Taxation of Spin-off – U.S. and German Corporate Tax Law

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Taxation of spin-off – U.S. and German corporate tax law

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A. Introduction

Corporate law provides for a transaction commonly referred to as “spin-off”. The corporate enterprise is divided in (at least) two corporations. The stock of a controlled subsidiary will be distributed pro rata by a parent corporation to its shareholders which end up owning a brother/sister pair of corporate enterprises.

The Internal Revenue Code (IRC) in § 355 provides special rules for the distribution of stock and securities of a controlled corporation. The transaction is known as a “D reorganization”, if such a distribution follows the transfer by a corporation of all or a part...
of its assets to another corporation, § 368(a)(D) IRC. If the requirements of these sections are met, the Code allows tax free treatment on corporate as well as shareholder level.

The rules of § 355 IRC are rather complicated and give rise to an ongoing discussion on how to amend the Code to make the law less complex. The basic idea behind these provisions is to prevent tax avoidance schemes. In the context of § 355 IRC two principal concerns might be the driving forces: spin-offs could be used (1) to convert ordinary dividend income at the shareholder level into capital gain, and (2) to transfer appreciated property out of the corporation without triggering tax on the corporate level (“circumvent the purposes of General Utilities repeal”). Whether the current rules on the background of these concerns are convincing or amendments should be suggested will be discussed in this paper.

It might be helpful to compare the current U.S. law to the German tax code. German corporate law provides for a similar transaction referred to as “Abspaltung”. This corporate transaction allows the transfer of part of the assets of a corporation to a new or existing other corporation in exchange for stock in this corporation transferred directly to the shareholders of the transferor corporation. From a corporate perspective the results are the same as in case of a “D reorganization” within § 368(a)(D) IRC. § 15 German Transformation Tax Act( “Umwandlungssteuergesetz” – UmwStG) provides for tax free treatment on corporate and shareholder level, if its requirements are met. Although the requirements are similar to those of § 355 IRC they differ in part. Particularly § 15 (3) UmwStG, which contains a provision disallowing the transfer of stock of corporations

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taking part in the Abspaltung to third parties, might present new arguments to the
discussion whether the current rules of § 355 IRC, especially the “device” rule and
§ 355(d), and (e) IRC, should be retained or amendments seem necessary.

The paper will describe the U.S. and German tax provisions. The advantages and
disadvantages of the national rules will be discussed. This might give rise to the conclu-
sion that part of the U.S. rules should be implemented in German tax law or vice versa.

B. U.S. law

I. Basic understanding of spin-off transactions

1. Spin-off transactions – definition and business reasons

a) Definition of spin-off transactions

A corporate enterprise can engage in different businesses. From a corporate law
point of view there is no need to incorporate several independent corporations. Never-
theless, a division of such a multidivisional corporation might be desirable. If the only
purpose of such a separation of businesses is to insulate the remaining corporate enter-
prise from the potential liabilities of risky operations, the creation of a subsidiary might
be sufficient.¹ However, often the desired objective can be accomplished only if the
shares of an existing or newly created subsidiary corporation are distributed by the parent

¹ Provided the structure does not trigger a piercing of the corporate veil. See for New York law Walkovksy
v. Carlton, 18 N.Y. 2d 414 (1966); parent-subsidiary context: Bernardin, Inc. v. Midland Oil Corp., 520
F.2d 771 (5th Cir. 1975).

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corporation to (some or all of) its shareholders. Typically, this latter type of transaction is referred to as “division of the corporation”.\textsuperscript{2}

The division of a corporation can be structured in different ways. Generally, the corporate divisions might be accomplished in three forms: (1) the spin-off as the “basic” form of corporate division in which shares of an existing or newly created subsidiary corporation are distributed to shareholders as a dividend; (2) the split-off in which the subsidiary stock is transferred to some of the parent’s shareholders in exchange for their parent stock; and (3) the split-up in which the parent corporation is liquidated and its assets are distributed to its shareholders.\textsuperscript{3}

It is up to the corporation to select the form best suited to its business purposes.\textsuperscript{4}

The paper will focus on the spin-off as the basic form of corporate division. Other forms of corporate divisions (i.e. split-off and split-up) will be discussed in the context of separation of shareholder groups.

\textbf{b) Business reasons for divisive transactions}

A divisive transaction might serve several purposes. One reason often stated is the possibility to insulate liabilities of different businesses.\textsuperscript{5} As mentioned above,\textsuperscript{6} this goal

\begin{itemize}
  \item \textsuperscript{2} See \textit{Solomon}, White on New York Corporations, Part I, § 6.01.
  \item \textsuperscript{3} Cf. \textit{Solomon}, White on New York Corporations, Part I, § 6.03; \textit{Howley}, Business Organizations with Tax Planning, Part 23, § 150.03.
  \item \textsuperscript{4} \textit{Howley}, Business Organizations with Tax Planning, Part 23, § 150.03.
  \item \textsuperscript{5} \textit{Howley}, Business Organizations with Tax Planning, Part 23, § 150.02 [2].
  \item \textsuperscript{6} Under B.I.1.a).
\end{itemize}

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can be accomplished without spinning off the stock of a subsidiary to the parent’s share-
holders – generally the formation of a subsidiary is sufficient.\(^7\) Stated from an investor
perspective, the spin-off by the parent corporation of riskier operations gives shareholders
the opportunity to decide on their own whether they want to stay invested in more
speculative businesses or not. A listing of “one-division” corporations allows investors to
decide in which business to invest – this might result in a higher valuation of the parts
after corporate division.\(^8\)

If Antitrust considerations or government regulation require a division of the
corporate entity, a spin-off might be the best solution. The mere formation of a subsidiary
will not be sufficient in these cases.\(^9\)

Dividing the corporation allows to dispose unwanted assets in a tax-free sale. An
acquirer might be interested only in one of several businesses. To achieve an acquisition
via tax-free merger the target business has to be spun-off first.\(^10\) Notably, § 355 IRC
contains limitation with respect to these pre-sale or pre-acquisition transactions. The
same applies to spin-offs which shall facilitate the sale of assets without paying tax on the
corporate level. This result generally could be achieved by transferring the assets into a

\(^7\) See Treas. Reg. § 1.355-2(b)(5), Example (3); Solomon, White on New York Corporations, Part I, § 6.02
[2].

\(^8\) Howley, Business Organizations with Tax Planning, Part 23, § 150.02 [2]; Solomon, White on New York
Corporations, Part I, § 6.02 [4]; Lind/Schwarz/Lathrope/Rosenberg, Fundamentals of Corporate Taxation,
5.E., Ch. 10 A.2.

\(^9\) Cf. Commissioner v. Morris Trust, 367 F.2d 794 (4th Cir. 1966); Fox/Fox, Corporate Acquisitions and
Mergers, Part 2, § 4.09 [1].


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newly created corporation (NewCo) and then spinning off NewCo’s stock to the parent’s shareholders. If § 355 IRC would not provide for limitations, the shareholders could realize the value of the assets by just selling the distributed stock instead of the corporation selling the assets and the gain realized being distributed to the shareholders.

Divisive transactions allow the separation of shareholder groups.\textsuperscript{11} If the shareholders of the transferor corporation are no longer able to solve their conflicts or the decision process is too time consuming, the corporation can no longer compete successfully. If the existing shareholder groups wish to continue parts of the business in a corporate form, a divisive reorganization seems to be the solution. Typically such a separation of shareholder groups will be accomplished by a split-off.\textsuperscript{12}

2. Spin-off transactions under U.S. corporate law

To divide a corporation by means of a spin-off as the “basic” form of corporate division, the shares of an existing or newly created subsidiary corporation are distributed to shareholders as a dividend. A two-step approach is needed, if no subsidiary exists. Initially, the transferor corporation would cause a NewCo to be formed and then transfer at least one business to NewCo in exchange for all of NewCo’s outstanding stock. The corporate law requirements for this transfer are identical with those for any formation of a corporation.\textsuperscript{13} In a second step, the transferor corporation would distribute the subsidiary


\textsuperscript{12} \textit{Fox/Fox}, Corporate Acquisitions and Mergers, Part 2, § 4.09 [1].

\textsuperscript{13} \textit{Solomon}, White on New York Corporations, Part I, § 6.01, Fn. 2.

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stock to its shareholders as a dividend in kind. To this dividend the same corporate law limitations as to any other dividend apply.\textsuperscript{14}

If a split-off is desired, the same steps described above would be taken except that the subsidiary stock is transferred only to some of the transferor corporation’s shareholders and the distribution of the subsidiary stock is in exchange for the transferor corporation’s own outstanding stock. Corporate law requirements of transactions by a corporation with respect to its own shares apply to this purchase of own stock by the transferor corporation.\textsuperscript{15}

It should be mentioned that a registration under the Securities Act of 1933 might be necessary, if the transferor corporation’s shares are listed on a public market. In this case the distributed stock of the subsidiary ends up to be held by the shareholders of the transferor corporation, i.e. the investing public.\textsuperscript{16}

\textbf{II. U.S. corporate tax regime}

\textbf{1. General corporate tax regime}

The Internal Revenue Code (IRC) provides under Subchapter C for a double taxation of distributed corporate earnings.\textsuperscript{17} The income is taxed first on the corporate

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\textsuperscript{14} E.g. N.Y. Bus. Corp. Law § 510 (no insolvency, out of surplus); see Solomon, White on New York Corporations, Part I, § 6.03 [1].

\textsuperscript{15} For New York law cf. N.Y. Bus. Corp. Law § 513 (e.g. no insolvency, correct purchase price); Solomon, White on New York Corporations, Part I, § 6.03 [1].

\textsuperscript{16} Cf. Fox/Fox, Corporate Acquisitions and Mergers, Part 5, § 23.02 [3]. See also Rule 145 of Securities Act of 1933.

\textsuperscript{17} This is not true for corporations taxed under Subchapter S (§§ 1361-1378 IRC). However, the paper will focus on the general principles of the taxation of corporations laid out in Subchapter C.

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level and taxed a second time when distributed to the shareholders. The applicable tax rate on the corporate level is 35%.\(^{18}\) Generally, the tax rate of the shareholders is determined in accordance with §§ 1 (a)-(d), 11 IRC, which ever is applicable. However, the tax burden for corporations is reduced by the dividend-received deduction.\(^ {19}\) For individual taxpayers, starting in 2003, the tax rate for dividends has been significantly lowered. Qualified dividends received by individual shareholders are taxed at the same rates that apply to net capital gain.\(^ {20}\)

If the shareholder sells the corporation’s shares, the shareholder has to include the difference of the amount realized and the adjusted basis in taxable income.\(^ {21}\) This gain is not taxed as ordinary income, but rather in accordance with the tax rates on capital gains under § 1 (h) IRC, provided the shares have been held by the individual taxpayer for more than one year.\(^ {22}\) The preferential treatment of capital gains might encourage structuring transactions to receive a capital gains treatment rather than including the items in ordinary income. This is especially true with respect to spin-off transactions.\(^ {23}\)

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\(^ {18}\) For details see § 11 (b) IRC

\(^ {19}\) Cf. § 243 IRC.


\(^ {21}\) Cf. § 1001 (a) IRC.

\(^ {22}\) Regarding the applicable tax rates see new § 1 (h) IRC, as amended by Jobs and Growth Tax Relief Reconciliation Act of 2003, May 28, 2003. Cf. § 1221 IRC defining capital asset and Bielfeldt v. Commissioner, 231 F.3d 1035 (7th Cir. 2000) for the distinction between ordinary and capital income with respect to securities. For corporations a 35% tax rate on capital gains applies, cf. § 1201 (a) IRC.

\(^ {23}\) See B.III. for details.

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2. Consolidated group

A group of corporations related through one “parent” corporation holding directly or indirectly at least 80% of the other group members (so called “affiliated group”)\(^{24}\) may elect to file a consolidated tax return treating the group as a single unit for tax purposes.\(^{25}\) Once the election is made for a taxable year, the group members must continue to file on a consolidated basis unless the IRS consents to a termination or the common parent corporation is no longer in existence.\(^{26}\)

The affiliated group is treated as a single unit for tax purposes. Accordingly, the tax liability is computed based on dealings with third parties outside the affiliated group. Transactions within the group have to be eliminated.\(^{27}\) As an important advantage, losses of one group member can be used to offset income of profitable members of the affiliated group\(^{28}\) with certain limitations.\(^{29}\)

\(^{24}\) Cf. § 1504 IRC.

\(^{25}\) See § 1501 IRC.

\(^{26}\) Abrams/Doernberg, Federal Corporate Taxation, 5.E., Ch. 11.07; Lind/Schwarz/Lathrope/Rosenberg, Fundamentals of Corporate Taxation, 5.E., Ch. 13 B.2.b.

\(^{27}\) Cf. Abrams/Doernberg, Federal Corporate Taxation, 5.E., Ch. 11.07 (d); Lind/Schwarz/Lathrope/Rosenberg, Fundamentals of Corporate Taxation, 5.E., Ch. 13 B.3; for details.

\(^{28}\) Lind/Schwarz/Lathrope/Rosenberg, Fundamentals of Corporate Taxation, 5.E., Ch. 13 B.5; Abrams/Doernberg, Federal Corporate Taxation, 5.E., Ch. 11.07 (g).

\(^{29}\) See Abrams/Doernberg, Federal Corporate Taxation, 5.E., Ch. 11.07 (g), describing several limitations according to the Treasury Regulations § 1-1502, e.g. rules based on §§ 381, 382 IRC disallowing loss deductions in case of the acquisition of a corporation with “built-in” losses.

