Recent Section 355 Developments

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Agenda

- Background of Section 355 Provisions
- The No Device Requirement
  - Section 355(g)
  - Proposed No-Device Regulations
    - Treatment of Cash and Liquid Assets in Device Analysis
    - Impact on Routine Corporate Finance Decisions
    - Business Purpose as a Nondevice Factor
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- The Active Trade or Business ("ATB") Requirement
  - Proposed "Small" Active Trade or Business Regulations
- Rules Relating to both the Proposed No Device and "Small" Active Trade or Business Regulations
- Evolution of IRS Ruling Policy
- *General Utilities*-Related Concerns
- Recapitalizations into Section 368(c) Control
  - Revenue Procedure 2016-40
- Business Purpose Requirement
- Revenue Procedure 2016-45

Background of Relevant Section 355 Provisions

Section 355 Requirements

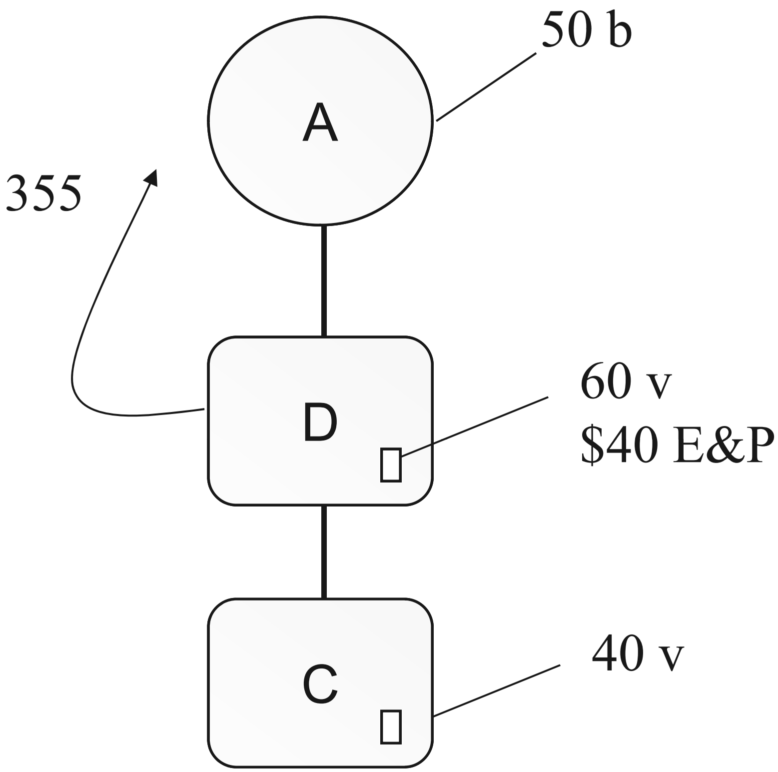
- Statutory Requirements
  - **Control Immediately Before**
  - Distribution of Stock and Securities Constituting Control
  - **Not a Device for Distribution of E&P**
  - **Distributing & Controlled Engaged in an Active Trade or Business**
- **Section 355(g)**
- Section 355(a) Non-statutory Requirements
  - **Business Purpose**
  - Continuity of Shareholder Interest
  - Continuity of Business Enterprise
- Special Corporate-Level Requirements
  - Section 355(d) and (e)

The No Device Requirement

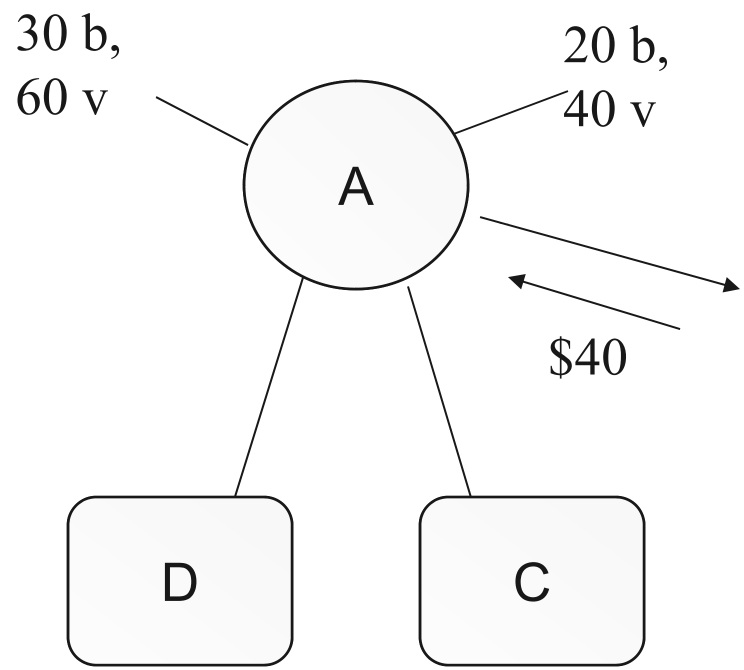
No Device Requirement

- The distribution cannot be used principally as a device for the distribution of the earnings and profits ("E&P") of either D or C.
- Seeks to prohibit bail-out of a corporation's E&P at capital gains rates.

Device – The Concern



Distribution of C
$40 dividend or 355?



IF 355 & sale of C
$20 cap. gains

Relevance to a “Unified Rate” Regime

- When capital gains rates and qualified dividend rates are the same, what is the relevance, if any, of the no device requirement?
  - What if D shareholder(s) have no basis in their D stock prior to spin off?
  - What if D shareholder(s) are eligible for a 0% withholding rate under an applicable income tax treaty?

Device: Facts & Circumstances Analysis

- Device factors (Treas. Reg. section 1.355-2(d)(2))
  - Pro-rata distribution
  - Sale or exchange of D or C after distribution
    - A sale or exchange of D or C stock pursuant to an arrangement negotiated or agreed upon prior to the distribution is substantial evidence of device
  - **D or C has excessive non-business assets**
- Non-Device factors (Treas. Reg. section 1.355-2(d)(3))
  - Corporate business purpose
  - D is publicly traded and no 5% shareholder
  - All distributee corporations entitled to DRD

Treas. Reg. Section 1.355-2(d)(5)(iv) Section 302(a) Transactions

- Treas. Reg. Section 1.355-2(d)(5)(iv)
  - A distribution is *ordinarily* considered not to have been used principally as a device if, in the absence of section 355, with respect to each shareholder distributee, the distribution would be a redemption to which section 302(a) applied.
  - Treas. Reg. section 1.355-2(d)(5)(i) provides that such distributions are ordinarily considered not to have been used principally as a device, notwithstanding the presence of *any* of the device factors described in Treas. Reg. section 1.355-2(d)(2).
  - Treas. Reg. section 1.355-2(d)(5)(i) "ordinarily" protection is not available if the same shareholder(s) receive more than one C in a split off and then one or more C is retained while one or more C is sold (the "Exception"). *See also* Treas. Reg. section 1.355-2(d)(5)(v), Ex. 2.
    - Exception presumably concerned with economically similar transaction where D splits off C where C has 2 or more businesses and then C contributes a business to C1 and spins off C1 pro rata to the shareholders split off from D.
- What does "ordinarily" mean? Is the exception to such language limited to the Exception? Is the allocation of E&P under Treas. Reg. section 1.312-10 evidence of device because it potentially enables future distributions to result in a smaller dividend?

Device (Cont'd): Nature & Use of Assets Treas. Reg. Section 1.355-2(d)(2)(iv)

- General Rule
  - The determination of whether a transaction was used principally as a device will take into account the nature, kind, amount, and use of the assets of D and C (and corporations controlled by them) immediately after the transaction.
- Non-Qualifying Assets
  - The existence of assets that are not used in a trade or business that satisfies the ATB requirement ("Non-Qualifying Assets") is evidence of device.
  - Examples include cash and other liquid assets that are not related to the reasonable needs of the ATB.
- The higher the ratio for each corporation of the value of Non-Qualifying Assets not used to the value of ATB-qualifying assets, the more evidence of device.
- In a split off, liquid assets used to equalize values *ordinarily* is not evidence of device.

Device (Cont'd): Treas. Reg. Section 1.355-2(d)(4), *Ex. 4*

- Background: Corporation X is engaged in a regulated business in State M and owns all of the stock of corporation Y, which is not engaged in a regulated business in State M. State M has recently amended its laws to provide that affiliated corporations operating in M may not conduct both regulated and unregulated businesses.
- X purchases operating assets unrelated to the Y business and transfers them to Y. X then distributes the Y stock pro rata among X's shareholders.
- As a result of the transfer of the recently acquired operating assets, the ratio of the value of its Non-Qualifying Assets to the value of its ATB-qualifying assets is substantially greater for Y than for X.
- There is no other evidence of device or evidence of nondevice.
- Conclusion: The transaction is considered to have been used principally as a device.

Nature & Use of Assets: Related Function Treas. Reg. Section 1.355-2(d)(2)(iv)(C)

- There is evidence of device if the D (or C) business is:
  - A "secondary business" that continues as such for a significant period after the spinoff, and
  - Can be sold without adversely affecting the business of C (or D)
- A secondary business is a D (or C) business that's principal function is to serve the C (or D) business.
- The activities of the secondary business may consist of providing property or performing services.

Related Function Example
Treas. Reg. Sections 1.355-2(d)(2)(iv)(C), -3(c) (*Ex. 11*)

- Background: For the past eight years, corporation X has been engaged in the manufacture and sale of steel and steel products. X owns all of the stock of corporation Y, which, for the past six years, has owned and operated a coal mine for the sole purpose of supplying X's coal requirements in the manufacture of steel.
- Transaction: X distributes the stock of Y to X's shareholders where X and Y each satisfy the ATB requirement.
- The coal mine's principal function of supplying X's coal requirements continued after separation and the coal mine could be sold without adversely affecting X's steel business.
- Conclusion: Evidence of device exists.

Relevance of Business Purpose to No Device Requirement: Treas. Reg. Section 1.355-2(d)(3)(ii)

- The corporate business purpose for the transaction is evidence of nondevice.
- The stronger the evidence of device, the stronger the corporate business purpose required to satisfy the no device requirement.
- The transfer or retention of Non-Qualifying Assets can be outweighed by the existence of a corporate business purpose for such transfers or retentions.
- Strength of a corporate business purpose will be based on all of facts and circumstances, including, but not limited to, the following factors:
  - The importance of achieving the purpose to the success of the business;
  - The extent to which the transaction is prompted by a person not having a proprietary interest in D or C, or by other outside factors beyond the control of the D; and
  - The immediacy of the conditions prompting the transaction.

Section 355(g)

Section 355(g)

- Section 355 will not apply if:

  (A) Immediately after the transaction, either D or C is a Disqualified Investment Corporation ("DIC"), and

  (B) Immediately after the transaction, any person owns a 50 percent (vote or value, applying section 318 attribution) or greater interest in any DIC, but only if such person did not hold such an interest in such corporation immediately before the transaction.

- When describing "current law," the House Report briefly discusses the device requirement limiting its discussion to describe the section 302(a) ordinarily no device exception.

Disqualified Investment Corporation Definition

- D or C is a DIC if 2/3 or more of the FMV of all of its assets constitutes investment assets.
- "Investment Assets" include:
  - Cash, stock or securities, certain partnership interests, debt, options, forward or futures contract, notional principal contract, derivative, foreign currency, or any similar asset.
  - **Look-through rule when ownership of at least *20%* of the vote and value in lower-tier corporate subsidiaries.**
  - Exception for certain assets used in financial trade or business, certain mark-to-market assets.

Proposed No-Device Regulations

The Proposed Regulations

The Proposed No-Device Regulations include several new provisions, including the following:

- The "nature and use of assets" factor of the No Device Requirement now distinguishes between **Business and Nonbusiness Assets** (each as defined below) **rather than active trade or business ("ATB") and non-ATB assets**.
- Guidance is provided regarding the determination of when the **presence of Nonbusiness Assets** or a **difference between the ratios** of the Business Assets to Nonbusiness Assets of Distributing and Controlled ("D" and "C," respectively) constitutes evidence of device.
- A ***per se* device rule** is provided for certain situations involving large quantities of Nonbusiness Assets and a large difference between the ratios of the Business Assets to Nonbusiness Assets of D and C.
- A business purpose that relates to the separation of Business Assets from Nonbusiness Assets may no longer be evidence of nondevice.
- An anti-abuse rule and various operating rules are included (discussed below after the slides on the "Small" ATB Exception).

