IRS Issues Proposed Regulations on "Device" and "Active Trade or Business" Rules Under Section 355

Background and Executive Summary

On July 14, 2016, the Internal Revenue Service (the "IRS") and the U.S. Treasury Department ("Treasury") issued proposed regulations that are designed to limit taxpayers' ability to engage in tax-free distributions under Section 355 (a "Section 355 Distribution") in situations where either the distributing corporation ("Distributing") or the controlled corporation ("Controlled"), or both, holds a disproportionally large amount of non-business assets (such as cash or a minority position in another corporation) in comparison to its business assets.

The proposed regulations would modify the application of the "active trade or business" test (the "ATB Test") and the "device" test (the "Device Test") under Code Section 355 for transactions occurring on or after the date on which the IRS publishes final regulations.

The IRS had previously indicated its concern with these types of transactions in 2015 when it modified its "no-rule" policy with respect to private letter rulings.[1] Similar concerns also appear to have motivated the IRS's refusal to rule on Yahoo!'s proposed spinoff of its portfolio position in Alibaba together with a small active trade or business.[2]

As described in greater detail below, the proposed regulations would modify the application of the "active trade or business" test (the "ATB Test") and the "device" test (the "Device Test") under Code Section 355 for transactions occurring on or after the date on which the IRS publishes final regulations.[3] The preamble to the proposed regulations emphasizes, however, that the IRS and Treasury believe that the Device and ATB Tests are, in some cases, being inappropriately applied by taxpayers under existing law and that taxpayers have attempted to use Section 355 Distributions in a manner that is "inconsistent with the purpose of [S]ection 355." This guidance strongly supports the view that current IRS and Treasury decision makers have reservations about public Section 355 Distributions in which non-business assets are the dominant asset class in either Distributing, Controlled or both and the fact that the proposed regulations are not effective until issued in final form does not mean these transactions will not be challenged by the IRS on audit. Accordingly, taxpayers currently planning a Section 355 Distribution should carefully consider the potential impact of the preamble to the proposed regulations (as well as the approach taken in the proposed regulations).

The IRS and Treasury also issued Revenue Procedure 2016-40 (discussed in greater detail below) on July 15, 2015, which modifies current IRS ruling practice, and provides a welcome safe harbor, with respect to certain Section 355 Distributions involving "high-vote, low-vote" structures. This pronouncement should give taxpayers pursuing Section 355 Distributions with a dual voting class (high-vote, low-

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vote) capital structure some certainty regarding their ability to collapse the structure in the future, if warranted by market and business considerations.

Proposed Modifications to the Device Test

In order to qualify for tax-free treatment under the Code, a purported Section 355 Distribution must not be used principally as a "device" for the distribution of the earnings and profits of Distributing or Controlled, or both. As a general matter, the Device Test was added to the Code to prevent taxpayers from engaging in Section 355 Distributions that have the effect of converting ordinary dividend income into capital gain as well as which provide for the recovery of tax basis in lieu of the receipt of dividend income. Under current law, whether a Section 355 Distribution constitutes a "device" is based on all the facts and circumstances, including the presence or absence of certain device and non-device factors specified in the regulations.

The preamble to the proposed regulations emphasizes that the IRS and Treasury believe that (i) device remains an important concern even when (as is the case today) capital gains and dividends are generally taxed at the same rate, and (ii) taxpayers have been weighing the device and non-device factors under the Device Test incorrectly in a number of respects. Specifically, the preamble to the proposed regulations notes that the IRS and Treasury believe, under current law, that:

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- Taxpayers are overemphasizing the publicly traded status of distributing corporations as a non-device factor and are putting too much emphasis on what the IRS and Treasury view as "weak" business purposes in the publicly traded context in offsetting the evidence of device resulting from the separation of nonbusiness assets from business assets, even when pressure from public shareholders was a catalyst for the transaction; and

- Device potential generally exists if either Distributing or Controlled has a large percentage of non-business assets or if Distributing's and Controlled's respective percentage of such assets differs substantially.

