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# Proposed Regs Modify Device and Active Trade or Business Analysis

*By Mark J. Silverman and Andrew F. Gordon*

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# Proposed Regs Modify Device and Active Trade or Business Analysis

**by Mark J. Silverman and Andrew F. Gordon**

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In this report, Silverman and Gordon discuss the substantial changes in the recently proposed regulations under section 355 that address the device prohibition and the active trade or business requirement, paying special attention to how the regs could affect taxpayers and practitioners and how the IRS might approach future guidance.

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Ever since the IRS unexpectedly announced in May 2015 that it was suspending the issuance of private letter rulings under section 355 for transactions involving relatively small businesses, the issuance of guidance seemed inevitable.[1] A notice, several no-rules, and over one year later, that guidance came on July 14, when the IRS issued proposed regulations under section 355 that contain rules regarding the device prohibition and the active trade or business requirement (the proposed regulations).[2] This report discusses the significant changes introduced in the proposed regulations and considers both the impact on taxpayers and practitioners structuring transactions under section 355 and the IRS's approach to future guidance on section 355.

## I. Device, Active Trade or Business Requirement

Section 355 permits the tax-free separation of businesses through the distribution by a corporation (Distributing) to its shareholders of stock in a controlled corporation (Controlled). A distribution that qualifies under section 355 generally will not result in the recognition of any income or gain by Distributing or its shareholders. Among the numerous requirements under section 355 are (1) that the transaction not be used as a "device" for the distribution of earnings and profits, and (2) the satisfaction of an active trade or business test.

### A. Device Prohibition

Under section 355(a)(1)(B), the transaction must not be used principally as a device for the distribution of the earnings and profits of either Distributing or Controlled. This requirement is primarily designed to prevent the distribution from being used as a means to avoid shareholder-level tax on dividend income.[3] The regulations provide that the determination of whether a transaction is used

[1]The IRS's announcement was prompted by a series of well-publicized transactions, the most notable of which was the proposed spinoff by Yahoo Inc. of its stake in Alibaba Group Holding Ltd. *See* Amy S. Elliott, "IRS Announces Spinoff Ruling Pause; Yahoo Implicated?" *Tax Notes*, May 25, 2015, p. 857. Yahoo ultimately abandoned that transaction because of the IRS's evolving position under section 355 and its unwillingness to grant a private letter ruling. *See* Elliott, "Yahoo Drops Plan to Spin Off Alibaba, Aims for Reverse Spinoff," *Tax Notes*, Dec. 14, 2015, p. 1343.

[2]81 F.R. 46004 (July 15, 2016).

[3]The regulations state that "section 355 recognizes that a tax-free distribution of the stock of a controlled corporation presents a potential for tax avoidance by facilitating the avoidance of the dividend provisions of the Code through the subsequent sale or exchange of stock of one corporation and the retention of the stock of another corporation. A device can include a transaction that effects a recovery of basis." Reg. section 1.355-2(d)(1).



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principally as a device is based on all facts and circumstances, including enumerated device and non-device factors.[4]

The current regulations indicate that among those factors, the existence of assets that are not used in a qualifying business — that is, a business that satisfies the active trade or business requirement in section 355(b) — is evidence of device (for example, cash and other liquid assets that are not related to the reasonable needs of the business). The regulations specify that the device analysis must take into account the nature, kind, amount, and use of the assets of Distributing and Controlled (and their controlled subsidiaries) immediately after the transaction. The strength of the device evidence depends on all facts and circumstances, including each corporation's ratio of the value of assets not used in a qualifying business to the value of its qualifying business.[5]

The other factors in the regulations identified as evidence of device are (1) a pro rata distribution; and (2) a subsequent sale or exchange of Distributing or Controlled stock, with the device evidence being substantial if the sale or exchange is prearranged.[6]

The non-device factors in the regulations are (1) the strength of the corporate business purpose for the distribution, (2) that Distributing is publicly traded and has no significant (5 percent) shareholder, and (3) that a distributee corporation would have been entitled to a dividends received deduction.[7]

Also, the regulations identify several transactions that are ''ordinarily considered not to have been used principally as a device'' despite the presence of any device factors.[8] That includes, for example, a distribution that would be a section 302(a) redemption for each shareholder distributee if section 355 did not apply.[9]

## B. Active Trade or Business Requirement

Under section 355(a)(1)(C) and (b), Distributing and Controlled must each be engaged in the active conduct of a trade or business immediately after the distribution. To qualify, the relevant trade or business must have been operated throughout the five-year period preceding the distribution and not have been acquired directly or indirectly in a taxable transaction during that period.[10] A corporation is engaged in a trade or business if it is carrying on a specific group of activities for the purpose of earning income or profit and the corporation itself performs active and substantial management and operational functions.[11] In determining whether a corporation is engaged in the active conduct of a trade or business, all members of the corporation's separate affiliated group (SAG) are treated as one corporation.[12]

Neither section 355(b) nor the regulations thereunder (see reg. section 1.355-3) make specific reference to the required size of the active trade or business. Although the size of the qualifying business may be relevant as a device factor in considering the asset makeup of a corporation, there is no indication that a relatively small business would result in the automatic failure of the active trade or business requirement. Historically, the IRS's position has been that a business can satisfy the active trade or business requirement regardless of its size. In Rev. Rul. 73-44, the IRS stated that ''there is no requirement in section 355(b) that a specific percentage of the corporation's assets be devoted to the active conduct of a trade or business.''[13] As referenced in the preamble to the proposed regulations, the IRS has also issued numerous private letter rulings under section 355 involving businesses of de minimis value relative to the assets of Distributing or Controlled.[14]

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[4] *Id.*

[5] Reg. section 1.355-2(d)(2)(iv).

[6] Reg. section 1.355-2(d)(2).

[7] Reg. section 1.355-2(d)(3). Although listed as a non-device factor, a corporate business purpose for the transaction is an independent requirement under section 355. Specifically, a distribution must be motivated in whole or substantial part by one or more corporate business purposes — *i.e.*, a real and substantial nonfederal tax purpose germane to the business of Distributing, Controlled, or Distributing's affiliated group. *See* reg. section 1.355-2(b). This requirement ensures that section 355 treatment is afforded only to distributions that are incident to readjustments of corporate structures required by business exigencies and that effect only readjustments of continuing interests in property under modified corporate forms. *Id.*

[8] Reg. section 1.355-2(d)(5).

[9] Reg. section 1.355-2(d)(5)(iv).

[10] Section 355(b)(2).

[11] Reg. section 1.355-3(b)(2)(ii) and (iii).

[12] Section 355(b)(3)(A). A corporation's SAG is the affiliated group that would be determined under section 1504(a) if the corporation were the common parent and section 1504(b) did not apply. Section 355(b)(3)(B).

