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CLIENT PUBLICATION

TAX | July 15, 2016

Treasury and IRS Issue New Spin-Off Proposed Treasury Regulations on Device and Active Trade or Business Requirements

On July 14, 2016, the Treasury Department and the IRS issued proposed regulations under Section 355 on spin-off transactions (the "Proposed Regulations") that provide guidance with respect to the spin-off device prohibition (the "Device Requirement") and the 5-year active trade or business requirement of Section 355(b) (the "ATB Requirement"). The Proposed Regulations contain substantive rules with respect to spin-off areas that Treasury and the IRS previously announced were under study and for which private letter rulings would not be issued. Most significantly, the Proposed Regulations add new rules examining the ratio of non-business assets to business assets and add a new test pursuant to which a transaction would be a per se device. In addition, the Proposed Regulations would require that the qualifying active trade or business represent at least 5% of the distributing and controlled corporations' assets. The Proposed Regulations are intended to discourage highly-structured transactions that are sometimes pursued by activist shareholders in addressing corporate reorganizations such as in the case of Yahoo Inc. So-called "cash-rich split-off" transactions should not be affected by the Proposed Regulations other than the new 5% active trade or business rule. The Proposed Regulations will be effective for spin-offs occurring on or after the date that the Proposed Regulations are published as final regulations, although certain previously planned spin-offs will be grandfathered.

Prior Announcements

The Proposed Regulations follow the September 2015 release of (i) Rev. Proc. 2015-43 (the "Rev. Proc.") pursuant to which the IRS announced new "no-rule" areas with respect to spin-offs involving substantial amounts of investment assets, small amounts of active trade or business assets, or elections to be treated as real estate investment trusts ("REITs") or regulated investment companies, and (ii) Notice 2015-59 (the "Notice") pursuant to which Treasury and the IRS announced that these no-rule areas were under study. The Rev. Proc. and Notice were updates to prior announcements by the IRS in May and July of 2015 regarding potential changes in its ruling practice for spin-offs, including with respect to the ATB Requirement.

In the Notice, the Treasury and the IRS stated that they have become concerned that spin-offs involving the no-rule areas (i) present evidence of device under the Device Requirement, (ii) violate the ATB Requirement or (iii) violate the requirement that a spin-off have a valid non-tax corporate business purpose. The Treasury and IRS also expressed concern that these spin-offs could circumvent the purposes of Section 311, which requires corporations to recognize any built-in gain upon the distribution of appreciated property to their shareholders. These prior

announcements generally appear to have been in response to highly-publicized “cash-rich” spin-offs and spin-offs involving corporations electing REIT status. In December 2015, Sections 355(h) and 856(c)(8) were enacted, which prohibit spin-offs where only one of the distributing corporation (“D”) and the controlled corporation (“C”) is a REIT or where D or C elect to be a REIT within 10 years following a spin-off.

Device Requirement

Under the Device Requirement, a spin-off must not be used principally as a device for the distribution of earnings and profits of D or C. This determination analyzes whether the spin-off facilitates a circumvention of the dividend rules through a subsequent sale of stock of D or C for cash. Whether a spin-off fails the Device Requirement is based on the facts and circumstances.

Current Regulations

Current regulations set forth various factors that are evidence of device or nondevice.

Evidence of device includes (i) a pro rata spin-off, (ii) a subsequent sale of D or C stock for cash in a taxable transaction, and (iii) the nature, kind, amount and use of assets of D and C (the “Use of Assets Device Factor”).

Under the Use of Assets Device Factor, assets not used in a 5-year active trade or business that satisfies the ATB Requirement (an “ATB”) are evidence of device. Such assets include cash and other liquid assets not related to the reasonable needs of an ATB. The strength of the evidence of device under this factor includes D’s and C’s ratios of non-ATB assets to ATB assets. Any difference in the ratios of D and C is ordinarily not evidence of a device in the case of a split-off where the difference relates to equalizing the values of the D stock surrendered by D shareholders in exchange for C stock.

Evidence of nondevice includes: (i) a corporate business purpose for the spin-off (the “Business Purpose Device Factor”), (ii) D being publicly-traded and widely-held, and (iii) C stock distributed to D shareholders that are US corporations entitled to the dividends-received deduction. For purposes of the Business Purpose Device Factor, the stronger the evidence of device, the stronger the corporate business purposes must be to prevent the spin-off from failing the Device Requirement. In addition, evidence of device with respect to the transfer or retention of non-ATB assets can be outweighed by the existence of a corporate business purpose for such transfer of retention.

Finally, a spin-off ordinarily will not fail the Device Requirement, even in the presence of device factors, if, in the absence of Section 355 treatment, the spin-off would be treated as a sale or exchange under Section 302(a) (i.e., a split-off where the exchanging shareholders meaningfully reduce their interest in D).

Proposed Regulations

The Proposed Regulations modify the Use of Assets Device Factor and Business Purpose Device Factor, and they also add a new test where a spin-off can be treated as a per se device and thus fail the Device Requirement (the “Per Se Device Rule”).

