

## WHAT'S HOT? WHAT'S NOT?

### SECTION 355, ACTIVE BUSINESS AND THE NEW "HOT STOCK" RULES

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In May 2007 the IRS issued proposed regulations (the "Proposed Active Business Regulations")<sup>2</sup> under which members of affiliated groups (or sub-groups) of corporations are generally treated as a single corporation in determining whether a corporation is engaged in an "active business" for purposes of § 355(b).<sup>3</sup> The proposed regulations heated up an issue that they left unanswered: would—and if so, how would—the "affiliated group" approach to the active business requirement for spin-offs affect the treatment of recently-acquired stock of the spun-off corporation ("Controlled") as "boot" in the spin-off under § 355(a)(3)(B) (the "Hot Stock Rule")?

On December 12, 2008, the IRS issued proposed, temporary and final regulations addressing the Hot Stock Rule (the "Hot Stock Regulations").<sup>4</sup> In general, the Hot Stock Regulations provide that any stock of Controlled acquired by the distributing corporation ("Distributing") will not be treated as hot stock if Controlled is a member of Distributing's "separate affiliated group" ("DSAG") at any time after the acquisition. While this and related rules in the new Hot Stock Regulations provide welcome conformity between the rules under

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<sup>1</sup> © Candace A. Ridgway. The views expressed herein are my own, and do not necessarily reflect those of Jones Day or any other member thereof.

<sup>2</sup> Prop. Reg. § 1.355-3, 2007-23 IRB 1357, REG-123365-03, 72 FR 26012 (May 8, 2007).

<sup>3</sup> Unless otherwise indicated, all "§" references herein are to sections of the Internal Revenue Code of 1986, as amended.

<sup>4</sup> Regs. § 1.355-2T, issued in T.D. 9435, REG-150670-07, December 12, 2008.

§ 355(a)(3)(b) and § 355(b), they also raise a number of interesting questions that the IRS has still to resolve.

What WAS Hot?

The issue regarding the Hot Stock Rule arose from the enactment of § 355(b)(3) in the Tax Increase Prevention and Reconciliation Act of 2005 (“TIPRA”)<sup>5</sup> and the promulgation of the Proposed Active Business Regulations.<sup>6</sup> Under the new and proposed active business rules, Distributing and Controlled must each be engaged in a 5-year active business at the time of the spin-off, and they cannot any longer satisfy that requirement by having, as their only significant assets, stock of controlled subsidiaries that satisfy the requirement.<sup>7</sup> Instead, they can satisfy the active business requirement by taking into account the businesses of all members of the DSAG, in Distributing’s case, or Controlled’s separate affiliated group (“CSAG”) in its case.<sup>8</sup>

Under these rules, if Distributing or Controlled acquires all of the stock of a target corporation, or at least an amount of stock causing the target corporation and the acquiring corporation to be “affiliated,” it will be treated as having acquired all of the assets and liabilities of the target rather than target stock for purposes of the active business test.<sup>9</sup> Because of this, if the acquisition is taxable, it will not fall afoul of the prohibition on taxable acquisitions of the

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<sup>5</sup> P.L. 109-222, sect. 202; amended by the Tax Relief and Health Care Act of 2006, P.L. 109-432, Div. A, sect. 410, and by the Tax Technical Corrections Act of 2007, P.L. 110-172, sect. 4(b) (“2007 Technical Corrections”).

<sup>6</sup> See generally Ridgway, “Extreme Makeover: The Proposed § 355 Active Business Regulations In Theory And Practice,” Tax Management Memorandum Vol. 48 No. 19, 339 (Sept. 17, 2007).

<sup>7</sup> Although this result was not explicit under the statute as originally enacted, the current version of § 355(b)(2)(A) and (b)(3), as amended by the 2007 Technical Corrections, makes clear that the “controlled subsidiary” route to active business qualification is no longer an option, confirming the IRS’s position in the proposed regulations that the “controlled subsidiary” method had been effectively, if not literally, written out of the Code by TIPRA.

<sup>8</sup> See § 355(b)(3)(A), (B); Prop. Regs. § 1.355-3(b)(1)(i), (ii).

