Tax Alert

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Five Things about the IRS's Proposed Regulations on the Spinoff Device and Active Business Tests

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On July 14, 2016, the Internal Revenue Service (IRS) proposed long-anticipated regulations tightening the "device" and "active trade or business" tests that are necessary for a corporation to distribute a subsidiary in a tax-free spinoff under Section 355 of the Internal Revenue Code of 1986, as amended (the Code). The IRS has been studying the rules in response to widely publicized spinoffs in which tiny businesses were matched with large minority equity interests or pools of investment assets.

The proposed regulations include two expanded device tests, one of which is a *per se* ban, based on newly defined categories of Nonbusiness Assets and Business Assets, as well as a new active trade or business test. Importantly, the IRS chose to limit its new rules to the traditional device and active trade or business tests and not to invoke (for now) its power to police spinoffs under *General Utilities* repeal, which imposes corporate-level tax on an asset or stock distribution unless one of a number of exceptions outlined in the regulations applies.

1. **Business Assets**. The proposed regulations introduce the concept of a Business and Business Assets, which are a business (or the gross assets thereof) used in the active conduct of a trade or business (without taking into account the requirements of a five-year active trade or business (five-year ATB)), including reasonable amounts of working capital and assets held for regulatory purposes or business exigencies. Nonbusiness Assets are gross assets other than Business Assets. Stock in corporations and interests in partnerships are generally Nonbusiness Assets, except that (i) all members of a "Separate Affiliated Group" (SAG) as defined in Code Section 355(b)(3)(B) are treated as one corporation, (ii) if a corporation is considered to be engaged in the Business conducted by a partnership (using the criteria that would cause a corporation to be engaged in the partnership's five-year ATB), the partnership interest is bifurcated into

Business/Nonbusiness Assets in the same proportion as the partnership's Business/Nonbusiness Assets, (iii) a similar rule applies to stock of a corporation that is not a member of a SAG (which has an 80 percent ownership threshold) but would be a member of a SAG applied with a 50 percent ownership threshold and (iv) adjustments would prevent distortions for indebtedness between a distributing or spun off corporation and a partnership or corporation described in item (ii) or (iii) above.

2. **Business Assets *Per Se* Ban**. A spinoff that separates Nonbusiness Assets from one or more Businesses or Business Assets will generally fail to be tax-free because it will be considered a *per se* device. A distribution will be a *per se* device if (i) Nonbusiness Assets comprise 66 2/3 percent of the total assets of the distributing or spun off corporations *and* (ii) the transaction falls within one of the following three bands that compare Nonbusiness Assets of the distributing and spun off corporations: (A) Nonbusiness Assets comprise 66 2/3 percent or more but less than 80 percent of the total assets of the distributing or spun off corporations (first corporation) and the corresponding percentage of Nonbusiness Assets of the other corporation is less than 30 percent, (B) Nonbusiness Assets comprise 80 percent or more but less than 90 percent of the total assets of the first corporation and the corresponding percentage of the other corporation is less than 40 percent, or (C) Nonbusiness Assets comprise 90 percent or more of the total assets of the first corporation and the corresponding percentage of the other corporation is less than 50 percent. The bands are intended to capture transactions in which there is a significant disparity between the percentage of Nonbusiness Assets of the distributing and spun off corporations. There are very limited exceptions to the *per se* device rule. If you fail this test, your transaction is a device *per se*.

3. **Other Business Assets Tests**. The presence of Nonbusiness Assets is evidence of device, and, continuing the theme of the *per se* rule, evidence of device increases with more Nonbusiness Assets and a greater disparity between the percentage of Nonbusiness Assets of the distributing and spun off corporations. Under two limited objective safe harbors, ordinarily the following are not evidence of device: (A) neither the distributing nor spun off corporation has Nonbusiness Assets that comprise 20 percent of total assets and (B) the disparity between the Nonbusiness Assets (as a percentage of total assets) of the distributing and spun off corporations is less than 10 percentage points or, in the case of a non-pro rata distribution, the disparity equalizes the value of the stock and securities of the spun off corporation and the stock redeemed by the distributing corporation. Further, although a corporate business purpose can generally outweigh evidence of device, a corporate business purpose that relates to a separation of Nonbusiness Assets from one or more Businesses or Business Assets cannot outweigh evidence of device unless the business purpose involves a business exigency.

4. **Five-Year ATB Test**. The gross assets of the five-year ATB that satisfies the active trade or business test of Code Section 355(b)(2) for each of the distributing and spun off corporations must comprise at least 5 percent of their total assets, respectively. Stock in non-SAG corporations and interests in partnerships are not included as five-year ATB assets, except partnership interests (but not stock in 50 percent-owned non-SAG corporations) are subject to bifurcation rules similar to the Business/Nonbusiness Asset rules under the device test.

5. **Effective Date**. The new rules would only be effective for distributions after publication of the final regulations, with grandfathering for distributions pursuant to a binding agreement (or resolution of other corporate action) entered into before that date, for which an IRS ruling was

requested before that date or described in a public announcement or filing with the Securities and Exchange Commission before that date.

If you have any questions about the content of this alert, please contact the Pillsbury attorney with whom you regularly work, or the attorneys below.

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