Report No. 1356

New York State Bar Association Tax Section

Report on Proposed Regulations under Section 355

Concerning the Device Prohibition and Active Trade or Business Requirement

October 14, 2016

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I. INTRODUCTION

This report (the "**Current Report**")[1] of the Tax Section of the New York State Bar Association comments on proposed regulations issued by the Treasury Department ("**Treasury**") and the Internal Revenue Service (the "**Service**," and, together with Treasury, the "**government**") under Section 355 of the Code,[2] concerning the application of the device prohibition of Section 355(a)(1)(B) (the "**Device Prohibition**," and a transaction that violates this prohibition, a "**Device**") and the active trade or business requirement of Section 355(b) (the "**ATB Requirement**," and the trade or business relied upon, the "**ATB**") that were published on July 15, 2016 (the "**Proposed Regulations**").[3]

Prior to the issuance of the Proposed Regulations, the Tax Section of the New York State Bar Association submitted a report on issues associated with the Device Prohibition and the ATB Requirement (the "**Prior Report**").[4] The Prior Report acknowledged the concerns previously

[1] This report was prepared by a working group composed of Howard Adams, William Alexander, Neil Barr, John Barrie, Stanley Barsky, Andy Braiterman, Michael Bruni, Robert Cassanos, Peter Connors, James Coss, Kathleen Ferrell, Nicole Field, Peter Furci, Lawrence Garrett, Edward Gonzalez, Tatyana Johnson, Joshua Holmes, Shane Kiggen, Morris Kramer, Jon Lamphier, Thomas May, Reza Nader, Richard Nugent, Deborah Paul, Yaron Reich, Rachel Reisberg, Michael Schler, David Sicular, Eric Sloan, Eric Solomon, Karen Sowell, Linda Swartz, Joseph Toce, Shun Tosaka, Davis Wang, Gordon Warnke, and Sarah Zablotney, with helpful comments from Kim Blanchard, Elizabeth Kessenides, Stephen Land, Richard Reinhold, David Schnabel, and Jodi Schwartz. This Report reflects solely the views of the Tax Section of the New York State Bar Association and not those of the NYSBA Executive Committee or the House of Delegates.

[2] Except as otherwise indicated, all references to "**Section**" and "**Reg. §**" refer, respectively, to sections of the Internal Revenue Code of 1986, as amended (the "**Code**"), and the Treasury Regulations promulgated thereunder.

[3] REG-134016-15, 81 Fed. Reg. 46004 (July 15, 2016).

[4] N.Y. ST. BA. ASS'N, TAX SEC., *Report on Notice 2015-59 and Revenue Procedure 2015-43 Relating to Substantial Investment Assets, De Minimis Active Trades or Businesses and C-to-RIC Spin-offs* (Rep. No. 1342, Apr. 12, 2016).

expressed by Treasury and the Service in Notice 2015-59[5] and Revenue Procedure 2015-43,[6] which also underlie the Proposed Regulations, stating, "[w]e agree with the concern expressed in the Notice that distributions characterized by substantial and disproportionate investment assets (within the meaning of the Notice) were not, as a general matter, intended to be covered by Section 355."[7]

Nevertheless, the Prior Report recommended that guidance focus on addressing distributions involving substantial and disproportionate *appreciated* investment assets, because these distributions have the potential for avoidance of corporate-level taxation (*i.e.*, the avoidance of the repeal of the *General Utilities*[8] doctrine). The Prior Report recommended against issuing guidance addressing purely shareholder-level concerns, based on our view that the current rules work well in the majority of cases and that transactions involving substantial investment assets implicating only shareholder-level concerns are rare. Consistent with these overall views, the Prior Report recommended issuing guidance aimed at imposing corporate-level gain on spin-offs involving substantial and disproportionate allocations of appreciated investment assets and did not recommend the adoption of a *de minimis* rule for the ATB Requirement or new Device rules addressing only shareholder-level concerns.

Treasury and the Service considered the Prior Report before issuing the Proposed Regulations and chose a different course. We believe that the framework of the Proposed Regulations—in particular, its introduction into an inherently factual inquiry of numerical tests for the Device Prohibition and the ATB Requirement and its application of these tests equally to external distributions and preparatory internal distributions—raises significant concerns. We continue to believe that our recommendations in the Prior Report better address the underlying policy concerns. Nevertheless, the Current Report does not revisit the proposals made in the Prior Report and instead focuses on technical and policy issues raised by the framework and language of the Proposed Regulations, with the goal of assisting in finalizing rules in this important area.

II. SUMMARY OF RECOMMENDATIONS

1. Under the Proposed Regulations, a pro-rata spin-off involving a substantial and disproportionate allocation of appreciated investment assets generally would be considered a Device. But a non-pro rata split-off generally would not, because, consistent with the current regulations, the Proposed Regulations provide that a distribution is ordinarily not considered a

5 2015-40 I.R.B. 459.

6 2015-40 I.R.B. 467.

7 Prior Report at 3.

8 General Utilities & Operating Co. v. Helvering, 296 U.S. 200 (1935).

Device if it would be treated as a sale or exchange under Section 302(a) with respect to each shareholder distributee (the "**Section 302(a) Exception**"). Accordingly, we recommend that, in connection with finalizing new rules for the Device Prohibition, consideration should be given to issuing guidance under Section 337(d) to address non-pro rata split-offs qualifying under the Section 302(a) Exception and involving substantial and disproportionate allocation of appreciated investment assets, as these transactions have the potential to eliminate corporate-level gain recognition in a manner inconsistent with *General Utilities* repeal.

2. We believe that it will be difficult for taxpayers to certify that the Section 302(a) Exception applies with respect to each shareholder distributee in many circumstances, particularly in the public company context. Accordingly, we recommend that the government modify the Section 302(a) Exception so that taxpayers can satisfy it and know they have satisfied it, which would be most appropriate if the government adopts our recommendation concerning the issuance of Section 337(d) guidance relating to certain non-pro rata split-offs qualifying under the Section 302(a) Exception.

3. Although we recognize that the Per Se Device Test (defined below) responds to the government's stated policy concerns, we believe that other frameworks would better respond to these concerns without creating an absolute bar to implementation of business-driven disproportionate allocations of Nonbusiness Assets (defined below) in certain contexts (*e.g.*, Preparatory Intra-Group Distributions (defined below)). Accordingly, we recommend that the government replace the Per Se Device Test with an evidentiary presumption under which a distribution would be presumed to be a Device if the conditions specified in Prop. Reg. § 1.355-2(d)(iii) are satisfied unless the taxpayer establishes by strong evidence that the difference in the disproportion in investment assets facilitates attaining one or more business purposes (the "**Presumptive Device Test**").

4. We recommend that the final regulations provide that (i) the existence of either Not Evidence Factor (defined below) is considered evidence of non-Device, (ii) the failure to meet either Not Evidence Factor is considered evidence of device (except that a disproportionate allocation of Nonbusiness Assets should not be evidence of device if the absolute Nonbusiness Asset Percentage (defined below) is below 20%), and (iii) the combined existence of the two Not Evidence Factors provides strong evidence of non-Device. In addition, we suggest the government consider raising the relevant thresholds at which a Not Evidence Factor is applicable.

5. We believe that additional clarification is necessary regarding the weight to be accorded individual Device and non-Device Factors when multiple factors are present and recommend that the final regulations, through definition or exemplification, clarify the appropriate weight of individual factors, including the ability of non-Device factors to mit-

igate evidence of Device presented by Intermediate Factors (defined below). For example, we believe that final regulations should clarify that a proportionate allocation of Nonbusiness Assets can overcome a high absolute Nonbusiness Asset Percentage.

6. We recommend that the regulations implementing the Device Prohibition for internal distributions (i) clarify that the Affiliated Group Exception (defined below) applies to an intercompany distribution between two members of a consolidated group and (ii) be appropriately tailored to take into account the circumstances relevant to Preparatory Intra-Group Distributions. For example, we believe that it is particularly important to apply a presumptive, rather than a *per se*, rule in the context of Preparatory Intra-Group Distributions and that a disproportionate allocation of Nonbusiness Assets in a Preparatory Intra-Group Distribution should be permissible if there is a sufficient connection between the allocation and the business purposes motivating the External Spin (defined below).

7. In order to ensure that the definitions of Business Assets and Five-Year-Active-Business Assets (and the related concepts of Working Capital, Required Assets, and exigency) (all defined below) are appropriately tailored to achieve the relevant goals and avoid inequitable results (especially in the context of the Per Se Device Test, Minimum ATB Threshold, and significantly weighted Intermediate Factors), we recommend that the final regulations: (i) clarify and expand the circumstances under which cash or cash equivalents will be considered Working Capital, including by amending Example 4 of the Proposed Regulations to provide that cash held for specifically identified, reasonably foreseeable or expected expenditures constitutes a Business Asset, allow flexibility to consider prevailing working capital levels in the particular business or industry in which a corporation is engaged, and suggest that the government consider an approach similar to that taken in the regulations promulgated under Section 355(d) regarding when cash held for use in a business does not exceed the reasonable needs of the business; (ii) provide that real estate related to a Business or held by a REIT (defined below) is a Business Asset and, if ownership of the real estate is logically connected to an ATB, a Five-Year-Active-Business Asset (defined below); and (iii) allow the Corporate Business Purpose Non-Device Factor (defined below) to be satisfied in cases where a disproportionate allocation is sufficiently motivated by a corporate business purpose that does not constitute an "exigency."

8. Recognizing the difficulties that may arise in ascertaining fair market value in certain situations, we recommend that the government consider whether, in circumstances where valuations are not feasible and other appropriate metrics are readily available, the determination of whether a distribution satisfies the Device Prohibition and the ATB Requirement should be made by reference to an alternative metric. Further, we request clarification regarding the reasoning underlying the treatment of liabilities described in Section 357(c)(3)

and suggest the government consider whether, alternatively, the final regulations should take into account all or no liabilities in making determinations as to fair market value.

9. We recommend that operating rules in the Proposed Regulations which allow a corporate partner or owner to "look-through" certain interests in partnerships or corporations be amended to treat the corporate partner or owner, where applicable, as holding a ratable share of the partnership's or corporation's gross assets, rather than allocating the fair market value of the interest in the partnership or corporation in proportion to the underlying allocation of that corporation's or partnership's assets. Further, we suggest the government consider providing relief in situations where a corporate owner holds an interest in a corporation that is engaged in a business related to the Business of Distributing or Controlled, but that interest is not sufficient to satisfy the 50-Percent-Owned Group Rule (defined below).

10. Consistent with the approach taken under Section 355(e) and the regulations thereunder, where Distributing distributes multiple Controlled corporations, we feel it is appropriate to isolate the consequences of a distribution that fails the Device Prohibition to a particular Controlled (unless Distributing is the corporation with substantial and disproportionate Nonbusiness Assets).

11. As in the Prior Report, we continue to believe that an important focus of the Anti-Abuse Rules (defined below) should be on whether a transaction is effectively a purchase for or on behalf of the shareholders of Distributing or Controlled. However, we believe that the Anti-Abuse Rules should apply only to (i) non-transitory transfers where a controlling shareholder is driving the terms of the transfer or otherwise directing the acquisition of Business Assets for its benefit or (ii) transitory transfers.

12. We recommend that the final regulations clarify that transitional relief is also available for Preparatory Intra-Group Distributions to the extent these distributions are preparatory to an external distribution that qualifies for transitional relief under the standards contained in the Proposed Regulations. If this recommendation is not adopted, we recommend that the government provide guidance as to what constitutes an adequate description of a Preparatory Intra-Group Distribution in a public filing or announcement to qualify under the third prong of the transition relief.

III. BACKGROUND

A. The Proposed Regulations

1. Concerns Discussed in the Preamble

The preamble to the Proposed Regulations (the "**Preamble"**) identifies several concerns. With respect to the Device Prohibition, the Preamble states that Treasury and the Service have determined that "certain clarifying changes" should be made to the current regulations governing the Device Prohibition, as they "are not specific as to the quality or quantity of assets relevant in the nature and use of assets [D]evice factor or the appropriate weighing of the [D]evice and [non-Device] factors" and that "in some situations, insufficient weight has been given to the nature and use of assets [D]evice factor and that [D]evice factors have not been balanced correctly against [non-Device] factors."[9] The government believes that certain types of non-Device factors should not outweigh the substantial evidence of Device presented by a distribution that separates Nonbusiness Assets from Business Assets (defined below), and have accordingly determined to provide "clearer, more objective guidance" regarding the Device Prohibition.[10] Further, the Preamble affirms the continuing vitality of the Device Prohibition in the context of a unified rate regime for long-term capital gains and qualified dividend income because of the continuing differences in federal income tax treatment of capital gains and dividends (including the potential for basis recovery).[11]

Concerning the ATB Requirement, the Preamble states that the Treasury and the Service have determined that a "relatively *de minimis* active business" should not be sufficient to satisfy the ATB Requirement, and that "interpreting [S]ection 355(b) as having meaning and substance and therefore requiring an active business that is economically significant is consistent with congressional intent, case law, and the reorganization provisions."[12] Accordingly, the Proposed Regulations would operate to prevent the separation of "a corporation that owns only nonbusiness assets and a relatively *de minimis* active business…from a corporation with another active business" from qualifying under Section 355, because "the substance of the transaction is not a separation of businesses as contemplated by [S]ection 355."[13]

[9] Preamble at 46008.

[10] *Id.*

[11] *Id.*

[12] *Id.*

[13] Preamble at 46009.

2. Modifications to the Device Prohibition

As described further below, the Proposed Regulations modify the Device Prohibition in three principal ways. First, the Proposed Regulations modify the nature and use of assets Device factor in Treas. Reg. § 1.355-2(d)(2)(iv) (the "**Nature and Use of Assets Device Factor**"). Second, the Proposed Regulations establish thresholds beyond which a distribution will generally be considered a Device notwithstanding the presence of non-Device factors (*i.e.*, the Per Se Device Test).[14] A single set of operating rules applies in each of the aforementioned cases. Third, the Proposed Regulations modify the corporate business purpose non-Device factor in Treas. Reg. § 1.355-2(d)(3)(ii) (the "**Corporate Business Purpose Non-Device Factor**").

(a) Modifications to Nature and Use of Assets Device Factor

The Proposed Regulations modify the Nature and Use of Assets Device Factor by looking to the amount of "**Business Assets**" and "**Nonbusiness Assets**" in Distributing and Controlled, and provide that, above specified thresholds, the ownership of Nonbusiness Assets will be evidence of Device. The Proposed Regulations define Business Assets as the "gross assets used in one or more Businesses."[15] In turn, the Proposed Regulations define Business, for this purpose, as an ATB, but without regard to: (i) the five-year requirement of Section 355(b)(2)(B) and Treas. Reg. § 1.355-3(b)(3), (ii) the prohibition on certain acquisitions of businesses (or control of a business) in Section 355(b)(2)(C) and (D) and Treas. Reg. § 1.355-3(b)(4), (iii) the collection of income requirement in Treas. Reg. § 1.355-2(b)(2)(ii), and (iv) the Minimum ATB Threshold (defined below).[16] The Proposed Regulations further specify that Business Assets include[17] (i) cash (and cash equivalents) to the extent "held as a reasonable amount of working capital for one or more Businesses" ("**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" ("**Required Assets**").[18] Required Assets include assets required "to secure or otherwise provide for a financial obligation reasonably expected to arise from a Business" and those "held to implement a binding commit-

[14] Prop. Reg. § 1.355-2(d)(5)(iii).

[15] Prop. Reg. § 1.355-2(d)(2)(iv)(B)(*2*).

[16] Prop. Reg. § 1.355-2(d)(2)(iv)(B)(*1*).

[17] We note that it is not entirely clear whether the specifically "included" Business Assets described in clauses (i) and (ii) are the *only* Business Assets or merely examples of assets that are used in a Business. We believe the government intended Working Capital and Required Assets as safe harbor examples of the types of assets that are Business Assets, but we recommend that final guidance make clear that these examples are not the only categories of assets that qualify as Business Assets.