New Definitions

The Proposed Regulations add the following defined terms:

- **Business.** "Business" generally means the active conduct of a trade or business for Section 355(b) purposes without regard to certain requirements, such as the five-year active conduct requirement and the collection-of-income requirement.
- **Business Assets.** "Business Assets" of a corporation are its gross assets **used** in one or more Businesses.
  - Cash and Cash Equivalents. Strict test for characterizing cash and cash equivalents as "Business Assets." See discussion below.
- **Nonbusiness Assets.** "Nonbusiness Assets" of a corporation are its gross **assets other than Business Assets**.
- Total Assets. "Total Assets" of a corporation are its Business Assets and its Nonbusiness Assets, collectively.
- **Nonbusiness Asset Percentage.** The "Nonbusiness Asset Percentage" of a corporation is the percentage determined by dividing the fair market value ("*FMV*") of its Nonbusiness Assets by the FMV of its Total Assets.

Evidence of Device
Presence of Nonbusiness Assets & Proportionality

Presence of Nonbusiness Assets and their relative proportions can constitute evidence of device. ***See* Prop. Treas. Reg. section 1.355-2(d)(2)(C).**

- Magnitude of Nonbusiness Assets
  - **Ownership of Nonbusiness Assets by D or C is evidence of device.**
  - The strength of the evidence will be based on all the facts and circumstances, including the Nonbusiness Asset Percentage for each corporation.
  - The larger the Nonbusiness Asset Percentage of either corporation, the stronger is the evidence of device.
  - **Favorable Presumption:** Ownership of Nonbusiness Assets **ordinarily** is not evidence of device if the Nonbusiness Asset Percentage of **each** of D and C is less than **20 percent**.
- Proportionality of Nonbusiness Asset Percentages
  - **A difference between the Nonbusiness Asset Percentage of D and the Nonbusiness Asset Percentage of C is evidence of device**, and the larger the difference, the stronger is the evidence of device.
  - **Favorable Presumption:** Such a difference **ordinarily** is not itself evidence of device (but may be considered in determining the presence or the strength of other device factors) if—
    - The difference is **less than 10 percentage points**; or
    - **Exception for split-off to equalize values**.

Corporate Business Purpose: Evidence of device presented by ownership of Nonbusiness Assets, or the difference between the Nonbusiness Asset Percentages for D and C, can be outweighed by a corporate business purpose ***for the ownership or the difference***. ***See* Prop. Treas. Reg. section 1.355-2(d)(3)(ii).**

Addition of "Per Se" Device Test

Prop. Treas. Reg. Section 1.355-2(d)(5)

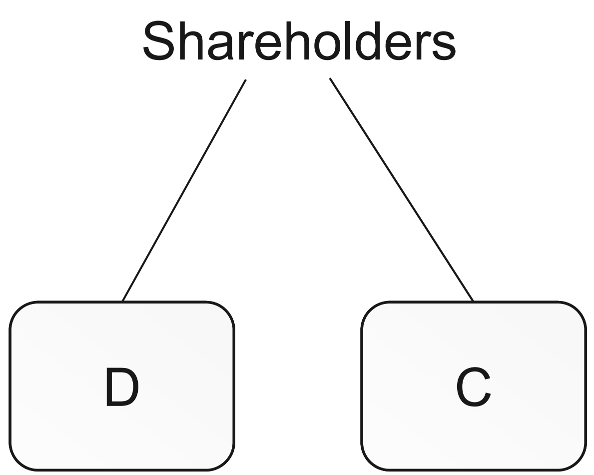
- The Proposed Regulations add a "*per se*" test (the "*Per Se Test*"), which provides that a distribution is considered to have been used principally as a device, notwithstanding the presence of nondevice factors, where 2 requirements are met:
  - the **Nonbusiness Asset Percentage** of **either** D or C is **66 ⅔ percent or more**; **and**
  - a specified level of disproportionality exists between D's and C's Nonbusiness Asset Percentages as follows:
    - **Nonbusiness Assets between 66 ⅔ percent and 80 percent.** Both (1) the Nonbusiness Asset Percentage of either D or C is greater than or equal to 66 ⅔ percent and less than 80 percent and (2) the Nonbusiness Asset Percentage of the other corporation is less than 30 percent;
    - **Nonbusiness Assets between 80 percent and 90 percent.** Both (1) the Nonbusiness Asset Percentage of either D or C is greater than or equal to 80 percent and less than 90 percent and (2) the Nonbusiness Asset Percentage of the other corporation is less than 40 percent; or
    - **Nonbusiness Assets 90 percent or Above.** Both (1) the Nonbusiness Asset Percentage of either D or C is greater than or equal to 90 percent and (2) the Nonbusiness Asset Percentage of the other corporation is less than 50 percent.
- Significant departure from the existing facts-and-circumstances model of the current Regulations (particularly given the strict definition of "Business Assets").

Exceptions to the Per Se Test

- Exceptions to the Per Se Test exist for two categories of transactions:
  - Dividends Received Deduction. Distributions to corporations that, if Section 355 did not apply, would result in an 80-percent or 100-percent DRD.
  - Certain Presumptively Good Transactions. As provided above, certain distributions are "ordinarily" not considered to have been used principally as a device.
    - Absence of earnings and profits ("*E&P*")
    - Capital gain treatment in the absence of Section 355 with respect to **each** distributee
- Compare the 80-percent DRD exception to transactions that do not fully meet the test for presumptively good transactions:
  - The 80-percent DRD exception allows for the potential to convert 20 percent of the value of C stock into capital gain (including the potential basis recovery on a subsequent stock sale), yet the exception applies.
  - In contrast, if 20 percent of the distributee shareholders in a split-off would not have received capital gain treatment, the exception does not apply.
    - Question: Should the exception be expanded to include any distribution which, in the absence of Section 355, would result in dividend income with respect to 20 percent or less of the distributed shares?

Per Se Device Test
Examples

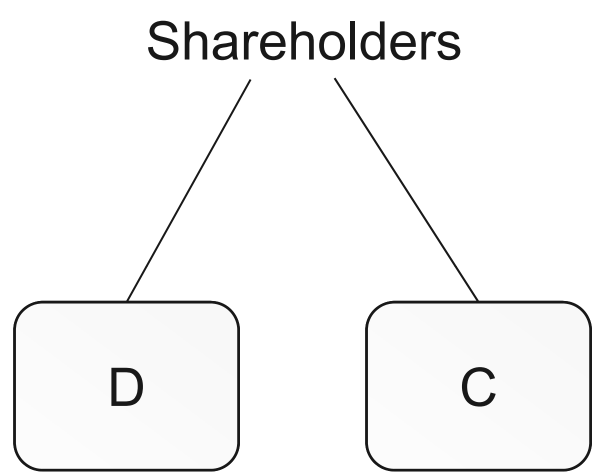
"Per Se" Device



Nonbusiness Asset Percentage of 85%

Nonbusiness Asset Percentage of 35%

Not "Per Se" Device
Facts-and-Circumstances Test Applies



Nonbusiness Asset Percentage of 75%

Nonbusiness Asset Percentage of 35%

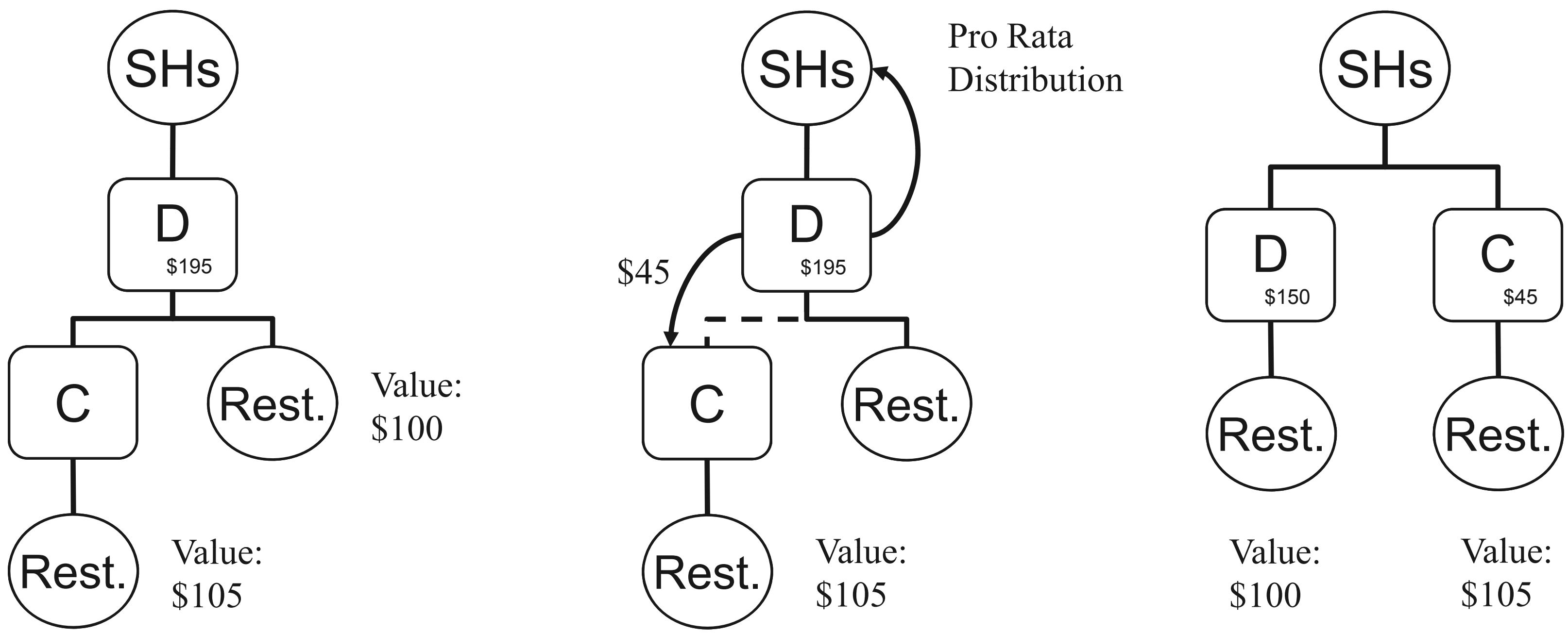
Treatment of Cash and Liquid Assets in Device Analysis

Device Analysis
Treatment of Cash and Cash Equivalents ("Per Se" Test)

- **Working Capital.** Business Assets include cash and cash equivalents held as a reasonable amount of working capital for one or more Businesses.
- **Required for Exigencies.** Business Assets "include" assets **required (by binding commitment or legal requirement)** to be held to provide for (1) **exigencies related to a Business** or (2) **regulatory purposes** with respect to a Business.
  - Does the use of "include" suggest that an asset in certain situations may constitute a Business Asset even if its holding is not a "requirement"? ***But see*** **Prop. Reg. Example 4.**
  - What about an asset not required by law to be held for regulatory purposes, but nonetheless is held for the purpose of maintaining a constructive relationship with regulators?
- **Securing Financial Obligations.** Business Assets "include:"
  - assets that the holder is **required** (by binding commitment or legal requirement) to hold to secure or otherwise provide for a financial obligation **reasonably expected to arise** from a Business; and
  - assets held to implement a binding commitment to expend funds to expand or improve a Business.

Division of Nonbusiness Assets – Device

Prop. Reg. Example 2: Disproportionate Division of Nonbusiness Assets



Facts:

- D operates a restaurant with a value of $100, and C operates a restaurant with a value of $105. D also has $195 cash, which D holds as a Nonbusiness Asset.
- C will lose its franchise if it remains a subsidiary of D. The franchise is about to expire.
- D will be forced to relocate within **24 months** and, while D has not made any plans, it is **weighing its option** to purchase a building for the relocation.
- D contributes $45 to C, which C will retain, and distributes the stock of C pro rata among D's shareholders.

