SPECIAL REPORT

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A New Role for the Device Test?

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In Rev. Proc. 2015-43, the IRS announced that it would not issue private letter rulings for spinoff transactions involving small active trades or businesses, significant investment assets, or real estate investment trust elections, adding to several section 355 no-rules already in place. In Notice 2015-59, which accompanied the revenue procedure, the IRS suggested that the section 355 device test could be used as a tool to police *General Utilities* repeal. That guidance represents a significant departure from current law and has created much uncertainty in planning spinoff transactions. Rizzi, Zarlenga, and Azebu examine the role of the device test, discuss the limited options available to the IRS to address the concerns about *General Utilities* repeal, and review the state of spinoff planning following the release of the guidance.

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I. Introduction

The release of Rev. Proc. 2015-43[1] and Notice 2015-59[2] on September 14, 2015, brought increased uncertainty to the planning of spinoff transactions. Together, they announced a significant shift in the IRS's ruling policy for transactions meant to qualify for tax-free treatment under section 355 and provided what some believe to be a map for the government's increased scrutiny of some high-profile transactions. Notice 2015-59 states that the transactions under study "may present evidence of device for the distribution of earnings and profits, may lack an adequate business purpose or a Qualifying Business, or may violate other section 355 requirements." It also says that the transactions "may circumvent the purposes of Code provisions intended to repeal the Supreme Court's decision in *General Utilities & Operating Co. v. Helvering*." That statement represents a strong signal that tests under section 355 should take into account the need to police the repeal of *General Utilities*, which is itself a new departure for the device test.

The notice's concentration on the no-device requirement is somewhat surprising, given that tax practitioners have often viewed the requirement as a shareholder-level determination focused on taxpayer efforts to bail out dividends at capital gains tax rates. That was certainly the overwhelming focus of the device test during the first half-century of its application. That focus became much less salient as soon as tax rate changes created parity between CGT rates and dividend tax rates. Moreover, so-called OpCo-PropCo transactions, which are referenced in the notice and revenue procedure, would seem extremely unlikely to be used as a device to convert dividend income into capital gains, because after electing real estate investment trust status, a corporation must annually distribute most of its taxable income as dividends to maintain REIT status[3] and purge any pre-REIT E&P before

[1] 2015-40 IRB 467.
[2] 2015-40 IRB 459.
[3] *See* section 857(a)(1).

the end of its first REIT year.[4] Nonetheless, the notice and revenue procedure, combined with recent comments from government officials, suggest that the IRS has come to believe that the device test may also be a corporate-level determination and a tool for policing *General Utilities* repeal. However, without further guidance, it is unclear how the IRS plans to apply the device test, a potential mechanism for disqualifying a wider range of spinoffs, given that the current multifactor device analysis appears to be primarily focused on the avoidance of dividend treatment by shareholders.

Suggesting that the device test is a tool for policing *General Utilities* repeal adds further uncertainty to an already murky area. With that and the no-ruling policies described in Rev. Proc. 2015-43, many taxpayers contemplating spinoff transactions will become increasingly reliant on tax opinions. Even though the IRS has indicated that any coming guidance will not be retroactive to the release date of the notice and revenue procedure,[5] tax practitioners may face some anxiety in opining on the transactions described in the notice because those transactions will likely be subject to greater scrutiny by the IRS and it is unclear exactly how the no-device requirement will be applied.

The cost of failing to meet section 355 is so significant that taxpayers generally do not engage in spinoff transactions without obtaining a private letter ruling or a legal opinion. However, further clarifying guidance from the IRS is necessary to give greater assurance to tax practitioners opining on those transactions and to establish a sufficient framework for the Service to resume providing letter rulings on the legal issues surrounding spinoffs. Further, in light of the popularity of spinoffs under current market conditions, any significant delay in providing that additional guidance could create market distortions and have real economic costs.

This report will examine the role of the no-device requirement, discuss the limited options available to the IRS and Treasury to address their concerns about *General Utilities* repeal without a statutory change, and review the state of spinoff planning following the release of Rev. Proc. 2015-43 and Notice 2015-59.

II. Rev. Proc. 2015-43 and Notice 2015-59

Rev. Proc. 2015-43 provides that absent unique and compelling circumstances, the IRS ordinarily will not rule on any issue regarding:

- the qualification of a transaction if the active trade or business of the distributing corporation (Distributing) or the controlled corporation (Controlled) is less than 5 percent of the total fair market value of the gross assets of that corporation; or
- the qualification of a transaction if, as part of a plan or series of related transactions, Distributing or Controlled becomes a regulated investment company[6] or REIT.[7] This no-rule does not apply if, immediately after the date of the distribution, both Distributing and Controlled will be RICs, or both of those corporations will be REITs, and there is no plan or intention on the date of the distribution for either Distributing or Controlled to cease to be a RIC or a REIT.

Rev. Proc. 2015-43 also provides that pending further study, the IRS will not rule on any issue regarding the qualification of a transaction if either Distributing or Controlled meets all three of the following tests:

- the FMV of the investment assets (generally defined as cash, corporate stock or securities, foreign currency, and similar assets)[8] of Distributing or Controlled is two-thirds or more of the total FMV of its gross assets;
- the FMV of the gross assets of the trade(s) or business(es) on which Distributing or Controlled relies to satisfy the active trade or

[4]*See* section 857(a)(2). As discussed below, the Protecting Americans From Tax Hikes (PATH) Act of 2015, enacted December 18, 2015, largely bans OpCo-PropCo transactions.

[5]Amy S. Elliott, "Wellen Emphasizes That Ruling Program Is Open for Business," *Tax Notes*, Oct. 26, 2015, p. 474 (Robert Wellen, IRS associate chief counsel (corporate), when asked by practitioners about the impact of Notice 2015-59, said, "I don't think you should be looking for [guidance] that is retroactive to the date of the notice.").

[6]A RIC includes any domestic corporation that (1) at all times during the tax year is either registered under the Investment Company Act of 1940 (15 U.S.C. section 80a-1 to section 80b-2), as amended, as a management company or unit investment trust, or has in effect an election under that act to be treated as a business development company; or (2) is a common trust fund or similar fund excluded by section 3(c)(3) of the act (15 U.S.C. section 80a-3(c)) from the definition of investment company and is not included in the definition of common trust fund by section 584(a). Section 851(a).

[7]A REIT is defined under section 856(a) as a corporation, trust, or association (1) that is managed by one or more trustees or directors; (2) the beneficial ownership of which is evidenced by transferable shares or by transferable certificates of beneficial interest; (3) that (but for the REIT code provisions) would be taxable as a domestic corporation; (4) that is neither a financial institution referred to in section 582(c)(2) nor an insurance company to which subchapter L applies; (5) the beneficial ownership of which is held by 100 or more persons; (6) that is not closely held; and (7) that meets the requirements of section 856(c). To maintain its REIT status, an entity must also satisfy specific income and asset tests and must distribute most of its income as dividends. *See* section 856(c).

[8]*See* section 355(g)(2)(B).

business requirement of section 355(b) is less than 10 percent of the FMV of its investment assets; and

- the ratio of the FMV of the investment assets to the FMV of the non-investment assets of Distributing or Controlled is three times or more of that ratio for the other corporation (that is, Controlled or Distributing, respectively).

The IRS will also not rule if, as part of a plan or series of related transactions, investment assets are disposed of, or property, including active trade or business property, is acquired with a principal purpose of avoiding this no-rule.

The no-rules do not apply to purely intragroup spinoffs, specifically when (1) all the stock of Controlled that is distributed in the distribution is distributed to one or more members of the affiliated group, as defined in section 243(b)(2)(A), of which Distributing is a member; and (2) that distribution is not part of a plan or series of related transactions under which stock of any corporation will be distributed outside that affiliated group in a distribution otherwise described in the revenue procedure.

Meanwhile, Notice 2015-59 identifies the following four circumstances in which qualification of a distribution under section 355 is under study: (1) when either Distributing or Controlled owns a small amount of active trade or business assets in relation to all of its assets; (2) when either Distributing or Controlled owns investment assets having substantial value in relation to the value of all of that corporation's assets and the value of the active trade or business assets; (3) when there is a significant difference between Distributing's ratio and Controlled's ratio of investment assets to non-investment assets; and (4) when either Distributing or Controlled makes an election to be a RIC or a REIT. Traditionally, indicating that a particular situation is under study indicates that the IRS is troubled by transactions that include the identified features.

The notice and revenue procedure appear to have been motivated at least in part by government concerns about the growing number of so-called OpCo-PropCo transactions, in which Distributing (the OpCo) transfers a portion of its real estate assets to a new company (the PropCo) that it plans to spin off in accordance with the section 355 requirements, thus allowing for tax-free treatment. PropCo then elects to be treated as a REIT and generally leases the real estate back to OpCo through a triple net lease. Darden Restaurants Inc. announced that it had completed such a transaction on November 9, 2015,[9] and several other companies (including Windstream Holdings Inc. and Penn National Gaming Inc.) recently completed similar transactions that have drawn attention in the tax community.

