



TaxNewsFlash

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IRS considering “active trade or business” guidance for ventures with research activities

The IRS today posted a statement on its website announcing that the IRS and Treasury Department are considering guidance to address whether a business can qualify as an “active trade or business” if entrepreneurial activities—as opposed to investment or other non-business activities—take place with the purpose of earning income in the future, but no income has yet been collected.

The [IRS statement](#) (September 25, 2018) informs taxpayers of the IRS study regarding the active trade or business requirement under section 355(b). The IRS has requested comments.

Also, the IRS indicated that it will entertain requests for certain private letter rulings.

Background

The IRS statement notes that section 355 generally permits a corporation to distribute to its shareholders or security holders the stock and securities of a controlled subsidiary without recognition of gain to itself, its shareholders, or its security holders.

To qualify for tax-free treatment, various requirements must be satisfied—including a requirement under section 355(b) that the distributing corporation and the controlled corporation each be engaged in an active trade or business. The regulations under section 355(b) provide that an active trade or business “ordinarily must include the collection of income and the payment of expenses.”

Reason for possible future guidance

The IRS reported that it has observed a “significant rise in entrepreneurial ventures” that have activities consisting of research and development in lengthy phases. During these phases, the ventures often collect no income (or negligible income) but incur significant financial expenditures and perform day-to-day operational and managerial functions that historically have evidenced an “active” business.

The IRS noted that, for instance, a venture in the pharmaceutical or technology field might engage in research to develop new products with the purpose of earning income in the future from sales or licenses. The venture might even forgo current income opportunities to obtain increased future income by developing products on its own. The nature and duration of the research phases is often dictated by regulatory agencies, which require complex review processes that can span multiple years and cost millions of dollars.

Due to the emergence of these ventures, the IRS and Treasury Department are considering guidance to address whether a business can qualify as an active trade or business if entrepreneurial activities—as opposed to investment or other non-business activities—take place with the purpose of earning income in the future, but no income has yet been collected.

Comments are requested regarding all aspects of the requirement that an active trade or business “ordinarily must include the collection of income” including:

- The scope of the requirement under current law and administrative guidance
- Whether any applicable administrative guidance needs to be withdrawn, revoked, modified, or declared obsolete
- Whether the requirement needs to be modified, for example, whether an exception would apply to any particular business model due to its unique characteristics

The IRS said that it does not contemplate industry-specific guidance.

Private letter ruling requests

The IRS statement continues by noting that while the study is on-going, the IRS will entertain requests for private letter rulings regarding the active trade or business qualification of corporations that have not collected income. The IRS release encourages taxpayers and their advisers to request pre-submission conferences to discuss requests for rulings on these matters.

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