[13] 1973-1 C.B. 182. In the ruling, publicly traded X owned three businesses: qualifying Business 1, qualifying Business 2, and a third business operated through its subsidiary, Y, which was recently acquired in a taxable transaction. X transferred Business 2 to Y, which represented a substantial portion, but less than 50 percent, of the value of Y's total assets. X then distributed Y's stock to its shareholders. The IRS found that the active trade or business requirement was satisfied even though Y's qualifying business assets represented less than half of its value after the distribution.

[14] *See* 81 F.R. 46004, 46007 (July 15, 2016) (''The IRS has taken the position, in letter rulings and internal memoranda, that an active business can satisfy the active business requirement regardless of its absolute or relative size. . . . The IRS issued

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### C. Changes to Section 355 Letter Ruling Policy

On September 14, 2015, the IRS issued Notice 2015-59,[15] in which the IRS communicated its concerns regarding qualification under section 355 for specific types of transactions, including: (1) transactions in which Distributing or Controlled own investment assets (as defined in section 355(g)(2)(B), with modifications) with substantial value in relation to the value of all the corporation's assets and the value of the assets of the corporation's qualifying business; (2) a significant difference between the ratio of investment assets to other assets of Distributing and Controlled; and (3) ownership by Distributing or Controlled of a small amount of qualifying business assets in relation to all its assets. Concurrently, in Rev. Proc. 2015-43,[16] the IRS expanded its no-rule policy under section 355 to cover those areas of concern. Pending formal guidance, the IRS announced that it will no longer issue private letter rulings on any issue relating to qualification under section 355 if the following conditions exist after the distribution:

- the value of the investment assets of Distributing or Controlled is two-thirds or more of the total value of its gross assets;
- the value of the gross assets of the qualifying business of Distributing or Controlled is less than 10 percent of the value of its investment assets; and
- the ratio of the value of the investment assets to the value of the other assets of Distributing or Controlled is three times or more of such ratio for the other corporation.

Also, the IRS stated that it will not usually issue private letter rulings (a taxpayer must show unique and compelling reasons for the letter ruling) on any issue relating to qualification under section 355 if the post-distribution value of the gross assets of the qualifying business of Distributing or Controlled is less than 5 percent of the total value of the corporation's gross assets.[17]

In adopting those no-rule positions, the IRS expressly excluded distributions within an affiliated group (as defined in section 243(b)(2)(A)) if there is no plan to distribute stock outside the group in a distribution otherwise described in Rev. Proc. 2015-43. The IRS also mentioned the possibility of promulgating regulations under section 337(d) to address the repeal of the *General Utilities* doctrine[18] in raising more general concerns regarding the use of section 355 as a mechanism to avoid corporate-level gain.[19]

## II. Summary of the Proposed Regulations

In issuing the proposed regulations, the IRS seeks to implement rules that would effectively adopt the no-rule positions introduced in Rev. Proc. 2015-43 as substantive rules of law. The proposed regulations do so through new rules applicable to the device prohibition and the active trade or business requirement.

### A. Device Prohibition

**1. Device factor — nature and use of assets.** The proposed regulations would modify the nature and use of assets device factor based on the IRS's view that the potential for device exists if (1) Distributing or Controlled owns a large percentage of assets not used in business operations compared with its total assets, or (2) there is a substantial difference between the percentage of nonbusiness assets held by Distributing and Controlled. As modified, the device factor takes into account assets used in a business and not just those assets used in a qualifying business (a business meeting the requirements of section 355(b)).[20] Thus, ownership of

numerous letter rulings on section 355 distributions involving active businesses that were de minimis in value compared to the other assets of Distributing or Controlled.'').

[15]2015-40 IRB 459.

[16]2015-40 IRB 467.

[17]The no-rule effectively reinstates the IRS's prior no-rule position in Rev. Proc. 96-43, 1996-2 C.B. 330, under which the IRS would not rule on whether a distribution qualified under section 355 when the gross assets of the qualifying business had a value that was less than 5 percent of the total value of the gross assets of the corporation directly conducting the business. However, the IRS indicated that it would still rule if it could be established that the businesses were not de minimis compared with the other assets or activities of the corporation and its subsidiaries. The IRS deleted this no-rule in Rev. Proc. 2003-48, 2003-2 C.B. 86.

[18]Section 337(d) authorizes the issuance of regulations necessary or appropriate to carry out the repeal of the *General Utilities* doctrine, under which a corporation generally could distribute appreciated property to its shareholders without recognizing gain (the doctrine itself is derived from the Supreme Court's decision in *General Utilities & Operating Co. v. Helvering*, 296 U.S. 200 (1935)).

[19]The IRS also targeted section 355 transactions that facilitate a conversion by Distributing or Controlled to a real estate investment trust. Separately, in December 2015, Congress enacted sections 355(h) and 856(c)(8) to restrict REIT spinoff transactions (in the Protecting Americans From Tax Hikes Act of 2015, which was part of the Consolidated Appropriations Act, 2016, P.L. 114-113). On June 7 the IRS issued temporary regulations under section 337(d), which contain additional rules on REIT spinoff transactions designed to impose corporate-level gain and prevent abuses of sections 355(h) and 856(c)(8). T.D. 9770.

[20]This change would make it less likely that a transaction violates the device prohibition. For example, under the current regulations, evidence of device exists if a corporation owns 3 percent qualifying business assets and 97 percent nonqualifying business assets (for example, assets acquired four years ago in a

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nonbusiness assets by Distributing or Controlled constitutes evidence of device. The larger the percentage of a corporation's total assets that constitutes nonbusiness assets, as measured by value (the corporation's nonbusiness asset percentage), the stronger the evidence of device. A difference between the nonbusiness asset percentages of Distributing and Controlled is also evidence of device, with the strength of the device evidence corresponding to the size of that difference.

The proposed regulations reflect the IRS's view that the presence of business assets generally does not raise any more device concerns than the presence of assets used in a qualifying business. For this purpose, business assets include reasonable amounts of cash and cash equivalents held for working capital and assets held for business exigencies or regulatory purposes in accordance with a binding commitment or legal requirement. Unlike Rev. Proc. 2015-43, the proposed regulations focus on nonbusiness assets rather than investment assets. According to the IRS, investment assets may include specific assets that do not raise device concerns (for example, cash needed for working capital) and fail to take into account other assets that do raise device concerns (for example, real estate not related to a taxpayer's business).