Rev. Proc. 2015-43 and Notice 2015-59 suggest that the IRS may have concerns about other recently completed or announced corporate spinoffs involving a small active trade or business, other than OpCo-PropCo transactions. On August 29, 2014, the IRS released a private letter ruling approving what is believed to be Liberty Interactive Corp.'s spinoff of its stake in TripAdvisor Inc. and BuySeasons, a small online retailer.[10] On January 27, 2015, Yahoo Inc. announced a similar transaction, stating that it planned to spin off its stake in Alibaba Group Holding Ltd. (SpinCo) and that following the transaction, SpinCo would own all of Yahoo's remaining 384 million shares of Alibaba (valued at $40 billion based on the closing price on January 26, 2015), as well as a small legacy, ancillary Yahoo business.[11] Approximately two weeks before the release of Rev. Proc. 2015-43 and Notice 2015-59, the IRS declined to issue a private letter ruling to Yahoo.[12] Yahoo announced on December 9, 2015, that it had abandoned the planned spinoff, in part because the company was "concerned about the market's perception of tax risk, which would have impaired the value of [SpinCo] stock until resolved."[13]

III. REIT Spinoff Legislation

Following the release of Notice 2015-59 and Rev. Proc. 2015-43, the Protecting Americans From Tax Hikes (PATH) Act of 2015 was enacted, which adds section 355(h), generally making section 355 inapplicable to any distribution if either Distributing or Controlled is a REIT.[14] The law provides exceptions for spinoffs of a REIT by another REIT and for spinoffs of some taxable REIT subsidiaries.[15] Moreover, if a corporation is a distributing or controlled corporation for any distribution to which section 355 applies, the law generally provides that the

[9]Darden Restaurants Inc., Current Report on Form 8-K (Nov. 9, 2015).

[10]LTR 201435005.

[11]Yahoo Inc., Current Report on Form 8-K (Jan. 27, 2015).

[12]Yahoo, Current Report on Form 8-K (Sept. 8, 2015).

[13]Yahoo press release, "Yahoo Provides Update on Planned Spin Off of Remaining Stake in Alibaba Group" (Dec. 9, 2015).

[14]P.L. 114-113, section 311. The provision applies to distributions on or after December 7, 2015, but does not apply to any distribution in accordance with a transaction described in a ruling request initially submitted to the IRS on or before that date, which request has not been withdrawn and regarding which a ruling has not been issued or denied in its entirety as of that date.

[15]*Id.*

corporation (and any successor corporation) is ineligible to make a REIT election for any tax year beginning before the end of the 10-year period beginning on the date of that distribution.[16] Thus, the PATH Act bans most of the REIT spinoff transactions described in the notice and revenue procedure, and in some respects goes further by banning those transactions even if not part of a plan or series of related transactions. Unlike the notice and revenue procedure, the PATH Act does not apply to RICs, nor does it appear to cover spinoffs effected by conversion transactions.[17]

IV. *General Utilities* Repeal

In *General Utilities*,[18] the Supreme Court held that corporations could distribute appreciated property to their shareholders tax free. In 1954 Congress codified the *General Utilities* doctrine by enacting sections 311(a) and 336(a), which provided that a corporation would not recognize gain or loss on a distribution of property to shareholders, regardless of whether the distribution was in the form of a dividend, redemption, or liquidating distribution.[19] Over the next several decades, case law and statutory enactments slowly eroded the *General Utilities* rule.[20] The Tax Reform Act of 1986 added section 311(b), effectively repealing the *General Utilities* doctrine.[21] Regarding the decision to repeal *General Utilities*, the House committee report states:

> The *General Utilities* rule tends to undermine the corporate income tax. Under normally applicable tax principles, nonrecognition of gain is available only if the transferee takes a carryover basis in the transferred property, thus assuring that a tax will eventually be collected on the appreciation. Where the *General Utilities* rule applies, assets generally are permitted to leave corporate solution and to take a stepped-up basis in the hands of the transferee without the imposition of a corporate-level tax. Thus, the effect of the rule is to grant a permanent exemption from the corporate income tax.[22]

Under section 311(b), if a corporation distributes appreciated property to its shareholders, the corporation must recognize gain as if that property were sold at its FMV. Thus, following the repeal of *General Utilities*, the code generally imposes two levels of tax (one at the corporate entity level and one at the shareholder level) on distributions of appreciated property, including stock, outside corporate solution. To further combat the inevitable efforts of taxpayers to mitigate this double taxation, Congress enacted section 337(d), which provided broad authority to Treasury to issue regulations necessary to enforce the principles of *General Utilities* repeal. Section 337(d) states that Treasury "shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of" *General Utilities* repeal, including "regulations to ensure that such purposes may not be circumvented through the use of any provision of law or regulations . . . or through the use of a regulated investment company, real estate investment trust, or tax-exempt entity," and "regulations providing for appropriate coordination of the provisions of this section with the provisions of this title relating to taxation of foreign corporations and their shareholders."

V. Section 355 Requirements

A. Overview

Section 355, which predates TRA 1986, offers a limited exception to the repeal of the *General Utilities* doctrine and provides that the distribution of stock of a subsidiary (Controlled) that is "controlled"[23] by another corporation (Distributing) may not be subject to tax either at the corporate level or at the recipient shareholder level if several requirements are met. Regarding the repeal of *General Utilities*, Congress stated that it believed that "the same policy rationale that justifies nonrecognition by the shareholders on the receipt of the stock — namely, that the transaction merely effects a

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[16] *Id.*

[17] A conversion transaction means the qualification of a C corporation as a RIC or REIT or the transfer of property owned by a C corporation to a RIC or REIT. Reg. section 1.337(d)-7(a)(2)(ii).

[18] *General Utilities and Operating Co. v. Helvering*, 296 U.S. 200 (1936).

[19] *See* Revenue Act of 1954, P.L. 83-591.

[20] For example, in the early 1960s, Congress enacted sections 1245 and 1250, which required the taxpayer to recapture as ordinary income, in the year of sale, all or part of the depreciation previously taken. *See* P.L. 87-834, section 13 and P.L. 88-272, section 231(a). Later, the Tax Reform Act of 1969 made major changes to the *General Utilities* rule by enacting section 311(d), which applied recognition treatment to transactions involving redemptions. P.L. 91-172, section 905. The 1982 Tax Equity and Fiscal Responsibility Act (P.L. 97-248) and the Deficit Reduction Act of 1984 (P.L. 98-369) further restricted the scope of the *General Utilities* rule.

[21] P.L. 99-514, section 631(c).

[22] H.R. Rep. No. 99-426, at 282 (1985).

[23] A corporation is considered to control another corporation for purposes of section 355 if it owns stock possessing 80 percent of the total combined voting power of all classes of stock entitled to vote in the second corporation and at least 80 percent of the total number of shares of each of the other classes of stock of that corporation. Section 368(c); Rev. Rul. 59-259, 1959-2 C.B. 115.

readjustment of the shareholder's continuing interest in the corporation in modified form and subject to certain statutory and other constraints — also justifies nonrecognition of gain or loss to the distributing corporation in this situation.''[24]

B. Technical Requirements

Under section 355(a)(1), the spinoff will be tax free to both Distributing and its shareholders if (1) Distributing distributes to a shareholder all the stock and securities of Controlled held by it immediately before the distribution, or an amount of Controlled stock constituting control; (2) Distributing and Controlled each satisfy the active trade or business requirements under section 355(b);[25] and (3) the transaction is not used principally as a device for the distribution of the E&P of Distributing, Controlled, or both.

In addition to these requirements, the transaction must be carried out for one or more valid corporate business purposes, which are defined as a ''real and substantial non-Federal tax purpose germane to the business of the distributing corporation, the controlled corporation, or the affiliated group . . . to which the distributing corporation belongs.''[26] A corporation need not succeed in meeting the business purpose, as long as the purpose existed and motivated the distribution.[27] A shareholder purpose, such as the personal planning purposes of a shareholder, is not a corporate business purpose. However, in some cases a shareholder purpose for a transaction may be so nearly coextensive with a corporate business purpose as to preclude any distinction between them. If so, the transaction will be treated as having a corporate business purpose.[28] For example, in Rev. Rul. 75-337,[29] the IRS ruled that the shareholder's estate planning goals also served the corporate business purpose of ensuring smooth and continued operation of the corporation after the death of the shareholder.[30]

As discussed later, corporate business purpose is also relevant for determining whether a transaction is a device. Appendix A of Rev. Proc. 96-30[31] listed corporate business purposes approved by the IRS for ruling purposes. Rev. Proc. 96-30 tracked many of the formal and informal guidelines on corporate business purpose that had developed for spinoffs over the past 40 years, and it added specific requirements for establishing those business purposes. Although Rev. Proc. 2003-48[32] deleted Appendix A and stated that the IRS would no longer rule on the business purpose for a spinoff, tax practitioners still refer to the business purposes listed in Rev. Proc. 96-30 as guidelines for acceptable corporate business purposes.[33]

Finally, the transaction must meet a continuity of interest requirement in order to be treated as tax free under section 355.[34] The regulations under section 355 also appear to include a continuity of business enterprise requirements, stating that ''section 355 contemplates the continued operation of the business or businesses existing prior to the separation.''[35]

Five statutory provisions have been added to section 355 to protect *General Utilities* repeal. After TRA 1986 was passed, Congress became concerned that taxpayers were using section 355 to ''bust up'' recently purchased corporations tax free through disguised sales, thereby circumventing the repeal of

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[24]Joint Committee on Taxation, ''General Explanation of the Tax Reform Act of 1986'' (1986), at 337.

