Simpson Thacher

Memorandum

Internal Revenue Service Changes Course in Proposed Regulations Regarding Active Trade or Business Requirement and Device Prohibition in Spinoffs

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Introduction

On July 14, 2016, the Internal Revenue Service (the "IRS") and Treasury Department released proposed regulations regarding tax-free spinoffs by a parent corporation (the "distributing corporation") of stock in a subsidiary corporation (the "controlled corporation") in which the distributing corporation or the controlled corporation owns significant nonbusiness assets compared to its other assets. Under a previous IRS policy, a private ruling would not be issued if the assets comprising the active trade or business of the distributing corporation or the controlled corporation were less than 5% of such corporation's total assets. The IRS later abandoned the unfavorable ruling policy and liberalized certain technical aspects of the active trade or business requirement for tax-free treatment.[1] In a course reversal, the new rules, if finalized, would implement the prior ruling policy in regulations.[2] Accordingly, even a significant active business would no longer satisfy the active trade or business requirement if the business did not constitute at least 5% of the value of the corporation. The proposed regulations would also make tax-free treatment more difficult to achieve by adding a new per se "device" rule that would trump the longstanding weighing of facts and circumstances if the relative percentages of nonbusiness assets of the distributing corporation and the controlled corporation exceed certain ratios.

[1] For example, allowing taxpayers to look through certain corporate subsidiaries and partnership interests, and making it easier to expand an active business in a taxable transaction.

[2] Because the policy is implemented in regulations, spinoffs that would otherwise proceed on the basis of an opinion from a company's legal advisers may find it more difficult to proceed.

Background

Section 355 of the Internal Revenue Code of 1986, as amended (the "Code"),[3] generally provides that, if certain requirements are satisfied, a distributing corporation may distribute the stock of a controlled corporation in a tax-free transaction. However, Section 355 does not apply to a distribution if the transaction is used principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both (the "device prohibition"). The determination of whether a transaction violates the device prohibition is generally based on all relevant facts and circumstances, including the presence of certain "device factors" and "nondevice factors" set forth in regulations. In addition, under Section 355 the distributing corporation and the controlled corporation must each be engaged in the active conduct of a trade or business immediately after the distribution (the "active trade or business requirement"), and the transaction must be carried out for one or more corporate business purposes (the "business purpose requirement"). Under current regulations, the existence of assets that are not used in the active trade or business that satisfies the active trade or business requirement is treated as a device factor.

Prior to 2003, the IRS would not issue a favorable ruling under Section 355 if the fair market value of the gross assets used in a trade or business actively conducted throughout the 5-year period ending on the distribution date ("Five-Year Active Trade or Business Assets") of the distributing corporation or the controlled corporation was less than 5% of the total fair market value of the gross assets of such corporation.[4] This ruling policy, however, was revoked in 2003,[5] and the IRS issued numerous private letter rulings on Section 355 distributions involving Five-Year Active Trade or Business Assets that were de minimis in value compared to other assets of the distributing corporation or the controlled corporation. In 2015, the IRS returned to the ruling policy in place prior to 2003 and would not ordinarily issue a letter ruling under Section 355 if the fair market value of the Five-Year Active Trade or Business Assets of the distributing corporation or the controlled corporation were less than 5% of the total fair market value of the gross assets of such corporation.[6]

Revision of Device Factors and Nondevice Factors

Under current regulations, the existence of assets that are not Five-Year Active Trade or Business Assets is a device factor. The proposed regulations would revise (in a taxpayer friendly manner) this device factor to focus on the existence of Five-Year Active Trade or Business Assets, determined for this purpose without

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[3] All "Section" references are to the Code, and all "Treas. Reg. Section" references are to the Treasury Department regulations promulgated thereunder.

[4] See Rev. Proc. 96-43, 1996-2 C.B. 330.

[5] See Rev. Proc. 2003-48, 2003-2 C.B. 86.

[6] See Rev. Proc. 2015-43, 2015-40 I.R.B. 467; Notice 2015-59, 2015-40 I.R.B. 459.

regard for whether the business had actually been owned for at least five years prior to the date of the distribution (such assets, "Business Assets," and assets that are not Business Assets, "Nonbusiness Assets").[7] If neither the distributing corporation nor the controlled corporation own Nonbusiness Assets comprising 20% or more of its total assets, the ownership of Nonbusiness Assets ordinarily would not be a device factor. Additionally, a difference in the percentages of Nonbusiness Assets for the distributing corporation, on the one hand, and the controlled corporation, on the other, of less than 10 percentage points ordinarily would not be a device factor.[8]

Under current regulations, a strong corporate business purpose for the transaction is a nondevice factor. The proposed regulations would revise the nondevice factor such that a corporate business purpose that relates to the separation of Nonbusiness Assets from Business Assets or one or more underlying businesses would generally not be a nondevice factor.

