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United States Proposes Further Limits on Spinoffs

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Spinoffs or split-offs are commonly sought by shareholder activists of public companies to increase shareholder value. Such proposals assume the tax-free nature of the transaction, because a taxable transaction could involve tax to both the distributing corporation (Distributing) and its shareholders. Under intercompany agreements, the distributed corporation (Controlled) may also assume the obligation for the corporate level tax (particularly if its actions later trigger the tax). Yet there are many hurdles to tax-free spinoffs and split-offs that must meet a host of rigorous requirements set forth in the Internal Revenue Code (Code), Treasury regulations and case law. One of those requirements is that Distributing and Controlled each hold a qualifying five-year active business immediately after the transaction (Active Business Test); another requirement is that the transaction not be used as a mere device for the distribution of earnings and profits (Device Test).[1] We focus here on the Active Business Test and the Device Test because these are the subjects of some newly proposed regulations (Proposed Regulations).

Background

Historically, the IRS has been willing to issue private rulings to reduce uncertainty about whether a distribution will qualify as a tax-free spinoff or split-off. In addition, sometimes Congress loosens the requirements for tax-free treatment, including adopting a group-wide test for qualifying an active business. In recent years, however, Congress has moved to narrow the class of tax-free transactions in which there is a split-off of a corporation with substantial liquid assets or a split-off following the purchase of a control position, and transactions involving a change in the control of either Distributing or Controlled before or after a spinoff but under a plan.

In September 2015, the IRS announced, in Notice 2015-59 and Revenue Procedure 2015-43, that it was likely to revisit whether tax-free treatment would be afforded to a spinoff whereby either Distributing or Controlled held both a relatively small active business and a relatively large amount of investment assets. The IRS invited comments on the issues and then released new ruling guidelines. Under the new guidelines, the IRS would "not ordinarily rule" on transactions in which the percentage of active business assets represented less than 5% of the total assets of either Distributing or Controlled and that it would temporarily not rule at all when three conditions were met – namely, when at least 2/3 of the assets of either Distributing or Controlled were investment assets; when the active business represented less than 10% of the total assets of either Distributing or Controlled; and when the ratio of investment to total assets of either company was three times that ratio for the other company.[2]

It appears that only the New York State Bar Association's Tax Section submitted comments (in mid-April 2016) in response to Notice 2015-59. But on July 14, 2016, the Proposed Regulations were published. They would be effective generally to transactions occurring on or after publication of those rules in final form.[3]

New Rules in Context

The Proposed Regulations would include more objective rules, as explained in its preamble.[4] The Proposed Regulations detail alternative valuation dates for applying the objective tests and require that the same date be used (consistently) by the parties.

***De Minimis* Active Business Test.** The most straightforward and objective of the new rules is found under the Active Business Test. As foreshadowed in Rev. Proc. 2015-43, the Proposed Regulations would require that active business assets (meeting the five-year test) represent *at least 5%* of the total assets of both Distributing and Controlled.

New Device Test. The New Device Test would include a host of objective tests. In contrast, the current regulations apply the Device Test on the basis of "all of the facts and circumstances" and suggest a weighing of three identified "device factors" against three "non-device factors". Current regulations provide only limited guidance on how to weigh the factors. The current regulations include as evidence of a device a disproportionate holding of investment assets by either Distributing or Controlled compared with the amount of five-year active business assets. As described further below, the Proposed Regulations include much more objective rules and compare instead the relative holdings of "nonbusiness assets" to total assets of each tested party. Special rules are proposed to deal with the classification of assets held by a partnership from which an active business could be attributed and in computing the nonbusiness asset portion of stock or debt of a 50% or greater subsidiary. In each of these two situations, the Proposed Regulations would not adopt a look-through to the underlying gross assets of the partnership or subsidiary, but only to the net value represented by the partnership or share interest, respectively.

The Proposed Regulations include an objective test *to rule out a device* (specifically, when the nonbusiness asset percentage of each entity is less than 20%, the ratios differ by less than 10 percentage points, or when the distribution is not pro rata). Similarly, the Proposed Regulations include a two-pronged "*per se* device" rule that is based on objective criteria. The first prong is met if at least 66 2/3% of the total assets of either Distributing or Controlled consist of nonbusiness assets. The second prong compares the nonbusiness asset percentage of each of Distributing and Controlled, and is met if (i) one company's nonbusiness asset percentage is at least 66 2/3% but less than 80%, and the other company's nonbusiness asset percentage is less than 30%; (ii) one company's nonbusiness asset percentage is at least 80% but less than 90%, and the other company's nonbusiness asset percentage is less than 40%; or (iii) one company's nonbusiness asset percentage is at least 90% but the other company's nonbusiness asset percentage is less than 50%. If both prongs are met, the transaction would be considered a device, notwithstanding the presence of any non-device factors.[5]

In another revision to the current rules, the Proposed Regulations would not automatically permit a strong business purpose to override other evidence of device factors. In particular, when nonbusiness assets are being divided disproportionately, no such override would apply unless a business exigency justifies it. An example illustrates the use of such assets within six months of the spinoff as not a device.

Anti-abuse Rules. The Proposed Regulations include a number of anti-abuse rules designed to permit the IRS to disregard certain related party transactions undertaken with the principal purpose of changing the nonbusiness asset percentage or the active business asset percentage used in the new objective tests; however, there are exceptions for transactions that occur within an affiliated group. According to the preamble, the Proposed Regulations reverse an interpretation of the current regulations that permitted intragroup asset purchases (without regard to where in the group the assets had been located) to qualify under the Active Business Test.

Conclusion

Adoption of a *de minimis* test for a qualifying business is not very surprising, and use of a 5% rule was foreshadowed by Rev. Proc. 2015-43. Adoption of detailed and tight proportionality requirements for nonbusiness assets is more surprising. This aspect of the Proposed Regulations will be controversial. But reducing uncertainty in this important corner of the tax world would be good.

[1]Other requirements include having a valid business purpose, not having acquired the active businesses in the last five years in a taxable transaction, and distributing shares of Controlled that represent a "control" position. The Internal Revenue Service (IRS), recently issued Revenue Procedure 2016-40, unrelated to the Proposed Regulations. The Revenue Procedure provides a safe harbour under which taxpayers that have implemented a high-vote share structure to satisfy the "control" requirement of the spinoff rules can unwind the high-vote structure without affecting the qualification of the transaction as a tax-free spinoff if the unwinding occurs more than 24 months after spinoff.

[2] Rev. Proc. 2015-43 also included transactions involving a spinoff of a company after which one converted to a REIT or a RIC; in December 2015, Congress restricted similar transactions, and recent regulations require immediate gain recognition on such conversions.

[3]The proposed regulations include a transition rule that provides that the rules therein do not apply to a distribution that is (i) made under an agreement, resolution or other corporate action that is binding on or before the date on which the new provisions are published as final regulations in the *Federal Register*; (ii) described in a ruling request submitted to the IRS on or before *July 15, 2016;* and (iii) described in a

public announcement or filing with the Securities and Exchange Commission on or before the date on which the new provisions are published as final regulations in the *Federal Register*.

[4] The preamble explains that the *de minimis* rule should not be considered to contradict an old published ruling, but indicates that the ruling will be modified.

[5] There are certain limited exceptions to this *per se* rule, including an exception for distributions to a corporate distributee that would be entitled to a dividends-received deduction and an exception for certain transactions that are not ordinarily considered a device under the current regulations (e.g., distributions when there is an absence of earnings and profits, distributions that in the absence of Code section 355 would be treated as a redemption taxable as a sale or exchange, such as a split-off).

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