[18] Prop. Reg. § 1.355-2(d)(2)(iv)(B)(*2*). *See also* Prop. Reg. § 1.355-9(a)(3).

ment to expend funds to expand or improve a Business."[19] Finally, the Proposed Regulations define Nonbusiness Assets as a corporation's "gross assets other than its Business Assets."[20]

Under the Proposed Regulations, the Nature and Use of Assets Device Factor inquiry looks to both the ownership of Nonbusiness Assets by Distributing or Controlled (*i.e.*, the "Nonbusiness Asset Percentage"[21] of Distributing or Controlled) (the "**ownership test**"), and the difference between the Nonbusiness Asset Percentages of Distributing and Controlled (the "**comparison test**").

Under the ownership test, the ownership of Nonbusiness Assets by Distributing or Controlled is evidence of Device.[22] The strength of the evidence is based on all facts and circumstances, including the Nonbusiness Asset Percentage of each corporation, and the strength of the evidence of Device increases as the Nonbusiness Asset Percentage of either corporation increases.[23] However, ownership of Nonbusiness Assets "ordinarily is not evidence of [D]evice" if the Nonbusiness Asset Percentage of each of Distributing and Controlled is less than 20% (the "**20% Threshold**").[24]

Under the comparison test, a difference between the Nonbusiness Asset Percentages of Distributing and Controlled is evidence of Device, and the strength of the evidence of Device increases as the difference increases.[25] However, a difference ordinarily is not itself evidence of Device (but may be considered in determining the presence or the strength of other Device factors) where (i) the difference is less than 10% (the "**10% Threshold**"),[26] or (ii) the distribution is non-pro rata among Distributing's shareholders and the difference is attributable to a need to equalize the values between Distributing and Controlled (an "**Equalization Motivated Dispari-**

[19] *Id.*

[20] Prop. Reg. § 1.355-2(d)(2)(iv)(B)(3). The Proposed Regulations further define "Total Assets," which is relevant for certain calculations under the Proposed Regulations, as the total of a corporation's Business Assets and Nonbusiness Assets. Prop. Reg. § 1.355-2(d)(2)(iv)(B)(*4*).

[21] The "Nonbusiness Asset Percentage" of a corporation is the percentage determined by dividing the fair market value of the corporation's Nonbusiness Assets by the fair market value of its Total Assets. Prop. Reg. § 1.355-2(d)(2)(iv)(B)(*5*).

[22] Prop. Reg. § 1.355-2(d)(2)(iv)(C)(*1*).

[23] *Id.*

[24] *Id.*

[25] Prop. Reg. § 1.355-2(d)(2)(iv)(C)(*2*).

[26] Prop. Reg. § 1.355-2(d)(2)(iv)(C)(*2*)(*i*).

ty" and, together with the 20% Threshold and the 10% Threshold, the "**Not Evidence Factors**").[27]

(b) *Introduction of the Per Se Device Test*

In addition to the changes to the Nature and Use of Assets Test Device Factor described above, the Proposed Regulations also introduce a Per Se Device Test, which establishes thresholds beyond which a distribution is considered to have been used principally as a Device, notwithstanding the presence of non-Device factors or other facts and circumstances (with certain exceptions discussed below).[28] The Preamble states that the government has determined that "by their nature, these transactions present such clear evidence of device…that the [non-Device] factors can never overcome the [D]evice potential."[29] The Per Se Device Test utilizes the same definitions and operating rules (discussed below) as the Nature and Use of Assets Device Factor.[30] The Per Se Device Test includes two "prongs"—the ownership test and the comparison test—and applies to characterize a transaction as a Device when both prongs are met.

The ownership test prong of the Per Se Device Test is met if Distributing or Controlled has a Nonbusiness Asset Percentage of 66 2/3% or more.[31] If the ownership test prong of the Per Se Device Test is met, the comparison test prong is applied in three "bands," which are determined by the results under the ownership test prong. In the first band, which applies if the Nonbusiness Asset Percentage of Distributing or Controlled (the "**first corporation**") is 66 2/3% or more but less than 80%, the comparison test prong is met if the other corporation (the "**second corporation**") has a Nonbusiness Asset Percentage of less than 30%.[32] In the second band, which applies if the Nonbusiness Asset Percentage of the first corporation is 80% or more but less than 90%, the comparison test prong is met if the second corporation has a Nonbusiness Asset Percentage of less than 40%.[33] In the third band, which applies if the Nonbusiness Asset Percentage of the first corporation is 90% or more, the comparison test prong is met if the second corporation has a Nonbusiness Asset Percentage of less than 50%.[34]

[27] Prop. Reg. § 1.355-2(d)(2)(iv)(C)(*2*)(*ii*).

[28] Prop. Reg. § 1.355-2(d)(5)(i).

[29] Preamble at 46010.

[30] Prop. Reg. § 1.355-2(d)(5)(ii).

[31] Prop. Reg. § 1.355-2(d)(5)(iii)(A).

[32] Prop. Reg. § 1.355-2(d)(5)(iii)(B)(*1*).

[33] Prop. Reg. § 1.355-2(d)(5)(iii)(B)(*2*).

[34] Prop. Reg. § 1.355-2(d)(5)(iii)(B)(*3*).

Although a distribution meeting the Per Se Device Test will be considered to have been used principally as a Device notwithstanding the presence of non-Device factors or other facts and circumstances, the Proposed Rules provide certain safe harbor exceptions. The Per Se Device Test ordinarily will not apply where (i) the distribution is to a domestic corporation that generally would, in the absence of Section 355, be entitled to an 80%-or-more dividends received deduction (the "**Affiliated Group Exception**"), (ii) the distribution would be described in Section 302(a) (or Section 303(a)) in the absence of Section 355 (*i.e.*, a split-off to an unrelated shareholder or a distribution in redemption of stock or to pay death taxes) (*i.e.*, the Section 302(a) Exception), or (iii) neither Distributing or Controlled has earnings and profits (and no distribution of property by Distributing or Controlled before the separation would produce current earnings and profits).[35]

i. Operating Rules Where Distributing or Controlled Owns Stock in another Corporation or an Interest in a Partnership

Where Distributing or Controlled owns stock in another corporation or an interest in a partnership, the Proposed Regulations provide four operating rules that apply when classifying assets as Business Assets or Nonbusiness Assets for purposes of both the Nature and Use of Assets Device Factor and the Per Se Device Test. First, all members of a separate affiliated group (a "**SAG**"), as defined in Section 355(b)(3)(B), of which Controlled is the common parent (the "**CSAG**"), and all members of a SAG of which Distributing is the common parent, excluding Controlled and the CSAG, (the "**DSAG**") are treated as a single corporation.[36] Second, a partnership interest is generally a Nonbusiness Asset.[37] However, where Distributing or Controlled is considered to be engaged in the ATB conducted by a partnership under Section 355(b) and Treas. Reg. § 1.355-3 (a "**Reliance Partnership**"), the fair market value of that corporation's partnership interest is allocated between Business Assets and Nonbusiness Assets in the same proportion as the proportion of the fair market values of the Business Assets and Nonbusiness Assets of the partnership.[38] Third, where Distributing or Controlled owns stock in a corporation that is not part of the DSAG or the CSAG, that stock is generally a Nonbusiness Asset.[39] However, if that corporation is a member of a "50-Percent-Owned Group",[40] the fair market value of

[35] Prop. Reg. § 1.355-2(d)(5)(i). *See* Reg. § 1.355-2(d)(3)(iv); Reg. § 1.355-2(d)(5).

[36] Prop. Reg. § 1.355-2(d)(2)(iv)(D)(*2*).

[37] Prop. Reg. § 1.355-2(d)(2)(iv)(D)(*6*)(*i*).

[38] Prop. Reg. § 1.355-2(d)(2)(iv)(D)(*6*)(*ii*).

[39] Prop. Reg. § 1.355-2(d)(2)(iv)(D)(*7*)(*i*).

[40] 50-Percent-Owned Group has the same meaning as SAG, except that "50-percent" is substituted for "80-percent" each place it appears in Section 1504(a)(2), for purposes of Section 355(b)(3)(B), and a member

the stock of that member is allocated between Business Assets and Nonbusiness Assets in the same proportion as the proportion of the fair market values of the Business Assets and Nonbusiness Assets of that member (the "**50-Percent-Owned Group Rule**").[41] Fourth, where an obligation of Distributing or Controlled is held by a member of a 50-Percent-Owned Group or a Reliance Partnership, or vice versa, the Proposed Regulations provide that proper adjustments will be made to prevent double inclusion of assets or an inappropriate allocation between Business Assets and Nonbusiness Assets on account of that obligation (the "**Proper Adjustments Rule**").[42]

ii. Other Operating Rules

The Proposed Regulations provide several additional operating rules that apply for both the Nature and Use of Assets Device Factor and the Per Se Device Test. First, if a transaction involves distributions by Distributing of multiple Controlled corporations, in addition to applying the comparison test between Distributing and each Controlled as directed under the Nature and Use of Assets Device Factor and the Per Se Device Test, the comparison test must also be applied between each Controlled (the "**Multiple Controlleds Rule**").[43] If *any* distribution is determined to have been used principally as a Device, then *all* distributions involved in the transaction are considered to have been used principally as a Device.[44] Further, the Proposed Regulations provide that (i) "fair market value" is determined under general federal tax principles but reduced (but not below the adjusted basis of the asset) for any liabilities described in Section 357(c)(3),[45] (ii) the time to identify and characterize relevant assets as Business Assets or Nonbusiness Assets is immediately after the distribution,[46] and (iii) the determination of the fair market value of the relevant assets can generally be made, at the election of the parties on a consistent basis, either immediately before the distribution, on any date within the 60-day period before the distribution, on the date of a binding agreement with respect to the distribution, or on

of a 50-Percent-Owned Group is a corporation that would be a member of the DSAG or CSAG with the substitution provided above. Prop. Reg. § 1.355-2(d)(2)(iv)(B)(*7*)).

41 Prop. Reg. § 1.355-2(d)(2)(iv)(D)(*7*)(*ii*). To the extent necessary, this computation is first made with respect to lower-tier members of a 50-Percent-Owned group. *Id.*

42 Prop. Reg. § 1.355-2(d)(2)(iv)(D)(*8*). *See* Prop. Reg. § 1.355-2(d)(4), Exs. 6 and 7.

43 Prop. Reg. § 1.355-2(d)(2)(iv)(D)(*1*).

44 *Id.*

45 Prop. Reg. § 1.355-2(d)(2)(iv)(D)(*5*). All other liabilities are disregarded for purposes of determining the fair market value of an asset. *Id.*

46 Prop. Reg. § 1.355-2(d)(2)(iv)(D)(*3*).

the date of a public announcement or filing with the Securities and Exchange Commission with respect to the distribution.[47]

iii. Device Anti-Abuse Rule

The Proposed Regulations contain a broad anti-abuse rule, whereby a transaction (or series of transactions) undertaken with a principal purpose of affecting the Nonbusiness Asset Percentage of any corporation will not be given effect for purposes of the Nature and Use of Assets Device Factor or the Per Se Device Test (the "**Device Anti-Abuse Rule**").[48] While the Device Anti-Abuse Rule encompasses a change in the form of ownership of an asset, an issuance, assumption, or repayment of debt or other obligations, or an issuance or redemption of stock, the rule generally does not apply to a non-transitory acquisition or disposition of assets from or to an unrelated party or to a non-transitory transfer between Distributing and Controlled.[49]

(c) Modifications to the Corporate Business Purpose Non-Device Factor

The Proposed Regulations modify the Corporate Business Purpose Non-Device Factor by restricting the ability of a corporate business purpose to be evidence of non-Device with respect to Nonbusiness Assets. The Proposed Regulations provide that evidence of Device presented by the ownership of Nonbusiness Assets by Distributing or Controlled or by a difference between the Nonbusiness Asset Percentages of Distributing and Controlled can be outweighed by a corporate business purpose for the ownership or difference, respectively.[50] However, a corporate business purpose that relates to a separation of Nonbusiness Assets from one or more Businesses or Business Assets is not evidence of non-Device unless the business purpose involves an *exigency* that requires an investment or other use of the Nonbusiness Assets in one or more Businesses of Distributing, Controlled, or both.[51] The Preamble states the government has determined that "absent such an exigency, such separations are not consistent with the intent of Congress to prevent [S]ection 355 from applying to a distribution that is used principally as a [D]evice."[52]

47 Prop. Reg. § 1.355-2(d)(2)(iv)(D)(*4*).

48 Prop. Reg. § 1.355-2(d)(2)(iv)(E).

49 *Id.*

50 Prop. Reg. § 1.355-2(d)(3)(ii).

51 *Id.*

52 Preamble at 46010.

3. Modifications to ATB Requirement

The Preamble states that, although Section 355(b) does not contain a literal requirement regarding the minimum size of an ATB, the government has determined that a distribution involving only a relatively *de minimis* ATB does not comport with Congress' intention that Section 355(b) require that distributions have substance.[53] Accordingly, the Proposed Regulations introduce a new requirement that each of Distributing and Controlled must have a "Five-Year-Active Business Asset Percentage" (as explained below) of at least 5% (the "**Minimum ATB Threshold**") in order to satisfy the ATB Requirement.[54] For purposes of the Minimum ATB Threshold, terms are defined in a parallel manner to those used in connection with the Nature and Use of Assets Device Factor and the Per Se Device Test, with "Five-Year-Active-Business" substituted for "Business" and "Non-Five-Year-Active-Business" substituted for "Nonbusiness." The Proposed Regulations define "Five-Year-Active Business" as the active conduct of an ATB within the meaning of Section 355(b)(2) and Treas. Reg. § 1.355-3(b) (*i.e.*, without the exceptions applicable to a Business).[55] In addition, the same operating rules[56] (with a similar substitution) as those used in connection with the Nature and Use of Assets Device Factor and the Per Se Device Test apply for purposes of the Minimum ATB Threshold, with the exceptions that the Minimum ATB Threshold does not contain operating rules similar to the 50-Percent-Owned Group Rule, the Multiple Controlleds Rule, or the Proper Adjustments Rule. In addition, the operating rule regarding interest in partnerships is formulated differently to reflect the differences between the definitions of Business and Five-Year-Active-Business. Regarding the omission of a rule similar to the 50-Percent-Owned Group Rule, the Preamble states that the government feels the amendments to Section 355(b) to adopt the SAG rules of Section 355(b)(3) limit the ability of the government to introduce a similar rule for purposes of the Minimum ATB Threshold. Finally, the Proposed Regulations contain an anti-abuse rule which operates to disregard a transaction "undertaken with a principal purpose of affecting the Five-Year-Active-Business Percentage of any corporation" (the "**ATB Anti-Abuse Rule**" and, together with the Device Anti-Abuse Rule, the "**Anti-Abuse Rules**") and in all other respects functions identically to the Device Anti-Abuse Rule.[57]

[53] Preamble at 46011.

[54] Prop. Reg. § 1.355-9(b).

[55] Prop. Reg. § 1.355-9(a)(2).

[56] The operating rules similarly substitute "Five-Year-Active-Business" for "Business" and "Non-Five-Year-Active-Business" for "Nonbusiness."

[57] Prop. Reg. § 1.355-9(d).

IV. ANALYSIS OF PROPOSED REGULATIONS

A. Fundamental Policy Issues

1. Non-Pro Rata Split-offs

(a) Guidance under Section 337(d) with respect to Non-Pro Rata Split-offs Not Subject to the Per Se Device Test

The current regulations provide that a distribution that would be treated as a sale or exchange under Section 302(a) with respect to each shareholder distributee is ordinarily not considered a Device, notwithstanding the presence of other evidence of Device.[58] The Section 302(a) Exception maintains this rule and excepts such transactions from the scope of the Per Se Device Test.[59] The import of this exception is that many non-pro rata distributions may avoid the application of the Device Prohibition. Notice 2015-59, by contrast, specifically stated the government's belief that characteristics such as substantial and disproportionate "**Investment Assets**" could potentially overcome the non-Device factor of a non-pro rata distribution.[60]

Split-offs, as well as spin-offs, present the potential for corporate-level gain avoidance. In the Prior Report, we described two examples of pro rata distributions that raise potential *General Utilities* issues, each of which includes the potential for eliminating corporate-level gain. This potential erosion of *General Utilities* repeal is equally present in the case of non-pro rata distributions, as illustrated by the following two examples.