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III. Taxation of Spin-offs

1. Overview

There are several legitimate business reasons to pursue a corporate division. The purpose of § 355 IRC is to allow such business driven corporate divisions without triggering taxes on corporate or shareholder level.30

In accordance with this rationale, non-recognition treatment shall be available to transactions which merely change the form of the business without changing the ownership.31 Divisive reorganizations not serving a legitimate business reason will be taxable. Typically, spin-offs are utilized (1) to convert ordinary dividend income at the shareholder level into capital gain, and (2) to transfer appreciated property out of the corporation without triggering tax on the corporate level. The requirements of § 355 IRC are designed to differentiate between corporate divisions primarily aimed to realize the tax benefits of § 355 IRC and those with valid business reasons.

To achieve tax free treatment of the divisive transaction under the Code, the taxpayers have to comply with the complicated provision § 355 IRC as well as judicial requirements.32 First, the distributing corporation must be in “control” of the existing or – in case of a “D reorganization” under § 368 (a)(1)(D) IRC – newly created subsidiary the

30 Lind/Schwarz/Lathrope/Rosenberg, Fundamentals of Corporate Taxation, 5.E., Ch. 10 A.4.


32 For the following see Fox/Fox, Corporate Acquisitions and Mergers, Part 2, § 4.09 [2]. Lind/Schwarz/Lathrope/Rosenberg, Fundamentals of Corporate Taxation, 5.E., Ch. 10 A.4.a.

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stock of which is transferred. The transferor corporation must distribute at least sufficient stock to constitute control under § 368 (c) IRC to its shareholders. Third, both the distributing corporation and the controlled corporation must be engaged in the “active conduct of a trade or business” immediately after the distribution and for a 5-year period preceding the transaction. Fourth, the transaction is not used principally as a device for the distribution of earnings and profits. Additional judicial limitations apply: non-recognition is available only if the divisive transaction is carried out for an independent corporate business purpose and the shareholders of the enterprise prior to the division maintain adequate continuity of interest in the corporation taking part in the transaction after the distribution.

A transaction under § 355 IRC need not be part of a reorganization. However, if the distributing corporation initially transfers part of its assets to a newly-formed subsidiary corporation the stock of which will be distributed, the transaction as a whole will constitute a divisive “D reorganization” under § 368 (a)(1)(D) IRC. According to

33 § 355 (a)(1)(A) IRC.

34 § 355 (a)(1)(D) IRC.

35 § 355 (a)(1)(C) with (b) IRC.

36 § 355 (a)(1)(B) IRC.

37 See Treas. Reg. § 1.355-2(b), (c).

38 Cf. § 355 (a)(2)(C) IRC.

39 Provided that the requirements of a reorganization are met: (1) a reorganization within § 368 (a)(1) IRC takes place, (2) the exchange is made in accordance with the plan of reorganization, and (3) the parties to the exchange are parties to the reorganization within § 368 (b) IRC, or shareholders or security holders of a party to the reorganization; see Calvitch, Business Organizations with Tax Planning, Part 26, Ch. 176.01 [1]-[4]; Schler, Simplifying and Rationalizing the Spinoff Rules, 56 SMU L. Rev. 239 (242).

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§ 361 (a) IRC, the transferor corporation will recognize no gain or loss on the asset transfer if the transfer is solely in exchange for stock. The basis of the assets transferred will generally be the same for the new subsidiary corporation as in the hands of the transferor corporation.\textsuperscript{40} Earnings and profits of the transferor corporation are apportioned between the transferor and the transferee corporation,\textsuperscript{41} but § 381 IRC, providing for carryover of net operating loss, does not apply.\textsuperscript{42} For the whole reorganization to receive the tax free treatment, the second step of the reorganization – the distribution of the NewCo’s stock – must qualify under § 355 IRC.\textsuperscript{43}

2. Statutory and judicial requirements of § 355 IRC

a) Control requirement

The corporation – in case of a “D reorganization”– transferring the assets to a newly formed subsidiary and distributing the stock must distribute to its shareholders the shares of a corporation which “it controls immediately before the distribution”.\textsuperscript{44} “Control”, for this purpose, means ownership of at least 80% of the combined voting power of all classes of stock entitled to vote, and at least 80% of the number of shares of

\textsuperscript{40} See § 362 (b) IRC.

\textsuperscript{41} Lind/Schwarz/Lathrope/Rosenberg, Fundamentals of Corporate Taxation, 5.E., Ch. 10 D.3.

\textsuperscript{42} Cf. § 381 (a), (c) IRC; Lind/Schwarz/Lathrope/Rosenberg, Fundamentals of Corporate Taxation, 5.E., Ch. 10 D.3.

\textsuperscript{43} According to § 368 (a)(1)(D) IRC the stock must be distributed in a transaction which “qualifies under § 354, 355, or 356” IRC. See Doernberg/Abrams, Federal Income Taxation of Corporations and Partnerships, 3.E., Ch. 11.A, Note 7 (p. 466-467). – The initial transfer to the newly created subsidiary would otherwise qualify for non-recognition under § 351 IRC, but the reorganization provision take precedence, cf. Lind/Schwarz/Lathrope/Rosenberg, Fundamentals of Corporate Taxation, 5.E., Ch. 10 A.1.

\textsuperscript{44} § 355 (a)(1)(A) IRC.

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all other classes of stock. To meet this ownership requirement, the ownership immediately before the distribution is decisive. After the transfer of the shares ownership can be shared by the stockholder of the distributing corporation.

The stock of the controlled corporation must be distributed to the shareholders with respect to the distributing corporation’s stock or distributed to a security holder of the distributing corporation in exchange for its securities. A non pro-rata distribution of the subsidiary’s shares in exchange of the stock of the distributing corporation would effect a split-off.

b) Distribution of all stock

The distributing corporation must distribute all of the stock and securities in the controlled corporation held by it immediately before the distribution to its shareholders. Alternatively, the distribution must comprise at least sufficient stock to constitute control within § 368 (c) IRC and it is established to the satisfaction of the Secretary that the retention by the distributing corporation of stock in the controlled corporation was not pursuant to a plan having as one of its principal purposes the avoidance of tax. For example, this may apply if the distributing corporation has pledged part of the

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45 § 368 (c) IRC. For details see Howley, Business Organizations with Tax Planning, Part 23, § 150.05 [2]; Lind/Schwarz/Lathrop/Rosenberg, Fundamentals of Corporate Taxation, 5.E., Ch. 10 A.4.a.; Schler, Simplifying and Rationalizing the Spinoff Rules, 56 SMU L. Rev. 239 (259).


47 § 355 (a)(1)(A)(i) and (ii) IRC. See Solomon, White on New York Corporations, Part I, § 6.04 [4][b][i].

48 Fox/Fox, Corporate Acquisitions and Mergers, Part 2, § 4.09 [2][e].

49 § 355 (a)(1)(D)(i) IRC.

50 See § 355 (a)(1)(D)(ii) IRC.

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subsidiary’s stock as collateral for a loan and is therefore not able to transfer these shares.\footnote{Fox/Fox, Corporate Acquisitions and Mergers, Part 2, § 4.09 [2][e]; Howley, Business Organizations with Tax Planning, Part 23, § 150.05 [3].}

c) **Active trade or business requirement**

The distributing corporation and the controlled corporation have to be directly or indirectly\footnote{For a indirect activity see § 355 (b)(1)(B), (b)(2)(A) IRC; Howley, Business Organizations with Tax Planning, Part 23, § 150.05 [4]; Solomon, White on New York Corporations, Part I, § 6.04 [4][b][v].} engaged immediately after the distribution in an active conduct of a trade or business which has been so conducted throughout the 5-year period ending on the date of distribution.\footnote{Cf. § 355 (a)(1)(C), (b)(1)(A) and (2) IRC.} The purpose of this requirement is to prevent the bailout of cash or investment assets by separating active trade or business in either the distributing or the controlled corporation and then selling off this corporation.\footnote{Cf. Fox/Fox, Corporate Acquisitions and Mergers, Part 2, § 4.09 [2][c]; Abrams/Doernberg, Federal Corporate Taxation, 5.E., Ch. 10.04 (a), at 266.} The 5-year period is designed to preclude a temporary investment of liquid assets in a new\footnote{Only the acquisition of a new business violates the “active trade or business” requirement. If the transaction can be characterized as an expansion of an existing business, i.e. the acquisition of another business in the same line of work, tax-free treatment will still be available; see Treas. Reg. § 1.355-3(b)(3)(ii); Solomon, White on New York Corporations, Part I, § 6.04 [4][d][ii].} business and then spinning it off to meet the active trade or business requirement.\footnote{Abrams/Doernberg, Federal Corporate Taxation, 5.E., Ch. 10.04 (a), at 268; Howley, Business Organizations with Tax Planning, Part 23, § 150.05 [5]. Note, that a business may be acquired during this 5-year period in a tax-free transaction without violating the rule, see § 355 (b)(2)(C) IRC; Fox/Fox, Corporate Acquisitions and Mergers, Part 2, § 4.09 [2][c].} To achieve this goal, the scope of the provision is very broad: even the taxable acquisition of the distributing corporation by the distributee shareholder might violate the requirement if within the 5-year period.\footnote{Cf. § 355 (b)(2)(D)(i) with (ii) IRC.}

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§ 355 IRC does not define the term “active business”. According to the Regulations the corporation shall be treated as engaged in a trade or business if a specific group of activities are being carried on by the corporation for the purpose of earning income or profit, and the activities include every operation that forms a step in the income-earning process.\(^{58}\) This trade or business is (generally) actively conducted if the corporation performs active and substantial management and operational functions.\(^{59}\) An active conduct of a trade or business does not include the holding for investment purposes of stock, securities, land, or other property,\(^{60}\) or owner-occupied or leased real property with respect to which the owner does not provide significant services.\(^{61}\) Therefore, the transfer of real property to a newly formed subsidiary might not qualify if the real property is merely leased-back to the transferor corporation. The new owner has at least to provide sufficient management and maintenance services to qualify for an actively conducted trade or business.\(^{62}\)

\(^{58}\) Treas. Reg. § 1.355-3(b)(2)(ii).

\(^{59}\) See Treas. Reg. § 1.355-3(b)(2)(iii), for details. Generally, these activities must be performed by the corporation itself, i.e. its employees; cf. Howley, Business Organizations with Tax Planning, Part 23, § 150.05 [4].

\(^{60}\) Treas. Reg. § 1.355-3(b)(2)(iv)(A).

\(^{61}\) Rafferty v. Commissioner, 452 F.2d 767 (1st Cir. 1971); Treas. Reg. § 1.355-3(b)(2)(iv)(B). See also Abrams/Doernberg, Federal Corporate Taxation, 5.E., Ch. 10.04 (a), at 266/267.

\(^{62}\) See Treas. Reg. § 1.355-3(c), Example (12). The services must be conducted by employees of the corporation – hiring an independent contractor will not be sufficient; Treas. Reg. § 1.355-3(b)(iii). For details regarding the spin-off of real estate cf. Howley, Business Organizations with Tax Planning, Part 23, § 150.05 [5][b]; Solomon, White on New York Corporations, Part I, § 6.04 [4][d][iv].

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There need not have been two active trades or businesses before the division. A “vertical” division of a single preexisting business into two separate, independent businesses will qualify for the “active trade or business” requirement, provided the divided business was conducted for at least five years prior to the transaction.63

d) Not a “device”
§ 355 (a)(1)(B) IRC requires that a corporate division not be used principally as a device for the distribution of the earnings and profits of the distributing or the controlled corporation. Historically, the restriction was intended to prevent use of divisive transactions to convert dividend income into capital gains.64

The Regulations use a facts-and-circumstances test to determine whether a transaction fails the device test.65 Three factors identified by the Regulations as evidence of a “device” provide some guidance for this fact-and-circumstances test. However, the presence of one or more of these factors is not controlling.66

First, a distribution that is pro rata or substantially pro rata among the shareholders of the distributing corporation is evidence of a “device”.67 Due to the similarity of

63 Commissioner v. Coady, 289 F.2d 490 (6th Cir. 1961); United States v. Marett, 325 F.2d 28 (5th Cir. 1963); Treas. Reg. § 1.355-3(c), Example (4); Solomon, White on New York Corporations, Part I, § 6.04 [4][d][ii]; Howley, Business Organizations with Tax Planning, Part 23, § 150.05 [5][a].

64 Today, the meaning and scope of the “device clause” seems not free of uncertainty; Lind/Schwarz/Lathrope/Rosenberg, Fundamentals of Corporate Taxation, 5.E., Ch. 10 C.3.a.


66 Lind/Schwarz/Lathrope/Rosenberg, Fundamentals of Corporate Taxation, 5.E., Ch. 10 C.3.a. How to balance the relevant factors is illustrated by Howley, Business Organizations with Tax Planning, Part 23, § 150.05 [8].


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such a pro rata distribution to a regular dividend the criteria seems convincing. However, this interpretation might be in conflict with § 355 (a)(2)(A) IRC. The second factor mentioned in the Regulations is a subsequent sale or exchange of stock of the distributing or controlled corporation. The greater the percentage of the stock sold and the shorter the period of time between the distribution and the sale or exchange, the stronger the evidence of a device. If the subsequent sale or exchange is negotiated or agreed upon before the distribution, this shall be treated as substantial evidence of a device. But even without such a prior arrangement, the sale or exchange shall be evidence of a device.

Notably, § 355 (a)(1)(B) IRC itself states that a subsequent sale – if not pre-arranged – shall not be construed to mean the transaction was used principally as a device. Again the Regulations appear to be in conflict with the language of the Code. The result may be justified in assuring continuity of interest, but the utilization of the “device” clause does not seem convincing. The third device factor under the Regulations is “the nature, kind, amount and use of the assets of the distributing and controlled corporation”. E.g. the spin-off of liquid or other assets not used in trade or business shall be evidence of device, even if these assets satisfy the requirements of § 355 (b) IRC.

