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New York State Bar Association Tax Section

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

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New York State Bar Association

Tax Section

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 [*]

I. INTRODUCTION

This report (this "**Report**") of the Tax Section of the New York State Bar Association comments on the issues raised in Notice 2015-59[1] (the "**Notice**") regarding the application of Section 355 of the Code[2] in the context of corporate distributions having certain characteristics identified in the Notice and the additions made in Revenue Procedure 2015-43[3] (the "**Revenue Procedure**") to the Service's list of "no rule" areas ("**no-rules**").

The Treasury Department (the "**Treasury**") and the Internal Revenue Service (the "**Service**") announced in the Notice their intention to study issues under Sections 337(d) and 355 pertaining to certain corporate distributions intended to qualify under Section 355 involving substantial investment assets, reliance on relatively small active businesses, and conversion into a regulated investment company.[4] The Treasury and the Service stated in the Notice that

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[1] 2015-40 I.R.B. 459 ("**Notice 2015-59**").

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

[3] 2015-40 I.R.B. 467 ("**Rev. Proc. 2015-43**").

[4] The Notice also identifies, and the Revenue Procedure contains a no-rule describing, transactions in which either the distributing corporation ("**Distributing**") or the controlled corporation ("**Controlled**") (but not

transactions having one or more of these characteristics may present evidence of Device (as defined below), lack an adequate business purpose, rely on insufficiently large active trades or businesses, or have the effect of circumventing the repeal of *General Utilities*.[5] Issued concurrently with the Notice, the Revenue Procedure added three no-rules to the Service's then-existing no-rule guidance provided in Revenue Procedure 2015-3.[6]

Section 355 was intended to govern a certain paradigm of transaction, namely, one in which each company continues with a robust business after the separation. Congress intended the spin-off provisions to permit corporate taxpayers to separate ongoing operating businesses such that they may be continued under modified corporate form. A mere readjustment of business interests within corporate solution should not be impeded by gain recognition at either the corporate or shareholder level. Section 355 serves the efficient functioning of businesses and capital markets by permitting businesses to separate for *bona fide* business purposes. Thus, the prototypically "good" spin-off transaction is one where each company holds and operates a robust business following the separation, with a certain degree of shareholder continuity.

The prototypically "bad" transaction is *Gregory v. Helvering*,[7] typified by the separation and distribution of principally passive, non-business assets. *Gregory* represented an attempt to use the spin-off provisions to avoid the dividend provisions of the Code. As well, the *Gregory* transaction would have permanently eliminated the built-in corporate-level gain in the distributed passive assets. Thus, *Gregory* represents both shareholder-level dividend avoidance and, viewed from today's perspective, corporate-level tax avoidance.

In light of these paradigms, this Report examines the types of transactions targeted by the no-rules and analyzes the statutory and regulatory framework that Congress and the Treasury have built over the years to address the abuses perceived in *Gregory*-like transactions. The Device regulations, the ATB Requirement (as defined below) and the business purpose requirement, and the statutory responses to *General Utilities* repeal are the principal exemplars of this framework. A pure *Gregory* transaction today would not satisfy the active trade or business requirement, for example. But, on slightly different facts—the inclusion of a relatively small active trade or business—a similar transaction might appear to qualify. Is such a

both) convert to a "real estate investment trust" (as defined in Section 856) (a "**REIT**") in connection with the distribution. As part of the Protecting Americans from Tax Hikes Act of 2015, PUB. L. 114-113 (the "**PATH Act**"), new Section 355(h) was added to the Code, which disqualifies from nonrecognition treatment under Sections 355 and 356 any distribution in which either Distributing or Controlled (but not both) is a REIT. In light of this legislative change, this Report does not address further the topic of C-to-REIT spin-offs.

[5] For a discussion of the repeal of the *General Utilities* doctrine, *see* text accompanying notes 53-58 *infra*.

[6] 2015-1 I.R.B. 129.

[7] Gregory v. Helvering, 293 U.S. 465 (1935).

transaction too *Gregory*-like to be permitted, or does the fact that it appears to satisfy literally the technical requirements of Section 355 mean that it passes muster? By considering potential transactions from that perspective, this Report strives to identify not only the types of transactions that are or are not what Congress intended to be within Section 355, but also what makes those transactions perhaps too *Gregory*-like to merit tax-free treatment.

In addition to considering traditional Device and business purpose concerns raised in *Gregory*, this Report considers corporate-level tax dimensions. *General Utilities* repeal, broadly speaking, stands for the principle that corporate distributions of appreciated property should be subject to corporate-level tax. *General Utilities* repeal is agnostic as to the nature and quality of the appreciated property. It makes no distinction between a distribution of appreciated investment assets and a distribution of an active business and would impose gain recognition on a distribution of any such assets. Section 355, however, excepts from the broad sweep of *General Utilities* repeal distributions that satisfy a specific set of requirements intended to ensure that the distribution is consistent with the overall policy of Section 355, permitting business-motivated separations of operating businesses. As such, some distributions should not be excepted from *General Utilities* repeal under Section 355, because they do not comport with the policies underlying Section 355.

We 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. These transactions raise concerns stemming from the packaging of substantial amounts of passive assets into a corporation dominated by those assets and separate from the historical business assets of Distributing, all without much of a business purpose. The tacking on of a small active trade or business does not change the nature of the transaction—and its resemblance to *Gregory*—in our view.

Thus, we recommend that where *General Utilities* concerns are at play on account of the investment assets being appreciated, consideration should be given to guidance that would prevent distributions involving substantial and disproportionate investment assets. These transactions evoke *Gregory* and are not the kind of transaction that Section 355 was intended to protect. Such transactions may well already fail under current law, as they raise Device, business purpose and ATB Requirement concerns. Indeed, this Report does not advocate a wholesale rethinking of Section 355. The existing rules work well in the majority of cases. Furthermore, the types of transactions described in the Notice involving substantial investment assets are few and far between in our experience. The vast majority of Section 355 transactions are not shades of *Gregory*. Nonetheless, we believe that consideration should be given to guidance where the investment assets are appreciated. Where transactions involve purely shareholder-level concerns, we believe that current law works adequately given the stakes in a regime where long-term capital gain and qualified dividend income are generally taxed at the same rate and given the

rarity of this type of transaction. Thus, we do not recommend consideration be given to guidance to address purely shareholder-level concerns.

In distributions characterized by a relatively small five-year active trade or business, we believe that the nature of the other assets held by the relevant company is pertinent. A company holding a very small five-year active trade or business complemented by passive investment assets differs significantly from a Section 355 policy point of view from a company holding a very small five-year active trade or business complemented by a robust set of business assets that, for one reason or another, do not count toward the five-year active trade or business requirement. The former looks like *Gregory*, whereas the latter looks more like bad timing. As such, we do not recommend adoption of a *de minimis* rule for purposes of the ATB Requirement, but instead, as mentioned, recommend consideration of guidance in relation to substantial investment assets in cases raising *General Utilities* repeal concerns.

Many of the issues raised in this Report may be pertinent to cross-border distributions or foreign-to-foreign distributions. However, those distributions may also raise special concerns (*e.g.*, relating to repatriation of earnings of a controlled foreign corporation or distribution of earnings to a foreign parent). Thus, we consider cross-border distributions and foreign-to-foreign distributions to be beyond the scope of this Report and, accordingly, limit our analysis to distributions involving solely domestic corporations and shareholders.

Substantial investment assets held in corporate solution may implicate the accumulated earnings tax, which serves to penalize the hoarding of cash and passive investments by corporations and consequent deferral or avoidance of shareholder dividend tax.[8] However, the accumulated earnings tax is beyond the scope of this Report.

Part II of this Report describes the Notice and the Revenue Procedure. Part III sets forth our recommendations. Part IV discusses the background of Section 355, with particular focus on the active trade or business requirement, the Device test, and the repeal of the *General Utilities* doctrine. Part V discusses the Device and business purpose tests, both relating to shareholder-level policy concerns and corporate-level policy concerns, discusses the relationship of *General Utilities* repeal and Section 355, and sets forth parameters for guidance that we would recommend be considered in the case of distributions involving appreciated investment assets. Part VI discusses the active trade or business requirement. Part VII discusses intra-group distributions that are and are not preparatory to an external distribution. Part VIII discusses whether dispositions and acquisitions made with a principal purpose of satisfying guidance

[8] Section 532(a) (the accumulated earnings tax generally applies to every corporation "formed or availed of for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation").

related to investment asset composition should taint the distribution. Part IX discusses the definition of investment assets.

II. The Notice and the Revenue Procedure

Based, in part, on transactions that have come to the Service's attention through taxpayers' requests for private letter rulings, the Notice identifies certain characteristics evidenced by recent transactions that the Treasury and the Service believe are inconsistent with the policies underlying Sections 337(d) and the requirements of Section 355. These characteristics are: (1) ownership by Distributing or Controlled of investment assets (as defined in Section 355(g)(2)(B), with modifications, "**Investment Assets**") that are substantial in value relative to (a) the value of the corporation's total gross assets ("**Total Assets**") and (b) the fair market value of the gross assets used in the active trade(s) or business(es) relied on by the corporation to satisfy the active trade or business requirement of Section 355(b) (the "**ATB Requirement**," such assets, "**Qualifying Business Assets**" and the trade or business associated with such assets, the "**ATB**"); (2) a "significant difference" between the ratio of Investment Assets to non-Investment Assets ("**Investment Asset Ratio**") for each of Distributing and Controlled; and (3) a "small amount" of Qualifying Business Assets in relation to a corporation's Total Assets (a "***de minimis* ATB**").

A. Substantial Investment Assets

The Treasury and the Service are "most concerned" with transactions that result in (1) either Distributing or Controlled owning "a substantial amount" of Investment Assets relative to the value of both its Total Assets and its Qualifying Business Assets and (2) one of the two corporations having a significantly higher Investment Asset Ratio than the other corporation.[9] While the Treasury and the Service study these issues, the Service will not rule on any issue under Section 355 and related provisions in respect of a distribution (or a distribution that is part of the same plan or series of related transactions) if, immediately after the distribution, all of the following conditions exist: (1) the fair market value of either Distributing's or Controlled's gross Investment Assets is equal to or greater than two-thirds of the value of its Total Assets (the "**Two-Thirds Prong**"); (2) the value of either Distributing's or Controlled's Qualifying Business Assets is less than 10 percent of the fair market value of its gross Investment Assets (the "**10 Percent Prong**"); and (3) the Investment Asset Ratio of one corporation is more than three times

[9] Notice 2015-59, § 2.

that of the other corporation (the "**3:1 Ratio Prong**," and, together, the "**Substantial Investment Asset No-Rule**").[10]

In addition, the no-rule applies to any distribution if, as part of a plan or series of related transactions, Investment Assets are disposed of or assets (including Qualifying Business Assets) are acquired, in each case, "with a principal purpose of avoiding" the application of the no-rule (the "**Principal Purpose Exception**").[11]

The Revenue Procedure added this no-rule to Section 5.01 of Revenue Procedure 2015-3, which is reserved for areas on which the Service temporarily will not rule while the area in question is under study. As such, and unlike the other no-rules added by the Revenue Procedure, there is no exception to the Substantial Investment Asset No-Rule, even where a taxpayer can demonstrate "unique and compelling" circumstances.