**a. Device safe harbors.** The proposed regulations provide two safe harbors (the device safe harbors) that apply if Distributing and Controlled hold a relatively small amount of nonbusiness assets or there is a minimal disparity between the amount of nonbusiness assets held by Distributing and Controlled. First, nonbusiness assets are usually not evidence of device if the nonbusiness asset percentages of both Distributing and Controlled are less than 20 percent. Second, a difference between the nonbusiness asset percentages of Distributing and Controlled is usually not evidence of device (but may be considered in determining the presence or strength of other device factors) if:

- the difference is less than 10 percent; or
- the distribution is not pro rata and the difference is attributable to a need to equalize the value of the Controlled stock distributed and the Distributing stock exchanged by the distributees.

**b. Per se device test.** Conversely, the proposed regulations introduce a rule under which a transaction is deemed to violate the device prohibition in circumstances in which the nonbusiness assets held by Distributing or Controlled present such clear evidence of device that it is impossible for non-device factors to overcome the device potential (the per se device test). The per se device test, which is substantially similar to the no-rule relating to investment assets adopted in Rev. Proc. 2015-43, has two prongs that must be met for the distribution to be treated as a device. The first prong is satisfied if the nonbusiness asset percentage of either Distributing or Controlled is 66⅔ percent or more. The second prong is met when there is a substantial difference between the nonbusiness asset percentages of Distributing and Controlled. However, in recognition of the difficulty in valuing and categorizing assets, the second prong is applied using three different bands, so that there is a per se finding of device in any of the following circumstances involving Distributing and Controlled:

1. if one corporation's nonbusiness asset percentage is 66⅔ percent or more but less than 80 percent, and the other corporation's nonbusiness asset percentage is less than 30 percent;

2. if one corporation's nonbusiness asset percentage is 80 percent or more but less than 90 percent, and the other corporation's nonbusiness asset percentage is less than 40 percent; and

3. if one corporation's nonbusiness asset percentage is 90 percent or more, and the other corporation's nonbusiness asset percentage is less than 50 percent.

There are two exceptions to the per se device test: (1) if the corporate distributee would be entitled to a dividends received deduction, or (2) if the transaction falls within the list of transactions not ordinarily considered a device in reg. section 1.355-2(d)(5) (for example, a distribution that would be a section 302(a) redemption for each shareholder if section 355 did not apply).[21]

**c. Indirect ownership of assets.** The proposed regulations contain several operating rules for assets owned indirectly by Distributing or Controlled through a corporate subsidiary or partnership. Generally, all members of the SAG of Distributing or Controlled are treated as a single corporation.[22] A

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taxable transaction). Under the proposed regulations, in that circumstance all of the corporation's assets would be considered "good" business assets that would not present evidence of device.

[21]That the IRS would except these transactions from the per se device test suggests that those transactions would constitute a device only in the narrowest of circumstances.

[22]Note that the SAG rules apply the section 1504(a) test for affiliation (*i.e.*, ownership of at least 80 percent voting power and value), which is different from the definition of control that applies for section 355 purposes. *See* section 368(c) and Rev. Rul. 59-259, 1959-2 C.B. 115 (requiring ownership of at least 80 percent voting power and at least 80 percent of the total number of shares of each class of nonvoting stock).



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partnership interest is generally considered a nonbusiness asset, but if a corporation is considered to be engaged in the business conducted by the partnership,[23] the value of the partnership interest is allocated between business and nonbusiness assets in the same proportion as the assets held by the partnership. A similar rule would apply for stock owned by Distributing or Controlled if the subsidiary would be treated as a member of the corporation's SAG by applying a lower 50 percent ownership threshold.

**2. Non-device factor — corporate business purpose.** The current regulations state that a corporate business purpose is evidence that a transaction is not being used principally as a device, and that the strength of that purpose is relevant in assessing whether the transaction may overcome evidence of device.[24] In the preamble to the proposed regulations, the IRS warns that taxpayers are improperly taking the position that a weak corporate business purpose, combined with the non-device factor that Distributing is publicly traded, can offset the substantial evidence of device presented by the separation of nonbusiness assets. Therefore, the proposed regulations amend the corporate business purpose non-device factor to state clearly that a corporate business purpose that relates to a separation of nonbusiness assets from business assets is not evidence of non-device unless the business purpose involves an exigency that requires an investment or other use of the nonbusiness assets in a business. In other words, that business purpose must be directly related to the nonbusiness assets to constitute evidence of non-device.

The proposed regulations also state that evidence of device from the ownership of nonbusiness assets can be outweighed by a corporate business purpose for that ownership. Similarly, device evidence from a difference between the nonbusiness asset percentages of Distributing and Controlled can be outweighed by a corporate business purpose for the difference.

### B. Minimum Size for Active Trade or Business

Although the IRS acknowledges that section 355(b) does not clearly provide a minimum or relative size requirement for a qualifying business, it determined that section 355(b) requires some level of substance in order to give effect to congressional intent. The proposed regulations adopt the position that a distribution with only a relatively de minimis business should not qualify under section 355 because the distribution is not a separation of businesses as contemplated by the statute. The proposed regulations do so by introducing the requirement that, in order to satisfy section 355(b), the value of the assets comprising the business that would otherwise qualify under section 355(b) must be at least 5 percent of the value of the corporation's total assets (the 5 percent qualifying business test). Included in the value of the assets of the business are reasonable amounts of cash and cash equivalents held for working capital and assets held for business exigencies or regulatory purposes in accordance with a binding commitment or legal requirement.

As in the device rules, the proposed regulations provide operating rules when assets are owned indirectly by Distributing or Controlled through a partnership. Thus, if a corporation is considered to be engaged in a business conducted by a partnership, the value of the partnership interest is allocated between qualifying business assets and other assets in the same proportion as the values of those assets held by the partnership. However, the IRS's approach regarding corporate subsidiaries deviates from the proposed device regulations based on the view that the SAG rules limit the ability to take into account assets held by subsidiaries for section 355(b) purposes. Thus, while the SAG rules apply, stock owned in a non-SAG member is considered a nonbusiness asset and neither Distributing nor Controlled can be treated as holding qualifying business assets through the ownership of that stock.

### C. Operating Rules and Effective Date

**1. Determination of value.** In determining value under the device and active trade or business rules, the proposed regulations instruct that the assets to be considered are those held by Distributing and Controlled immediately after the distribution, and that the characterization of those assets (as business or nonbusiness, or as part of a qualifying business) is also determined then. The valuation of those assets, however, is not made immediately after the distribution. Instead, Distributing and Controlled must choose the point in time at which the value of the relevant assets is determined, with the choices being (1) immediately before the distribution, (2) on any date within the 60-day period before the distribution, (3) on the date of a binding agreement for

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[23] In general, a corporation is treated as engaged in the active conduct of a partnership's business for section 355(b) purposes if (1) it owns a significant (one-third or greater) partnership interest, or (2) it owns a 20 percent or greater partnership interest and performs active and substantial management functions for the partnership. *See* Rev. Rul. 2007-42, 2007-2 C.B. 44; Rev. Rul. 2002-49, 2002-2 C.B. 288; Rev. Rul. 92-17, 1992-1 C.B. 142.