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68 Abrams/Doernberg, Federal Corporate Taxation, 5.E., Ch. 10.04 (a), at 265.


72 Cf. Lind/Schwarz/Lathrope/Rosenberg, Fundamentals of Corporate Taxation, 5.E., Ch. 10 C.3.b.


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The Regulations also list three factors which are evidence that a distribution is not a device ("corporate business purpose", "distributing corporation publicly traded and widely held", "distribution to domestic corporate shareholders entitled to dividends received deduction")\(^{75}\). In addition, the Regulations describe distributions that will not be treated as a device. E.g., if neither the distributing corporation nor the controlled corporation has earnings and profits, the distribution will not be treated as a "device".\(^{76}\) This appears to be justified: no bail-out of earnings and profits without earnings and profits.\(^{77}\)

In summary, the "device" requirement is utilized as a do-it-all provision. This seems reasonable to prevent tax avoidance. However, the wording of the Code might not support the broad understanding of the "device" clause.

e) Independent business purpose

The business purpose doctrine originated in *Gregory v. Helvering*\(^{78}\) has become an important limitation under § 355 IRC.\(^{79}\) It parallels the "device" clause in its focus on the taxpayer’s motivation of the transaction.\(^{80}\) However, the test is much broader as the inquiry is not focused on whether the taxpayer tries to circumvent taxation on dividends

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\(^{76}\) See *Treas. Reg.* § 1.355-2(d)(5)(ii).

\(^{77}\) *Abrams/Doernberg*, Federal Corporate Taxation, 5.E., Ch. 10.04 (a), at 265.

\(^{78}\) Supreme Court of the United States, 293 U.S. 465 (1935).

\(^{79}\) *Lind/Schwarz/Lathrope/Rosenberg*, Fundamentals of Corporate Taxation, 5.E., Ch. 10 C.1.; *Abrams/Doernberg*, Federal Corporate Taxation, 5.E., Ch. 10.04 (a), at 262.

\(^{80}\) *Lind/Schwarz/Lathrope/Rosenberg*, Fundamentals of Corporate Taxation, 5.E., Ch. 10 C.1.

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by achieving capital gains treatment, but rather on whether the transaction is driven by any kind of tax avoidance. 81

The business purpose test requires the division to be motivated by some business purpose of the corporate enterprise as opposed to business purpose of a shareholder. 82 According to the Regulations, such a corporate business purpose is a “real and substantial non-Federal tax purpose germane to the business of the distributing corporation, the controlled corporation, or the affiliated group to which the distributing corporation belongs”. 83 Accepted reasons for a division include compliance with an antitrust order, resolution of shareholder conflicts, and facilitation of a public offering, 84 but not the reduction of Federal taxes (e.g. distribution to facilitate an election under Subchapter S, even if no tax avoidance). 85 Shareholder purposes are only of relevance if they interfere with the corporate sphere, as in the case of shareholder conflicts, which might impede

81 Cf. Solomon, White on New York Corporations, Part I, § 6.04 [4][b][iv]; Abrams/Doernberg, Federal Corporate Taxation, 5.E., Ch. 10.04 (a), at 263. Please note, that a transaction motivated neither by legitimate business concerns nor by tax avoidance will not qualify as a tax-free division under § 355 IRC; Howley, Business Organizations with Tax Planning, Part 23, § 150.06 [1].

82 Treas. Reg. § 1.355-2(b)(1).

83 Treas. Reg. § 1.355-2(b)(2).

84 See Lind/Schwarz/Lathrope/Rosenberg, Fundamentals of Corporate Taxation, 5.E., Ch. 10 C.1.; Abrams/Doernberg, Federal Corporate Taxation, 5.E., Ch. 10.04 (a), at 263. – Rev. Proc. 96-30, 1996-1 C.B. 696, provides for guidelines with respect to the business purpose requirement and sets forth the formalities the taxpayer has to comply with to obtain an advance ruling; cf. Fox/Fox, Corporate Acquisitions and Mergers, Part 2, § 4.09 [2][b]; Lind/Schwarz/Lathrope/Rosenberg, Fundamentals of Corporate Taxation, 5.E., Ch. 10 C.1.

85 Cf. Treas. Reg. § 1.355-2(b)(5), Example (6). This approach may be questionable, see Abrams/Doernberg, Federal Corporate Taxation, 5.E., Ch. 10.04 (a), at 264; Solomon, White on New York Corporations, Part I, § 6.04 [4][d][vii].

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corporate performance.\textsuperscript{86} Although there is a valid business purpose, the transaction will not qualify for tax-free treatment under § 355 IRC if this business purpose can be achieved through another kind of nontaxable transaction which is neither impractical nor unduly expensive.\textsuperscript{87} Due to this broad wording (“neither impractical nor ‘unduly’ expensive”) even pure business decisions might not qualify for § 355 IRC.\textsuperscript{88}

f) Continuity of interest requirement

The Regulations require that those persons with an interest in the corporate enterprise prior to the division must own, in the aggregate, stock establishing “continuity of interest” in each of the modified corporate forms in which the enterprise is conducted after the distribution.\textsuperscript{89} This requirement is intended to prevent tax-free treatment of transactions that are substantially equivalent to a sale to third parties.\textsuperscript{90} Accordingly, the continuity of interest requirement is not violated by a non-pro rata distribution leaving some shareholders owning the distributing corporation and other shareholders owning the controlled corporation. In aggregate, the former shareholders\textsuperscript{91} of the distributing

\textsuperscript{86} Treas. Reg. § 1.355-2(b)(2); see also Howley, Business Organizations with Tax Planning, Part 23, § 150.06 [1]; Solomon, White on New York Corporations, Part I, § 6.04 [4][d][vii]; Abrams/Doernberg, Federal Corporate Taxation, 5.E., Ch. 10.04 (a), at 263.

\textsuperscript{87} Treas. Reg. § 1.355-2(b)(3).

\textsuperscript{88} If the Regulations are applied in accordance with Treas. Reg. § 1.355-2(b)(5), Examples (4) and (5), this might not be a problem since the results seem correct. But not every case is such a clear shot; cf. Solomon, White on New York Corporations, Part I, § 6.04 [4][d][vii].

\textsuperscript{89} Treas. Reg. § 1.355-2(c)(1). See Lind/Schwarz/Lathrope/Rosenberg, Fundamentals of Corporate Taxation, 5.E., Ch. 10 C.2.

\textsuperscript{90} Howley, Business Organizations with Tax Planning, Part 23, § 150.06 [2].

\textsuperscript{91} According to Lind/Schwarz/Lathrope/Rosenberg, Fundamentals of Corporate Taxation, 5.E., Ch. 10 C.2., shareholders who acquire stock in the distributing corporation prior to the time that this corporation decides to engage in a division should qualify as former or “historic” shareholders.

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corporation still own the modified corporate forms resulting from this transaction.\(^{92}\)

However, a minimum continuity must be retained in each of the modified corporate forms after the distribution\(^{93}\) – an ownership of 50% is sufficient for the continuity of interest requirement, an ownership of 20% is not.\(^{94}\)

### 3. Tax consequences for the parties of the corporate division

#### a) Taxation of a division within the legal requirements

If all the requirements of § 355 IRC are met, the distribution of stock will be tax-free both on corporate and shareholder level.

The corporation does not have to recognize any gain otherwise triggered by the distribution of appreciated stock.\(^{95}\) According to § 311 (b)(1)(A) IRC (“distribution to which subpart A [i.e. §§ 301-307 IRC] applies”) this provision of the Code does not apply to transactions under § 355 IRC.\(^{96}\) If the corporation distributes boot\(^{97}\) in addition to the stock, gain (but not loss) in the amount the fair market value of the boot exceeds its adjusted basis has to be recognized under § 355 (c) IRC or (in case of a “D reorganiza-

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\(^{92}\) Cf. Treas. Reg. § 1.355-2(c)(2), Example (1).

\(^{93}\) A sale shortly after the distribution may violate the continuity of interest requirement, cf. Lind/Schwarz/Lathrope/Rosenberg, Fundamentals of Corporate Taxation, 5.E., Ch. 10 C.2.

\(^{94}\) See Treas. Reg. § 1.355-2(c)(2), Examples (2) and (4); Solomon, White on New York Corporations, Part I, § 6.04 [4][b][ii].

\(^{95}\) § 355 (c)(1) IRC. For general treatment of a distribution of appreciated property see § 311 (b)(1) IRC.

\(^{96}\) Abrams/Doernberg, Federal Corporate Taxation, 5.E., Ch. 10.04 (b), at 270; Lind/Schwarz/Lathrope/Rosenberg, Fundamentals of Corporate Taxation, 5.E., Ch. 10 D.3.

\(^{97}\) Stock of a controlled corporation acquired by the distributing corporation in a taxable transaction within 5 years of the distribution is treated as boot, see § 355 (a)(3)(B) IRC. For details cf. Howley, Business Organizations with Tax Planning, Part 23, § 150.07 [1].

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tion”) under § 361 (c) IRC.\(^{98}\) Earnings and profits of the transferor corporation are apportioned between the transferor and the transferee corporation.\(^{99}\) No other tax attributes of the distributing corporation are affected – § 381 IRC, providing for carryover of net operating loss, does not apply even if the distribution is part of a “D reorganization”.\(^{100}\)

According to § 355 (a) IRC the shareholder generally does not have to recognize any gain or loss in the distribution. If the shareholder in addition to the stock receives boot he might be taxable under § 356 (a) or (b) IRC. Boot received in a distribution is taxed up to an amount equal to fair market value of the boot under the tax regime for distributions of property (i.e. § 301 IRC).\(^{101}\) If boot is received in an exchange (e.g. split-off), any gain realized in this exchange will be taxable up to an amount equal to fair market value of the boot.\(^{102}\) The basis of the stock received by the distributee shareholder is determined under § 358 IRC. If the shareholder receives no boot, the aggregated basis of his original stock will be allocated among the stock distributed and the stock retained in proportion to their fair market value.\(^{103}\) If boot is received, the boot will take a basis equal to its fair market value; the amount allocable to any stock distributed and retained will be decreased by the amount of the boot received and increased by the amount of any

\(^{98}\) Abrams/Doernberg, Federal Corporate Taxation, 5.E., Ch. 10.04 (b), at 270.


\(^{100}\) Cf. § 381 (a), (c) IRC; Lind/Schwarz/Lathrope/Rosenberg, Fundamentals of Corporate Taxation, 5.E., Ch. 10 D.3.

\(^{101}\) Cf. § 356 (b) IRC.

\(^{102}\) See § 356 (a) IRC; for details Lind/Schwarz/Lathrope/Rosenberg, Fundamentals of Corporate Taxation, 5.E., Ch. 10 D.2.

\(^{103}\) Cf. § 358 (a)(1), (b)(1) and (2) IRC.

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dividend or gain recognized.\textsuperscript{104} The shareholder’s holding period in the stock received includes the holding period of the stock of the distributing corporation.\textsuperscript{105}

\textbf{b) Taxation of a failed division}

The tax consequences of the distribution itself depend on the form of divisive transaction.\textsuperscript{106} This distinction applies, whether the defective division is part of a “D reorganization” or the corporation distributed stock of a pre-existing subsidiary. In the case of a “D reorganization” the formation of the NewCo still qualifies for non-recognition, governed by § 351 IRC rather than § 368 IRC.\textsuperscript{107}

If a pro-rata spin-off fails to qualify under § 355 IRC, the transaction will be taxed as a distribution (i.e. § 301 IRC). The shareholder will be taxed as receiving a dividend to the extent of current and accumulated earnings and profits; the fair market value of stock distributed exceeding this amount and the shareholders’ basis for their stock in the distributing corporation will be treated as capital gain.\textsuperscript{108} A failed split-off will be tested under the stock redemption rules of § 302 IRC.\textsuperscript{109} If the redemption does not meet the

\textsuperscript{104} § 358 (a)(1)(A) and (B), (2) IRC.

\textsuperscript{105} See § 1223 (1)(B) IRC; \textit{Lind/Schwarz/Lathrope/Rosenberg}, Fundamentals of Corporate Taxation, 5.E., Ch. 10 D.2.

\textsuperscript{106} \textit{Solomon}, White on New York Corporations, Part I, § 6.04 [4][e].

\textsuperscript{107} \textit{Lind/Schwarz/Lathrope/Rosenberg}, Fundamentals of Corporate Taxation, 5.E., Ch. 10 D.4.


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requirements for exchange treatment (cf. § 302 (b) IRC), it will be treated as ordinary
distribution under § 301 IRC.\textsuperscript{110}

The distributing corporation in a failed spin-off or split-off must recognize gain
on any unrealized appreciation in the stock distributed as if it had sold the shares for an
amount equal to its fair market value; no loss is recognized.\textsuperscript{111}

\textbf{4. Special provisions with respect to change of control}

Until 1986, the \textit{General Utilities} doctrine permitted a corporation to distribute
appreciated property to its shareholders without recognizing gain on the appreciation.\textsuperscript{112}
The Tax Reform Act of 1986 introduced several changes strengthening the corporate
double taxation. Especially, a distribution of appreciated property was no longer possible
without triggering tax on corporate level.\textsuperscript{113} A tax-free division of a corporate business in
preparation for a sale of stock of either the distributing or the controlled corporation may
contravene this new policy.\textsuperscript{114} Accordingly, Congress added § 355 (d) and (e) IRC, which
provide for a taxation of the distributing corporation in case of a pre- or post-distribution
transfer of control.\textsuperscript{115}

\textsuperscript{110} \textit{Lind/Schwarz/Lathrope/Rosenberg}, Fundamentals of Corporate Taxation, 5.E., Ch. 10 D.4.

