

TaxNewsFlash

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Regulations: Defining predecessor, successor and limiting recognition of gain under section 355(e)

The U.S. Treasury Department and IRS today released for publication in the Federal Register temporary regulations (T.D. 9805) and, by cross-reference, proposed regulations (REG-140328-15) that provide guidance regarding the distribution by a distributing corporation of stock or securities of a controlled corporation without the recognition of income, gain, or loss.

The [**temporary regulations**](#) [PDF 386 KB] provide:

- Guidance in determining whether a corporation is a predecessor or successor of a distributing or controlled corporation for purposes of section 355(e)
- Certain limits on the recognition of gain in specific instances involving a predecessor of a distributing corporation
- Rules regarding the extent to which section 355(f) causes a distributing corporation (and in certain cases its shareholders) to recognize income or gain on the distribution of stock or securities of a controlled corporation

With today's [**proposed regulations**](#) [PDF 364 KB], regulations that were proposed under section 355(e)(4)(D) in November 2004 are withdrawn.

Background

In general, section 355(e) provides that a distributing corporation (Distributing) recognizes corporate-level gain on the distribution of controlled stock or securities (Controlled) if the distribution is part of a plan (or a series of related transactions) (Plan) pursuant to which one or more persons acquire directly or indirectly stock representing a 50% or greater interest in Distributing or any Controlled (Planned 50-Percent Acquisition). Pursuant to section 355(e)(4)(D), any reference to Distributing or Controlled includes a reference to any predecessor or successor of such corporation.

Proposed regulations issued in November 2014 set forth definitions of a predecessor of Distributing (POD) (a corporation that transferred its assets to Distributing in a section 381 transaction), and for certain limited purposes, a predecessor of Controlled. The 2014 proposed regulations also defined the term “successor” as a corporation to which Distributing or Controlled transfers property after the distribution in a transaction to which section 381 applies and treated the stock of a successor as stock of Distributing or Controlled, as the case may be. The proposed regulations provided that the determination of whether there was a Planned 50-Percent Acquisition was made separately with respect to Distributing and any POD and that acquisitions of a corporation and its successor would be combined. The proposed regulations also contained other rules for determining when there would be a Planned 50-Percent Acquisition involving the acquisition of a POD in combination with a transfer from a POD to Distributing. In addition, the proposed regulations provided limitations on the amount of section 355(e) gain that could be recognized when there was a Planned 50-Percent Acquisition of Distributing, a POD, Controlled or their successors.

Temporary regulations

The preamble to the temporary regulations explains the 2014 proposed regulations are being adopted with “significant modifications” based on the comments received with respect to those proposed regulations.

The temporary regulations provide that section 355(e) will apply if a distribution of Controlled stock (or stock and securities) is part of the same Plan that includes a Planned 50-Percent Acquisition of a predecessor of Distributing (i.e., a POD), Distributing, Controlled, a successor of Distributing, or a successor of Controlled. The temporary regulations have two principal purposes. The first is to ensure that section 355(e) applies to a section 355 distribution if, as part of a Plan, some of the assets of a POD are transferred directly or indirectly to Controlled without full recognition of gain, and the distribution accomplishes a division of the assets of the POD. The second is to ensure that section 355(e) applies when there is a Planned 50-Percent Acquisition of a successor of Distributing or successor of Controlled. The rules of the temporary regulations are to be interpreted and applied in a manner that is consistent with and reasonably carries out such purposes.

Unlike the proposed regulations, which applied irrespective of whether the transfers from a potential POD occurred pursuant to the Plan including the Planned 50-Percent Acquisition, under the temporary regulations, a corporation generally will be a POD only if its assets are transferred to Distributing as part of a Plan that includes the Planned 50-Percent Acquisition. Further, a potential POD will be treated as a POD only if: as part of a Plan, the distribution accomplishes a division of the assets that the potential POD directly and indirectly held during the Plan Period (defined below and such assets, as more fully described below, are referred to in the temporary regulations as Relevant Property); that division occurs through transfers, as part of a Plan, resulting in Controlled directly or indirectly holding some but not all of those assets immediately after the distribution; and all of the gain on the potential POD’s

assets directly or indirectly held by Controlled is not recognized before the distribution. While the requirement that the transfer from the potential POD be part of the Plan limits the definition of POD from that contained in the proposed regulations, the definition is extended in that it no longer solely applies to a section 381 transfer. The preamble to the temporary regulations provides that the definition was expanded to fully address section 355(e) policy concerns and to apply section 355(e) to a section 355 distribution if, as part of a plan, some assets of a POD are transferred to Controlled without full recognition of gain, and the distribution accomplished a division of the POD's assets.

Although the modified definition of a POD is conceptual in nature, it and other aspects of the temporary regulations are implemented through application of a set of defined terms, of which the definition of Relevant Property and Plan Period are integral. "Relevant Property" is defined as any property held directly or indirectly, by a potential predecessor at any point during the Plan Period and "Plan Period" is defined as the period ending immediately after the distribution and beginning on the earliest date on which any pre-distribution step that is agreed to or understood, arranged, or substantially negotiated by one or more officers or directors acting on behalf of Distributing or Controlled, by controlling shareholders of Distributing or Controlled, or by another person or persons with implicit or explicit permission of one or more such officers, directors, or controlling shareholders, but excluding property that was owned directly or indirectly by Distributing unless that property was directly or indirectly transferred to Distributing as part of the Plan. In addition, the definition includes concepts of "Substitute Assets" (any property held directly or indirectly during the Plan Period by Distributing that was received in exchange for Relevant Property acquired directly or indirectly by Distributing if all gain on such transferred Relevant Property was not recognized) and "Separated Property" (each item of Relevant Property transferred to Controlled as part of a plan and is held by Controlled immediately before the distribution). As noted above, the definition of a POD, focuses on the division of Relevant Property as part of a Plan and requires satisfaction of certain pre-distribution and post-distribution requirements. Such rules (as well as the gain limitation rules discussed below) will require tracking of assets transferred to Distributing from potential PODs as part of a Plan including the Planned 50-Percent Acquisition. In addition, the temporary regulations contain certain rules related to acquisitions of stock that could implicate the predecessor or successor rules.