[24] Reg. section 1.355-2(d)(3)(ii) ("the stronger the evidence of device . . . the stronger the corporate business purpose required to prevent the determination that the transaction was used principally as a device").



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the distribution, or (4) on the date of a public announcement or filing with the SEC for the distribution. In making that choice, Distributing and Controlled are required to make consistent determinations of value and use the same determination date; otherwise, the valuation is generally determined as of immediately before the distribution.

**2. Antiabuse rules.** The proposed regulations contain antiabuse rules under which a transaction or series of transactions is not given effect if the principal purpose is to affect a corporation's nonbusiness asset percentage in order to avoid a determination that a distribution was a device or to affect a determination that a distribution does not meet the 5 percent qualifying business test.[25] The transactions covered by the antiabuse rules generally do not include (1) a non-transitory transfer of assets between Distributing and Controlled; or (2) a non-transitory acquisition or disposition of assets, unless that transaction is with a person related to Distributing or Controlled (as determined under the constructive ownership rules in section 318(a), minus section 318(a)(4)).

**3. Effective date.** The proposed regulations are prospective and would apply to transactions occurring on or after the date the regulations are finalized. Under a transition rule, the proposed regulations would not apply to a distribution that is: (1) made under an agreement, resolution, or other corporate action that is binding on or before the date the regulations are finalized and at all times thereafter; (2) described in a private letter ruling request submitted on or before July 15, 2016; or (3) described in a public announcement or filing with the SEC on or before the date the regulations are finalized.

## III. Impact of the Proposed Regulations

### A. Observations on the IRS's Approach

The proposed regulations provide some helpful guidance to taxpayers. Unfortunately, this guidance is accompanied by stringent bright-line rules under the device prohibition and the active trade or business requirement that impose new restrictions on the ability to engage in section 355 transactions.

In the proposed regulations, the IRS attempts to provide clarity regarding the application of the device prohibition, an area of considerable uncertainty for taxpayers and practitioners. The proposed modifications to the nature and use of assets device factor would clarify and narrow the application of this factor by focusing on the existence of nonbusiness assets. The introduction of the objective standards in the device safe harbors would also provide help to taxpayers and practitioners who must assess the impact of nonbusiness assets on the device analysis. The corresponding amendment to the corporate business purpose non-device factor suggests that taxpayers and practitioners should be hesitant to give significant weight to this factor in a distribution involving nonbusiness assets unless the transaction is clearly motivated by a purpose directly relating to those nonbusiness assets and the business of Distributing or Controlled.

The proposed regulations, however, represent a significant shift in the IRS's approach to guidance under section 355 and, for the per se device test and the 5 percent qualifying business test in particular, appear to go beyond the scope of the IRS's stated concerns.[26] The proposed regulations would remove several of the no-rule areas that currently restrict the section 355 private letter ruling process through the issuance of formal guidance. Specifically, the proposed regulations would, with modifications, convert the investment asset and active trade or business no-rule positions introduced in Rev. Proc. 2015-43 into substantive rules of law under which transactions meeting specified standards would simply fail to qualify under section 355. In this way the proposed regulations would not really eliminate the no-rule positions as much as they would preclude any ability to engage in transactions that fall within those no-rule areas. Thus, the proposed regulations would go beyond the IRS's existing no-rule positions by restricting the ability to engage in transactions for which private letter rulings may be currently available and eliminating the opportunity to seek guidance on those

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[25]The need for an antiabuse rule for the device prohibition is arguably unnecessary given that the device prohibition already uses a facts and circumstances analysis that should require one to consider transactions undertaken solely to avoid a device determination.

[26]Although not within the IRS's control, an arguably better approach to address the concerns identified by the IRS in Notice 2015-59 and the proposed regulations would be for Congress to amend section 355(g) so that it also applies to pro rata distributions. In its current form, section 355(g) provides that section 355 does not apply to any distribution that is part of a transaction or series of transactions if (1) either Distributing or Controlled is a disqualified investment corporation immediately after the transaction; and (2) any person holds, immediately after the transaction, a 50 percent or greater interest in any disqualified investment corporation, but only if that person did not hold that type of an interest immediately before the transaction. For this purpose, Distributing or Controlled is a "disqualified investment corporation" if the value of the corporation's investment assets (for example, cash, debt, stock, or a partnership interest) is two-thirds or more of the value of all its assets. Extending the application of section 355(g) to pro rata distributions should remove the need to address the IRS's concerns through the changes to the device and active trade or business requirements in the proposed regulations.



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transactions through the private letter ruling process. The IRS's approach forecloses transactions that were previously believed to qualify under section 355 and that were clearly approved of by the IRS.

**1. The device prohibition is not a bright-line test.** The introduction of bright-line standards is a departure from existing law under the device prohibition. Although it is clear that the transactions motivating the per se device test raise concerns regarding device, the device prohibition has always been a factually intensive inquiry that depends on the weighing of various device and non-device factors. It is nothing short of groundbreaking for the IRS to implement a rule in the form of the per se device test that does away with that facts and circumstances inquiry. This certainly provides clarity and theoretically makes the device prohibition easier to administer, but the IRS should be able to achieve its objective through less drastic means — for example, by adopting a presumption of device that a taxpayer could rebut in appropriate circumstances (or, to borrow language used elsewhere in the device regulations, that those distributions are ordinarily considered to have been used principally as a device). In that case, the determination of whether a transaction is a device, and thus fails to qualify under section 355, would not be contingent on the relatively arbitrary lines drawn in the per se device test. It also seems unfair to adopt a rule that results in the automatic failure of the device prohibition when the device safe harbors act to establish only that there is ordinarily not evidence of device and do not result in a determination that there is no device concern.

**2. The 5 percent qualifying business test exceeds the intent of the statute.** The IRS's approach is even more groundbreaking for the active trade or business requirement in section 355(b). Since its enactment in 1954, the active trade or business requirement has never been interpreted or applied in a manner that requires a minimum percentage of qualifying business assets. Even though the 5 percent qualifying business test is generally consistent with the IRS's current and prior private letter ruling practice, under that practice a taxpayer is (and was) still able to obtain a private letter ruling in appropriate circumstances. Moreover, there is a stark contrast between the IRS's deciding not to entertain a private letter ruling request because of the size of a corporation's qualifying business and concluding under the 5 percent qualifying business test that, as a matter of law, a transaction does not qualify under section 355 because it fails to meet a 5 percent threshold. As with the per se device test, the 5 percent qualifying business test provides clarity through a bright-line test, but, as with the device prohibition, the IRS should be able to achieve its goal through a less harsh approach. For example, the IRS could turn the 5 percent qualifying business test into a presumption that section 355(b) is not satisfied if a corporation's business assets do not satisfy a 5 percent threshold, which the taxpayer could rebut in appropriate circumstances similar to those applied by the IRS in its private letter ruling practice. Alternatively, or in combination with that presumption, the IRS could apply a lower threshold so that the automatic failure of section 355(b) would result only if a corporation's qualifying business assets are truly de minimis — that is, less than 1 percent of its total assets.