B. *De Minimis* ATB

Reviving a modified form of its prior no-rule guidance in respect of *de minimis* ATBs,[12] the Service will no longer rule on any issue under Section 355 and related provisions on a distribution (or distribution that is part of the same plan or series of related transactions) if, immediately after the distribution, the fair market value of the Qualifying Business Assets of either Distributing or Controlled is less than five percent of the fair market value of the corporation's Total Assets (the "***De Minimis* ATB No-Rule**"). The Notice explains that, while transactions involving small active trades or businesses were common in the past, based on changes to the active trade or business rules (in particular, the elimination of the so-called

[10] Rev. Proc. 2015-43, § 3.02. For purposes of determining the fair market value of a corporation's Investment Assets, Non-Investment Assets, Qualifying Business Assets, and Total Assets, all members of the corporation's separate affiliated group (within the meaning of Section 355(b)(3)(B), the "**SAG**") are treated as one corporation. Furthermore, if either Distributing or Controlled relies on an active trade or business conducted by a partnership to satisfy the ATB Requirement, then it will be treated as owning its ratable share of the partnership's gross assets.

[11] *Id.* The Principal Purpose Exception evokes various "principal purpose" tests under recently issued guidance under Section 7874. *See* Notice 2009-78, 2009-40 I.R.B. 452; Notice 2014-52, 2014-42 I.R.B. 712; Notice 2015-79, 2015-49 I.R.B. 775. Unlike Section 355, however, Section 7874 itself contains a principal purpose test on which the Service's guidance is based.

[12] First promulgated in Revenue Procedure 96-43, 1996-2 C.B. 330 (Aug. 8, 1996) and later revoked in Revenue Procedure 2003-48, 2003-2 C.B. 86 (Jun. 24, 2003) as part of a larger overhaul of the Service's spin-off ruling policy, the Service ordinarily would not rule on any distribution in which the gross assets of the active trade(s) or business(es) relied on to satisfy the ATB Requirement had a fair market value of less than five percent of the total fair market value of the gross assets of the corporation directly conducting those trade(s) or business(es).

"holding company rule" discussed in Part VI below), the Treasury and the Service "have concluded that, under current law," such distributions "may have become less justifiable."

The *De Minimis* ATB No-Rule was added to Section 4.01 of Revenue Procedure 2016-3, which lists the areas on which the Service will not "ordinarily" issue private letter rulings. As such, the Service may issue a ruling where the taxpayer demonstrates "unique and compelling reasons" to justify the issuance of such a ruling.[13] In determining whether unique and compelling circumstances exist, the Service will consider "all of the facts and circumstances," including (1) whether a "substantial portion" of the corporation's assets other than Qualifying Business Assets would be Qualifying Business Assets but for the five-year requirement of Section 355(b)(2)(B) and (2) whether there is a "relationship between the business purpose for the distribution" and the active trade or business of Distributing or Controlled.[14]

C. C-to-RIC Distributions

The Service will not rule on any issue relating to the qualification, under Section 355 and related provisions, of a distribution (or distribution that is part of the same plan or series of related transactions) in which, as part of the same plan as the distribution, either Distributing or Controlled (but not both) converts to a regulated investment company (within the meaning of Section 851, a "**RIC**") in a "conversion transaction" (as defined in Treas. Reg. § 1.337(d)-7(a)(2)(ii)) with respect to which no deemed sale election described in Treas. Reg. § 1.337(d)-7(c) is made (the "**C-to-RIC No-Rule**").[15] The no-rule does not apply if, immediately after the distribution, both Distributing and Controlled will be RICs and there is no plan or intention as of the distribution for either to cease being a RIC. Because the Treasury and the Service generally are not concerned about transactions in which Distributing has been a RIC for a substantial period of time, it will continue to consider under its current ruling practice distributions where Distributing is a RIC, whether or not Controlled will be a RIC after the distribution.[16]

The addition of the C-to-RIC No-Rule appears to be motivated by the proliferation of Section 355 distributions involving REITs (which distributions are now disqualified under new Section 355(h)).[17] The Treasury and the Service had become concerned over the use of so-called "OpCo-PropCo" spin-offs that involved separating REIT-qualifying assets from non-qualifying assets followed by a REIT election by either Distributing or Controlled. We presume that, because of the similar pass-through nature of RICs, the Service identified the same concerns in

[13] Rev. Proc. 2016-3, 2016-1 I.R.B. 126, § 2.01.

[14] Notice 2015-59, § 2.

[15] Rev. Proc. 2015-43, § 3.01(57).

[16] Notice 2015-59.

[17] *See* note 4 *supra*.

the case of C-to-RIC distributions. However, no C-to-RIC distributions appear to have occurred as of the date of this Report.

D. Intra-Group Distribution Exception

Because the Treasury and the Service "generally are more concerned" with transactions that result in distributions outside the affiliated group (as defined in Section 243(b)(2)(A)) (the "**Section 243 Affiliated Group**"), neither the Substantial Investment Asset No-Rule nor the *De Minimis* ATB No-Rule applies to distributions within such an affiliated group, provided there is no "plan or intention" for the stock of any corporation to be distributed outside the group in a distribution that is subject to any of the no-rules described in the Revenue Procedure (the "**Intra-Group Distribution Exception**").[18]

E. Evidence of Device: Public vs. Non-Public / *Pro-Rata* vs. Non-*Pro Rata*

Treasury Regulations provide that evidence of non-Device (as defined below) includes the publicly traded status of a distributing company[19] and the non-*pro rata* nature of a distribution.[20] Nevertheless, the Notice observes that the Treasury and the Service believe that the characteristics identified in the Notice "may overcome both the non-Device factor of public trading and the non-*pro rata* structure of a distribution." Moreover, the Notice states that these characteristics may make it less likely that the transaction will satisfy the business purpose requirement (separate and apart from the Device test) or have a sufficiently strong business purpose to constitute a non-Device factor. As a result, the no-rules "do not distinguish between transactions involving distributing corporations the stock of which is or is not publicly traded or between *pro rata* and non-*pro rata* distributions."

F. Definition of Investment Assets

For purposes of applying the new no-rules, the Revenue Procedure incorporates and modifies the definition of "investment assets" under Section 355(g)(2)(B). Under the modified definition of Investment Assets, stock of a publicly traded corporation (within the meaning of

[18] Although state-level tax considerations are beyond the scope of this Report, we note that many states do not allow consolidated or combined returns, and those that do only do so when the corporation is engaged in a unitary business. As such, a transaction outside the ambit of the Revenue Procedure's no-rules because it involves distributions solely within the taxpayer's Section 243 Affiliated Group may, nevertheless, have state-level tax consequences.

[19] Treas. Reg. § 1.355-2(d)(3)(iii) (stating that public trading and absence of a five percent holder are evidence of non-Device).

[20] Treas. Reg. § 1.355-2(d)(5)(iv) (stating that a redemption to which section 302(a) would apply is evidence of non-Device).

Treasury Regulation Section 1.1092(d)-1(b)) will be treated as an Investment Asset, and no "look-through" will be permitted, unless Distributing or Controlled owns at least 50 percent of the outstanding shares of that corporation.

Partnership interests are largely assimilated to stock under the Revenue Procedure, except in the case of partnerships which are relied upon (or would be relied upon but for the five-year requirement) to satisfy the ATB Requirement. In the case of partnership interests, if the active trade or business on which either Distributing or Controlled relies for purposes of the ATB Requirement (or would rely but for the five-year ownership requirement of Section 355(b)(2)(B) of the Code) is owned by a partnership (a "**Reliance Partnership**"), then that corporation will be treated as owning its ratable share of the partnership's underlying assets ("**look-through treatment**"). Otherwise, interests in publicly traded partnerships are treated like stock in publicly traded corporations, and interests in partnerships that are not publicly traded are treated like stock in corporations that are not publicly traded.

Specifically, in the case of a publicly traded partnership (within the meaning of Section 7704(b), and without regard to whether it is treated as a corporation pursuant to Section 7704(a)) that is not a Reliance Partnership, the same ownership threshold for look-through treatment that applies to stock of a publicly traded corporation (*i.e.*, 50 percent or more) applies to the interests in that partnership. Thus, look-through treatment applies if Distributing or Controlled owns at least 50 percent of the publicly traded partnership, and if not, the partnership interest is an Investment Asset.

In the case of partnerships that are not publicly traded and that are not Reliance Partnerships, the same ownership threshold for look-through treatment that applies to stock of a corporation that is not publicly traded (*i.e.*, 20 percent or more) applies to the interests in those partnerships. Thus, in each such case, look-through treatment applies if Distributing or Controlled owns at least 20 percent of the partnership, and if not, the partnership interest is an Investment Asset.

III. RECOMMENDATIONS

Our recommendations are as follows:

1. Consideration should be given to guidance circumscribing Section 355 in the case of distributions involving substantial and disproportionate appreciated Investment Assets. Any such guidance should permit allocations of appreciated Investment Assets that:

    a. do not exceed the reasonable needs of the business of Distributing or Controlled;

    b. are proportionate to an objective metric such as fair market value, revenues or earnings;

   c. do not exceed a specified percentage of the Total Assets of Distributing or Controlled; or

   d. result in a ratio of Investment Asset Ratios of Distributing and Controlled that does not exceed a stated number.

2. In any such guidance, the Intra-Group Distribution Exception should not apply to intra-group distributions that are not preparatory to an external distribution. That is, intra-group distributions that are not preparatory to an external distribution should not be given a "pass" on the basis that they are intra-group. On the other hand, as provided in the Revenue Procedure, in any such guidance, the Intra-Group Distribution Exception should apply to intra-group distributions that are preparatory to an external distribution that itself does not run afoul of whatever guidance is promulgated regarding Investment Assets.

3. Any such guidance should refine the Principal Purpose Exception:

   a. Whether an acquisition by Distributing of non-Investment Assets for Investment Assets as part of the plan runs afoul of Investment Asset guidance should generally be analyzed by reference to whether Distributing is making the acquisition at the request or direction of Distributing's shareholders.

   b. Allocations of existing assets held by Distributing or its subsidiaries between Distributing and Controlled should not be subject to the Principal Purpose Exception.

   c. Distributions of Investment Assets to shareholders (as a Section 301 distribution or in a share repurchase) and distributions of Investment Assets to creditors should be taken into account in measuring Investment Assets. That is, these distributions should reduce the amount of Investment Assets held by Distributing or Controlled for purposes of any Investment Asset guidance.

4. In any such guidance, the Service should clarify that the definition of "Investment Asset" does not include (1) debt of another member of the SAG, (2) ordinary course debt that relates to the business of Distributing or Controlled (or, if this debt is considered an Investment Asset, it should be able to be allocated pursuant to our Recommendation 1.a) and (3) cash that is intended to be paid out to shareholders or creditors as part of the plan of distribution.

5. The Service should clarify that the Substantial Investment Asset No-Rule (and any guidance that follows its form) applies solely to transactions in which either Distributing satisfies all three conditions or Controlled satisfies all three conditions.