<sup>9</sup> See Prop. Regs. § 1.355-3(b)(1)(ii).

stock of active business corporations under § 355(b)(2)(D); but will instead be tested as a taxable acquisition of a “business” under § 355(b)(2)(C). A long-recognized exception to the prohibition on taxable business asset acquisitions is the acquisition of assets of a business in which the acquiror already engages—thus constituting merely an expansion of an existing business rather than an acquisition of an entirely new business.<sup>10</sup> That is, § 355(b)(2)(C) applies to prevent a taxable acquisition of a *new* business, but not an expansion of an existing business. Thus, if the target is engaged in the same business as that of Distributing or Controlled (through any member of their respective SAGs), the taxable acquisition of target stock by any member of that SAG will be treated as merely an expansion of an existing business of the SAG, and if that business qualifies as an “active” 5-year business of the DSAG or the CSAG, then Distributing and/or Controlled, as the case may be, will qualify as engaged in the target’s active business.

This is, of course, a very fine and happy result for Distributing and/or Controlled as far as the “active business” requirement goes. The issue that the proposed active business rules heated up was that of how they related—or did not relate—to the treatment of hot stock under § 355(a)(3)(B). Neither the statutory provisions relating to “active business” nor the proposed regulations under them applied, by their terms, to the Hot Stock Rule. If they were treated as separate from each other, then the fact that the new active business rules enabled Controlled to be treated as engaged in a qualified 5-year active business even if it had been taxably acquired within five years before its spin-off would avail Distributing nothing—a spin-off of Controlled stock would nevertheless be treated as fully taxable to the extent of the newly-acquired Controlled hot stock.

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<sup>10</sup> See, e.g., Regs. § 1.355-3(b)(3)(ii), (c) Examples (5)-(8); Prop. Regs. § 1.355-3(b)(3)(ii), (d)(2) Examples 18-21.

For example, assume Distributing was engaged in Business X in Location Q for over five years, and Controlled was engaged in Business X in Location R, and Distributing purchased all of the Controlled stock in Year 1. Under the Proposed Active Business Regulations, for purposes of the active business requirement Distributing would be treated as merely having expanded its X Business by buying the Controlled Business X assets and liabilities in Location R. Thus, the Distributing/Controlled entity would be considered to have been engaged in an active business for over five years, and Distributing would not be treated as having taxably acquired either Controlled stock or a new business at the time of the Controlled acquisition. Assuming all other requirements for a valid spin-off were satisfied, Distributing could therefore turn around and spin Controlled off at any time after the acquisition.<sup>11</sup> However, under § 355(a)(3)(B) and Regs. § 1.355-2(g) (prior to promulgation of the new temporary regulations), a spin-off of Controlled before Year 6 would be fully taxable as that most curious of beasts: a “qualified” spin-off in which all of the stock distributed is taxable “boot”!<sup>12</sup>

The IRS recognized this problem when it issued the Proposed Active Business Regulations, and requested comments concerning whether, and the extent to which, application of the § 355(a)(3)(B) Hot Stock Rule should be conformed to the rules under new § 355(b)(3).<sup>13</sup> Congress provided the IRS with some assistance in this regard when it enacted the clarifying changes to § 355(b)(2)(A) and (b)(3) in the 2007 Technical Corrections. Those clarifying changes included replacing the existing § 355(b)(3)(D), which had become deadwood, with a

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<sup>11</sup> See Regs. §§ 1.355-3(b)(3)(ii), 1.355-3(c) Ex. 8; Prop. Regs. §§ 1.355-3(b)(3)(ii), 1.355-3(d)(2) Ex. 20.

<sup>12</sup> In its Comments on the proposed regulations, the New York State Bar Association Tax Section took the position that § 355(b)(2) and (3) were completely unrelated to § 355(a)(3)(B), and that this result was thus appropriate. NYSBA Tax Section Comments on Proposed Rules (REG-123365-03) Regarding Active Trade or Business Under Section 355(b) (“NYSBA Comments”) (January 11, 2008), published in *BNA Daily Tax Report* January 15, 2008.

