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Federal Tax ADVISORY ■

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New Spin-Off Regulations Proposed

In July the Treasury proposed regulations reinterpreting Section 355 in cases where one of the corporations involved in the spinoff has more investment assets than the other or very little five-year active trade or business assets. If finalized, they will mean that certain minimum thresholds must be met, although a safe harbor is also provided.

Current Reg. Section 1.355-2(d) divides the world of assets into five-year active trade or business assets (ATB) and all others. A lot of other assets or a difference in the ratios of such assets between the two corporations is a so-called "device factor." This means that absent some "nondevice factors," the IRS could find the spinoff to have been used as a device to distribute earnings and profits to the shareholders, and thus tax it.

The proposal creates a different set of comparisons: nonbusiness assets versus business assets. It promotes the assets of a business that have been bought in the last five years into the "good" category. Therefore, the only assets that can cause a problem are what we might call investment assets, such as a minority position in the stock of other corporations, or cash. If these nonbusiness assets are too great in size or proportion, then those are device factors.

The good news is the safe harbor. If the nonbusiness assets are less than 20 percent of the asset value of a corporation, they can be ignored. If the difference between the percentage of such assets in the two corporations is less than 10 percentage points, the difference can be ignored.

On the other hand, the proposal contains two per se "bad" rules:

- If a corporation does not have a 5 percent ATB, it does not have an ATB that counts for Section 355 purposes, and so cannot be a party to a Section 355 spinoff.
- If the disproportion between the nonbusiness asset percentages of the two corporations is too great under a sliding scale, then Section 355 cannot apply.

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There will be grumbling about the proposal because it will necessitate fair market valuations before many spinoffs can be carried out to ensure avoidance of the per se rules or compliance with the safe harbor. However, in general the proposal is good news, both because it could have been a lot worse, and because it provides some needed certainty.

For additional information, call Jack Cummings at 919.862.2302.

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