In light of these concerns, the IRS and Treasury proposed the following modifications to the Device Test:

- Providing that a business purpose involving the separation of business assets from non-business assets fails to rebut evidence of device unless that business purpose relates to the near-term need for the use of such non-business assets in one or more businesses of Distributing, Controlled, or both.[4]

- Adding a new "device" factor that applies when 20 percent or more of the total assets of Distributing or Controlled (or both) consist of non-business assets.

- Adding a new "device" factor that applies when the difference between the nonbusiness asset percentage of Distributing and Controlled is 10 percent or more.

New Per Se Device Rule

The proposed regulations also add a per se rule under which a Section 355 Distribution will be automatically treated as a device if either of Distributing or Controlled flunk specified mechanical tests that compare the ratio of non-business assets to total assets in each corporation, without regard to any of the other device and non-device factors. The per se device rule generally applies when the non-business assets of either corporation equals or exceeds two-thirds of its total assets and is measured by reference to bands in order to avoid or limit valuation disputes.[5]

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For the purpose of determining this ratio, each of Distributing and Controlled will be treated as holding directly the gross assets of each member of its respective "separate affiliated group" and the stock of each such member will be ignored. Stock of a corporation that is not a separate affiliated group member and any partnership interest are generally considered non-business assets unless and to the extent a special look-through rule applies to treat as a business asset a percentage of the fair market value of the stock or partnership interest that is equal to the percentage of such corporation's or partnership's total gross assets that are business assets.[6] The effect of these changes is to make the application of the Device Test more mechanical and rigid and may not take into account all circumstances or good business reasons for certain divisions of assets. It is likely the IRS's and Treasury's perspective that the burdens resulting from, and rigidity of, these mechanical tests are warranted and supportable when more than two-thirds of Distributing's or Controlled's assets consist of non-business assets.

The proposed regulations provide two important exceptions to the per se device rule that should appropriately free most "cash-rich split-offs" to corporate shareholders (that pass muster under Section 355(g)) from the application of such rule. First, the per se device rule does not apply if the distributees in the transaction are domestic corporations that would be eligible for the 80 percent dividend received deduction under Section 243(a) or 245(b) of the Code. Second, the per se device rule ordinarily does not apply to certain transactions with important non-device indicia, described under Treas. Reg. 1.355-2(d)(5), such as transactions in which Distributing and Controlled lack earnings and profits or split-off transactions in which it is clear that the distribution would otherwise qualify as a non-pro rata redemption to all Distributing shareholders under Section 302(a) of the Code, if such transaction was taxable.

Despite the stated intent to make the Device Test more mechanical, the application of the per se device rule will, in practice, require difficult determinations as to the value and character of the assets held by Distributing and Controlled. As a general matter, the proposed regulations look to the ATB rules to determine whether an asset is a business asset or a non-business asset (disregarding certain aspects of those rules that are not relevant to device, including the five-year history requirement) and clarify that cash and cash equivalents can constitute business assets to the extent they represent "a reasonable amount of working capital for one or more Businesses" or are "required (by binding commitment or legal requirement) to be held to provide for exigencies related to a Business or for regulatory purposes with respect to a

Business." The per se device rule does not address, however, the treatment of (1) stock or securities of Controlled that are retained by Distributing for use in related split-offs, debt-for-equity exchanges or debt-for-debt exchanges, or (2) cash "boot" received by a Distributing that will be distributed to Distributing shareholders or creditors pursuant to a plan, although it would be reasonable and appropriate to conclude that each should be disregarded as an asset of Distributing because there is a plan to dispose of such assets.

