Proposed Treasury Regulations Raise New Hurdles for Tax-Free Spin-Offs

Skadden

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On July 14, 2016, the Internal Revenue Service (IRS) and Treasury Department proposed new Treasury regulations that, if finalized, would generally become effective for distributions under Section 355 of the Internal Revenue Code (the Code) after publication of the final regulations. The proposed regulations raise a variety of new hurdles for certain tax-free spin-offs that traditionally have been viewed as nonabusive.

If a number of requirements are satisfied, Section 355 allows a corporation (Distributing) to distribute stock and securities in a controlled corporation (Controlled) to its shareholders and security holders without Distributing, its shareholders, or security holders recognizing income, gain or loss on the distribution. Among these requirements, Section 355 provides that the transaction must not be used principally as a device for the distribution of the earnings and profits of Distributing or Controlled or both (the device test) and that Distributing and Controlled each must be engaged, immediately after the distribution, in the active conduct of a trade or business (the active trade or business test). An active trade or business must have been conducted throughout the five-year period ending on the date of the distribution and must not have been acquired, directly or indirectly, within this period in a transaction in which gain or loss was recognized (subject to certain exceptions for intracompany transactions).

Following up on concerns raised in Notice 2015-59, issued on September 14, 2015, the IRS and Treasury indicated in the preamble to the proposed regulations that they believe that (i) certain taxpayers are interpreting Section 355 and the applicable regulations in ways that are inconsistent with the purpose of Section 355, (ii) taxpayers are taking the position that "nondevice" factors in the current regulations can outweigh the substantial evidence of device presented by large amounts of nonbusiness assets in certain distributions, and (iii) Distributing or Controlled should not be able to satisfy the active trade or business test with a *de minimis* active trade or business.

The proposed regulations seek to address these concerns by modifying existing law in two ways: (i) significantly tightening the device test and (ii) adding a minimum relative size requirement to satisfy the active trade or business test, protected by an anti-abuse rule.

Modified Device Regulations

The proposed regulations introduce the concept of Business Assets, which are gross assets used in the active conduct of a trade or business (as defined by the active trade or business test without taking into account the five-year or revenue recognition requirements). They include reasonable amounts of cash or cash equivalents held for working capital and assets held for regulatory or business exigencies. Nonbusiness Assets are gross assets other than Business Assets. Stock in corporations and interests in partnerships are generally Nonbusiness Assets but will be "looked through" or classified proportionately in accordance with the corporation's or partnership's underlying assets where sufficient ownership is present.

The proposed regulations impose a ban on Section 355 qualification for a distribution that is considered to be a *per se* device. With certain exceptions, a distribution is a *per se* device if:

- Nonbusiness Assets comprise two-thirds or more of the total assets of Distributing or Controlled; and
- the transaction falls within one of three bands of percentage comparisons in which a significant disparity exists between the percentage of Nonbusiness Assets of Distributing and Controlled.

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The principal exceptions to *per se* device treatment are for distributions to domestic corporate shareholders (*e.g.*, inside a consolidated group), distributions by corporations without earnings and profits (*e.g.*, S corporations) and distributions that, if taxable to each distributee, would be afforded capital redemption treatment (*e.g.*, certain split-offs).

In addition, the proposed regulations generally find evidence (though not conclusive or *per se* evidence) of device if: (i) at least 20 percent of Distributing's or Controlled's gross assets consist of Nonbusiness Assets (the greater the percentage, the stronger the evidence of device) or (ii) the disparity between the Nonbusiness Assets of Distributing and Controlled is 10 percentage points or more (the greater the disparity, the stronger the evidence of device). The proposed regulations also restrict the use of a corporate business purpose as a factor evidencing that the transaction is not a device in various ways relating to Nonbusiness Assets. Finally, a new anti-abuse rule generally prohibits acquisitions of assets from related parties in order to comply with the new device requirements.

New Active Trade or Business Threshold

Under current law, an active trade or business does not generally need to be any minimum size. In addition, Distributing or Controlled may generally acquire an active trade or business from an affiliate to facilitate a spin-off, even in a taxable transaction. The proposed regulations modify these rules, requiring the gross assets of the five-year active trade or business for each of Distributing and Controlled to comprise at least 5 percent of its gross total assets. Notably, stock in nonaffiliated corporations is treated as a "bad" gross asset for purposes of this test, and partnership interests are subject to bifurcation rules similar to the Business/Nonbusiness Asset rules under the device test. Moreover, a new anti-abuse rule generally prohibits acquisitions of trade or business assets from related parties (whether taxable or tax-free) in order to satisfy such 5 percent standard.

Further Restrictions

The preamble to the proposed regulations indicates that the government is considering further restrictions on divisive transactions involving Nonbusiness Assets under the authority of Section 337(d) of the Code. This might involve further limitations on tax-free split-offs.

Potential Impacts

The broad application of the foregoing rules may make it more difficult to consummate transactions that would traditionally be viewed as nonabusive distributions in a tax-free manner, particularly for certain intercompany spin-offs made to facilitate a public spin. A few examples are:

Partnership With Corporate Subsidiary

Under current law, a partner in a partnership owning a corporate subsidiary may not look to the trade or business of such subsidiary in order to satisfy the active trade or business test, as such corporate subsidiary cannot qualify as a member of Distributing's or Controlled's "separate affiliated group." Under the proposed regulations, however, it may be more challenging for Distributing or Controlled to satisfy the active trade or business test, as the subsidiary's nonaffiliate status would now cause it to be affirmatively treated as a "bad" asset for purposes of both the device and active trade or business tests.

Intercompany Treasury Center

In connection with a carve-out of a multinational business, it is common for a new treasury center to be established within a subsidiary of the new publicly traded Controlled. Such intercompany treasury center would generally hold significant cash, cash equivalents and liquid assets that would be available for use by other members of the group in their normal business operations. While the proposed regulations do allow reasonable amounts of working capital to be characterized as Business Assets, at least a portion of the assets held by such treasury center may be characterized as Nonbusiness Assets under the proposed regulations for many internal spins (intercompany obligations would be disregarded for the external spin if the counterparty is a member of the new publicly traded Controlled's affiliated group). If that is the case, an internal spin of a subsidiary in which the new treasury function resides (directly or indirectly) or of any other subsidiary that has substantial intragroup receivables may prove problematic under the new device test.

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The proposed regulations intend to provide a set of bright-line rules but create unintended uncertainty. Grandfathering rules would apply for distributions made pursuant to a binding agreement, resolution or other corporate action entered into before the date on which the regulations are finalized, for which an IRS ruling was requested before July 15, 2016, or which are described in a public announcement or filing with the Securities and Exchange Commission before the date on which the regulations are finalized. Questions have been raised about how to obtain eligibility for grandfathering for internal spin-offs preparatory to spin- or split-offs by the ultimate parent corporation, which may be addressed by the government before other issues involving the proposed regulations are resolved.

Whether the regulations will be finalized in their proposed form remains to be seen. Meanwhile, taxpayers are advised to carefully review the potential application of these proposed rules to their individual situations.

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