Treasury and the IRS have determined that device potential generally exists if (i) D or C owns a large percentage of assets not used in business operations compared to its total assets, or (ii) or their respective percentages of assets not used in business operations differ substantially.

Use of Assets Device Factor

The Proposed Regulations modify the Use of Assets Device Factor by taking into account assets used in a business as “good assets” regardless of whether such business satisfies the ATB Requirement (“Business Assets”). For this purpose, Business Assets include (i) cash and other liquid assets held as a reasonable amount of working capital and (ii) assets required (by binding commitment or legal requirement) to be held to provide for exigencies related to a business or for regulatory purposes with respect to a business, including assets to hold or secure or otherwise provide for a financial obligation reasonably expected to arise from a business and to expend funds to expand or improve a business.

In contrast, assets held by D or C that are not Business Assets (“Non-Business Assets”) are evidence of device. Non-Business Assets, however, ordinarily are not evidence of device if the percentage owned by each of D and C is less than 20%. In addition, a difference between the Non-Business Assets percentages of D and C is evidence of device. Any difference in ratios ordinarily is not evidence of device if the difference is less than 10% or in the case of a split-off where the difference relates to equalizing values of D stock exchanged for C stock.

For purposes of determining Non-Business Assets percentages, all members of D’s and C’s “separate affiliated group” or “SAG” (as defined in Section 355(b)—generally, corporations with 80% common ownership) will be treated as a single corporation. Interests in a partnership will be treated as Non-Business Assets unless, based on percentage ownership and participation in management, D or C could be attributed the partnership business and satisfy the ATB Requirement in which case the partnership interest will only proportionately be treated as a Non-Business Asset. In addition, stock of a corporation that is not a SAG member will be treated as a Non-Business Asset unless there is at least 50% ownership in which case the stock will only proportionately be treated as a Non-Business Asset.

Assets will be identified as Business Assets and Non-Business Assets immediately after the spin-off. Non-Business Assets percentages are based on fair market value and generally reduced by deductible liabilities that relate to such assets (or their associated business). Fair market values may be determined as of one of the following dates (D and C must use the same date): (i) immediately before the spin-off, (ii) on any date during the 60-day period preceding the spin-off, (iii) the date of a binding agreement to effect the spin-off and (iv) the date of a public announcement or filing with the SEC with respect to the spin-off.

If a spin-off involves the distribution of the stock of more than one C, the Use of Assets Device Factor requires a comparison of the Non-Business Assets percentages of D and each C and each C as compared to each other C. If one C distribution fails the Device Requirement by reason of the Use of Assets Device Factor, then all C distributions will fail the Device Requirement.

Finally, a new anti-abuse rule provides that transactions with a principal purpose to affect a Non-Business Asset percentage will be disregarded. The anti-abuse rule generally will not apply to acquisitions or dispositions of assets from or to an unrelated party or transfers between D and C.

Business Purpose Factor

The Proposed Regulations modify the Business Purpose Factor by adding that evidence of device presented by ownership of Non-Business Assets can be outweighed by a corporate business purpose for such ownership. In

addition, evidence of device presented by a difference between the Non-Business Assets percentages of D and C can be outweighed by a corporate business purpose for such difference. In order to represent evidence of non-device, a corporate business purpose with respect to the separation of Non-Business Assets from a related business must involve an exigency that requires an investment or other use by the corporation to which the Non-Business Assets were transferred.

The Proposed Regulations contain examples of the application of the modified Use of Assets Device and Business Purpose Factors. These examples demonstrate that a spin-off can fail the Device Requirement, notwithstanding a valid corporate business purpose for the spin-off, if (i) the Business Assets of D and C have about the same value, (ii) each corporation's Non-Business Assets percentage exceeds 20%, (iii) there was a disproportionate allocation of Non-Business Assets and D's Non-Business Assets percentage is 30 percentage points higher than C's, and (iv) there was no corporate business purpose for the disproportionate allocation (e.g., one business did not have an immediate need for additional cash). In contrast, a spin-off may not fail the Device Requirement if facts change such that (x) there is a corporate business purpose for a significant portion of the disproportionate allocation of the Non-Business Assets or (y) the Non-Business Assets were allocated such that each of D's and C's Non-Business Assets percentage exceeds 20% but their relative percentages differ by only 2.5%.

Per Se Device Rule

The Proposed Regulations provide that spin-offs with certain Non-Business Assets percentages will be treated as failing the Device Requirement regardless of any non-device factors.

A spin-off is subject to the Per Se Device Rule if (i) the Non-Business Assets percentage of D or C is at least 66 2/3% and (ii) the Non-Business Assets percentage of D or C, as applicable, is (A) 66 2/3% or more but less than 80%, and the Non-Business Assets percentage of the other corporation is less than 30%, (B) 80% or more but less than 90%, and the Non-Business Assets percentage of the other corporation is less than 40%, and (C) 90% or more, and the Non-Business Assets percentage of the other corporation is less than 50%.

In addition, the anti-abuse rule that applies with respect to the Use of Assets Device Factor applies in the same manner to the Per Se Device Rule.

