

Reproduced with permission from Daily Tax Report, 160 DTR J-1, 8/18/16. Copyright © 2016 by The Bureau of National Affairs, Inc. (800-372-1033) <http://www.bna.com>

Corporate Reorganizations

Steptoe's Lisa Zarlenga, Cameron Arterton and John Cobb examine the IRS's proposed reorganization rules (REG-134016-15) under Section 355 that would modify current device regulations and add a new minimum size for the active trade or business requirement. The authors break down the more objective standards outlined in the rule proposal and critique some of the requirements.

New Spinoff Standards Proposed in IRS Regulations On Device and Active Trade or Business Under Section 355

BY LISA ZARLENGA, CAMERON ARTERTON
AND JOHN COBB

As foreshadowed in Notice 2015-59 and the accompanying no-rules in Revenue Procedure 2015-43 issued in September 2015, the Treasury Department and the Internal Revenue Service have issued proposed regulations under tax code Section 355.

The proposed rules (REG-134016-15) generally fall into two categories:

- first, rules that would modify the current device regulations to provide more objective guidance on certain device and non-device factors; and

Lisa Zarlenga is a partner in Steptoe & Johnson LLP's Washington office. She serves as co-chair of Steptoe's Tax Group, having returned to the firm after serving nearly four years as tax legislative counsel at the U.S. Treasury Department's Office of Tax Policy.

Cameron Arterton is of counsel in Steptoe's Washington office. Previously, she was deputy tax legislative counsel in the Treasury Department's Office of Tax Policy. Her practice focuses on tax policy and tax controversy matters.

John Cobb is an associate in Steptoe's Tax Group.

- second, rules that would add a new minimum size for the active trade or business requirement.*

Existing Device Regulations

In general, Section 355 doesn't apply to a transaction that is used principally as a device for the distribution of the earnings and profits of the distributing corporation, the controlled corporation or both (a "device"). In other words, if the distribution is a device, it will be taxable to both the distributing corporation and the shareholders.

The existing regulations under Section 355 provide that the determination of whether a transaction was used principally as a device will be made from all of the facts and circumstances, including, but not limited to, the presence of certain device factors and certain non-device factors.

A key purpose of the device requirement is to attack transactions in which shareholders convert dividend income to capital gains. Capital gains have historically been taxed at more favorable rates to individual shareholders, but even in today's environment where the rates are generally the same, the existing regulations

* Significantly, the preamble says that the government continues to study both the active trade or business issues in the proposed regulations and issues relating to the repeal of the "General Utilities doctrine" presented by the separation of business and non-business assets.

also point to recovery of basis as another benefit that capital gains transactions enjoy over dividends.

The device and non-device factors reflect this key purpose by focusing on characteristics of dividends versus capital gains. Specifically, the device factors include:

- pro rata distribution;
- a subsequent sale or exchange of stock; and
- the nature and use of assets, including the existence of assets not used in an active trade or business.

Non-device factors include:

- a corporate business purpose for the transaction;
- the distributing corporation is widely held and publicly traded; and
- the distribution is to domestic corporate shareholders eligible for a dividends-received deduction.

In addition, the existing regulations identify certain transactions that are ordinarily not considered to have been used as a device, notwithstanding the existence of device factors, including a distribution in which neither the distributing nor controlled corporation has earnings and profits (that is, the distribution couldn't be a dividend), and a distribution in which, in the absence of Section 355, the distribution would be a redemption to which Section 302(a) or 303(a) applied (that is, the distribution would already have given rise to capital gains).

The preamble states that, in some situations, insufficient weight has been given to the “nature and use of assets” device factor and the device factors haven’t been balanced correctly against non-device factors.

Notice 2015-59 indicated that the government was particularly concerned about spinoffs in which either the distributing or controlled corporation owns investment assets having substantial value in relation to the value of all of that corporation's assets, and there is a significant difference between the distributing and controlled corporation's ratio of investment assets to non-investment assets.

The preamble to the proposed regulations indicates that the framework of the current rules is sufficient to address these concerns, but Treasury and the IRS believe that certain clarifying changes need to be made. In particular, the preamble states that, in some situations, insufficient weight has been given to the “nature and use of assets” device factor and the device factors haven't been balanced correctly against non-device factors.

As discussed further below, the proposed regulations modify the nature and use of assets device factor, modify the corporate business purpose non-device factor, and add a per se device test.

Nature and Use of Assets Factor

Under the current regulations, the existence of assets that aren't used in a five-year-active trade or business satisfying the requirements of Section 355(b) (an ATB), including cash and other liquid assets that aren't related to the reasonable needs of the business, is evidence of device.

The strength of the evidence of device depends on the facts and circumstances, including the ratio for each corporation of the value of assets not used in an ATB to the value of assets used in an ATB, unless the difference in the ratios is necessary to equalize the values of the stock to be exchanged in the case of a non-pro rata distribution.

