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October 14, 2016

The Honorable Mark Mazur
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
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The Honorable John Koskinen
Commissioner
Internal Revenue Service
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Washington, DC 20224

The Honorable William J. Wilkins
Chief Counsel
Internal Revenue Service
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Re: *Report No. 1356 on Proposed Regulations under Section 355 Concerning the Device Prohibition and Active Trade or Business Requirement*

Dear Messrs. Mazur, Koskinen and Wilkins:

I am pleased to submit the attached report (the "**Current Report**") of the Tax Section of the New York State Bar Association. The report comments on proposed regulations published on July 15, 2016 (the "**Proposed Regulations**") concerning the application of the device prohibition of Section 355(a)(1)(B) (the "**Device Prohibition**") and the active trade or business requirement of Section 355(b) (the "**ATB Requirement**").

Previously, the Tax Section of the New York State Bar Association submitted a report (the "**Prior Report**") on issues associated with the Device Prohibition and the ATB Requirement, in which we recommended that guidance focus on addressing distributions involving substantial and disproportionate appreciated investment assets, and recommended against

issuing guidance addressing purely shareholder-level concerns. Consistent with these overall views, we 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 rules addressing only shareholder-level concerns under the Device Prohibition.

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.

Specifically, we make the following recommendations:[1]

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 Device if it would be treated as a sale or exchange under Section 302(a) with respect to each shareholder distributee. 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

[1] All capitalized terms not defined herein have the meaning ascribed to them in the Current Report.

3. Although we recognize that the Per Se Device Test 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 in certain contexts (*e.g.*, Preparatory Intra-Group Distributions). 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.

4. We recommend that the final regulations provide that (i) the existence of either Not Evidence Factor 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 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 applies.

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 definitions or examples, clarify the appropriate weight of individual factors, including the ability of non-Device factors to mitigate evidence of Device presented by Intermediate Factors. 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 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.

7. The definitions of Business Assets and Five-Year-Active-Business Assets (and the related concepts of Working Capital, Required Assets, and exigency) should be appropriately tailored to achieve the relevant goals and avoid inequitable results (especially in the con-

text of the Per Se Device Test, Minimum ATB Threshold, and significantly weighted Intermediate Factors). We therefore 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 is a Business Asset and, if ownership of the real estate is logically connected to an ATB, a Five-Year-Active-Business Asset; and (iii) allow the Corporate Business Purpose Non-Device Factor 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.

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 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.

We appreciate your consideration of our recommendations. If you have any questions or comments regarding this report, please feel free to contact us and we will be glad to discuss or assist in any way.

Respectfully submitted,

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Chair

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