IV. BACKGROUND

Spin-offs have, from their inception, stoked controversy as taxpayers have long sought to use the form of a spin-off to extract corporate earnings at capital gains rates. When spin-offs were first permitted to occur without dividend treatment, the United States taxed dividend income at significantly higher rates than it did capital gains, creating a strong preference among taxpayers for capital gain over dividend income.[21] As such, the tax rate structure tempted shareholders to forgo dividends with a view toward cashing out their investment through a sale or liquidation. The predecessors of Section 355 facilitated shareholders' ability to maintain a stake in the company while at the same time using a sale or liquidation to extract cash at capital gains rates. As discussed below, the Device and ATB Requirements have served as the principal bulwarks against attempts by taxpayers to engage in these sorts of transactions. Before the Tax Reform Act of 1986 ("**TRA '86**"),[22] most of the debate around the spin-off provisions of Section 355 and its predecessors revolved around shareholder-level consequences: whether a distribution of stock to a shareholder would be taxable as a dividend.[23] After TRA '86, as discussed below, the debate shifted to include the extent to which the spin-off rules needed to be circumscribed in order to avoid circumvention of the repeal of *General Utilities*.

The first statutory provision allowing tax-free corporate separations, Section 202(b) of the Revenue Act of 1918 (the "**1918 Act**"),[24] applied tax-free treatment to split-ups[25] (and possibly split-offs[26]), but not to spin-offs,[27] as it required an exchange by the shareholder in

[21] *See* note 24 *infra* for a discussion of dividend treatment of spin-offs prior to the passage of the Revenue Act of 1924.

[22] Tax Reform Act of 1986, PUB. L. NO. 99-514, 100 STAT. 2085 (1986).

[23] *See* Jeffrey T. Sheffield & Herwig J. Schlunk, *Reconciling Spin-Offs with General Utilities Repeal*, 74 TAXES 941, 943–45 (Dec. 1996); Peter C. Canellos, *The Section 355 Edifice Spin-Offs: Past, Present and Future*, 104 TAX NOTES 419 (July 26, 2004).

[24] Revenue Act of 1918, 40 Stat. 1060. In *United States v. Phellis*, 257 U.S. 156 (1921) and *Rockefeller v. United States*, 257 U.S. 176 (1921), the Supreme Court held that a corporate division by means of a spin-off resulted in a taxable dividend to its shareholders under the Internal Revenue Code of 1913.

[25] A split-up is a *pro rata* distribution of at least two subsidiary corporations where the distributing corporation liquidates.

[26] A split-off is a non-*pro rata* distribution of a subsidiary corporation in exchange for stock of the distributing corporation. *See* Seymour S. Mintz *Divisive Corporate Reorganizations: Split-Ups and Spin-Offs*, 6 TAX L. REV. 365, 367 (1950–51) (stating that the applicability of the 1918 Act to split-offs was unclear because of the similarity of a *pro rata* split-off to a spin-off).

[27] A spin-off is a *pro rata* distribution of a subsidiary corporation.

order for tax-free treatment to apply.[28] Congress eliminated the shareholder exchange requirement with the Revenue Act of 1924 (the "**1924 Act**") thus permitting tax-free treatment for spin-offs. Congress believed that taxation should not impede changes in corporate form, perceived prior law to be difficult to apply accurately or consistently,[29] and desired to avoid formal distinctions.[30] Thus, the 1924 Act provided tax-free treatment to distributions of stock or securities to a shareholder "without the surrender by such shareholder of stock or securities."[31]

Soon thereafter, taxpayers came to recognize that spin-offs could facilitate an extraction or "bail out" of corporate earnings and profits without shareholders having to pay the high marginal tax rates then applicable to dividend income.[32] This susceptibility of spin-offs was cast in high relief by the series of court opinions that culminated in the now-famous Supreme Court decision in *Gregory v. Helvering.*[33]

In *Gregory*, the taxpayer, Evelyn F. Gregory, was the sole shareholder of United Mortgage Corporation ("**UMC**"), which in turn owned some of the outstanding stock of Monitor Securities Corporation ("**MSC**"). In 1928, Mrs. Gregory wanted to dispose of her indirect interest in MSC, but if UMC were to sell the MSC shares and distribute the proceeds to her as a dividend, not only would UMC be subject to corporate tax on the sale, but Mrs. Gregory would be taxed on the distribution of the proceeds at the high marginal tax rates then applicable to dividend income. Following the path apparently prescribed by the new spin-off provision in the 1924 Act, Mrs. Gregory caused UMC to contribute the MSC stock to a newly-formed corporation ("**Averill**") and Averill to issue its shares to Mrs. Gregory. Four days later, she

[28] Section 202(b) of the 1918 Act required an exchange by the shareholder. It provided that if "in connection with the reorganization, merger, or consolidation of a corporation a person receives in place of stock or securities owned by him new stock or securities of no greater aggregate par or face value, no gain or loss shall be deemed to occur from the exchange, and the new stock or securities received shall be treated as taking the place of the stock, securities, or property exchanged."

[29] *See* H.R. Rep. No. 68-179, at 14, 251 (1924) (stating that a general rule of recognition coupled with specific exceptions "results in definiteness and accuracy and enables a taxpayer to determine prior to the consummation of a given transaction the tax liability that will result therefrom.").

[30] *Id.* (arguing that the distinction between a split-up and a spin-off is formal: "The [spin-off] represents a common type of reorganization and clearly should be included within the reorganization provisions of the statute so long as the exemption [for split-ups] under the present law is continued.").

[31] Revenue Act of 1924, ch. 234, § 203(c), 43 STAT. 256.

[32] Robert A. Jacobs, *Spin-Offs: The Pre-Distribution Two Business Rule – Edmund P. Coady and Beyond*, 19 TAX. L. REV. 155, 157–158 (1964). *See also* Jeffrey T. Sheffield & Herwig J. Schlunk, *supra* note 23, at 941 (observing that, under the 1924 Act, "a tax on dividends at a rate of up to 46 percent could, under the literal terms of the [1924 spin-off] statute, be converted into a tax on capital gains at a rate of only 12.5 percent.").

[33] Gregory, *supra* note 7.

caused the Averill Corporation to liquidate and distribute the stock of MSC to Mrs. Gregory. Mrs. Gregory sold the stock of MSC that she received in the liquidating distribution of Averill to a third party for cash that same day.

In the taxpayer's view of the world, the receipt of Averill stock was not a recognition event for Mrs. Gregory, because the Averill stock was received in a "reorganization," but the liquidation of Averill was a recognition event. In that liquidation, according to Mrs. Gregory, she recognized capital gain on the receipt of the MSC stock equal to the difference between the value of the MSC stock and her basis in the Averill stock (which basis was an allocation of her original basis in her UMC shares). Taking a stepped-up fair market value basis in the MSC stock following the liquidation, Mrs. Gregory believed she recognized no gain or loss on the subsequent sale of the MSC stock.

The Commissioner argued before the Board of Tax Appeals (the "**BTA**") that Averill should be disregarded on account of its transitory nature and lack of substantive business purpose. The Commissioner argued that the transaction should be viewed as if UMC sold the MSC shares for cash and distributed the proceeds to Mrs. Gregory in a cash dividend. The BTA disagreed with the Commissioner, however. Adopting a strict textualist approach, the BTA explained that "[a] statute so meticulously drafted must be interpreted as a literal expression of the taxing policy."[34]

On appeal, the Second Circuit reversed the BTA's decision on the ground that the transaction did not comport with the principle of "reorganization" intended by Congress in enacting Section 112(g).[35] The Second Circuit respected the steps as actually occurring, but held that the steps were nonetheless "not what the statute means by a 'reorganization.'"[36] According to the Second Circuit, "the meaning of a sentence may be more than that of the separate words, as a melody is more than the notes."[37]

The Supreme Court affirmed the Second Circuit's decision, finding that the transaction was devoid of any "business or corporate purpose" and was nothing more than a:

> mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, and the sole object and accomplishment of which

[34] Gregory v. Comm'r, 27 B.T.A. 223, 225-226 (1932).

[35] Helvering v. Gregory, 69 F.2d 806 (2d Cir. 1934), *rev'g* 27 B.T.A. 223 (1932), *aff'd by*, 293 U.S. 465 (1935).

[36] *Id*. at 808.

[37] *Id*. at 807–8.

> was the consummation of a preconceived plan, not to reorganize a business or any part of a business, but to transfer a parcel of corporate shares to the petitioner.[38]

Before the Supreme Court's decision in *Gregory* was released, Congress passed the Revenue Act of 1934 (the "**1934 Act**"), which eliminated the spin-off provision entirely,[39] because transactions of the type undertaken by Mrs. Gregory were permitting corporations "to pay what would otherwise be taxable dividends, without any taxes upon their shareholders."[40]

Several attempts were made after the 1934 Act to reinstate the spin-off provisions into the Code,[41] but it was not until the Revenue Act of 1951 (the "**1951 Act**") that Congress reenacted tax-free treatment for spin-offs as Section 112(b)(11) of the Internal Revenue Code of 1939.

Unlike prior statutory incarnations, Section 112(b)(11) contained two new safeguards to prevent the type of transaction made infamous in the *Gregory* case: the "two active business" rule and the "device" requirement. The "two active business" rule, a precursor to the present-day ATB Requirement, required that both corporations that are party to the reorganization be "intended to continue the active conduct of a trade or business after such reorganization." Adopting the Supreme Court's nomenclature from *Gregory*, the "device" stipulation provided nonrecognition treatment only so long as Controlled not be "used principally as a device for the distribution of earnings and profits to the shareholders of any corporation a party to the reorganization" (the "**Device Requirement**" and, such a transaction, a "**Device**").[42]

The floor statements of Senator Hubert Humphrey accompanying the 1951 Act indicate that the "two active business" rule was intended, along with the Device Requirement, to prevent the use of spin-offs to bail out corporate earnings to shareholders at capital gains rates. Senator Humphrey cited the example of a corporation with "a very large amount of cash and Government bonds" that are in excess of its business needs.[43] To avoid paying out the surplus as a dividend and subjecting its shareholders to the higher tax rates applicable to ordinary income on the distribution, the corporation, "claiming some trumped-up business purpose," could instead transfer the cash and bonds to a new corporation and distribute the stock of that corporation to its shareholders, who would not be taxed on its receipt under the spin-off provisions, absent the

[38] Gregory v. Helvering, *supra* note 7.

[39] Revenue Act of 1934, ch. 277, § 112, 48 Stat. 680, 704–06. The split-up provision was, however, retained. *See* Michael L. Schler, *Simplifying and Rationalizing the Spinoff Rules*, 565 SMU L. REV. 239, 243 (2003).

[40] H.R. Rep. No. 73-704, at 14 (1934), 1939-1 C.B. (Part 2) 554, 564.

[41] There were bills proposed in 1948 and 1950 to reinstate the tax-free spin-off. *See* S. Rep. No. 82-781 (1951), *reprinted in* JACOB S. SEIDMAN, SEIDMAN'S LEGISLATIVE HISTORY OF FEDERAL INCOME AND EXCESS PROFITS TAX LAWS 1939–1953, at 1556 (1954).

[42] Section 112(b)(11)(B) of the Internal Revenue Code of 1939.

[43] Remarks of Sen. Humphrey, 97 CONG. REC. (1951), *reprinted in* SEIDMAN, *supra* note 41, at 1558.

protections of the "two active business" rule and the Device Requirement. The "two active business" rule "prevent[s] this type of avoidance," he stated, by requiring that both Distributing and Controlled be "intended to carry on active business after the reorganization and by providing that [Controlled] was not used as a device to distribute the earnings and profits of either corporation."[44] The notion of the ATB Requirement as a secondary bulwark against Device has become received wisdom among the Service, the courts, and practitioners.[45]

The Treasury interpreted the "intention" language of the 1951 Act as permitting the separation of cash from a business so long as the corporation intended to purchase a business soon after the distribution even if the corporation was not in a business at the time of the distribution.[46] In a Treasury Regulation example, the Service held that a distribution of a controlled corporation holding nothing but cash, bonds and a contract to acquire land satisfied Section 112(b)(11), including the "two active business" rule. In that example, Distributing owned a department store, wanted to provide parking facilities for its customers, entered into a contract to acquire land and contributed cash, bonds and the contract to Controlled. After the distribution, Controlled completed the purchase of the land and developed the parking facilities, but Controlled was not in a business prior to the distribution.