> Example 1. *Diversified Portfolio of Appreciated Investment Assets.* Distributing owns Nonbusiness Assets consisting of a diversified portfolio of appreciated stocks and bonds. In a purported 368(a)(1)(D)/355 transaction, Distributing contributes the Nonbusiness Assets to Controlled, together with a small amount of Qualifying Business Assets and exchanges the stock of Controlled for Distributing stock in a non-pro rata distribution to which the Section 302(a) Exception applies.[61]

[58] Reg. § 1.355-2(d)(5)(iv).

[59] Prop. Reg. § 1.355-2(d)(6)(iv).

[60] Notice 2015-59, § 2, 2015-40 I.R.B. at 460. One of the concerns expressed by Notice 2015-59 was the potential for these distributions to avoid corporate-level gain recognition with respect to appreciated Investment Assets.

[61] *Cf.* Example 2, Prior Report at 28. Treasury and the Service determined that the "Investment Assets" focused on in Revenue Procedure 2015-43 and Notice 2015-59 might include certain assets that do not raise Device concerns (*e.g.*, cash used as working capital), and the Proposed Regulations therefore instead focus

Example 2. *Stock of a Single Issuer*. Distributing owns a significant amount of substantially appreciated stock of a single issuer ("**Issuer**"). In a purported 368(a)(1)(D)/355 transaction, Distributing contributes the stock of Issuer to Controlled, together with a small amount of business assets that satisfy the ATB Requirement, and exchanges the stock of Controlled for Distributing stock in a non-pro rata distribution to which the Section 302(a) Exception applies.[62]

In Example 1, Controlled might convert to a RIC, or be acquired by a RIC, after the distribution, eliminating corporate-level gain on the Nonbusiness Assets subject to the application of Reg. §1.337(d)-7. This Regulation provides rules essentially requiring the RIC to pay corporate level tax on built-in gains acquired from a C corporation which are recognized within 10 years of the conversion or acquisition.[63] In Example 2, an acquisition by the Issuer would appear to be likely for the reasons discussed in the Prior Report (*i.e.*, the Issuer is a "natural" buyer because of the potential to eliminate *General Utilities* gain). Thus, the concerns raised by the examples in the Prior Report, while addressed in the context of pro rata spins by the proposed modifications to the Device rules, remain valid in the context of a non-pro rata exchange.

While the transactions described in Example 1 and Example 2 *may* fail to qualify under the current Section 355 regulations, it is not clear that this would necessarily be the case. For instance, Distributing in Example 2 may argue that a corporate business purpose (*e.g.*, an inability to utilize equity-based compensation to align management's interests with shareholders' interests because of the impact of Issuer's stock price on Distributing's stock price) both satisfies the business purpose test and overcomes other evidence of Device. To create parity between spin-offs and split-offs, therefore, additional guidance addressing *General Utilities* repeal is necessary.

Accordingly, as in the Prior Report, we recommend that, in connection with issuing new rules for the Device Prohibition, consideration should be given to issuing guidance under Section 337(d) to address split-offs that have the potential to eliminate corporate-level gain recognition in a manner inconsistent with *General Utilities* repeal. As one approach, Section 337(d) regulations could impose tax where the Device Prohibition would have been violated by virtue of a distribution in circumstances similar to Example 1 and Example 2 but for the Section 302(a) Ex-

on Nonbusiness Assets in analyzing whether a distribution is a Device. The Examples provided in this Report reflect the Proposed Regulations' terminology. The only other substantive difference between the Example 1 and Example 2 in this Report and the related examples in the Prior Report is a shift from highlighting pro rata distributions to non-pro rata distributions.

62 *Cf.* Example 3, *id.* at 33. *See* note 5 *supra*.

63 *Cf.* Reg. §1.337(d)-7T(c)(6) (requiring gain recognition upon conversion of Distributing or Controlled into a real estate investment trust ("**REIT**") in similar circumstances).

ception (*i.e.,* the bulk of the assets spun off or retained are appreciated investment assets or appreciated stock of a single Issuer). As discussed in the Prior Report, the current Device regulations impose tax, if at all, at the time of the distribution based, in part, on factors that appear aimed at identifying scenarios in which a post-distribution acquisition is likely.[64] Section 337(d) regulations could take a similar approach, which would be relatively straightforward as an administrative matter. Alternatively, because the avoidance of corporate-level tax generally requires additional post-distribution transactions (*e.g.,* a downstream merger of Controlled into the Issuer), it may be appropriate for guidance under Section 337(d) to impose tax, where the split-off would be excepted from the new Device Prohibition rules by virtue of the Section 302(a) Exception, only upon the occurrence of the later transaction, rather than at the time of the spin-off, so long as that event occurs within a specified period of time (*e.g.*, 10 years). It is interesting to note that recent legislation and regulations have addressed parallel concerns where spin-offs occur in connection with the conversion of Distributing or Controlled to a REIT. The net effect of these rules is to impose tax either at the time of the distribution (under Section 355(h)) or, if later, upon the conversion (under Treas. Reg. § 1.337(d)-7T). We recommend that the Service and the Treasury consider adopting a similar framework in the context of distributions similar to those illustrated by Example 1 and Example 2, where the Device Prohibition would have been violated but for the Section 302(a) Exception.

(b) Increased Emphasis on the Section 302(a) Exception

The burdens imposed on taxpayers under the Proposed Regulations in general, and the Per Se Device Test in particular, place increased emphasis on Distributing's ability to prove that a transaction qualifies for the Section 302(a) Exception.[65] Given the high stakes, taxpayers will likely seek certainty that the Section 302 Exception would apply to a transaction prior to engaging in a split-off. However, because the exception is phrased as applying "with respect to each shareholder distributee," achieving the requisite certainty may be difficult as a practical matter in most circumstances.

Consider the following example:

[64] In the Prior Report, we noted that the fact that a number of considerations pointed to as evidence of Device, such as distributing a secondary business, the pro rata nature of a distribution, and the nature of the assets of the distributing and controlled corporations, are "intended to predict whether the shareholders will sell their stock in Distributing or Controlled without requiring an actual sale to occur." Prior Report at 35.

[65] More specifically, taxpayers will be increasingly motivated to structure their transactions to ensure the exceptions set forth under Reg. § 1.355-2(d)(5) apply in order to avoid the compliance burdens associated with the Per Se Device Test and to provide greater certainty regarding the qualification of a transaction under Section 355.

Example 3. *Split-off—Section 302(a) Considerations.* Distributing is a widely held, publicly traded company with a single class of stock outstanding. At a time when there are 1,000,000 shares of Distributing common stock outstanding, Distributing offers to exchange all of the outstanding stock of Controlled for 100,000 Distributing shares. Prior to the exchange, shareholder A holds 20,000 shares of Distributing stock (or 2%). A exchanges 6,000 Distributing shares for stock of Controlled, with the result that A's direct ownership in Distributing is 1.56% (14,000/900,000) immediately after the exchange.

As described above, the Section 302(a) Exception will apply if every shareholder's exchange would be a redemption to which Section 302(a) applied (in the absence of Section 355). Section 302(a) generally will apply with respect to a shareholder who owns less than 50% of the total combined voting power of all classes of stock entitled to vote, if the percentage of the corporation's voting stock owned by the shareholder immediately after the redemption is less than 80% of the percentage of the corporation's voting stock owned by the shareholder immediately before the redemption (a "**Substantially Disproportionate Distribution**"). In Example 3, A's ownership interest in Distributing immediately after the exchange (1.56%) is less than 80% of the 2% interest held prior to the exchange (1.6%). However, if A's exchange was limited to 5,500 shares as a result of proration due to oversubscription, A's post-exchange ownership interest would be 1.61% and thus would no longer qualify under this rule for Section 302(a) treatment. (A's exchange might otherwise qualify as a Section 302(a) redemption on the grounds that it is "not essentially equivalent to a dividend," but because that analysis applies a facts and circumstances test, as opposed to a bright-line test, taxpayers are likely to be reluctant to rely on this alternative test for planning purposes where the taxability of a spin-off is at stake.)[66] Attribution rules or the existence of multiple classes of stock may also affect and complicate the calculation of A's ownership interest in value or vote (*e.g.*, because stock may be held by a related party or subject to an option agreement).[67]

If Distributing's stock is publicly traded and widely held, it is likely to be even more difficult to determine, with certainty, that the Section 302(a) Exception applies if the distribution is effected as an exchange offer (rather than as a pro rata distribution). The application of the Sec-

[66] Section 302(b) provides alternate routes to redemption qualification under Section 302(a), but none would apply to the distributing corporation in Example 3. Specifically, the distribution does not constitute a "complete redemption of all of the stock of the corporation owned by the shareholder" or a "partial liquidation of the distributing corporation." Section 302(b)(3), (b)(4). Section 355 distributions are considered "corporate separations"—not partial liquidations—and therefore do not fall within the ambit of Section 302(b)(4). *See, e.g.*, Rev. Rul. 75-223, 1975-1 C.B. 109.

[67] Subject to certain modifications, the constructive ownership rules of Section 318(a) apply in determining the ownership of stock for purposes of Section 302. *See* Section 302(c).

tion 302(b) tests potentially turn on the specific facts and circumstances relevant to each shareholder, into which Distributing is unlikely to have (or have the ability to have) sufficient visibility.

In order for the Section 302(a) Exception to have vitality, particularly in the publicly traded context, we believe that Treasury and the Service should consider modifying the Section 302(a) Exception so that taxpayers can satisfy it and know they have satisfied it. For example, prior to a distribution, Distributing may have an expectation that substantially all (*e.g.*, more than 90% for this purpose) of the split-off exchanges will result in Section 302(a) redemptions, but (other than in the case of certain closely-held corporations), will be unlikely to be able to establish that each redemption will so qualify. In a recent private letter ruling, the taxpayer represented that:

> Based in part upon the shareholder composition of Distributing 3 [the public distributing corporation], substantial relevant market data for tender offers comparable to the External Split-Off, and the existence of a minimum condition for the tender offer that Distributing 3 will distribute no less than *f%* of the stock of SplitCo to the Distributing 3 shareholders in the Initial Exchange, Distributing 3 believes and expects that, in accordance with the written opinion of Advisor, at least *k%* of the stock of SplitCo will be represented by the sum of the shares: (1) distributed in the External Split-Off to Distributing 3 shareholders who, as a result of their tenders in the External Split-Off, would be entitled to sale or exchange treatment if section 355 were not applicable to the External Split-Off; (2) distributed in the Separation to Distributing 3 shareholders that are exempt from taxation under the Code; (3) transferred in a Stock-for-Debt Exchange; and (4) sold by Distributing 3 in a taxable transaction.[68]

The value of the business of SplitCo is described as being "approximately *m* (10 or more)% of the fair market value of the stock of Corp," presumably an investment asset of SplitCo.[69] The Service did not rule on whether the proposed transaction (which included two internal spin-offs and an external split-off) would be a Device, but the representation provides a potential model for an alternative Section 302(a) Exception. Under this alternative, a distribution would satisfy the Section 302(a) Exception if Distributing reasonably expects that substantially all of the Controlled stock will be distributed in exchanges qualifying as Section 302(a) redemptions.

[68] *See* Priv. Ltr. Rul. 201634010 (Aug. 19, 2016).

[69] The Service ruled that the relative fair market value of the gross assets of the business as compared to the fair market value of SplitCo would not prevent the proposed transaction from meeting the ATB Requirement. *See id.*

In the public company context, Distributing could attempt to ensure that it meets this standard by making an exchange offer conditional on the receipt of appropriate shareholder certifications. For example, Distributing might require each shareholder (or each controlling shareholder, if the above presumption applies) to certify that the exchange would qualify as a Section 302(a) redemption (whether because it would be a Substantially Disproportionate Distribution or otherwise), taking into account all stock held, directly or constructively, by each shareholder. Even this process would not guarantee that substantially all exchanges are, in fact, Section 302(a) exchanges, and it introduces additional administrative burdens on both Distributing and its shareholders. Further, shareholders may not be able to make the requisite certification prior to the transaction because the tax treatment of the exchange cannot yet be known. As discussed above, certain factors outside of a shareholder's knowledge or control could lead to an exchange failing to qualify as a Substantially Disproportionate Distribution (*e.g.*, proration of a tender offer or an increase in the maximum number of shares accepted for tender).

Thus, in order to provide sufficient comfort to allow taxpayers to know with certainty that they have satisfied the Section 302(a) Exception, Treasury and the Service could provide a presumption that split-offs involving less-than-five-percent shareholders qualify as Section 302(a) redemptions absent actual knowledge to the contrary.[70] Particularly in the public company context, such a rule would seem to strike an appropriate balance between the government's interest in protecting the integrity of a purpose-based rule like the Device Prohibition and the countervailing interests of providing certainty to allow deals to go forward and facilitating reasonable administration of the Device Prohibition. However, it would be most appropriate for Treasury and the Service to adopt our recommendations regarding the Section 302(a) Exception in conjunction with our recommendations under Section 337(d) addressing non-pro rata split-offs that are not subject to the Device Test (like those illustrated by Examples 1 and 2). In the ab-

[70] Regulations under Section 355(d) and (e) have allowed for similar simplifying assumptions with respect to a distributing corporation's determination of shareholder ownership. *See, e.g.*, Treas. Reg. § 1.355-6(f) (providing that "less-than-five-percent shareholders" are presumed not to have acquired stock by purchase under Section 355(d)(5) or (8) during the preceding five-year period for the purpose of determining whether disqualified persons hold Distributing stock or the stock of any Controlled corporation); Treas. Reg. § 1.355-7(d)(7) (providing a safe harbor protecting open market purchases of Controlled or Distributing stock, so long as the transaction does not involve Controlled, Distributing, certain of their affiliates, a "controlling shareholder" or a "ten-percent shareholder" as defined in the regulations). *See also* Rev. Proc. 96-30, 1996-1 C.B. 696 (providing a safe harbor from the Device Prohibition for purchases by either Distributing or Controlled of its stock if there is sufficient business purpose for the purchase, the purchased stock is widely held, the purchase is made on the open market and there is no intention to purchase 20% or more of the outstanding stock of Distributing or Controlled) (*modified by* Rev. Proc. 2003-48, 2003-2 C.B. 86).

sence of guidance under Section 337(d), loosening the Section 302(a) Exception could facilitate distributions that are inconsistent with *General Utilities* repeal.

2. The Per Se Device Test

As discussed in Part III.A above, the Proposed Regulations add the Per Se Device Test, which treats certain distributions involving the separation of Nonbusiness Assets from Business Assets as a Device, notwithstanding the presence of non-Device factors. The Preamble justifies the Per Se Device Test on the grounds that there are certain situations in which the composition of Distributing's or Controlled's assets presents such strong evidence of Device that non-Device factors should be precluded from overcoming the evidence of Device.[71] As discussed below, the Per Se Device Test has certain advantages and disadvantages. We believe, on balance, that there are better ways to address the government's stated policy concerns. Accordingly, we recommend that the government replace the Per Se Device Test with an evidentiary presumption under which a distribution would be presumed to be a Device if the conditions specified in Prop. Reg. § 1.355-2(d)(iii) are satisfied unless the taxpayer establishes by strong evidence that the difference in the Nonbusiness Asset Percentage for Distributing and Controlled facilitates attaining one or more business purposes (*i.e.*, the Presumptive Device Test).

