# Proposed Regulations under Section 355 Clarify Device and Active Trade or Business Requirements for Tax-Free Spin-offs

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On July 15, 2016, the U.S. Internal Revenue Service (IRS) and the Department of the Treasury (Treasury) published proposed regulations that would modify the device and active trade or business requirements for tax-free spin-offs under section 355 of the Code.[1]The proposed regulations are generally consistent with Notice 2015-59 (the "Notice"), which was issued in September 2015,[2] and make three important changes.

First, the proposed regulations clarify the "device" test and its relationship to the "business purpose" requirement.

Second, the proposed regulations would prohibit a tax-free spin-off if (1) two-thirds or more of the assets of the distributing corporation or the controlled corporation consist of nonbusiness assets and (2) the percentage of the distributing corporation's nonbusiness assets differs significantly from those of the controlled corporation under three specified tests.

Third, the proposed regulations would require that the assets constituting an active trade or business must represent at least 5% of the total assets of the distributing corporation and the distributed corporation in order for the spin-off to be tax-free. Thus, the proposed regulations would effectively repeal the so-called "hot dog stand" rule, under which a de minimis active trade or business could support a spin-off of a relatively much larger collection of passive assets.

If promulgated as proposed, these regulations will affect distributing corporations and their shareholders and security holders in spin-offs, split-offs and split-ups that occur on or after final regulations are published (subject to the limited grandfathering rules described below).

***Background***

Section 355 describes the circumstances under which a corporation ("Distributing") may make a tax-free distribution to its shareholders and security holders of the stock and securities in a controlled corporation ("Controlled").[3] For distributions of stock and securities by a corporation in which the distribution is not subject to section 355, the usual rules for distributions apply: namely, the fair market value of distributed property (i.e., stock and securities of Controlled) would be treated as a dividend to the extent of Distributing's earnings and profits, and any unrealized appreciation in the stock or securities distributed would be recognized by Distributing.[4]

Section 355 is one of the few remaining areas of tax law where a corporation can distribute appreciated property without recognizing gain. Therefore, a number of requirements must be met for a distribution to satisfy section 355. In recent months, the IRS and Treasury have focused on three requirements in particular: (1) the existence of a business purpose (independent of federal tax reasons) for the distribution; [5] (2) both Distributing and Controlled must be engaged in the "active conduct of a trade or business", which has been conducted for at least five years before the distribution (a "five-year active business"); [6] and (3) the distribution must not be "principally [ ] a device for the distribution of the earnings and profits" of Distributing.[7]

In Notice 2015-59, the IRS and Treasury expressed concern over distributions where corporations had separated a collection of active business assets from a collection of relatively passive assets and, in particular, distributions of relatively small active businesses and distributions where the ratio of active business assets and passive business assets between the distributing and distributed corporation were substantial.[8] Earlier that year, Yahoo Inc. had announced a proposed spin-off of its stake in Alibaba Group Holding Ltd. (valued at approximately $40 billion when the transaction was announced) with a relatively small legacy Yahoo business. The IRS refused to issue a private letter ruling relating to the spin-off, and it issued Notice 2015-59 shortly thereafter.[9] These new proposed regulations address the concerns raised by the Yahoo transaction and in the Notice generally.

***Device Test***

Under current law, whether a transaction is a device to distribute E&P is a facts and circumstances test. Three device factors are weighed against three non-device factors, and no single factor is determinative.[10] The proposed regulations provide more objective rules as to the application of the device test.

Modification of device factor relating to nature and use of assets. One of the current device factors relates to the nature, kind, amount and use of the assets of Distributing and Controlled. Current regulations provide that the existence of assets that are not used in a five-year active business—a rough way of identifying passive assets—is evidence of device. Although the strength of this device factor depends on all facts and circumstances, the ratio of nonbusiness assets to business assets for each of Distributing and Controlled is relevant. With limited exceptions, differences in these ratios between Distributing and Controlled would generally be evidence of device.

