

# Tax Alert

## Newly Proposed Regulations Regarding Section 355 Active Trade or Business and Device Requirements

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On July 14, 2016, the Treasury Department and the IRS released proposed regulations (the “Proposed Regulations”) modifying the 5-year active trade or business and “device” requirements for tax-free treatment under Section 355.<sup>1</sup> Among other things, the Proposed Regulations require that the qualifying active trade or business (“ATB”) of both the distributing corporation (“Distributing”) and the distributed subsidiary (“Controlled”) constitute at least 5% of the fair market value of their respective gross assets and impose a new *per se* device test when a distribution involves a disproportionate amount of non-business assets being held by Distributing or Controlled.

### I. Active Trade or Business Requirement

Section 355 provides a limited exception to the general requirement that a corporation must recognize gain when it distributes appreciated stock of a subsidiary to its shareholders if certain requirements are met. One such requirement is that Distributing and Controlled generally must each be engaged, directly or indirectly, in an active trade or business immediately after the distribution (the “ATB Requirement”). To satisfy the ATB Requirement, a trade or business generally must have been actively conducted for five years as of the distribution date, and such ATB must not have been acquired, directly or indirectly, in a taxable transaction within such five-year period.

For a number of years, the IRS required a representation that the gross assets used in the ATB of both Distributing and Controlled comprised at least 5% of the total assets of the corporation directly conducting the ATB unless it could be shown that the ATB was not *de minimis*. The IRS revoked this requirement in 2003, and for a number of years maintained a position that the relative size of an ATB was a device factor only, rather than a factor under the ATB Requirement. The IRS subsequently issued numerous private letter rulings involving distributions where the ATB was *de minimis* in value compared to the other assets of Distributing or Controlled.

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1. All section references are to the Internal Revenue Code of 1986, as amended.

Following highly publicized reports of potential Section 355 distributions involving relatively small ATBs, the IRS announced in 2015 that it was revisiting its position on the issue and that the issue would be added to the “no ruling” list until its review was complete. The Proposed Regulations are product of that study.

### **A. 5% Minimum ATB Requirement**

To satisfy the ATB Requirement, the Proposed Regulations would institute a bright-line rule requiring that the fair market value of the gross assets of Distributing and Controlled used in their respective five-year ATBs (including reasonable amounts of cash for working capital and assets held for regulatory or business requirements) must be at least 5% of the fair market value of their respective total gross assets.<sup>2</sup>

For this purpose and for purposes of the modified device tests described below, Distributing and Controlled must each consistently determine the fair market value of their respective assets as of one of several specified dates. If a consistent determination is not made, then the fair market values of the assets generally will be determined as of immediately prior to the Distribution.

## **II. Device**

Another requirement under Section 355 is that a distribution cannot be used principally as a “device” for distributing the earnings and profits of Distributing, Controlled or both. This determination is based upon a facts and circumstances analysis with certain enumerated factors supporting and others rebutting the treatment of a distribution as a device.

### **A. Nature of Assets of Distributing and Controlled**

Under current regulations, if either Distributing or Controlled holds assets that are not used in a trade or business that meets the ATB Requirements, it is evidence of a device with additional weight given as the respective percentages of non-ATB assets held by Distributing and Controlled diverge, unless the difference relates to equalizing the value of the Distributing stock surrendered in exchange for Controlled stock in a split-off (*i.e.*, a non-pro rata distribution of Controlled stock to Distributing stockholders).

The Proposed Regulations relax this factor in one respect by focusing on “Business Assets,” which are assets used in any active trade or business (including reasonable amounts of cash for working capital and assets held for regulatory or business requirements) regardless of whether such trade or business has been conducted for five years, was acquired in a taxable transaction or meets the income collection test. “Nonbusiness Assets” are assets other than “Business Assets.”<sup>3</sup>

Under the Proposed Regulations, the ownership of Nonbusiness Assets by Distributing or Controlled is generally evidence of device, and the larger the percentage of the fair market value of Distributing or Controlled’s total assets that is comprised of Nonbusiness Assets (the “Nonbusiness Asset Percentage”), or the larger the difference between the Nonbusiness Asset Percentages of Distributing and Controlled, the stronger the evidence of device.