(a) Advantages and Disadvantages of the Per Se Device Test

(i) Advantages of the Per Se Device Test

Under current law, the Device Prohibition is a facts-and-circumstances test whose outcome turns on a weighing of various Device and non-Device factors. The standards for weighing the various factors generally are vague, and thus the outcome of the application of these factors to particular cases can be uncertain. One benefit of the Per Se Device Test is that it would promote predictability and consistency in the application of the Device Prohibition in certain cases involving the combination of (i) the presence of a Distributing or Controlled corporation the assets of which are heavily weighted to Nonbusiness Assets and (ii) a substantial disproportion in the allocation of Nonbusiness Assets between Distributing and Controlled. In particular, by specifying conditions under which the composition of Distributing's and Controlled's assets always renders a transaction a Device, the Per Se Device Test would ensure that the Device Prohibition is not interpreted in these cases in a manner inconsistent with the policies underlying it.

Consider the following example:

> Example 4. *Closely held Distributing with significant cash assets.* Closely held Distributing holds a significant amount of cash and cash equivalents as

[71] *See* Preamble at 46010.

> Nonbusiness Assets. In a purported Section 368(a)(1)(D)/355 transaction, Distributing contributes all the Nonbusiness Assets to Controlled, along with a relatively small amount of Business Assets that satisfy the ATB Requirement, and distributes the distributes the stock of Controlled to its shareholders pro rata. Assume that there is a corporate business purpose for separating the businesses, but no corporate business purpose for the difference of Nonbusiness Asset Percentages. Assume further that there is no exigency that requires Controlled to use or invest the Nonbusiness Assets following the distribution.

Example 4 presents evidence of Device and Non-Device. On one hand, the presence of Nonbusiness Assets in Controlled is evidence of Device. Furthermore, the strength of this evidence is formidable, given the extreme difference in Nonbusiness Asset Percentages and the absence of any corporate business purpose for it. On the other hand, though, Example 4 posits a corporate business purpose for separating the businesses, which is evidence of non-Device. Moreover, there is no indication in Example 4 that the shareholders actually intend to dispose of any of their Controlled stock or that Controlled actually intends to make a distribution which will effect a return of capital. As discussed in detail in the Prior Report, examples in the current regulations provide guidance on the interplay of these factors.[72] These regulations suggest that because Nonbusiness Assets are allocated disproportionately to Controlled without a corporate business purpose that relates to the disproportionate allocation, the transaction illustrated by Example 4 is likely a Device. However, the vague nature of the Device Prohibition makes this result less determinate than it should be.[73] Adding the Per Se Device Test would remove all doubt, provided that Controlled's Nonbusiness Asset Percentage is at least 66 2/3 percent and there is essentially a 2:1 ratio between Controlled's Nonbusiness Asset Percentage and Distributing's Nonbusiness Asset Percentage.

In addition to making the application of the Device Prohibition more predictable and consistent in certain cases, the Per Se Device Test would make the Device test easier to administer where it clearly applies by its terms. Under current law, determining whether a distribution is a Device requires an inquiry into the taxpayer's intent and motive. These inquiries are costly, and the government is not well-positioned to enforce the Device Prohibition on a case-by-case basis due to resource constraints. Furthermore, the government has an inherent disadvantage versus taxpayers because taxpayers control the relevant information. A bright-line rule such as the Per

[72] *See* Prior Report at 22-23.

[73] *See Pulliam v. Comm'r,* 73 T.C.M. (CCH) 3052 (1997), *nonacq.,* 1998-2 C.B. 664 (holding that a distribution undertaken to facilitate a sale of a 49% interest in Controlled to a key employee of Controlled was not a Device, on the ground that business purpose for the distribution overcame the evidence of Device created by the prearranged sale).

Se Device Test in certain cases would obviate the need for a cumbersome facts-and-circumstances test where the composition of Distributing's and Controlled's assets warrants significant concern that a distribution is a Device.

(ii) Disadvantages of the Per Se Device Test

Nevertheless, there are countervailing considerations which appear to outweigh the benefits of the Per Se Device Test. The Per Se Device Test's benefits would require giving up the flexibility needed to respond to unforeseen and unusual circumstances. As a result, the Per Se Device Test risks ensnaring transactions that would pass muster under the facts-and-circumstances test. In this respect, the addition of the Per Se Device Test would mark a change in the basic character of the Device test, which has been based on consideration of all facts and circumstances since it first appeared in the statute in 1951. Although vague, it has retained its basic character throughout—precisely because the complex nature of the Device inquiry does not lend itself to rigid rules. Determining whether a distribution is a Device truly does require weighing various factors, many of which are vague and subjective. Furthermore, some factors may be more relevant in some situations than in others.

Furthermore, while the Per Se Device Test itself is mechanical, several of its inputs are subjective in nature or subject to the potential for different judgments and therefore reasonable disputes. For one, the application of the Per Se Device Test depends crucially on the characterization of Distributing's and Controlled's assets as Business Assets and Nonbusiness Assets, as well as the related concept of an "exigency." As discussed in greater detail below,[74] these terms are subject to a range of interpretations, and their meanings are context-dependent. In some cases, it may be unclear whether certain assets are properly characterized as falling into one category or the other. Similarly, it may be uncertain whether a plan for the use or investment of Nonbusiness Assets constitutes an "exigency." The Per Se Device Test would dramatically increase the stakes of these determinations. Moreover, it would appear that in making those determinations, the government would face similar challenges to those presented by a general facts-and-circumstances test.

In addition, the Per Se Device would place a premium on the accuracy of valuation judgments with respect to Distributing's and Controlled's Business Assets and Nonbusiness Assets. Conducting a valuation is an inherently factual and resource-intensive process for taxpayers and the government alike. And valuations can vary dramatically depending on the methodology

[74] Part IV.B.1 (p. 35).

and assumptions used.[75] In other contexts, disputes over valuation have been at the center of lengthy and expensive high-profile litigation,[76] or the subject of additional guidance to address perceived abuses.[77] Treasury and the Service have often drafted regulations to minimize the potential for valuation disputes.[78] Thus, rather than alleviating the difficulties associated with fact-intensive inquiries, the Per Se Device Test can be viewed as merely shifting the focus of the inquiry from the business purpose motivating a transaction to categorizing the nature and value of the assets allocated in the transaction.

Despite these concerns, in the context of external distributions, the thresholds in the Per Se Device Test in our experience are high enough that the risk of capturing transactions that should pass muster is likely to be relatively low. This risk could be further reduced by adopting broader, more flexible definitions of the terms Business Assets and Nonbusiness Assets, discussed further below. However, as discussed below,[79] it remains far more likely that intra-group distributions that are preparatory to an external distribution will be captured by the rule where they should not be.

(b) The Presumptive Device Test Alternative

The most significant issue that would arise with a Presumptive Device Test concerns the burden of proof required to overcome the presumption. Because the case for the Presumptive Device Test is premised on the importance of preserving the flexibility needed to respond to extraordinary circumstances, and because the thresholds in the Per Se Device Test are already high, we believe that the burden of proof to overcome the presumption also should be high. Specifically, we recommend that the taxpayer be required to prove by strong evidence a clear-cut plan to invest or otherwise use the Nonbusiness Assets to meet bona fide business, regulatory, or legal objectives. This "strong evidence" standard would require more than a showing that the differ-

[75] The Preamble acknowledges these difficulties, indicating that the existence of the three "bands" in the second prong of the Per Se Device Test is intended to reduce the precision necessary for asset valuation. *See* Preamble at 46010.

[76] *See, e.g.*, *U.S. v. Microsoft Corp.*, No. 2:15-CV-00102-RSM, 2015 WL 4496749 (W.D. Wash. June 17, 2015).

[77] *See* proposed regulations under Section 2704, REG-163113-02, 81 Fed. Reg. 51413 (Aug. 4, 2016).

[78] *See, e.g.*, Treas. Reg. § 1.382-9(k)(7) and T.D. 8530, Preamble, 59 Fed. Reg. 12840, 12842 (Mar. 18, 1994) ("The proposed regulations provide that the value of any stock issued in connection with the ownership change cannot exceed the value of the property received by the loss corporation in consideration for the stock. A commenter questioned the appropriateness of this limitation. The final regulations, however, retain the limitation to preclude any claims that the stock is worth more than what was paid for it. The limitation avoids the valuation disputes that would result from these claims.").

[79] Part IV.A.4 (p. 30).

ence in Nonbusiness Asset Percentages is "reasonable" but less than proof of an "exigency" for the investment or other use of the Nonbusiness Assets, and would focus the inquiry on whether the rationale for the difference in Nonbusiness Assets is abusive in nature.

A lower burden of proof would risk rendering the Presumptive Device Test toothless. In this respect, the example of the accumulated earnings tax[80] is informative. A corporation is subject to the accumulated earnings tax if it is "formed or availed of" for the purpose of avoiding the personal income tax with respect to its shareholders, or the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of being divided or distributed.[81] But a corporation otherwise subject to the accumulated earnings tax may avoid the tax by showing that its earnings and profits were accumulated for "the reasonable needs of the business."[82] Because public companies have proved capable of demonstrating a reasonable business need justifying just about any level of retention, the accumulated earnings tax has been rendered ineffective.[83]

If Treasury and the Service concluded that such a Presumptive Device Test is too flexible or could be prone to abuse, further safeguards could be implemented. As one example, the Service could implement a framework similar to that which the Service has used to determine when it will issue favorable rulings on the retention of stock or options in Controlled.[84] Under this approach, the Service could articulate a limited set of circumstances in which a taxpayer could receive a ruling according tax-free treatment to a distribution that would otherwise fail the Presumptive Device Test.[85] An alternative option could be modeled on the waiver of family

[80] Sections 531 through 537.

[81] Section 537(a).

[82] Section 533(a).

[83] *See, e.g.*, Robert Charles Clark, *The Morphogenesis of Subchapter C: An Essay in Statutory Evolution and Reform*, 87 YALE L.J. 103 (1977); *U.S. v. Donruss Co.*, 393 U.S. 297 (1969); RICHARD A. BREALEY & STEWART C. MYERS, PRINCIPLES OF CORPORATE FINANCE 434 (5th ed. 1996) ("public companies are almost always able to justify their retentions to the IRS").

[84] *See* Appendix B of Rev. Proc. 96-30, 1996-1 C.B. 696. Generally, the Service will issue a favorable ruling on the retention of stock in a widely-held corporation where there is (i) sufficient business purpose for the retention, (ii) there are no overlapping directors or officers between Distributing and Controlled (subject to appropriate exceptions), (iii) the retained interests are disposed of as soon as warranted consistent with the business purpose for the retention, and in no event later than five years after the distribution, and (iv) Distributing will vote the retained stake in proportion to the votes cast by the other shareholders of Controlled. *Id.*

[85] *See* Rev. Proc. 2016-45, 2016 I.R.B. 344 (the Service will issue private letter rulings on significant issues relating to the Device Prohibition).

attribution rules under Section 302(c)(2).[86] Under this approach, a taxpayer could rebut the presumption only by taking affirmative action to mitigate the Device potential in a transaction that otherwise violated the Presumptive Device Test, such as by agreeing to hold the stock of Distributing and Controlled for a specified period and observing notice and documentation requirements during that period. Under either alternative, the goal would be to confine the application of Device Prohibition to circumstances that do not raise a realistic possibility of abuse and to allow Treasury and the Service to address unintended applications of the Device Prohibition that may only become apparent through experience.

A Presumptive Device Test along the lines described above would respond to the fundamental policy concern animating the Per Se Device Test, namely, that there are certain situations in which the composition of Distributing's and Controlled's assets presents such a risk of Device that any non-Device factors should not be allowed to overcome the evidence of Device except pursuant to a strong demonstration of contrary evidence. Furthermore, the Presumptive Device Test would acknowledge the need for guidance on the application of the Device Prohibition to distributions involving the separation of Nonbusiness Assets from Business Assets, while preserving the flexibility needed to respond to unforeseen and unusual circumstances. Finally, while definitional issues and valuations would remain important under the Presumptive Device Test, they would not necessarily be decisive in and of themselves.

3. Non-Device Presumption and Intermediate Factors

(a) Presence of Nonbusiness Assets Not Ordinarily Considered a Device

We feel that additional clarification is necessary regarding the circumstances in which the presence of Nonbusiness Assets will ordinarily not be considered evidence of a Device. The Proposed Regulations establish certain thresholds below which the amount of Nonbusiness Assets in, or the ratio of Nonbusiness Assets between, Distributing and Controlled ordinarily is not evidence of Device. As described above, ownership of Nonbusiness Assets or a difference between the Nonbusiness Asset Percentages of Distributing or Controlled ordinarily is not evidence of Device if (i) the Nonbusiness Asset Percentage of each of Distributing and Controlled is less than the 20% Threshold, (ii) the difference is less than the 10% Threshold, or (iii) the distribution is non-pro rata among Distributing's shareholders and the difference equalizes values pursuant to the Equalization Motivated Disparity. We recommend that the final regulations provide that (i)

[86] This waiver is generally available where, (i) the distributee has no interest in Distributing (except that of a creditor) immediately after the distribution, (ii) the distributee doesn't acquire a prohibited interest within 10 years after the distribution, (iii) the distributee agrees to notify the Service if a prohibited interest is acquired within this period, (iv) the distributee agrees to maintain certain records, and (v) the distributee did not make certain tax avoidance dispositions or acquisitions in the ten years prior to the redemption.

the existence of either Not Evidence Factor (defined below) is considered evidence of non-Device, (ii) the failure to meet either Not Evidence Factor is considered evidence of device (except that a disproportionate allocation of Nonbusiness Assets should not be evidence of device if the absolute Nonbusiness Asset Percentage (defined below) is below 20%), and (iii) the combined existence of the two Not Evidence Factors provides strong evidence of non-Device.

As an initial matter, we think that the government should clarify that the presence of one of the Not Evidence Factors should constitute affirmative evidence of non-Device. For example, following a pro rata distribution where Distributing's Nonbusiness Asset Percentage is 0% and Controlled's Nonbusiness Asset Percentage is 19%, we think that satisfaction of the 20% Threshold should constitute affirmative evidence of non-Device. The greater-than-10% difference between Distributing's and Controlled's Nonbusiness Asset Percentage should constitute affirmative evidence of Device, but not where each corporation's Nonbusiness Asset Percentage is below 20%.

As another example, following a pro-rata distribution where the Nonbusiness Asset Percentage of each of Distributing and Controlled is 65%, we think that satisfaction of the 10% Threshold should constitute affirmative evidence of non-Device sufficient to outweigh any evidence of Device presented by the ownership of Nonbusiness Assets by Distributing or Controlled, notwithstanding the fact that the 20% Threshold has been exceeded.

In either of these two cases, it seems that the presence of a Not Evidence Factor makes it substantially more difficult to undertake a transaction constituting a classic Device, such as a return of capital distribution or a sale of the stock of Distributing or Controlled, if the disposition does not materially reduce the seller's interest in business operations. Furthermore, if proportionality does not constitute affirmative evidence of non-Device, it will be very difficult for a corporation with significant Nonbusiness Assets to rebut the evidence of Device presented by the ownership of Nonbusiness Assets and make a distribution qualifying under Section 355. If this were the case, the only method of redress would be for Distributing to distribute its Nonbusiness Assets in a taxable distribution prior to the distribution of Controlled. Assuming that no other provision of law would have required Distributing to distribute its Nonbusiness Assets in a taxable distribution if Distributing's business operations had been continued in a single entity, it does not appear that Section 355 should be interpreted to require this result where Distributing is separating significant existing businesses and the identical allocation of Nonbusiness Assets precludes a finding that the true purpose of the transaction is to segregate the Nonbusiness Assets in Distributing or Controlled. Consequently, preventing proportionality from constituting affirmative evidence of non-Device would significantly impact routine distributions, including legitimate Preparatory Intra-Group Distributions.