<sup>13</sup> See REG-123365-03 Preamble, Section F (May 8, 2007).

new § 355(b)(3)(D) expressly authorizing regulations “which . . . modify the application of subsection (a)(3)(B), in connection with the application of this paragraph.”<sup>14</sup> As the preamble to T.D. 9435, promulgating the Hot Stock Regulations, points out, the Joint Committee’s explanation of the 2007 Technical Corrections was printed in the Congressional Record of December 19, 2007, at the request of Senator Baucus as an expression of the Senate Finance Committee’s understanding of the provisions. That explanation not only endorsed the treatment of an acquisition of a SAG member as an acquisition of assets subject to § 355(b)(2)(C) rather than § 355(b)(2)(D)—and thus potentially eligible for “expansion” treatment—but also stated that “the Treasury Department *shall* prescribe regulations that . . . modify the application of section 355(a)(3)(B) . . . in a manner consistent with the purposes of this provision.” (Emphasis added.)<sup>15</sup>

With this encouragement, the IRS promulgated the Hot Stock Regulations to generally conform the Hot Stock Rule to the SAG-based active business rules under the Proposed Active Business Regulations.

#### What’s Not Hot

Under the Hot Stock Regulations, any stock of Controlled that was taxably acquired by the DSAG within five years before the spin-off will *not* be hot stock—*i.e.*, will not be “boot” in a

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<sup>14</sup> § 355(b)(3)(D); 2007 Technical Corrections, section 4(b). The new § 355(b)(3)(D) also expressly authorizes regulations providing for the application of § 355(b)(3) to § 355(b)(2)(C) and (D), which of course the Proposed Active Business Regulations do. Some commentators had questioned whether Treasury had the authority to apply the SAG rules of § 355(b)(3) to any section other than § 355(b)(2)(A), to which § 355(b)(3) specifically referred. The 2007 Technical Corrections also replaced the former § 355(b)(3)(C) with a new one which expressly approved the proposed regulations’ treatment of an acquisition of stock of a new SAG member as an acquisition of the member’s business (*i.e.*, as a potential § 355(b)(2)(C) or a potential business “expansion” transaction).

<sup>15</sup> T.D. 9435 Preamble, Explanation of Provisions § 1., quoting 153 Cong. Rec. S16057 (daily ed. Dec. 19, 2007).

spin-off of Controlled—if Controlled is a member of the DSAG at any time after the acquisition and prior to the spin-off of Controlled.<sup>16</sup>

In addition, and also consistently with the Proposed Active Business Regulations, any transfers of Controlled stock among members of the DSAG are simply disregarded—*i.e.*, for purposes of the Hot Stock Rule, they are not treated as transfers, taxable or otherwise, of Controlled stock.<sup>17</sup>

*Not* consistent with the Proposed Active Business Regulations, but consistent with the IRS's moratorium on applying the applicable provision of the proposed regulations, the Hot Stock Regulations currently also conform to the existing rule regarding transfers to Distributing by members of its “affiliated group” under both the existing active business regulations and the prior Hot Stock Regulations.<sup>18</sup> Under that rule, transfers to Distributing by any member of an “affiliated group” (defined and broadened by reference to § 1504) of which it is a member are also disregarded. The difference between the “transfers within DSAG” rule and the “transfers within affiliated group” rule is that the former would disregard only transfers by direct and indirect subsidiaries of Distributing, while the latter would allow transfers by brother-sister and parental (or higher) corporations if they are members of the same affiliated group as Distributing.<sup>19</sup> The Proposed Active Business Regulations’ scaling back of the existing

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<sup>16</sup> Regs. § 1.355-2T(g)(2)(i).

<sup>17</sup> Regs. § 1.355-2T(g)(1). *See* Prop. Regs. § 1.355-3(b)(1)(ii) (similar rule for “active business” purposes).

<sup>18</sup> *See* Regs. § 1.355(g)(2)(ii), referring to current Regs. § 1.355-3(b)(4)(iii), exempting transfers among members of an “affiliated group” from the rules of § 355(b)(2)(C) and (D). In Notice 2007-60, 2007-2 C.B. 466, the IRS announced that it will not challenge the applicability of current Regs. § 1.355-3(b)(4)(iii) to spin-offs until such time as that provision has been modified by temporary or final regulations.