\textsuperscript{111} § 311 (a)(2), (b)(1) IRC. See \textit{Solomon}, White on New York Corporations, Part I, § 6.04 [4][e];
\textit{Lind/Schwarz/Lathrope/Rosenberg}, Fundamentals of Corporate Taxation, 5.E., Ch. 10 D.4.

\textsuperscript{112} \textit{General Utilities & Operating Co. v. Helvering}, 296 U.S. 200 (1935).

\textsuperscript{113} § 311 (b) IRC.

\textsuperscript{114} See \textit{Lind/Schwarz/Lathrope/Rosenberg}, Fundamentals of Corporate Taxation, 5.E., Ch. 10 E.1.c., citing

\textsuperscript{115} Cf. \textit{Abrams/Doernberg}, Federal Corporate Taxation, 5.E., Ch. 10.04 (c), at 271.

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a) § 355 (d) IRC

According to § 355 (d) IRC, in case of a disqualified distribution the distributing corporation has to recognize gain on any appreciated stock distributed.116 A distribution is disqualified, if one person (1) by means of purchase117 acquires stock of the distributing or the controlled corporation within a 5-year period ending on date of distribution, and (2) the stock held by this person so acquired or attributable to distributions on stock so acquired immediately after the distribution represents at least 50% (by vote or value) of stock of the distributing or controlled corporation.118 The consequence of this provision is a kind of pre-distribution continuity of interest test, without triggering tax on the shareholder level.119

To prevent avoidance of the 50% or more ownership test, aggregation and attribution rules are applied to determine the shareholder ownership after distribution.120 In addition, the 5-year pre-distribution holding period might be extended under certain circumstances for any time period during which the holder’s risk of loss with respect to

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116 § 355 (d)(1) IRC. The controlled corporation is not permitted to increase the basis of its assets to reflect any gain recognized by the distributing corporation; cf. Burke, Federal Income Taxation of Corporations and Stockholders, 5.E., Ch. 10 § 14, at 318; see also Abrams/Doernberg, Federal Corporate Taxation, 5.E., Ch. 10.04 (c), at 275, regarding § 355 (e) IRC.

117 As defined in § 355 (d)(5) IRC, which excludes certain non-recognition transactions. Cf. Howley, Business Organizations with Tax Planning, Part 23, § 150.11.

118 § 355 (d)(2) and (3) IRC. Example: Purchaser may acquire stock of the parent equal in value to the value of the desired subsidiary, and later surrender that stock for stock of the subsidiary in a transaction intended to qualify as non-pro-rata division under § 355 IRC; cf. Abrams/Doernberg, Federal Corporate Taxation, 5.E., Ch. 10.04 (c), at 271.

119 Lind/Schwarz/Lathrope/Rosenberg, Fundamentals of Corporate Taxation, 5.E., Ch. 10 E.1.c.

120 See § 355 (d)(7) and (8) IRC. For details cf. Howley, Business Organizations with Tax Planning, Part 23, § 150.11; Lind/Schwarz/Lathrope/Rosenberg, Fundamentals of Corporate Taxation, 5.E., Ch. 10 E.1.c., at 554.
the stock is substantially diminished. Due to the broad aggregation and attribution rules § 355 (d) IRC might apply in situations in which the distribution does not violate the purpose of § 355 (d) IRC. According to the Regulations in such a case § 355 (d) IRC will not trigger taxation (so-called “purpose exception”).

b) § 355 (e) IRC

According to § 355 (e) IRC, the distributing corporation has to recognize gain on any appreciated stock distributed in a transaction to which the subsection applies. § 355 (e) IRC is triggered by any distribution under § 355 IRC which is part of a plan (or series of related transactions) pursuant to which 1 or more persons acquire directly or indirectly stock representing at least 50% (by vote or value) in the distributing or any controlled corporation. The provision was enacted in response to concerns that so-called Morris-Trust-type transactions (i.e. divisive reorganization followed by a tax-free merger) could be utilized to avoid taxes. The “device” requirement might not be violated in such a case because the pre-arranged disposition of the distributing corporation.

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121 § 355 (d)(6) IRC. See also Lind/Schwarz/Lathrope/Rosenberg, Fundamentals of Corporate Taxation, 5.E., Ch. 10 E.1.c., at 555; Howley, Business Organizations with Tax Planning, Part 23, § 150.11.

122 Treas. Reg. § 1.355-6(b)(3)(i): If the effect of the distribution is neither to increase ownership (combined direct and indirect) in the distributing corporation or any controlled corporation by a disqualified person (as defined in Treas. Reg. § 1.355-6(b)(3)(ii)), nor to provide a disqualified person with a purchased basis in the stock of any controlled corporation.

123 § 355 (e)(1) IRC.

124 See § 355 (e)(2)(A) IRC.

125 Commissioner v. Morris Trust, 367 F.2d 794 (4th Cir. 1966).

126 Abrams/Doernberg, Federal Corporate Taxation, 5.E., Ch. 10.04 (c)(ii), at 274.

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corporation occurs as part of a tax-free transaction; such a disposition might not bail-out earnings and profits since the shareholders continue to hold stock.\textsuperscript{127}

Decisive for the application of § 355 (e) IRC is the existence of a “plan”. According to § 355 (e)(2)(B) IRC such a plan is presumed to exist if one or more persons acquire directly or indirectly stock representing at least 50% in the distributing or any controlled corporation occurring less than two years before or after the distribution. Transfers taking place outside this 4-year window receive no presumption for or against taxation under § 355 (e) IRC.\textsuperscript{128} In such cases the existence of a plan will be decided based on all facts and circumstances, if no “safe harbor” rule applies.\textsuperscript{129} An “acquisition” of corporate control within § 355 (e) IRC is not limited to the taxable or tax-free transfer of stock. Under § 355 (e)(3)(B) IRC tax-free acquisitions of assets of the distributing or any controlled corporation (e.g. tax-free merger) are treated as acquiring stock in the corporation from which the assets were acquired.\textsuperscript{130}

As § 355 (d) IRC the provision levies tax only on the distributing corporation; for the shareholders the transaction remains tax-free. The amount of gain recognized by the distributing corporation is determined by the appreciation of the distributed stock,

\textsuperscript{127} See Abrams/Doernberg, Federal Corporate Taxation, 5.E., Ch. 10.04 (c)(ii), at 273.

\textsuperscript{128} Abrams/Doernberg, Federal Corporate Taxation, 5.E., Ch. 10.04 (c)(ii), Fn. 129.

\textsuperscript{129} Temp. Reg. § 1.355-7T(b)(1). For so-called “plan factors” and “non-plan factors” see Temp. Reg. § 1.355-7T(b)(3) and (4). For “safe harbor” rules cf. Temp. Reg. § 1.355-7T(d)(1)-(7). See also Lind/Schwarz/Lathrope/Rosenberg, Fundamentals of Corporate Taxation, 5.E., Ch. 10 E.2., at 557, discussing the original proposed Regulations, and Schler, Simplifying and Rationalizing the Spinoff Rules, 56 SMU L. Rev. 239 (274/275).

\textsuperscript{130} Cf. Abrams/Doernberg, Federal Corporate Taxation, 5.E., Ch. 10.04 (c)(ii), at 276.

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regardless whether the distributing or the controlled corporation is acquired.131 Despite the fact that the appreciation in the stock distributed is taxed no adjustment will be made to the basis of any corporate assets even if this results in a “triple tax”.132

C. German law

I. Basic understanding of applicable corporate law

1. German corporate law

German corporate law, as distinguished from the U.S. system, is Federal law. It provides for two major types of corporations, the stock corporation (“Aktiengesellschaft” – AG) and the limited liability company (“Gesellschaft mit beschraenkter Haftung” – GmbH). Both are separate legal entities with liability of the shareholder limited to the corporation’s assets (including any outstanding contributions of the shareholders). Both can be formed by one or more persons, including individuals or other corporations.

The GmbH is the corporate form of choice of most investors. Due to the flexibility offered, the GmbH is generally preferred as corporate form for closely held companies. According to § 45 (1) of Limited Liability Company Act (“Gesetz betreffend die Gesellschaften mit beschraenkter Haftung” – GmbHG) it is up to the shareholders to customize the articles of association to the needs of the enterprise. Furthermore, GmbHG allows shareholders at the shareholders’ meeting not only to formulate general guidelines

131 Burke, Federal Income Taxation of Corporations and Stockholders, 5.E., Ch. 10 § 14, at 323.
132 See Lind/Schwarz/Lathrope/Rosenberg, Fundamentals of Corporate Taxation, 5.E., Ch. 10 E.2, at 557; Abrams/Doernberg, Federal Corporate Taxation, 5.E., Ch. 10.04 (c)(ii), at 275/276.

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for management, but also to specifically instruct the management with respect to business
decisions. It is therefore the preferred form for corporate subsidiaries.

Most of Germany’s largest corporations are incorporated in the corporate form of
an AG. Unlike a GmbH,\textsuperscript{133} the shares of an AG can be transferred with relative ease,\textsuperscript{134}
thereby enabling the enterprise to be listed on a stock exchange. This transferability
comes with a price: the legal structure for the AG is relatively strict – the articles of an
AG may depart from statutory provisions only where this is expressly allowed by the
German Stock Corporation Act (‘‘Aktiengesetz’’ – AktG).\textsuperscript{135}

2. Spin-off transactions under German law

The reorganization and restructuring of business entities under German law is
governed by the German Transformation Act (‘‘Umwandlungsgesetz’’ – UmwG). The
German Transformation Act’s goal is to reduce formalities when a legal structure is
changed. UmwG permits the process of reorganization to take place by way of universal
succession (‘‘Gesamtrechtsnachfolge’’).\textsuperscript{136}

UmwG deals with three different types or reorganizations, namely merger
(‘‘Verschmelzung’’), splitting (‘‘Spaltung’’) and the conversion of a business entity to

\textsuperscript{133} See § 15 (3)-(5) GmbHG – contractual transfer of ownership must be notarized and can be made
conditional upon the consent of the GmbH or other shareholders.

\textsuperscript{134} Cf. § 68 AktG according to which the articles of incorporation only in the case of registered shares
(‘‘Namensaktien’’ – i.e., where the name of the owner is registered in the AG’s share register) may provide
that a transfer requires the consent of the company.

\textsuperscript{135} Cf. § 23 (5) AktG.

\textsuperscript{136} See § 20 (1) No. 1 UmwG

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another legal form (“Formwechsel”). Within the splitting reorganization the UmwG distinguishes further between a split-up of the legal entity into two or more new or existing entities (“Aufspaltung”), a spin-off of part of the assets of the entity to a new or existing other corporation in exchange for stock in this corporation (“Ausgliederung” – thereafter “spin-off type II”), and a spin-off of part of the assets of the entity to a new or existing other corporation for stock in this corporation transferred directly to the shareholders of the transferring corporation (“Abspaltung” – thereafter “spin-off type I”). From a corporate perspective the last mentioned form of the spin-off is similar to the “D reorganization” under § 368 (a)(D) IRC.

The split-up and spin-off type I (“Abspaltung”) allow to divide a corporation in one transaction. A similar result can be reached by a two-step approach, first transferring assets into an existing or new wholly owned subsidiary and then distributing the stock of this subsidiary to the corporation’s shareholders. Even if the economic effect of this two-step approach is the same as in a so-called Abspaltung (the shareholder of the transferor corporation in the end own stock of the transferor corporation as well as of the transferee corporation), the tax treatment will be different.

The text will focus on the spin-off type I (“Abspaltung”), since it is the transaction most similar to a reorganization under § 368 (a)(D) IRC. However, the tax

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137 § 123 (1) UmwG.
138 § 123 (3) UmwG.
139 § 123 (2) UmwG.
140 See C.III.4.

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treatment of stock distributed to shareholders will be discussed to show the differences between German tax law and the treatment under § 355 IRC.

**II. Basic information: German corporate tax regime**

1. General corporate tax regime

   Today’s corporate tax regime under the Corporation Tax Act (“Koerperschaftsteuergesetz” – KStG) is based on the changes implemented by the Tax Reform in 2000. Prior to this reform, two corporate tax rates existed: retained earnings were taxed at a tax rate of 40%, distributed earnings were taxed at only 30%. To avoid double taxation, the shareholder receiving the distribution was credited with the 30% of tax paid by the corporation, but had to include the distribution (plus the 30% of tax credited) in his taxable income.

   The 2000 Tax Reform introduced a definitive flat tax rate of 25% for corporations, regardless of whether the profits are retained or distributed.\[141\] In case of an individual the distribution is subject to the “half-income” rule (“Halbeinkuenfteverfahren”) on the shareholder level – only 50% of the amount distributed has to be included in taxable income.\[142\] If the earnings are distributed to a domestic corporation, no further tax has to be paid – the distribution is exempt from taxable income.\[143\] As the consequence, costs which are related to this exempt income are non-deductible.\[144\]

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\[141\] § 23 (1) KStG.

\[142\] § 20 (1) No. 1 with § 3 No. 40 (d) German Income Tax Act (“Einkommensteuergesetz” – EStG).

\[143\] § 8b (1) KStG.

\[144\] § 3c (1) EStG.

