

# PROPOSED REGULATIONS ON NONDEVICE & ACTIVE BUSINESS REQUIREMENTS UNDER CODE §355

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## Tags

Active Trade or Business  
Test  
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Spinoff

The I.R.S. recently issued proposed regulations (the “Proposed Regulations”)<sup>1</sup> clarifying the application of the “device” prohibition and the “active business” requirement of Code §355. The Proposed Regulations will affect corporations and their shareholders that plan to distribute stock of controlled corporations in tax-free transactions under Code §355.

## CORPORATE DISTRIBUTIONS

Generally, a distribution of assets from a corporation to its shareholders is a taxable event. The corporation recognizes gain to the extent the fair market value of the distributed property exceeds the corporation’s adjusted basis.<sup>2</sup> For the shareholders, the distribution will be treated as a dividend to the extent of the corporation’s earnings and profits.<sup>3</sup> The portion of the distribution that is not treated as a dividend is first applied against, and is used to reduce, the adjusted basis of the stock.<sup>4</sup> The excess amount is treated as a gain from the sale or exchange of property.<sup>5</sup>

Code §355 generally provides that, if certain requirements are satisfied, a distributing corporation (“Distributing”) may distribute the stock, or stock and securities, of a controlled corporation (“Controlled”) to its shareholders and security holders, without Distributing, its shareholders, or its security holders recognizing income, gain, or loss on the distribution. However, Code §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 Distributing, Controlled, or both.<sup>6</sup> Numerous other requirements also must be satisfied for Code §355 to apply to a distribution. One such requirement is that Distributing and Controlled must each be engaged in the active conduct of a trade or business immediately after the distribution (the so-called active business requirement).<sup>7</sup>

As mentioned above, the Proposed Regulations deal with both the device prohibition and the active business requirement. For more on divisive D-reorganizations and the additional requirements under Code §355, please see our article “Tax 101: How to Structure a Corporate Division.”<sup>8</sup>

<sup>1</sup> REG-134016-15, July 15, 2016.

<sup>2</sup> Code §311(b).

<sup>3</sup> Code §301(c)(1).

<sup>4</sup> Code §301(c)(2).

<sup>5</sup> Code §301(c)(3).

<sup>6</sup> Code §355(a)(1)(B).

<sup>7</sup> Code §355(a)(1)(C) and (b)(1)(A).

<sup>8</sup> Elizabeth V. Zanet, “Tax 101: How to Structure a Corporate Division,” *Insights*

## DEVICE PROHIBITION

Generally, the determination of whether a transaction is used principally as a device will be made from all the facts and circumstances, including, but not limited to, the presence of certain device and nondevice factors.<sup>9</sup> The existing regulations specify three factors that are evidence of a device<sup>10</sup> and three factors that are evidence of a nondevice.<sup>11</sup>

The device factors are (i) a *pro rata* distribution, (ii) a subsequent sale or exchange of stock, and (iii) the existence of assets that are not used in a trade or business (the “nature and use of assets” factor).<sup>12</sup>

The nondevice factors are (i) the presence of a corporate business purpose, (ii) the fact that the stock of Distributing is publicly traded and widely held, and (iii) the fact that the distribution is made to certain domestic corporate shareholders.<sup>13</sup>

Although the device prohibition primarily targets the conversion of dividend income to capital gain, a device can still exist if there would be a recovery of stock basis in lieu of the receipt of dividend income, even if the shareholder’s Federal income tax rates on dividend income and capital gain are the same.

The Proposed Regulations modify Treas. Reg. §1.355-2(d), which addresses transactions that are or are not a device. Specifically, the Proposed Regulations would revise (i) the nature and use of assets device factor and (ii) the corporate business purpose nondevice factor, and (iii) would add a *per se* device test.

### **Nature and Use of Assets**

The preamble to the Proposed Regulations states that device potential will generally exist (i) if Distributing or Controlled owns a large percentage of gross assets that are not used in business operations (“Nonbusiness Assets”), as compared to the total assets, or (ii) if Distributing’s and Controlled’s relative percentages of these assets (“Nonbusiness Asset Percentages”) differ substantially.

The Proposed Regulations would provide thresholds for determining whether the ownership of Nonbusiness Assets and/or differences in the Nonbusiness Asset Percentages for Distributing and Controlled are evidence of device. If neither Distributing nor Controlled has Nonbusiness Assets that comprise 20% or more of its total assets, the ownership of Nonbusiness Assets ordinarily would not be evidence of a device.<sup>14</sup>

Additionally, a difference in the Nonbusiness Asset Percentages of Distributing and Controlled ordinarily would not be evidence of a device if the difference is less than

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10 (2015).

<sup>9</sup> Treas. Reg. §1.355-2(d)(1).

<sup>10</sup> Treas. Reg. §1.355-2(d)(2).

<sup>11</sup> Treas. Reg. §1.355-2(d)(3).

<sup>12</sup> Treas. Reg. §1.355-2(d)(2).

<sup>13</sup> Treas. Reg. §1.355-2(d)(3).

<sup>14</sup> Prop. Treas. Reg. §1.355-2(d)(2)(iv)(C)(1).

10% or if, in the case of a non-*pro rata* distribution, the difference is attributable to a need to equalize the value of the distributed stock and securities of Controlled and the consideration exchanged by the distributees.<sup>15</sup> Accordingly, the Proposed Regulations treat these circumstances as ordinarily not constituting evidence of a device.