Under the proposed regulations, Treasury and the IRS indicated that the ownership of assets that are used in an active business that has been operated or owned for fewer than five years does not raise device concerns. Accordingly, the proposed rules will no longer treat such assets as passive, nonbusiness assets when determining the percentage of nonbusiness assets relative to total assets for Distributing and Controlled.[11] As in the current regulations, working capital is treated as a business asset; the proposed regulations further clarify, however, that assets held pursuant to legal or regulatory requirements and binding commitments (including to secure a reasonably expected financial obligation) also will be treated as business assets.[12]

Furthermore, although the current regulations relied solely on facts and circumstances when determining whether the nature and use of assets were evidence of device, the proposed regulations provide two objective guidelines that should be welcome to taxpayers planning spin-offs. First, if less than 20% of the assets of each of Distributing and Controlled are nonbusiness assets, the ownership of these assets "ordinarily is not evidence of device."[13] Second, if the percentage of nonbusiness assets held by Distributing differs from the percentage of nonbusiness assets held by Controlled, the distribution "ordinarily is not itself evidence of device" if either (i) the difference is less than ten percentage points, or (ii) the difference is attributable to a need to equalize the consideration in non-pro rata distributions.[14]

If Distributing distributes more than one Controlled, under the proposed regulations, the not-a-device requirement must be satisfied with respect to the distribution of each Controlled distributed as part of the transaction as compared to Distributing, and as compared to each other Controlled. If the distribution of a single Controlled would be treated as a device for distributing E&P in accordance with these proposed regulations, then the distributions of the other Controlleds distributed as part of the transaction would be similarly tainted.[15]

Corporate business purpose for separation of nonbusiness assets generally is disregarded. Under current regulations, the presence of a corporate business purpose is evidence of non-device and can outweigh evidence of device relating to the nature and use of assets. Although this rule continues to apply, the proposed regulations would generally disregard a proffered business purpose for separating nonbusiness assets from business assets "unless the business purpose involves an exigency that requires an investment or other use" of the nonbusiness assets.[16]

*Per se* device test. One of the most significant changes in the proposed regulations is a new *per se* test that treats any distribution (including a distribution of publicly traded and widely held shares or a distribution supported by a valid corporate business purpose) as a device (that will disqualify a tax-free distribution) if:

(1) at least two-thirds of the assets of Distributing or Controlled were comprised of nonbusiness assets, and

(2) the percentage of Distributing's nonbusiness assets differs significantly from those of Controlled.

This second prong is satisfied if the percentages of the nonbusiness assets of Distributing and Controlled fall within any of the following bands: (1) nonbusiness assets represent 66.67% to 79.99% of one corporation's assets, while less than 30% of the other corporation's assets are nonbusiness assets; (2) nonbusiness assets represent 80% to 89.99% of one corporation's assets, while less than 40% of the other corporation's assets are nonbusiness assets; and (3) at least 90% of one corporation's assets are nonbusiness assets, while less than 50% of the other corporation's assets are nonbusiness assets.[17]

Distributions to domestic corporations entitled to a dividends received deduction, distributions by, and of, corporations with no earnings and profits, and distributions treated as redemptions under section 302(a) or section 303(a) would be exempt from being treated as a *per se* device under this rule.[18]

### *Active Trade or Business*

Section 355(b) generally requires that both Distributing and Controlled be engaged, immediately after the distribution, in the active conduct of a trade or business that was conducted for the five years preceding the distribution. The terms of section 355(b) provide for no minimum size for this active trade or business, and because the IRS had neither issued regulations requiring a minimum size nor formally imposed any particular minimum size requirements, taxpayers tried to satisfy the active trade or business requirement in spins of their valuable, appreciated nonbusiness assets by including among those assets the proverbial actively conducted hot dog stand. Historically, however, the IRS would not issue a private letter ruling to a taxpayer regarding a section 355 distribution unless the taxpayer could represent that the assets making up the active business was at least 5% of the total assets of the distributing corporation and the distributed corporation.[19]

The proposed regulations formalize this 5% size requirement and would require that assets used by each of Distributing and Controlled in a five-year active business represent at least 5% of their respective total assets. For this purpose, working capital and assets held pursuant to legal or regulatory requirements and binding commitments would be treated as business assets.[20]

### *Rules of Implementation*

To implement the foregoing, the proposed regulations provide operating rules regarding the timing and manner of identifying nonbusiness assets, look-through rules for ownership of active businesses through partnerships and anti-abuse rules. A look-through rule for ownership of business assets held through controlled corporations applies with respect to the device requirement (but not the active trade or business requirement).