<sup>19</sup> *See* Prop. Regs. § 1.355-3(b)(1)(iii), Regs. § 1.355-3(b)(4)(iv). There is also a slight difference in definition of “affiliated group” between the two provisions, in that current Regs. § 1.355-3(b)(4)(iv) requires taking “plain vanilla preferred” stock into account but the SAG rule does not. The preamble to T.D. 9435 expressly states, in Explanation of Provisions § 3., that the “affiliated group” definition will continue to include plain vanilla preferred stock for purposes of the Hot Stock exception.

exemption for affiliated corporation transfers to include only transfers among DSAG members drew criticism, principally for its disruption of settled expectations.<sup>20</sup> The preamble to T.D. 9435 observes that the IRS and Treasury are continuing to study the “affiliated group transfers” question, and contemplate that final rules, when adopted, will generally be applied consistently in the active business and hot stock contexts.<sup>21</sup>

Thus, under the Hot Stock Regulations, the answer to the burning question raised above is “no”—a completely qualified spin-off under the Proposed Active Business Regulations could not also be completely taxable as a distribution solely of “boot” under the Hot Stock Rule.

One point might stand clarification, however. The Hot Stock Regulations’ reference to the timing of Controlled’s membership in the DSAG is not entirely clear. Should the “at any time” language be read to modify both “after the acquisition” and the parenthetical “prior to the distribution”? Or should the parenthetical reference to “prior to the distribution” be read separately, to mean that Controlled must still be a member of the DSAG immediately prior to the spin-off? For instance, consider the following scenario: Distributing owned § 368(b) but not § 1504(a) “control” of Controlled, then bought enough additional stock of Controlled to make Controlled join the DSAG, then sold stock (or Controlled issued additional stock) so that Controlled left the DSAG, and then Distributing spun off Controlled within five years after its additional stock purchase. Alternatively, and perhaps more graphically, consider the earlier example in which Distributing engaged in Business X in Location Q while Controlled engaged in Business X in Location R. The Hot Stock Regulations make clear that Distributing’s purchase of the Controlled stock, causing Controlled to join the DSAG, will prevent the spun-off Controlled

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<sup>20</sup> See, e.g., NYSBA Comments, § VI (praising the Notice 2007-60 moratorium on applying the proposed regulation and suggesting further expansion of the moratorium).

<sup>21</sup> T.D. 9435 Preamble, Explanation of Provisions § 3.

stock from being “hot”—at least if Controlled is still a member of the DSAG at the time of the spin-off. But what if it is not?

Would the fact that Controlled *was* a member of the DSAG at some time prior to the spin-off immunize all recently-purchased (*i.e.*, purchased at or before the time that Controlled joined the DSAG) stock from treatment as hot stock? Or would the fact that Controlled was no longer a member of the DSAG immediately prior to the spin-off cause the recently-purchased stock to be hot? If the latter were correct, could Distributing remove the problem by selling the same Controlled stock that it had recently purchased? How would Distributing establish exactly which stock of Controlled was purchased and sold?

If Distributing had actually purchased Controlled assets, rather than being deemed to purchase them when Controlled joined the DSAG, and then had contributed the Controlled assets to a “New Controlled” of which it owned stock constituting § 368(b) but not § 1504(a) “control,” it seems clear that none of the stock distributed in a subsequent spin-off of New Controlled would be hot stock. In addition, applying the deemed-asset acquisition paradigm to Controlled entering the DSAG, and having that asset acquisition qualify under the active business rules, should result in the conclusion that the device concerns that originally led Congress to add § 355(a)(3)(B) to backstop the active business rules cannot be implicated by a deemed “good” asset acquisition followed by incorporation of “New Controlled.” Finally, the most coherent way to read the regulatory language is with “at any time” modifying both of the following concepts—especially in view of the fact that when the IRS has meant to require something to exist “immediately before” something else it has typically been quite capable of saying so.

Accordingly, the proper interpretation of the “member of the DSAG prior to the spin-off” requirement should be that Controlled must be a member of the DSAG at *any time* that is both

after the stock acquisition and prior to the spin-off.<sup>22</sup> It would be helpful if the IRS would clarify this point.