[25]Under section 355(b)(2), a corporation is treated as engaged in an active trade or business if (1) the corporation is engaged in the active conduct of a trade or business; (2) that trade or business has been actively conducted throughout the five-year period ending on the date of the distribution; (3) that trade or business was not acquired within that five-year period in a transaction in which gain or loss was recognized in whole or in part; and (4) control of a corporation that was conducting that trade or business was not acquired by any distributee corporation or Distributing directly (or through one or more corporations) within the five-year period in a transaction in which gain or loss was recognized in whole or in part.

[26]Reg. section 1.355-2(b)(2).

[27]Rev. Rul. 2003-55, 2003-1 C.B. 961.

[28]Reg. section 1.355-2(b)(2).

[29]1975-2 C.B. 124.

[30]Similarly, in Rev. Rul. 2003-52, 2003-1 C.B. 960, the IRS stated that although a distribution was intended in part to promote family harmony and to further the personal estate planning goals of the father and mother, the distribution was also intended to eliminate disagreement between the son and daughter and to allow each child to focus exclusively on a particular business. The IRS therefore ruled that the distribution was motivated in substantial part by a real and substantial nonfederal tax purpose and that the business purpose requirement was satisfied.

[31]1996-1 C.B. 696.

[32]2003-2 C.B. 86.

[33]These business purposes include enabling a key employee to acquire an equity stake in the employer business, facilitating a stock offering or borrowing, cost savings, ''fit and focus,'' raising capital, facilitating an acquisition of Distributing by another corporation, facilitating an acquisition by Distributing or Controlled, risk reduction, and resolving the taxpayer's problems with customers or suppliers who object to Distributing or Controlled being associated with a business that competes with the customer or supplier. Subsequent revenue rulings have supported some of these corporate business purposes, including fit and focus (see Rev. Rul. 2003-74, 2003-2 C.B. 77) and raising capital (see Rev. Rul. 2003-75, 2003-2 C.B. 79).

[34]Reg. section 1.355-2(c).

[35]Reg. section 1.355-1(b).

the *General Utilities* doctrine. Those bust-up transactions were also known as mirror subsidiary transactions and mirror substitute transactions.[36] Congress responded in 1987 and 1988 by amending section 355(b)(2)(D), which denies the application of section 355 when a corporate distributee or Distributing has acquired control of Distributing or Controlled within the five-year period before the distribution.[37] However, section 355(b)(2)(D) did not effectively preclude all the transactions that Congress meant to prevent, which led to the passage of section 355(d). Under section 355(d), which was added by the Omnibus Budget Reconciliation Act of 1990,[38] a spinoff is ineligible for tax-free treatment at the corporate level if, after the spinoff, any person owns 50 percent or more of the stock of either Distributing or Controlled and that stock was acquired in a taxable transaction within five years before the distribution. The House committee report indicates that the change was influenced by taxpayer efforts to avoid *General Utilities* repeal through these disguised sales:

> The committee is concerned that some corporate taxpayers may attempt, under present-law rules governing divisive transactions, to dispose of subsidiaries in transactions that resemble sales, or to obtain a fair market value stepped-up basis for any future dispositions, without incurring corporate-level tax. The avoidance of corporate level tax is inconsistent with the repeal of the General Utilities doctrine as part of the Tax Reform Act of 1986.[39]

Taxpayers also attempted to avoid the repeal of *General Utilities* by using spinoff transactions to dispose of unwanted businesses in preparation for a tax-free acquisition by another corporation (so-called *Morris Trust*[40] transactions). The Taxpayer Relief Act of 1997 essentially eliminated these transactions by adding section 355(e).[41] Section 355(e) provides that a spinoff is not eligible for tax-free treatment at the corporate level if both the spinoff and a change of ownership of 50 percent or more of either Distributing or Controlled occur as part of a plan or series of related transactions. The legislative history of section 355(e) highlights the transactions at which section 355(e) was aimed:

> The Committee believes that section 355 was intended to permit the tax-free division of existing business arrangements among existing shareholders. In cases in which it is intended that new shareholders will acquire ownership of a business in connection with a spin off, the transaction more closely resembles a corporate level disposition of the portion of the business that is acquired.[42]

The Tax Increase Prevention and Reconciliation Act of 2005 added section 355(g),[43] under which ''cash-rich'' non-pro-rata split-offs in which a shareholder acquires a 50 percent or greater interest in a disqualified investment corporation are ineligible for tax-free treatment. Generally a disqualified investment corporation is any corporation in which the FMV of its investment assets is two-thirds or more of the FMV of all its assets.[44] Investment assets mean cash; any stock or securities in a corporation; any interest in a partnership; any debt instrument or other evidence of indebtedness; an option, a forward or futures contract, a notional principal contract, or derivative; foreign currency; or any similar asset.[45] Section 355(g) does not apply to pro rata spinoffs, and the no-rules under Rev. Proc. 2015-43 suggest that the IRS believes that section 355(g) as currently drafted may not go far enough, given that the revenue procedures cover *all* spinoff transactions in which the FMV of the investment assets of Distributing or Controlled is two-thirds or more of the total FMV of the corporation's gross assets.

Finally, as discussed above, the PATH Act added section 355(h), generally making section 355 inapplicable to any distribution if either Distributing or Controlled is a REIT, and providing that Distributing, Controlled, and any successor corporation are ineligible to make a REIT election for any tax year

[36]For a more detailed discussion of mirror subsidiary and mirror substitute transactions, see Mark J. Silverman and Lisa M. Zarlenga, ''The Section 355(d) Regulations: Narrowing the Scope of an Overly Broad Statute,'' in Practising Law Institute, *Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations & Restructurings* 3-7 (2015).

[37]OBRA of 1987, P.L. 100-203, section 10223(a); Technical and Miscellaneous Revenue Act of 1988, P.L. 100-647, section 2003(k).

[38]P.L. 101-508, section 11321.

[39]H.R. Rep. No. 101-881, at 341 (1990).

[40]*Commissioner v. Mary Archer W. Morris Trust*, 367 F.2d 794 (4th Cir. 1966), *acq.*, Rev. Rul. 68-603, 1968-2 C.B. 148.

[41]P.L. 105-34, section 1012.

[42]H.R. Rep. No. 105-148, at 462 (1997); S. Rep. No. 105-33, at 139-140 (1997). The Taxpayer Relief Act of 1997 also added section 355(f), which provides that a spinoff is not eligible for tax-free treatment at the corporate level if stock is distributed from one member of an affiliated group to another member of that group if the distribution is part of a plan or series of transactions as described in section 355(e).

[43]P.L. 109-222, section 507.

[44]Section 355(g)(2)(A).

[45]Section 355(g)(2)(B).

beginning before the end of the 10-year period beginning on the date of the distribution.[46]

VI. No-Device Requirement

A. Historical Development

The section 355 regulations say the following about the no-device requirement:

> Section 355 does not apply to a transaction used principally as a device for the distribution of the earnings and profits of the distributing corporation, the controlled corporation, or both (a "device"). 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 the recovery of basis.[47]

The reference to the "avoidance of the dividend provisions" suggests that a key purpose of the no-device requirement is to attack transactions in which shareholders converted dividend income to capital gains. This makes sense in light of the historical development of section 355. Before the Revenue Act of 1924, an exchange made in a split-off transaction was tax free, but a distribution in a spinoff transaction was subject to tax.[48] The argument was that in one case an exchange had been made, while in the other case it had not.[49] The Revenue Act of 1924 amended the code to permit tax-free spinoff transactions in which the shareholders of Distributing did not exchange any shares upon receipt of Controlled stock.[50] However, Congress soon learned that taxpayers were taking advantage of the tax-free treatment of spinoff transactions to bail out E&P at favorable capital gains tax rates through the "device" of a spinoff followed by a sale. From 1924 until 1933, capital gains were taxed at a maximum rate of 12.5 percent, while the top ordinary income tax rate ranged from 24 to 63 percent.[51] This rate differential gave taxpayers an incentive to engage in transactions to convert ordinary income to capital gains.