Notice 2015-59 and Revenue Procedure 2015-43 further elaborated that the relevant comparison was between assets used in an ATB and investment assets as defined in Section 355(g).

The proposed regulations would shift the focus to the relative proportions of business assets and non-business assets. Business assets would be defined as gross assets used in a business (without regard to whether the business qualifies as an ATB—including the requirements that the business has been operated or owned for at least five years prior to the date of the distribution and that the business include the collection of income and payment of expenses), including reasonable amounts of cash and cash equivalents held for working capital and assets required to be held to provide for exigencies or for regulatory purposes with respect to a business.

The preamble explains that Treasury and the IRS have shifted their focus from investment assets because investment assets may include certain assets that don't raise device concerns, such as cash needed by a corporation for working capital, and may not include other assets that do raise device concerns, such as real estate not related to the taxpayer's business.

The proposed regulations would provide two new thresholds for determining whether the ownership of non-business assets and the differences in the proportion of business/non-business assets held by the distributing and controlled corporations are evidence of device:

- If neither the distributing nor controlled corporation has non-business assets that comprise 20 percent or more of its assets, it is ordinarily not evidence of device.
- If the difference in percentages of non-business assets between the distributing and controlled corporations is less than 10 percent, it is ordinarily not evidence of device. Similar to the existing regulations, if the difference is 10 percent or more, but the difference is attributable to the need to equalize the values of the stock to be exchanged in a non-pro rata distribution, it is ordinarily not evidence of device.

Corporate Business Purpose Factor

Under the current regulations, a corporate business purpose for the transaction is evidence of non-device. The stronger the evidence of device, the stronger the corporate business purpose required to show non-device. Evidence of device presented by non-ATB assets can be outweighed by the existence of a corporate busi-

ness purpose for the transfer or retention of such assets.

The preamble to the proposed regulations states that taxpayers have taken the position that a weak business purpose plus a publicly traded distributing corporation offsets evidence of device presented by a separation of non-business from business assets, a position with which Treasury and the IRS don't agree.

Accordingly, the proposed regulations would modify the business purpose non-device factor to clarify that a business purpose that relates to a separation of business and non-business assets isn't evidence of non-device unless the business purpose involves an exigency that requires an investment or other use of the non-business assets in a business of the distributing corporation, the controlled corporation or both.

Per Se Device Rule

The proposed regulations would also add a new per se device rule if:

- either the distributing or controlled corporation holds 66-2/3 percent or more of non-business assets; and
- a threshold difference in percentages of non-business assets between the distributing and controlled corporations is satisfied.

The threshold difference is a sliding scale, which is satisfied if:

- one corporation has 66-2/3 percent to 80 percent non-business assets and the other has less than 30 percent;
- one corporation has 80 percent to 90 percent non-business assets and the other has less than 40 percent; or
- one corporation has more than 90 percent non-business assets and the other has less than 50 percent.

The preamble indicates that the bands were adopted to provide some leeway in the valuation of assets and in the determination of whether certain assets are business assets.

There are exceptions to the per se device rule if the non-device factor for distributions to domestic corporate shareholders eligible for the dividends-received deduction applies, or if the transaction falls into one of the specified kinds of transactions that ordinarily don't present the potential to be a device (absence of earnings and profits, Section 302(a) transactions and Section 303(a) transactions).

The proposed rule reflects a determination by Treasury and the IRS that if a high enough proportion of assets of the distributing or controlled corporation consists of non-business assets, and if the assets of the other corporation include a much lower proportion of non-business assets, the evidence of device is so strong that non-device factors generally shouldn't be allowed to overcome the evidence of device.

Operating Rules

The proposed device regulations contain certain operating rules for purposes of determining which assets

are business assets and which are non-business assets where the distributing or controlled corporation owns a partnership interest or stock in another corporation.

First, members with respect to which the controlled corporation or the distributing corporation is the common parent of a "separate affiliated group," as defined in Section 355(b)(3) and the regulations for purposes of the ATB requirement, are treated as a single corporation.

Second, a partnership interest generally would be considered a non-business asset. However, if the corporation is considered to be engaged in the business conducted by such partnership for purposes of Section 355(b) (based on the criteria in Revenue Rulings 92-17, 2002-49 and 2007-42), the proposed regulations provide a look-through rule pursuant to which the fair market value of the partnership interest would be allocated between business assets and non-business assets in the same proportions as the assets of the partnership.

Third, a similar rule would apply for stock in a corporation that isn't part of a separate affiliated group under the first rule above. Specifically, such stock is generally considered a non-business asset, except that there is a look-through rule for 50-percent-owned groups.

Finally, the proposed regulations would provide for certain adjustments to prevent distortions from related-party debt.

Minimum Size for Active Trade Or Business Regulations

Section 355(b) doesn't provide for any minimum absolute or relative size requirement for an ATB.