### What's Next?

In the preamble to the Hot Stock Regulations, the IRS raises to an art form its tradition of requesting comments on open issues related to the guidance being provided. In addition to answering three hot stock questions, it raises a swarm of additional questions relating to the application of the Hot Stock Rule in *Dunn Trust*<sup>23</sup> and other “indirect acquisition” and “predecessor” contexts,<sup>24</sup> as well as in the case of taxable issuances of Controlled stock to Distributing and redemptions of Controlled stock.

Questions posed in these areas, and some thoughts on them, follow.

- **Whether (or when) the “hot stock” rule should apply to stock of Controlled owned by a target corporation acquired by the DSAG in a taxable transaction.**<sup>25</sup>

Certainly, under the statutory and Proposed Active Business Regulations’ treatment of an acquisition of stock as an acquisition of the target’s assets if the target becomes a member of the SAG, any stock of Controlled owned by the target corporation would be considered to be such an “acquired asset.” Arguably, then, the deemed-taxable-acquisition of Controlled stock should in turn be examined—for both active business and hot stock purposes—to determine its proper

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<sup>22</sup> Of course, the preceding discussion assumes that the hypothetical pre-spin-off acquisition and subsequent disposition (or disaffiliation) both occurred for good business reasons.

<sup>23</sup> *Dunn Trust v. Comr.*, 86 T.C. 745 (1986), acq. in result only (1998-1 C.B. 5 n.4), in which Distributing acquired stock of target in a taxable transaction and then contributed the stock to Controlled in exchange for Controlled stock in a § 351 transaction. The Tax Court ruled that the Controlled stock attributable to the target stock was not hot stock. So far, the IRS and Treasury remain unconvinced.

<sup>24</sup> In the *Dunn Trust* and “predecessors” context, the Preamble explains, the IRS is considering future guidance regarding “the effect of indirect acquisitions and the extent to which predecessor rules should apply for purposes of the Hot Stock Rule.” T.D. 9435 Preamble, § 4.A.

<sup>25</sup> The Preamble refers to § 355(b)(3)(B) and Prop. Reg. § 1.355-3(b)(1)(ii) and (b)(4)(i); generally providing that the acquisition of stock of a corporation that becomes a member of the acquiring SAG is treated as the acquisition of all of the assets of that corporation.

treatment under the same regulations.<sup>26</sup> Thus, if Controlled itself is a member of the DSAG at any time after the acquisition and prior to the distribution, the means by which it was acquired should make no difference; if not, and the acquisition of the target was treated as an asset acquisition for purposes of the active business test because target joined the DSAG, it should also be so treated for purposes of the Hot Stock Rule, and the Controlled stock should be hot stock.

- **Whether the Hot Stock Rule should apply to taxable acquisitions of Controlled stock by a target that joins the DSAG in a non-taxable transaction.**<sup>27</sup>

Once again, it should arguably be the rule that there is no hot stock if Controlled is a member of the DSAG before the spin-off—no matter how it was acquired. The situation becomes more complex if it does not. A simple § 338-tier-down type analysis would result in treating the DSAG as having acquired the stock of Controlled in a non-taxable transaction, thus immunizing that stock under both § 355(b)(2)(D) and § 355(a)(3)(B). Is that an appropriate result, given the fact that target actually acquired the Controlled stock taxably? Is this one of those “non-taxable acquisitions” that should be treated as a “taxable acquisition” in defense of the basic anti-device principle, or “common purpose” of the prohibition on taxable acquisitions, which disqualifies acquisitions in exchange for Distributing assets? If target was actually acquired in a non-taxable transaction, and that transaction itself would not be recharacterized under the Proposed Active Business Regulations as a taxable transaction, then it would seem that the illegitimate-asset-usage issue would only be implicated if the two acquisitions—target’s of

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<sup>26</sup> This procedure would be analogous to the tiering-down of deemed asset acquisitions resulting from § 338 elections.

<sup>27</sup> Prop. Reg. § 1.355-3(b)(4)(i)(A) specifies that the general prohibition on taxable acquisitions of a trade or business under § 355(b)(2)(C) “also applies . . . to any acquisition during the pre-distribution period of a trade or business, an interest in a partnership engaged in a trade or business, *or stock of a corporation engaged in a trade or business by a corporation that later becomes a subsidiary SAG member.*” (Emphasis added.)