Gregory v. Helvering[52] is the most famous example of this type of planning. It involved a transaction in which Ms. Gregory was the sole owner of United Mortgage Corp. (UMC), which owned a minority stake in Monitor Securities Corp. (MSC). At the time, if UMC had distributed the MSC securities to Gregory, there would have been no corporate-level tax, but Gregory would have reported dividend income on the distribution. To avoid dividend treatment, Gregory had UMC transfer its MSC shares to the newly formed Averill Corp. in exchange for Averill's shares, which were distributed to Gregory. Gregory then caused Averill to liquidate and distribute the MSC shares to her. Gregory immediately sold the shares and reported capital gain on the liquidation of Averill. Although the transaction technically met the requirements for tax-free treatment under the predecessor to section 355, the Supreme Court ultimately held that the transaction was a "mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, the sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganize a business or any part of a business, but to transfer a parcel of corporate shares to the petitioners."[53]

Before the Supreme Court decided *Gregory*, Congress passed the Revenue Act of 1934, which repealed the provision permitting tax-free treatment for spinoffs.[54] The House committee report notes that "corporations have found it possible to pay what would otherwise be taxable dividends, without any taxes upon their shareholders. The committee believes that this means of avoidance should be ended."[55] Although spinoffs were reinstated in 1951, the revised spinoff provisions included additional requirements to qualify for tax-free treatment, including the no-device requirement and the active trade or business requirement.[56] Regarding the no-device requirement, the Revenue Act of 1951 stated that a spinoff would not be tax free if "the corporation whose stock is distributed was used principally as a device for the distribution of E&P to the shareholders of any corporation a party to the reorganization."[57] This was the first time the no-device requirement appeared in the code for spinoff transactions and other corporate separations. Given

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[46]P.L. 114-113, section 311. As discussed above, the law provides exceptions for spinoffs of a REIT by another REIT and for spinoffs of some taxable REIT subsidiaries.

[47]Reg. section 1.355-2(d)(1).

[48]Revenue Act of 1918, ch. 18, section 202(b).

[49]*Merten's Law of Federal Income Taxation*, section 43B:2 (Nov. 2007).

[50]Revenue Act of 1924, ch. 234, section 203(c).

[51]*See* Urban-Brookings Tax Policy Center, "Historical Highest Marginal Income Tax Rates" (Feb. 19, 2015). *See also* Citizens for Tax Justice, "Top Federal Income Tax Rates Since 1913," *available at* http://www.ctj.org/pdf/regcg.pdf.

[52]293 U.S. 465 (1935).

[53]*Id.* at 469.

[54]Revenue Act of 1934, ch. 277.

[55]H.R. Rep. No. 73-704, at 14 (1934). *See also* S. Rep. No. 73-558 (1934), at 16.

[56]Revenue Act of 1951, section 317.

[57]*Id.*

Gregory, this requirement appears largely motivated by corporate efforts to pay what would otherwise be treated as dividends without any shareholder taxes. Indeed, subsequent IRS guidance and court decisions further indicate that the policy rationale behind the no-device requirement was focused primarily on taxpayer attempts to avoid dividend treatment.[58]

Congress made some additional changes to the no-device requirement when it incorporated the requirement into section 355 of the 1954 code. The statute noted that the ''mere fact that subsequent to the distribution stock or securities in one or more of [Controlled or Distributing] are sold or exchanged by all or some of the distributees (other than pursuant to an arrangement negotiated or agreed upon prior to such distribution) shall not be construed to mean that the transaction was used principally as such a device.''[59]

B. The 1989 Treasury Regulations

1. Introduction of basis recovery rationale. TRA 1986 eliminated the favorable tax rate for capital gains, resulting in parity between the tax rates for ordinary income and capital gains for the first time since the inception of the federal income tax.[60] The capital gains preference was reinstated in 1990 when ordinary income tax rates were raised without a similar increase in CGT rates.[61] Capital gains continued to be taxed at lower rates than dividend income until 2003, when Congress reintroduced parity between the tax rates for ordinary income and capital gains.[62]

In 1989 the section 355 regulations were revised, in part to highlight that a device includes ''a transaction that effects a recovery of basis,''[63] indicating that at a minimum, the no-device requirement remains relevant as long as basis recovery would result in the government collecting only a portion of the tax it would have collected if the transaction had been characterized as a dividend. The regulatory history contains no earlier mention of the basis recovery rationale for the no-device requirement. Although the regulatory history sheds no light on this addition, the timing suggests that the rationale was developed in response to the newly equal capital gains and ordinary income tax rates. It may also be that the IRS and Treasury were attempting to apply a section 301(c) framework to the no-device requirement. The government's current focus on E&P (described in greater detail below) is consistent with this framework. Under section 301(c), the portion of a distribution that is not treated as a dividend under section 316 is applied against and reduces the adjusted basis of the stock.[64] In any event, the focus on basis recovery seems to have been an effort to keep the device test relevant despite the (then-temporary) diminution of rate differentials. Some commentators nonetheless noted that rate equivalence made the device test less salient.[65]

2. Multifactor test: A focus on the avoidance of dividend treatment. The 1989 regulations also introduced much of the multifactor test that is used today to determine whether a transaction is used principally as a device for the distribution of E&P. The regulations enumerate various specific factors but also state that additional factors not listed bear

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[58]*See* Rev. Rul. 71-383, 1971-2 C.B. 180 (''Consequently, the transaction is not a device to distribute E&P (that is, to convert dividend income into capital gains).''); *Morris Trust*, 367 F.2d 794, 798 (''The [section 355(a)(1)(B)] limitation was an additional precaution intended to encompass any other possible use of the device for the masquerading of a dividend distribution.''); *Rafferty v. Commissioner*, 452 F.2d 767, 770 (1st Cir. 1971) (''Had the taxpayers received cash dividends and made investments to provide for their female descendants, an income tax would, of course, have resulted. . . . Once the stock was distributed, if it could potentially be converted into cash without thereby impairing taxpayers' equity interest in RBS, the transaction could easily be used to avoid taxes.''); *Commissioner v. Wilson*, 353 F.2d 184, 186 (9th Cir. 1965) (stating that regarding corporate separations, ''Congress early learned, however, that shareholders would select the part of the assets of an original corporation which could most readily be converted into cash or its equivalent, spin those parts into the second corporation, distribute the stock in that corporation to themselves, and thus have available for sale and capital gains tax treatment stock in that corporation, though in fact what they sold represented accumulated earnings of the original corporation, which earnings, if they had been paid directly to the shareholders of the original corporation, would have been fully taxable to them as dividend income.''); and *Gada v. United States*, 460 F. Supp. 859, 870 (D. Conn. 1978) (''The only possible advantage to spinning off the new corporations prior to the sale is the avoidance of the corporate dividend tax, which is the very result that the limitations of section 355 are meant to prevent.'').

[59]Section 355(a)(1)(B) (1954).

[60]P.L. 99-514, section 302.

[61]OBRA of 1990, P.L. 101-508, section 11101.

[62]*See* Jobs and Growth Tax Relief Reconciliation Act of 2003, P.L. 108-27, section 302.

[63]T.D. 8238.

[64]To the extent the portion of the distribution that is not a dividend exceeds the adjusted basis of the stock, it is treated as a gain from the sale or exchange of property. Section 301(c)(3).

[65]*See, e.g.*, Robert Willens, ''The Business Purpose Doctrine in Section 355: Current Trends,'' 67 *Taxes* 584 (1989) (''The device test — designed to police transactions structured to bail out E&P at capital gains rates — is less significant in an era in which capital gains and ordinary income are taxed at the same rate.''); Eric M. Zolt, ''The *General Utilities* Doctrine: Examining the Scope of the Repeal,'' 65 *Taxes* 819, 820 n.7 (1987) (''For example, Sections 302, 304 and 355 were adopted to prevent bailout of corporate earnings at capital gains rates. With the elimination of the preferential rates for capital gains, the role these provisions should play after the 1986 Act becomes unclear.'').

on whether a transaction has been undertaken as a device.[66] The presence of any of the device factors is evidence of device, while the presence of any of the non-device factors is evidence of non-device.[67] The strength of this evidence depends on the facts and circumstances, which creates inherent uncertainty for taxpayers attempting to determine whether a particular transaction raises an issue that could disqualify the entire tax-free nature of a corporate spinoff.