The Per Se Device Rule, however, does not apply to spin-offs (x) where the shareholders of the distributing corporation are US corporations eligible for the dividends-received deduction or (y) that ordinarily are not considered to be a device under the regulations, which includes split-offs.

ATB Requirement

Under the ATB Requirement, both D and C must be engaged in a trade or business that was actively conducted during the 5-year period preceding the spin-off and was not acquired in a taxable transaction unless such acquisition is treated as an expansion of an existing business.

Current Regulations

The current regulations with respect to the ATB Requirement do not contain any rules regarding the size of the ATB. Rev. Rul. 73-44 specifically states that "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" but notes that the percentage of ATB

assets is a relevant factor for the Device Requirement. For ruling purposes, beginning in 1996, the IRS required ATB assets to represent at least 5% of the total assets of the corporation (unless facts and circumstances showed that the ATB assets were not *de minimis*). This 5% ruling requirement was eliminated in 2003, and, until the 2015 announcements (including the Rev. Proc. and the Notice), the IRS had not appeared to require a minimum percentage of ATB assets and implied that a “hot dog” stand was sufficient.

Previously issued proposed regulations contain rules regarding the ATB Requirement, including activities that constitute a trade business, attribution of activities from partnerships and affiliates and taxable transactions that are disregarded. The preamble to the Proposed Regulations provides that the IRS is still studying the issues contained in these other proposed regulations.

Proposed Regulations

The preamble to the Proposed Regulations provides that the IRS’ prior view of the size of an ATB was partially based on complex restructurings previously required to satisfy the ATB Requirement. Now that the SAG rules treat affiliated groups as a single corporation for purposes of the ATB Requirement, such restructurings are not required.

The Proposed Regulations provide that the ATB Requirement will not be satisfied unless the percentage of ATB assets of each of D and C is at least 5%. For this purpose, ATB assets include the same working capital and assets required to be held that were included in Business Assets for purposes of the Use of Assets Device Factor.

The same rules for identifying and valuing assets described above with respect to the Device Factor, apply to the ATB Requirement. In addition, although partnership interests will be proportionately taken into account if D or C is attributed a partnership business that is an ATB, stock of a corporation other than an SAG member will be treated as a non-ATB asset (*i.e.*, no look-through based on 50% ownership).

The anti-abuse rule described above with respect to the Device Factor generally applies in the same manner with respect to the ATB Requirement.

Effective Date

The Proposed Regulations apply to spin-offs occurring on or after the date final regulations are published. Notwithstanding the foregoing, any such final regulations will not apply to spin-offs that occur after such date but were (i) made pursuant to an agreement, resolution, or other corporate action that is binding on or before such date and at all times thereafter, (ii) described in a ruling request submitted to the IRS on or before such date or (iii) described in a public announcement or filing with the SEC on or before such date.

Request for Comments

Treasury and the IRS request comments on the Proposed Regulations, including whether there should be exceptions to the 5% rule for the ATB Requirement. The preamble does not contain any deadline for the comments or a timeline for final regulations.

In addition, Treasury and the IRS continue to study issues relating to corporate-level gain recognition under Section 311 with respect to transactions involving the separation of non-business assets from business assets, and are considering issuing guidance under Section 337(d).

The Proposed Regulations represent a more detailed and stronger response than the Notice and Rev. Proc. by announcing substantive rules with respect to Non-Business Assets and the Device Requirement and the size of an ATB for purposes of the ATB Requirement. We do not expect the Proposed Regulations to affect most spin-off transactions. However, spin-off transactions that involve small ATBs or significant Non-Business Assets that are disproportionate between D and C could encounter difficult issues involving asset identification and valuation. In addition, the Proposed Regulations should not affect so-called "cash-rich split-off" transactions other than requiring the ATB to represent at least 5% of the assets of C. As discussed above, the Per Se Device Factor is not applicable to split-offs. Section 355(g), which was previously enacted to place limitations on cash-rich split-offs, requires C's cash and investment assets to be less than 66 2/3% of its total assets.

CONTACTS

Laurence M. Bambino
New York
+1.212.848.4213
lbambino@shearman.com

Laurence E. Crouch
Menlo Park
+1.650.838.3718
lcrouch@shearman.com

Ethan D. Harris
Washington, DC
+1.202.508.8163
ethan.harris@shearman.com

Robert A. Rudnick
Washington, DC
+1.202.508.8020
New York
+1.212.848.5033
rrudnick@shearman.com

Michael B. Shulman
Washington DC
+1.202.508.8075
mshulman@shearman.com

D. Kevin Dolan
Washington, DC
+1.202.508.8016
kevin.dolan@shearman.com

Jeffrey A. Quinn
Washington, DC
+1.202.508.8000
jeffrey.quinn@shearman.com

Nathan Tasso
Washington DC
+1.202.508.8046
nathan.tasso@shearman.com

ABU DHABI | BEIJING | BRUSSELS | DUBAI | FRANKFURT | HONG KONG | LONDON | MENLO PARK | MILAN | NEW YORK
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This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

401 9th STREET, NW | SUITE 800 | WASHINGTON, DC | 20004-2128

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