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If the shares are sold by an individual, the capital gain is generally included in taxable income and taxed at ordinary tax rates. Only if the shares are held by an individual as “private assets” (“Privatvermögen” – i.e. for investment purposes), were not received in a tax free contribution in kind (so-called “Einbringung”) and present an ownership of less than 1% in the corporation, capital gains are tax free, provided the shares are sold after a holding period of one year.\footnote{145} In any case, however, in analogy to the treatment of dividends only 50% of the capital gain is included in the taxable income of the individual.\footnote{146} If the stock is sold by a corporation any gain is exempt from income.\footnote{147}

2. Determining taxable income of the corporation

A Corporation resident in Germany, i.e. maintaining either its registered office or its central place of management in Germany, is subject to taxation on its world-wide income (“unbeschränkte Steuerpflicht”). As an underlying principle of determining this world-wide income, tax accounting is based on financial accounting (“Massgeblichkeitsprinzip”). Therefore, taxable income is based on the results shown by the annual financial accounts, adjusted to comply with special tax provisions. Tax losses which cannot be offset in the current year may be carried back one year to a limited amount and may be

\footnote{145} See § 21 German Transformation Tax Act (“Umwandlungssteuergesetz” – UmwStG), § 23 (1) No. 2 EStG and § 17 EStG.

\footnote{146} Cf. § 3 No. 40, sentence 1, lit. a), c), and j) with § 3c (2) EStG. If the shares were received in a tax free contribution in kind, generally the 50%-exemption is applicable only after a holding period of seven years, see § 3 No. 40, sentence 3 and 4 EStG.

\footnote{147} § 8b (2) KStG which is subject to the anti-tax avoidance provision of § 8b (4) KStG.

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carried forward indefinitely.\textsuperscript{148} Capital gains are included in taxable income – no special tax rates apply.

\textbf{3. Consolidated group}

German tax law does not provide for consolidated tax returns. However, the tax treatment of the so-called “Organschaft” provides similar relief. Under these rules income or loss of a controlled company (“Organgesellschaft”) is attributed to the controlling company (“Organträger”).\textsuperscript{149} The controlled company is only taxed on payments to minority shareholders.\textsuperscript{150} In order to qualify for Organschaft, a profit and loss pooling agreement (“Ergebnisabführungsvertrag”) must be in place, and the controlling company must hold at least the majority of voting stock of the controlled corporation.\textsuperscript{151}

\textbf{4. Additional taxes, especially Trade tax}

In addition to Corporation tax the taxable income of corporate entities is subject to Trade Tax (“Gewerbesteuer”) and Solidarity Surcharge (“Solidaritätszuschlag”).

Trade Tax is based on federal law, but is levied by local municipalities, based on corporation’s “trade income” (“Gewerbeertrag”), which is the taxable income for Corporation Tax purposes, increased by certain additions and decreased by certain deductions. Trade Tax is then determined by applying a multiplier (“Hebesatz”) differing

\textsuperscript{148} § 8 (1), (4) KStG with § 10d EStG

\textsuperscript{149} See § 14 KStG.

\textsuperscript{150} Cf. § 15, 16 KStG.

\textsuperscript{151} For details see § 14 No. 1, 3 KStG.

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for each local municipality. As a rule of thumb, Trade Tax creates circa 13% of additional tax levy for the corporation.

The Solidarity Surcharge of 5.5% is levied on the assessed amount of Corporation Tax. The tax rate for corporations of 25% is therefore increased by the Solidarity Surcharge to 26.375%.

**III. Taxation of Spin-offs**

1. **Overview**

   Under German tax law, there are specific provisions for split-up, spin-off type I and type II. The German Transformation Tax Act (“Umwandlungssteuergesetz” – UmwStG) provides for tax free treatment on corporate as well as shareholder level, if certain requirements are met.

   The main purpose of the German spin-off rules is to facilitate a separation of different businesses of a corporate entity into one or more existing or new corporate entities. Accordingly, the spin-off type I under German Transformation Tax Act requires that the transferee corporation acquires at least one business (“Teilbetrieb” – thereafter also “operational unit”) and the transferor corporation retains at least one such operational unit. Furthermore, the transfer must be solely in exchange for stock of the transferee corporation.

   If these requirements are met, the transaction generally does not trigger taxes. Carryover losses as well as any tax credits of the transferor corporation will be

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apportioned between transferor and transferee. Notwithstanding this general treatment, the transaction will be taxable if the splitting results in a sale to outside parties or the additional conditions for a separation of shareholder groups are not met.

2. General requirements of § 15 UmwStG

a) Divisive transaction under the German Transformation Act

In order to qualify for tax free treatment under § 15 UmwStG the divisive transaction must be a split-up or spin-off type I under the German Transformation Act. Other types of divisive transactions do not qualify under the German Transformation Tax Act.152

b) Separation of “operational units”

According to § 15 (1) UmwStG for a spin-off type I to qualify for tax free treatment the transferee corporation must acquire at least one operational unit153 and the transferor corporation must retain at least one such operational unit.154

An operational unit is understood as an organically self-contained part of an enterprise enjoying a certain amount of independence which, when viewed separately, has all the characteristics of a business unit and is viable as such.155 An interest in a partnership engaged in trade or business as well as a 100%-holding in a corporation is

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152 Cf. § 15 (1), sentence 1 UmwStG with § 1 (1) and (4) UmwStG. The spin-off type II is subject to the rules of § 20 UmwStG, i.e. the rules for a tax-free contribution in kind.

153 § 15 (1), sentence 1 UmwStG.

154 § 15 (1), sentence 2 UmwStG.


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deemed to be an operational unit. A transaction also qualifies if only part of an interest in a partnership is transferred and the other part is retained by the transferor corporation.

Decisive for the tax treatment is that all essential assets (so-called “wesentliche Betriebsgrundlagen”) of the operational unit are transferred together (or retained). The decision whether an asset is essential for the operational unit or not has to be based solely on the function of the asset within the operational unit. Non-essential assets might or might not be transferred depending on the equity contribution necessary to set up the transferee corporation. If such an asset is used by various operational units (e.g. real property), it has to be assigned to one operational unit based on time of use. However, a tax free spin-off is unattainable if essential assets are used by different operational units. Such assets have to be divided and assigned to the operational units prior to the spin-off. In case of real property it might be enough to provide for ownership in

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156 § 15 (1), sentence 3 UmwStG.


159 See Hoertnagl, in Schmitt/Hoertnagl/Stratz, Umwandlungsgesetz, Umwandlungssteuergesetz, 3.E., § 15 UmwStG para. 58. The alternative approach based on the value of the asset is not applicable under § 15 UmwStG.

160 Ministry of Finance, UmwStE, para. 15.08; Hoertnagl, in Schmitt/Hoertnagl/Stratz, Umwandlungsgesetz, Umwandlungssteuergesetz, 3.E., § 15 UmwStG para. 67-69.


162 Schoenwald, Die Spaltung von Kapitalgesellschaften, Steuer & Studium 2002, p. 8 (10). Decisive is the date of the shareholder resolution approving the spin-off; Ministry of Finance, UmwStE, para. 15.10;

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common (so-called “Bruchteilseigentum”). However, the ownership of the asset or at least the beneficial ownership must be assigned to the operational unit. A lease agreement therefore is not sufficient.

c) Other general requirements, especially § 11 UmwStG

If the requirements of § 15 UmwStG are met, the rules for tax free treatment of mergers (§§ 11-13 UmwStG) apply. Accordingly, the transfer of assets has to be solely for (new or treasury) stock in the transferee corporation (granted to the transferor corporation’s shareholders). If the shareholders of the transferor corporation receive boot, the basis of the assets transferred in the transfer balance sheet is increased by the amount of boot received (minus the part of the basis attributable to the boot as part of the total consideration of boot and stock). As a consequence of the increase in basis, gain has to be recognized by the transferor corporation.

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Furthermore, the assets transferred must be subject to German corporate taxation in the transferee corporation.\textsuperscript{170} This is the case, if the transferee corporation’s place of incorporation or place of management is in Germany\textsuperscript{171} and the transferee corporation is not exempt from German Corporation Tax.\textsuperscript{172}

3. Tax consequences of a spin-off under § 15 UmwStG

a) Spin-off in accordance with § 15 UmwStG

\textit{(i) Taxation of the transferor corporation}

The transferor corporation has to prepare a transfer balance sheet for tax purposes as of the transfer date for tax purposes (so-called “Übertragungsstichtag”),\textsuperscript{173} which may provide for retroactive effect up to eight months. The German Transformation Tax Act offers alternative treatment in the transfer balance sheet. According to the tax law the transferor corporation may elect to transfer the assets tax free or to write up the assets transferred in the transfer balance sheet up to the so-called going concern value (“Teilwert”),\textsuperscript{174} thereby realizing gain in the amount of the Teilwert minus adjusted basis.\textsuperscript{175} However, since German financial accounting generally does not permit to

\textsuperscript{170} § 11 (1) No. 1 UmwStG.

\textsuperscript{171} See § 1 (1) KStG.

\textsuperscript{172} Ministry of Finance, UmwStE, para. 11.03; Schmitt in Schmitt/Hoertnagl/Stratz, Umwandlungsgesetz, Umwandlungssteuergesetz, 3.E., § 11 UmwStG para. 60, 66.

\textsuperscript{173} § 15 (2) UmwStG.

\textsuperscript{174} “Teilwert” is the amount an acquirer would pay for the asset as part of the purchase price for the whole trade or business, cf. § 6 (1) No. 1, sentence 3 EStG.

\textsuperscript{175} § 15 (1) UmwStG with § 11 UmwStG. See also Hoertnagl, in Schmitt/Hoertnagl/Stratz, Umwandlungsgesetz, Umwandlungssteuergesetz, 3.E., § 15 UmwStG para. 236.

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recognize gain in the transfer balance sheet and the tax accounting has to follow financial accounting, typically tax free treatment is the only viable option.

If the shareholders of the transferor corporation receive boot in addition to the stock, the transferor corporation is taxed on the gain resulting from the mandatory write-up of the basis of the assets transferred.

**(ii) Taxation of the transferee corporation**

For the transferee corporation the spin-off does not trigger taxable income. The basis in the assets transferred is the same as it would be in the hands of the transferor corporation (so-called “Buchwertfortführung”). I.e., generally the assets’ basis is the adjusted basis in the hands of the transferor corporation. However, if boot was part of the consideration, the new basis in the hands of the transferee corporation reflects the necessary write-up of the assets transferred.

The transferee corporation is the legal successor of the transferor corporation by means of universal succession. Accordingly, the transferee corporation applies the same

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176 See above, under C.II.2. (so-called “Massgeblichkeitsprinzip”).

177 Cf. *Ministry of Finance*, UmwStE, para. 15.12; *Schoenwald*, Die Spaltung von Kapitalgesellschaften, Steuer & Studium 2002, p. 8 (14). According to *Hoertnagl*, in *Schmitt/Hoertnagl/Stratz*, Umwandlungsgesetz, Umwandlungssteuergesetz, 3.E., § 15 UmwStG para. 241, the Massgeblichkeitsprinzip does not apply allowing the transferor corporation to opt for a taxable transfer (e.g. to offset carry-over losses).

178 See above, under C.III.2.c).


180 § 15 (1) UmwStG with §§ 12 (1), 4 (1) UmwStG.

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general and special depreciation; holding periods for tax purposes are computed based on the acquisition date by the transferor corporation.\textsuperscript{181}

The transferee corporation succeeds in a net operating loss of the transferor corporation. The total loss carryover of the transferor corporation has to be allocated to the operational units transferred and retained based on the fair market value of the net assets\textsuperscript{182} transferred or retained.\textsuperscript{183} However, the trade or business to which the loss is attributable has to be continued for another five years on a comparable level\textsuperscript{184}. Otherwise the loss carryover allocated to the transferee corporation will cease.\textsuperscript{185}

(iii) Taxation of the shareholder

As a result of the spin-off type I the shareholders of the transferor corporation receive stock of the transferee corporation. The transaction is tax free on shareholder level.\textsuperscript{186} The basis of the transferor corporation’s stock in the hands of each shareholder prior to the spin-off has to be allocated between the retained shares of the transferor


\textsuperscript{182} Fair market value of the assets minus liabilities attributable to these assets; see Schoenwald, Die Spaltung von Kapitalgesellschaften, Steuer & Studium 2002, p. 8 (14).

\textsuperscript{183} § 15 (4) UmwStG. For details see Ministry of Finance, UmwStE, para. 15.42 and 15.43; Hoertnagl, in Schmitt/Hoertnagl/Stratz, Umwandlungsgesetz, Umwandlungssteuergesetz, 3.E., § 15 UmwStG para. 270-279.

\textsuperscript{184} It might be continued by the transferor or the transferee corporation; cf. Schoenwald, Die Spaltung von Kapitalgesellschaften, Steuer & Studium 2002, p. 8 (13/14); Hoertnagl, in Schmitt/Hoertnagl/Stratz, Umwandlungsgesetz, Umwandlungssteuergesetz, 3.E., § 15 UmwStG para. 269.

\textsuperscript{185} § 15 (1) UmwStG with § 12 (3) sentence 2 UmwStG.

\textsuperscript{186} § 15 (1) UmwStG with § 13 (1), (2), sentence 1, (3), sentence 1 UmwStG.

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corporation and the new shares of the transferee corporation based on the fair market
value of the net assets transferred and retained by the transferor corporation.\footnote{187}

Furthermore, to assure proper taxation in case of a later sale of the stock retained
and received, the German tax law provides for special rules tainting the stock in question.
As mentioned before,\footnote{188} a stock sale by an individual shareholder is taxable if the
shareholder holds the shares in a trade or business (so-called “Betriebsvermögen”),
holds an investment of at least 1% in the corporation,\footnote{189} has received the stock in a tax
free contribution in kind\footnote{190} or has held the stock for less than one year.\footnote{191} § 13 UmwStG
assures that the taxation of a later sale of the stock retained or received is in line with
these rules.\footnote{192} According to § 13 (2) UmwStG the stock retained and/or received is
deemed to be stock as part of an investment of at least 1% (so-called “spaltungsgeborene
Anteile”), if the stock held prior to the spin-off was such an investment. Under § 13 (3)
UmwStG the stock retained and/or received is deemed to be received in a tax free
contribution in kind, if the stock held prior to the spin-off was received in such a
contribution. Under both provisions a later sale of the stock is a taxable event even if the
requirements of §§ 17 EStG, 21 UmwStG were not met otherwise.