Although there are legitimate concerns motivating the IRS's adoption of the 5 percent qualifying business test, we question whether it is appropriate to impose any requirement under section 355(b) when there are numerous other requirements that appear to police those same concerns — namely, the device prohibition and the corporate business purpose requirement.[27] It is unclear why the IRS believes that there is a need to layer on an additional requirement to section 355(b) based on general statements of congressional intent regarding section 355 and its function to facilitate the separation of active businesses. The plain language of the statute contains no mention of a minimum size requirement. The decision to implement this approach now on the basis of legislative intent is puzzling given that it has been over 60 years since the enactment of the statute and multiple sets of regulations have already been issued that interpret these rules without even raising the issue, including a comprehensive set of new rules in proposed active trade or business regulations that have been outstanding for nearly 10 years.

In support of its position on the 5 percent qualifying business test, the IRS points to developments since section 355 was enacted, such as Congress's enactment of the SAG rules and the IRS's permitted attribution of business activities conducted through a partnership, as reducing the burden of complying with the active trade or business requirement. However, none of those developments provided any indication that section 355(b) should be applied

[27]The active trade or business requirement acts as an additional protection against the tax avoidance targeted by the device prohibition. The corporate business purpose requirement serves a similar function and thus overlaps with the active trade or business requirement, as the IRS acknowledges in the preamble to the proposed regulations. *See* 81 F.R. 46004, 46008 (July 15, 2016) (''Additionally, when the active business of Distributing or Controlled is economically insignificant in relation to its other assets, it is unlikely that any non-federal tax purpose for separating that business from other businesses is a significant purpose for the distribution.'').



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how the IRS suggests in the proposed regulations. It is true that the presence of these rules arguably makes it less likely that a corporation would be affected by the 5 percent qualifying business test, but that does not provide any direct support for the adoption of the 5 percent qualifying business test itself.

The rationale supporting the IRS's adoption of the 5 percent qualifying business test raises a question about the potential impact on the application of the active trade or business requirement in circumstances that fall outside the scope of the 5 percent threshold in that test. The discussion of the 5 percent qualifying business test in the preamble to the proposed regulations suggests that the IRS has determined that an analysis of the substance of a transaction is embedded within the active trade or business requirement and must be considered in all transactions:

> The Treasury Department and the IRS have determined that Distributing or Controlled should not satisfy the active business requirement by holding a relatively de minimis active business. . . . [T]he Treasury Department and the IRS have determined that interpreting section 355(b) as having meaning and substance and therefore requiring an active business that is economically significant is consistent with congressional intent, case law, and the reorganization provisions. . . . Allowing section 355(b) to be satisfied with an active business that is economically insignificant in relation to other assets of Distributing or Controlled is not consistent with the congressional purpose for adopting the active business requirement. It is generally understood that Congress intended section 355 to be used to separate businesses, not to separate inactive assets from a business. . . . Accordingly, when a corporation that owns only nonbusiness assets and a relatively de minimis active business is separated from a corporation with another active business, the substance of the transaction is not a separation of businesses as contemplated by section 355.[28]

In giving effect to the position that section 355(b) should not be satisfied if a corporation has relatively de minimis business assets, the 5 percent qualifying business test establishes a floor by imposing a minimum 5 percent threshold under which a transaction automatically fails to qualify under section 355 regardless of the circumstances. But what if the applicable percentage of qualifying business assets is more than 5 percent but still represents a relatively low percentage of the corporation's assets (for example, 10 percent)? Would the amount of qualifying business assets in that case automatically not be considered ''relatively de minimis,'' or must the taxpayer determine whether the relative amount of business assets is sufficient to satisfy the active trade or business requirement based on the IRS's interpretation of section 355(b)? If the former, the IRS should clarify that this type of analysis under section 355(b) is unwarranted outside circumstances that implicate the 5 percent qualifying business test. If the latter, the IRS has injected an unneeded level of uncertainty into the analysis under section 355(b) for which there is no guidance or authority to aid in this determination. Also, it is unclear whether the IRS's rationale reflects a view that the IRS could challenge a transaction under current law on the basis that section 355(b) is not satisfied by a relatively de minimis qualifying business.

### B. Taxpayers/Practitioners' Practical Concerns

**1. Valuation requirements.** The proposed regulations introduce a series of tests — the device safe harbors, the per se device test, and the 5 percent qualifying business test — that use bright-line thresholds that depend on the ability to produce an accurate measurement of the value of a corporation's assets. The exercise of valuing assets, however, is an inherently difficult and uncertain process, and this increased emphasis on valuation would place added administrative burdens and costs on taxpayers seeking to engage in section 355 transactions.

The challenge of producing precise and reliable valuations, as well as the potentially severe consequences of an incorrect valuation, should lead risk-averse taxpayers to adopt in practice thresholds that extend beyond those in the per se device test and the 5 percent qualifying business test. Thus, the proposed regulations are likely to affect transactions that do not appear to fall within those tests but, because of the uncertainty likely to surround any valuation of assets, steer clear from anything that even approaches those thresholds. For example, a taxpayer may want to implement a self-imposed standard under which qualifying business assets represent at least 10 percent of a corporation's total assets to ensure that the 5 percent qualifying business test is satisfied. For similar reasons, taxpayers may take action to ensure that they comfortably fit within the device safe harbors so that nonbusiness assets are ordinarily not considered evidence of device (for example, by having Distributing and Controlled hold no more than 10 percent nonbusiness assets).

[28]81 F.R. 46004, 46008-46009 (July 15, 2016).



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The importance of valuations also presents new uncertainties for practitioners tasked with issuing opinions under section 355. Practitioners may be forced to make difficult determinations regarding whether a particular asset is characterized as a business or nonbusiness asset (for purposes of a device analysis) or as part of a qualifying business (for purposes of the 5 percent qualifying business test). Practitioners will also need to assess whether it is sufficient to rely on a representation from the taxpayer regarding the value of a corporation's assets in analyzing the rules in the proposed regulations or whether a third-party valuation is also needed to substantiate a determination of value. These same considerations regarding the valuations required under the proposed regulations would also need to be taken into account for purposes of satisfying an independent auditor that the applicable tests are met and in determining how a transaction is reported for financial disclosure purposes.