The multifactor analysis further reflects the focus of the no-device requirement on transactions essentially equivalent to the payment of a dividend, given that the factors tend to treat transactions having characteristics less analogous to dividend payments as less likely to be indicative of device. For example, because dividends are generally distributed pro rata, a distribution that is pro rata or substantially pro rata among Distributing's shareholders presents the ''greatest potential for the avoidance of the dividend provisions'' and thus is evidence of a device.[68] Meanwhile, the fact that Controlled's stock is distributed to one or more domestic corporations that if section 355 did not apply would be entitled to an 80 percent or 100 percent dividends received deduction is evidence of a non-device[69] because it is less likely that the transaction is motivated by a desire to avoid dividend treatment.

A subsequent sale or exchange of stock of Distributing or Controlled after the distribution is also evidence of a device, likely because those transactions resemble the transaction described in *Gregory* and present an opportunity for the conversion of dividend income to capital gains.[70] Generally, the greater the percentage of the stock sold or exchanged and the shorter the time between the distribution and the sale-exchange, the stronger the evidence of a device.[71] Also, if the subsequent sale or exchange is negotiated or agreed on before the distribution, it is substantial evidence of a device.[72]

Two other factors added by the 1989 regulations concern the distinction between corporate and shareholder business purpose. First, a corporate business purpose for the transaction is evidence of a non-device.[73] It could be argued that a strong corporate business purpose makes it less likely that the spinoff was entirely motivated by a desire of the shareholders to avoid dividend treatment. However, a desire to reduce federal taxes is never a valid corporate business purpose.[74] Second, the fact that Distributing is publicly traded and has no shareholder who is directly or indirectly the beneficial owner of more than 5 percent of any class of stock is also evidence of a non-device,[75] in part because it is less likely that the transaction was primarily motivated by a shareholder business purpose, such as a desire to avoid dividend treatment.

Finally, the existence of assets not used in a trade or business (such as cash or other liquid assets) is evidence of a device.[76] The IRS may look at each corporation's ratio of the value of assets not used in a qualifying active business to the value of assets that are used in a qualifying business.[77] A significantly higher nonqualifying asset ratio in one corporation is evidence of a device, especially if the difference results from a shift of assets from one corporation to another. There is also evidence of a device if a business of either Distributing or Controlled is (1) a secondary business that continues as a secondary business for a significant period after the separation and (2) can be sold without harming the business of the other corporation (or a corporation controlled by it). A secondary business is a business of either Distributing or Controlled if its principal function is to serve the business of the other corporation (or a corporation controlled by it). The continued integration of the secondary business with the main business suggests that the transaction did not have a strong business purpose.

It could be argued that the ''mix of assets'' device factor focuses more on corporate-level consequences than on shareholder-level consequences, since in some circumstances a shift of assets from Distributing to Controlled could be used later to

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[66] Reg. section 1.355-2(d)(1).

[67] *See* reg. section 1.355-2(d)(2)(i) and (d)(3)(i).

[68] Reg. section 1.355-2(d)(2)(ii).

[69] Reg. section 1.355-2(d)(3)(iv).

[70] Interestingly, the multifactor analysis suggests that an intention to sell stock of Distributing or Controlled may be enough to make a transaction a device, even if no actual sale occurs. This could be read as contrary to the statute, which indicates that the mere fact that after the distribution stock or securities are sold or exchanged by all or some of the distributees, other than under an arrangement negotiated or agreed on before the distribution, will not be construed to mean that the transaction was used principally as a device for the distribution of E&P. Section 355(a)(1)(B).

[71] Reg. section 1.355-2(d)(2)(iii)(A).

[72] Reg. section 1.355-2(d)(2)(iii)(B).

[73] The assessment of the strength of a corporate business purpose will be based on all the facts and circumstances, including the following factors: (1) the importance of achieving the purpose to the success of the business; (2) the extent to which the transaction is prompted by a person not having a proprietary interest in either the corporation, or by other outside factors beyond the control of Distributing; and (3) the immediacy of the conditions prompting the transaction. Reg. section 1.355-2(d)(3)(ii).

[74] Reg. section 1.355-2(b)(2).

[75] Reg. section 1.355-2(d)(3)(iii).

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

[77] *Id.*

effectively move those assets out of corporate solution and avoid corporate tax. The regulations do not specify the amount of nonbusiness assets that could be problematic. This particular factor is implicated in both the OpCo-PropCo transactions and in transactions involving a small active trade or business. Regarding the OpCo-PropCo transactions, the triple net lease that the parties enter into in connection with the spinoff is generally not considered an active trade or business.[78] Thus, OpCo typically transfers a relatively small active trade or business (relative to the value of the real estate) to PropCo to satisfy the section 355 requirements. That business is usually a secondary business under the regulations. Similarly, the nonqualifying asset ratio limitation is likely implicated in the Liberty Media and Yahoo transactions because the portfolio stock would be considered assets not used in a trade or business. It is unclear exactly how small the active trade or business must be to indicate a device, and it is also unclear how this element would interact with all the other device and non-device factors in the required analysis.

3. Balancing the factors. There is little guidance in the regulations indicating how the factors should be balanced and whether some factors are more important than others. The regulations do state that the stronger the evidence of a device, the stronger the corporate business purpose required to prevent the determination that the transaction was used principally as a device.[79] Tax practitioners have generally interpreted this to mean that a strong corporate business purpose can trump the remaining device factors.[80] Indeed, a strong corporate business purpose would seem particularly likely to subsume the other device factors (except, perhaps, the mix of assets factor) when capital gains and ordinary income tax rates are the same, given the dividend equivalence focus of the factors. However, the IRS's increased concentration on the no-device requirement in Notice 2015-59 and Rev. Proc. 2015-43 may challenge the generally accepted prominence of corporate business purpose in the multifactor analysis by forcing a tougher look at why a strong corporate business purpose should trump other device factors.

Moreover, Example 3 in reg. section 1.355-2(d)(4) suggests that a strong corporate business purpose for the distribution is not always enough to guarantee tax-free treatment of a spinoff transaction. In the example, Corp. X is engaged in a regulated business in State M and owns all the stock of Corp. Y, which is not engaged in a regulated business in State M. State M has recently amended its laws to provide that affiliated corporations operating in M may not conduct both regulated and unregulated businesses. X transfers to Y cash unrelated to the reasonable needs of the business of X or Y and then distributes the Y stock pro rata among X's shareholders. Although there is a strong business purpose for the distribution, the example states that the business purpose does not pertain to the transfer of cash, which is strong evidence of a device because it results in Y holding disproportionately more assets not used in a trade or business. Thus, the transaction is considered to have been used principally as a device.

Adding to the confusion is reg. section 1.355-2(d)(5), which identifies three transactions that are "ordinarily considered not to have been used principally as a device, notwithstanding the presence of any of the device factors."[81] The common characteristic of the transactions is that in the absence of section 355, they would not have constituted a dividend, and therefore there is no potential for dividend avoidance. The transactions are (1) a distribution in which neither Distributing nor Controlled has E&P; (2) a distribution in which, in the absence of section 355, for each shareholder, the distribution would be a redemption to which section 303(a) applied; and (3) a distribution in which, in the absence of section 355, for each shareholder, the distribution would be a redemption to which section 302(a) applied.

Tax practitioners have generally regarded those three transactions as "superfactors" that trump the multifactor device analysis. However, the regulations offer no guidance about the meaning of the phrase "ordinarily considered" and do not explain how, if at all, the multifactor analysis should be applied to those transactions.[82] Further, Notice

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[78]*Compare* Rev. Rul. 2001-29, 2001-1 C.B. 1348, which concludes that the rental of real estate in compliance with the REIT provisions can constitute the active conduct of a trade or business for purposes of the tax-free spinoff rules.

[79]Reg. section 1.355-2(d)(3)(ii).

[80]*See, e.g.*, Elliott, "Does Size Matter? Getting to Will on a Hot Dog Stand ATB," *Tax Notes*, July 13, 2015, p. 128 ("The philosophy historically embraced by the [IRS Office of Associate Chief Counsel] is that . . . a bad device factor can be cured by a good nontax corporate business purpose."); and Richard M. Nugent, "REIT Spinoffs: Passive REITS, Active Businesses, Part 2," *Tax Notes*, Mar. 30, 2015, p. 1635 ("The regulations provide that the assessment of the strength of the corporate business purpose, *which can mitigate any evidence of device that is present for a distribution*, must consider all the relevant facts and circumstances" (emphasis added).).

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

[82]The regulations do indicate that a transaction is not protected by reg. section 1.355-2(d)(5) if it involves the distribution of the stock of more than one controlled corporation and facilitates the avoidance of the dividend provisions of the code

(Footnote continued on next page.)

2015-59 casts doubt on the ability of the superfactors to overcome evidence of a device, stating that "certain characteristics of a transaction may overcome both the nondevice factor of public trading and the non-pro rata structure of a distribution," citing reg. section 1.355-2(d)(3)(iii) (regarding the publicly traded non-device factor) and reg. section 1.355-2(d)(5)(iv) (regarding distributions that would be redemptions to which section 302(a) applied in the absence of section 355). This idea was reiterated by an IRS official.[83] This is surprising, given the historical emphasis on the avoidance of dividend treatment for the no-device requirement, and it is unclear in what situations that transaction would still be considered a device.