Controlled stock and DSAG's of target's assets—are sufficiently interrelated that they should be viewed as a unified transaction under traditional step-transaction analysis.<sup>28</sup>

- **Whether a DSAG should be treated as having made any acquisition made by a “predecessor” of a DSAG member—i.e., a corporation that transfers its assets to the DSAG member in a transaction to which § 381(a) applies.**

Essentially, albeit perhaps not exactly, the same analysis should apply here as the analysis caused by the deemed nontaxable assets transfer in the prior scenario; arguably the same result should apply.

- **Whether, if a DSAG acquires stock of a target in a taxable transaction and then, in a *Dunn Trust*-type situation, Controlled acquires the target in a § 381(a) (or possibly other non-taxable) transaction, the target stock—or, rather, Controlled stock reflecting the value of the target stock—should be considered hot stock.<sup>29</sup>**

Again, of course, this scenario presumably excludes cases in which target becomes a member of the DSAG, which should be treated as an acquisition of the target assets not implicating any stock. If the acquisition of target assets did not qualify as an “expansion,” then it would not be a 5-year active business and contributing it to Controlled would not make it one (unless, of course, it was an expansion of Controlled's business, in which case no harm, no foul).

The Preamble, however, posits the following case: Distributing owns § 368(c) control of Controlled but not § 1504(a)(2) control (*i.e.*, Controlled is not part of the DSAG); Controlled owns stock of a target that is a member of the CSAG; Distributing taxably acquires additional

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<sup>28</sup> Those who want only explicit rules, with no messy judicial facts-and-circumstances analysis, will probably object to such an approach, but sometimes life and taxes are messy.

<sup>29</sup> In *Dunn Trust*, of course, the subsequent transfer of target was in a § 351 transaction rather than one to which § 381 applied, and the court held that the Controlled stock “attributable to” target was not hot stock. As reiterated in the Preamble, the IRS and Treasury are still not so sure of that.

target stock and contributes it to Controlled in a § 351 transaction; both Controlled and target remain *non-members* of the DSAG. Should the recently-acquired target stock be considered the stock of the “real Controlled” for purposes of the Hot Stock Rule in such circumstances? Should it be *only if* Controlled is relying on the target stock acquired by the DSAG in the taxable transaction—*i.e.*, if target was *not* a member of the CSAG before the acquisition and transfer to Controlled (or the CSAG), but was after (and only because of) that acquisition? It would not seem that the mere fact that Distributing has contributed assets of some sort to Controlled prior to the spin-off should implicate § 355(a)(3)(B). To the extent, of course, that Distributing is “stuffing” Controlled by means of such transactions, the “device” and “disqualified investment corporation” rules should address the problem. Otherwise, the only real issue seems to arise, as suggested in the Preamble, if Controlled would not have qualified as engaged in an active business without the contribution of the taxably-acquired stock—*i.e.*, if the target was not a member of the CSAG before the contribution and is afterwards (but, of course, is still not a member of the DSAG). Under the theory explained in sections C.1 and 3.b.i.<sup>30</sup> of the Preamble to the Proposed Active Business Regulations, the use of *Distributing’s* assets to provide Controlled with an active business (which neither Distributing nor Controlled previously owned) should be treated as a “taxable acquisition” of the business, and thus Controlled’s business should not qualify as an active business for five years. Accordingly, in the situation presented in the Preamble, it would seem that “active business” should be the issue rather than hot stock.

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<sup>30</sup> An example in § C.3.b.i. of the Preamble to the Proposed Active Business Regulations is analogous. In that example, Distributing owned all of Controlled, which was not engaged in an active business. To cause Controlled to qualify as engaged in an active business, Distributing arranged for Controlled to acquire an active business from target, an unrelated company, in a nontaxable reorganization solely in exchange for (less than 20% of) Controlled stock. Because the Controlled stock is considered to be an asset of Distributing used to acquire the new Controlled business (and furthermore, the prior owner(s) of the new business do not participate in the subsequent spin-off, so they have no “continuing interest” in the business), the Controlled business is not considered a qualifying active business.