The emphasis placed on valuations will inevitably lead to disputes with the IRS on examination regarding the categorization and valuation of different types of assets. A taxpayer that engages in a transaction that even remotely comes close to the thresholds in the per se device test and the 5 percent qualifying business test should obtain a third-party valuation to support its position and help withstand an IRS challenge. The situation may be less dire regarding the device safe harbors because the failure to meet the applicable standards will not result in an automatic finding of device. Nonetheless, other circumstances relevant to the device analysis may indicate that a third-party valuation is advisable to bolster the position that the device safe harbors apply. In any event, a third-party valuation may not be enough to prevent a transaction from facing scrutiny from the IRS, given the uncertainty plaguing those valuations and the potential for the IRS to seek out a competing and contradictory appraisal.

**2. Business Exigencies Involving Nonbusiness Assets.** Under the proposed regulations, an analysis of the device prohibition may require a determination about whether there is a sufficient business exigency for the use of a corporation's nonbusiness assets. The analysis presupposes that the asset — cash, for example — has been characterized as a nonbusiness asset because it does not constitute working capital and there is no legal requirement or binding commitment to hold the cash. The question then becomes whether one can sufficiently demonstrate an impending business need for the cash. That determination could be relevant for purposes of (1) assessing if a corporate business purpose for a distribution can serve as a non-device factor, or (2) deciding if there is a sufficient corporate business purpose to justify the presence of nonbusiness assets or a difference in the nonbusiness asset percentages of Distributing and Controlled. In either circumstance, whether a purported business exigency for nonbusiness assets satisfies the standard contemplated by the IRS is a highly factual question that could prove extraordinarily difficult to answer.

The IRS attempted to provide guidance on this issue through two examples in the proposed regulations (see prop. reg. section 1.355-2(d)(4)). In Example 2, D and its wholly owned subsidiary C operate fast food restaurants. D and C hold business assets worth $100 and $105, respectively, while D also has $195 in cash as a nonbusiness asset. D needs to spin off C because C will lose its franchise if it remains a subsidiary of D. The lease for D's franchise location will also expire in 24 months, but D has not made any plans and is weighing its options to purchase a building to relocate. D contributes $45 to C and distributes its C stock pro rata to its shareholders. The nonbusiness asset percentages of D (60 percent) and C (30 percent), as well as the difference between those percentages, constitute evidence of device. Thus, a corporate business purpose relating to the use of the nonbusiness assets held by D and C is needed to offset this device evidence (even though the purpose for the distribution is evidence of non-device because it does not relate to a separation of nonbusiness and business assets). The example states that D has no corporate business purpose for the difference in the nonbusiness asset percentages of D and C. Even though D is considering purchasing a new building, the example finds that this purchase is not required by any exigency. The example concludes that the transaction violates the device prohibition.

Example 4 reaches the opposite conclusion when the facts are changed so that D's lease will expire in six months and D will use $80 of its $150 to purchase a new building. Again, the nonbusiness asset percentages of D and C and the difference between those percentages constitute evidence of device. However, the example states that D has a corporate business purpose for a significant part of the difference in nonbusiness asset percentages because D's use of $80 is required by business exigencies. The different conclusion reached in the example is apparently based on two factors: (1) the shorter time period for the use of the cash, and (2) that a decision has been made to expend the cash to purchase the building.

Instead of providing clear guidance, examples 2 and 4 seem to create more uncertainty for purposes of determining whether a business exigency exists.



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It is difficult to draw any conclusions from the six- and 24-month time periods involved, apart from it is better to use the cash sooner rather than later. The apparent focus on whether a business decision has been made at the time of the distribution is also confusing because, by definition as a nonbusiness asset, there is no binding requirement to expend the cash in accordance with that decision. If the IRS intends to permit the holding of cash for a business exigency, it is unclear why the existence of the business exigency itself is not sufficient to support evidence of non-device, provided that there is a reasonable possibility that the cash will be used for that purpose.

**3. Impact on pre-distribution planning.** The per se device test and the 5 percent qualifying business test would put renewed emphasis on the need to engage in pre-distribution restructuring transactions involving business and nonbusiness assets to ensure qualification under section 355. As the IRS points out, the need to carry out those types of restructurings is lessened to the extent that a corporation can take into account assets held indirectly through a corporation under the SAG rules or a partnership. Note, however, that the proposed regulations on the device prohibition are more generous in this regard because they would also allow a corporation to take into account business assets held through a 50 percent-owned corporate subsidiary. Taxpayers attempting to meet the 5 percent qualifying business test do not have this flexibility because of the IRS's view that the indirect ownership of assets through corporate subsidiaries under section 355(b) is limited to the SAG rules provided in that section. Although there is logic to the IRS's position on this point, there is an inconsistency in adopting such a strict interpretation of section 355(b) for purposes of applying a rule that has no support in the statutory text. It would also seem preferable to avoid the creation of different rules applicable to the device prohibition and the active trade or business requirement to limit confusion and potentially inappropriate results.[29]

The antiabuse rules in the proposed regulations also show that the IRS is wary of any pre-distribution restructuring of assets that is unwound through a subsequent disposition. The IRS is also worried about less obvious efforts to avoid the rules in the proposed regulations, as demonstrated by the fact that the antiabuse rules mention the use of debt to manipulate the determination of the value of a corporation's assets. Although the proposed regulations clearly contemplate pre-distribution restructuring transactions undertaken to avoid a finding of device or a violation of the active trade or business requirement, taxpayers and practitioners would need to take care in planning those transactions by imposing restrictions on post-distribution transactions to avoid inquiries from the IRS.

**4. Different assets taken into account under the device and active trade or business tests.** An important aspect of the 5 percent qualifying business test is that it must be satisfied by the presence of assets that are part of a qualifying business under section 355(b). This differs from the proposed regulations on device, which focus only on the presence of nonbusiness assets and do not distinguish between business assets that are part of a qualifying business. Thus, the fact that a corporation has 1 percent qualifying business assets and 99 percent nonqualifying business assets (for example, from a business acquired two years ago in a taxable transaction) would not be evidence of device, but would nevertheless cause the corporation to fail to meet section 355(b) because of the 5 percent qualifying business test.

This difference also affects the ability to engage in pre-distribution transactions intended to alter the assets held by a corporation. A corporation with substantial investment or liquid assets could reduce or eliminate the potential device concern by using those assets to acquire business assets without regard to whether those assets are part of a qualifying business. In contrast, for purposes of engaging in transactions to ensure the satisfaction of the 5 percent qualifying business test, a corporation with excess nonbusiness assets would not be able to purchase business assets unless that acquisition constituted an expansion of an existing business under the applicable rules in reg. section 1.355-3.