C. Continuing Rationales

The Jobs and Growth Tax Relief Reconciliation Act of 2003 amended section 1(h) to provide that qualified dividend income would be taxed at an individual taxpayer's applicable long-term capital gains rate.[84] Qualified dividends consist of dividends from U.S. corporations and some qualified foreign corporations. In 2013 Congress made the provision permanent.[85] As a result, many tax practitioners question the continuing importance of the no-device requirement in light of the original purpose of the test, much as was the case when rates were equalized briefly in the late 1980s.[86] Notice 2015-59 and Rev. Proc. 2015-43 indicate that the IRS and Treasury believe that the no-device requirement continues to be relevant, while not clearly setting forth a supporting policy rationale. Below are some possible reasons for the continued importance of the no-device requirement.

1. Future tax rate changes and basis recovery. Because there has been substantial variation in ordinary income and capital gains tax rates since the inception of the income tax, one possible rationale for continuing to include the device test is that the rate differential could be reinstated. Also, the government may still be concerned about transactions that would permit taxpayers to exploit spinoff transactions to benefit from basis recovery, as noted in the regulations. It would seem, however, that the government is less able to justify the application of the no-device requirement in transactions involving the distribution of stock with zero basis, since the tax paid if the distribution were characterized as a dividend would be the same as the tax paid if the transaction satisfied the requirements under section 355 and the stock was later sold. Nonetheless, one IRS official has indicated that he is unsure that the no-device requirement would not continue to be relevant in a zero basis setting.[87]

2. Policing *General Utilities* repeal. In Notice 2015-59 and Rev. Proc. 2015-43, the IRS indicates, apparently for the first time, that it is concerned not only with the shareholder tax consequences of corporate separations (dividend treatment) but also with the corporate tax consequences (corporate tax avoidance) and specifically with policing the double tax regime created by the repeal of the *General Utilities* doctrine.[88] The implication created by the notice's reference to *General Utilities* is that although some transactions may technically comply with the requirements for tax-free treatment under section 355, those transactions may create consequences that run counter to the *General Utilities* repeal. Because section 355 by its terms is not explicitly restricted to shareholder consequences, the IRS might see the no-device requirement as mandating, or at least permitting, the Service to use

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through the subsequent sale or exchange of stock of one corporation and the retention of the stock of another corporation. Reg. section 1.355-2(d)(5)(i).

[83]*See, e.g.*, Elliott, "IRS Official Gives Direct Answers to No-Rule Guidance Questions," *Tax Notes*, Oct. 5, 2015, p. 25 (stating that Wellen said during the District of Columbia Bar Taxation Section meeting on September 29 "that the government doesn't think that the non-device 'super factor' — as some refer to it — in reg. section 1.355-2(d)(5)(iv) trumps the multifactor device analysis").

[84]P.L. 108-27, section 302.

[85]American Taxpayer Relief Act of 2012, P.L. 112-240, section 102.

[86]*See, e.g.*, Joshua D. Blank, "The Device Test in a Unified Rate Regime," *Tax Notes*, Jan. 26, 2004, p. 513 ("Given that basis recovery is now the only major difference between a taxable dividend and a tax-free spin-off, however, the government should consider limiting its enforcement of the device test, especially for individual shareholders with zero basis in their Distributing and Controlled shares who pose no risk of basis recovery."); and Peter C. Canellos, "The Section 355 Edifice: Spinoffs Past, Present, and Future," *Tax Notes*, July 26, 2004, p. 419 (suggesting that the device test "could be suspended during the concurrence of individual dividend and capital gains rates").

[87]Elliott, *supra* note 80. In response to a question at a D.C. Bar Taxation Section meeting on September 29, 2015, about whether the government remained concerned about device in transactions when the Distributing shareholders have no basis in their stock, Wellen said, "I see your point about there being no difference between ordinary income and capital gain" for the shareholders, noting, "That sounds like a pretty good case, but I'm really not sure we can say it's the whole story."

[88]*See* Elliott, "Officials' Comments Fuel Market Fears Over Spinoff Challenges," *Tax Notes*, Oct. 5, 2015, p. 29 (Wellen says that although the government has "traditionally thought of device as principally if not exclusively a shareholder-related matter" as opposed to a corporate-level issue like the avoidance of corporate-level tax arising from the repeal of the *General Utilities* doctrine, "we're trying to look at the situation holistically and see whether abuses might be present" at either the corporate level or the shareholder level). *See also supra* note 65.

the test to block efforts to avoid corporate-level tax on appreciated assets. That suggestion is somewhat revolutionary given that the no-device requirement precedes the repeal of *General Utilities* by several decades.

The repeal of *General Utilities* reflects Congress's view that a corporation should be taxed when appreciated assets leave corporate solution. In a section 355 transaction, although Controlled stock technically leaves corporate solution when distributed to Distributing's noncorporate shareholders, there is no violation of the principles of *General Utilities* repeal because Controlled is a corporation and any assets transferred to it as part of the transaction remain in corporate solution and subject to corporate-level tax when Controlled distributes them to its shareholders.

However, the IRS may be concerned about situations in which companies can structure a transaction so that the built-in gain on the corporate assets completely escapes corporate-level tax. For example, before passage of the PATH Act, OpCo-PropCo section 355 transactions could be used to avoid tax at the corporate level altogether. The express provisions of section 337(d), which permit regulations to police *General Utilities* repeal, have been used to prevent that avoidance in conversion transactions. Section 1374 applies to a conversion transaction unless the C corporation elects deemed sale treatment for that transaction.[89] Section 1374 imposes tax on the net built-in gain of the property if the REIT disposes of the property in a taxable transaction within the recognition period.[90] If the REIT does not dispose of the property within the recognition period, however, the built-in gain is wholly free of corporate tax.[91] Moreover, a REIT generally avoids corporate income tax on future rental income because it receives a dividends paid deduction and thus is not subject to corporate tax if it distributes to its shareholders substantially all of its taxable income for the year. Further, in OpCo-PropCo transactions, the triple net lease would strip income from OpCo's tax base through deductible rent payments. With the new section 355(h), Congress has largely addressed its concerns regarding *General Utilities* repeal for OpCo-PropCo transactions.

It is less clear how the *General Utilities* repeal may be implicated in the transactions described in the notice dealing with a mix of active and nonactive assets, although one Treasury official has indicated that he does not believe the *General Utilities* concern is limited to transactions involving RIC or REIT elections.[92] It may be that the IRS is concerned that taxpayers may engage in post-spinoff transactions that would allow the nonactive assets to escape corporate taxation — for example, through a tax-free liquidation or downstream merger. Nonetheless, it seems that the appropriate mechanism for policing *General Utilities* repeal would be through the section 337(d) regulations rather than the device test because it is the subsequent transaction, not the spinoff, that raises the *General Utilities* concern.

3. Timing advantage. One possible additional rationale for the continued application of the no-device requirement is that although a dividend distribution is taxed currently, a section 355 transaction is tax free until the disposition of Controlled shares.[93] Thus, even in cases involving stock with zero basis, a taxpayer could enjoy the benefit of tax deferral until the sale of Controlled shares. This concern is not mentioned in the section 355 legislative history, and it seems unlikely that the timing advantage is the primary focus of the government's concerns in the no-device requirement. Congress was historically troubled by a quick sale of Controlled shares following a section 355 distribution[94] because those transactions allowed shareholders to convert dividend income to capital gains (similar to the *Gregory* transaction).

4. Consequences of shifting of E&P. Comments by government officials at a District of Columbia Bar event suggest that Treasury and the IRS may be focusing on the location of E&P, noting that the statutory language merely references a device for

[89]Reg. section 1.337(d)-7(a).

[90]P.L. 114-113, section 127. As amended by the PATH Act, the recognition period is the five-year period beginning with the first day of the first tax year for which the corporation was a REIT. Section 1374(d)(7). The period was originally 10 years, but it had been temporarily reduced in recent years. In determining net recognized built-in gain for tax years beginning in 2011 through 2014, the recognition period is generally five years rather than 10 years, and for any tax year beginning in 2009 or 2010, the recognition period is generally seven years. Section 1374(d)(7).

[91]As discussed above, the PATH Act provides that neither Distributing nor Controlled can make a REIT election for 10 years following any distribution to which section 355 applies. The application of section 1374 requires that a corporation wait an additional five years before it can dispose of property without incurring a tax on the built-in gain.

[92]*See* Elliott, *supra* note 88 (Krishna Vallabhaneni, acting Treasury deputy tax legislative counsel, stating that while it might not be entirely clear how section 337(d) might apply "to inform us on device concerns, I don't think the intent was to limit it just to the RIC or REIT situation").