Division of Nonbusiness Assets – Device

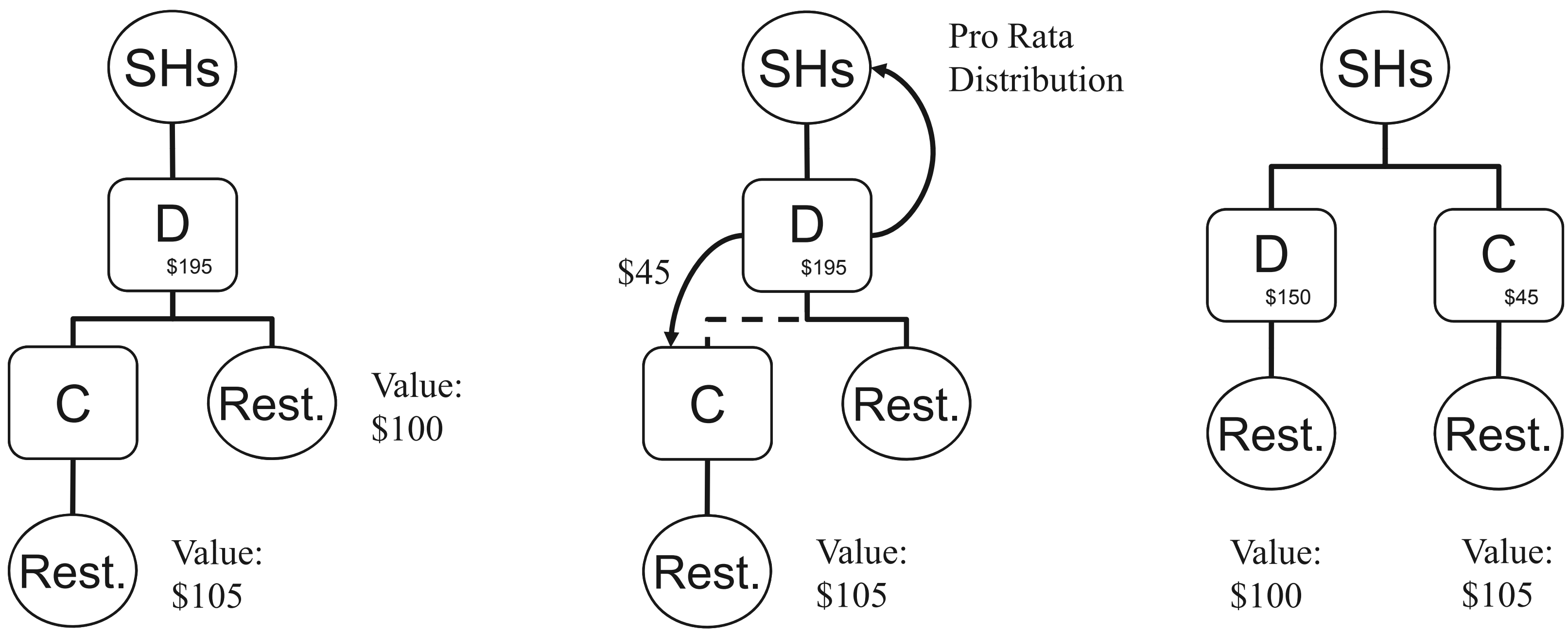
Prop. Reg. Example 2: Disproportionate Division of Nonbusiness Assets (cont'd)

Analysis:

- The Nonbusiness Asset Percentage for each of D and C exceeds 20 percent and is evidence of device.
  - Nonbusiness Asset Percentage of D = 60 percent ($150/$250).
  - Nonbusiness Asset Percentage of C = 30 percent ($45/$150).
- The difference between D's Nonbusiness Asset Percentage and C's Nonbusiness Asset Percentage exceeds 10 percentage points (it is 30 percentage points), which is also evidence of device.
- The corporate business purpose for the distribution is evidence of nondevice.
  - <u>However</u>, no corporate business purpose exists for the difference of Nonbusiness Asset Percentages because the purchase that is being considered is "<u>**not required by any exigency**</u>."
- The fact that the distribution is pro rata is also evidence of device.
- <u>Conclusion</u>: <u>Device</u>.

Division of Nonbusiness Assets – Nondevice

Prop. Reg. Example 4: Disproportionate Division of Nonbusiness Assets



Facts:

The facts are the same as in Prop. Reg. Example 2, except that:

- The lease for the State M location will expire in **6 months** instead of 24 months; and
- D **will use** $80 of the $150 cash it retains to purchase a nearby building for the relocation.

***See* Prop. Treas. Reg. section 1.355-2(d)(4), Ex. 4**

Analysis:

- Nonbusiness Asset Percentage of each of D and C exceeds the 20-percent presumption threshold and is evidence of device (60 percent for D; 30 percent for C).
- The difference between Nonbusiness Asset Percentages (60 percent versus 30 percent) is also evidence of device.
- D's corporate business purpose for a significant part of the difference of Nonbusiness Asset Percentages is evidence of nondevice because D's committed use of such Nonbusiness Asset is "**required by business exigencies**."
- **Conclusion: No device.**

Division of Nonbusiness Assets – Nondevice

Prop. Reg. Example 4: Disproportionate Division of Nonbusiness Assets (cont'd)

- **Unaccounted-for cash; Emphasis on Proportionality.** No device, even though D and C have cash not designated for any particular corporate business purpose, the amount of which is equal to 28 percent, and 30 percent, of their respective assets.
- **Required by Business Exigency.** Prop. Reg. Examples 2 and 4 indicate that the facts-and-circumstance analysis for cash employs a "required by a business exigency" standard (although not a binding commitment or legal requirement like the Per Se Test).
  - Consideration of use of cash within 12 months is insufficient (*See* Prop. Reg. Example 2), but certainty of use of cash within 6 months is sufficient (*See* Prop. Reg. Example 4).
  - **Probability of Use of Cash.** How certain does the use of cash have to be to meet the standard? Is a "reasonable expectation" enough? What about a "significant possibility"? If so, a clarification would be desirable.
  - **Timing Standard.** Consider the importance of the reference to "6 months" in light of past guidance suggesting a 12-month period.
    - <u>See</u> Rev. Proc. 96-30 (Appendix A), which enumerates a number of business purposes generally based on a 12-month period.
- **Are the Proposed Regulations intended to impact routine corporate finance decisions?**

Impact on Routine Corporate Finance Decisions

Impact of Disproportionality

Hypothetical 1: Influence on Routine Corporate Finance Policy

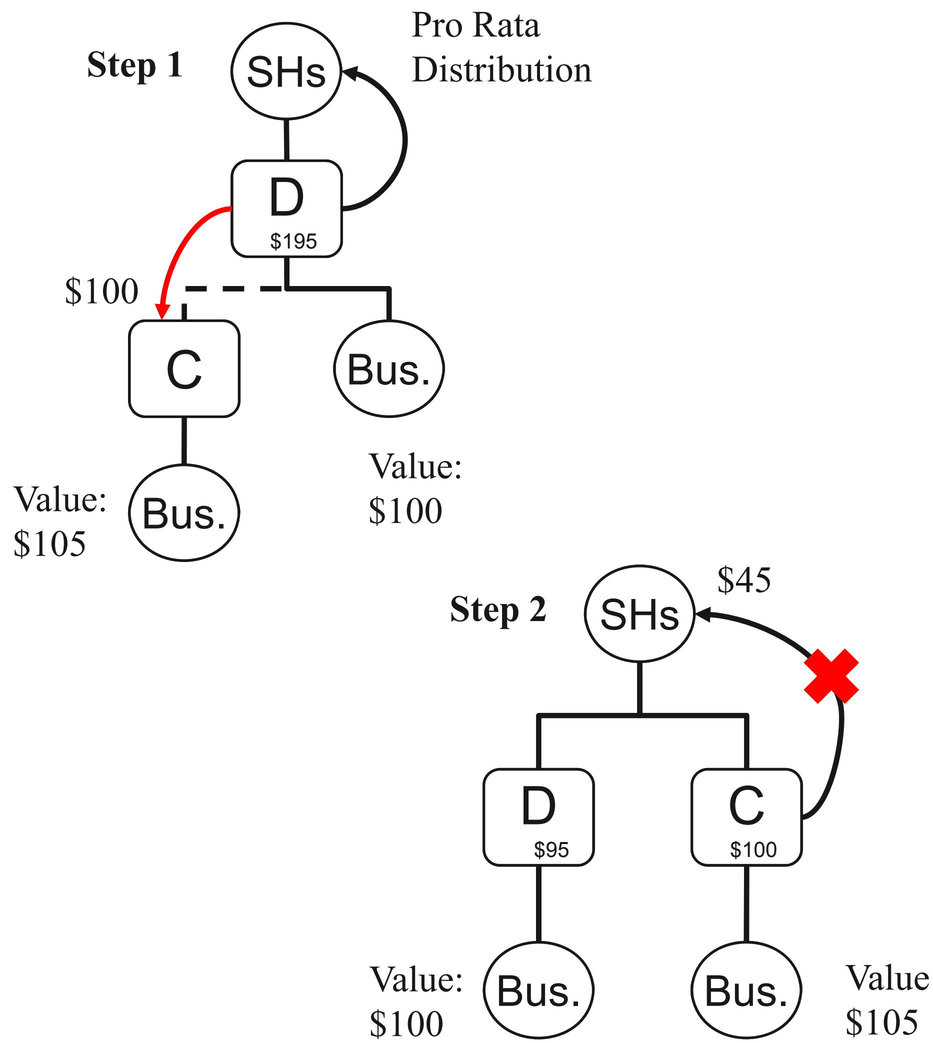
Facts:

Consider the same facts as Prop. Reg. Example 2, except that:

- D has a ***reasonable expectation*** to use such cash in its Restaurant business ***within 18 months***, and D's management would keep D's cash at D to avoid the potential for future overleveraging or a dilutive public offering.
- **C has no use for additional cash** and is expected to generate excess cash in the future.
- The Proposed Regulations create uncertainty as to whether such reasonable expectation is sufficient.

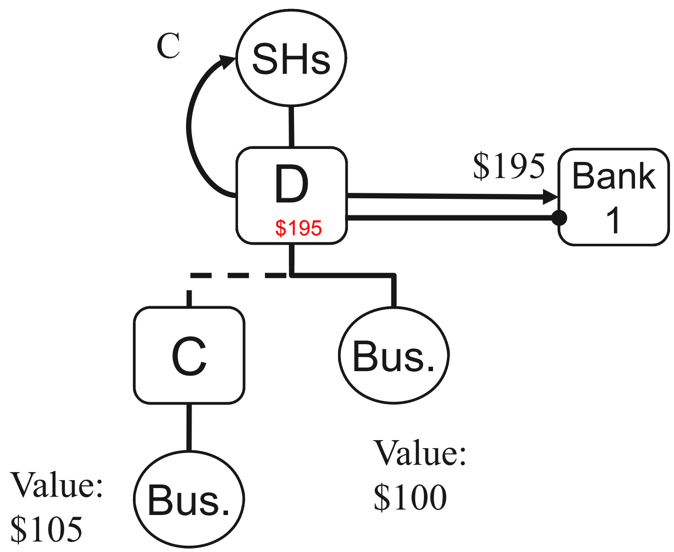
Questions:

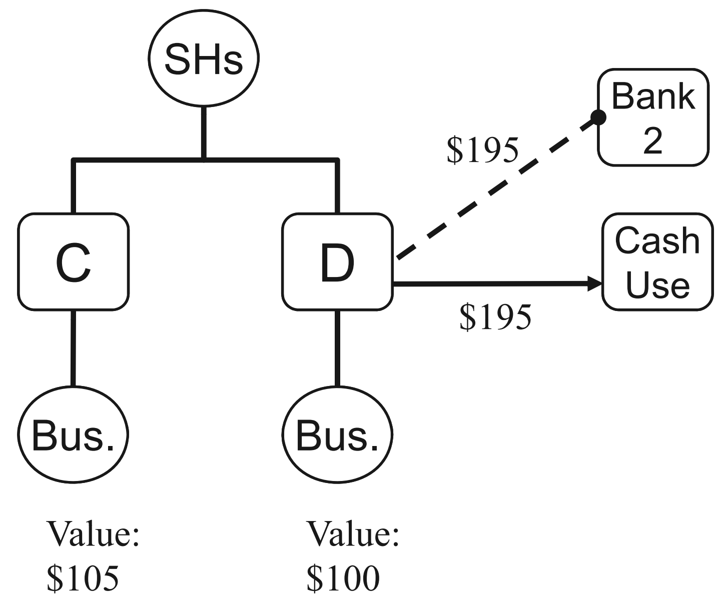
- **Overarching Issue: Must D reduce its cash to qualify under Section 355 and risk becoming overleveraged later?**
- **Option 1:** D pays a cash dividend to its shareholders, which clearly would eliminate the issue.
- **Option 2:** As depicted to the right, could D contribute a proportionate amount of cash to C even though C has no use for the cash (preferable to Option 1 but also undesirable)? This approach will cure disproportionality but significant Nonbusiness Assets will remain. *See* Prop. Reg. Example 4.
- **Anti-Abuse Rule:** Consider the need for a tax sharing agreement to force C to keep this cash for which it has no use.
  - **Note:** The Anti-Abuse Rule may prohibit a post-spin-off distribution by C.



Hypothetical 2:

Anti-Abuse Rule & Business Judgment





Facts:

Consider the same facts as Hypothetical 1, except that:

- D has preexisting debt to Bank 1 which it repays.
- D makes the repayment with the understanding that it may have to borrow in the future to finance its anticipated (but not firm) expansion plans.

Questions:

- If D borrows in the future pursuant to its reasonable expectation existing at the time of repayment, would the Anti-Abuse Rule (discussed below) apply on the theory that the repayment was "transitory"?
- Would it matter if the "old and cold" and new borrowings were carried out pursuant to the same revolver?
- If the Anti-Abuse Rule is inapplicable, why should D have to incur expenses associated with debt repayment and new borrowings?