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Modifications to the ATB Test

The IRS and Treasury also proposed modifying the ATB Test to require that the ATB of each of Distributing and Controlled must represent at least five percent of the fair market value of the respective corporation's gross assets. The preamble to the proposed regulations specifically notes that this new rule is a departure from the IRS's historic ruling position in which a very small trade or business could satisfy the ATB Test.[7]

Although the five-percent ATB requirement appears to overlap with the mechanical per se device rule described above, there are a number of situations in which a taxpayer might avoid running afoul of the per se device rule, and nonetheless fail the five-percent ATB requirement, including:

- Where both Distributing and Controlled have substantial business assets, but only a small percentage of those business assets relate to a five-year ATB;
- Either Distributing or Controlled has minimal business assets (and so would be in "band 3" under the per se device test), but the per se device test is not flunked because 50 percent or more of the other corporation's assets are non-business assets; or
- Distributing or Controlled would fail the per se device test but for the exceptions from the per se device rule described above (e.g., because the distribution, such as a cash-rich split-off, would otherwise be a Section 302(a) redemption).

The proposed regulations do not provide an exception to the five-percent ATB requirement for internal distributions undertaken in anticipation of an external distribution of Controlled stock to, for example, Distributing public shareholders. Internal distributions are frequently necessary in order to organize the appropriate assets within Controlled, prior to an external distribution. Because the five-percent ATB requirement applies to these preparatory internal distributions, taxpayers may have to find ways to move active businesses within a group to meet this requirement, which could prove to be a complex and difficult exercise, depending on the internal structure of the group and the location of the various business assets within the corporate structure.

The proposed regulations also include an anti-abuse rule which will disregard any transaction or series of transactions undertaken with a principal purpose of avoiding the five-percent ATB requirement.

General Utilities Repeal

The preamble to the proposed regulations indicates that the government remains focused on Section 355 Distributions that appear to be motivated in whole or substantial part by a desire to avoid corporate-level gain with respect to non-business assets. The IRS and Treasury have requested comments on whether additional guidance should be issued to address these types of transactions, but the proposed regulations in their current form do not include any rules specifically focused on the circumvention of the repeal of *General Utilities.*

Rev. Proc. 2016-40 and the "Control" Requirement

On July 15, 2016, the IRS and Treasury issued Revenue Procedure 2016-40, which provides a safe harbor with respect to the potential unwind of so-called "high-vote, low-vote" structures put in place at or around the time of a Section 355 Distribution.

Specifically, Rev. Proc. 2016-40 applies to a series of transactions in which (1) Distributing owns an amount of stock of Controlled that does not satisfy the "control" requirement under Section 355 (i.e., 80 percent of the total combined voting power and 80 percent of each non-voting class of stock), (2) Controlled recapitalizes its shares, as a result of which Distributing acquires "control" of Controlled through the creation of high-vote and low-vote classes of stock (the "Recapitalization"), (3) Distributing distributes Controlled stock in a Section 355 Distribution, and (4) in the future, Controlled desires to effectively unwind the dual class structure created in the Recapitalization.

The Revenue Procedure indicates that the IRS will not challenge or otherwise attempt to recharacterize these transactions in a way that results in a failure to distribute "control" so long as either (i) no action is taken by Controlled (or its director or officers) to unwind the Recapitalization at any time prior to 24 months after the distribution, or (ii) the unwind of the Recapitalization results from an unanticipated transaction with a third-party (determined pursuant to technical rules regarding overlapping ownership and the absence of a plan or arrangement to effect the unwind). This guidance provides helpful certainty to taxpayers considering a dual class Section 355 Distribution that there may, in the future, be a pathway to rationalize Controlled's capital structure if warranted by market and business considerations.

Rev. Proc. 2016-40, by its terms, does not appear to apply to a situation in which Distributing owns historic "control" of Controlled and, in order to (i) retain more than 20 percent of the outstanding stock of Controlled to be disposed of in the future following a Section 355 Distribution or (ii) issue more than 20 percent of the stock of Controlled in an IPO prior to a Section 355 Distribution while maintaining such "control," recapitalizes Controlled's shares into a "high-vote, low-vote" structure. IRS officials have, however, taken the position in public forums explaining the safe harbor that Rev. Proc. 2016-40 extends to situations in which Distrib-

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uting historically owned "control" of Controlled and recapitalizes into a dual class structure.[8] The justification for requiring a two year period in order to fit the safe harbor is questionable in a case where there is no argument that Distributing's ownership of control of Controlled was transitory.