[44] *Id*. Senator Humphrey evidently believed that these safeguards could be improved upon, for he offered an amendment to the provision that would also have denied nonrecognition treatment if, within a three-year period following the distribution, (1) either Distributing or Controlled ceased to continue the active conduct of a trade or business or (2) the stock of Controlled was sold or exchanged. Senator Humphrey believed that the latter provision protected both against the conversion of ordinary income to capital gain at the shareholder level and against the avoidance of corporate-level tax on a disposition of appreciated assets. *Id.* at 1558–59. Accordingly, Senator Humphrey's second proposed amendment could be viewed as a precursor to Section 355(e).

[45] *See, e.g.*, King Enterprises v. Comm'r, 55 T.C. 677, 696 (1971), *rev'd*, 458 F. 2d 245 (1972) ("The *raison d'etre* of the [ATB Requirement] is to prevent the tax-free segregation of passive investment-type assets into an inactive corporate entity; thus enabling future sale at capital gains rates of the inactive portion of the distributing corporation's business. The inactive assets may well represent the accumulated earnings and profits of the continuing active business."); Coady v. Comm'r, 33 T.C. 771, 777 (1960), *aff'd*, 289 F. 2d 490 (6th Cir. 1961) (the function of the ATB Requirement is "to prevent the tax-free separation of *active* and *inactive* assets into *active* and *inactive* corporate entities."); Wayne T. Murray, *The Gregory Rules of Section 355*, PRACTISING LAW INSTITUTE, 16 THE CORPORATE TAX PRACTICE SERIES: STRATEGIES FOR ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATIONS & RESTRUCTURINGS 3–4 (2015) (viewing the ATB requirement as a "discrete statutory element of the device test that must be fully satisfied to help ensure that the transaction is not being used principally as an earnings bailout."); G.C.M. 35476 (Sept. 13, 1973) (stating the purpose of the ATB Requirement to be "the prevention of the temporary investment of liquid assets in a new business by an existing corporation in order to distribute the stock of the new business to the shareholders of the existing corporation in a 'spin-off' or other tax-free corporate division.").

[46] *See* Treas. Reg. 118, § 39.112(b)(11)-2, Example (2) (1953).

Section 355 was codified in substantially its current form a few years later in the Internal Revenue Code of 1954 (the "**1954 Code**").[47] In addition to including several new requirements, the 1954 Code reformulated both the ATB Requirement and the Device Requirement. The Device Requirement was updated in the 1954 Code to provide that a spin-off would qualify for tax-free treatment under Section 355 so long as "the transaction was not used principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both."[48]

The ATB Requirement of Section 355(b)(2) in the 1954 Code provided that a corporation would be treated as engaged in the active conduct of a trade or business only if the trade or business was actively conducted throughout the five-year period ending on the date of the distribution and, within that five-year period, neither the trade or business nor control (within the meaning of Section 368(c)) of a corporation conducting the trade or business was acquired in a transaction in which gain or loss was recognized in whole or in part. In adopting the requirement of a five-year history for the active trade or business, the 1954 Code rejected the 1951 Act's rule that an intention to conduct a business was sufficient.

The legislative history of the 1954 Code emphasizes Congress's intention that Section 355 not apply to the separation of an active business from inactive assets. In 1954, the House of Representatives contemplated permitting spin-offs on a tax-free basis where Distributing or Controlled was an "inactive corporation."[49] An inactive corporation under the House bill was any corporation unless for each of the past five years, among other things, 90 percent or more of the gross income of the business of such corporation was other than personal holding company income.[50] In the case of such a spin-off, the House bill would have imposed a penalty, treating any amounts received by shareholders during the ten years following the spin-off (whether sales proceeds or liquidating or other distribution proceeds) as ordinary income. The Senate rejected this construct in favor of the ATB Requirement, apparently finding the House's rule too lenient in that the House's rule permitted separations of active businesses and inactive assets if shareholders were willing to wait ten years:

[47] Internal Revenue Code of 1954, PUB. L. 83-591, 68 STAT. 730 (1954). The 1954 Code also permitted for the first time a tax-free distribution of a pre-existing controlled corporation not preceded by a 368(a)(1)(D) reorganization.

[48] Section 355(a)(1)(B). The Device Requirement as formulated in the 1951 Act was narrower, specifying that a distribution would qualify for tax-free treatment only if "the corporation whose stock is distributed" was not used principally as a Device.

[49] H.R. 8300 § 353, 83rd Cong. (1954).

[50] *Id.* at § 353(c).

> It is not believed that the business need for this kind of transaction is sufficiently great to permit a person in a position to afford a 10-year delay in receiving income to do so at capital gain rather than dividend rates. [The] committee requires that both the business retained by the distributing company and the business of the corporation the stock of which is distributed must have been actively conducted for the 5 years preceding the distribution, a safeguard against avoidance not contained in existing law.[51]

Meanwhile, the 1954 Code provided in Section 311 that no gain or loss would be recognized to a corporation on the distribution of property with respect to its stock. An exception applied for certain inventory and for liabilities in excess of basis. Section 311, along with Sections 336 and 337 of the 1954 Code, codified the doctrine of the 1935 Supreme Court case *General Utilities and Operating Co. v. Helvering*[52] to the effect that a corporation recognized no gain or loss on the distribution of assets to its shareholders.

Congress circumscribed the scope of nonrecognition under Section 311 over the ensuing years. In 1969, Congress amended Section 311 to provide as a general matter for recognition of gain on the distribution of appreciated property in redemption of a shareholder's stock, subject to certain exceptions.[53] In 1984, a further amendment provided that Section 301 distributions and distributions in redemption of a shareholder's stock would be treated the same, generally, triggering recognition of gain, but still subject to certain exceptions, such as an exception for distributions to certain large individual shareholders.

In TRA '86, Congress repealed what then remained of the Supreme Court's decision in *General Utilities* and also eliminated the difference in tax rates between ordinary income and capital gains.[54] In a stroke, the statutory preoccupation of Section 355 with shareholder

[51] S. Rep. No. 83-1622, at 50–51 (1954), *reprinted in* U.S. CODE CONG. & ADMIN. NEWS 4621, 4682 (1954).

[52] 296 U.S. 200 (1935).

[53] Tax Reform Act of 1969, PUB. L. 91-172, 83 STAT. 487, § 905 (1969).

[54] Congress repealed *General Utilities* because it perceived the doctrine as resulting in disparate tax treatment for economically similar transactions and thereby causing taxpayers to engage in superfluous transactions to plan into *General Utilities*. *See* STAFF OF SEN. FIN. COMM., 99th Cong., 1st Sess., FINAL REPORT ON SUBCHAPTER C REVISION ACT OF 1985, at 42 (1985) (noting the preference under *General Utilities* for liquidations as compared with sales and distributions by ongoing corporations and expressing concern that the incentive may encourage merger and acquisition activity: "No clear policy goal is achieved by providing this preference."). *See also Tax Treatment of Corporate Mergers and Acquisitions, and Certain Distributions of Appreciated Property, and Job Training Credit Proposal: Hearing before the Committee on Finance*, U.S. Senate, 97th Cong., 2nd Sess. (July 15, 1982), testimony of John S. Nolan on behalf of the Tax Section of the American Bar Association, HG 97-106 at 111 ("Rational tax policy could either embrace the *General Utilities* principle in full or reject it in full. Rational tax policy cannot, however, embrace it

avoidance of dividend taxation was replaced with a newfound attention to corporate-level taxes.[55] Section 355 became the only remaining means by which a corporation could distribute appreciated property without the imposition of corporate-level tax.[56]

The legislative history to TRA '86 described the interplay between *General Utilities* repeal and Section 355 as follows:

> The repeal of the *General Utilities* doctrine is designed to require the corporate level recognition of gain on a corporation's sale or distribution of appreciated property, irrespective of whether it occurs in a liquidating or non-liquidating context. The conferees expect the Secretary to issue, or to amend, regulations to ensure that the purpose of the new provisions is not circumvented through the use of any other provision, including the consolidated return regulations or the tax-free reorganization provisions of the Code (part III of Subchapter C).[57]

In TRA '86, Congress gave the Treasury a broad grant of authority to issue regulations under Section 337(d) to prevent the circumvention of *General Utilities* repeal.[58] Section 337(d), after amendment in 1988, provides:

> The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of the amendments made by subtitle D of title VI of the Tax Reform Act of 1986, including . . . regulations to ensure that such purposes may not be circumvented through the use of any provision of law or regulations (including the consolidated return regulations and part III of this subchapter) or through the use of a regulated investment company, real estate investment trust, or tax exempt entity . . .

only in part, and much mischief has come from prior attempts to do so … Thus, when some distributions (*e.g.*, redemptions and partial liquidations) are made taxable at the corporate level while others (*e.g.*, ordinary distributions and complete liquidations) are not, immense tax differentials are created. These differentials result in pressure to avoid the more onerous classifications and to enjoy the more liberal ones. They necessitate much complexity in the tax system.").

55 *See* Canellos, *supra* note 23, at 420.

56 *See* S. Rep. No. 99-47, at 53 (1985) ("Exceptions to the general rule [that a corporation recognizes gain on the distribution of property in respect of its stock] are provided in the case of … distributions qualifying as a section 355 transaction.").

57 H.R. Rep. No. 841, at II-204. *See also* STAFF OF THE JOINT COMM. ON TAX'N, EXPLANATION OF THE TAX REFORM ACT OF 1986, JCS-10-87, at 345 (1987).

58 Section 337(d).

Subtitle D of Title VI of TRA '86 was entitled "Recognition of Gain and Loss on Distributions of Property in Liquidation" and included the TRA '86 amendments to Sections 311, 336, 337, 338 and 1374.

Congress subsequently narrowed the scope of corporate-level nonrecognition in a Section 355 distribution, aiming to impose corporate-level tax on distributions that resemble taxable sales. Adopted in 1990, Section 355(d) imposes corporate-level tax in cases where a corporate taxpayer uses Section 355 "to dispose of subsidiaries in transactions that resemble sales, or to obtain a stepped up basis for any future dispositions" tax free.[59] Similarly, Congress enacted Section 355(e) in 1997 to impose corporate-level tax on transactions resembling a taxable sale of a subsidiary by taxing Distributing on any appreciation in Controlled stock in a distribution otherwise qualifying under Section 355 if, pursuant to a plan, one or more persons acquires directly or indirectly 50 percent or more of the stock of either Distributing or Controlled.[60]

The Treasury and the Service issued expansive regulations under Section 355 in January 1989 (the "**1989 Regulations**")[61] supplementing the existing statutory Device and active trade or business tests. The 1989 Regulations imposed an independent "business purpose" requirement,[62] which distinguished between acceptable "corporate business purposes"—*i.e.*, a purpose identified as a "real and substantial non Federal tax purpose germane to the business of" Distributing or Controlled—and an unacceptable "shareholder purpose."[63] Recognizing that corporate business purposes and shareholder purposes are sometimes co-extensive, the 1989 Regulations made it so that a spin-off otherwise satisfying the statutory Device and active trade or business requirements, would nevertheless fail to qualify for nonrecognition treatment if undertaken for insufficient corporate business purposes.[64] Following close on the heels of *General Utilities* repeal and notwithstanding the direct grant of regulatory authority to address

[59] H.R. Rep. No. 101-881, at 2342–43. *See also* Omnibus Budget Reconciliation Act of 1990, Pub. L. 101-508, 104 Stat. 143 (1990). Section 355(d) imposes corporate-level tax on Distributing if, in connection with a Section 355 distribution, a shareholder holds a 50 percent or greater interest in either Distributing or Controlled that is attributable to stock purchased within the preceding five-year period. Section 355(d).