**5. Application to consolidated groups.** The proposed regulations reverse course from the IRS's approach in Rev. Proc. 2015-43 by declining to exclude distributions between affiliated corporations from the per se device test and the 5 percent qualifying business test.[30] The IRS, in fact, specifically rejected an exception to the 5 percent qualifying business test for internal distributions, insisting

[29]For example, it makes little sense to conclude that a corporation with a 70 percent owned subsidiary could look to the assets held by the subsidiary for purposes of analyzing device while also concluding that the corporation is precluded from taking those same assets into account in applying the 5 percent qualifying business test.

[30]We note that certain transactions between affiliates are excluded from the per se device test — specifically, transactions in which a corporate distributee would otherwise be entitled to a dividends received deduction (by cross-referencing reg. section 1.355-2(d)(3)(iv), in which those distributions are identified as a non-device factor). However, because a dividends received deduction is not available for intercompany distributions (see

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that the rule apply to ''all'' distributions.[31] Thus, even if a distribution occurs wholly within a consolidated group (and is not followed by an external distribution), the asset makeup of Distributing or Controlled could cause the transaction to fail to qualify under section 355 because of the per se device test or the 5 percent qualifying business test. Thus, taxpayers and practitioners structuring section 355 distributions would need to be cognizant of the application of the proposed regulations to transactions occurring in consolidation.

The IRS's unwillingness to acknowledge the significance of distributions in consolidation is a surprising development, especially because it appears to conflict with the IRS's own recent thinking when it issued Notice 2015-59. That is particularly troubling regarding the device analysis because it is widely thought that a distribution within a consolidated group presents little, if any, device concern (even though the device regulations make no mention of consolidation as a relevant factor). Because dividends paid from one member of a consolidated group to another are generally not included in the income of the distributee member (and instead reduce the basis in the distributing corporation stock held by the distributee member), device should not be an issue for an intercompany distribution when the corporate business purpose requirement is otherwise satisfied.[32] Thus, it is unclear why the per se device test should apply to distributions within a consolidated group.[33]

The applicability of the per se device test and the 5 percent qualifying business test in consolidation would have a significant adverse impact on the ability to engage in lower-tier distributions to align particular assets in preparation for a distribution outside of the consolidated group. That concern is amplified by the fact that the antiabuse rules in the proposed regulations appear to negate the ability to engage in other types of pre-distribution, intercompany transactions to alter the assets held by Distributing or Controlled and ensure qualification under section 355. The IRS's approach in the proposed regulations is wholly inconsistent with its position in Notice 2007-60, in which the IRS said that it would continue to apply the rule in reg. section 1.355-3(b)(4)(iii) and disregard any direct and indirect acquisitions (even if taxable) of a business between members of an affiliated group for purposes of section 355(b).[34]

### C. Future IRS Guidance under Section 355

**1. Device and *General Utilities* repeal.** The proposed regulations make one thing abundantly clear — the IRS believes that the device prohibition continues to serve a critical function under section 355. Although the current rate parity between dividend income and capital gain might lead one to assert that the device prohibition has limited practical effect under present law, the IRS continues to believe that the device prohibition serves an important purpose and that steps must be taken to ensure it is properly enforced.[35] Those steps even include the indirect enforcement of device through the imposition of a minimum size requirement in the proposed regulations for a business to qualify under section 355(b).

Those device concerns intersect with the IRS's continued focus on the use of section 355 as a means to distribute assets without incurring corporate-level gain. The proposed regulations do not include any new rules under section 337(d) regarding *General Utilities* repeal, but the IRS stated plainly that it is still considering the issuance of regulations under that section for other transactions involving the separation of nonbusiness assets from business assets.[36] Exactly what the IRS has in mind is unclear. The IRS has targeted transactions involving section

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reg. section 1.1502-13(f)(2)), this exception does not appear to apply to distributions within consolidation.

[31]*See* 81 F.R. 46004, 46012 (July 15, 2016).

[32]*See* reg. section 1.1502-13(f)(2), -32(b)(2)(iv). A distribution that exceeds the member's basis in the distributing corporation stock results in an excess loss account in the stock. *See* reg. section 1.1502-19(a)(2)(i); -32(a)(3)(ii).

[33]It is also unclear why the IRS remains concerned with transactions between affiliates (whether consolidated or not), given that device should generally not be an issue for a corporate recipient, which prefers dividend treatment to capital gains.

[34]2007-2 C.B. 466. Reg. section 1.355-3(b)(4) is generally applicable to distributions on or before December 15, 1987, but the IRS has continued to apply it administratively to distributions occurring after that date. In Notice 2007-60, the IRS stated that it had no intent to change this practice absent the adoption of new regulations modifying the rule.

[35]*See* 81 F.R. 46004, 46007-46008 (July 15, 2016) (''The device prohibition continues to be important even though the federal income tax rates for dividend income and capital gain may be identical for many taxpayers. . . . Because of continuing differences in the federal income tax treatment of capital gains and dividends, including the potential for basis recovery (*see* [reg. section] 1.355-2(d)(1)) and the availability of capital gains to absorb capital losses, the device prohibition continues to be important.'').

[36]*See* 81 F.R. at 46009 (''The Treasury Department and the IRS continue to study issues relating to *General Utilities* repeal presented by other transactions involving the separation of nonbusiness assets from business assets, and are considering issuing guidance under section 337(d) to address these issues.''); *see also* Amy S. Elliot, ''Separate *General Utilities* Repeal Guidance Is in the Works,'' *Tax Notes*, Oct. 10, 2016, p. 226 (quoting Robert Wellen, IRS associate chief counsel (corporate), as stating that in Notice 2015-59 ''we say, 'Well, maybe device really is about [*General Utilities*] repeal as well as the shareholder-level concerns.' . . . We've concluded that that's not a direction we should be going and that [*General Utilities*] repeal concerns

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355 that facilitate a conversion into a real estate investment trust, and it is likely that the IRS would be troubled by similar types of transactions involving passthrough entities or the elimination of corporate-level tax (for example, a spinoff followed by a downstream merger). However, the fact that section 355 permits a distribution without the recognition of gain to Distributing should itself have no impact on whether the distribution is a device.[37] Moreover, the avoidance of *General Utilities* repeal should not be a concern when assets remain in corporate solution and subject to corporate-level tax, meaning that guidance under section 337(d) is not needed in those circumstances to regulate section 355 transactions.