[93]*See* Mark J. Silverman, "Corporate Divisions Under Section 355," Practicing Law Institute (June 2013), at 1.

[94]*See, e.g.*, Blank, *supra* note 86 (stating that "it would be contradictory for the government to argue that the device test is necessary because without it, tax-free spinoff treatment could prolong income recognition; rather, the government is most troubled by sales that occur soon after a tax-free distribution").

the "distribution of earnings and profits."[95] Thus, the IRS and Treasury might extend the device test to constrain attempts to use section 355 transactions to shift E&P outside the United States or to shift E&P to a corporation less likely to make dividend distributions in the future, resulting in tax avoidance either at the corporate or shareholder level. It is not clear that any high-profile spinoff transactions have been used for this purpose or have in fact had this result.

The location of E&P is relevant for determining a U.S. shareholder's subpart F inclusion[96] and for determining whether a U.S. shareholder is required to treat gain on some dispositions of stock in controlled foreign corporations as dividend income under section 1248.[97] Moreover, a corporation's E&P is relevant in determining whether future distributions will receive dividend treatment.[98] Thus, there is some opportunity for a taxpayer to bail out E&P when allocating E&P between Distributing and Controlled.[99] Also, corporate separations involving foreign shareholders might shift untaxed earnings outside the United States. For example, if a domestic Distributing distributes stock of a domestic Controlled to a foreign distributee shareholder, capital gain realized on a subsequent sale of Controlled stock is generally not subject to U.S. tax as long as it is not effectively connected with a U.S. trade or business.[100] Section 367(e)(1) governs section 355 distributions by U.S. corporations to foreign persons and states that "to the extent provided in regulations, gain shall be recognized under principles similar to the principles of this section." Section 367(e)(1) regulations provide that a domestic Distributing does not recognize gain on the distribution of a domestic Controlled.[101]

Despite the potential for tax avoidance in cross-border section 355 planning, this policy rationale for the no-device requirement appears to be a recent development, although there is some indication that Treasury and the IRS have been troubled by the cross-border allocation of E&P over the years.[102] Notice 2015-59 and Rev. Proc. 2015-43 do not by their terms indicate a concern with the cross-border implications of section 355, and none of the transactions under study in the notice specifically involve foreign corporations or foreign shareholders. Nonetheless, some tax practitioners have recently highlighted the importance of the location of E&P in section 355 transactions,[103] and the IRS may therefore consider the application of section 355 in an international context as it studies the transactions described in the notice. Should the IRS issue new

[95]Elliott, *supra* note 83 (Wellen stating that in the cross-border context, "the location of E&P can be awfully important," and Vallabhaneni stating that "to the extent you're getting rid of" E&P at Distributing or Controlled, depending on how the E&P gets allocated, "I'm not sure that device is 1,000 percent focused on shareholder tax consequences.").

[96]Section 952(c).

[97]*See* reg. section 1.367(b)-2(c)(1).

[98]*See* section 301(c).

[99]Under reg. section 1.312-10(a), in section 355 transactions that are also divisive D reorganizations, E&P is allocated between Distributing and Controlled. For a newly created Controlled, the allocation will generally be made in proportion to the FMV of the business or businesses retained by Distributing and the business or businesses of Controlled immediately after the transaction. However, "in a proper case," E&P may be allocated between Distributing and Controlled in proportion to the net basis of assets transferred and assets retained, "or by such other method as may be appropriate under the facts and circumstances of the case." Net basis means the basis of the assets less liabilities assumed or liabilities to which those assets are subject. If a section 355 transaction is a spinoff or a split-off (and not a divisive D reorganization), the E&P of Distributing is decreased by the lesser of (1) the amount of the adjustment that would have been made to the E&P of Distributing if it had transferred the stock of Controlled to a new subsidiary in a divisive D reorganization, or (2) the net worth of Controlled. Reg. section 1.312-10(b). Thus, under reg. section 1.312-10, Distributing's E&P is generally reduced, but that reduction is not always accompanied by an increase in Controlled's E&P, resulting in a potential bailout of Distributing's E&P by making it more likely that future distributions could avoid dividend treatment. Moreover, reg. section 1.312-10 appears to allow the taxpayer a great deal of discretion in choosing a proper allocation method, which could allow the taxpayer to shift E&P to avoid tax in some situations.

[100]Section 871(a)(2).

[101]Reg. section 1.367(e)-1(c). In contrast, if a U.S. corporation distributes the stock of a foreign Controlled, gain (but not loss) must be recognized on any distribution to a shareholder that is not a qualified U.S. person, which is defined as a domestic corporation. Reg. section 1.367(e)-1(b). Despite the potential for shifting E&P, the IRS determined that section 355(d) and (e) and the no-device and continuity of interest requirements of section 355 would adequately protect the policies of section 367(e)(1), particularly when weighed against "the administrative burdens to taxpayers and the Government in connection with rules requiring gain recognition agreements and similar arrangements." T.D. 8834.

[102]For example, proposed regulations on the allocation of E&P for section 367(b) transactions involving corporate reorganizations, liquidations, or divisions involving one or more foreign corporations were issued in November 2000. *See* REG-116050-99. However, the proposed regulations were never finalized.

[103]*See* New York State Bar Association Tax Section, "Report on the Allocation of Earnings and Profits in Connection With Divisive Transactions" (Dec. 1, 2015). The report states that "the location and category of E&P following cross-border section 355 transactions is critical for determining the tax consequences of future distributions by foreign corporations" and that "clear rules are essential in order to minimize inappropriate repatriation opportunities and provide taxpayers with certainty." The report proposes eliminating the ambiguity created by reg. section 1.312-10(a), which, as discussed *supra* note 99, states that the net basis method (or any other method) for allocating the distributing corporation's E&P to the controlled corporation may be used in a "proper case."

guidance on this topic, however, it appears that the appropriate route would be through either section 367(e) or reg. section 1.312-10, rather than section 355.

VII. Limited Options for Further Guidance

Given the uncertainty surrounding the no-device requirement and the IRS's apparent desire to use it to police *General Utilities* repeal, the issuance of clarifying guidance as quickly as possible would benefit taxpayers, their counsel, and the government. Moreover, that guidance could provide a sufficient framework for the IRS to resume issuing rulings on the legal issues surrounding spinoff transactions. However, we believe that the IRS's options for incorporating the principles of *General Utilities* repeal into section 355 are limited under the current statute.

To address the active trade or business concerns raised in Notice 2015-59 and Rev. Proc. 2015-43, Treasury and the IRS could adopt some threshold size for the active trade or business. On one hand, adopting a specific percentage of assets or a similar numeric threshold as a substantive rule (and not just as a private letter ruling guideline) seems arbitrary. On the other hand, requiring that the active trade or business be "significant" or "substantial" introduces a subjective standard, which would be difficult for taxpayers and the IRS to apply. One workable option would be to add a safe harbor based on Rev. Proc. 2015-43, providing that an active trade or business will be considered significant if it is at least 5 percent of the total FMV of the gross assets of the given corporation. Nonetheless, this approach does not provide guidance for an active trade or business that does not meet the safe harbor.

Regarding the device test, additional safe harbors could be added to the regulations for the mix of assets device factor, based on the guidelines in Rev. Proc. 2015-43. The IRS could also issue detailed guidance — in a revenue ruling or new examples in the regulations — applying the existing multifactor test specifically to the transactions described in the revenue procedure and notice. Given the lack of guidance about how each factor should be balanced, and the fact that the analysis of whether a transaction is a device is based on all the facts and circumstances (rather than solely the factors enumerated in the regulations), the existing test seems broad enough for the IRS to find that the described transactions qualify as a device. However, by applying those factors to specific elements that concern the IRS (such as, apparently, the presence of investment assets), the factor analysis might be useful to guide future transactions. That analysis could provide safe harbors in addition to those discussed above and provide guidance on whether some factors are more important than others. Moreover, the analysis could shed greater light on how the government believes the superfactors under reg. section 1.355-2(d)(5)(i) should be applied in the general multifactor device analysis. It would be particularly helpful if that guidance discussed whether the superfactors should be treated as safe harbors, whether they should be given greater weight in the general multifactor device analysis, or whether they should be treated as merely additional factors. Also, the revised regulations could provide examples of circumstances under which transactions described in reg. section 1.355-2(d)(5) might still be a device.

