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Client Alert

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Tax Department

IRS Issues Temporary Regulations Suspending the Application of the "Hot Stock" Rule in Certain Tax-Free Corporate Spin-Offs

On December 12, the IRS issued temporary regulations providing guidance on the distribution of stock of a controlled corporation purchased within the past five years.

Background

One of the key statutory requirements for a tax-free spin-off or split-off is that each of the distributing and controlled corporations must be engaged immediately after the distribution in the active conduct of a trade or business which has been actively conducted throughout the five year period ending on the date of the distribution. Under prior law, a corporation was treated as engaged in a trade or business only if it was directly engaged in such trade or business, or if substantially all of its assets consisted of stock and securities of a corporation controlled by it immediately after the distribution which was so engaged. To comply with this rule, taxpayers often had to implement elaborate internal corporate restructuring.

Recently, Congress changed the law in an effort to alleviate the burden of restructuring a business to comply with the above described requirement. For distributions occurring after May 17, 2006 and on or before December 31, 2010, the active business test was amended (the 2007 Active Business Test) and is determined by reference to the relevant affiliated group which is treated as a single corporation. Thus, in determining whether the active trade or business requirement is met by the distributing corporation, the distributing corporation (as common parent) and all corporations affiliated with the distributing corporation through stock ownership described in the consolidated return rules (*i.e.*, Code Section 1504(a)(1)(B), without regard to Section 1504(b)) immediately after the distribution are treated as a single corporation. The same is true for the affiliated group for the controlled corporation.

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The Hot Stock Rule

Code Section 355(a)(3)(B) provides that stock of the controlled corporation that is acquired by the distributing corporation in a taxable transaction within five years of the distribution is not treated as stock of the controlled corporation, but is instead treated as "other property." The impact of this so-called "hot stock" rule is that a distribution of such stock is taxable, even if the transaction otherwise meets the requirements for a tax-free spin-off.

The hot stock rule could have the effect of undoing the benefit of the 2007 Active Business Test. For example, suppose the distributing corporation acquired all of the controlled corporation's stock in a taxable transaction that qualified as an expansion of the distributing corporation's existing five year active trade or business. Suppose that one year later the distributing corporation distributed all such stock to its shareholders in a spin-off. This transaction would satisfy the 2007 Active Business Test, but, absent a change in the hot stock rule, would nevertheless be a fully taxable transaction. The IRS issued the new temporary regulations to help harmonize the 2007 Active Business Test and the hot stock rule.

New Regulations "Turn Off" the Hot Stock Rule Where Controlled is a Member of Distributing's Affiliated Group

The new temporary regulations provide that controlled corporation stock acquired in a taxable transaction by the distributing corporation's affiliated group within the five year period preceding the distribution constitutes hot stock *except if the controlled corporation is a member of the distributing corporation's affiliated group at any time after the acquisition, but before the distribution*.

Consistent with the separate affiliated group regime of the 2007 Active Business Test, which treats the distributing corporation's separate affiliated group as one corporation, the new regulations also disregard transfers of controlled stock owned by corporations that are members of such separate affiliated group immediately before and immediately after the transfer.

The IRS identified a number of future issues, not addressed in these regulations, on which it is considering issuing guidance. For example, future guidance may address whether, in a situation where a corporation that owns controlled corporation stock joins the distributing corporation's separate affiliated group in a taxable transaction, the separate affiliated group should be treated as acquiring the controlled corporation stock in a taxable transaction. Similarly, future guidance may address the treatment of taxable acquisitions of controlled corporation stock during the five years prior to the distribution by a corporation that subsequently joins the distributing corporation's separate affiliated group in a non-taxable transaction.

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