\footnote{187 \textit{Ministry of Finance}, UmwStE, para. 15.51. According to \textit{Hoertnagl}, in \textit{Schmitt/Hoertnagl/Stratz, Umwandlungsgesetz, Umwandlungssteuergesetz}, 3.E., § 15 UmwStG para. 291, the basis shall be allocated based on the fair market value of the stock of the transferor corporation retained and the stock of the transferee corporation received.}

\footnote{188 Under C.II.1.}

\footnote{189 § 17 EStG.}

\footnote{190 Cf. § 21 UmwStG.}

\footnote{191 See § 23 (1) EStG.}

\footnote{192 \textit{Schoenwald}, Die Spaltung von Kapitalgesellschaften, Steuer & Studium 2002, p. 8 (15).}

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b) Consequences of a failed spin-off transaction

If the requirements of § 15 (1) and § 11 UmwStG are not met (e.g. operational unit either not transferred or not retained) the transaction will be treated as a distribution in kind to the transferor corporation’s shareholders. Accordingly, the transferor corporation is taxed on the amount by which the fair market value of the assets transferred exceeds the adjusted basis in the hands of the transferor corporation. Intangible rights as well as goodwill have to be taken into account, even if the transferor corporation’s basis in such rights was Zero. The taxable income is subject to Corporation Tax (including Solidarity Surcharge) as well as Trade Tax.

In a second step, the assets deemed distributed to the shareholders will be deemed contributed by them to the transferee corporation. The transferee corporation’s basis in the assets deemed contributed is the going concern value (“Teilwert”) of the assets.

On the shareholder level the treatment follows the general rules for distributions. Individual shareholders of the transferor corporation have to include the deemed

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194 Ministry of Finance, UmwStE, para. 15.11.


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dividend in income, subject to the “half-income” rule. If the earnings are distributed to a domestic corporation, the distribution is exempt from taxable income.\textsuperscript{199} The basis in the transferee corporation’s stock received equals the basis of the assets deemed contributed in the hand of the shareholders.\textsuperscript{200}

### 4. Anti-tax avoidance rules

**a) Disallowed creation of an “operational unit”, § 15 (3), sentence 1 UmwStG**

The tax free treatment of §§ 15 (1), 11 (1) UmwStG requires that the transferee corporation must acquire at least one operational unit, and the transferor corporation must retain at least one such operational unit.\textsuperscript{201} However, tax free treatment is not available if an interest in a partnership or a 100\% holding in a corporation (i.e., a deemed operational unit) was acquired or increased during the 3-year period ending on the transfer date for tax purposes (“\textit{Uebertragungsstichtag}”) by contributing assets which did not constitute an operational unit.\textsuperscript{202}

The rationale of the provision is to disallow the tax-free spin-off of appreciated\textsuperscript{203} assets, which in fact are no operational unit, by converting them into such an operational unit prior to the actual spin-off.\textsuperscript{204} E.g., if the transferor corporation in a first step

\textsuperscript{199} See above, C.II.1.


\textsuperscript{201} See above, under C.III.2.b).

\textsuperscript{202} § 15 (3), sentence 1 UmwStG.

\textsuperscript{203} I.e. fair market value exceeds adjusted basis.


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contributes real property to a partnership for an increased interest in the partnership, and then in a second step spins off the partnership interest (or all other operational units, thereby retaining the partnership interest), such spin-off will not qualify for tax-free treatment. § 15 (3), sentence 1 UmwStG is not applicable, if not the transferor corporation, but rather an unrelated third party contributes the assets. E.g., if the transferor corporation holds 60% in X-corporation and an unrelated 40%-shareholder of X-corporation contributes its 40% stake to X-corporation (resulting in transferor corporation holding 100%), a tax-free spin-off of the new 100%-interest in X-corporation is still available.

It should be noted that § 15 (3), sentence 1 UmwStG only applies to partnership interests and 100%-holdings in corporations (so-called deemed operational units). Any other type of operational unit might be established immediately before the spin-off.

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205 Such transaction is tax free under § 6 (5), sentence 3, No. 1 EStG.

206 Cf. Ministry of Finance, UmwStE, para. 15.15. According to Hoertnagl, in Schmitt/Hoertnagl/Stratz, Umwandlungsgesetz, Umwandlungssteuergesetz, 3.E., § 15 UmwStG para. 115, no tax is triggered if the new partnership interest/100%-share is retained. This might be correct; yet, the reason for the result is not that § 15 (3), sentence 1 UmwStG is not applicable, but rather the fact that the assets of the operational unit to which § 11 (1) UmwStG does not apply are not transferred. Without a transfer in exchange for stock no realization in these assets and accordingly no recognition of taxable income.

207 Ministry of Finance, UmwStE, para. 15.16, Example 2; Schoenwald, Die Spaltung von Kapitalgesellschaften, Steuer & Studium 2002, p. 8 (11/12).

208 See Ministry of Finance, UmwStE, para. 15.19; Schoenwald, Die Spaltung von Kapitalgesellschaften, Steuer & Studium 2002, p. 8 (12).


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b) No sale to outside parties, § 15 (3), sentences 2-4 UmwStG

The spin-off will not qualify for tax free treatment under § 11 (1) UmwStG if the transaction results in a sale to outside parties. The same applies if the transaction shall create the prerequisites for such a sale.

Again the motivation for these provisions is to battle tax avoidance. The rules for tax free spin-off shall (only) permit the taxpayer to continue a trade or business in a different form without paying taxes up-front. Since the taxpayer in case of a sale does not continue the trade or business, no tax free treatment shall be available. E.g., if the transferor corporation in a first step spins off an operational unit and in a second step the shareholder receiving the stock of the transferee corporation sells this stock to a third party, taxation might be avoided completely. Without the spin-off rules such a sale of an operational unit would trigger tax on the corporate level. By tax free spinning off the operational unit in question the transferor corporation enables its shareholders to sell the stock received subject to the tax rules applicable to the shareholder. The shareholder might sell the stock received tax free, if he is a corporation, a foreign shareholder not

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210 § 15 (3), sentence 2 UmwStG.

211 § 15 (3), sentence 3 UmwStG.


213 See § 8b (2) KStG described above, under C.II.1. Cf. also Hoertnagl, in Schmitt/Hoertnagl/Stratz, Umwandlungsgesetz, Umwandlungssteuergesetz, 3.E., § 15 UmwStG para. 141.
subject to German taxation on the capital gains\footnote{Schoenwald, Die Spaltung von Kapitalgesellschaften, Steuer & Studium 2002, p. 8 (12); Hoertnagl, in Schmitt/Hoertnagl/Stratz, Umwandlungsgesetz, Umwandlungssteuergesetz, 3.E., § 15 UmwStG para. 141.} or an individual who holds the stock for one more year.\footnote{§ 23 (1) EStG, cf. under C.II.1.}

Accordingly, the spin-off will not qualify for tax free treatment under § 11 (1) UmwStG if the transaction results in a sale to outside parties or creates the prerequisites for such a sale.\footnote{The second alternative can be understood as the general rule since a sale cannot be accomplished solely by a spin-off; cf. Hoertnagl, in Schmitt/Hoertnagl/Stratz, Umwandlungsgesetz, Umwandlungssteuergesetz, 3.E., § 15 UmwStG para. 132.} Under § 15 (3), sentence 4 UmwStG, the spin-off is deemed to be such a preparation for sale if shares of a corporation involved in the spin-off are sold within five years of the transfer date for tax purposes and these shares equal more than 20\% of the shares of the transferor corporation before the spin-off. This limitation applies to the shares of the transferor and the shares of the transferee corporation.

Tax under § 15 (3), sentence 2-4 UmwStG is only triggered if shares received in the spin-off are actually sold to a third party; the sole spin-off with the intention to sell the stock received is not sufficient.\footnote{Hoertnagl, in Schmitt/Hoertnagl/Stratz, Umwandlungsgesetz, Umwandlungssteuergesetz, 3.E., § 15 UmwStG para. 142.} “Sale” to a third party\footnote{Reorganizations within a consolidated group within the meaning of § 271 (2) HGB are exempted; cf. Ministry of Finance, UmwStE, para. 15.26.} is understood very broad: any exchange for money or other consideration,\footnote{Accordingly, shares transferred not for consideration (e.g. gift or inheritance) do not trigger tax; see Ministry of Finance, UmwStE, para. 15.23; Hoertnagl, in Schmitt/Hoertnagl/Stratz, Umwandlungsgesetz, Umwandlungssteuergesetz, 3.E., § 15 UmwStG para. 147.} any exchange for shares (i.e. merger)

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or any contribution in kind which economically transfers the ownership of the shares qualifies for a “sale”: This sale must take place within five years after the transfer date for tax purposes of the spin-off transaction. By means of the sale of the transferor and/or the transferee corporation(s)’ shares representing more than 20% of the shares of the transferor corporation prior to the spin-off must be assigned to third parties. The 20%-quota is based on the fair market value of the stock transferred and comprises the total shares transferred of all corporations involved in the spin-off (i.e. transferor as well as transferee corporation(s)) within the five year period.

**c) Consequences of a violation of § 15 (3) UmwStG**

If either § 15 (3), sentence 1 UmwStG or § 15 (3), sentence 2-4 UmwStG is applicable, tax free treatment under § 11 (1) UmwStG will not be available. However, the transaction is taxable only on the corporate level. The shareholders still will benefit from § 13 UmwStG.

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221 Assets held by the transferor or transferee corporation(s) can be sold; cf. *Hoertnagl*, in *Schmitt/Hoertnagl/Stratz*, Umwandlungsgesetz, Umwandlungssteuergesetz, 3.E., § 15 UmwStG para. 156.

222 See *Ministry of Finance*, UmwStE, para. 15.28; *Hoertnagl*, in *Schmitt/Hoertnagl/Stratz*, Umwandlungsgesetz, Umwandlungssteuergesetz, 3.E., § 15 UmwStG para. 170-173, for details.

223 *Ministry of Finance*, UmwStE, para. 15.29 and 15.30; *Hoertnagl*, in *Schmitt/Hoertnagl/Stratz*, Umwandlungsgesetz, Umwandlungssteuergesetz, 3.E., § 15 UmwStG para. 167.


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The transferor corporation will be taxed on the step-up in basis of the assets transferred. In the case of § 15 (3), sentence 1 UmwStG only the assets being part of the operational unit which was established in violation of the provision have to be written up to the going concern value (“Teilwert”). Yet, if the spin-off results in a sale to outside parties or establishes the prerequisites for such a sale, the assets of all operational units transferred have to be increased to the going concern value. The transferee corporation will carry-over this basis as in the case of a spin-off in accordance with § 15 (1) and (3) UmwStG without triggering taxable income. All the other tax consequences (succession in depreciation, holding periods, and loss-carryover) are the same as in the case of a spin-off under § 15 (1) UmwStG.

However, the spin-off does not trigger tax on the corporate level if the transferor corporation would have been able to transfer the operational unit tax free without utilizing the spin-off rules. This might be the case if the operational unit transferred is a 100%-interest in a corporation. Under § 8b (2) KStG – subject to certain requirements – such a transfer would have been tax free for the transferor corporation. Consequently, the

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228 See above, under C.III.3.


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spin-off can not be identified as tax avoidance. Any income triggered on corporate level by § 15 (3) UmwStG is therefore exempt under § 8b (2) KStG.230

d) Application of § 42 AO

§ 42 General Fiscal Code (“Abgabenordnung” – AO) provides for a general anti-tax avoidance provision. However, this general provision is not applicable if the tax law, as in the case of § 15 (3) UmwStG, provides for special rules. Accordingly, in the context of spin-offs § 42 AO is only applicable if the taxpayer attempts to avoid the provisions of § 15 (3) UmwStG. E.g., if within five years of the spin-off the shares of the transferee corporation are transferred indirectly (by means of a sale of stock of the direct shareholder), § 15 (3) UmwStG generally would not be applicable. In such case, however, the indirect sale of the stock in the transferee corporation might be treated as a direct sale by applying § 42 AO.231

5. Separation of shareholder groups, § 15 (3), sentence 5 UmwStG

If the spin-off is aimed at separating shareholders or shareholder groups (i.e., non-pro rata distribution of the shares of the transferee corporation), one additional requirement has to be met. In this case, according to § 15 (3), sentence 5 UmwStG the shareholders of the transferor corporation have to have held their stock for at least five years prior to the spin-off.232 Otherwise § 11 (1) UmwStG does not apply, triggering taxes on


232 For details see Hoernagl, in Schmitt/Hoernagl/Stratz, Umwandlungsgesetz, Umwandlungssteuergesetz, 3.E., § 15 UmwStG para. 205-229.

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the corporate level. However, an increase or decrease in the percentage of stock held during the five year period does not disqualify for tax free treatment as long as no change in the shareholders’ person has taken place.

6. Alternative transactions: distribution of stock

As an alternative to a spin-off type I transaction, the transferor corporation in a first step might form a new subsidiary by contributing the operational unit in exchange for stock in the NewCo. In a second step, the stock of the NewCo might be distributed to the transferor corporation’s shareholders. This second step could trigger tax on the corporate as well as the shareholder level.