Additionally, the proposed regulations provide for a per se test in which a transaction will violate the device prohibition notwithstanding the presence of any other nondevice factors. In order the violate the device prohibition under this test, two requirements must be satisfied. First, the distributing corporation or the controlling corporation must have Nonbusiness Assets equal to 66⅔% or more of the total assets of the corporation (such corporation with 66⅔% Nonbusiness Assets, the "First Corporation," and the other corporation, the "Second Corporation"). Second, the First Corporation and the Second Corporation must be described in one of the following three bands:

- the First Corporation has at least 66⅔%, but less than 80%, Nonbusiness Assets, and the Second Corporation has less than 30% Nonbusiness Assets;
- the First Corporation has at least 80%, but less than 90%, Nonbusiness Assets, and the Second Corporation has less than 40% Nonbusiness Assets; or
- the First Corporation has at least 90% Nonbusiness Assets, and the Second Corporation has less than 50% Nonbusiness Assets.

Internal spinoffs within a U.S. corporate group may avoid application of the per se device test under the proposed regulations.

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[7] The focus on "investment assets" under Rev. Proc. 2015-43 (now incorporated into Rev. Proc. 2016-3, 2016 I.R.B. 126) does not apply under the proposed regulations.

[8] In the case of a non-pro rata distribution, the difference would not be a device factor if such difference is attributable to a need to equalize the value of the controlled corporation's stock and securities distributed and the consideration exchanged therefore by the distributees.

Assets Used in the Five-Year Active Trade or Business Must Represent at Least 5% of Total Assets

The proposed regulations provide that if the fair market value of the Five-Year Active Trade or Business Assets of the distributing corporation or the controlled corporation is less than 5% of the total fair market value of the gross assets of such corporation, the spinoff would not satisfy the active trade or business requirement. No exception to this rule is provided for internal spinoffs within a corporate group, which could affect the ability of a corporate group to implement separation of assets in anticipation of an external spinoff that would satisfy the active trade or business requirement.

Effective Date and Transition Rule

In general, the proposed regulations are to be effective on the publication date of the final regulations. However, the proposed regulations, if finalized, would not apply to a distribution that is (i) made pursuant to an agreement, resolution, or other corporate action that is binding on or before the publication date of the final regulations, (ii) described in a ruling request submitted to the IRS on or before July 15, 2016, or (iii) described in a public announcement or filing with the Securities and Exchange Commission on or before the publication date of the final regulations.

Conclusion

The proposed regulations provide insight into the IRS and Treasury Department's views on spinoffs in which substantial Nonbusiness Assets are present (such as cash-rich spinoffs) and could have a significant impact on such transactions even before the rules are finalized. We recommend clients pursuing a potential spinoff transaction carefully consider whether the transaction implicates any of the rules set forth in the proposed regulations. We will continue to monitor developments in this area, which remains subject to continued study by the IRS and Treasury Department.

For further information, please contact one of the following members of the Firm's Tax Practice.

NEW YORK CITY

Gary B. Mandel
+1-212-455-7963
gmandel@stblaw.com

Robert E. Holo
+1-212-455-2514
rholo@stblaw.com

Jonathan Goldstein
+1-212-455-2048
jgoldstein@stblaw.com

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UNITED STATES

New York
425 Lexington Avenue
New York, NY 10017
+1-212-455-2000

Houston
600 Travis Street, Suite 5400
Houston, TX 77002
+1-713-821-5650

Los Angeles
1999 Avenue of the Stars
Los Angeles, CA 90067
+1-310-407-7500

Palo Alto
2475 Hanover Street
Palo Alto, CA 94304
+1-650-251-5000

Washington, D.C.
900 G Street, NW
Washington, D.C. 20001
+1-202-636-5500

EUROPE

London
CityPoint
One Ropemaker Street
London EC2Y 9HU
England
+44-(0)20-7275-6500

ASIA

Beijing
3901 China World Tower
1 Jian Guo Men Wai Avenue
Beijing 100004
China
+86-10-5965-2999

Hong Kong
ICBC Tower
3 Garden Road, Central
Hong Kong
+852-2514-7600

Seoul
25th Floor, West Tower
Mirae Asset Center 1
26 Eulji-ro 5-Gil, Jung-Gu
Seoul 100-210
Korea
+82-2-6030-3800

Tokyo
Ark Hills Sengokuyama Mori Tower
9-10, Roppongi 1-Chome
Minato-Ku, Tokyo 106-0032
Japan
+81-3-5562-6200

SOUTH AMERICA

São Paulo
Av. Presidente Juscelino
Kubitschek, 1455
São Paulo, SP 04543-011
Brazil
+55-11-3546-1000