

# WNTS Insight

A Washington National Tax Services (WNTS)  
Publication

November 21, 2011

## Final regulations diminish impact of "hot stock" provision, but leave important questions unanswered

Recently issued final regulations addressing the application of section 355(a)(3)(B) (the "hot stock" provision) in light of the 2007 amendment to the active trade or business rules under section 355(b)(3) diminish significantly the effect of the hot stock provision, as did prior temporary regulations, but leave unanswered several important questions.

### *Background*

Temporary regulations addressing the application of section 355(a)(3)(B) were issued on December 15, 2008. The final regulations, which are effective for distributions occurring after October 20, 2011, adopt without substantive change the rules set forth in the temporary regulations.

Under section 355(a)(3)(B), stock of a controlled corporation (Controlled) acquired by the distributing corporation (Distributing) in a transaction in which gain or loss is recognized within five years of a section 355 distribution is treated as other property, or "hot stock." Generally, the distribution of hot stock results in Distributing recognizing gain, but not loss, under section 311 and in its shareholders receiving a distribution taxable under section 301.

### *The final regulations*

The final regulations diminish the impact of the hot stock provision by providing the following three exceptions:

- No gain is recognized on the distribution of hot stock if Controlled becomes a member of Distributing's separate affiliated group (DSAG) any time after the acquisition but before the section 355 distribution;



- No gain is recognized on the distribution of hot stock if Distributing acquired the stock of Controlled from another member of the DSAG; and
- No gain is recognized on the distribution of hot stock if Distributing acquired the stock of Controlled from another member of the affiliated group of which Distributing was a member (e.g., if Distributing buys Controlled stock from Distributing's parent).

For purposes of these exceptions, the term "DSAG" is defined as the affiliated group that would be determined under section 1504(a) if Distributing was the common parent and section 1504(b) did not apply. The term "affiliated group" means an affiliated group as defined in section 1504(a) (without regard to section 1504(b)), except that the term stock includes nonvoting stock described in section 1504(a)(4).

### *Observations:*

Although diminishing the effect of section 355(a)(3)(B), the final regulations leave unresolved certain questions:

- Whether, in a situation in which a corporation that owns Controlled stock joins the DSAG in a taxable transaction, the DSAG is treated as acquiring the Controlled stock in a taxable transaction;
- Whether the DSAG is treated as making any acquisition made by a predecessor of a DSAG member;
- Whether issuances by Controlled of Controlled stock to Distributing in taxable transactions should give rise to hot stock; and
- Whether a redemption by Controlled of its stock from unrelated parties would cause any portion of Distributing's Controlled stock to become hot stock.

Taxpayers still should perform diligence as to whether a distribution qualifies as a tax-free distribution under section 355. A distribution that avoids the application of section 355(a)(3)(B) may not necessarily satisfy the other requirements of section 355, including the active trade or business requirement in section 355(b).

*For more information, please do not hesitate to contact:*

<i>Rich McManus</i>	<i>(202) 414-1447</i>	<i>rich.mcmanus@us.pwc.com</i>
<i>Derek Cain</i>	<i>(202) 414-1016</i>	<i>derek.cain@us.pwc.com</i>

Link to WNTS Insight archive: <http://www.pwc.com/us/en/washington-national-tax/newsletters/washington-national-tax-services-insight-archives.jhtml>

This document is for general information purposes only, and should not be used as a substitute for consultation with professional advisors.

#### SOLICITATION

© 2011 PricewaterhouseCoopers LLP. All rights reserved. In this document, "PwC" refers to PricewaterhouseCoopers LLP, a Delaware limited liability partnership, which is a member firm of PricewaterhouseCoopers International Limited, each member firm of which is a separate legal entity.