In addition to introducing the safe harbor, Rev. Proc. 2016-40 removed from the list of areas on which the IRS will not issue private letter rulings the question of whether Distributing is in "control" of Controlled if, in anticipation of a distribution of Controlled, Distributing acquires putative control of Controlled.

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1 See Rev. Proc. 2015-43, §3 (Sept. 14, 2015). For detailed coverage of the IRS's modification to its no-rule policy, see "IRS Makes Important Changes to Ruling Policy for Spinoffs" (Sept. 2015), available at https://www.kirkland.com/siteFiles/Publications/Alert_091715.pdf.

2 "Yahoo to Pursue Alibaba Stake Spinoff Without IRS Ruling," *The Wall Street Journal* (Sept. 28, 2015), *available at* http://www.wsj.com/articles/yahoo-to-pursue-alibaba-stake-spinoff-without-irs-ruling-1443475940.

3 There is a grandfathering exception for transactions undertaken pursuant to an agreement, resolution, or other corporate action that is binding on or before the date the proposed regulations are finalized, that are described in a ruling request submitted to the IRS on or before July 15, 2016 or that are described in a public announcement or filing with the Securities and Exchange Commission on or before the date the proposed regulations are finalized.

4 In public statements following the issuance of the proposed regulations, IRS officials have indicated that the IRS may be willing to rule with respect to whether a business exigency with respect to the use of non-business assets exists for purposes of applying the Device Test. Amy S. Elliot, *Size Does Matter: Wellen Explains New Hot Dog Stand Regs*, Tax Notes (Jul. 21, 2016) (quoting IRS associate chief counsel (corporate) Robert Wellen saying that he would be "tempted" to be responsive to ruling requests on this issue).

5 We refer to this ratio as the "NBAR." The following table illustrates the application of this rule with respect to each band. The first row represents the NBAR of Distributing or Controlled that is equal to or in excess of two-thirds and the second row reflects the NBAR of the other relevant corporation:

	Band 1	**Band 2**	**Band 2**
NBAR for D or C	66.66% ≤ NBAR < 80%	80% ≤ NBAR < 90%	90% ≤ NBAR
Minimum NBAR permitted for other corporation in order to pass the per se test	30%	40%	50%

[6] This look-through rule generally applies to (i) the stock of a 50 percent owned corporation that is not a member of a separate affiliated group but generally would be a member of a separate affiliated group but for the failure of the requisite 80 percent ownership threshold to be satisfied with respect to such corporation and (ii) interests in partnerships in which Distributing or Controlled is considered to be engaged in the Business conducted by the partnership (using the same criteria that would be used to make this determination for purposes of the ATB Test).

[7] Among other things, the preamble provides that the IRS and Treasury believe that Rev. Rul. 73-44, 1973-1 CB 182 (in which the active trade or business assets of Controlled represented less than 50 percent of its gross assets), which holds that "[t]here is no requirement in section 355(b) that a specific percentage of the corporation's assets be devoted to the active conduct of a trade or business," has been read too broadly. The IRS and Treasury intend to modify Rev. Rul. 73-44 with regard to this statement to clarify that a de minimis ATB cannot satisfy the ATB Test.

[8] Amy S. Elliot, *Size Does Matter: Wellen Explains New Hot Dog Stand Regs*, Tax Notes (Jul. 21, 2016) (reporting IRS associate chief counsel (corporate) Robert Wellen's affirmative response to a question as to whether Rev. Proc. 2016-40 was "intended to cover the situation where Distributing owns 100 percent of Controlled pre-spin but then Controlled issues 30 percent low-vote stock to the public before being spun off, followed by a recap into a single class of stock two years later.").

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