GT GreenbergTraurig

Tax | Alert

July 2016

New Proposed Regulations Provide Clarity and Rigidity to Tax-Free Spin-Off Rules

If finalized, newly released proposed Treasury regulations may make spin-offs more difficult to accomplish despite providing important clarity. The proposed regulations tighten the standard for what constitutes an "active trade or business" to qualify for tax-free treatment in a spin-off transaction by raising the floor of required active business assets to 5 percent of total company assets. The proposed regulations also would prevent tax-free treatment if there exists a significant disparity in the relative size of nonbusiness assets between the distributing and spun-off companies. The issuance of these proposed Treasury regulations continue the trend of the federal taxing authorities adopting objective per se rules instead of facts and circumstances inquiries. Referred to as the "Hot Dog Stand guidance" by some commentators, the proposed regulations attempt to prevent the situation where operating a hot dog stand (or other insubstantial business) would be sufficient business activity to spin-off a large amount of cash tax-free to shareholders. Recently, a large public spin-off was derailed in part by the active trade or business requirement.

Under Section 355 of the Internal Revenue Code of 1986, as amended (the Code), a corporation may distribute to its shareholders the stock of a subsidiary without triggering income or gain to itself or its shareholders. If a spin-off is busted, the result could be a transaction treated as a taxable exchange. In order for the corporation to distribute the stock tax-free, certain statutory and non-statutory requirements must be met, including:[1]

1. Control: The distributing corporation must own and distribute at least 80 percent of the vote and value of the stock of the distributed corporation.

[1] Code Section 355 contains many additional requirements not discussed here. Please consult tax counsel when considering a tax-free spinoff transaction.

2. Business purpose: The transaction must be carried out for valid, non-tax motivated, business purposes.

3. Device: The transaction must not be used as a device to distribute the earnings and profits of either corporation.

4. Active trade or business: Both the distributing and controlled corporation must have been engaged in an active trade or business for five years.

5. Post-spin transactions: A spin-off cannot be done in order to have control of the distributing or controlled corporation be acquired by an unrelated person.

The newly proposed regulations address the device and active trade or business requirements. The active trade or business requirement has generally been ambiguous in the past. While it requires that a corporation engage such a business for at least five years, the size of the business assets relative to non-business assets (*e.g.,* cash) was left unclear. Certain tax practitioners questioned the relevance of the active trade or business requirement before these proposed regulations. The device test is also based on facts and circumstances and is thus similarly unclear. The proposed regulations clarify both requirements by creating standard and attaching valuation requirements.

Active Trade or Business

In general, Code Section 355 requires that each of the distributing and controlled corporations are engaged in the conduct of an active trade or business for five years, as determined immediately after the spin-off. In the absence of a definition in the statute, case law and IRS guidance has filled the void. A corporation is attributed the active trade or business of its affiliated group, so a parent may be attributed a business by virtue of the operations of a subsidiary. A "trade or business" is defined in the Treasury Regulations as a specific group of activities carried on the purpose of earning income or profit.[2] The "active" requirement refers to active and substantial management and operational functions.[3]

There are no statutory requirements regarding the relative size of the assets engaged in the active trade or business in the statute. The IRS had previously endorsed as low as 2 percent of the assets being engaged in an active trade or business as satisfying their requirements.[4] Over the years, the IRS consistently took positions that a very small percentage would suffice.[5] In 1996, the IRS abandoned this approach and instead announced they would not grant ruling requests where the gross assets of the trade or business relied on to meet the active business requirement had a fair market value of less than 5 percent of the total fair market value of the gross assets of the corporation.[6] While later abandoned in 2003, this standard was once again revived in 2015.[7]

The proposed regulations make clear that the percentage of assets attributable to an active trade or business must be a minimum of 5 percent. This is a per se rule and not subject to an assessment of facts and circumstances. The IRS has abandoned its historical position that there is no absolute requirement for some minimum percentage of active trade or business assets.