### **Corporate Business Purpose**

Under the Proposed Regulations, a corporate business purpose that relates to a separation of Nonbusiness Assets from one or more businesses, or from assets used in business operations (“Business Assets”), would not be evidence of a nondevice, unless the business purpose involves an exigency that requires an investment in, or other use of, the Nonbusiness Assets.<sup>16</sup> Under the Proposed Regulations, absent such an exigency, separations are treated as distributions used principally as a device.

### **Per Se Device Test**

The Proposed Regulations add a *per se* device test, which provides that some non-device factors can never overcome the device factors if the test is met.<sup>17</sup> The *per se* device test has two prongs:

- The first prong is met if Distributing or Controlled has a Nonbusiness Asset Percentage of at least 66.67%.
- The second prong is met if the Nonbusiness Asset Percentage of Distributing differs significantly from that of Controlled.

Specifically, the second prong is satisfied if any of the following three bands are met:

- Band One: One corporation’s Nonbusiness Asset Percentage is 66.67% or more, but less than 80%, and the other corporation’s Nonbusiness Asset Percentage is less than 30%.
- Band Two: One corporation’s Nonbusiness Asset Percentage is 80% or more, but less than 90%, and the other corporation’s Nonbusiness Asset Percentage is less than 40%.
- Band Three: One corporation’s Nonbusiness Asset Percentage is 90% or more, and the other corporation’s Nonbusiness Asset Percentage is less than 50%.

All of these bands represent cases in which the Nonbusiness Asset Percentages of Distributing and Controlled are significantly different.

### **Example**

Distributing has Business Assets of \$80 and Controlled has Business Assets of \$105. Distributing also has \$195 cash, which Distributing holds as a Nonbusiness Asset. Distributing contributes \$5 to Controlled. Controlled retains the amount, and

<sup>15</sup> Prop. Treas. Reg. §1.355-2(d)(2)(iv)(C)(2).

<sup>16</sup> Prop. Treas. Reg. §1.355-2(d)(3)(ii).

<sup>17</sup> Prop. Treas. Reg. §1.355-2(d)(5).

*“The Proposed Regulations add a per se device test, which provides that some nondevice factors can never overcome the device factors if the test is met.”*

the stock of Controlled is distributed *pro rata* among Distributing's shareholders. Distributing's Nonbusiness Asset Percentage is 70% (*i.e.*, \$190/\$270), and Controlled's Nonbusiness Asset Percentage is 4.5% (*i.e.*, \$5/\$110).

### Analysis

The first prong would be met because Distributing has a Nonbusiness Asset Percentage of more than 66.67%. The second prong would be met because Distributing's Nonbusiness Asset Percentage is more than 66.67%, but less than 80%, and Controlled's Nonbusiness Asset Percentage is less than 30% (Band One). In this example, the distribution would, *per se*, be considered a device for the distribution of the earnings and profits of Distributing, Controlled, or both. Therefore, the distribution could not qualify for tax-free treatment under Code §355.

## ACTIVE BUSINESS REQUIREMENT

Under the active business requirement, Distributing and Controlled must each be engaged in the active conduct of a trade or business immediately after the distribution.<sup>18</sup> To qualify, a corporation must conduct an active business throughout the five-year period ending on the date of the distribution, and within that period, it may not have directly or indirectly acquired the business in a transaction in which gain or loss was recognized.<sup>19</sup>

The Code does not currently provide a minimum or relative size requirement for an active business to qualify under Code §355(b). The Proposed Regulations would require the "Five-Year-Active-Business Asset Percentage" (*i.e.*, the percentage determined by dividing the fair market value of a corporation's "Five-Year-Active-Business Assets"<sup>20</sup> by the fair market value of its total assets with respect to the above-mentioned five-year period) of each corporation, Distributing and Controlled, to be at least 5% for the requirements of Code §355(a)(1)(C) and (b) to be satisfied with respect to a distribution.<sup>21</sup>

## ANTI-ABUSE RULE

The Proposed Regulations also provide an anti-abuse rule.<sup>22</sup> A transaction or series of transactions (such as a change in the form of ownership of an asset, an issuance, assumption or repayment of indebtedness, or an issuance or redemption of stock) would not be given effect if undertaken with a principal purpose of affecting (i) the Nonbusiness Asset Percentage of any corporation, in order to avoid a determination that a distribution was a device, or (ii) the Five-Year-Active-Business Asset Percentage of any corporation, in order to avoid a determination that a distribution does not meet the active business requirement. The transactions covered by the anti-abuse rule generally would not include an acquisition or disposition of assets

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<sup>18</sup> Code §355(a)(1)(C), (b).

<sup>19</sup> Code §355(b)(2)(B), (C), (D).

<sup>20</sup> The Five-Year-Active-Business Assets of a corporation means its gross assets used in one or more businesses that meet the five year active business requirements of Code §355(b)(2). Prop. Treas. Reg. §1.355-9(a)(3).

<sup>21</sup> Prop. Treas. Reg. §1-355-9(a).

<sup>22</sup> Prop. Treas. Reg. §1-355-2(d)(2)(iv)(E).

(other than an acquisition from or disposition to a related person) or a transfer of assets between Distributing and Controlled.

## MOVING FORWARD

The Proposed Regulations will become effective as of the date the final regulations are published in the Federal Register. The Proposed Regulations will not change current rules with respect to the transactions that occurred before the Proposed Regulations become final, but taxpayers should consider the proposed rules when planning a distribution intended to qualify under Code §355.



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