If the Nonbusiness Asset Percentage of both Distributing and Controlled is less than 20% or

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2. For this purpose all members of Distributing’s or Controlled’s 80% “Separate Affiliated Group” as defined by Section 355(b)(3)(B) (“SAG”) are treated as one corporation. Also, if Distributing or Controlled is considered to be engaged in a five-year ATB conducted by a partnership, then a look through rule treats a portion of the partnership interest as an ATB asset in proportion to the fair market value of the ATB assets to the total assets of the partnership.
  3. For this purpose stock and partnership interests are generally treated as “Nonbusiness Assets” except that (1) all members of Distributing’s or Controlled’s SAG are treated as one corporation, (2) a pro rata look through rule applies for partnership interests if Distributing or Controlled is treated as engaged in the active trade or business of the partnership (using the same criteria as under the ATB Requirement) or corporate stock if the corporation would be a member of the SAG of Distributing or Controlled if a 50% ownership threshold (rather than an 80% threshold) were used to determine SAG membership and (3) adjustments would be made to prevent distortion for indebtedness between Distributing and Controlled and any partnership or corporation described in clause (2).

the differences between the Nonbusiness Asset Percentage of Distributing and Controlled is less than 10%, then the ownership, or difference in percentage ownership, of Nonbusiness Assets is generally not evidence of device.

Conversely, the Proposed Regulations treat a distribution as a *per se* device if the following two prong test regarding the Nonbusiness Asset Percentages of Distributing and Controlled is satisfied.

**Distribution a *Per Se* Device if**

<b>Prong 1</b>	<b>Nonbusiness Asset Percentage of either Distributing or Controlled exceeds 66 2/3%</b>	
<b>and</b>		
<b>Prong 2</b>	<b>Nonbusiness Asset Percentage of Distributing and Controlled fall within one of the following 3 bands</b>	
	<i>Distributing or Controlled's Nonbusiness Asset Percentage</i>	<i>Other Corporation's Nonbusiness Asset Percentage</i>
<b>Band 1</b>	66 2/3% or more but less than 80%	Less than 30%
<b>Band 2</b>	80% or more but less than 90%	Less than 40%
<b>Band 3</b>	90% or more	Less than 50%

Finally, the Proposed Regulations would carry over the provisions from the current regulations that specify certain types of distributions that ordinarily are not considered a device (and generally are exempt from the new *per se* rule), including distributions where (1) the stockholder of Distributing would have received a dividends received deduction if Section 355 did not apply to the distribution, (2) Distributing and Controlled have no accumulated earnings and profits at the beginning of the year of the distribution and no current earnings and profits for the year of the distribution as of the date of the distribution, and immediately before the distribution, Distributing does not have built-in gain property that would produce current earnings and profits if distributed, or (3) the distribution would constitute a redemption qualifying as capital

gain (rather than dividend) treatment to each of the Distributing stockholders if Section 355 did not apply.

For purposes of applying the foregoing, rules similar to those for the ATB Requirement described above will be used to determine the date upon which the value and characterization of the assets of Distributing and Controlled will be made.

**B. Corporate Business Purpose**

Under current regulations, the presence of a corporate business purpose for a distribution is generally a non-device factor that can be used to outweigh evidence of device based upon holding non-ATB assets in the facts and circumstances analysis. Treasury believed that taxpayers were improperly taking the position that even a weak corporate business purpose could outweigh substantial evidence of device.

To address this issue, the Proposed Regulations modify the corporate business purposes non-device factor to explicitly state that the stronger the device factors are the stronger and more direct the corporate business purpose must be to overcome such factors. Additionally, if the corporate business purpose for the distribution relates to the separation of Business Assets from Nonbusiness Assets, there must be an exigency requiring an investment of such Nonbusiness Assets in a business of Distributing or Controlled.

**III. Further Study**

The Treasury Department and the IRS continue to study whether tax-free separations of large amounts of nonbusiness assets from business assets should be permitted and may consider issuing additional regulations addressing such transactions.

**IV. Effective Date**

The Proposed Regulations, once finalized, will apply to any distributions occurring on or after the date the final regulations are published. The proposed regulations also provide that the following Distributions will be grandfathered under the prior rules once final regulations are issued: (1) distributions described in a public announcement or SEC filing made, or occurring pursuant to a binding agreement, resolution or other corporate action entered into, on or before the date

final regulations are published and (2) distributions described in a private letter ruling request submitted on or before July 15, 2016.

## V. Conclusion

The Proposed Regulations provide clarity on Treasury's current position on the Section 355 ATB and device requirements, but they will make executing tax-free distributions more challenging if the ATB of either Distributing or Controlled is small relative to its other assets or if either holds a large percentage of

assets that are unrelated to its respective businesses. In particular, the various new requirements that rely upon a determination of the fair market value of certain assets of Distributing and Controlled will require additional planning and consideration regarding the timing of a potential distribution.

Please contact us for advice that is specific to your situation. We would be happy to discuss any aspect of the foregoing and its potential impact on your organization.

If you have questions concerning the contents of this issue, or would like more information about Weil's Tax practice group, please speak to your regular contact at Weil, or to:

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