- **Whether (or when) stock issued by Controlled to Distributing in taxable transactions should not be considered hot stock. For instance, issuances in a § 351 transaction that is taxable by reason of § 357(c) have not generally been considered to run afoul of either § 355(b)(2)(D) or § 355(a)(3)(B);<sup>31</sup> should other issuances by Controlled generally be exempted only if Distributing already owns a minimum percentage of Controlled stock?**

Bearing in mind, once again, that if Distributing acquires enough to bring Controlled into the DSAG the question ought to be moot anyway, it seems that, as in the case of the previous question (and as suggested in the Preamble’s question), such non-DSAG-importation issuances are likely adequately addressed by the “device” and “disqualified investment corporation” provisions, or the active business requirement itself.

- **Whether redemptions of Controlled stock should cause some portion of the remaining Controlled stock to be treated as hot stock.**

The Preamble explains that under § 355(b)(2)(D), *McLaulin v. Commissioner*<sup>32</sup> and Rev. Rul. 57-144,<sup>33</sup> a redemption that results in Distributing having § 368(b) “control” of Controlled would be treated as a disqualified taxable acquisition of such “control” by Distributing (even though Controlled was the only one actually acquiring *stock*). While initially suggesting that the transaction might not run afoul of the Hot Stock Rules because (a) Distributing is not in fact distributing any stock which it acquired taxably, and (2) the Hot Stock Rules focus on the nature of the distributed stock itself rather than on the qualification of Controlled to be spun off; ultimately it concludes that “a redemption of controlled stock from a shareholder other than

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<sup>31</sup> See, eg., Rev. Rul. 78-442, 1978-2 CB 143.

<sup>32</sup> 276 F.3d 1269 (11th Cir. 2001).

<sup>33</sup> 1957-1 CB 123.

distributing is the equivalent of distributing's purchase of controlled stock from the redeemed shareholder to the extent distributing is the source of funds for the redemption."<sup>34</sup> Once again, such a deemed stock purchase should presumably matter only if Controlled is not a member of the DSAG after the deemed purchase. In addition, if the deemed stock purchase resulted in acquisition of control of Controlled (but not in Controlled joining the DSAG), the spin-off would presumably be disqualified under § 355(a)(2)(D). Thus, the only situation in which this question should be relevant to the Hot Stock Rule—*i.e.*, in which the issue is not resolved at the “active business” level—is the case in which Distributing already owns § 368(b) “control” of Controlled before the redemption, but Controlled is not a member of the DSAG after the redemption. In that case, there are both practical and policy objections to treating the redemption as giving rise to hot stock. Practically: given that the existence of § 368(b) but not § 1504(a) control requires the existence of different classes of stock, how would one determine exactly what stock of Controlled is “hot”? From a policy perspective: what would be the objection to Distributing contributing funds to Controlled which Controlled uses to redeem out some of its shareholders, where the redemption does not result in acquisition of control? Distributing is not thereby bestowing a disguised dividend on its shareholders; Controlled's former shareholders have cashed out so there is no dividend there. Alternatively, if shareholders whose stock is redeemed are not sufficiently redeemed to qualify under § 302(b), they will be treated as receiving dividends—why should the redemption result in dividends *both* to those actually receiving them *and* to the “innocent bystander” shareholders of Distributing, who are not enriched in any way by reason of the redemption? Controlled's active business is not implicated. And of course, it is hard to imagine why Distributing and Controlled would engage in such a transaction without a

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<sup>34</sup> T.D. 9435 Preamble, Explanation of Provisions § 4.C.

compelling business purpose (most likely, buying out a troublesome minority shareholder). It is therefore hard to conceive of a reason to treat any such redemptions as resulting in a distribution of hot stock.

Warmest Regards for the Hot Stock Regulations

The Hot Stock Regulations have generally been warmly welcomed by the corporate tax community, as not only taxpayer-friendly but sensible and principled extensions of the Proposed Active Business Regulations that appear completely consistent with Congressional intent. They also provide reason to be optimistic that the IRS's further guidance on its open puzzlements will be similarly sensible, principled and consistent (not to mention taxpayer-friendly).