[60] While Sections 355(d) and (e) reflect legislative attempts to weave *General Utilities* repeal into the fabric of Section 355, there has never been a thoroughgoing reassessment of Section 355 in light of *General Utilities* repeal.

[61] T.D. 8238, 54 Fed. Reg. 283 (Jan. 5, 1989).

[62] Treas. Reg. § 1.355-2(b).

[63] T.D. 8238, 54 Fed. Reg. 283, 283–84 (Jan. 5, 1989).

[64] *Id.* at 284.

General Utilities repeal, the 1989 Regulations refrained from tackling perceived abuses of *General Utilities* repeal under Section 355.[65]

V. DEVICE, BUSINESS PURPOSE AND *GENERAL UTILITIES* REPEAL

We believe that the transactions described in the Substantial Investment Asset No-Rule are more closely akin to *Gregory v. Helvering* than they are to the paradigm of a Distributing corporation dividing up historic businesses for a compelling business purpose. These transactions raise Device and business purpose concerns. Further, like all corporate distributions, these transactions raise *General Utilities* repeal concerns, but, unlike paradigmatic Section 355 transactions, these do not embody business-motivated separations of businesses, and thus would generally not appear to merit the protection of Section 355.

We believe that new rules are not needed, however, for transactions that raise purely shareholder-level concerns. Those transactions likely are not within the scope of Section 355 under current law and, as a practical matter, are few and far between. Further, the importance of Device, as traditionally understood as reflecting shareholder-level policies, has diminished in the context of a unified rate regime for long-term capital gains and qualified dividend income.

We would recommend that consideration be given to the issuance of guidance relating to transactions involving substantial and disproportionate Investment Assets and that involve the potential for elimination of corporate-level gain. While these transactions, like transactions that raise only shareholder-level concerns, are likely already not within the scope of Section 355 and are also rare, the stakes are higher for these transactions and thus guidance should be considered.

Of course, if guidance is issued, then doing so would involve a delicate line-drawing exercise, as real world transactions do not hew to the extremes. We make initial suggestions below for this guidance, following certain themes already found in current law. We recommend that any guidance (a) permit an allocation of Investment Assets not in excess of the reasonable needs of the business, (b) permit an allocation of Investment Assets consistent with an objective metric such as fair market value of the non-Investment Assets, earnings or revenues, (c) include a safe harbor to the effect that if the percentage of Investment Assets to total assets does not exceed a stated threshold, then the transaction will not be subject to any special rules relating to substantial Investment Assets and (d) include a safe harbor to the effect that if the ratio of Investment Asset Ratios of Distributing and Controlled does not exceed a stated number, then the transaction will not be subject to any special rules relating to substantial Investment Assets.

[65] The Treasury specifically reserved Treas. Reg. § 1.355-6 for regulations that it was developing under Section 337(d), but regulations were not issued thereunder until 2000, after Congress enacted Section 355(d). *See* T.D. 8238, 54 Fed. Reg. 283, 294 (Jan. 5, 1989); T.D. 8913, 65 Fed. Reg. 79,722 (Dec. 20, 2000).

A. Transactions that Resemble *Gregory v. Helvering*

We believe that cases that bear a strong resemblance to *Gregory v. Helvering* are not within the scope of Section 355, as they do not involve the business-motivated separation of businesses that Section 355 is intended to protect. We believe that the existing doctrines of Device and business purpose under Section 355 prohibit these transactions. Consider the following example:[66]

> Example 1. *High Basis Investment Assets*. Distributing owns a diversified portfolio of Investment Assets consisting of cash, cash equivalents and/or high basis stocks or bonds. In a purported 368(a)(1)(D)/355 transaction, Distributing contributes the Investment Assets to Controlled, together with a small amount of Qualifying Business Assets and distributes the stock of Controlled to Distributing's shareholders *pro rata*.

Example 1 does not appear to be within the intendment of Section 355. Treasury Regulation Section 1.355-1(b) states that Section 355 is meant to apply to a "separation . . . of one or more existing businesses formerly operated, directly or indirectly, by a single corporation . . ." As well, Treasury Regulation Section 1.355-1(b) states that "Section 355 contemplates the continued operation of the business or businesses existing prior to the separation." In Example 1, there is no historic business being separated, other than the small Qualifying Business Assets. We do not view the existence of the Qualifying Business Assets as changing the quality of the transaction. Those assets appear to have been tacked on.

The transaction resembles *Gregory* in that both Example 1 and *Gregory* involve a Controlled that holds only (or almost only) Investment Assets, and both transactions appear to be motivated by a purpose of removing the Investment Assets from Distributing without dividend income tax to shareholders.[67] The transaction's resemblance to *Gregory* reinforces the view that Example 1 is inconsistent with the policies of Section 355.

Example 1 differs from *Gregory* in that any subsequent sales of Controlled are not pre-arranged, but suppose that the Distributing shareholders are able to sell their shares in Controlled for cash either on the public markets or to a single buyer. From the shareholders' perspective, Example 1 then resembles a scenario in which Distributing sold the portfolio of stocks and bonds

[66] Example 1 is intended to focus the discussion in this Part V.A on shareholder-level treatment by involving Investment Assets that are not appreciated. One could argue, however, that a spin-off involving full-basis assets in Controlled does raise corporate-level tax concerns if the assets that remain behind in Distributing are appreciated. The direction of the spin should arguably make no difference in the corporate-level tax analysis.

[67] In *Gregory*, the Investment Assets were appreciated. Thus, another purpose of the *Gregory* transaction was to remove the Investment Assets from corporate solution without corporate-level tax.

for cash and distributed the cash to shareholders (resulting in dividend income to shareholders) or, alternatively, a scenario in which Distributing distributed the Investment Assets to its shareholders (resulting in dividend income to shareholders) who then sold the portfolio of stocks and bonds for cash. However, in Example 1, if the form is respected and the transaction is considered to satisfy Section 355, shareholders would have capital gain, based on their basis in their Controlled shares, upon the sale, rather than dividend income. We do not believe that a post-distribution sale is necessary for Example 1 to raise a Device concern. If the paradigm of Device is *Gregory*, Example 1 approximates *Gregory* in that the shareholders receive Controlled which owns cash, cash equivalents and/or a diversified portfolio of fungible assets, and the distribution facilitates the separate (indirect) disposition of those Investment Assets.

1. Current Law Application to Example 1

Indeed, Example 1 likely does not satisfy Section 355 under current law because of the Device Requirement, the business purpose requirement or both.

To begin with, it is difficult to fathom a corporate business purpose that would support the distribution in Example 1. The business purpose requirement is a meaningful and important test. Even a "fit and focus" business purpose would not seem to support the distribution in Example 1. Revenue Procedure 96-30 describes "fit and focus" as a scenario in which the distribution "will enhance the success of the businesses by enabling the corporations to resolve management, systemic or other problems that arise (or are exacerbated) by the taxpayer's operation of different *businesses* within a single corporation or affiliated group" (emphasis added).[68] "Fit and focus" does not seem apposite to Example 1, as the holding of passive assets is not a business and holding passive assets would not generally give rise to a management, systemic or other problem.

As to Device, Treasury Regulation Section 1.355-2(d)(2)(iv) provides that the Device Requirement takes into account the "nature, kind, amount, and use" of the assets of Distributing and Controlled and that the existence of assets that are not Qualifying Business Assets is evidence of Device. Further, the strength of this type of evidence of Device depends on all the facts and circumstances, including the ratio of the value of assets that are not Qualifying Business Assets to the value of assets that are Qualifying Business Assets.[69] Thus, a disproportionate allocation of assets that are not Qualifying Business Assets is evidence of Device.

[68] Rev. Proc. 96-30, 1996-1 C.B. 696, Appendix A, § 2.05(1) ("**Rev. Proc. 96-30**").

[69] Treas. Reg. § 1.355-2(d)(2)(iv)(B) (but, in a non-*pro rata* distribution, such a difference in ratios is ordinarily not evidence of device if attributable to a need to equalize the value of the Controlled stock distributed and the value of the Distributing stock or securities exchanged by the distributees).

Corporate business purpose is evidence of non-Device. The stronger the evidence of Device, the stronger the corporate business purpose must be to overcome such evidence of Device.[70] Moreover, evidence of Device that takes the form of a disproportionate allocation of assets that are not Qualifying Business Assets can be outweighed by a corporate business purpose for the disproportionate allocation.[71]

The Regulations illustrate the interplay of these Device and non-Device factors with examples. In one example, Distributing has a small amount of cash and marketable securities in excess of the reasonable needs of its business. Distributing distributes Controlled for a strong business purpose, allocating the cash and marketable securities between Distributing and Controlled based on the relative value of the business remaining in Distributing and the business of Controlled. The distribution is held not to be a Device.[72]

On the other hand, in another example in the Regulations, Distributing distributes Controlled for a strong business purpose, transferring to Controlled cash not related to the needs of the business of either Distributing or Controlled and thereby leaving Controlled with a substantially greater ratio of the value of its assets that are not Qualifying Business Assets to the value of its business as compared with Distributing's ratio.[73] Although the strong business purpose is evidence of non-Device, the distribution is held to be a Device because of the disproportionate ratios and because the strong business purpose does not pertain to the allocation of the cash and investment assets.[74]

In light of these rules and examples, especially the business purpose requirement and Example (3) in the Device Regulations, it would be difficult for Example 1 to pass muster under current law. In Example 1, Investment Assets in excess of the reasonable needs of the business are allocated disproportionately without a corporate business purpose that relates to the disproportionate allocation.[75]

[70] Treas. Reg. § 1.355-2(d)(3)(ii).

[71] *Id.*

[72] Treas. Reg. § 1.355-2(d)(4), Example (2).

[73] Treas. Reg. § 1.355-2(d)(4), Example (3).

[74] *Id.*

[75] Of course, there may be some fact pattern under which Example 1 would not be a Device (*e.g.*, if Distributing did not otherwise have current or accumulated earnings and profits or if the distribution were a non-*pro rata* split-off that would be treated as a sale or exchange under Section 302 to each exchanging shareholder, *see* Treas. Reg. § 1.355-2(d)(5)) as Device is a facts and circumstances test, and Device factors may be balanced by the presence of non-Device factors. *See* Robert Rizzi, *The Interaction between Device and Business Purpose*, 43 J. OF CORP. TAX'N 28 (2016) (discussing business purpose as a non-Device factor). Such transactions would still need to satisfy the business purpose requirement to pass muster, and

2. Device in a Unified Rate Regime

Device remains a meaningful policy concern despite the unified rate regime for long-term capital gain and qualified dividend income, but its importance has been considerably diminished. Thus, we do not see a need for the Service to expend its resources bolstering the Device test to address purely shareholder-level concerns.

