect to employees of the disregarded entity.[182] Under either scheme, therefore, the IRS looks through the disregarded entity to its owner for payment of employment taxes. In other words, the IRS actually does "disregard" the disregarded entity.

2. Section 1031 transactions

Under I.R.C. Section 1031, a taxpayer who exchanges real property held for investment or for use in a trade or business for real property of a "like kind" which is similarly held for investment or for use in a trade or business may defer recognizing gain on the transfer of such

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[179] Notice 99-6, 1999-3 I.R.B. 12 (January 19, 1999).
[180] *Id.*
[181] *Id.*
[182] *Id.*

property.[183] A number of cases and rulings have clarified that the taxpayer that transfers the relinquished property must be the same taxpayer who acquires the replacement property in order to obtain the tax-deferral.[184] In two recent letter rulings, the IRS ruled that a taxpayer's transfer of replacement property from the seller in the second leg of a Section 1031 exchange directly to the taxpayer's wholly owned LLC would not disqualify the taxpayer from receiving nonrecognition treatment.[185] The IRS concluded that because the LLC is disregarded as an entity separate from the taxpayer, the transfer of title to the replacement property directly to the LLC would be treated as if the taxpayer had directly received the replacement property. Accordingly, the exchange qualified because the taxpayer that transferred the relinquished property was the same taxpayer that received the replacement property.[186]

3. Tax-Exempt Organizations

In Revenue Procedure 99-4[187], the IRS ruled that the national office will not issue a letter ruling with respect to a disregarded entity when the sole member of the entity is an exempt organization.[188] The IRS' no ruling position appears to tacitly hold that, since the disregarded entity's owner is exempt from federal taxation, there is no need for the IRS to rule on the disregarded entity's status, since such entity is disregarded for federal tax purposes.

4. Use of Disregarded Entities by Foreign Entities

The IRS issued Proposed Treasury Regulation 301.7701-3(h) on November 29, 1999.[189] The proposed regulation would prevent, in limited circumstances, the use of changes in entity

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[183] I.R.C. §1031 (1999).
[184] *See, e.g.* TAM 9818003; *see also* Turney P. Berry, et al., *Charity From Nothing: Protection From Environmental and Premises Liability Under Check-the-Box*, 1999 TNT 130-26 (July 8, 1999).
[185] PLR 9807013 (November 13, 1997); PLR 975012 (September 5, 1997); *see also* Berry, *supra* Note 184.
[186] *Id.*
[187] 1999-1 I.R.B., 115.
[188] *Id.*, §8.11
[189] *See* 64 Fed. Reg. 66591-66595 (1999).

classification to alter a taxpayer's federal tax consequences.[190] Under the regulations, a change in classification by a foreign eligible entity that was originally classified as an association taxable as a corporation (and, but for these regulations, would be classified as an entity disregarded as an entity separate from its owner) will be invalidated in certain limited circumstances.[191] The important implication for the alternative spin-off is the IRS' comment that the rationale for the proposed regulation. The proposed regulation addressed the IRS' concern that taxpayers may attempt to use disregarded entities to achieve results, in relation to certain transactions, that are inconsistent with the policies and rules of particular code sections or tax treaties.[192] This is important in the Section 355 context because, as discussed previously, the alternative spin-off involving a one-member LLC does not allow shareholders of the Parent Corporation to extract earnings and profits from the corporation at capital gains rates.[193] Thee alternative spin-off is therefore not inconsistent with the policy of Section 355; namely to prevent the corporation's shareholders to extract earnings and profits from the corporation at capital gains rates.[194]

B. Inapplicability of the Step Transaction Doctrine

The IRS sometimes uses the "step transaction doctrine" to get at the substance of a transaction, rather than focusing on the form the transaction takes.[195] Under this doctrine, a series of formally separate steps are amalgamated and treated as a single transaction if the steps in substance are "integrated, interdependent, and focused toward a particular result."[196]

The step transaction doctrine usually comes into play in determine "substance" over

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[190] Prop. Treas. Reg. § 301.7701-3(h); *see also Summaries of Today's Important Tax News*, Tax Notes Today (November 29, 1999).
[191] *Id.*
[192] *Id.*
[193] The shareholders cannot extract earnings and profits at capital gains rates because the shareholders receive no distribution in the alternative spin-off. *See* Section V(C), *supra.*
[194] Ridgway, *supra* Note 3, at A-1.
[195] Barton, *supra* Note 163, at ¶ 9.
[196] *Comm'r v. Ashland Oil & Refining Co.*, 99 F.2d 588 (6th Cir. 1938), *cert. denied* 306 U.S. 661 (1939); *see also*

"form" of a particular transaction.[197] In the disregarded entity context, the step transaction doctrine would not apply, because the disregarded entity is already disregarded; thus there is in fact only one step to the transaction.[198]

The IRS' rulings on disregarded entities to date suggest a willingness to allow the use of disregarded entities in corporate transactions such as the spin-off. Further, the step transaction doctrine is inapplicable to disregarded entities. Thus, the use of a disregarded entity to achieve an "alternative" tax-free spin-off should not provoke IRS scrutiny.[199]

VIII. CONCLUSION

Recent developments in limited liability company law have made possible an alternative spin-off mechanism for a corporation desiring to separate lines of its business without meeting the onerous requirements of Section 355. This alternative, however, is not without its drawbacks. The alternative spin-off is only available to accomplish three of the nine most commonly asserted business purposes; i.e., to create a structure to provide equity compensation to a key employee (or employees), to enhance the borrowing position of the business, and to reduce risks associated with certain lines of business. Further, the alternative spin-off form has significantly different tax consequences for the corporation's shareholders. The shareholders do not realize any benefit under the alternative form. The alternative spin-off mechanism does, however, provide practitioners another means with which to serve their business clients' needs.

Barton, *supra* Note 163, at ¶ 9.

[197] *Id.*

[198] Id., ¶¶ 9-10, 37.

[199] The IRS may, however, restrict a corporation's ability to use a Section 355 spin-off for those purposes made possible by the alternative form. *See* Treas. Reg. §1.355-2(b)(3) ("If a corporate business purpose can be achieved through a nontaxable transaction that does not involve the distribution of stock of a controlled corporation and which is neither impractical nor unduly expensive, then the separation is not carried out for that corporate business purpose").