The proposed regulations seem to suggest that a company could purchase business assets to raise their percentage above the 5 percent threshold.[8] These assets would have to be related to the company's current business, and not a new

---

[2] Treas. Reg. Section 1.355-3(b)(2)(ii). Note, there are exceptions where earning a profit is not required to qualify for tax-free treatment under Section 355.

[3] Treas. Reg. Section 1.355-3(b)(2)(iii). Management activities refer to decision making with respect to significant business issues. Operational activities relate to production, distribution, and sale of goods, or provision of services by the business to its customers.

[4] GCM 31799 (Sept. 29, 1960)

[5] GCM 34238 (Dec. 15, 1969) assets equal to 5 percent of corporation's net book value used in active trade or business; PLR 9510005 (Dec. 5, 1994) cash and investment assets were 93 percent by book value; PLR 8921065 (Feb. 28, 1989) investment assets were 79 percent by book value.

[6] Rev. Rul. 96-43, 1996-2 C.B. 330. This Rev. Rul. Was later revoked without explanation in Rev. Proc. 2003-24, 2003-1 C.B. 81.

[7] Rev. Proc. 2015-43 and Notice 2015-59 (Sept. 14, 2015).

[8] Prop. Reg. 1.355-9(d). The anti-abuse provision does not apply to a non-transitory acquisition of assets from an unrelated party.

business line, to avoid triggering the anti-abuse provisions of the proposed regulations. However, the 5 percent minimum is not a safe harbor; it is merely satisfaction of one part of the active trade or business requirement.

Device

The device test in Code Section 355 requires that the transaction not be used principally as a device for the distribution of the earnings and profits of either corporation. This requirement arose due to certain planning techniques which took advantage of the differing capital gains and ordinary income tax rates.[9]

The proposed regulations would provide thresholds for determining whether the ownership of non-business assets and/or their relative size to business assets is evidence of device. The larger the presence of nonbusiness assets, the stronger the evidence of device. Similarly, the larger the difference between the relative percentage of business assets of each of the distributing and controlled corporation, the stronger the evidence of device.

The proposed regulations introduce a per se rule that present an irrebuttable presumption of device based on these factors. The first prong is whether either corporation has nonbusiness assets that make up two-thirds or more of their total assets. A strong potential for device exists if the two-thirds threshold is exceeded.

The second prong compares nonbusiness assets of the distributing and controlled corporations. Treasury acknowledges the difficulty in valuations and thus gives ranges of percentages for its second prong as a sliding scale:

		Corporation B		
	% Nonbusiness Assets	Less than 30%	Less than 40%	Less than 50%
Corporation A	66 2/3%-79.9%	Fail Device		
	80-89.9%		Fail Device	
	90+%			Fail Device

If both prongs of the per se device test are met, the distribution would be a per se device and other general facts and circumstances factors are irrelevant.

Business Impact

The proposed regulations will put a heavier emphasis on the valuation of business and nonbusiness assets to qualify for tax-free treatment. Previously, with more ambiguous rules on the size of the business assets, precise valuation was less important. But now, even with a sliding scale in the per se test, valuation will take a central role. Planning opportunities may exist by purchasing active business assets from unrelated third parties to increase a company's active business asset percentage.

The use of a per se rule is now the second time this year that the Treasury Department has adopted such a rule (the other being proposed debt-equity regulations under Code Section 385). This may indicate the beginning of a trend to use more objective tests and less facts and circumstances inquiries.

As none of the proposed regulations contain safe harbors, companies should consult with counsel in order to engage in careful review of their tax structuring to ensure tax-free treatment. The good news is that companies now know with certainty not to cross the 5 percent line. Historically companies planning spin-offs would submit a private ruling request to the IRS to ensure a tax-free outcome. However, as the IRS has narrowed the types of spin-off issues it will rule on,

[9] Generally dividends from a domestic corporation and some foreign corporations are currently taxed at the same rate as capital gains. However, dividends are not offset by tax basis.

taxpayers instead have sought opinions from tax counsel. The proposed regulations allow those tax professionals to give opinions with greater certainty and thus reduce the risk of a significant tax exposure.