Business Purpose as a Nondevice Factor

New Corporate Business Purpose Limitation

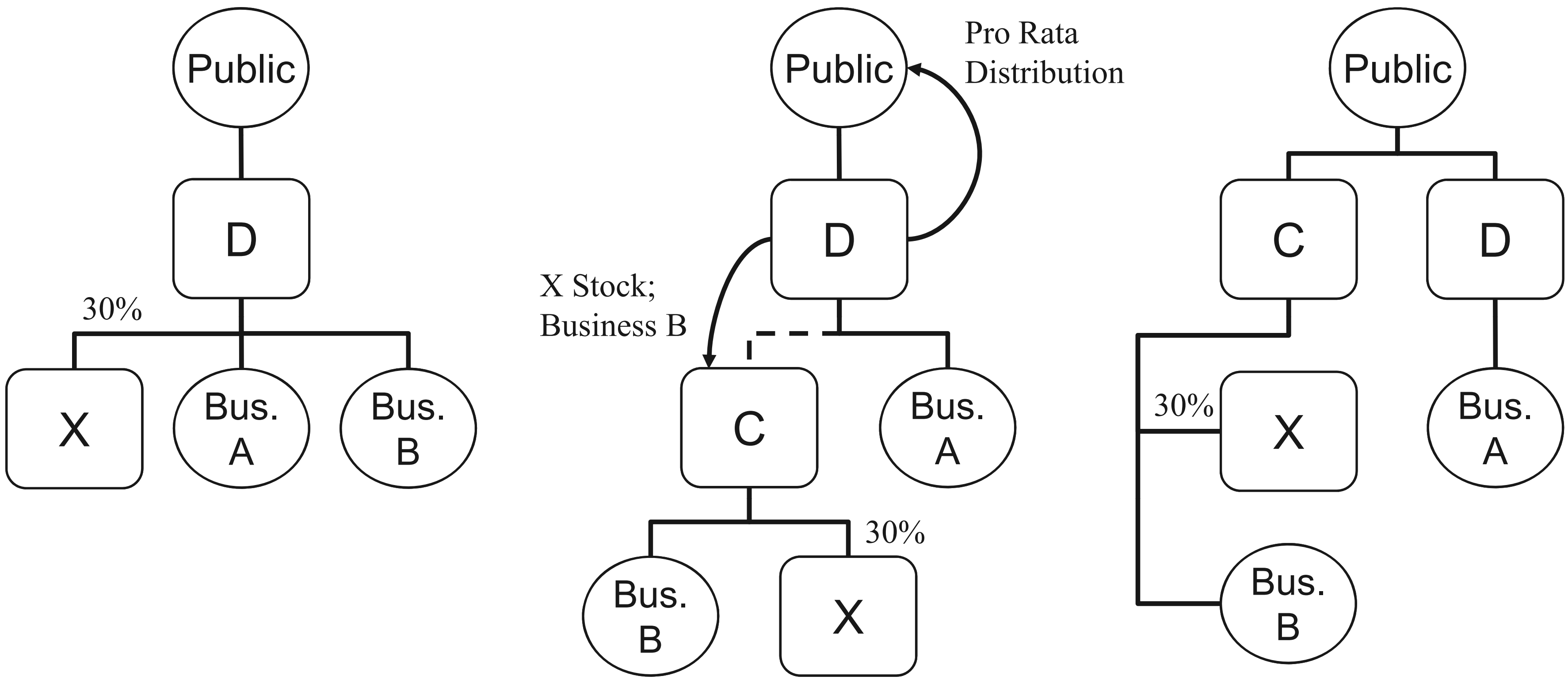
A corporate business purpose that relates to a separation of Nonbusiness Assets from one or more Businesses or Business Assets is not evidence of nondevice unless the corporate business purpose involves *an exigency requiring an investment or other use of the Nonbusiness Assets* in one or more Businesses of D or C, or both.

- No other corporate business purpose can offset such a device factor notwithstanding how significant the corporate-level benefits may be for D or C (and notwithstanding the absence of any shareholder-level purpose).
- The fact that the corporate business purpose completely and compellingly explains the Nonbusiness Assets is not otherwise taken into account.
- The significance of the corporate-level benefits to the ATB is not taken into account.

Prop. Treas. Reg. section 1.355-2(d)(3)(ii)

New Corporate Business Purpose Nondevice Limitation

Hypothetical 3: Required Disposal of Nonbusiness Asset



Facts:

- D is a widely held corporation that conducts Business A and Business B, and also owns 30 percent of the stock of X; each of Business A and Business B has a FMV approximating the value of the X stock that D owns.
- Pursuant to an anti-trust order, D must either dispose of its X stock or significantly curtail its operations of Business A.
- To comply with this anti-trust order, D contributes Business B and its X stock to C and distributes the C stock pro rata to its shareholders.

New Corporate Business Purpose Nondevice Limitation

Hypothetical 3: Required Disposal of Nonbusiness Asset (cont'd)

Analysis:

- The anti-trust order, and damage that otherwise would result to D's ATB, cannot be taken into account as evidence of nondevice to offset the Nonbusiness Asset device factor, even though the corporate business purpose is compelling and completely explains the existence of the device factor.

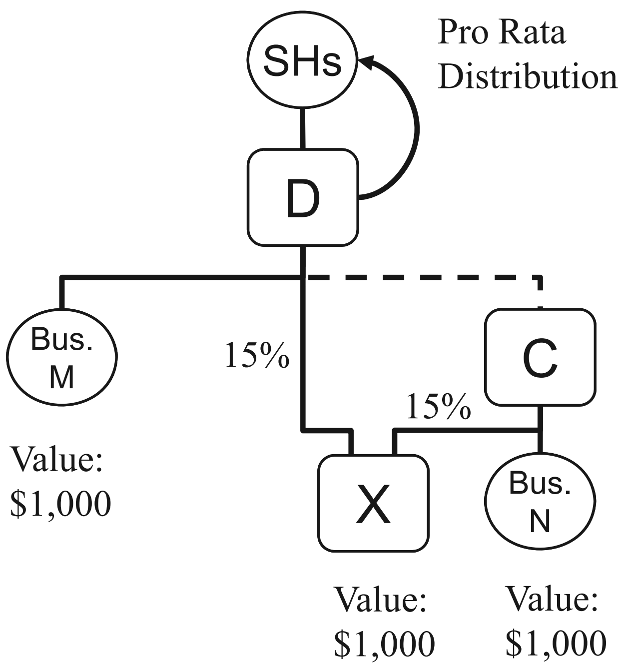
Questions:

- The substantial business purpose relating to the impending substantial damage to Business A meaningfully distinguishes this fact pattern from a Gregory-type fact pattern referenced in the Proposed Regulations' preamble. Why should the purpose no longer be relevant to the device analysis, as it otherwise would be under the facts-and-circumstance analysis of the current Regulations?
- **Publicly Traded/ No Five-Percent Shareholder Nondevice Factor.** Can the publicly traded nondevice factor outweigh this evidence of device where no corporate business purpose for the distribution is to facilitate sales by any shareholders?
  - The fact that the shareholders readily could sell their stock of C or D on the public market regardless of any disproportionality in Nonbusiness Assets is supportive of a conclusion that the purpose for the disproportionality is something other than to facilitate sales.

New Corporate Business Purpose Nondevice Limitation

Hypothetical 4: Incremental Benefit Creating Device Uncertainty

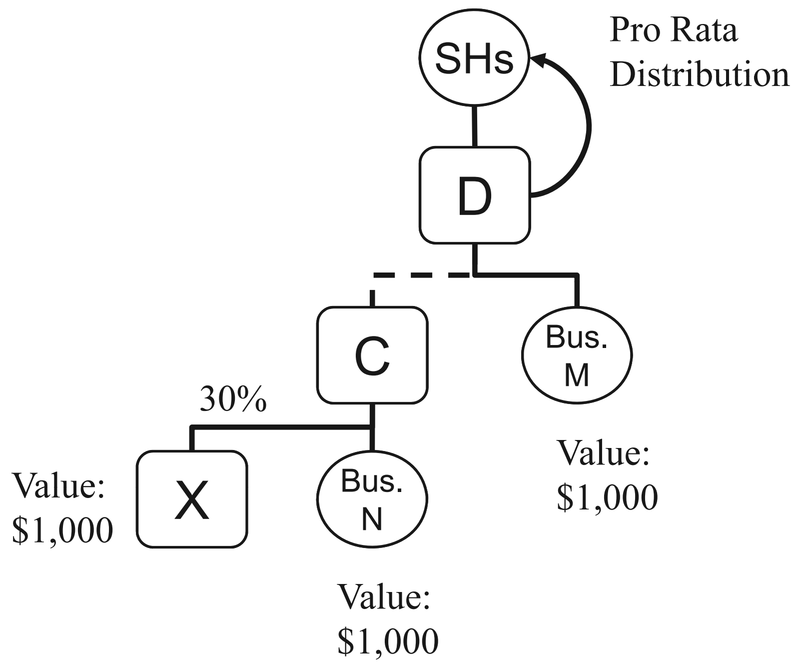
Scenario 1: Regulatory-Motivated Spin-Off



Facts:

- D has three groups of assets: Business M and Business N, each of which comprises Business Assets worth $1,000, and 30 percent of the stock of X, a Nonbusiness Asset which has a value of $1,000.
- D proposes to separate Business N from Business M solely to achieve a $50 regulatory benefit for Business M. In addition to contributing Business N to C, D also contributes half of its X stock to C so as to allocate its Nonbusiness Assets on a pro-rata basis.
- No device.

Scenario 2: Incremental Regulatory Benefit



Facts:

- Same as Scenario 1, except that a complete separation of the stock of X from Business M will result in an incremental $100 regulatory benefit to Business M.
- D's sole motivations for the spin-off of Business N and the X stock are (1) the same $50 risk-reduction benefit in Scenario 1, and (2) a $100 regulatory benefit to Business M resulting from the total separation of X.
- Device, notwithstanding an even stronger business purpose?
- Must D sell or separately distribute the X stock?

Other Operating Rules

Ownership Interests in Partnerships & Subsidiaries

- Interest in Partnerships. ***See* Prop. Treas. Reg. section 1.355-2(d)(2)(iv)(D)(6)**
  - General Rule: A partnership interest generally is considered a Nonbusiness Asset.
  - Exception: If a D or C is considered to be engaged in the Business conducted by a partnership using ATB criteria, the FMV of the partnership interest would be allocated between Business Assets and Nonbusiness Assets in the same proportion as the proportion of the FMVs of the partnership's Business Assets and Nonbusiness Assets.
- Stock in Corporations. ***See* Prop. Treas. Reg. section 1.355-2(d)(2)(iv)(D)(7)**
  - General Rule: Stock in a corporation, other than a member of the DSAG or the CSAG, generally is a Nonbusiness Asset.
  - Exception: If a Member of a 50-Percent-Owned Group with respect to D or C owns stock in another Member of such 50-Percent-Owned Group (other than a member of the DSAG or the CSAG, respectively), the FMV of such stock would be allocated between Business Assets and Nonbusiness Assets in the same proportion as the proportion of the FMVs of the issuing corporation's Business Assets and Nonbusiness Assets.
  - Computation made with respect to lower-tier members before the computations with respect to higher-tier members.
  - 50-Percent-Owned Group, Member of a 50-Percent-Owned Group.
    - "50-Percent-Owned Group" has the same meaning as SAG, except that "50-percent" is substituted for "80-percent" each place it appears in Section 1504(a)(2), for purposes of Section 355(b)(3)(B).
    - A Member of a 50-Percent-Owned Group is a corporation that would be a member of a DSAG or a CSAG, with the substitution provided in this Prop. Treas. Reg. section 1.355-2(d)(2)(iv)(B)(7).
- Proper Adjustments made for Obligations between Entities
- Divergence from Section 355(g) Model.
  - 50-percent threshold for corporations versus 20-percent threshold provided in Section 355(g).
  - Proposed Regulations are based on "net value" rather than "gross value."

SAG & FMV Concepts

- Separate Affiliated Group.
  - Members of the DSAG are treated as a single corporation, and members of a CSAG are treated as a single corporation.
  - References to D include all members of the DSAG.
  - References to C include all members of the CSAG.
- Fair Market Value. The FMV of an asset is determined under general U.S. federal income tax principles.
  - The FMV is reduced (but not below the adjusted basis of the asset) by the amount of any liability that is described in Section 357(c)(3) and relates to the asset (or to a Business with which the asset is associated).
    - What is the reason for this reduction?
  - Any other liability is disregarded for purposes of determining the FMV of an asset.