### *Effective Date and Grandfathering Rules*

The proposed rules would be effective for distributions that occur on or after the date on which final regulations are published in the Federal Register.[21] The proposed regulations would also grandfather distributions that (i) were made pursuant to an agreement, resolution or other corporate action that was binding before the publication of final regulations (and all times thereafter); (ii) described in an IRS ruling request filed prior to July 16, 2016; or (iii) publicly announced or filed with the SEC before publication of final regulations.[22]

[1] All section references are to the U.S. Internal Revenue Code of 1986, as amended (the "Code").

[2] 81 Fed. Reg. 46004 (July 15, 2016); see also Notice 2015-59, 2015-40 I.R.B. 459 (Sept. 14, 2015).

[3] Section 355(a).

[4] Section 301(c) (distribution treated as dividend); section 311(b) (gain on unrealized appreciation).

[5] Section 355(a)(1)(B); Reg. § 1.355-2(d)(3)(ii).

[6] Section 355(b). Under section 355(b)(3), for the purpose of determining if the active trade or business requirement has been satisfied, all members of the separate affiliated group ("SAG") for which Controlled is the common parent ("CSAG") would be treated as a single corporation, and all members of the SAG for which Distributing is the common parent (but excluding the CSAG) ("DSAG") would be treated as a single corporation.

[7] Section 355(a)(1)(B).

[8] Notice 2015-59, 2015-40 I.R.B. 459 (Sept. 14, 2015). The Notice also raised concerns relating to distributions where either the distributing or distributed corporation elected to become a real estate investment trust (a "REIT") or a regulated investment company (or "RIC") after the distribution, eliminating an entity-level tax on the corporation and reducing the overall corporate tax base of the combined enterprises. Congress had previously amended section 355 to address those distributions used to create REITs (but not RICs). See Section 355(h).

[9] On July 25, 2016, Verizon announced that it would acquire Yahoo's core internet business. Yahoo shareholders will retain interests in Alibaba, interests in Yahoo Japan, non core patents, and cash.

[10] The device factors are the nature and use of the assets of both Distributing and Controlled, a pro rata distribution, and a subsequent sale of the stock received. See Reg. § 1.355-2(d)(2). The non-device factors are a business purpose for the distribution, the fact that Distributing is publicly traded and widely held, and a distribution to domestic corporate shareholders. Reg. § 1.355-2(d)(3).

[11] Prop. Reg. § 1.355-2(d)(2)(iv)(B).

[12] Prop. Reg. § 1.355-2(d)(2)(iv)(B).

[13] Prop. Reg. § 1.355-2(d)(2)(iv)(C)(1).

[14] Prop. Reg. § 1.355-2(d)(2)(iv)(C)(2) (emphasis added). Although generally not itself evidence of device, this difference may be considered when determining the presence or strength of other device factors. Id.

[15] Prop. Reg. § 1.355-2(d)(2)(iv)(D)(1).

[16] Prop. Reg. § 1.355-2(d)(3)(ii).

[17] Prop. Reg. § 1.355-2(d)(5)(iii).

[18] Prop. Reg. § 1.355-2(d)(6).

[19] Rev. Proc. 96-43, 1996-2 C.B. 330 (same), superseded by Rev. Proc. 97-3, 1997-1 C.B. 507.

[20] Prop. Reg. § 1.355-9(a)(3).

[21] Prop. Reg. § 1.355-2(i)(1)(i).

[22] Prop. Reg. § 1.355-2(i)(1)(ii).


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