Clarification that the presence of a Not Evidence Factor constitutes evidence of non-Device and can be sufficient to outweigh other evidence of Device presented by ownership of

Nonbusiness Assets by Distributing or Controlled or a difference between the Nonbusiness Asset Percentages of Distributing and Controlled is consistent with Treas. Reg. § 1.355-2(d)(2)(iv)(B), which provides that the ownership of assets not used in an ATB is evidence of Device, but the "strength of the evidence of device depends on all the facts and circumstances, including, but not limited to, the ratio for each corporation of the value of assets not used in [an ATB] to the value of its [assets used in an ATB]." There is no indication in the Preamble that the government intended to depart from this approach; in fact, Example 3 of the Proposed Regulations arguably demonstrates that the government intended to continue this approach. In that example, Distributing and Controlled have Nonbusiness Asset Percentages of 50% and 47.5%, respectively. The example notes that Distributing's and Controlled's Nonbusiness Asset Percentages is evidence of Device, but concludes that, based on all the facts and circumstances, the transaction is considered not to have been used principally as a Device. One could reasonably infer from this conclusion that the absence of any significant difference in the Nonbusiness Asset Percentages of Distributing and Controlled served to overcome the evidence of Device presented by the fact that the Nonbusiness Asset Percentages of Distributing and Controlled exceeded the 20% Threshold.

In addition, the government should provide that the presence of factors (i) and (ii) together should constitute strong evidence of non-Device. Currently, the Proposed Regulations state that satisfaction of the 20% Threshold "ordinarily is not evidence of Device,"[87] and satisfaction of the 10% Threshold "ordinarily is not itself evidence of Device (but may be considered in determining the presence or the strength of other Device factors)."[88] Just as the Proposed Regulation's two-pronged construction of the Per Se Device Test implicitly acknowledges that the amount of Nonbusiness Assets in Distributing or Controlled and the difference between the Nonbusiness Asset Percentages of Distributing and Controlled can interact to present strong evidence of Device, it seems logical that these factors could similarly interact to present strong evidence of non-Device. As above, it appears that the presence of both factor (i) and (ii) would make it extraordinarily difficult to undertake a transaction constituting a classic device. Nonetheless, we do recognize that the government should still be able to overcome this strong evidence of non-Device when appropriate, such as where Distributing or Controlled borrows against its business assets to make a return of capital distribution.

Finally, we recommend that the government should consider raising the thresholds established by the 20% Threshold and the 10% Threshold. While we agree that satisfaction of either threshold generally should be evidence of non-Device, we think this conclusion remains true beyond the levels specified by the Not Evidence Factors. In particular, we feel that the ownership of Nonbusiness Assets should ordinarily not be evidence of Device if the Nonbusiness Asset

87 Prop. Reg. § 1.355-2(d)(2)(iv)(C)(*1*).

88 Prop. Reg. § 1.355-2(d)(2)(iv)(C)(*2*).

Percentage of each of Distributing and Controlled is less than 33 1/3%, because, in such a case, the majority of the assets of Distributing and Controlled would still consist of Business Assets. In addition, we feel that a difference between the Nonbusiness Asset Percentages of Distributing and Controlled should ordinarily not be evidence of Device where the difference is less than 20 percentage points, because, in this case, the concentration of Nonbusiness Assets in Distributing or Controlled does not appear high enough to determine that the transaction is being used principally as a Device.[89]

(b) Clarification Regarding Weighing of Intermediate Factors

In between the poles of the Per Se Device Test and the Not Evidence Factors, we feel that additional clarification is necessary regarding how the Device and non-Device factors relate to other Device and non-Device factors, and what weight should be given to individual factors when multiple factors are present. With regard to the ownership of Nonbusiness Assets by Distributing or Controlled, the Proposed Regulations provide:

> Ownership of Nonbusiness Assets by the distributing corporation or the controlled corporation is evidence of [D]evice. The strength of the evidence will be based on all the facts and circumstances, including the Nonbusiness Asset Percentage for each corporation. The larger the Nonbusiness Asset Percentage of either corporation, the stronger is the evidence of [D]evice.[90]

Similarly, with regards to the difference between the Nonbusiness Asset Percentages of Distributing and Controlled, the Proposed Regulations provide:

> [a] difference between the Nonbusiness Asset Percentage of the distributing corporation and the Nonbusiness Asset Percentage of the controlled corporation is evidence of [D]evice, and the larger the difference, the stronger is the evidence of [D]evice.[91]

Thus, where the ownership of Nonbusiness Assets by Distributing or Controlled or the difference between the Nonbusiness Asset Percentages of Distributing and Controlled exceed the thresholds of the Not Evidence Factors, but are not high enough to cause application of the Per Se Device Test, these factors (“**Intermediate Factors**”) will be considered evidence of Device, and the strength of the evidence increases as the Nonbusiness Asset Percentage (or difference between the Nonbusiness Asset Percentage, as the case may be) increases.

89 Note that this ratio is less than the minimum difference necessary to satisfy the second prong of the Per Se Device Test (*i.e.*, essentially 2:1).

90 Prop. Reg. § 1.355-2(d)(2)(iv)(C)(*1*).

91 Prop. Reg. § 1.355-2(d)(2)(iv)(C)(*2*).

However, the Proposed Regulations do not provide guidance on the extent to which other Device or non-Device factors will interact with an Intermediate Factor, and what weight should be given each factor in making the overall determination of whether a transaction is a Device. Example 2 of the Proposed Regulations (below) demonstrates the need for additional clarity.

> Example PR-2. [Distributing] owns and operates a fast food restaurant in State M and owns all of the stock of [Controlled], which owns and operates a fast food restaurant in State N. The value of the Business Assets of [Distributing]'s and [Controlled]'s fast food restaurants are $100 and $105, respectively. [Distributing] also has $195 cash which [Distributing] holds as a Nonbusiness Asset. [Distributing] and [Controlled] operate their businesses under franchises granted by competing businesses F and G, respectively. G has recently changed its franchise policy and will no longer grant or renew franchises to subsidiaries or other members of the same affiliated group of corporations operating businesses under franchises granted by its competitors. Thus, [Controlled] will lose its franchise if it remains a subsidiary of [Distributing]. The franchise is about to expire. The lease for the State M location will expire in 24 months, and [Distributing] will be forced to relocate at that time. While [Distributing] has not made any plans, it is weighing its option to purchase a building for the relocation. [Distributing] contributes $45 to [Controlled], which [Controlled] will retain, and distributes the stock of [Controlled] pro rata among [Distributing]'s shareholders.[92]

The analysis following Example PR-2 explains that, following the distribution, Distributing's Nonbusiness Asset Percentage is 60%, and Controlled's Nonbusiness Asset Percentage is 30%. Accordingly, both Distributing and Controlled's levels of ownership of Nonbusiness Assets and the difference between their Nonbusiness Asset Percentages are considered evidence of Device. Further, the corporate business purpose for the distribution is evidence of non-Device, but there is no corporate business purpose for the difference of Nonbusiness Asset Percentages. Finally, the fact that the distribution is pro rata is also evidence of a Device. The analysis following Example PR-2 concludes that "[b]ased on all the facts and circumstances, the transaction is considered to have been used principally as a Device."

As relevant to the discussion here, it seems that Example PR-2 introduces, but fails to resolve, questions regarding the appropriate weight to be given to Device and non-Device factors. First, because the fact pattern does not contain any non-Device factors other than the business purpose for the overall transaction, it is not clear whether the presence of any other non-Device factor, such as the fact that the stock of Distributing is publicly traded, would be sufficient to determine that the transaction was not a Device. Second, although Example PR-2 contains several

[92] Prop. Reg. § 1.355-2(d)(4), Ex. 2.

Device factors, it does not indicate what weight is given to individual factors in determining that the transaction is a Device. Further, although we do not think that this is the intended, or correct, result, one reading of Example PR-2 could be that, in the absence of any non-Device factors, the existence of an Intermediate Factor would be sufficient to determine that a transaction was a Device.

For these reasons, we recommend that the final regulations demonstrate how the existence of non-Device factors, such as the fact that the stock of Distributing is publicly traded, would alter the analysis under facts similar to those presented in Example PR-2.

4. Intra-Group Distributions

In our view, the Proposed Regulations do not adequately address the circumstances applicable to intra-group distributions, which at least in certain cases justify additional flexibility when applying the Device Prohibition. In the Prior Report, we recommended that any guidance addressing distributions involving substantial Investment Assets or *de minimis* ATBs include an exception for intra-group distributions that are preparatory to external distributions ("**Preparatory Intra-Group Distributions**"). The Proposed Regulations provide no such exception, which the Preamble rejected, notwithstanding the announcement by Treasury and the Service in Notice 2015-59 that they were generally more concerned about distributions outside of an affiliated group, and would focus on intra-group distributions only in the absence of a planned or intended external distribution (a "**Non-Preparatory Intra-Group Distribution**").[93]

As an initial matter, we agree with the position of Treasury and the Service regarding Non-Preparatory Intra-Group Distributions. In the Prior Report, we urged that any exception for Preparatory Intra-Group Distributions not apply with respect to Non-Preparatory Intra-Group Distributions, offering the following example:

> Example 5. [Prior Report Example 6] *Internal Spin.* Parent owns Distributing and has a high basis in the stock of Distributing. Distributing owns operating businesses and a diverse portfolio of Investment Assets with a low tax basis. Parent would like to cause Distributing to sell the Investment Assets but doing so would trigger a large amount of gain. Instead, Parent causes Distributing to form Controlled, contribute the Investment Assets and a small amount of Qualifying Business Assets to Controlled and distribute Controlled to Parent. Eventually,

[93] Notice 2015-59, § 2, 2015-40 I.R.B. at 460. As noted in the Prior Report, however, the Service may have been applying the Substantial Investment Assets No-Rule to all intra-group distributions, consistent with the position taken in the Proposed Regulations. *See* Prior Report at 47.

not as part of the plan with the distribution, an acquirer acquires Controlled from Parent for cash.[94]

As we noted previously, the transaction described in Example 5 threatens *General Utilities* repeal and implicates Device concerns by allowing basis recovery without an apparent "true separation of business."[95] Under the Proposed Regulations, this transaction might appropriately fail to meet the Device Prohibition (including pursuant to the Per Se Device Test) or the ATB Requirement.

Our focus is instead on Preparatory Intra-Group Distributions and our recommendations below are limited to them. These distributions are more susceptible to taxation as a Device under the Proposed Regulations. The allocation of Business Assets and Nonbusiness Assets may be essentially determined by (or, at least, need to be responsive to) the larger goals of the external transaction. At the same time, the composition and valuations of assets in different geographies or corporate sub-groups may not lend itself to a pro rata allocation of Nonbusiness Assets in proportion to Business Assets in Preparatory Intra-Group Distributions. Putting these factors together, the Preparatory Intra-Group Distributions are likely to have higher concentrations of Nonbusiness Assets than an external distribution and more substantial disparities in Nonbusiness Assets supported by legitimate business objectives. Moreover, valuation of assets involved in Preparatory Intra-Group Distributions is likely to be more subjective and uncertain with a broader range of reasonable outcomes than valuations required for external distributions where public market data often is available.[96]

Consider the following example:

Example 6. *Preparatory Internal Spin.* Parent wholly owns each of Regulated Entity and Distributing; Distributing, in turn, wholly owns Controlled. Regulated Entity's business is subject to regulatory oversight which requires it to hold a certain amount of liquid investment assets, computed on a consolidated basis (*i.e.*, looking to the investment assets held by the Regulated Entity's subsidiaries). Controlled is engaged in a business that is related to Regulated Entity's business, but is not subject to the same regulations on a standalone basis. As part of a broader internal restructuring and pursuant to a plan, Parent intends to (1) cause Distributing to distribute Controlled to Parent (the "**Internal Spin**"), (2) contribute Controlled to Regulated Entity and (3) distribute Regulated Entity to its public shareholders pro rata (the "**External Spin**"). After the Internal Spin, Dis-

94 Prior Report at 48.

95 *Id*.

96 *See infra* Part IV.B.2 (p. 45).

> tributing's Nonbusiness Asset Percentage is 30% and Controlled's Nonbusiness Asset Percentage is 60%; after the External Spin, Parent's Nonbusiness Asset Percentage is 25% and Regulated Entity's Nonbusiness Asset Percentage is 27.5%. Parent's corporate business purpose for the External Spin is not related to a separation of Nonbusiness Assets from one or more Businesses or Business Assets.

As Treasury and the Service recognize, Congress has taken steps to avoid requiring corporations to engage in burdensome restructuring to satisfy the requirements of Section 355.[97] Further, a corporate business purpose of facilitating an external transaction involving an acquisition of Controlled should satisfy the business purpose test.[98] However, under the Proposed Regulations, the Preparatory Intra-Group Distribution described above may violate the Device Prohibition because each of Distributing and Controlled's Nonbusiness Asset Percentages is greater than 20%, the difference between their Nonbusiness Asset Percentages is 30%, and Distributing's corporate business purpose for the difference in Nonbusiness Asset Percentages does not involve an "exigency that requires an investment or other use of the Nonbusiness Assets in one or more Businesses of the distributing corporation, the controlled corporation, or both."[99]

Although we believe Preparatory Intra-Group Distributions present unique challenges, we do not argue against the proposition that "each distribution must meet all the requirements of section 355."[100] We recognize that Preparatory Intra-Group Distributions could be used to facilitate transactions that raise policy concerns within the context of a larger business-based transaction. For example, as illustrated below, Treasury and the Service may be concerned about the ability of a Section 355 distribution to facilitate repatriation without residual U.S. taxation.

> Example 7. *Cross-Border Internal Spin.* Same as Example 5, except that the Investment Assets transferred to Controlled include cash as well as appreciat-

97 Preamble at 46007.

98 *See, e.g.*, *Comm'r v. Morris Trust*, 367 F.2d 794 (4th Cir. 1966), *acq.* 1968-2 C.B. 148 (acquisition of Distributing). The Service has also ruled that facilitating an acquisition of Controlled is a good corporate business purpose. *See* Thomas F. Wessel, Joseph M. Pari *et al.*, *Corporate Distributions Under Section 355*, THE CORPORATE TAX PRACTICE SERIES: STRATEGIES FOR ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATIONS & RESTRUCTURINGS 2015, at 761-62 (Louis S. Freeman ed., 2015).

99 Preamble at 46010. *See, e.g.*, Prop. Reg. § 1.355-2(d)(4), Ex. 2 (finding a Device where Distributing and Controlled have Nonbusiness Asset Percentages of at least 20%, the difference between Distributing's and Controlled's Nonbusiness Asset Percentages is 30%, and Distributing has no corporate business purpose for the difference of Nonbusiness Asset Percentages).

100 Preamble at 46012.

> ed assets, and there is no acquisition of Controlled by acquirer. Parent is a U.S. corporation and each of Distributing and Controlled is a foreign corporation. Eventually, as part of the plan with the distribution and prior to the realization of any gain with respect to the Investment Assets, Controlled pays Parent a cash dividend in excess of its allocable earnings and profits, and this excess is treated as a return of capital.

The allocation of earnings and profits to Distributing and Controlled under Section 355 could potentially result in a lower income inclusion than if Distributing had made the same distribution (and, in some cases, may even result in the permanent elimination of earnings and profits).[101] This potential is present in the case of both Preparatory Intra-Group Distributions and Non-Preparatory Intra-Group Distributions.

As we indicated in the Prior Report, in our experience, Preparatory Intra-Group Distributions generally do not implicate Device, business purpose, or *General Utilities* repeal concerns. The issues presented by Example 7 and related concerns could presumably be more directly addressed through guidance clarifying the allocation of earnings and profits or under Section 367, without introducing the uncertainty and burdens described above.

If the government does not adopt a blanket exception for Preparatory Intra-Group Distributions from a new framework for substantial and disproportionate allocation of Nonbusiness Assets, we suggest that final regulations be tailored to take into account the relevant circumstances. First, we believe that it is particularly important to apply a presumptive, rather than a *per se*, rule in the context of Preparatory Intra-Group Distributions. Second, we believe that the Corporate Business Purpose Non-Device Factor needs to be modified to take into account how a business purpose related to an external transaction may necessarily guide and justify a disproportionate allocation of Nonbusiness Assets in the context of Preparatory Intra-Group Distributions. In particular, if the purpose for the disproportionate allocation facilitates achieving (*i.e.,* is consistent with) the business purposes for the external transaction, the disproportionate allocation ordinarily should not be considered evidence of Device.