See generally **Prop. Treas. Reg. section 1.355-2(d)(2)(iv)(D)(2) & (5)**

Nonbusiness Asset Percentage

Prop. Reg. Example 5: Illustration of Look-Through Rules

Determination of SAG

- S1 is a member of the C 50-Percent-Owned Group because C owns at least 50% of the stock of S1
- S3 is a member of the C 50-Percent-Owned Group because S1 owns at least 50% of the stock of S3
- S2 is not a member of the C 50-Percent-Owned Group

Nonbusiness Asset Percentage of S3

- S3's Nonbusiness Asset Percentage is 33⅓% ($1,500 Nonbusiness Assets / $4,500 Total Assets)

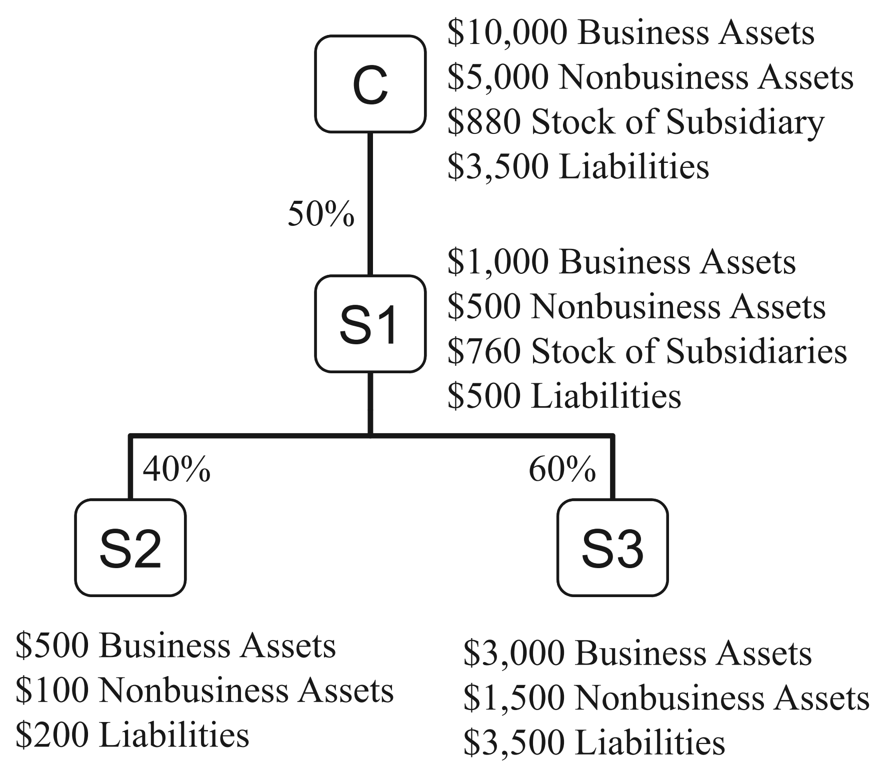
Nonbusiness Asset Percentage of S1

- S1's stock in S2 worth $160 is a Nonbusiness Asset
- S1's stock in S3 worth $600 is divided in proportion to S3's Nonbusiness Asset Percentage of 33⅓% ($400 Business Assets and $200 Nonbusiness Assets)
- S1 has $1,400 of Business Assets and $860 of Nonbusiness Assets
- S1's Nonbusiness Asset Percentage is 38.05% ($860 Nonbusiness Assets / $2,260 Total Assets)

Nonbusiness Asset Percentage of C

- C's stock in S1 worth $880 is divided in proportion to S1's Nonbusiness Asset Percentage of 38.05% ($545 Business Assets and $335 Nonbusiness Assets)
- C has $10,545 of Business Assets and $5,335 of Nonbusiness Assets
- C's Nonbusiness Asset Percentage is 33.6% ($5,335 Nonbusiness Assets / $15,880 Total Assets)

C's Nonbusiness Asset Percentage is 3.6%



Nonbusiness Asset Percentage

Prop. Reg. Example 7: Illustration of Look-Through Rules

Facts

- D borrows $500 from P in exchange for a note (the "D Note")
- The D Note is a Nonbusiness Asset in the hands of P
- D invested the proceeds of the D Note in Nonbusiness Assets

Application of Partnership Look-Through

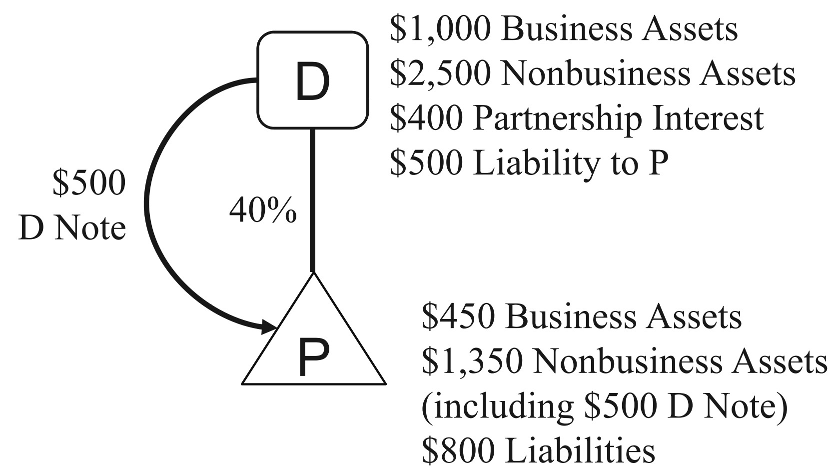
- D's interest in P is treated as a Nonbusiness Asset in proportion to P's Nonbusiness Asset percentage
- P's Nonbusiness Asset Percentage is 75% ($1,350 Nonbusiness Assets / $1,800 Total Assets)

Nonbusiness Asset Percentage of D

- D's 40% interest in P worth $400 is divided in proportion to P's Nonbusiness Asset Percentage of 75% ($100 Business Assets and $300 Nonbusiness Assets)
- Because there is an obligation between D and P, "appropriate adjustments" must be made to avoid double inclusion of assets under Prop. Treas. Reg. section 1.355-2(d)(2)(iv)(D)(8)
  - Because D has a 40% interest in P, D is treated as having borrowed $200 (40% of $500) from itself
  - D's Nonbusiness Assets must be decreased by $200
- D's Nonbusiness Asset Percentage is 70% ($2,600 Nonbusiness Assets / $3,700 Total Assets)

Would the "appropriate adjustment" be the same if D had invested the proceeds of the D Note in Business Assets?

D's Nonbusiness Asset Percentage is 70%



Multiple Controlled Corporations

- General Rule: If a transaction involves distributions by D of the stock of more than one C, the general asset test and the Per Se Test will apply to all such Cs.
- To the extent any rule would require a comparison between characteristics of D and C, there would have to be a comparison between D and each C and between each C and each other C.
- If any comparison under the general asset test or the Per Se Test would result in a determination that a distribution is a device, then all distributions involved in the transaction would be considered a device.

See generally **Prop. Treas. Reg. section 1.355-2(d)(2)(iv)(D)(1)**

Timing Rules

- Time to Identify Assets and Determine Character of Assets.
  - **Identification of D's and C's relevant assets, and determination of such assets' character as Business Assets or Nonbusiness Assets, are made immediately after the distribution.**
  - Thus, D's assets do not include any asset, including stock of C, that is distributed in the transaction.
- Time to Determine FMV of Assets.
  - **D and C each must determine the FMV of its assets as of one of the following dates:**
    - a) immediately before the distribution;
    - b) on any date within the 60-day period before the distribution;
    - c) on the date of an agreement with respect to the distribution that was binding on D on such date and at all times thereafter; or
    - d) on the date of a public announcement or filing with the SEC with respect to the distribution.
  - What constitutes a "binding agreement" for purposes of alternative (c)?
    - What is the impact of modifications or amendments to the agreement?
    - Has the Government considered applying the rules of Treas. Reg. section 1.368-2(e)(2)(ii) (relating to the signing date rule)?
  - **Consistency: D and C must determine FMV consistently with each other and as of the same date.**
    - If consistency is not met, FMV of assets will be determined immediately before the distribution for all purposes of such provisions, unless the Commissioner determines that the use of such date is inconsistent with the purposes of Section 355 and the Regulations thereunder.
    - What would be an example of the use of a date that is inconsistent with the purposes Section 355 and the regulations thereunder?

***See generally* Prop. Treas. Reg. section 1.355-2(d)(2)(iv)(D)(3) & (4)**

The Active Trade or Business Requirement

Active Trade or Business Requirement

(1) D and C must each be engaged in an active trade or business ("ATB") immediately after the distribution.

(2) Both D and C's business must have been actively conducted throughout the 5-year period ending on the date of the distribution.

(3) Neither D nor C's business (nor control of a corporation conducting such business) can have been acquired in a taxable transaction within 5-years of the distribution.

Section 355(b), Treas. Reg. section 1.355-3, Prop. Treas. Reg. section 1.355-3.

Note: The ATB test was inserted in order to prevent the tax free separation of an existing corporation into active and inactive entities. S. Rept. No. 1622, 83d Cong., 2d Sess. 51 (1954).

Section 355(b)(3): ATB Tested Through "Separate Affiliated Group"

- Starting in 2006, all members of a corporation's "separate affiliated group" (i.e., the affiliated group that would be determined under section 1504(a) if such corporation were the common parent and section 1504(b) did not apply)—determined immediately after the distribution—generally are treated as a single corporation for purposes of the ATB requirement.

- Congress believed "that it is appropriate to simplify planning for corporate groups that use a holding company structure to engage in distributions that qualify for tax-free treatment under section 355." (H. Rep. No. 109-304).

- A stock acquisition that results in a corporation joining a SAG is treated as an acquisition by the SAG of the assets of that corporation.

- Note that the SAG rules use a different definition of control (i.e., 80% vote/value) from section 355's "control" requirement (i.e., 80% vote and 80% of each non-voting class).

- Under regulations proposed in 2007, certain tax-free transactions would be treated as taxable (and certain taxable transactions as tax-free) for purposes of the SAG rules.

Size of D's and C's ATB Relative to Other Assets

- Section 355(b) and Treas. Reg. section 1.355-3(b)
  - No specific reference to absolute or relative size of the ATB.
- Rev. Rul. 73-44
  - D owns three lines of business: (1) ATB-qualifying assets ("Biz1"), (2) active business assets, owned by C, that do not satisfy the ATB requirement because they were recently acquired in a transaction in which gain was recognized ("Biz2") and (3) ATB-qualifying assets ("Biz3").
  - D transfers Biz3 to C; after the transfer, Biz3 represents represents a "substantial portion" but less than 50% of the value of C's total assets.
  - "There 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. In the instant case, therefore, it is not controlling for purposes of the [ATB] requirement that the active business assets of [C] represent less than half of the value of [C] immediately after the distribution."
  - "The fact that . . . investment assets were not involved, and that the transaction was compelled by valid business purposes are indicative of the absence of device."
  - "[T]he assets included in [C] represent operating businesses, and not assets that could be used to facilitate the distribution of [D's or C's E&P]."

General Counsel Memoranda Relating to Size of Active Trade or Business

- GCM 34238 (underlies Rev. Rul. 73-44; ATB requirement satisfied where C's only qualifying ATB assets represented approximately 5% of the net book value of its assets; C's other assets generally were not investment-type assets).

- GCM 31959 (ATB requirement satisfied where C's ATB assets were "only a small percentage" of C's total assets; C's other assets consisted of stock in wholly owned subsidiaries which held ATB assets).

- GCM 31799 (ATB requirement satisfied where ATB assets represented less than 2% of corporation's assets, but 65% of its assets consisted of stock in wholly owned subsidiaries which held ATB assets and the remainder consisted of either internal JV interests or interests in corporations shared with outside investors which also held ATB assets).

- GCM 36069 (ATB requirement satisfied where only 16% of C's assets were ATB-qualifying assets; C's other assets consisted of wholly owned subsidiary stock which only held real estate solely used by C, and a small amount of cash).

Proposed "Small" Active Trade or Business Regulations

Relatively Small ATBs

- The Preamble explains that adopting a minimum size requirement (the "MSR") for ATBs is both appropriate and consistent with prior guidance.
- According to the Preamble:
  - Permitting section 355(b) to be satisfied with an ATB that is economically insignificant in relation to the other assets of D or C is not consistent with the congressional purpose of section 355 because it would permit the separation of inactive assets from a business, rather than the separation of different businesses.
  - Recent changes to section 355, particularly the SAG rules, make compliance with the MSR simpler than it would have been prior to those changes.
  - Rev. Rul. 73-44 is not inconsistent with the MSR as the ruling concludes there is no requirement that a specific percentage of a corporation's assets be devoted to the ATB not that an economically insignificant ATB satisfies section 355(b).
    - However, the statement in Rev. Rul. 73-44 regarding a minimum percentage will be modified to take into account the MSR.