Device has traditionally been principally about the conversion of dividend income to capital gain. For many years, the *raison d'être* for the Device test, therefore, rested on dividend income being higher-taxed than long-term capital gain.[76] The role of Device as the original sin of spin-offs had more salience years ago. In 1954, the top marginal tax rate on ordinary income was 91 percent, compared with a 25 percent tax on capital gains.[77] The Device regulations specifically recognize "that a tax-free distribution of a controlled corporation presents a potential for tax avoidance by facilitating the avoidance of the dividend provisions of the Code" by permitting shareholders to sell the stock of one corporation, while retaining the stock of another corporation.[78] Thus, the policy rationale underlying the Device Requirement was to prevent shareholders from using spin-offs to convert dividend income to capital gain.[79]

In Example 1, had Distributing forgone the Section 355 gymnastics and simply distributed the Investment Assets to its shareholders, the result would have been dividend income to the shareholders (and generally qualified dividend income, in the case of individual shareholders). Unlike in the days of Mrs. Gregory (1928) or at the time the Device prohibition was first enacted (1951), nowadays, that dividend income is taxed at the same rates as the long-term capital gain the shareholders would have had if they sold their Controlled stock immediately following the Section 355 distribution in the example (assuming the distribution qualified under Section 355).

There do remain, in some cases, reasons why a taxpayer may prefer capital gains over dividend income. First, when a taxpayer receives stock of a controlled corporation in a spin-off, it allocates a portion of its basis in its stock of Distributing to the Controlled stock received in the

any non-*pro rata* split-off could implicate Section 355(g). Furthermore, it is debatable whether Example 1 would satisfy the ATB Requirement. *See* Part VI.B. *infra*.

[76] Long-term capital gain and ordinary income rates were equalized in 1986, but then diverged a few years later, a situation that persisted until long-term capital gain and qualified dividend income tax rates were again equalized in 2003.

[77] *See* Sections 1 and 1201 of the 1954 Code.

[78] Treas. Reg. § 1.355-2(d)(1).

[79] H.R. Rep. No. 83-1337, at 39 (1954) ("There is ample evidence … that closely held corporations may undertake these transactions solely in the hope of distributing earnings to shareholders at capital gains rates.").

distribution.[80] As a result, gain realized in a subsequent disposition of either Distributing or Controlled will generally be less than the amount of dividend income the taxpayer would have had to include in gross income if the distribution had been taxed as a dividend (assuming sufficient earnings and profits to cause the distribution to be a dividend under Section 301(c)(1)). The Treasury recognized this potential for tax avoidance and, as part of the 1989 Regulations, broadened the definition of Device to include "a transaction that effects a recovery of basis."[81]

To illustrate that basis recovery advantage of a Section 355 transaction, in Example 1, suppose a shareholder having a basis in the taxpayer's Distributing stock equal to fair market value (assume $100) receives Controlled stock worth $25, and suppose the ratio of the fair market value of Controlled to the fair market value of post-distribution Distributing is 1 to 3. In that case, in Example 1 (assuming the distribution qualifies under Section 355), the taxpayer will take the Controlled stock with a basis of $25. Upon a sale of the Controlled stock, the taxpayer would recognize no gain because basis equals value. By contrast, if Distributing had simply distributed the Investment Assets to its shareholders in a taxable distribution, the shareholder would have had $25 of dividend income (assuming adequate earnings and profits).

Second, in the case of individual taxpayers, capital gains are preferred to dividend income because the former may be offset by capital losses. Thus, the Device concern could be relevant even where a shareholder has little or no basis in the shareholder's shares.[82]

Third, foreign shareholders generally prefer capital gain over dividend income, because capital gain is not subject to withholding,[83] while dividends are subject to 30 percent withholding, subject to reduction under treaties. While this may be of key importance in the cross-border context, as mentioned, cross-border considerations are beyond the scope of this Report.

Capital gains treatment is not always better for taxpayers, however. A domestic corporation will generally prefer dividends because it can avail itself of the dividends received deduction (subject to the application of Section 1059).[84] For individuals, qualified dividend

[80] Treas. Reg. § 1.358-2(a)(2)(iv).

[81] Treas. Reg. § 1.355-2(d)(1). *See* T.D. 8238, 54 Fed. Reg. 283 (Jan. 5, 1989) (clarifying, without explanation, that Device "can include a transaction that effects a recovery of basis.").

[82] *Cf.* Joshua D. Blank, *The Device Test in a Unified Rate Regime*, 102 TAX NOTES 513, 520 (Jan. 26, 2004) (arguing that the application of the Device test to shareholders with zero basis in Distributing shares is unnecessary in a unified rate regime).

[83] Treas. Reg. § 1.1441-2(a).

[84] Section 1059 generally provides that a corporation that receives an "extraordinary dividend" with respect to any share of stock that it has not held for more than two years must reduce its basis in such stock by the nontaxed portion of such extraordinary dividend.

income is taxed at lower rates than short-term capital gains. Thus, an individual taxpayer with a short-term holding period will often prefer dividends.

3. Enactment of Section 355(g)

We believe that the decision by Congress to attack the types of transactions covered by Section 355(g) is not particularly probative in respect of transactions like Example 1.

One could argue that the enactment of Section 355(g) implies that Example 1 should be permitted. Perceiving an end-run around shareholder taxation in the context of so-called "cash-rich split-offs," Congress enacted Section 355(g) in 2006 as part of the Tax Increase Prevention and Reconciliation Act of 2005.[85] In the prototypical cash-rich split-off, a shareholder of Distributing would exchange its Distributing stock for stock of a controlled subsidiary holding a substantial amount of cash or other liquid assets in proportion to its other assets (in particular, its Qualifying Business Assets), in a transaction intended to qualify for nonrecognition treatment under Section 355. Example 1 does not run afoul of Section 355(g) because it involves a *pro rata* spin-off rather than a non-*pro rata* exchange, a prerequisite of Section 355(g).[86] One could argue that Congress has drawn the line in this area in imposing Section 355(g) and that Example 1 should therefore be permitted.

But, we do not agree with that conclusion. The enactment of Section 355(g) was aimed at transactions that resemble cash redemptions of the stock in Distributing that is held by a large shareholder. The transactions targeted by Section 355(g) were intended to cash out large shareholders on a tax-free (or at least tax-deferred) basis by having Distributing contribute the sale consideration to a controlled corporation and splitting it off under Section 355 to the shareholder in exchange for the shareholder's Distributing shares.[87] The fact that Congress decided to address that problem does not mean that Congress was expressing an intention regarding Example 1. Example 1 raises different policy concerns, which we believe are addressed by the Device and business purpose requirements.

[85] PUB. L. 109-222, § 507(a), 120 STAT. 359 (2006).

[86] Section 355(g) applies only if a shareholder ends up owning 50 percent or more of a "cash-rich" Distributing or Controlled who did not hold such an interest immediately before the transaction. Section 355(g)(1).

[87] STAFF OF THE JOINT COMM. ON TAX'N, OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES, JCS-02-05, Part V.C, at. 153, 155 & n. 359 (Jan. 27, 2005), *reprinted in* TAX NOTES TODAY, 2005 TNT 18-18, (Jan. 29, 2005).

4. Device in a Public Company Context

Another reason that we do not believe that new rules are needed to address Example 1 is that, at least in the public company context, we do not see Example 1 as particularly realistic. In our experience, we have not seen public companies pursue a transaction like Example 1, which involves cash or a diversified portfolio of Investment Assets.

Furthermore, we would submit that public companies generally do not consider the potential shareholder-level tax benefits (beyond tax-free receipt of Controlled shares) of a Section 355 distribution in deciding to undertake a distribution. Nuances such as shareholder-level basis recovery, withholding tax on foreign shareholders and the ability of a shareholder to offset capital losses against capital gains simply do not come up in public company deliberations as to whether to engage in a Section 355 distribution. Indeed, the Device regulations have long provided that a publicly traded distributing corporation in which no single shareholder owns more than five percent is evidence that a distribution is not a Device.[88] That rule is based on the notion, consistent with our experience, that a publicly traded corporation with no significant shareholder will not be motivated to bail out its earnings and profits for the benefit of its shareholders.[89]

Moreover, public companies have far more straightforward mechanisms to return excess cash to shareholders. A public company may more effectively unburden itself of its excess liquid assets and deliver value to its shareholders through share tenders, rather than trying to wend its way through the byzantine requirements of Section 355.

It is true that a share buyback has a different result from Example 1 in that in a share buyback, the shareholder gives up its interest in the entire corporation, while, in Example 1, the shareholder is able to retain its interest in Distributing. The essence of a spin-off is the ability to separate some assets from others, unlike a share buyback. The essence of a Device is the ability to extract cash while retaining one's interest in the non-cash non-Investment Assets of the corporation. Still, share buybacks have proven far more typical in the public company context than Section 355 distributions involving excess Investment Assets along the lines of Example 1.

Thus, on balance, although we believe that Example 1 presents *Gregory*-like concerns, we do not believe that new rules are needed to protect against purely shareholder-level concerns.

[88] Treas. Reg. § 1.355-2(d)(3)(iii).

[89] Nevertheless, public officials have, in the past, suggested that this non-Device factor ought to be discounted because there may exist a corporate-level intent to bail out corporate earnings and profits. *See* Lee A. Sheppard, *More Devices to Beat Section 355*, 14 DAILY TAX HIGHLIGHTS & DOCS. (TAX ANALYSTS) 3031 (Sept. 22, 1989) (describing a former Service official comment that the publicly traded non-Device factor should rarely be invoked because the intent to bail out earnings can be present at the corporate level).

The Device and business purpose requirements each remain bulwarks against these types of transactions. Dividend income is not as onerous for shareholders as it once was. Public companies do not engage in such transactions in any event. We are also not aware of private companies engaging in such distributions to individual shareholders, but such distributions would encounter significant obstacles under current law.

B. Corporate-Level Tax Considerations

1. Section 355 as an Exception to *General Utilities* Repeal

Consider a distribution involving appreciated Investment Assets:

> Example 2. *Diversified Portfolio of Appreciated Investment Assets*. Same as Example 1, except that the Investment Assets consist of a diversified portfolio of appreciated stocks and bonds.

Example 2 raises the same Device, business purpose and ATB Requirement concerns as does Example 1. But, more is at stake in Example 2 than Example 1. If the distribution does not qualify under Section 355, then not only is shareholder treatment affected but also, under Section 311(b), Distributing recognizes gain on the distribution.[90] Thus, Example 2 implicates the boundary between Section 355 and Section 311(b). What is the proper scope of Section 355 in protecting corporate-level nonrecognition against the backdrop of a general rule, Section 311(b), that provides that distributions of appreciated property are recognition events for the distributing corporation?

To begin with, Example 2, like Example 1, would have a difficult time qualifying under current law for all the reasons discussed in Part V.A above. The transaction does not appear to be within the intendment of Section 355 in light of the substantial and disproportionately held Investment Assets. As mentioned above, Section 355 was meant to apply to business-motivated separations of businesses. Example 2 resembles a sale by Distributing of the Investment Assets to Controlled—or to whoever may acquire Controlled—rather than a readjustment of corporate form to facilitate the operation of a business.

