Section 355 Guidance Imposes New Minimum Thresholds for Business Assets and Provides Safe Harbors for Control/Unwind Transactions

Tax Alert
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Background

On July 14, 2016, the Department of Treasury (Treasury) issued proposed regulations under section 355 dealing with the "active trade or business" (ATB) and "device" requirements for spin-off transactions (the Proposed Regulations), and on July 15, 2016, the Internal Revenue Service (IRS) issued Revenue Procedure 2016-40 that provides two safe harbors for unwinding high-vote/low-vote structures following a spin-off. The Proposed Regulations and the Revenue Procedure provide needed guidance in areas that had previously been "no-rule areas" under study by Treasury and the IRS. The safe harbors in the Revenue Procedure are effective immediately. The Proposed Regulations generally will apply to spin-offs occurring on or after the date that they are published as final regulations, with limited relief for pending transactions.

Size Matters -- New Five Percent Threshold for Active Trade or Business

The Proposed Regulations provide that the section 355(b) requirement that each of Distributing and Controlled be engaged in an ATB that has been conducted for the five-year period preceding the spin-off (a Five-Year-Active-Business) will only be met if the fair market value of the assets of the Five-Year Active Businesses is at least five percent of the fair market value of total assets. The preamble to the Proposed Regulations states that a de minimis Five-Year-Active-Business is inconsistent with the congressional purpose for adopting the Five-Year-Active-Business requirement. The Five-Year-Active Business may include a reasonable amount of working capital and assets required to be held to meet regulatory requirements or for business exigencies relating to such business. An interest in a partnership, however, is not treated as a Five-Year Active Business asset unless Controlled or Distributing is considered to be engaged in a Five-Year-Active-Business conducted by the partnership.

Device Test

Existing Treas. Reg. §1.355-2(d)(2)(iv) treats assets that are not used in a Five-Year-Active Business as evidence of device. The Proposed Regulations treat assets that are not used in an ATB as evidence of a device, without regard to whether the ATB satisfies the requirements for a Five-Year-Active Business. To implement this change, the Proposed Regulations introduce a new term: Business Assets. Business Assets are assets used in an ATB, including a reasonable amount of working capital and assets required to be held to meet regulatory requirements or for business exigencies, but without regard to whether the assets meet the five-year requirement for a Five-Year-Active-Business or the collection of income requirement of Treas. Reg. §1.355-3(b)(3). All assets other than Business Assets are defined as Nonbusiness Assets. Partnership interests are treated in the same manner as they are treated under the ATB rules (generally treated as Nonbusiness Assets, unless the Five-Year-Active-Business conducted by a partnership would be attributed to Distributing or Controlled). Corporate stock is generally a Nonbusiness Asset unless it is stock of a member of a separate affiliated group (SAG), or a corporation that would be a SAG member if the threshold were 50 percent instead of 80 percent.

The Proposed Regulations provide that the ownership of Nonbusiness Assets by either Controlled or Distributing is evidence of
device, and the larger the proportion of Nonbusiness Assets to total assets, the stronger the evidence of the device. Similarly, a difference between the percentage of Nonbusiness Assets in Distributing and Controlled is evidence of a device. The Proposed Regulations provide two safe harbors (i.e., will not ordinarily be evidence of a device) if (i) the percentage of Nonbusiness Assets in Distributing and Controlled is less than 20 percent or (ii) the difference between the percentage of Nonbusiness Assets of Distributing and Controlled is less than 10 percent or is attributable to a need to equalize values in a split-off transaction.

Anti-abuse provisions in the Proposed Regulations will disregard any transaction or series of transactions undertaken with a principal purpose of affecting the percentage of Business Assets of any corporation for purposes of the device or the Five-Year Active Businesses requirements. These anti-abuse rules generally will not apply to non-transitory, third party transactions or to a non-transitory transfer of assets between Distributing and Controlled.

**Per Se Device**

The Proposed Regulations treat certain spin-off transactions as a “per se device” meaning they will be taxable without regard to whether there are countervailing nondevice factors. A spin-off will be considered to be a “per se device” if (i) the ratio of Distributing or Controlled’s Nonbusiness Assets to total assets is two-thirds or greater, and (ii) the respective ratios of Distributing and Controlled’s Nonbusiness Assets to total assets differ substantially and fall within one of the following proscribed bands:

- One corporation’s ratio of Nonbusiness Assets is between 66 ⅔ percent and 80 percent and the other corporation’s percentage is less than 30 percent.
- One corporation’s ratio of Nonbusiness Assets is between 80 percent and 90 percent and the other corporation’s percentage is less than 40 percent.
- One corporation’s ratio of Nonbusiness Assets is 90 percent or more and the other corporation’s percentage is less than 50 percent.

This rule is the IRS’s response to recent publicized transactions such as Yahoo’s proposed spin-off of its minority stake in Alibaba. Notably, the per se device rule will not apply to internal domestic spin-offs and to split-off transactions or to certain other transactions not ordinarily considered a device in the current regulations. Accordingly, spin-off transactions that would be subject to the per se device rule will only work if they can be structured as split-off, rather than spin-off, transactions.

**Business Purpose and Device**

The Proposed Regulations limit the circumstances where a corporate business purpose may outweigh evidence of a device. A corporate business purpose that involves the separation of Business Assets from Nonbusiness Assets, regardless of its strength, cannot override pro-device factors, unless the business purpose involves a business exigency that requires using the Nonbusiness Assets in an ATB. In addition, examples in the Proposed Regulations demonstrate that a spin-off may be treated as a device, notwithstanding a strong corporate business purpose, in certain circumstances if there are substantial Nonbusiness Assets or a difference in the ratio of Nonbusiness Assets held by Distributing and Controlled.

**Safe Harbors in Revenue Procedure 2016-40**

Revenue Procedure 2016-40 provides two safe harbors for spin-off transactions in situations where Distributing acquires “control” of Controlled (e.g., through a dual class high-vote/low-vote structure) and Controlled subsequently engages in a transaction that has the effect of restoring to its shareholders’ original voting rights (the Unwind Transaction).
The Revenue Procedure states that the Service will not assert that Distributing’s acquisition of “control” lacks substance if either:
(a) no action is taken (including adopting a plan or policy) within 24 months of the spin-off to effect the Unwind Transaction or
(b) the Unwind Transaction occurs as a result of a third party transaction (e.g., a merger) and there are no agreements, arrangements, substantial negotiations or discussions concerning the third party transaction during the 24-month period ending on the date of the spin-off and no persons own more than 20 percent by vote or value of the stock of both Controlled and the third party.

The Revenue Procedure eliminates the current no-rule area relating to “acquisition of putative control of a corporation,” indicating that this is no longer an area under study. The Revenue Procedure cautions that the Service “may decline to issue a letter ruling addressing an acquisition of control when appropriate in the interest of sound tax administration or on other grounds when warranted by the facts or circumstances of a particular case.”

2. Prop. Reg. § 1.355-9 (b). The fair market value of the Five-Year-Active-Business Assets must be at least five percent of the fair market value of the total gross assets.
3. See Preamble, at 17.
5. If Distributing or Controlled is treated as engaging in a Five-Year-Active-Business conducted by the partnership, then a portion of the fair market value of the partnership interest will be treated as a Five-Year-Active-Business asset based on the proportion of Five-Year-Active-Business assets of the partnership. Prop. Reg. §1.355-9(c)(3).
14. Prop. Reg. § 1.355-2(d)(5). Note that the proposed regulations move paragraph (d)(5) of the current regulations to paragraph (d)(6).
16. Id.

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