Generally, the transferor corporation is taxed on the amount the fair market value of the assets transferred exceeds the adjusted basis in the hands of the transferor corporation. But according to a special exemption for the sale, exchange or transfer of stock implemented by the 2000 Tax Reform, if stock is distributed any gain realized is exempt from tax. However, this exemption does not apply if the stock distributed was received by the transferor corporation in exchange for a tax free contribution in kind (so-

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233 See above, under C.III.4.c).


235 This transfer is tax free under § 20 (1), sentence 1, (2), and (4) UmwStG, if the transferor corporation is in control of the subsidiary (50% + 1 vote) after the transaction.


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called “einbringungsgeborene Anteile”, § 21 UmwStG). Accordingly, the distribution is subject to tax on the corporate level.

On the shareholder level the treatment follows the general rules for distributions. Individual shareholders of the transferor corporation have to include the fair market value of the dividend in kind in income, subject to the “half-income” rule. If the earnings are distributed to a domestic corporation, the distribution is exempt from taxable income.

D. Comparison of the tax regimes and potential changes

I. Comparison of the spin-off rules

1. Overview

The U.S. as well as German tax law provide for quite similar treatment of divisive transactions. A spin-off is tax free on both the corporate and the shareholder level, if certain requirements are met. Both jurisdictions allow a divisive transaction only for separating active business units. Under both tax laws the transferor corporation and the transferee corporation have to be engaged in an active trade or business before and after

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237 § 8b (4), sentence 1 No. 1 KStG. § 8b (4) KStG provides for several anti-tax avoidance rules with respect to the tax free exchange of stock by corporations under § 8b (2) KStG. According to § 8b (4), sentence 2 No. 1 KStG a tax free sale, exchange, or distribution of the stock is permitted, if the stock has been held for seven years.

238 § 20 (1) No. 1 with § 3 No. 40 (d) EStG. See above, under C.II.1. For details Prinz/Schuerner, Tracking Stocks und Sachdividenden – ein neues Gestaltungsinstrument fuer spartenbezogene Gesellschaftsrechte, DStR 2003, 181 (184/185); Lutter/Leinekugel/Roedder, Die Sachdividende – Gesellschaftsrecht und Steuerrecht, ZGR 2002, 204 (233).


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the distribution. The method of choice for both jurisdictions to assure future taxation of the appreciated property and the appreciated stock is a basis carry-over: the transferee corporation carries over the transferor corporation’s basis and the transferor corporation’s shareholder has to allocate his basis in the transferor corporation’s stock prior to the spin-off to both the transferor and the transferee corporation’s stock. Accordingly, both tax regimes provide for a deferral in taxes, not an exemption.

However, there are differences with respect to the requirements as well as the tax consequences of a spin-off transaction. The following examples shall identify differences and will try to explain the reasons for the different approaches.

2. Structure of transaction and control requirement

U.S. and German corporate law provide for divisive transactions which might qualify for tax free treatment. The German corporate law, however, establishes spin-off transactions more limited in their result but easier to facilitate. The spin-off type I (so-called “Abspaltung”) combines the contribution of assets to a newly formed or existing subsidiary in exchange for stock with the distribution of the subsidiary’s shares to the transferor corporation’s shareholders. U.S. corporate law, in contrast, achieves the same result by means of a two-step approach. First, the transferor corporation contributes

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240 Under U.S. tax law the distributing and the controlled corporation have to be engaged immediately after the distribution in an active conduct of a trade or business which has been so conducted throughout the 5 years prior to the distribution; cf. B.III.2.c). Under German tax law an operational unit has to be transferred to the existing or newly formed subsidiary the stock of which will be distributed, and an operational unit has to be retained by the transferor corporation – accordingly, both the transferor and the transferee corporation will retain or receive an operational unit in the spin-off transaction; see C.III.2.b).

241 See above, under C.I.2.

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assets to a subsidiary in exchange for stock. Second, the transferor corporation distributes
the shares received to its shareholders.

The tax law reflects these differences. German tax law provides for tax free
treatment only if the spin-off transaction is in accordance with the special provisions
under German corporate law, whereas under U.S. tax law both the two-step reorganizations described above (so-called “D reorganizations”) and mere distributions of stock
in a subsidiary qualify for tax free treatment. Even more important, a tax free
distribution under U.S. law may be achieved without owning 100% of the subsidiary the
stock of which is distributed. In contrast, under German law in the typical case of a
spin-off to a newly formed subsidiary no outside ownership in the stock distributed will
be allowed. 100% of the shares of the transferee corporation end up in the hands of the
transferor corporation’s shareholders. The same 100% ownership is required for the
transferor corporation to spin off an existing subsidiary (to achieve a similar result as
with the mere distribution of the subsidiary’s stock). The transaction qualifies for tax

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242 See above, under C.III.2.a).
243 See above, under B.III.1.
244 Control of the subsidiary (i.e. 80% ownership of votes and shares) is sufficient, cf. B.III.2.a).
245 It should be noted, however, that the assets also can be spun off to an existing corporation with outside
shareholders. Nevertheless, the new stock will be directly transferred only to the existing shareholders of
the transferor corporation.
246 Such transaction results in the transferor corporation’s shareholders owning 100% in a holding company
which itself owns 100% of the former subsidiary. In a second step, the holding might merge with the
subsidiary in a tax free transaction under §§ 11-13 UmwStG or establish a consolidated group (so-called
“Organschaft”).

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free treatment only, if the subsidiary has been owned 100% by the transferor corporation for the three years prior to the spin-off.  

The reasons for this more limited approach of German law might be twofold. The German spin-off law is based on an European Union Directive which provided for the transactions referred to as split-up (“Aufspaltung”) and spin-off type I (“Abspaltung”) under German law. Based on these changes in corporate law the spin-off rules were added to the German Transformation Tax Act. Accordingly, only these types of transactions were permitted for tax free treatment. Second, under German law tax free treatment generally is only available if the entire trade or business or at least an operational unit is transferred. The transferor must have been engaged in a trade or business via the unit transferred and the transferee must continue to be engaged like that. Therefore, the interest in a partnership (which is subject to look-through treatment under German tax law) engaged in a trade or business is treated as direct engagement in such trade or business. However, in case of corporations generally no look-through treatment is applicable. Only if the corporation is wholly owned it seems justified that the

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247 See above, under C.III.2.b) and under C.III.4.a) for the related anti-tax avoidance rules.


251 Hoertnagl, in Schmitt/Hoertnagl/Stratz, Umwandlungsgesetz, Umwandlungssteuergesetz, 3.E., Vor §§ 15, 16 UmwStG para. 9, § 15 UmwStG para. 43.

252 Cf. § 15 (1) No. 2 EStG.

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trade or business engaged in by the corporation might be assumed to be one by the shareholder. Thus, only the transfer of a 100%-interest qualifies for tax free treatment under the German Transformation Tax Act.\textsuperscript{253}

It should be noted that under § 8b (2) KStG introduced by the 2000 Tax Reform a distribution of stock does not trigger tax on the corporate level.\textsuperscript{254} Yet, these new rules were not meant to change the spin-off rules, but rather as to avoid double taxation under the new corporate tax regime which is no longer based on a credit for taxes paid by the corporation.\textsuperscript{255}

3. Device clause and more restrictive active business requirement

Both the U.S. and the German tax law provided for an active business requirement.\textsuperscript{256} Under the U.S. tax regime, however, the active business requirement is much more restrictive. No investment of liquid assets in a new business will be allowed in the five years prior to the spin-off.\textsuperscript{257} Under German tax law, in contrast, an operational unit may be established immediately before the spin-off takes place.\textsuperscript{258} Only if deemed operational units are created or increased within three years prior to the divisive transaction,

\textsuperscript{253} Different rules apply in the case of a contribution in kind in exchange for stock (§ 20 UmwStG). However, the requirement of an interest of more than 50% in the corporation’s stock (§ 20 (1), sentence 2 UmwStG) is based on European Union law, implemented in German law in 1992, cf. Schmitt in Schmitt/Hoertnagl/Stratz, Umwandlungsgesetz, Umwandlungssteuergesetz, 3.E., § 20 UmwStG para. 134.

\textsuperscript{254} § 8b (2) KStG is subject to certain anti-tax avoidance rules under § 8b (4) KStG; cf. C.III.6.

\textsuperscript{255} See C.II.1.

\textsuperscript{256} See above, under D.I.1.

\textsuperscript{257} See above, under B.III.2.c).

\textsuperscript{258} Hoertnagl, in Schmitt/Hoertnagl/Stratz, Umwandlungsgesetz, Umwandlungssteuergesetz, 3.E., § 15 UmwStG para. 74.

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tax free treatment is not available.\(^{259}\) Furthermore, U.S. tax law provides in § 355 (a) IRC for the so-called “device clause”. This additional requirement denies tax free treatment for any divisive transaction which is used principally as a device for the distribution of the earnings and profits of the distributing or the controlled corporation.\(^{260}\) German tax law does not contain any similar provision.

Both requirements under U.S. tax law are aimed to prevent the bailout of cash by means of a spin-off transaction. If such transactions would qualify for tax free treatment under U.S. tax law, taxpayers could easily convert dividends into capital gains. Since for most of the time of the spin-off rules’ existence capital gain tax rates were significantly lower than ordinary tax rates on dividends this conversion benefited the taxpayer.\(^{261}\) Under German tax law there is no comparable differentiation between the tax rates on dividends and capital gains. At the time of enactment of the German spin-off provisions both dividends and capital gains were subject to regular tax rates. Starting with the Tax Reform 2000, dividends received by individual shareholders have been subject to the half-income rule (“Halbeinkuenfteverfahren”). However, capital gains on the sale or exchange of stock are subject to the same 50%-exemption.\(^{262}\) And stock related income

\(^{259}\) See above, under C.III.4.a).

\(^{260}\) See above, under B.III.2.d).

\(^{261}\) Cf. B.II.1.

\(^{262}\) Cf. C.II.1. At any time there was and still is tax free treatment available for the sale of stock held by an individual for investment purposes if the individual holds less than 1% in that corporation and the shares are held for more than one year (see §§ 17 (1), 23 (1) EStG). Yet, due to the requirement of less than 1% ownership these individual shareholders are typically not in a position to initiate a spin-off transaction for tax avoidance purposes. Furthermore, the German tax law under § 13 UmwStG provides for so-called “spaltungsgeborene Anteile” the sale of which is taxable even if the interest in the corporation is reduced to less than 1% due to the spin-off; see above, under C.III.3.a)(iii).

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received by a domestic corporation, whether in the form of dividends or in the form of capital gains on the sale of such stock, is fully exempt from tax. Accordingly, under German tax law there is no need for rules preventing the conversion of dividends into capital gains.

4. More complex anti-tax avoidance regime in the U.S.

The anti-tax avoidance regime under § 355 IRC might be characterized by the two principal concerns it is meant to prevent: (1) the conversion of ordinary dividend income at the shareholder level into capital gain, and (2) the transfer of appreciated property out of the corporation without triggering tax on the corporate level. To thwart the taxpayers’ attempts to accomplish such tax avoidance, the spin-off rules provide for a complex system of codified and judicial requirements. The device clause and the active business requirement are intended to disallow the conversion of income. The provisions of § 355 (d) and (e) IRC shall ensure taxation of appreciated property on the corporate level. The continuity of interest requirement can be understood as to prevent either the bailout of cash or the sale to third parties. Furthermore, there is the general anti-tax avoidance approach of the business purpose doctrine.

263 See above, under C.II.1.
264 Cf. B.III.2.c), d).
265 See B.III.4.a) and b).
266 *Lind/Schwarz/Lathrop/Rosenberg*, Fundamentals of Corporate Taxation, 5.E., Ch. 10 C.2.
267 *Howley*, Business Organizations with Tax Planning, Part 23, § 150.06 [2]; *Burke*, Federal Income Taxation of Corporations and Stockholders, 5.E., Ch. 10 § 9, at 308. These two goals are not necessarily opposed, since the typical way to facilitate a bailout is to spin-off the appreciated property and then to sale the stock received to third parties.
268 See B.III.2.e).

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What justifies this rather complicated system of overlapping provisions and rules? The German Transformation Tax Act by comparison seems rather clear and simple. The provision of § 15 (3) UmwStG intended to thwart the taxpayers’ attempts to avoid taxes focuses on the creation of operational units and the sale of such operational units to outside parties.

The reason for the different approach might be twofold. The German spin-off rules only deal with the problem of avoiding taxation on the corporate level,\footnote{Under the German tax regime there are no different rates for the taxation of dividends and the taxation of gains on the sale of stock; cf. D.I.3.} whereas the U.S. tax regime in addition shall prevent the conversions of ordinary income into capital gains. Yet, this cannot explain the fact that the tax regime under § 355 IRC is based on three rules with respect to the conversion of income,\footnote{Including the continuity of interest requirement.} three rules regarding the sale to outside parties\footnote{Again including the continuity of interest requirement.} and an additional general anti-tax avoidance rule. The answer for this complex set of rules might be simple: “time”. The anti-tax avoidance scheme of § 355 IRC has developed over more than 50 years, adding another rule to the system each time taxpayers were able to find means to get around the existing provisions.\footnote{See the brief description by \textit{Schler}, Simplifying and Rationalizing the Spinoff Rules, 56 SMU L. Rev. 239 (242-244).} And as if this would not be enough, Congress decided to change one of the underlying principles of the spin-off rules by repealing the \textit{General Utilities} doctrine.\footnote{See above, under B.III.4.} In contrast, § 15 UmwStG was enacted in 1994 and in force since January 1, 1995. It seems that there was
just not enough time for major changes and amendments to the German Transformation Tax Act. However, the German Tax Reform 2000 amended the Corporation Tax Act adding anti-tax avoidance provisions dealing with similar issues as § 15 (3) UmwStG. These new rules have an overlapping scope as well and seem to match with § 15 (3) UmwStG even less as the provisions and rules under § 355 IRC. It might be just a question of time until the rules under § 15 UmwStG resemble the ones under § 355 IRC.