The proposed regulations would add a new requirement that the assets used in an ATB must be at least 5 percent of the total fair market value of the corporation's assets.

Revenue Procedure 96-43 provided that the IRS ordinarily wouldn't issue a letter ruling or determination letter on whether a distribution qualified under Section 355 if the gross assets of the ATB would have a fair market value that was less than 5 percent of the total fair market value of the gross assets of the corporation directly conducting the ATB. However, a ruling could still be issued "if it can be established that, based upon all relevant facts and circumstances, the trades or businesses are not de minimis compared with the other assets or activities of the corporation and its subsidiaries." This no-rule provision was eliminated in Revenue Procedure 2003-48.

Revenue Ruling 73-44 is sometimes cited in support of the proposition that a de minimis ATB satisfies the Section 355(b) requirement. However, the preamble to the proposed regulations notes that Revenue Ruling 73-44 states only that there is no requirement in Section 355(b) that a specific percentage of a corporation's assets be devoted to the ATB, not that any size ATB can satisfy Section 355(b). In fact, the size of the ATB in that ruling represented a substantial portion of the con-

trolled corporation's assets, although less than half of its value.

Nevertheless, Treasury and the IRS believe that Congress intended that Section 355(b) would require that distributions have substance and that a distribution involving only a relatively de minimis ATB shouldn't qualify under Section 355 because such a distribution isn't a separation of businesses as contemplated by Section 355.

The proposed regulations, therefore, would add a new requirement that the assets used in an ATB (including reasonable amounts of cash and cash equivalents held for working capital and assets required to be held to provide for exigencies or for regulatory purposes with respect to an ATB) must be at least 5 percent of the total fair market value of the corporation's assets. In making the determination of the percentage of a corporation's assets that are ATB assets, the look-through rules for partnerships discussed above apply, but the look-through rules for 50-percent-owned corporate groups wouldn't apply, because Treasury and the IRS believe that the separate affiliated group rules provide the exclusive exception for the ATB requirement.

Timing of Asset Identification, Characterization and Value

Under the proposed regulations, the identification of assets held by the distributing corporation or controlled corporation, and the character of such assets, would be determined immediately after the distribution. The fair market value of such assets, however, would be determined, at the election of the parties on a consistent basis, either:

- immediately before the distribution;
- on any date within the 60-day period before the distribution;
- on the date of an agreement with respect to the distribution that was binding on the distributing corporation on such date and at all times thereafter; or
- on the date of a public announcement or filing with the Securities and Exchange Commission with respect to the distribution.

Anti-Abuse Rule

The proposed regulations would also provide an anti-abuse rule under which a transaction or series of transactions (such as a change in the form of ownership of an asset; an issuance, assumption or repayment of indebtedness; or an issuance or redemption of stock) wouldn't be given effect if undertaken with an improper purpose.

Specifically, the anti-abuse rule applies if the transaction is undertaken with a principal purpose of affecting the percentage of non-business assets of any corporation to avoid a determination that a distribution was a device or doesn't meet the new minimum size rule for an ATB.

Other Guidance

Notice 2015-59 and Revenue Procedure 2015-43 also indicate that the IRS wouldn't issue a ruling when either the distributing or controlled corporation makes an election to be a real estate investment trust (REIT). However, Congress effectively shut down REIT spinoffs in the Protecting Americans from Tax Hikes Act of 2015 (Pub. L. No. 114-113), and Treasury and the IRS issued temporary and proposed regulations (T.D. 9770, REG-126452-15) in June to address transactions that avoid the application of the statutory amendments. Accordingly, these regulations don't address REIT spinoffs.

The preamble to the proposed regulations indicates that Treasury and the IRS continue to study issues relating to the *General Utilities* repeal presented by other transactions involving the separation of non-business assets from business assets, and are considering issuing guidance under Section 337(d) to address these issues.

In addition, the preamble states that Treasury and the IRS continue to study the active trade or business issues in the proposed regulations. Thus, it is possible that Treasury and the IRS may issue additional rules in this area.

Conclusion

Overall the proposed regulations seem to provide welcome clarity to the device requirement without upsetting the long-standing framework of the device regulations. However, with respect to the minimum ATB requirement, while a de minimis rule may be appropriate, a 5 percent threshold may be too high, and a lower threshold should be considered. If a percentage as high as 5 percent is desired, there should be a way for taxpayers to prove that their ATB isn't de minimis, similar to the IRS's prior ruling guidelines.

The proposed regulations also place a lot of pressure on the valuation of business and non-business assets. Although the existing regulations require some valuation, the addition of rules requiring specific thresholds or ranges increases the need for accurate valuations and, therefore, the burden of complying with the regulations.

The preamble to the proposed regulations requests comments on a number of issues. Taxpayers may wish to consider the impact of the specific provisions and provide input on these issues for development of the final regulations, including the specific thresholds and the additional burden imposed by value-based rules.