> *Example 8. Internal Spin Preparatory to a Reverse Morris Trust ("**RMT**") Transaction*. Parent owns Distributing. Parent and Distributing each is engaged in Business A and Business B. Pursuant to a single integrated plan to transfer Business B to RMT Partner, Distributing forms Internal Controlled, contributes its Business Assets related to Business B to Internal Controlled, and

[101] *See* N.Y. ST. BA. ASS'N, TAX SEC., *Report on the Allocation of Earnings and Profits in Connection with Divisive Transactions*, at 53-64 (Rep. No. 1333, Dec. 1, 2015) for an extensive discussion on the allocation of earnings and profits among Distributing and Controlled in Section 355 distributions.

> distributes Internal Controlled to Parent (the "**Internal Spin**"). Subsequently, Parent forms External Controlled, contributes its Business Assets related to Business B and Internal Controlled to External Controlled, and distributes External Controlled to the shareholders of Parent (the "**External Spin**"). Following the distribution, External Controlled merges into RMT Partner with the former shareholders of External Controlled receiving 50.1% of the interests in the combined entity. After the Internal Spin, Distributing's Nonbusiness Asset Percentage is 50% and Internal Controlled's Nonbusiness Asset Percentage is 0%; after the External Spin, Parent's Nonbusiness Asset Percentage is 10% and External Controlled's Nonbusiness Asset Percentage is 0%. A substantial corporate business purpose for the External Spin is to facilitate the merger of External Controlled and RMT Partner.

Here, the difference in Nonbusiness Asset Percentages of Distributing and Controlled stems from the business deal underlying the RMT transaction: the Parent group wants to transfer, and Merger Partner wants to acquire, Business B; the Parent group does not want to transfer, and Merger Partner, does not want to acquire, any of Parent's Nonbusiness Assets.[102] Accordingly, there would seem to be no compelling policy reason to require Distributing to allocate a portion of its Nonbusiness Assets to Controlled in such case. In fact, that would be inconsistent with amendments to Section 355 intended to reduce the burden associated with internal transactions undertaken to effectuate a distribution under Section 355.[103]

We note that the Proposed Regulations helpfully continue to include the Affiliated Group Exception. For clarity, the Affiliated Group Exception should explicitly apply to a distribution between members of a consolidated group which is excluded from gross income of the distribute under Reg. § 1.1502-13(f)(2)(ii). Outside the affiliated group context, for the reasons discussed above, we recommend that final regulations implementing the Device Prohibition in the context of Preparatory Intra-Group Distributions be appropriately tailored by avoiding a *per se* rule in this context and, as discussed further below in connection with the discussion of the Corporate Business Purpose Non-Device Factor, by accommodating the circumstances relevant to Prepara-

[102] Similar issues can arise outside the context of an RMT transaction. For example, where Distributing wishes to separate a non-core business from its core business, one of the business purposes for doing so may be to eliminate internal competition for capital between the businesses. In such cases, the purpose for allocating a disproportionate amount of Nonbusiness Assets to the core business facilitates achieving the business purpose, and this fact should be accorded significant weight in the Device analysis.

[103] *See* Section 202 of the Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109-222, 120 Stat. 345, 348; Division A, Section 410 of the Tax Relief and Health Care Act of 2006, Pub. L. No. 109-432, 120 Stat. 2922, 2963; Section 4(b) of the Tax Technical Corrections Act of 2007, Pub. L. No. 110-172, 121 Stat. 2473, 2476.

tory Intra-Group Distributions, such as a separation of Nonbusiness Assets from one or more Businesses or Business Assets to facilitate achieving a business purpose motivating an External Spin.

B. Technical Issues

1. Definition of Business Asset and Corporate Business Purpose Non-Device Factor

Under the Proposed Regulations, the application of the Device Prohibition and the ATB Requirement depends crucially on the characterization of the assets of Distributing and Controlled as Business Assets (in the case of the Device Prohibition) and Five-Year-Active-Business Assets (in the case of the Minimum ATB Threshold). Not only is the definition of Business Assets (and its complement, Nonbusiness Assets) a touchstone for the application of the Per Se Device Test[104] and the Minimum ATB Threshold,[105] but this concept (and the related concept of an "exigency") is also central to the application of the Corporate Business Purpose Non-Device Factor.[106]

The question of what constitutes a Business Asset and the embedded question of what constitutes Working Capital or a Required Asset are inherently factual. If it is unclear whether a particular asset is "used" in a Business, which is likely to be the case with cash and other liquid, marketable, or fungible assets, the Proposed Regulations provide a safe harbor for Working Capital and Required Assets. But to the extent the assets in question are neither Working Capital nor Required Assets, the Proposed Regulations provide no comfort with respect to the classification of the assets as Business Assets.

A determination of whether a particular holder's assets are appropriately considered Business Assets requires an understanding of the holder's business, the relevant industries, what may constitute a reasonable expectation of business needs or foreseeable financial obligations, any applicable laws and regulatory regimes, and the holder's arrangements and agreements with third parties (and, potentially, persons related to the holder). Through the "facts and circumstan-

[104] Under Prop. Reg. § 1.355-2(d)(5), the Per Se Device Test applies by reference to the relative amounts of Business Assets and Nonbusiness Assets held by each of Distributing and Controlled.

[105] Under Prop Reg. § 1.355-9(b), compliance with the Minimum ATB Threshold is measured by reference to the relative amounts of Five-Year-Active-Business Assets and Non-Five-Year-Active-Business Assets held by each of Distributing and Controlled.

[106] *See* Prop. Reg. § 1.355-2(d)(3)(ii).

ces" approach of the current regulations,[107] the government has acknowledged the nature of the inquiry, but have avoided the need to craft a technical definition that is narrow enough to exclude passive investment assets unrelated to a relevant business while broad enough to take into account differences in the needs and reasonable expectations of the universe of businesses. However, the Proposed Regulations, if adopted, would impose *per se* rules (and numerically-based Device factors) and thus require strict adherence to guidelines that are measured by reference to the often amorphous concepts of when assets are "related" to a business, when they are "reasonably" needed for working capital, and when financial obligations are "reasonably expected" to arise. Where the rules specifically define concepts that are factual in nature (and were previously subject to a broad "facts and circumstances" analysis), we believe it is crucial to ensure the scope of the relevant definitions is appropriately tailored to achieve the relevant goals. This is even more important in the context of the application of *per se* rules, where the failure to satisfy the terms of the relevant definition without more, could cause a transaction to be taxable. Further, the scope of the relevant definitions should bear some relation to the weight of the Intermediate Factors[108] in determining whether a transaction is a Device (*i.e.*, the more difficult it is for a taxpayer to overcome evidence of Device presented by an Intermediate Factor, the more narrowly tailored the definitions central to such Intermediate Factors should be).

For this reason, if the Per Se Device Test or the Minimum ATB Threshold is retained (or if the Intermediate Factors bear significant weight in the Device analysis), we believe it would be appropriate to narrow the scope of transactions that fall within the ambit of such rules by broadening the definition of Business Asset. On the other hand, if the Device Prohibition, as reflected in final guidance, permits taxpayers to rebut a presumption of Device, including by showing why certain assets should qualify as Business Assets, and if the government provides guidance indicating that evidence of Device presented by the Intermediate Factors is able to be overcome by evidence of non-Device, a narrower definition would not present the same potential for inequi-

[107] *See* Reg. § 1.355-2(d)(1) ("Generally, the determination of whether a transaction was used principally as a [D]evice will be made from all of the facts and circumstances . . ."); -2(d)(2)(iv)(B) (the strength of the evidence of Device based on the existence of assets not used in an active trade or business "depends on all the facts and circumstances"); -3(b)(2)(iii) ("the determination whether a business is actively conducted will be made from all of the facts and circumstances").

[108] See discussion *supra* Part IV.A.3 (p. 25).

ty.[109] In other words, the breadth of the definition should reflect the type of rule adopted.[110] In addition, in light of the importance of the Corporate Business Purpose Non-Device Factor in overcoming evidence of Device presented by a difference between the Nonbusiness Asset Percentages of Distributing and Controlled, we believe it is important to ensure that such factor does not rely on an inappropriately narrow concept of when a separation of Nonbusiness Assets from a Business or from Business Assets is non-abusive in nature (*i.e.*, by not limiting a permissible business purpose to one which is created by an exigency).

(a) Working Capital

While Revenue Procedure 2015-43 defined Nonbusiness Assets (and conversely, Business Assets) by reference to the definition of "investment assets" for purposes of Section 355(g), the Proposed Regulations helpfully acknowledge that such definition is inappropriately narrow for purposes of the Device Prohibition and ATB Requirement.[111] Instead, the Proposed Regulations expressly include a reasonable amount of working capital in the definition of Business As-Assets (*i.e.*, Working Capital).[112] However, there is no further elaboration of what constitutes working capital, including when amounts are considered reasonable. We recommend that final regulations, by their terms or through examples, clarify whether, in the situations discussed below, assets would qualify as Working Capital (and thus, Business Assets).

First, contrary to what Example 2 and Example 4 in the Proposed Regulations suggest,[113] we believe that, especially in the context of the Per Se Device Test, Minimum ATB Threshold, and Intermediate Factors that bear significant weight in the Device analysis, Working Capital

[109] We note that the scope of definition of Business Assets and the concept of exigency remain central to the Minimum ATB Threshold. To the extent the government adopts a Presumptive Device Test, but final guidance retains the Minimum ATB Threshold, it may be appropriate to utilize a narrower definition for purposes of the Presumptive Device Test (because taxpayers will be able to present evidence that a transaction should not be treated as a Device) than for purposes of the Minimum ATB Threshold (because taxpayers will flatly fail the ATB Requirement if the Minimum ATB Threshold is not satisfied).

[110] *See* N.Y. ST. BA. ASS'N, TAX SEC., *Report on the Non-Ordinary Course Distribution Rules in Notice 2014-52* (Rep. No. 1324, July 6, 2015) ("To avoid over-inclusiveness, we believe that the breadth of the rule implemented by future guidance . . . should reflect the type of rule that is adopted (*i.e.*, a *per se* rule versus one that looks to purpose). The more the mechanic of the rule tilts the burden of proof in favor of the Service (with a *per se* rule in favor of the government being at one end of the spectrum), the narrower the scope of the rule should be.").

[111] *See* Preamble at 46010 ("investment assets as defined [in Section 355(g)] may include certain assets that do no raise [D]evice concerns, such as cash needed by a corporation for working capital").

[112] Prop. Reg. § 1.355-2(d)(2)(iv)(B)(*2*).

[113] *See* Prop. Reg. § 1.355-2(d)(4), Exs. 2, 4.

should include cash held to fund the reasonably foreseeable cash needs of a business based on specific plans or expectations, even if the business is not legally obligated or bound (by contract or otherwise) to use such cash in the expected manner. Consider fact patterns, based on Example 2 in the Proposed Regulations (set forth in Part IV.A.3(b) above) and Example 4 in the Proposed Regulations (set forth below):

> Example PR-4. *Disproportionate Division of Nonbusiness Assets (Certain Cash Need)*. Distributing owns and operates a fast food restaurant in State M and owns all of the stock of Controlled, which owns and operates a fast food restaurant in State N. The values of the Business Assets of Distributing's and Controlled's fast food restaurants are \$100 and \$105, respectively. Distributing also has \$195 cash. Controlled's franchise is about to expire. The lease for the State M location will expire in 6 months, and Distributing will be forced to relocate at that time. Distributing will purchase a building for the relocation, which will cost \$80. Distributing contributes \$45 to Controlled, which Controlled will retain, and distributes the stock of Controlled pro rata among Distributing's shareholders.

In each of the examples, if all \$195 of the cash is excluded from the definition of Business Assets, the allocation of Nonbusiness Assets between Distributing and Controlled would be disproportionate and, absent a qualifying corporate business purpose for the allocation, would be evidence of Device not overcome by evidence of non-Device presented by a qualifying business purpose. However, the Proposed Regulations make clear that, while, in both patterns, the cash is considered a Nonbusiness Asset,[114] the transaction in Example PR-4 is not used principally as a Device because the disproportionate allocation is motivated by a business exigency (*i.e.*, Distributing's binding requirement to purchase a building). However, in *neither* case do the Proposed Regulations treat any portion of the cash retained by Distributing as Working Capital or otherwise as a Business Asset, despite the apparent purpose of Distributing's retention to fund its reasonably expected (or certain) real estate purchase related to its business. We believe that both fact patterns could reflect sympathetic cases for treating a portion of Distributing's cash as a Business Asset. Certainly in Example PR-4, where Distributing has committed to spending, within six months, \$80 on an expenditure clearly related to its business, it seems inappropriate to characterize \$80 of Distributing's cash as being held other than as Working Capital or otherwise as a Business Asset. In fact, it is difficult to imagine a fact pattern presenting a more sympathetic

[114] In each example, the Proposed Regulations specify that Distributing holds the \$195 cash as a Nonbusiness Asset, but no explanation is provided for whether the analysis would be different if a portion of the cash were held with the reasonable expectation of use to fund the relocation. We believe a clarification along these lines would be helpful.

case for treating cash as a Business Asset than an expenditure related to Distributing's business that is certain to occur within a one-year period after the transaction. Accordingly, we recommend that Example PR-4 be amended to treat $80 of the cash retained by Distributing as a Business Asset.

Further, the only material differences between Examples PR-2 and PR-4 are that, in Example PR-2, the expenditure (1) is being considered but is not certain (and, thus, there is no known amount, only an estimated expenditure range), and (2) will occur, if at all, within two years (not six months). However, if, in the context of Distributing's business and given all available information, Distributing has specific, reasonably foreseeable plans for the potential expenditure, the nature of which can be specifically identified, the amount of the expenditure is reasonably quantifiable, and, in the context of past practices with respect to cash retention, it is reasonable for Distributing to retain cash for a specified purpose up to two years in advance, there does not seem to be a reason to treat $80 (the average of the potential range of expenditure) of the cash retained by Distributing as a Nonbusiness Asset. By suggesting that cash retained to fund reasonably foreseeable business expenditures is not Working Capital and thus not a Business Asset, the Proposed Regulations reach a result that may be at odds with the manner in which companies determine their business-related/operational cash needs. It is likely overly formalistic and simplistic to assume that any cash that is earmarked for use in a business is associated with a certain (as opposed to reasonably foreseeable or expected) expenditure that the business is obligated to make. For example, businesses that rely heavily on research and development (R&D) likely maintain high cash levels to fund those R&D efforts, but a portion of such cash may not have a designated or certain use beyond general R&D related to the business. If cash levels are generally consistent with historic and industry-wide practices regarding cash maintenance for R&D expenses, this cash should not be considered a Nonbusiness Asset. Failing to take into account in the definition of Business Assets cash meant to fund reasonably foreseeable, identifiable business needs may inappropriately penalize taxpayers whose allocation of cash between Distributing and Controlled is motivated by a legitimate business rationale and is not abusive in nature. In the context of a Per Se Device Test, Minimum ATB Threshold, and Intermediate Factors given significant weight, we recommend expanding the scope of the definition of Business Assets to address these issues, and suggest that the government consider an approach similar to that taken in the regulations under Section 355(d) regarding when cash held for use in a business does not exceed the reasonable needs of the business.[115] Under such an approach, regulations

[115] *See* Reg. § 1.335-6(d)(3)(iv)(C), (D). Generally, "purchased" stock for purposes of Section 355(d) includes stock received by a transferor in a Section 351 contribution to the extent received in exchange for certain assets, including cash. However, among other requirements, if the transferor contributes an ATB to the transferee, and the transferred items (*e.g.*, cash) are used in that business and do not exceed the reasonable needs of the business, the contribution of the cash does not taint the stock for purposes of Section

might include in the definition of Business Assets cash that is necessary to support the reasonably anticipated needs of the business, but require taxpayers to point to specific planned uses, a timetable consistent with the taxpayer's normal business planning and budgeting processes, and a capacity and commitment to executing on the plan in a prompt manner consistent with orderly procedure.