5. Carry-over of losses

Under U.S. law tax attributes of the transferor corporation generally do not carryover, even if the divisive transaction takes the form of a “D reorganization”. Only the earnings and profits of the distributing corporation are allocated between the distributing and controlled corporation(s) in proportion to the relative fair market values of the assets. But no capital loss and especially no net operating loss is attributed to the controlled corporation. In contrast, under German tax law the transferee corporation (partially) succeeds the transferee corporation in holding periods, depreciation and net operating loss.

This different treatment might be explained by taking the general understanding of the transaction into account. The German Transformation Act defines the general rules applicable for all reorganizations in the chapter for mergers. The rules for spin-off

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[274] E.g. § 15 (3), sentence 4 UmwStG provides for a five year holding period, § 8b (4) KStG provides for a seven year holding period.

[275] See above, under B.III.3.a), and Lind/Schwarz/Lathrope/Rosenberg, Fundamentals of Corporate Taxation, 5.E., Ch. 10 D.3.


[277] See §§ 2-122 UmwG.

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transactions refer to these merger rules\textsuperscript{278} and, accordingly, provide for a (partial) universal succession. The German Transformation Tax Act follows this corporate law approach. The spin-off rules in § 15 UmwStG refer to the merger provisions in §§ 11-13 UmwStG for the requirements as well as the consequences of a tax free treatment. Under the merger provisions succession rules seem appropriate to reflect the termination of the transferor corporation and the continuity of the trade or business in a new (larger) form. Accordingly, the transferee corporation (partially) succeeds the transferor corporation in a spin-off transaction the same way a transferee corporation does in a merger. U.S. tax law in § 355 IRC (with § 368 IRC) defines rules for a divisive transaction which resembles a mere distribution of stock. The transferor corporation will generally not cease to exist. Accordingly, there is less need for attribution rules and legal succession.

\textbf{II. Proposed changes of the U.S. spin-off rules}

Comparing the U.S. with the German spin-off tax regime shows several reasons for differences. The underlying principles might be different: U.S. tax law called for higher tax rates on dividends than on capital gains, unlike the German tax law. A tax system developed and amended over time tends to get more complicated than one which is newly implemented. This leads to the question: Is there no need for improvement?

Yet, there is an ongoing discussion in the U.S. how to amend the Code to make it less complicated. Since the spin-off provisions apply overlapping anti-tax avoidance rules, there is room for change. Furthermore, the underlying principles of the taxation of

\textsuperscript{278} § 125 UmwG.

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corporations in the U.S. might have changed. For dividends no longer the tax rates for ordinary income, but rather the capital gain tax rates apply.

1. Simplification of the U.S. spin-off rules?

The U.S. spin-off rules offer a complex system of codified and judicial requirements aimed to thwart tax avoidance schemes. These requirements can be separated into three groups: (1) provisions to disallow the conversion of ordinary income into capital gains (device clause and active business requirement), (2) rules to prevent avoidance of tax at the corporate level (§ 355 (d) and (e) IRC), and (3) general anti-tax avoidance provisions (continuity of interest requirement and business purpose doctrine).

Ideally, the legislator should aim at achieving all these objectives in the simplest way possible. Why is one provision for each of the groups not sufficient? And why are general anti-tax avoidance provisions necessary and applicable, if the Code provides for special ones designed to meet the concerns? However, it seems difficult to define new rules without leaving room for tax structures designed to circumvent these provisions. This seems a common observation of the articles dealing with simplification of the spin-off provisions.

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279 For the following cf. D.I.4.

280 Cf. Schler, Simplifying and Rationalizing the Spinoff Rules, 56 SMU L. Rev. 239 (252), who on the one hand wants to simplify the spin-off rules, but on the other hand is not willing to draw clear lines because certain transactions, which today would be disqualified, might get tax free treatment under the new rules. To put it different, the Schler-proposal reflects all the difficulties and details of the spin-off rules and in doing this does not solve its own task: to provide for less complex spin-off provisions (cf. Schler’s summary on page 282/283).

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Considering the rules focusing on the conversion of ordinary income into capital gains, the device clause covers transactions which are also targeted under the active business requirement. It seems problematic to utilize the broad device clause, if a transaction meets the elaborate requirements of the active business test.\(^{281}\) The device clause, due to its broad wording, should step back in such a case, because the requirements of the more special provision are met. Due to its broad wording the device clause is used as a do-it-all provision.\(^{282}\) It seems questionable to provide for such a rule in the Code, which inevitably needs clarification by the Courts and the Regulations. The same issues could be addressed with more accurate provisions decided on by the Congress itself (and not the Treasury).\(^{283}\) And if a transaction is aimed to circumvent the special provisions, there is still room to utilize a modified business purpose test.\(^{284}\) A transaction would not qualify for tax free treatment, if there is no business purpose for each of the single steps of the actual transaction used, even when meeting the requirements of the active business requirement.

\(^{281}\) Cf. *Abrams/Doernberg*, Federal Corporate Taxation, 5.E., Ch. 10.04 (a), at 268/269; *Lind/Schwarz/Lathrope/Rosenberg*, Fundamentals of Corporate Taxation, 5.E., Ch. 10 C.3.b.

\(^{282}\) See above, under B.III.2.d).

\(^{283}\) The reasons mentioned by *Schler*, Simplifying and Rationalizing the Spinoff Rules, 56 SMU L. Rev. 239 (254), to retain the device clause seem not convincing. Planned sales of stock after the distribution are covered by § 355 (d) and (e) IRC. Large amounts of nonbusiness assets in P or S need not be discouraged, because it is up the corporation and its shareholders (and not to the tax law) whether to retain or distribute earnings. And the question of a weak business purpose is still part of the inquiry suggested here – therefore a “backstop” is provided.

\(^{284}\) See also *Schler*, Simplifying and Rationalizing the Spinoff Rules, 56 SMU L. Rev. 239 (251/252).

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A similar approach seems appropriate with respect to § 355 (d) and (e) IRC. A combination\textsuperscript{285} of these provisions should be implemented, triggering tax on the corporate level, if the distribution is part of a plan according to which more than 50% (or any other given percentage) of the stock of the distributing or controlled corporation is sold to third parties.\textsuperscript{286} A plan might be presumed to exist in certain cases, e.g. if an acquisition of a particular percentage takes place within a certain time period before or after the distribution.\textsuperscript{287} This provision would define a set of disqualified transactions without being limited to these cases.\textsuperscript{288} It would be more specific than a general business purpose test or the continuity of interest requirement. Yet, transactions aimed to meet the language of the Code, but not its substance, would not qualify.\textsuperscript{289} A more specific business purpose test, analyzing each step of the actual transaction, could be employed as a backstop. Under such a regime the continuity of interest requirement would no longer appear necessary.\textsuperscript{290}

\textsuperscript{285} Cf. Yin, Corporate Tax: Taxing Corporate Divisions, 56 SMU L. Rev. 289 (299).

\textsuperscript{286} See also Yin, Corporate Tax: Taxing Corporate Divisions, 56 SMU L. Rev. 289 (296), who describes § 355 (e) IRC as a model for a change of ownership rule which should trigger taxation under the spin-off provisions.

\textsuperscript{287} Cf. § 355 (e)(2)(A) and (B) IRC.

\textsuperscript{288} See the similar approach under § 15 (3), sentence 2-4 UmwStG, which are also limited to trigger tax on the corporate level.

\textsuperscript{289} As Yin, Corporate Tax: Taxing Corporate Divisions, 56 SMU L. Rev. 289 (301), points out § 355 (e) IRC in its current form does not trigger tax on the shareholder level. This would only seem necessary, if the new change of ownership rule would also be utilized to disallow the conversion of ordinary income into capital gains; cf. also Schler, Simplifying and Rationalizing the Spinoff Rules, 56 SMU L. Rev. 239 (285/286). Such a broad approach might not be necessary for different reasons, see below, under D.II.2.

\textsuperscript{290} Cf. also Burke, Federal Income Taxation of Corporations and Stockholders, 5.E., Ch. 10 § 9, at page 310, which wants to utilize § 355 (e) IRC and the device clause to fully replace the continuity of interest requirement.

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In conclusion, it seems questionable that the current anti-tax avoidance regime under § 355 IRC is the only possible or even the best solution. Yet, since this complicated set of rules has been in place for a long time, a change is unlikely.\textsuperscript{291}

2. Is conversion of dividends into capital gains still tax avoidance?

In the past, the Code provided for different tax rates on ordinary income and capital gains.\textsuperscript{292} The rates on capital gains under § 1 (h) IRC were typically lower than the ordinary tax rates for individuals. Consequently, income was subject to higher tax rates if treated as dividend rather than as capital gain. The taxpayers were encouraged to convert ordinary income into capital gains. Corporations would not distribute any dividends to allow the shareholder to realize retained earnings by means of selling the stock. Under the spin-off rules, a corporation was able to transfer cash or liquid assets to its shareholders without triggering dividend treatment on the shareholder level by forming a new subsidiary and spinning off its stock. In a second step the shareholders would sell the stock, thereby realizing the value of the underlying liquid assets subject only to capital gains treatment. Several of the anti-tax avoidance provisions under § 355 IRC (e.g. device clause and active business requirement) are aimed to deal with this issue.\textsuperscript{293}

\textsuperscript{291} Yin, Corporate Tax: Taxing Corporate Divisions, 56 SMU L. Rev. 289 (290); Schler, Simplifying and Rationalizing the Spinoff Rules, 56 SMU L. Rev. 239 (285).

\textsuperscript{292} However, between 1987 and 1990 the tax rates were the same. This is still true for corporations the capital gain tax rates of which were not lowered in 1990; cf. Klein/Bankman/Shaviro, Federal Income Taxation, 13.E., Ch. 1 G.2.; Burke, Federal Income Taxation of Corporations and Stockholders, 5.E., Ch. 2 § 2, at page 26.

\textsuperscript{293} See above, under D.II.1.

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Since 2003, the tax rate for dividends has been significantly lowered for individual taxpayers. Qualified dividends received by individual\textsuperscript{294} shareholders are taxed at the same rates that apply to net capital gain.\textsuperscript{295} This will clearly decrease the advantages of utilizing spin-off transactions to convert ordinary income into capital gains. Instead of spinning off the cash via a new formed subsidiary to realize the value by selling the stock of the transferee subsidiary, the transferor corporation could just pay a dividend to its shareholders. The situation is similar to the tax environment in Germany. In the future, new acquisition structures might be advisable. Instead of spinning off a business with appreciated property and then selling the stock of the newly created subsidiary to the acquirer, the transferor corporation might sell the business to an Acquisition NewCo and then distribute the gain realized to its shareholders. The income realized by the transferor corporation can be offset by carryover losses or at least by a higher purchase price the acquirer is willing to pay since he will get a step-up in basis.

Consequently, there should be less concern about the conversion of ordinary income into capital gains. The anti-tax avoidance rules under § 355 IRC aimed to deal with this issue might be outdated soon, provided the U.S. legislation will retain the parallel treatment of dividends and capital gains on the sale of stock or – as in Germany\textsuperscript{296} – generally end the differentiation between tax rates for ordinary income and

\textsuperscript{294} Corporations are subject to the same tax rates on dividends and capital gains anyway, cf. § 1201 (a) IRC.

\textsuperscript{295} See new § 1 (h)(11) IRC, enacted by Jobs and Growth Tax Relief Reconciliation Act of 2003, May 28, 2003. The Act also provides for a sunset provision according to which the reduced tax rates expire, and regular tax rates apply to tax years beginning after December 31, 2008; cf. B.II.1.

\textsuperscript{296} The German tax regime provides relief from taxation on capital gains only for small individual investors (less than 1% ownership) which are not in a position to avoid taxes by structuring spin-off transactions; see above, under D.I.3.

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capital gains. By repealing the anti-bailout provisions a significant simplification of the tax regime for spin-off could be achieved.

E. Conclusion

The tax law in the U.S. and Germany offers special provisions dealing with divisive transactions commonly referred to as “spin-off”. Under the U.S. tax regime § 355 IRC deals with the distribution of stock and securities of a controlled corporation. If the requirements are met, the Code allows tax free treatment on corporate as well as shareholder level. Under German tax law, § 15 German Transformation Tax Act ("Umwandlungssteuergesetz" – UmwStG) establishes a tax regime for divisive transactions. If the requirements of §§ 15 and 11 UmwStG are met, the transaction is tax free on corporate and shareholder level.

These rules provide for quite similar treatments of divisive transactions. Both jurisdictions allow a divisive transaction only for separating active business units. Both jurisdictions assure future taxation by means of a basis carry-over. And both tax regimes provide for a deferral in taxes, not an exemption.

Nonetheless, there are significant differences especially with respect to the anti-tax avoidance provisions. The U.S. spin-off rules provide for a complex system of codified and judicial requirements which seek to (1) disallow the conversion of ordinary income into capital gains, and (2) prevent avoidance of tax at the corporate level. It seems advisable to tighten this regime by providing only one provision (instead of two or three

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overlapping ones) for each of these objectives. Furthermore, the conversion of ordinary income into capital gains might no longer be an issue, since – starting in 2003 – dividends are taxed at the same tax rates as capital gains both for individual and corporate shareholders.

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