Minimum Size Requirement for ATB

- In order to satisfy the MSR, the percentages of D's and C's gross assets that are used in 1 or more ATBs ("ATB Assets") must both be at least 5%. Prop. Treas. § 1.355-9(a)(3), (b).
- This test requires the ATB to satisfy all of the requirements for ATBs, including the 5-year requirement. Prop. Treas. § 1.355-9(a)(2), (4).
- Assets used in a Business that is not an ATB are not ATB Assets, even though they are Business Assets for the nature and use of assets factor of the No Device Requirement.
- ATB Assets include:
  - Reasonable working capital for 1 or more ATBs;
  - Assets that are required to be held to provide for exigencies related to the ATB;
  - Assets that are required to be held to secure or otherwise provide for a financial obligation reasonably expected to arise from an ATB; and
  - Assets held to implement a binding commitment to expend funds to expand or improve an ATB. Prop. Treas. § 1.355-9(a)(3).

Minimum Size Requirement Operating Rules

- All members of the CSAG and all members of the DSAG are treated as single corporations.
  - The 50-Percent Member rule from the proposed No Device Requirement modifications does not apply because an ATB of such 50-Percent Member would not be attributed to D or C under the current SAG rules.
  - *See* Prop. Treas. § 1.355-9(c)(1).

- Partnership interests owned by D or C:
  - The fair market value of an interest in an ATB Partnership will be allocated between ATB Assets and other assets in proportion to the percentage of ATB Assets held by the ATB Partnership.
  - No other partnership interests are ATB Assets.
  - *See* Prop. Treas. § 1.355-9(c)(3).

Rules Relating to both the Proposed No Device and "Small" Active Trade or Business Regulations

Anti-Abuse Rules

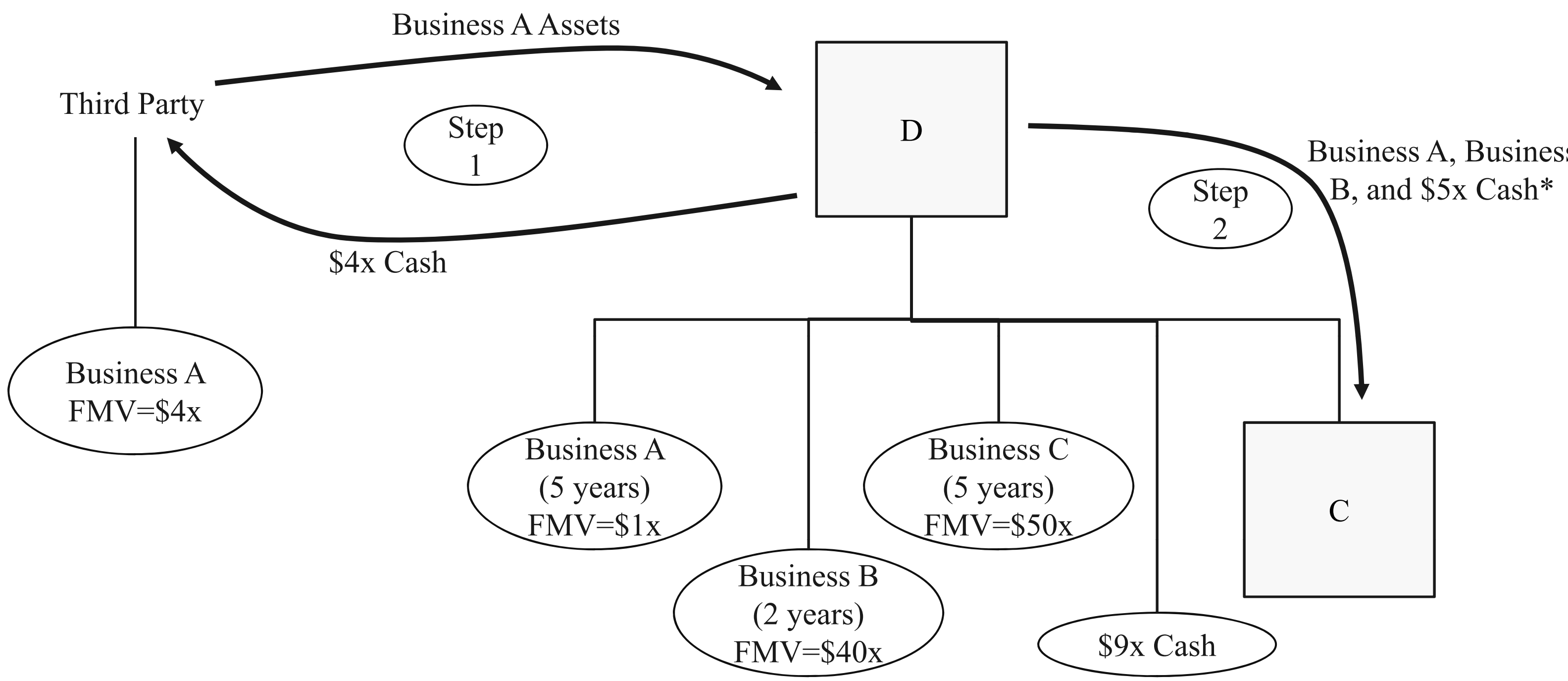
- A transaction or series of transactions undertaken with a principal purpose of affecting the Nonbusiness Asset Percentage of any corporation will not be given effect for purposes of the device factors described above.

- Similarly, a transaction or series of transactions undertaken with a principal purpose of affecting the percentage of any corporation's assets that are used in an ATB will not be given effect for purposes of the MSR.

Anti-Abuse Rules (cont'd)

- For these purposes, a transaction or series of transactions includes:
  - A change in the form of ownership of an asset;
  - An issuance, assumption, or repayment of indebtedness or other obligations; and
  - An issuance or redemption of stock.
- These anti-abuse rules do not apply to
  - A non-transitory transfer of assets between D and C; or
  - A non-transitory acquisition or disposition of assets from or to a person the ownership of whose stock would not be attributed to D or C under section 318(a) (but excluding the option attribution rules of section 318(a)(4)).
- Is the term "person" in the anti-abuse rule limited to sellers or buyers of assets that are attributed to D or C through corporate attribution?
  - For example, does the related party carve out to the exception apply where A owns 100% of D and 99% of a partnership and the partnership non-transitorily transfers assets to C prior to the distribution of C?
  - What if the partnership is wholly owned by members of the DSAG?
  - Does the anti-abuse rule effectively turn off the treatment permitted under Notice 2007-60?

Small ATB Anti-Abuse Rule – Example



- Without Step 1, C's ATB Assets would be less than 5% of its total assets.
- By purchasing additional Business A assets from a third party as an expansion of D's historically owned Business A, D causes C's ATB Assets to be in excess of 5% under the expansion doctrine.
- Anti-abuse rule does not appear to apply because D acquires assets from a third party that C has no intent to dispose of.

* C has no plan or intent to dispose of the Business A Assets acquired in Step 1.

Valuation Dates

- D and C can elect to use one of the following dates for purposes of determining the fair market value of their assets:
  - Immediately before the distribution;
  - Any date within the 60-day period before the distribution;
  - The date of the binding distribution agreement; or
  - The date of a public announcement or SEC filing with respect to the distribution.

- D and C both must consistently use the same date for purposes of the Nonbusiness Asset calculations and the MSR.

- A failure of D and/or C to consistently use the same date will cause the relevant valuation date to be immediately before the distribution, unless the IRS determines that the use of such date is inconsistent with the purposes of section 355 and the regulations thereunder.

Evolution of IRS Ruling Policy

Evolution of IRS Section 355 Ruling Policy

- Prior to Rev. Proc. 2003-48, private letter rulings addressing section 355 generally ruled on whether the transaction qualified in full, with few caveats.
  - Rev. Proc. 96-30 (and Rev. Proc. 86-41 before it) set forth in a checklist questionnaire the information that had to be included in requests for rulings under section 355.
  - However, under Rev. Proc. 96-43, for purposes of ATB requirement, the IRS required that the gross assets of the trades or businesses relied on to satisfy ATB requirement must have a FMV that is at least 5% of the total FMV of the gross assets of the corporation conducting the trades or businesses. *See* Section 4.01(30) of Rev. Proc. 2003-3, 2003-1 C.B. 113.
    - IRS may rule that the trades or businesses satisfy the ATB requirement 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.
    - Was the reason behind the IRS's willingness to rule when the ATB represented less than 5% related to IRS sympathy to structuring issues related to former section 355(b)(2)(A) which required that D or C, as the case may be, be engaged directly in an ATB or that "substantially all of [such corporation's] assets consist of stock and securities of a corporation controlled by [such corporation]"?
  - IRS willing to issue rulings on device and business purpose, among other requirements.

Evolution of IRS Section 355 Ruling Policy

- In Rev. Proc. 2003-48, the IRS instituted a pilot program (which it subsequently adopted on a more permanent basis) under which it would no longer rule on business purpose, device, or section 355(e) “plan” issues.
  - Section 4.07 of Rev. Proc. 2003-48 deleted the 5% ATB threshold by deleting section 4.01(30).
  - Though unwilling to rule on a “plan” issue, the IRS would still entertain requests for rulings on related “significant issues” under section 355(e).
  - The IRS justified the change in part by an intent to dedicate its resources to increasing the amount of published guidance under section 355.
  - The IRS also announced in Rev. Proc. 2003-48 that it would decline a request for a supplemental letter ruling unless the request presented a “significant issue.”

Evolution of IRS Section 355 Ruling Policy

- Ordinarily, the IRS will not issue a letter ruling on only part of an integrated transaction.

- In Rev. Proc. 2009-25, however, the IRS instituted an optional pilot program (subsequently made more permanent and exclusive in 2013) for rulings solely under the jurisdiction of the Associate Chief Counsel (Corporate) on “significant issues” involving the tax consequences or characterization of part of a transaction that occurs in the context of a section 355 distribution.

- The IRS also announced in Rev. Proc. 2009-25 that it would generally rule on non-plan section 355(e) issues, including the effect of redemptions, if an adverse ruling would result in there being an acquisition of a 50% or greater interest as part of a plan including the spin-off.

Evolution of IRS Section 355 Ruling Policy

- Rev. Proc. 2009-25 defined “significant issue” as an issue of law that met the following tests:

  (1) the issue is not clearly and adequately addressed by a statute, regulation, decision of a court, tax treaty, or other authority published in the Internal Revenue Bulletin;

  (2) the resolution of the issue is not essentially free from doubt (i.e., taxpayer’s counsel is unable to render a “will” opinion on the issue because of concern over a legal issue); and

  (3) the issue is legally significant and germane to determining the major tax consequences of the transaction.

Evolution of IRS Section 355 Ruling Policy

- In Rev. Proc. 2013-3, the IRS announced that three new areas were under study, and that it would not rule on them until publishing a revenue ruling, revenue procedure, regulations or other authority.

- These three new areas may be summarized as follows:

  (1) recapitalizations into control;

  (2) debt issued in anticipation of a spin-off; and

  (3) "north-south" transactions.

- In Rev. Proc. 2013-32, the rulings program for transactions under sections 332, 351, 355, 368 and/or 1036 was substantially cut back. Under the program, which is currently in effect, the IRS will only rule on issues that are "significant."
  - "Significant" is defined as an issue that is not essentially free from doubt and that is germane to the tax consequences of the transaction.

Rev. Proc. 2015-43 & Notice 2015-59

- IRS released Rev. Proc, 2015-43 and Notice 2015-59 (the "notice") on September 14, 2015.

- Rev. Proc. 2015-43 provided policies under section 355 and related provisions for spin-offs involving relatively small ATBs.

- The notice stated that Rev. Proc. 2015-43 does not distinguish between pro rata and non-pro rata distributions.

- Rev. Proc. 2015-43 provided that the IRS will not issue a ruling on "any issue relating to the qualification under section 355 and related provisions" if one of the three no-rule policies applies.

Rev. Proc. 2015-43 & Notice 2015-59

- The notice identified four circumstances in which qualification of a distribution under section 355 was under study:

1. Ownership by D or C of a small amount of ATB Assets in relation to all of its assets.

2. Ownership by D or C of investment assets having substantial value in relation to (a) the value of all of such corporation's assets, and (b) the value of the assets of the trade(s) or business(es) relied upon to meet the ATB requirement.

3. A significant difference between D's ratio of investment assets to assets other than investment assets and such ratio of C.