The temporary regulations also expand the definition of a POD to include a predecessor of a POD (the original proposed regulations did not permit a predecessor of a predecessor to be treated as a POD). The temporary regulations provide a similar rule for a predecessor of Controlled.

The temporary regulations further restrict the definition of a predecessor of Controlled (POC). While the definition of a POC is the same as in the proposed regulations (a corporation that transfers property to Controlled in a section 381 transaction), a corporation can only be a POC under the temporary regulations for purposes of determining whether a corporation is treated as remaining in existence as a result of a

transfer between members of an affiliated group (Temp. Reg. 1.355-8(f)). As noted above, unlike in the proposed regulations, a predecessor of a POC may be a POC.

In addition to the changes to the definition of a POD, another major change in the temporary regulations relates to the interplay of predecessor/successor rules and the Plan rules of Reg. 1.355-7. The temporary regulations reflect an intention that the normal construct of the Plan rules in Reg. section 1.355-7 generally apply to acquisitions of POD stock (as well as to acquisitions of the stock of Distributing, Controlled, and their Successors). Accordingly, a general rule is provided that references in Reg. 1.355-7 to Distributing or Controlled are treated as references to a POD, a predecessor of Controlled (POC), or a successor of Distributing or Controlled (Successor), as the context may require. Also, a reference to a distribution in such regulations generally includes a reference to a distribution and other related pre-distribution transactions that together effect a division of the assets of a POD. As a result of these rules, the various Plan safe harbors in Reg. 1.355-7 could apply to acquisitions involving PODs and the applicability of any such safe harbor, in lieu of depending on the relation of the acquisition to the distribution, would seem to depend on the timing of the acquisition of the POD in relation to the transaction effecting the division of assets of the POD.

The temporary regulations provide special rules with regard to the actions taken into account in determining whether a 50% acquisition of a POD occurs as part of Plan. The preamble points out that a 50% acquisition of a POD may occur contemporaneously with a distribution made by Distributing, but without the participation (or even the knowledge) of Distributing. The Treasury and IRS determined that it is not appropriate to impute to Distributing actions of a POD or its shareholders unless such parties would otherwise be taken into account (e.g., because the POD or its shareholder are a controlling shareholder of Distributing or Controlled). Accordingly, any agreement, understanding, arrangement, or substantial negotiations with regard to the acquisition of a POD is analyzed under Reg 1.355-7 by taking into account only the actions of the officers or directors of Distributing or Controlled, their controlling shareholders, or a person acting with implicit or explicit permission of one of those parties.

Like the proposed regulations, under the temporary regulations if there are Planned 50-Percent Acquisitions of multiple corporations (for example two PODs), Distributing must recognize section 355(e) gain in the amount described in section 355(c)(2) or section 361(c)(2), as applicable (the Statutory Recognition Amount) subject to certain gain limitation rules. The gain limitation rules of the proposed regulations are incorporated in the temporary regulations with modifications to address certain concerns. First, the section 355(e) gain is limited by the amount that would be present in hypothetical Controlled stock if Distributing had transferred all the Separated Property to a hypothetical Controlled and distributed the stock of such Controlled in a hypothetical section 368(a)(1)(D)/355 transaction, where section 355(e) applied (the proposed regulations used a hypothetical section 351 construct). The second gain limitation rule is the same as in the proposed regulations and applies if a section 381 transaction caused a Planned 50-Percent Acquisition of Distributing (for example

through an A reorganization of a POD into Distributing). In such situation, the section 355(e) gain is essentially limited to the excess, if any, of the Statutory Recognition Amount over the amount of gain that would have been attributed if the POD only was distributed in a section 355(e) transaction and not Distributing. Finally, the temporary regulations retain the rule that limits the overall amount of section 355(e) gain with respect to any single distribution to the Statutory Recognition Amount. Like the proposed regulations, the temporary regulations contain certain operating rules used when applying the gain limitation rules.

The temporary regulations keep the successor rules and treat as a Successor of Distributing or Controlled for section 355(e) purposes only a transferee to which Distributing or Controlled transferred its assets in a section 381 transaction. The Treasury and the IRS continue to study the possible application of the successor rules to a transferee in a section 351 or section 721 transaction.

The temporary regulations clarify that Distributing may elect to apply the regulations under section 336(e) to a distribution of Controlled stock to which the temporary regulations apply, provided the 336(e) regulations would apply and Distributing would otherwise recognize the Statutory Recognition Amount with respect to the Controlled stock it distributes.

Finally, because of a concern about encroachment on the first and second gain limitation rules, the temporary regulations provide that section 355(f) does not apply if there is a Planned 50-Percent Acquisition of stock of a POD of a lower-tier distributing but not the stock of the lower-tier Distributing or Controlled. As a result, section 355(e), and the first and second gain limitation rules, would apply to the internal distribution. A taxpayer may elect to apply section 355(f) to the internal distribution without any limitation on gain under certain circumstances.

For more information, contact a tax professional with KPMG's Washington National Tax practice

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