One can see that Example 2 should be outside Section 355 by comparing Example 2 with a similar case that is plainly outside of Section 355 and subject to Section 311(b), namely, a case where all the assets in Controlled are appreciated Investment Assets. From the perspective of the policy of Section 355, including its role as an exception to *General Utilities* repeal, it is difficult to make much of the presence in Example 2 of the Qualifying Business Assets and their absence in the similar case involving 100% Investment Assets that is outside Section 355. The presence

[90] In general, the contribution by Distributing to Controlled of the Investment Assets would likely qualify under Section 351, but the distribution of the stock of Controlled would be subject to Section 311(b).

of a small amount of Qualifying Business Assets does not change the nature of the transaction from a Section 355 policy perspective.

Section 355 was developed at a time when *General Utilities* applied and shareholder-level tax was a greater focus than corporate-level tax. Now that *General Utilities* has been decisively repealed, it is appropriate to ensure that Section 355 does not provide corporate-level gain nonrecognition to transactions that were not intended to be covered. As mentioned, current law already provides substantial hurdles to Example 2. But, given the stakes, we believe that consideration should be given to providing guidance that would either provide that Example 2 is outside Section 355 or that would impose corporate-level gain in the case of Example 2. As discussed below, Example 2 raises the possibility of the appreciation in the Investment Assets being removed from the corporate tax base altogether.

One could argue that Example 2 does not raise corporate-level tax concerns that should be addressed at all, because, unlike the *Gregory* case, the Investment Assets remain in corporate solution in the hands of Controlled and do not receive a stepped-up basis.[91] Any appreciation inherent in those assets is still subject to corporate-level tax. The only difference is that, following the distribution, the appreciated assets are held in separate corporations, and each such corporation would be subject to tax if it were to dispose of the appreciated assets. Indeed, one could argue that Example 2 differs from *Gregory* in that in *Gregory*, as part of the plan, the appreciation in the Investment Assets was removed from the corporate tax base altogether (via a liquidation of Controlled, which, at the time, under *General Utilities*, gave rise to no corporate-level tax).

We would not agree. The argument goes too far as it would mean that all transactions that take the form of a distribution of the stock of Controlled would qualify for corporate-level nonrecognition. Section 355 does not provide such blanket protection. This is a corollary of the fact that the Code does not exempt from tax all sale transactions among unrelated corporations on the ground that the assets remain in corporate solution. On the contrary, the tax law views each corporation as a separate taxpayer and imposes tax on the disposition by one corporation of appreciated assets to another corporation, unless a particular nonrecognition provision dictates otherwise.[92] Section 355 is an exception to the general rule of recognition. Section 355 is not meant to permit all distributions without corporate-level (or shareholder-level) taxation. Among other things, it monitors against transactions similar to *Gregory*.

[91] *Cf., e.g.*, Jodi J. Schwartz, *Can You Ever Be Too [Cash] Rich or Too [Active Business] Thin? Corporate Basis Shifting and the Cash-Rich Split-Off*, Tax Forum No. 583, on file with the author (Apr. 26, 2005) (discussing *General Utilities* concerns in light of absence of basis step-up).

[92] *See* Deborah L. Paul, *Spin-offs, Leverage and Value Extraction—A Spin by Any Other Name…*, 91 TAXES 99 (2013).

Moreover, the fact that inside basis is preserved in the case of a spin-off does not of itself mean that corporate-level nonrecognition is justified.[93] The "mirror liquidations" legislation in 1987 manifested the conviction of Congress that keeping assets in corporate solution, with no step-up in asset basis, is not sufficient to assuage its concerns that a taxpayer is circumventing *General Utilities* repeal where the assets end up in the hands of another corporation.[94]

2. C-to-RIC Spins

Example 2 raises further concerns because Controlled might convert to a RIC[95] or be acquired by a RIC after the distribution,[96] thereby eliminating corporate-level gain from the

[93] *See* Schler, *supra* note 39, at 245–48 (arguing that a carryover basis in Controlled's assets is necessary but not sufficient for a distribution under Section 355 to be consistent with *General Utilities* repeal).

[94] So-called "mirror liquidation" transactions enabled a corporate group to separate wanted and unwanted assets held in a corporate subsidiary in connection with a sale without recognizing corporate-level tax on the built-in gain. To accomplish this, a member of the group would form two "mirror" subsidiaries. One subsidiary would acquire stock of the corporation reflecting the fair market value of the corporation's wanted assets; the other corporation would acquire the remaining stock of the corporation, which would reflect the fair market value of the unwanted assets. The corporation would then liquidate and distribute the wanted assets to the first subsidiary and the unwanted assets to the second subsidiary. Before Congress amended Section 337(c) to disregard the application of the consolidated return regulations for purposes of determining whether a corporation was an 80-percent distributee, the group's ownership of the liquidating corporation was aggregated, resulting in each mirror subsidiary being treated as an 80-percent distributee for purposes of Section 337. As such, Section 311(b) did not apply to the liquidation of the corporation, and each mirror subsidiary would take either the wanted or unwanted assets with a carryover basis. The group could then sell the stock of the mirror subsidiary holding the unwanted assets at its fair market value and recognize little or no gain on the sale because its cost basis in the mirror subsidiary stock was equal to fair market value.

[95] A RIC is a corporation for U.S. federal income tax purposes, which functions as a conduit in respect of income and gain. Provided it meets a number of specific requirements relating to the source of its income, the diversification of its assets, and the distribution of its income, a RIC generally is not subject to entity-level tax. *See*, *generally*, Richard M. Hervey, *Taxation of Regulated Investment Companies*, B.N.A. TAX MGMT. PORTFOLIO 740-3RD, at V-VII.

[96] An impediment would be that, under Section 852(a)(2)(B), a RIC generally cannot qualify for favorable treatment under the RIC rules if it has accumulated earnings and profits. Thus, Controlled would likely have to engage in a transaction that "purges" itself of earnings and profits. Prior to the PATH Act, in the context of C-to-REIT spins, such purges were accomplished via a Section 305(b)(1) distribution that was, at the election of a shareholder and subject to proration, of stock or cash. *See* Richard M. Nugent, *REIT Spinoffs: Passive REITs, Active Businesses*, Tax Forum No. 662 at 13–14, on file with the author (Feb. 2, 2015) (noting that Controlled corporations typically distribute a mix of cash and stock to effect an earnings and profits purging distribution).

corporate tax base. [97] A RIC is subject to little or no entity-level tax. A RIC election for Controlled or the liquidating distribution of Controlled's assets to a RIC would constitute a "conversion transaction."[98] Thus, the RIC would be subject to corporate-level tax under Section 1374 on the net built-in gain in any of Controlled's assets that are disposed of during the five-year recognition period (unless the C corporation elects to recognize the built-in gain in a deemed sale).[99] Any built-in gain not recognized during the recognition period would be permanently removed from the corporate tax base.[100] A RIC could potentially manage its Section 1374 exposure by selectively disposing of its assets.

[97] As of the date of this Report, we are aware of only one contemplated C-to-RIC Section 355 distribution. *See* Priv. Ltr. Rul. 201605016 (Jan. 29, 2016) (including taxpayer representations that Distributing had negative current and accumulated earnings and profits and that the aggregate fair market value of the assets contributed to Controlled was less than their aggregate basis).

Notwithstanding its quasi-passthrough nature, because a RIC is a corporation for U.S. federal income tax purposes, it generally is subject to the same provisions of subchapter C applicable to non-RIC corporations, including Sections 351, 355 and 368. *See, e.g.*, Rev. Rul. 87-9, 1987-1 C.B. 133 (transfer by shareholders of cash and marketable securities to a RIC in exchange for stock qualified as an exchange under Section 351); Rev. Rul. 78-44, 1978-1 C.B. 216 (change of state of incorporation by RIC qualified as a reorganization within the meaning of Section 368(a)(1)(F)); Rev. Rul. 74-155, 1974-1 C.B. 86 (acquisition by a RIC of all of the assets of a personal holding company in exchange for stock of the RIC qualified as a reorganization within the meaning of Section 368(a)(1)(C)); Priv. Ltr. Rul. 201247009 (Nov. 23, 2012) (same); Priv. Ltr. Rul. 201001015 (Jan. 8, 2010) (same); Priv. Ltr. Rul. 200724004 (Jun. 15, 2007) (exchange of preferred stock in RIC for common stock in RIC qualified as a reorganization within the meaning of Section 368(a)(1)(E)).

[98] Treas. Reg. § 1.337(d)-7(a)(1)(ii) (defining "conversion transaction" as the qualification of a C corporation as a RIC or a REIT or the transfer of property owned by a C corporation to a RIC or REIT).

[99] Treas. Reg. § 1.337(d)-7(c). In the case of a deemed sale treatment election, the C corporation is treated as having sold all its assets to an unrelated third party at fair market value on the last day of the C corporation's last taxable year before the first taxable year in which it qualifies to be taxed as a RIC (or a REIT).

[100] It is also worth noting that the return on the appreciation in the Investment Assets (*e.g.*, the dividend and interest income on the portion of the Investment Assets consisting of the appreciation in the stocks and bonds) is immediately taken outside the corporate tax base without recognition of corporate-level tax on the appreciation. The appreciated portion of the Investment Assets is able to be deployed to earn a return without the appreciation itself being subject to corporate-level tax. Suppose that an Investment Asset consists of a share of stock that was purchased for $30 and is now worth $100 and pays dividends of $10 each year. Seventy percent of the dividends, or $7 each year, are attributable to the appreciated portion of the share. Upon a conversion to a RIC, this $7 of annual dividend income may be received without imposition of corporate-level tax despite the $70 of appreciation not having been subject to corporate-level tax.

One could argue that the potential for elimination of corporate-level gain on Investment Assets held for the recognition period is consistent with *General Utilities* repeal in that Congress decided that five years[101] was long enough. Congress made the policy decision that the Section 1374 taint goes away after five years.

Moreover, one could argue that a C-to-RIC distribution qualifying under Section 355 is no worse from the perspective of preserving the corporate tax base than a RIC election in the absence of a Section 355 distribution. A single corporation that owns 100 percent RIC-qualifying assets can convert to a RIC and, subject to the five-year waiting period, avoid corporate-level tax on the built-in gain in its assets and immediately remove the return on its assets from the corporate tax base. That being the case, it is arguably no worse for a corporation holding, say, 70 percent RIC-qualifying assets and 30 percent other assets to separate those qualifying assets into a separate corporation, distribute the corporation holding the qualifying assets to its shareholders, and have the spun-off corporation elect RIC status.

On balance, we believe that Example 2 raises concerns for which consideration should be given to issuing guidance as it facilitates the ability of a portion of Distributing's assets to be hived off and converted to, or acquired by, a RIC, albeit subject to Section 1374. While it is one thing for a whole corporation to convert to a RIC, it seems another for a portion of the assets of a corporation to be separated, distributed in a purported Section 355 transaction and wind up owned by a RIC. Such a transaction exacerbates concerns that Section 355 is not being used for its intended purpose as it suggests that the purpose of the transaction is corporate-level tax avoidance. Section 355 was meant to facilitate business-motivated separations of businesses, not to provide a mechanic to achieve RIC status for a portion of a corporation's assets.