In order to ensure that the rules would not be susceptible to taxpayer abuse, we recommend that the rules require the taxpayer to show substantial compliance with the specific plans by which it justified the characterization of cash as a Business Asset. Specifically, if, post-separation, the cash is utilized for a non-business purpose (*i.e.*, the cash is not used for the expected expenditures that justified the characterization of the cash as a Business Asset), the regulations should treat the cash as a Non-Business Asset. However, because the Device Prohibition is meant to assess the taxpayer's intent at the time of the separation, the characterization of the cash as a Business Asset should not be impacted if the taxpayer is able to show that it was forced to abandon its specific planned use of cash due to an unforeseen change in circumstances after the time of the separation. The government also could consider a rule that would treat the use of the cash for a non-business purpose (other than as a result of an unforeseen change in circumstances) as evidence of Device. However, if the application of the Per Se Device Test and Intermediate Factors after treating the cash as a Non-Business Asset would not otherwise raise Device concerns, it seems inappropriate for a separate rule to treat the mischaracterization of the cash as independent evidence of Device. For this reason, we believe that the appropriate "penal-

355(d). Reg. § 1.355-6(d)(3)(iv)(A). The Service considers all facts and circumstances in determining whether an exception is warranted. Reg. § 1.355-6(d)(3)(iv)(D). The regulations clarify that "the reasonable needs" of the business take into account the amount of cash that "a prudent business person apprised of all relevant facts would consider necessary for the present and reasonably anticipated future needs of the business." Reg. § 1.355-6(d)(3)(iv)(C). This requires "specific, definite, and feasible plans" for the use of the assets, and the standard takes into account anticipated future needs if the assets are "used as expeditiously as possible consistent with the business purpose for retention of the items." *Id.* A future need is not "reasonably anticipated" to the extent it is "uncertain or vague or where the execution of the plan for [the assets'] use is substantially postponed." *Id.* The Service has also indicated that it considers Distributing's retention of Controlled stock to be motivated by a sufficient corporate business purpose where the retention is intended to "provide Distributing with a source of cash for working capital needs, expansion and acquisitions." Priv. Ltr. Ruls. 201123030 (June 10, 2011), 201129005 (July 22, 2011), 201129006 (July 22, 2011). The reference to expansions and acquisitions appears to bless a future cash need that is reasonably anticipated.

In the context of the Device Prohibition and the Minimum ATB Threshold, this standard denotes, and should be administered as, a higher threshold (as to specificity of the plan, consistency with the taxpayer's normal business planning and budgeting processes, and commitment to prompt execution) than under the accumulated earnings tax.

ty" in a situation where cash is utilized in a manner inconsistent with the planned use of the cash should be the recharacterization of the cash as a Non-Business Asset (and the redetermination of whether the transaction satisfies the Device Prohibition taking into account this recharacterization).

Second, in determining whether cash qualifies as Working Capital, we believe it would be appropriate to make comparisons to working capital levels prevailing in the business or industry in which the particular holder operates. In other words, the determination of reasonableness should not follow a "one size fits all" approach such that all entities with a particular gross asset value are deemed to have a particular working capital level that represents the maximum level that would be reasonable. Instead, for example, an industry that is volatile or cyclical may justify the maintenance of a relatively high level of cash reserves to ensure sufficient liquidity in down markets or cycles. In order to transact with businesses in such an industry, suppliers or other third parties may demand the retention of a certain cash level. This cash might not have any real expectation of use, but its retention is reflective of that volatility (and may perhaps be common among peer entities). In the context of a Per Se Device Test, Minimum ATB Threshold, and Intermediate Factors that are difficult to overcome, we believe this cash (and other cash reflective of the nature of the relevant business) should be viewed as reasonable (and thus qualify as Working Capital or otherwise as a Business Asset) absent strong evidence to the contrary. At the same time, because the Device rules should not be an occasion for the government to broadly second-guess business judgments as to appropriate levels of Working Capital, the definitions of Working Capital and, by extension, Business Assets should respect objectively reasonable judgments about cash levels that deviate to a reasonable extent from industry norms based on the particular taxpayer's circumstances.

Third, the preamble to the Proposed Regulations suggests that, in at least certain instances, real estate may not qualify as a Business Asset.[116] However, neither the definition of Business Assets nor the examples provided in the Proposed Regulations discuss the treatment of real estate. We believe it is appropriate, and that regulations should specifically provide, that real estate related to a Business is a Business Asset. Further, we believe that, if Distributing and Controlled are REITs, absent an indication to the contrary, real estate held by either Distributing or Controlled would be a Business Asset and, if ownership of such real estate is logically connected to an ATB, a Five-Year-Active-Business Asset. We note that, as a practical matter, any failure to adopt rules treating real estate held by a REIT as a Business Asset would preclude transactions in which both Distributing and Controlled are REITs from qualifying under Section 355. While the

[116] *See* Preamble at 46010 (an approach that relies on the Section 355(g) definition of investment assets "may not include . . . assets that do raise [D]evice concerns, such as real estate not related to the taxpayer's Business").

government has foreclosed taxpayers from engaging in tax-free spin-offs where either Distributing or Controlled (but not both) becomes a REIT in connection with the transaction,[117] REIT-REIT spin-offs remain possible.[118] However, if real estate held by a REIT is not a Business Asset, REITs would, seemingly by definition, fail to satisfy the Device Prohibition or the ATB Requirement. To avoid this result, we recommend that final guidance contain an example clarifying the treatment of both real estate used in a business and real estate held by REITs.

Similarly, the departure from the Revenue Procedure's reliance on the Section 355(g) concept of "investment assets" calls into question the treatment of cash held by certain financial service companies for use in their businesses. Had the definition of Business Assets been based on the Section 355(g) "investment asset" concept, there would have been a clear exception to treatment as a Nonbusiness Asset for cash (and cash equivalents and other similar assets) "held for use in the active and regular conduct" of certain lending, finance banking, and insurance businesses.[119] This approach appears to be consistent with the general approach taken in the Proposed Regulations: *i.e.*, to the extent the financial business qualifies as a Business, cash held by that Business is an asset used in a Business. However, the Proposed Regulations do not address this cash, creating safe harbors only for Working Capital and Required Assets. It is unclear whether, in the context of a financial business, cash held by the business would qualify as Working Capital because there is no clear definition of this concept. Thus, we recommend that final guidance contain a safe harbor providing that cash and cash equivalents, stock or securities in a corporation, and other financial assets described in Section 355(g)(2)(B)(i) held for use in a Business described in Section 355(g)(2)(B)(ii) (*e.g.*, a lending, finance, banking, or insurance business) are Business Asses.

(b) Required Assets and Exigencies

In addition to Working Capital, the definition of Business Assets includes a safe harbor for Required Assets.[120] Further, the concept of an "exigency" is central to the ability to counteract evidence of Device through the Corporate Business Purpose Non-Device Factor. The Proposed Regulations' focus on binding requirements, through the concept of Required Assets and the Corporate Business Purpose Non-Device Factor, was likely intended to reduce the burden of the government in assessing the nature of assets and strength of business purposes. As indicated above, while these inquiries are inherently factual in nature and require some under-

[117] Section 355(h).

[118] Section 355(h)(2).

[119] *See* Section 355(g)(2)(B)(ii).

[120] Prop. Reg. § 1.355-2(d)(2)(iv)(B)(*2*).

standing of the relevant businesses, it is relatively straightforward to determine the existence of a binding legal commitment or applicable regulatory requirement.

As discussed above with respect to our recommendation to broaden the scope of assets that constitute Working Capital, it seems inappropriate to exclude from the definition of Business Assets items that are reasonably anticipated to be needed or used in a business, especially where consistent with industry practice and other relevant facts and circumstances. We do not believe it is necessary for the government to modify the definition of the Required Asset safe harbor, but, through implementing our recommendations in Part IV.B.1, final guidance should recognize that there are several categories of assets that may not qualify as Required Assets but should otherwise be characterized as Business Assets.

However, a narrow interpretation of the concept of "exigency" is more problematic in the case of the Corporate Business Purpose Non-Device Factor, where the Proposed Regulations appear to assume that the absence of an exigency is uncontroverted evidence that a disproportionate allocation of Business Assets and Nonbusiness Assets is evidence of Device.[121] We believe that situations may (and indeed, will) arise where a genuine corporate business purpose exists for a disproportionate allocation without an "exigency." Genuine corporate business purposes, such as those related to the motivations discussed above with respect to the retention of cash, are frequently not evidenced by external, binding confirmation of the needs of a business. Deference should be given to taxpayers with respect to determining the optimal allocation of assets and capital among various businesses.

The notion that external proof of internally developed corporate business purposes is too restrictive a standard in the context of the Corporate Business Purpose Non-Device Factor is consistent with the Service's approach in administering the general corporate business purpose requirement. Regulation §1.355-2(b)(1) generally requires that a transaction must be "motivated, in whole or substantial part, by one or more corporate business purposes," and § 1.355-2(b)(2) clarifies that a qualifying business purpose is a "real and substantial non Federal tax purpose germane to the business of" Distributing or Controlled. Despite the reference in the regulations indicating that the business purpose requirement is meant to ensure that Section 355 applies "only to distributions that are incident to readjustments of corporate structures required by business exigencies," taxpayers have not, in recent history, needed to prove that a separation is required by any external factor.[122] In fact, two examples provided in the regulations identify purely inter-

[121] *See* Preamble at 46010 ("absent such an exigency, [separations of Nonbusiness Assets from one or more Businesses or from Business Assets] are not consistent with the intent of Congress to prevent [S]ection 355 from applying to a distribution that is used principally as a [D]evice").

[122] *See* Reg. § 1.355-2(b)(1).

nal considerations as qualifying business purposes.[123] It is our understanding that a separation motivated, for example, by a desire to allow Controlled to invest in growth opportunities would not require proof that Controlled is legally or otherwise bound to make such investments. It is difficult to understand, then, why a corresponding allocation of cash to Controlled in light of this corporate business purpose, without proof of an "exigency" requiring these investments, would not be supported by a business purposes sufficient for purposes of the Corporate Business Purpose Non-Device Factor.

Similarly, in an RMT, the separation is driven by the need to separate the assets to be combined with the merger partner's assets from Distributing's remaining assets, which clearly reflects a genuine corporate business purpose. However, an allocation of cash similarly motivated by a desire to effect a combination of a certain set of assets would not be motivated by a business purpose sufficient for purposes of the Corporate Business Purpose Non-Device Factor unless an "exigency" required the allocation.

We recommend final guidance allow the Corporate Business Purpose Non-Device Factor to be satisfied without a showing of an "exigency." The government should consider a range of potential approaches with respect to defining the contours of the corporate business purposes considered sufficient to support a disproportionate allocation (each, an "**Allocation Corporate Business Purpose**"). On the one hand, a narrowly defined concept of an Allocation Corporate Business Purpose may prevent taxpayer abuse and the ability to point to vague notions of corporate motivations that may not be substantiated. On the other hand, a significant degree of flexibility is required to recognize that there is a broad range of legitimate corporate business purposes supporting asset allocations. The government's approach should reflect this complicated balancing act.

It is worth restating that, at a minimum, we believe that taxpayers should be required to show more than the existence of an overall corporate business purpose motivating the separation. That is, we agree that the Corporate Business Non-Device Factor should require taxpayers to point to an Allocation Business Purpose—*i.e.*, a business purpose for the allocation of Nonbusiness Assets in a disproportionate manner. To be clear, an Allocation Business Purpose may be derived from the overall corporate business purposes for the separation. For example, as discussed above, the business purposes for an RMT often will determine the appropriate allocation of Nonbusiness Assets between Distributing and Controlled (as well as Preparatory Intra-Group Distributions related thereto).

[123] *See* Reg. § 1.355-2(b)(5), Ex. 2 (shareholders interested in divergent businesses and expect each business will be enhanced by the separation); Ex. 8 (distribution intended to allow retention of a key employee who is critical to the success of one business).

The government should further consider the degree to which the Allocation Business Purpose must motivate the allocation of Nonbusiness Assets. As a general matter, it should be sufficient for the taxpayer to demonstrate that the Allocation Business Purpose actually motivates the disproportionate allocation, in whole or in substantial part. As with the definition of a Business Asset discussed above, the government may wish to include a specific rule providing that this determination will be made taking into account relevant objective factors, including actual post-distribution uses of the Nonbusiness Assets in a manner inconsistent with the asserted Allocation Business Purpose (absent a showing of an unforeseen change in circumstances).

We further note that the requirement, under the Corporate Business Purpose Non-Device Factor, to show that an allocation of Nonbusiness Assets relates to a required "investment or other use of the Nonbusiness Assets in one or more Business" of Distributing or Controlled may inappropriately narrow the scope of the concept of "exigency."[124] The reference to "investment" or "use" of the Nonbusiness Assets would seem to exclude, for this purpose, a requirement imposed on Distributing or Controlled, for example, by a governmental or regulatory regime, to hold, dispose of, or otherwise allocate cash in a manner that does not relate to a particular investment or use of such cash in a Business. Revenue Ruling 78-383[125] addressed such a fact pattern and concluded that a transfer of liquid assets to Controlled followed by a spin-off of Controlled to avoid government expropriation of Distributing's assets was not a Device. However, under the Proposed Regulations, if Controlled were to hold liquid assets transferred to it merely to avoid seizure in Distributing's hands (and not for any planned investment or use in a Business), such allocation would seem to fail the Corporate Business Purpose Non-Device Factor. We recommend that the government broaden the concept of "exigency" (if the concept is otherwise retained) to cover fact patterns similar to Revenue Ruling 78-383 and similar situations where an allocation is intended to accommodate a binding legal or regulatory requirement, but such requirement is unrelated to the Business.

2. Metrics for Device Prohibition and Minimum ATB Threshold

Just as the question of whether a specific asset falls within or outside of the scope of Business Assets can determine a transaction's compliance with the Device Prohibition and ATB Requirement, the calculation of the fair market value of the assets of Distributing and Controlled is a key component of the application of each of these rules. Thus, we believe it is equally important for the government to provide guidance ensuring that the valuation of assets for purposes

[124] Prop. Reg. § 1.355-2(d)(3)(ii).

[125] 1978-2 C.B. 142.

of these rules is clear and leads to equitable results. We note that there are several potential pitfalls as it relates to administering rules that rely on a determination of value.[126]

First, inevitably, situations will arise where fair market value may be difficult to ascertain. Not only are valuation methodologies uncertain, but, especially among large companies, the required valuation exercise is likely extremely complex and time consuming, especially given the application of various look-through rules.[127] Taxpayers may have limited insight into the appropriate valuation of assets held by less than wholly-owned entities, especially those over which they lack sufficient control or with respect to which their ability to access relevant documentation and information is constrained. In these situations, taxpayers may be uncertain as to how the Device Prohibition and Minimum ATB Threshold will apply to a transaction, as the Nonbusiness Asset Percentage and Five-Year-Active-Business Asset Percentage are each determined by reference to the fair market value of assets.[128] This uncertainty is problematic, as the effect of failing to satisfy either rule would significantly and fundamentally alter the tax treatment of the transaction, and it is critical for taxpayers to have clarity in this regard. For example, in a transaction involving a publicly traded Distributing, it is often believed that Controlled stock cannot be accurately valued until sometime after the transaction, when the market has reacted to and indicated the value of the new public company. This may also suggest that the value of Controlled's assets may not be appropriately valued until that time. However, under the Proposed Regulations, the latest time that taxpayers may value the assets of Distributing and Controlled is immediately before the distribution.[129]

In light of the difficulty in ascertaining fair market value and the pressure that any resulting uncertainty would place on the determination of a transaction's qualification under the Device Prohibition and the Minimum ATB Threshold, we recommend that the government consider adopting an approach that would recognize the imprecise nature of the valuation exercise. For example, in any given circumstance, several reasonable valuation methods based on a singular metric (*e.g.*, fair market value) might produce a range of asset values, with any specific value within that range representing a reasonably accurate measure. Therefore, the government should

[126] *See* Prior Report at 46 ("A *de minimis* threshold would raise a host of new issues, as well as identification of what assets count as Qualifying Business Assets (*e.g.*, working capital, accounts receivable, other assets not in excess of the reasonable needs of the business), valuation of the Qualifying Business Assets and timing for the valuation.").