4. An election by D or C (but not both) to be a RIC or a REIT.

Relevance of *General Utilities* Repeal to Device and ATB Requirements

- Treasury and the IRS referenced sections 337(d) and 355 when discussing the four circumstances under study.
- Section 337(d) provides:
  - The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of the amendments made by subtitle D of title VI of the Tax Reform Act of 1986, including—(1) regulations to ensure that such purposes may not be circumvented through the use of any provision of law or regulations (including the consolidated return regulations and part III of this subchapter) or through the use of a regulated investment company, real estate investment trust, or tax-exempt entity, and (2) regulations providing for appropriate coordination of the provisions of this section with the provisions of this title relating to taxation of foreign corporations and their shareholders.
- The preamble to the 1989 final device regulations provided that "[the IRS] is developing regulations under section 337(d) of the Code that will relate to the distribution of stock, or stock and securities, of a controlled corporation. New section 1.355-6 is reserved for this purpose."
- In March, 1989, Treasury indicated that it would be exercising its authority under section 337(d) to prevent the use of "subsidiary-tracking" stock to sell a business without triggering a *General Utilities* tax. The scheme, as explained by Treasury, was the purchase by X of D stock tracking C eventually followed by a split off of C to X.
- In 1990, Congress enacted section 355(d), effectively shutting down the transaction described immediately above.
- In 1992, Treasury closed the regulatory project reserved for under Treas. Reg. section 1.355-6 without the promulgation of regulations.
- Rev. Rul. 2003-110 (holding that "[i]n determining whether a distribution of the stock of a controlled corporation satisfies the [business purpose requirement] that the distribution be motivated, in whole or substantial part, by one or more corporate business purposes, the fact that [section] 355 permits [D] to distribute the stock of [C] without recognition of gain does not present a potential for the avoidance of Federal taxes under [Treas. Reg. section] 1.355-2(b).").

General Utilities-Related Concerns

General Utilities Repeal

- The Preamble provides that Treasury and the IRS remain concerned that taxpayers may interpret the regulations under section 337(d) and section 355 in a manner inconsistent with *General Utilities* repeal.

- Therefore, Treasury and the IRS continue to study whether permitting tax-free separations of large amounts of Nonbusiness Assets from Business Assets, especially when the gain in the Nonbusiness Assets is expected to be eliminated, is consistent with *General Utilities* repeal in all circumstances.

- Treasury requests comments on potential additional guidance under section 337(d) addressing such transactions.

Recapitalizations into Section 368(c) Control

Section 355 Control Requirement

- For a spin-off to be tax-free, D must:
  - Control C (within the meaning of section 368(c)) immediately before the distribution; and
  - Distribute control of C.

  Sections 355(a)(1)(A); 355(a)(1)(D).

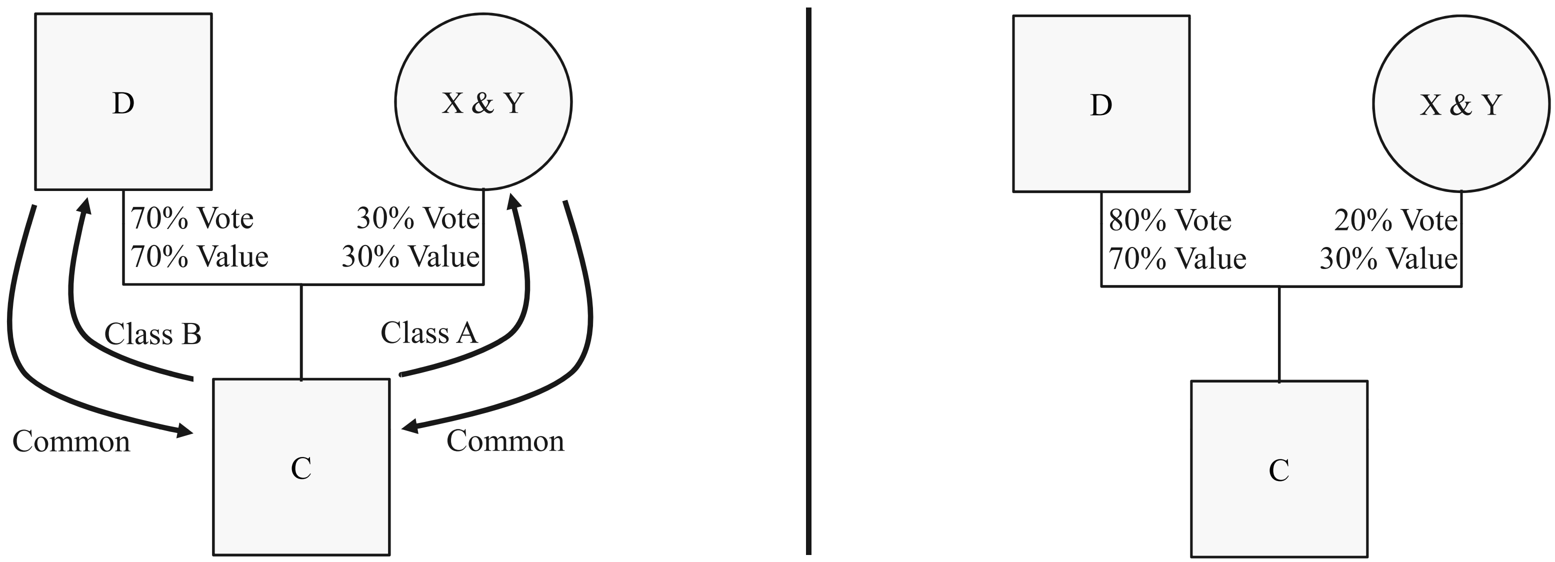
- Under section 368(c), “control” means ownership of:
  - Stock possessing 80% of the vote; and
  - 80% of each class of non-voting stock.

  Rev. Rul. 59-259.

Background – Control Requirement

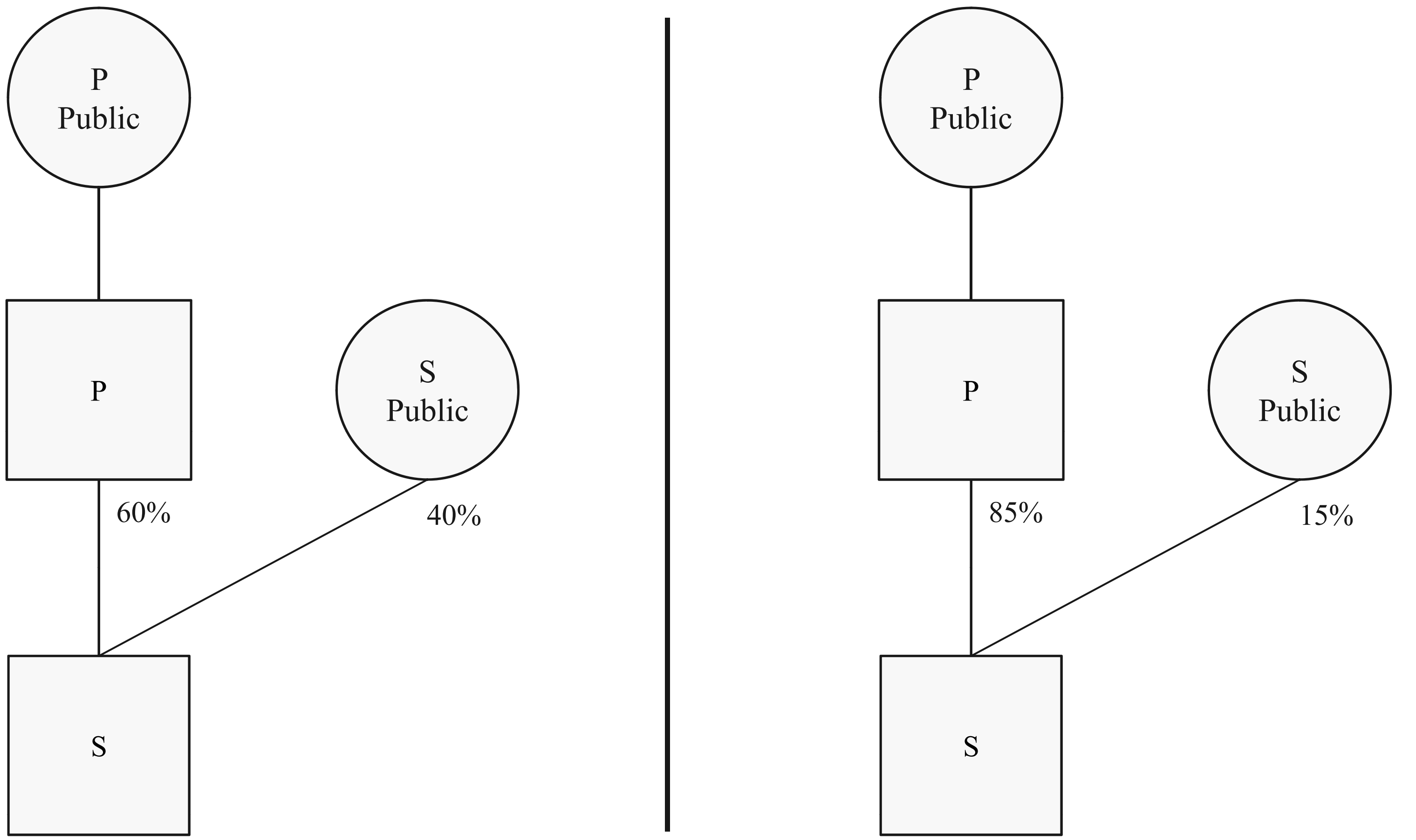
- In a section 355 transaction, Distributing must own and distribute "control" of the controlled corporation within the meaning of section 368(c) (i.e., Controlled stock with at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of each class of nonvoting stock).
- In Rev. Rul. 69-407, 1969-2 C.B. 50, the IRS ruled that a corporation could recapitalize to alter its capital structure in order to facilitate the acquisition of control by a shareholder prior to a section 355 distribution.
  - In the ruling, the IRS indicated that this type of recapitalization should be respected if it results in a "permanent realignment of voting control."
  - *See also* Rev. Rul. 56-117, 1956-1 C.B. 180 (permitting a recapitalization to obtain control for purposes of a section 355 spin-off); *cf.* Rev. Rul. 63-260, 1963-2 C.B. 147 (finding that section 355 did not apply because control was obtained in a "transitory and illusory sense").
- Consistent with Rev. Rul. 69-407, the IRS has issued numerous PLRs under which the creation of a high-vote / low-vote structure to ensure control is respected.
  - More recently, the IRS had gone one step further by issuing rulings that allow post-distribution recapitalizations to unwind a high-vote / low-vote structure that was put in place to facilitate a section 355 distribution.
  - These rulings generally permitted the unwinding if the subsequent recapitalization did not occur pursuant to a binding commitment entered into before the section 355 distribution and was dependent on intervening events.

Rev. Rul. 69-407



- In Rev. Rul. 69-407, C recapped the stock owned by D and X and Y so that D had 80% of the vote. The recapitalization did not change the proportional interests of D, X, and Y in C, but only altered the proportionate voting rights of the parties.
- The ruling concludes that respecting D as controlling C as a result of the recapitalization is appropriate because the recapitalization "resulted in a *permanent realignment of voting control*."
- *See also* Rev. Rul. 56-117, 1956-1 C.B. 180 (permitting a recapitalization to obtain control for purposes of a section 355 spin-off); *cf.* Rev. Rul. 63-260, 1963-2 C.B. 147 (finding that section 355 did not apply because control was obtained in a "transitory and illusory sense").