Beyond the options described above, it would be difficult for the IRS to stretch the bounds of the device test without a statutory change. It is unclear that a court would apply deference under *Natural Resources Defense Council Inc. v. Chevron U.S.A. Inc.*[104] if Treasury attempted to police the *General Utilities* repeal through the no-device regulations, given the limitations in *Chevron*. For an agency's interpretations of the statutes it administers, judicial review of the agency's regulations is guided by the two-step analysis described in *Chevron*. The first step is to determine whether Congress has "directly spoken to the precise question at issue." The purpose of this step is to determine congressional intent using "traditional tools of statutory construction."[105] Under the second step, if the statute is silent or ambiguous, the court is to defer to any "permissible" ("reasonable") agency determination. Given that section 355 predates the repeal of *General Utilities* and the fact that Congress seemed to believe it necessary to enact statutory changes through section 355(d) through (h) to address some concerns regarding *General Utilities* repeal, a court may decide that Treasury lacks the power to police *General Utilities* repeal through the no-device requirement without a statutory change.[106]

Rather than strain the device test to police the repeal of the *General Utilities* doctrine in addition to its historic dividend avoidance function, Treasury could alternatively use the explicit authority in section 337(d) to issue regulations, perhaps focusing on situations in which, as part of the same plan as a section 355 transaction, a corporation engages in a downstream merger or other transaction allowing the corporate assets to escape corporate taxation.

[104] *Chevron*, 467 U.S. 387 (1984).
[105] *INS v. Cardoza-Fonseca*, 480 U.S. 421, 446 (1987).
[106] The addition of section 355(h) following the release of Notice 2015-59 and Rev. Proc. 2015-43 to address the government's concerns regarding REIT spinoff transactions would seem to support this argument.

Although the language of section 337(d) appears broad enough to permit that action, the level of specificity required to make that guidance useful would likely take significant time to develop. Further, the more specific the guidance, the easier it would be for taxpayers to structure transactions to avoid triggering the guidance.

VIII. Future Transaction Planning

The release of Rev. Proc. 2015-43 is only the most recent instance of the IRS carving back on private letter rulings for spinoff transactions. In 2003 the IRS established a program under which it would no longer rule on inherently factual issues under section 355. The IRS will not rule on whether a proposed or completed distribution of stock is carried out for a corporate business purpose, whether the transaction is being used as a device for the distribution of E&P, or whether the distribution and acquisition are part of a plan under section 355(e).[107]

Since 2003, the IRS has imposed additional limitations on rulings under section 355. In Rev. Proc. 2013-3,[108] the IRS stated that it would no longer issue letter rulings involving the following three areas that implicate the step transaction doctrine: (1) whether transfers of stock, property, or money to a corporation and a later distribution from the corporation (north-south transactions) will be respected as separate transactions; (2) recapitalizations resulting in control through a two-tier voting structure before the spinoff; and (3) leveraged spinoffs in which a distribution of stock or securities is in exchange for, and in retirement of, any debt of Distributing, if the debt is issued in anticipation of the distribution. Also, Rev. Proc. 2013-32[109] provides that the IRS will no longer rule on whether transactions generally qualify for tax-free treatment under section 355 but will instead rule only on significant issues presented.

Despite these carveouts, obtaining a favorable private letter ruling under section 355 on other issues, such as the active trade or business requirement, has remained an important step for many tax practitioners working on spinoff transactions. Because of the limitations that the IRS has placed on private letter rulings, companies generally also need to obtain a favorable legal opinion from counsel regarding the tax-free treatment of the transaction. However, a legal opinion does not carry the same level of certainty as a private letter ruling. Although under current ruling practice, a given letter ruling might address only a single issue in a spinoff transaction, many taxpayers benefit from the ''halo effect'' of a favorable ruling, which results from a belief that the IRS must have, at least implicitly, satisfied itself that the overall transaction was a qualifying section 355 transaction.

With the release of Rev. Proc. 2015-43 and Notice 2015-59, the government has made an already murky area of corporate tax law even more confusing, particularly regarding the role of the no-device requirement. The additional no-rules in Rev. Proc. 2015-43 will put more pressure on legal opinions. However, it is unclear whether a legal opinion will be sufficient for companies planning spinoff transactions that have the characteristics described in Notice 2015-59, and it is unclear how the no-device requirement may be applied to those transactions. Even though the IRS has indicated that any coming guidance will not be retroactive to the release date of Rev. Proc. 2015-43 and Notice 2015-59,[110] both the notice and the revenue procedure express concerns under current law and suggest that the Service may take a broader view of the scope of the no-device requirement in reviewing spinoff transactions by applying a *General Utilities* gloss on the test.[111] Ultimately, the risk will likely be imposed either on law firm professional liability carriers or insurance carriers offering tax indemnity insurance policies to taxpayers.[112] This may also chill the practice of spinoff transactions, depending on the cost of insurance premiums.

What steps can taxpayers take to deal with the uncertainty from being unable to obtain a private letter ruling? To mitigate potential negative consequences of a failed section 355 transaction, taxpayers can make a protective election under section 336(e) to prevent multiple levels of taxation if the transaction does not qualify for tax-free treatment. If Distributing and Controlled make a section 336(e) election, the distribution of Controlled's stock

[107]Rev. Proc. 2003-48, 2003-2 C.B. 86.

[108]2013-1 IRB 113.

[109]2013-28 IRB 55.

[110]Elliott, *supra* note 5.

[111]*See also id.* (Wellen, when asked if the IRS might take a more rigorous view about the business purpose and no-device requirements, said, ''If a transaction comes to our attention and a decision is being made whether to challenge it or what to do about it, I'm not going to guarantee'' how the IRS will interpret the regulations in thinking about the case).

[112]Elliott, ''Greater Reliance on Tax Liability Insurance Raises Questions,'' *Tax Notes*, Oct. 26, 2015, p. 477. *See also* Willens and Harley G.A. Wright, ''Tax-Free Real Estate Spinoffs: Will They Catch On?'' *Tax Notes*, Feb. 4, 2002, p. 619 (stating that the split-off of Plum Creek Timber from Georgia Pacific, and the subsequent merger of Plum Creek Timber with The Timber Company, was initially premised on a favorable private letter ruling from the IRS but was ultimately allowed to proceed ''on the basis of receipt of acceptable tax opinions from both parties' tax counsel and a $500 million insurance policy against tax liability'').

would be treated as an asset disposition and would provide for a basis step-up in Controlled's assets. Also, taxpayers under the jurisdiction of the IRS Large Business and International Division can request that the Service examine specific issues concerning tax returns before those returns are filed. If the taxpayer and the IRS are able to resolve the examined issues before the returns that they affect are filed, Rev. Proc. 2009-14[113] authorizes the taxpayer and the Service to memorialize their agreement by executing a prefiling agreement (PFA). Unlike a private letter ruling, however, a PFA does not determine the tax treatment of prospective or future transactions — only that of completed transactions whose tax treatment has not yet been reported on a return. Thus, although taxpayers could get certainty on the tax treatment of a spinoff transaction more quickly under a PFA than if they waited for the IRS to complete an audit, it would be too late for a taxpayer to change or cancel the transaction if the Service decided that the transaction does not qualify for tax-free treatment under section 355.

IX. Conclusion

The IRS's apparent desire to use the no-device requirement as a tool for policing the repeal of *General Utilities* is troubling in light of the already murky nature of the multifactor device test and the expansion of the Service's no-rule policy under section 355. There is little in the historical development of the no-device requirement indicating that Congress intended for the device test to have anything other than a focus on the avoidance of dividend treatment and the conversion of dividend income to capital gains.

The current situation is undesirable for taxpayers, their counsel, and the IRS. The lack of clear guidance may give companies an incentive to test the bounds of section 355 requirements by participating in riskier spinoff transactions. On the other hand, the increased uncertainty produced by Notice 2015-59 and Rev. Proc. 2015-43 may dissuade more risk-averse taxpayers from participating in spinoff transactions that would otherwise be beneficial and noncontroversial under past standards. Finally, because billions of dollars may be at stake in spinoff transactions, the greater reliance on tax opinions produced by a more uncertain environment will result in potential uncertainty regarding the boundaries between taxpayers and their counsel over who should bear the risk that the transaction will not receive tax-free treatment.

Because the cost of failing to meet section 355 is so significant, taxpayers generally do not engage in spinoff transactions without obtaining a private letter ruling or a legal opinion. However, further clarifying guidance is necessary both to give tax practitioners opining on those transactions greater assurance and to provide a sufficient framework for the IRS to resume issuing rulings on the legal issues surrounding spinoffs. Although importing the policies of *General Utilities* repeal into the no-device requirement would likely require a statutory change, Treasury and the IRS could resolve some of their concerns by (1) revising the section 355 regulations to create additional safe harbors for transactions meeting the requirements in Rev. Proc. 2015-43 and to provide further guidance regarding how the superfactors under reg. section 1.355-2(d)(5)(i) should be applied in the general multifactor device analysis; and (2) issuing a revenue ruling or new examples in the regulations applying the existing multifactor test specifically to the transactions described in Notice 2015-59 and Rev. Proc. 2015-43. That guidance would create greater certainty for all parties involved in the planning of spinoff transactions and allow the IRS to resume issuing rulings on the legal issues surrounding them.

[113]2009-3 IRB 324.