This *GT Alert* was prepared by **Alejandro Ruiz** and **Josh Prywes**. Questions about this information can be directed to:

- Alejandro Ruiz | +1 415.655.1318 | ruiz@gtlaw.com
- Josh Prywes | +1 214.665.3626 | prywesj@gtlaw.com
- Or your Greenberg Traurig attorney

Albany
+1 518.689.1400

Amsterdam
+ 31 20 301 7300

Atlanta
+1 678.553.2100

Austin
+1 512.320.7200

Berlin¬
+49 (0) 30 700 171 100

Berlin-GT Restructuring¯
+49 (0) 30 700 171 100

Boca Raton
+1 561.955.7600

Boston
+1 617.310.6000

Chicago
+1 312.456.8400

Dallas
+1 214.665.3600

Delaware
+1 302.661.7000

Denver
+1 303.572.6500

Fort Lauderdale
+1 954.765.0500

Houston
+1 713.374.3500

Las Vegas
+1 702.792.3773

London*
+44 (0)203 349 8700

Los Angeles
+1 310.586.7700

Mexico City+
+52 55 5029.0000

Miami
+1 305.579.0500

New Jersey
+1 973.360.7900

New York
+1 212.801.9200

Northern Virginia
+1 703.749.1300

Orange County
+1 949.732.6500

Orlando
+1 407.420.1000

Philadelphia
+1 215.988.7800

Phoenix
+1 602.445.8000

Sacramento
+1 916.442.1111

San Francisco
+1 415.655.1300

Seoul∞
+82 (0) 2.369.1000

Shanghai
+86 (0) 21.6391.6633

Silicon Valley
+1 650.328.8500

Tallahassee
+1 850.222.6891

Tampa
+1 813.318.5700

Tel Aviv^
+972 (0) 3.636.6000

Tokyo¤
+81 (0)3 4510 2200

Warsaw~
+48 22 690 6100

Washington, D.C.
+1 202.331.3100

Westchester County
+1 914.286.2900

West Palm Beach
+1 561.650.7900

*This Greenberg Traurig Alert is issued for informational purposes only and is not intended to be construed or used as general legal advice nor as a solicitation of any type. Please contact the author(s) or your Greenberg Traurig contact if you have questions regarding the currency of this information. The hiring of a lawyer is an important decision. Before you decide, ask for written information about the lawyer's legal qualifications and experience. Greenberg Traurig is a service mark and trade name of Greenberg Traurig, LLP and Greenberg Traurig, P.A. ¬Greenberg Traurig's Berlin office is operated by Greenberg Traurig Germany, an affiliate of Greenberg Traurig, P.A. and Greenberg Traurig, LLP. ¯ Berlin - GT Restructuring is operated by Köhler-Ma Geiser Partnerschaft Rechtsanwälte, Insolvenzverwalter. *Operates as Greenberg Traurig Maher LLP. **Greenberg Traurig is not responsible for any legal or other services rendered by attorneys employed by the strategic alliance firms. +Greenberg Traurig's Mexico City office is operated by Greenberg Traurig, S.C., an affiliate of Greenberg Traurig, P.A. and Greenberg Traurig, LLP. ∞Operates as Greenberg Traurig LLP Foreign Legal Consultant Office. ^Greenberg Traurig's Tel Aviv office is a branch of Greenberg Traurig, P.A., Florida, USA. ¤Greenberg Traurig Tokyo Law Offices are operated by GT Tokyo Horitsu Jimusho, an affiliate of Greenberg Traurig, P.A. and Greenberg Traurig, LLP. ~Greenberg Traurig's Warsaw office is operated by Greenberg Traurig Grzesiak sp.k., an affiliate of Greenberg Traurig, P.A. and Greenberg Traurig, LLP. Certain partners in Greenberg Traurig Grzesiak sp.k. are also shareholders in Greenberg Traurig, P.A. Images in this advertisement do not depict Greenberg Traurig attorneys, clients, staff or facilities. No aspect of this advertisement has been approved by the Supreme Court of New Jersey. ©2016 Greenberg Traurig, LLP. All rights reserved.*