IPO Carve-Outs



Section 355: Recaps Into and Out of Control

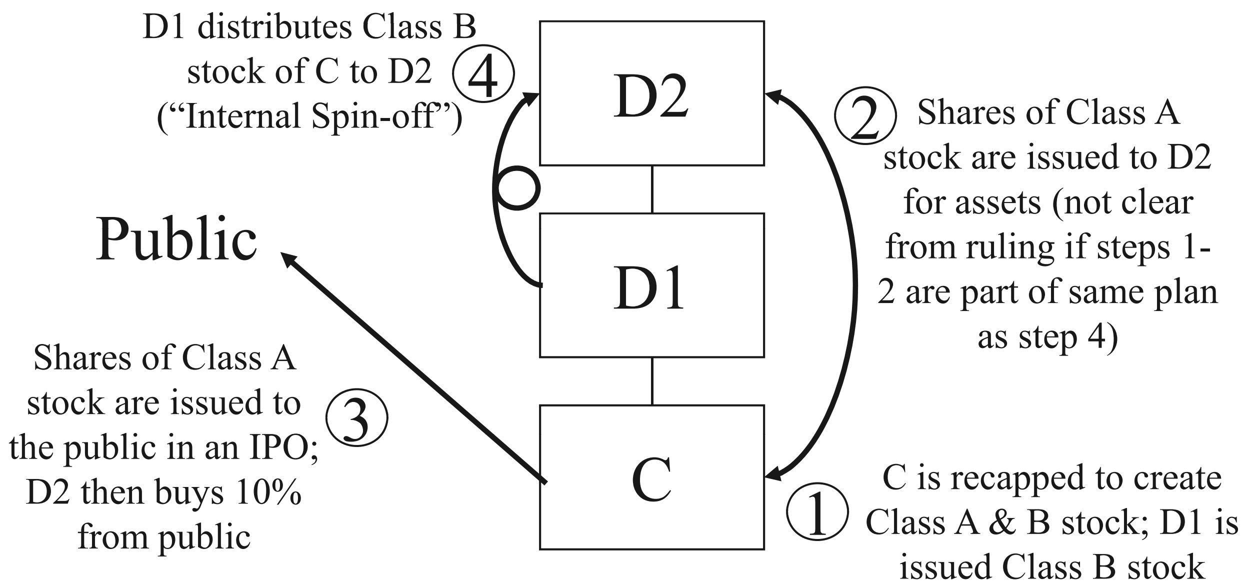
Date of Ruling/Spin	Date of Supplemental Ruling Request	Date Supplemental Ruling Published	Supplemental Ruling Number
3/25/99	6/28/01	9/28/01	200139011
6/2/99	10/8/03	1/16/04	200403041
8/30/02	8/19/03	11/21/03	200347013

Section 355: Recaps Into and Out of Control

- Rev. Proc. 2003-48 stated CC:Corp. would not issue supplemental rulings on spin-offs due to change of circumstances (did not apply to 3 rulings cited above, because sought before effective date).
  - What is scope of "change of circumstances"?
  - Around 2005 CC:Corp stopped requiring representations of no plan to undo dual vote structure.
- In 2008 Wessel, Pari and D'Avino added to their treatise:
  - "The authors understand that the Service will rule favorably if, following the distribution, the taxpayer expects that the board of directors of controlled will consider whether to unwind the dual class structure as long as it is subject to an independent shareholder vote." p. 417
- PLR 200837027 stated that "in connection with the resolutions to be submitted to the Controlled shareholders at the next regularly scheduled annual shareholders' meeting of Controlled or at a special shareholders' meeting of Controlled," shareholders could vote to approve a resolution to undo a recapitalization into control consummated in connection with the spin-off addressed by the ruling. Later rulings involving recaps into control included similar language in representations.

PLR 201007050

Recap into Control for Spin-off Followed by Unwind



Step 5: D2 offers to exchange its Class A stock in C for D2 stock owned by the D2 shareholders ("Exchange Offer" resulting in an "External Split-off" to the D2 shareholders). Offer provides that, if the conditions to the Exchange Offer are met, then D2 will convert the Class B stock received in the Internal Spin-off to Class A stock (the "Unwind") prior to consummation of the Exchange Offer/External Split-off.

Step 6: Conditions are met, and Unwind and External Split-off are consummated.

Step 7: D2 contributes assets to D1 (North-South issue). Rep: Internal Spin-off not conditional on contribution.

PLR 201007050 (cont'd)

- The IRS concludes: "the Unwind will not cause the Internal Spin-off to fail to satisfy the control immediately before requirement of section 355(a)(1)(A)." *Cf.* Rev. Rul. 98-27.
- The taxpayer represented that immediately after the Internal Spin-off, there would be "no legally binding obligation to change the capital structure or the Charter of Controlled" and "no legally binding obligation to proceed with the remainder of the Proposed Transaction."
  - Compare to prior PLRs requiring no plan or intention.
- Consummation of the Exchange Offer/External Split-off was conditioned upon a minimum level of participation in the Exchange Offer.
  - The exchange ratio for the Exchange Offer was set at a level intended to encourage the D2 shareholders to tender their D2 stock.
- Does "economic substance" under section 7701(o) affect the analysis? (Is tax benefit "clearly consistent" with the statute and policies?)

Taxpayer Reform Act of 1997

- Added section 355(e) and section 368(a)(2)(H) to the Code.
- In general, these provisions turned off the application of the step transaction doctrine with respect to transactions following spin-offs for purposes of determining whether a distribution qualifies under section 355.
  - Section 368(a)(2)(H)(ii) provides that, in the case of a transaction with respect to which the requirements of section 355 (or so much of section 356 as relates to section 355) are met, the fact that the shareholders of the distributing corporation dispose of part or all of the distributed stock, or the fact that the corporation whose stock was distributed issues additional stock, shall not be taken into account.
  - Section 355(e) generally imposes a corporate level (but not shareholder level tax) if, pursuant to a plan, one or more persons acquire directly or indirectly stock representing a 50-percent or greater interest in D or C.
- Rev. Rul. 98-27 revoked Rev. Rul. 96-30 and acknowledged that step transaction principles no longer applied with respect to transactions engaged in by D or C following a spin-off.

Taxpayer Reform Act of 1997

- Rev. Rul. 2003-79 turned off the step transaction doctrine with respect to "born to die" transactions and quoted the following legislative history to section 355(e) and section 368(a)(2)(H):

> The . . . bill does not change the present-law requirement under section 355 that the distributing corporation must distribute 80 percent of the voting power and 80 percent of each other class of stock of the controlled corporation. It is expected that this requirement will be applied by the Internal Revenue Service taking account of the provisions of the proposal regarding plans that permit certain types of planned restructuring of the distributing corporation following the distribution, and to treat similar restructurings of the controlled corporation in a similar manner. Thus, the 80-percent control requirement is expected to be administered in a manner that would prevent the tax-free spin-off of a less-than-80-percent controlled subsidiary, but would not generally impose additional restrictions on post-distribution restructurings of the controlled corporation if such restrictions would not apply to the distributing corporation.

H.R. Rep. No. 105-220, at 529-30 (1997); 1997-4 C.B. 1457, at 1999-2000.

Rev. Proc. 2013-3 No Rule

- Rev. Proc. 2013-13 provided that, until the IRS resolves the issue, it will no longer rule on:
  - Whether a corporation is a "controlled corporation" within the meaning of section 355(a)(1)(A) if, in anticipation of a distribution of the stock of the corporation, a distributing corporation acquires putative control of the controlled corporation (directly or through one or more corporations) in any transaction (including a recapitalization) in which stock or securities were exchanged for stock having a greater voting power than the stock or securities relinquished in the exchange, or if, in anticipation of a distribution of the stock of the putative controlled corporation, such corporation issues stock to another person having different voting power per share than the stock held by the distributing corporation.

Revenue Procedure 2016-40

Rev. Proc. 2016-40

- Rev. Proc. 2016-40 provides two safe harbors that generally may apply where a recapitalization into Control is followed by an "unwind" of the rearranged capital structure.

- Rev. Proc. 2016-40 also removes recapitalizations into Control from the No Rule list.
  - However, the IRS may decline to issue a letter ruling addressing an acquisition of Control where appropriate in the interest of sound tax administration or on other grounds when warranted by the facts and circumstances of a particular case.

Applicability of Rev. Proc. 2016-40

- Rev. Proc. 2016-40 applies to a distribution if:
  - D does not own stock constituting Control of C,
  - C issues shares of one or more classes of stock to D and/or to other shareholders of C (the "Issuance"), as a result of which D owns stock constituting Control of C,
  - D subsequently distributes its C stock in a section 355 transaction, and
  - C subsequently engages in a transaction that unwinds the Issuance (an "Unwind").

- An Unwind is a transaction that
  - Substantially restores C's shareholders to the relative interests they would have held in C (or its successor) had the Issuance not occurred and/or
  - Substantially restores the voting rights and value of the classes of C's stock that were present prior to the Issuance.

Rev. Proc. 2016-40 Safe Harbors

- If a distribution subject to Rev. Proc. 2016-40 falls within one of the safe harbors, the IRS will not assert that the Issuance lacks substance (and that therefore D lacks Control of C immediately before the distribution).

- These safe harbors only apply for purposes of determining whether an acquisition of Control has substance for purposes of the Control Requirement, and not for any other purposes.

- If a transaction falls outside the safe harbors, Rev. Proc. 2016-40 has no effect and the determination of whether an acquisition of Control has substance, and is therefore respected, is determined under general federal tax principles.

24-Month Safe Harbor

- The 24-month safe harbor is satisfied if:
  - No action is taken, including the adoption of a plan or policy,
  - At any time prior to 24 months after the distribution,
  - By C's board of directors or management, or any of C's controlling shareholders,
  - That would, if implemented, actually or effectively result in an Unwind.

- What if the SEC disclosures at the time of the spin state that, 24 months after the distribution, there will be an independent vote of the shareholders regarding whether or not to implement an Unwind?

Unanticipated Third Party Transaction Safe Harbor

- The unanticipated third party transaction safe harbor is satisfied if C engages in a transaction with one or more persons that results in an Unwind, regardless of whether the transaction takes place within 24 months after the distribution, provided that:
  - There is no agreement, understanding, arrangement, substantial negotiations, or discussions concerning the transaction or a similar transaction at any time during the 24 months prior to the distribution, and
  - No more than 20% of the interest in the other party (by vote or value) is owned by the same persons that own more than 20% of the stock of C.

- The terms "substantial negotiations," "discussions" and "similar transaction" used above are within the meanings of Treas. Reg. sections 1.355-7(h)(1), (6), and (12)-(13), respectively.

- The determination of 20% ownership of C and the other party applies the constructive ownership rules of section 318(a) as modified by section 304(c)(3), except that for purposes of applying section 318(a)(3)(A) and (B), the principles of section 304(c)(3)(B)(ii) apply without regard to section 304(c)(3)(B)(ii)(I).

Business Purpose Requirement

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Gregory v. Helvering

> "The whole undertaking, though conducted according to the terms of the [statute], was in fact an elaborate and devious form of conveyance masquerading as a corporate reorganization."

Business Purpose Requirement Treas. Reg. section 1.355-2(b)

- Corporate business purpose – The distribution must be carried out for one or more corporate business purposes. The transaction must be motivated, in whole or substantial part, by such corporate purposes.

- Exigency – Provide nonrecognition only to distributions incident to readjustments of corporate structure required by business exigency.

- Other than federal income tax avoidance – Must be a real and substantial non-federal tax purpose germane to the business of D, C or D's affiliated group.

- No impractical or unduly expensive nontaxable alternative.

- Rev. Proc. 96-30 contains a non-exhaustive list of IRS-approved corporate business purposes, though the IRS stopped issuing private letter rulings on the business purpose requirement in 2003.

  – Business purposes described in Rev. Proc. 96-30 include enhancing the fit and focus of each business, providing an equity interest in a particular business to a key employee, facilitating a borrowing or stock offering, facilitating an acquisition by D or C (or of D), producing cost savings, and eliminating competition with customers or suppliers.

- Does there need to be an independent, corporate business purpose for contributing the relied upon ATB to C (or holding back the relied upon ATB in D)?

Revenue Procedure 2016-45

Revenue Procedure 2016-45

- As noted above, since Rev. Proc. 2003-48 the Service has declined to rule on both the business purpose requirement under § 355(b) and Treas. Reg. § 1.355-2(b) and the device prohibition in § 355(a)(1)(B) and § 1.355-2(d).
- Revenue Procedure 2016-45 removes these two no rules.
  - "The Service has determined there are a number of unresolved legal issues under § 1.355-2(b) pertaining to the corporate business purpose requirement and under § 355(a)(1)(B) and § 1.355-2(d) pertaining to device that can be germane to determining the tax consequences of a distribution. The Service has also determined that it is appropriate and in the interest of sound tax administration to provide guidance to taxpayers on significant issues (as defined in section 3.01(50) of Rev. Proc. 2016-3) in these two areas."
  - "Accordingly, the Service will issue a letter ruling with respect to a significant issue under § 1.355-2(b) pertaining to the corporate business purpose requirement, and a significant issue under § 355(a)(1)(B) and § 1.355-2(d) pertaining to device, provided that the issue is a legal issue and is not inherently factual in nature. However, as with other requests for letter rulings, the Service may decline to issue a letter ruling addressing these significant issues when appropriate in the interest of sound tax administration or on other grounds when warranted by the facts or circumstances of a particular case. *See* section 6 of Rev. Proc. 2016-1 and section 3.02(10) of Rev. Proc. 2016-3."
- Note that rulings in these two areas are still subject to the "significant issue" requirement.
- The revenue procedure quotes Rev. Proc. 2016-3 and defines a "significant issue" as "an issue of law the resolution of which is not essentially free from doubt and that is germane to determining the tax consequences of the transaction."
- The issue also must be "a legal issue" and not "inherently factual in nature."

Revenue Procedure 2016-45

- How broadly will the Service interpret “significant legal issue” in the context of business purpose and device?
- Rev. Proc. 96-30 included what information was generally required to be shown to establish certain identified business purposes.
  - Will the Service require similar factual information to issue a ruling on a significant legal issue related to one of the business purposes identified in Rev. Proc. 96-30? Or will the Service rule without that information because it is “inherently factual” in nature?