[127] *See supra* Parts III.A.2.b.i (p. 10) and III.A.3. (p. 12).

[128] Prop. Reg. §§ 1.355-2(d)(2)(iv)(B)(*5*); -9(a)(6).

[129] Prop. Reg. §§ 1.355-2(d)(2)(iv)(D)(*4*); -9(c)(2). Fair market values are generally determined, at the taxpayer's election, immediately before the distribution, within sixty days before the distribution, on the date of a binding agreement with respect to the distribution, or on the date of a public announcement or SEC filing with respect to the distribution. Prop. Reg. § 1.355-2(d)(2)(iv)(D)(*4*)(*i*).

consider a rule that would respect a taxpayer's valuation to the extent a taxpayer can demonstrate that it utilized a reasonable valuation method, taking into account the facts and circumstances of a particular case. Moreover, it may be more appropriate to determine the application of the Device Prohibition and the Minimum ATB Threshold by reference to an alternative metric in situations where (1) valuations are not readily available or attainable because of the nature of the taxpayer's business, and (2) another readily available, appropriate metric exists.[130] In fact, the Service has indicated, in at least one private letter ruling, that utilizing a metric other than fair market value of assets may be appropriate in certain circumstances for purposes of determining whether a transaction satisfies the ATB Requirement.[131] Further, particular industries may utilize unique metrics specifically adapted to the nature of the specific business, and those might be equally relevant for purposes of determining compliance with the Device Prohibition and the Minimum ATB Threshold. Generally, as long as a consistent metric is used for purposes of the relevant calculations, absent any evidence indicating that such metric inaccurately reflects the relative values of the assets, there should not be any reason to prefer the use of fair market values to another metric.

To the extent the current rules related to the determination of the fair market value of assets are reflected in final guidance, we request clarification with respect to the manner in which the Proposed Regulations treat liabilities. The Proposed Regulations indicate that the fair market value of an asset is reduced, not below basis, by the amount of any liability described in Section 357(c)(3) that relates to the asset or a Business with which the asset is associated, but all other liabilities are disregarded for purposes of determining fair market value.[132]As an initial matter, it may be particularly challenging to quantify contingent liabilities. Moreover, the conceptual basis for such a rule is unclear. Liabilities not described in Section 357(c)(3), such as the principal amount of a loan, may be just as "related" to an asset or a Business as Section 357(c)(3) liabilities, such as accounts payable, interest and taxes. It may also be equally as difficult to allocate the amount of any such liabilities, whether described in Section 357(c)(3) or not, that is related to a particular asset or Business. We recommend that the government consider whether, alternative-

[130] For example, the FIRPTA rules, which generally operate by reference to the fair market value of assets, allow taxpayers to elect to apply an alternative test to measure the value of a corporation's U.S. real property interest, which looks to the book value ("the value at which an item is carried on the financial accounting records of the corporation, if such value is determined in accordance with generally accepted accounting principles applied in the United States") of U.S. real property interests. Reg. § 1.897-2(b)(2).

[131] *See, e.g.*, Priv. Ltr. Rul. 200234021 (Aug. 23, 2002) (ruling on the satisfaction of the ATB Requirement based on alternative tests based on either (1) fair market value of gross assets or (2) number of employees and gross revenues).

[132] Prop. Reg. § 1.355-2(d)(2)(iv)(D)(*5*).

ly, all or no liabilities should be taken into account in determining fair market value, and we request clarification of the reasoning behind any adopted approach.

3. Operating Rules Regarding Partnerships and 50%-Owned Corporations

Under the Device Prohibition rules and the Minimum ATB Threshold in the Proposed Regulations, the value of an interest in certain entities held by Distributing or Controlled in a non-SAG member is either (1) deemed to be a Nonbusiness Asset or (2) if certain requirements are meant, treated as partially a Business Asset and partially a Nonbusiness Asset, in proportion to the relative values of the Business Assets and Nonbusiness Assets held by such non-SAG member (*i.e.*, look-through treatment).[133] A partnership is eligible for look-through treatment if the corporate partner is considered to be engaged in a Business conducted by the partnership for purposes of the ATB Requirement.[134] A corporation that is not a member of the SAG of either Distributing or Controlled is eligible for look-through treatment if the corporation would have been a member of the SAG if the threshold were 50% instead of 80%.[135]

As an initial matter, the rule may inappropriately penalize taxpayers under the Device Prohibition who hold minority interests in entities that conduct active businesses, perhaps even active businesses related to one or more Businesses, but whose ownership in these entities does not allow look-through treatment. It is not inconceivable, for example, that Distributing or Controlled might own a 49% interest by value and a 50% or greater voting interest in a corporation that actively conducts a business that is the same as that relied on for purposes of the Minimum ATB Threshold. For purposes of the Device Prohibition, allowing Distributing or Controlled to take into account its ratable share of such corporation's Business Assets and Nonbusiness Assets, especially where the business conducted by the corporation bears relation to a Business in which Distributing or Controlled is engaged, does not appear to raise the specter of abuse.

[133] Prop. Reg. § 1.355-2(d)(2)(iv)(D)(*6*), (*7*).

[134] Prop. Reg. § 1.355-2(d)(2)(iv)(D)(*6*)(*ii*). The determination of whether a corporate partner is considered to be engaged in a Five-Year-Active Business conducted by a partnership is based on the criteria under Revenue Rulings 92-17 (1992-1 C.B. 142), 2002-49 (2002-2 C.B. 288), and 2007-42 (2007-2 C.B. 44). We note that the criteria reflected in the relevant Revenue Rulings and relied on for purposes of the Proposed Regulations is inconsistent with the approach taken in Section 875 for purposes of determining when nonresident aliens are considered to be engaged in a U.S. trade or business based on ownership of equity in a partnership or status as a beneficiary of an estate or trust. Generally, those rules do not involve threshold ownership levels or management involvement, instead attributing the conduct of a trade or business to any partner or beneficiary. But we recognize that this "no threshold" approach might lead to inappropriate results in the context of the ATB Requirement.

[135] Prop. Reg. § 1.355-2(d)(2)(iv)(D)(*7*)(*ii*).

Moreover, we note that the Proposed Regulations do not apply a full look-through approach, which would treat the corporate partner or owner as holding a ratable share of the applicable partnership's or corporation's gross assets (and then characterize those assets as Business Assets or Nonbusiness Assets, as applicable). Instead, look-through treatment under the Proposed Regulations allocates the fair market value of the interest in the partnership or corporation between Business Assets and Nonbusiness Assets by reference to the gross assets of the partnership or corporation. It is not clear why this is the preferred approach. We believe that a full look-through approach (where looking through a partnership or corporation is applicable) most accurately reflects the nature of the assets indirectly held by Distributing or Controlled and that the fair market value of the associated equity interest may not accurately reflect the value of the underlying assets. This is the approach taken in certain other Code provisions addressing similar concepts,[136] and the one we would suggest the government adopt in final guidance.

4. Multiple Controlleds Rule

Under the Multiple Controlleds Rule, if any distribution involved is determined to fail the Device Prohibition, all distributions are treated as failing the Device Prohibition.[137] It is not evident why the disqualification of all separation transactions is warranted in a fact pattern involving only a single problematic separation transaction. Instead, where Nonbusiness Assets are allocated disproportionately to one controlled corporation causing a violation of the Device Prohibition with respect to the distribution of that Controlled corporation (but there is no substantial disproportionality in the allocation of Nonbusiness Assets as between Distributing and the other Controlled corporations), it seems appropriate to isolate the consequences of a single failed distribution to the distribution of the particular Controlled corporation with the disproportionality problem. The government has adopted this approach in the context of testing distributions of multiple Controlled corporations by a single Distributing for compliance with Section 355(e), treating only the stock or securities of a Controlled corporation acquired as part

[136] *See, e.g.*, Sections 368(a)(2)(F)(iii) (for purposes of determining whether an entity is an investment company for purposes of the reorganization provisions, stock and securities in subsidiary corporations are disregarded and the parent corporation is deemed to own a ratable share of the subsidiary's assets); 382(l)(4)(E) (for purposes of determining whether a loss corporation has substantial nonbusiness assets, stock and securities in subsidiary corporations are disregarded and the parent corporation is deemed to own a ratable share of the subsidiary's assets); 856(m)(3)(A) (for purposes of determining compliance with the REIT asset tests, a REIT that owns securities of a partnership is deemed to own its proportionate share of each of the partnership's assets); 1202(e)(5) (for purposes of determining if a corporation's stock is qualified small business stock by virtue of meeting the active business requirement, stock and debt in any subsidiary corporation is disregarded and the parent corporation is deemed to own a ratable share of the subsidiary's assets and to conduct a ratable share of the subsidiary's activities).

[137] Prop. Reg. § 1.355-2(d)(2)(iv)(D)(*1*).

of a Section 355(e) plan as not representing qualified property under Section 355(e)(1).[138] This approach seems worthy of consideration in the context of testing distributions of multiple Controlled corporations by a single Distributing for compliance with the Device Prohibition (where Distributing does not itself own substantial and disproportionate Nonbusiness Assets).

5. Anti-Abuse Rules

While, in certain fact patterns, transactions taken with a "principal purpose" of affecting the Nonbusiness Asset Percentage or Five-Year-Active-Business Percentage might be abusive in nature, it is also true that *any* pre-distribution restructuring has the effect of affecting these metrics. In fact, the Proposed Regulations reflect that the government expect taxpayers to allocate (and would, indeed, disqualify transactions from tax-free treatment where taxpayers failed to allocate) Nonbusiness Assets between Distributing and Controlled in a manner that reflects a proportional distribution of such assets. Such allocation is often not possible without undertaking transactions with a principal purpose of altering the relevant percentages. This is why, we believe, it is important to craft broad exceptions to the Anti-Abuse Rules such that they apply only to (i) non-transitory transfers where a controlling shareholder is driving the terms of the transfer or otherwise directing the acquisition of Business Assets for its benefit, or (ii) transitory transfers.

As indicated in the Prior Report, we continue to believe that an important focus of the Anti-Abuse Rules, and especially the Device Anti-Abuse Rule, should be on "whether the transaction is, in effect, a purchase by [Distributing or Controlled] for or on behalf of the shareholders."[139] The government has asked whether the Anti-Abuse Rules should be revised to include a reference to acquisitions or assets by Distributing or Controlled on behalf of shareholders.[140] We believe such a reference would be appropriate, for the reasons discussed in the Prior Report.[141] While the Anti-Abuse Rules, as proposed, would disallow non-transitory transactions between Distributing or Controlled, on the one hand, and a corporation owned, in whole or in part, by a controlling shareholder of either entity, on the other hand, we do not believe the Anti-Abuse Rules squarely address non-transitory transactions between Distributing or Controlled, on the one hand, and either a controlling shareholder or another party, including a third party, at the direction of a controlling shareholder. These shareholder-driven transactions seem to clearly im-

[138] Treas. Reg. § 1.355-7(f).

[139] Prior Report. at 48.

[140] Preamble at 46013.

[141] Prior Report at 50–54 (noting that assets "acquired with a 'bad' principal purpose" should perhaps be subject to an anti-abuse rule if "purchased at the request of the shareholders, a scenario that is likely to come up only in closely held scenarios with a single shareholder or a unified group of shareholders").

plicate Device concerns. They also appear to implicate concerns related to the Minimum ATB Threshold in that Nonbusiness Assets held by Distributing or Controlled could be utilized to purchase, in a taxable transaction, assets held by a controlling shareholder (or a third party at the direction of a controlling shareholder), and these assets might qualify as an expansion of the Five-Year-Active Business. We recommend that the government clarify the application of the Anti-Abuse Rules with respect to these transactions when effected with or at the direction of shareholders.[142] However, as described in the Prior Report, we believe that exceptions to the Anti-Abuse Rules would be appropriate for Section 301 distributions to shareholders and share repurchases.[143]

It is unclear why non-transitory transfers not at the direction or on behalf of controlling shareholders should implicate the Device Prohibition or the Minimum ATB Threshold. These transfers change the asset composition of Distributing or Controlled and, as such, ought to be taken into account in determining compliance with the Device Prohibition and the Minimum ATB Threshold. As one example, existing regulations permit the acquisition of an ATB conducted for the requisite period from an affiliate that is not a member of the DSAG or CSAG because these acquisitions are not viewed as the type of acquisition which implicate the concerns at which Section 355(b)(2)(C) or (D) are aimed (the "**Affiliate's Exception**").[144] We do not believe that the Minimum ATB Threshold, through the ATB Anti-Abuse Rule, should be a vehicle for effectively repealing the Affiliate's Exception. The merits of the Affiliate's Exception should be resolved in the context of the broader consideration of the application of Section 355(b)(2)(C) and (D) in a SAG framework. Another example of non-transitory transfers between related parties which should not be disregarded under the Anti-Abuse Rules are assumptions, distributions, contributions, offsets, or cancellations of intercompany indebtedness. These transactions are

[142] We also recommend that final guidance contain an example confirming our understanding that, for purposes of the Anti-Abuse Rules, references to Distributing and Controlled include all members of their respective SAGs.

[143] *See* Prior Report at 50–54. ("a distribution to shareholders under Section 301 would address Device concerns" and "[a] share buyback within the usual parameters for share buybacks does not seem to raise special concerns"). A separate exception for payments to creditors should also be considered. *See id.* ("A payment to creditors does not seem to implicate Device.").

Relatedly, it would be helpful for the government to clarify that any such Section 301 distribution to shareholders would not be considered a "disposition to a person the ownership of whose stock would, under section 318(a) (other than paragraph (4) thereof), be attributed to" Distributing or Controlled and, thus, would not otherwise be implicated by the Anti-Abuse Rules.

[144] Reg. §1.355-3(b)(4)(iii). In Notice 2007-60, 2007-2 C.B. 466, the Service indicated that it would not challenge any transaction relying on the Affiliate's Exception where the distribution was effected prior to the finalization of regulations (*i.e.*, Prop. Reg. § 1.355-3 (May 8, 2007)) modifying the application of the regulation.

commonplace and necessary components of transactions preparatory to spin-off transactions, often assuring that this indebtedness does not cross business lines following the separation. As such, these transactions should not be disregarded for Device Prohibition or Minimum ATB Threshold purposes.

6. Transition Relief

The Proposed Regulations generally apply to transactions occurring on or after the date on which final guidance is promulgated ("**Final Guidance Date**").[145] However, transitional relief is available for distributions (1) made pursuant to a corporate action that is binding on or before the Final Guidance Date, (2) described in a ruling request submitted to the Service on or before July 15, 2016, or (3) described in a public announcement or SEC filing on or before the Final Guidance Date.[146] We believe that, consistent with our recommendations in Part IV.A.4, Preparatory Intra-Group Distributions should be entitled to this transitional relief to the extent that the subsequent external distribution so qualifies. For example, where an external distribution is described in an SEC filing but is not yet subject to binding corporate action, it would not be expected that Intra-Group Distributions intended to be undertaken in connection with the external distribution would have been described in the relevant public filing or subject to binding corporate action (and the structure of some Intra-Group Distributions may not yet have been finally determined). We recommend that final guidance adopt this approach to transitional relief. If this recommendation is not adopted, we recommend that the government provide guidance as to what constitutes an adequate description of a Preparatory Intra-Group Distribution in a public filing or announcement to qualify under the third prong of the transition relief.

[145] Prop. Reg. §§ 1.355-2(i)(1)(i); -9(e)(1).

[146] Prop. Reg. §§ 1.355-2(i)(1)(ii); -9(e)(2).