**2. Published guidance and section 355 private letter ruling policy.** The no-rules adopted by the IRS in Rev. Proc. 2015-43 represented the latest development in what seemed like a continuous effort by the IRS to limit the ability of taxpayers to obtain private letter rulings under section 355 (which, we understand, was in significant part because of IRS resource constraints). In 2013 the IRS began to reduce its section 355 private letter ruling practice by announcing that it would issue private letter rulings only for issues deemed ''significant'' and by identifying several specific issues on which it would not entertain a private letter ruling request.[38] At the time, the list of issues under section 355 that could not be addressed in the private letter ruling process already included the IRS's longstanding position that it would not rule on whether a transaction is a device or has a corporate business purpose.[39]

The proposed regulations effectively represent the codification of the no-rules in Rev. Proc. 2015-43, which, as discussed above, would make it more difficult for taxpayers and practitioners to engage in specific types of section 355 transactions. It is unfortunate that those rules would narrow the availability of section 355 without the benefit of considering specific facts. Nonetheless, it is encouraging that the IRS is actively attempting to issue guidance under section 355 in the form of substantive rules that could be relied on by taxpayers and practitioners in issuing opinions. Other substantive guidance issued recently by the IRS under section 355 further shows that the IRS is committed to eliminating its no-rule positions.[40]

On August 26, the IRS took another encouraging step forward by revising its section 355 private letter ruling practice to entertain requests on significant legal issues relating to the device prohibition and the corporate business requirement.[41] The availability of the private letter ruling process to address significant issues raised under the device prohibition should mean that issues raised by the device rules in the proposed regulations, once finalized, could be addressed by the IRS through a private letter ruling. Thus, for example, the IRS could determine under the proposed device rules whether cash held by a corporation constitutes a business asset (for example, as working capital or as required to be held for a business exigency or regulatory purpose) or whether a corporate business purpose relating to the separation of nonbusiness assets is prompted by a sufficient business exigency to be taken into account as a non-device factor.

In revising its ruling position on device and corporate business purpose, the IRS acknowledged that there are several unresolved legal issues relating to those requirements. This uncertainty is furthered by the IRS's increased focus on device, as evidenced by statements made in Notice 2015-59 and in the preamble to the proposed regulations, and should continue to persist even if the proposed regulations are adopted as final rules. In addition to addressing uncertain legal issues through the private letter ruling process, the IRS should consider issuing targeted guidance in the form of revenue rulings to address specific fact patterns and issues relating to the device and corporate business purpose requirements. For example, the IRS could issue

should be dealt with separately with their own set of criteria, their own set of rules, and we're working on that.'').

[37]*See* Rev. Rul. 2003-110, 2003-2 C.B. 1083 (in concluding that a distribution satisfied the corporate business purpose requirement despite the fact that section 355 allowed for the nonrecognition of corporate-level gain, stating that ''the fact that [section] 355 permits a distributing corporation to distribute the stock of a controlled corporation without the recognition of gain does not present a potential for the avoidance of Federal taxes under [reg. section] 1.355-2(b)'').

[38]*See* Rev. Proc. 2013-32, 2013-28 IRB 55 (stating that the IRS will issue a private letter ruling under section 355 only on significant issues); Rev. Proc. 2013-3, 2013-1 IRB 113 (announcing no-rule policies relating to the control requirement, north-south transactions, and transactions involving the use of Controlled stock and securities to satisfy Distributing debt).

[39]*See* Rev. Proc. 2003-48, 2003-2 C.B. 86 (providing that the IRS will not issue private letter rulings on the device prohibition and the corporate business purpose requirement).

[40]On July 15 the IRS issued substantive guidance on its prior no-rule policy relating to the control requirement. *See* Rev. Proc. 2016-40, 2016-32 IRB 228 (providing guidance on transactions undertaken to ensure that Distributing owns stock in Controlled representing control, including safe harbors for post-distribution transactions, and eliminating the IRS's corresponding no-rule position introduced in Rev. Proc. 2013-3).

[41]*See* Rev. Proc. 2016-45, 2016-37 IRB 1. The IRS determined that it is appropriate and in the interest of sound tax administration to provide guidance on significant issues in those areas, if the request relates to a ''legal issue'' and is ''not inherently factual in nature.''



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revenue rulings to: (1) confirm that a distribution that occurs within a consolidated group is not treated as a device; (2) examine the impact of post-distribution continuing relationships between Distributing and Controlled; or (3) provide guidelines on the effect of post-distribution sales of publicly traded Distributing or Controlled stock.

Eventually, it is hoped that the IRS's recent willingness to issue guidance under section 355 will also lead the IRS to take additional steps to revamp and expand its private letter ruling process under section 355. The unique nature of section 355 makes it critical that the private letter ruling process be available to the greatest extent possible to assist taxpayers and practitioners in structuring transactions. Many of the numerous requirements under section 355 lack clearly defined standards, which, when coupled with the fact that the failure to meet any of these requirements would have severe consequences to Distributing and its shareholders, places substantial risk on taxpayers and practitioners in planning transactions under section 355. Historically, taxpayers relied extensively on the IRS for private letter rulings to obtain certainty under section 355, but, as discussed above, the IRS has dramatically reduced this practice.

Given the critical function served by private letter rulings for section 355, the IRS should consider bolstering its practice through the implementation of procedures that allow the IRS to revert to issuing private letter rulings as to whether a transaction qualifies under section 355 and not limit private letter rulings to narrow, significant issues. To address the IRS's resource constraints, this could be accomplished through a streamlined private letter ruling process by revising the information required in the checklist for section 355 requests contained in Rev. Proc. 96-30.[42] The return to a system that grants private letter rulings on whether a transaction qualifies under section 355 would give taxpayers the ability to seek more complete guidance from the IRS and get the certainty needed when structuring transactions. An expanded private letter ruling process would also allow the IRS to see more transactions and gain a more complete understanding of the application of different issues in actual, real-world scenarios. The transparency and cooperation fostered by this type of private letter ruling system would ultimately be the most beneficial to both taxpayers and the IRS.[43]

## IV. Conclusion

The proposed regulations are an effort by the IRS to stop ''abusive'' section 355 distributions involving small amounts of business assets. In attempting to achieve that goal, the proposed regulations represent a significant shift in the IRS's approach to guidance on the device prohibition and the active trade or business requirement. The rules provide some helpful clarity for taxpayers and practitioners structuring transactions under section 355, but the clarity is offset by the use of overly strict bright-line standards and placing undue emphasis on difficult and burdensome determinations of fair market value. The IRS should consider whether it can achieve its objectives through a more restrained approach in finalizing the proposed rules. We are also hopeful that the IRS will continue in its efforts to provide substantive guidance to eliminate its no-rule positions under section 355 and, as part of those efforts, to revive and expand its section 355 private letter ruling practice.

[42]1996-1 C.B. 696.

[43]The expansion of the IRS's private letter ruling practice should also reduce the number of section 355 transactions reviewed by the IRS on audit (as well as the scope of any such review), a process that may involve IRS revenue agents with limited section 355 experience and require IRS National Office review years after the transaction has been completed.

**SUBMISSIONS TO *TAX NOTES***

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