We note that neither the Notice nor the Revenue Procedure addresses distributions in which Controlled subsequently converts to an S corporation. The quasi pass-through nature of S corporations presents the same *General Utilities* repeal concern as RICs. Unlike a RIC (or a REIT), however, an S corporation can generally own any combination or concentration of assets and can derive any measure of both active and passive income.[102] In that regard, no separation of assets is required in the same way that a typical C-to-RIC (or, prior to the PATH Act, C-to-REIT) distribution requires RIC-qualifying (or REIT-qualifying) assets to be separated prior to and in connection with the distribution.

[101] The PATH Act provides permanently for a five-year recognition period.

[102] An exception applies to an S corporation with earnings and profits and substantial amounts of passive income. Specifically, an election to be treated as an S corporation is terminated if the corporation (i) has accumulated earnings and profits at the close of each of three consecutive taxable years and (ii) has gross receipts for each of such taxable years more than 25 percent of which are passive investment income. Section 1362(d)(3). However, an S corporation can avoid such a termination by paying sufficient dividends to eliminate its accumulated earnings and profits.

Instead, in the case of S corporations, qualification for S corporation status is an issue of shareholder composition and scope, rather than type of assets. Both the number and types of shareholders that can hold S corporation stock is limited. For this reason, the analysis is distinguishable and beyond the scope of this Report. In order for a C-to-S distribution to bring about S corporation qualification for a portion of Distributing's assets (in circumstances where Distributing was not eligible prior to the distribution), the distribution generally would need to be a non-*pro rata* exchange such that, following the distribution, Distributing or Controlled has the appropriate number and type of shareholders in order to qualify as an S corporation. If Distributing could effect the transaction as a *pro rata* distribution then, in all likelihood, Distributing could have converted to an S corporation in the first place, without the necessary prerequisite of a separation transaction.

3. Investment Assets Consisting of Stock of a Single Issuer

Another situation that presents a potential for corporate-level tax avoidance is where the particular type of appreciated Investment Assets, such as stock of a single issuer, held by Distributing or Controlled facilitates the acquisition of that company by a third party in a manner that eliminates the corporate level appreciation altogether. Consider the following example:

> Example 3. *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 distributes the stock of Controlled to Distributing's shareholders *pro rata*.

Under these circumstances, everyone's interests are aligned in favor of an acquisition of Controlled by Issuer for Issuer stock at some point following the distribution. Issuer, in particular, will be motivated to reacquire its stock because of the market overhang and governance issues associated with having a large shareholder, Controlled. The shareholders, too, will generally be happy to dispose of their Controlled stock because of the tax inefficiencies—mitigated somewhat by the dividends-received deduction available to Controlled as a corporate shareholder of Issuer—of a corporation owning stock of another corporation not a member of the same affiliated group. Where Issuer is publicly traded, a shareholder who continues to want to hold Issuer stock is better served holding Issuer shares directly, rather than through Controlled. Distributing, meanwhile, has successfully disposed of appreciated Investment Assets, the Issuer stock, without paying tax and is indifferent as to whether Controlled is acquired (unless the acquisition affects the tax-free nature of Distributing's distribution of Controlled).

Example 3, like Examples 1 and 2, may well not satisfy Section 355 under current law, whether on account of the Device test, the business purpose test or both, regardless of whether

Issuer acquires Controlled.[103] However, Issuer would likely acquire Controlled via an issuance of Issuer stock, not cash, thus potentially obviating application of the Device or continuity of proprietary interest tests on account of the acquisition of Controlled by Issuer. Moreover, under Treasury Regulation Section 1.355-7(b)(2), Section 355(e) is not likely to apply because no negotiations with Issuer need be engaged in prior to the distribution.[104] The asset mix itself—stock of a single issuer—creates the conditions on which a subsequent acquisition of Controlled is predicated.

Issuer's indirect repurchase of its stock through an acquisition of Controlled following the distribution is especially troubling from a *General Utilities* repeal perspective because the built-in gain that arose in the hands of Distributing in the reacquired Issuer stock effectively disappears without corporate-level tax ever having been paid on the appreciation (or if a subsidiary of Issuer acquires Controlled, then the built-in gain is deferred indefinitely in the form of hook stock).

One could argue that the potential to eliminate corporate-level gain in this manner is appropriate. Prior to the distribution, Issuer's earnings are potentially subject to triple taxation, first in the hands of Issuer, then in the hands of Distributing (ameliorated by the dividends received deduction) and finally in the hands of Distributing's shareholders.[105] Further, a downstream merger of Distributing into Issuer could generally be done on a tax-free basis. Thus, arguably, the distribution of Controlled holding primarily Issuer stock in Example 3 is appropriate as it sets up the possibility of an eventual elimination of the Issuer stock altogether.

We do not agree, however, that the potential for triple taxation justifies permitting corporate nonrecognition in Example 3. Triple taxation is an artifact of the Code. While triple taxation may be undesirable as a policy matter, it is part of the infrastructure. Congress has not chosen to mitigate triple taxation beyond providing for the dividends received deduction and the consolidated return regulations. Section 355 was not intended to apply to address this triple taxation, as evidenced by the requirement in Section 355 that "control" (generally, 80% of the voting power and 80% of any non-voting class) of Controlled must be distributed by Distributing. Further, the fact that all of Distributing could be merged downstream into Issuer on a tax-free basis does not mean that a particular appreciated asset held by Distributing should be

[103] *See* our discussion in Part V.A.1.

[104] *See* Treas. Reg. § 1.355-7(b)(2) (providing that an acquisition following a distribution is not part of the plan if there was no "agreement, understanding, arrangement, or substantial negotiations … during the two-year period ending on the date of the distribution").

[105] *See* Deborah L. Paul, *Triple Taxation*, 56 TAX LAW. 571 (2003). The Code imposes tax on a corporation's sale of the stock of another corporation, generally without mitigation for the corporate-level tax on the earnings of the sold corporation. Thus, the Code potentially imposes three layers of tax on corporate earnings. *Id*.

able to be eliminated using Section 355. The overall transaction has the effect of a distribution by Distributing of its Issuer stock, a transaction that would squarely be within the gain recognition provisions of Section 311(b).

One could debate whether the potential (perhaps likelihood) itself for an acquisition of Controlled by Issuer after the distribution should lead to corporate-level tax at the time of the distribution or rather whether tax should not be imposed until or unless such an acquisition actually happens. In related areas, Section 355 sometimes waits until there is an actual acquisition. Sections 355(d) and 355(e) trigger corporate-level gain only if there is an actual distribution and third-party acquisition, and not merely a greater likelihood of one.[106] In the case of Section 355(e), under the Section 355(e) regulations, even facilitating a third-party acquisition is insufficient to justify taxing Distributing on the distribution, absent substantial negotiations between the parties. A distribution into a "hot market," where the acquisition of Distributing or Controlled is "reasonably certain" to occur soon after the distribution, does not of itself mean that a subsequent acquisition of Distributing or Controlled is "part of a plan" resulting in the application of Section 355(e).[107]

One could argue, though, that unlike a "hot market," the decision as to how Distributing's assets are to be divided between Distributing and Controlled is squarely in Distributing's control and thus imposing tax on the distribution in Example 3 at the time of the distribution, regardless of whether an acquisition of Controlled by the Issuer actually occurs, may be justified. There is precedent under Section 355 for imposing tax based on the likelihood of an ensuing transaction. The Device regulations, for example, state that the distribution of a "secondary business"—*i.e.*, a business that can be sold without adversely affecting the operations of the other business—is considered evidence of Device.[108] It appears that the reason that a secondary business is evidence of Device is that the secondary business is likely to be sold. Unlike the anti-*General Utilities* repeal provisions of Sections 355(d) and 355(e), the distribution of a "secondary business" does not require an actual acquisition to be evidence of Device. Indeed, other Device factors similarly are intended to predict whether the shareholders will sell their stock in Distributing or Controlled without requiring an actual sale to occur. Specifically, both the *pro rata* nature of the distribution—considered by the regulations to present "the greatest potential" for Device—and the nature of the assets both serve this function in policing Device.[109] To be sure, the Device regulations also may be triggered by shareholder sales following a distribution but even there,

[106] In the case of Section 355(d), the acquisition occurs before the distribution.

[107] Treas. Reg. § 1.355-7(j), Example (3).

[108] Treas. Reg. § 1.355-2(d)(2)(iv)(C). *See* BITTKER & EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 11.06[5] (describing the Service's concern as relating to Controlled holding a "cash cow" business which is "more of a solid investment asset than an active business.").

[109] *See* Treas. Reg. §§ 1.355-2(d)(2)(ii) and (iv).

unlike the mechanics of Section 355(e), there is no threshold for Device purposes at which a third-party sale is fatal to the tax-free qualification of the Distribution.[110]

The distribution in Example 3 seems designed to facilitate an acquisition of Controlled by Issuer. But, if that did not happen, it would seem that the distribution is designed to facilitate an acquisition of Controlled by someone else, perhaps a RIC,[111] as Controlled itself serves little purpose, being only a holding company (and holder of a small amount of Qualifying Business Assets), and comes with a cost—corporate-level tax on distributions. An acquiror of Controlled (other than Issuer) would take Controlled with all the appreciation inherent in the Issuer stock and the concomitant potential for corporate-level tax. But, an acquisition by a RIC would eliminate corporate-level tax, subject to Section 1374.

As mentioned, Example 3 also raises concerns relating to Section 355(a)(1)(D), the requirement that Distributing distribute "control" of Controlled. Issuer is not a controlled corporation within the meaning of Section 368(c). Yet, in Example 3, through the contrivance of dropping the Issuer stock into Controlled, Distributing in form is able to spin off a controlled corporation. An analog to Example 3 is the use of a pre-distribution recapitalization into a high-vote/low-vote equity structure as a means to retain or acquire control—itself the subject of a no-rule.[112] In our 2013 report regarding the application of the step transaction doctrine in Section 355 transactions, we noted that the policy behind the distribution of control requirement was "to limit tax-free treatment under Section 355 to transactions that result in the separation of what are, in effect, divisions of a single corporation."[113] Considered in that light, Example 3 is at odds with the policy behind this requirement because it effectively permits Distributing to distribute stock of a company which was never a part of Distributing's corporate enterprise. If circumvention of the "control" requirement is a concern, however, it is not clear why the Revenue Procedure permits look-through treatment for equity investments of 50 percent or more, rather than 80 percent or more.

[110] *See* Treas. Reg. § 1.355-2(d)(2)(iii)(C).

[111] Controlled could potentially be acquired by a RIC. Controlled itself could not elect RIC status because it would fail the diversification requirement. *See* Section 851(b)(3)(B) (providing that a corporation does not qualify for RIC status for any taxable year in which more than 25 percent of the value of its total assets is invested in securities of any one issuer).

[112] Rev. Proc. 2016-3, 2016-1 I.R.B. 126, § 5.01(4).

[113] N.Y. St. Ba. Ass'n Tax Sec., Rep. No. 1292, *Report on the Role of the Step Transaction Doctrine in Section 355 Transactions: Control Requirement and North-South Transactions* (Nov. 5, 2013).

4. Special Rules for Appreciated Investment Assets

Because of the high stakes involved in transactions that potentially eliminate corporate-level gain from the tax base, we believe that consideration should be given to issuing guidance addressing Examples 2 and 3.

(a) Guidance under Section 337(d), 355 or Both

One approach would be to issue guidance directly under Section 337(d). This would presumably result only in corporate-level nonrecognition for a transaction that is otherwise within the ambit of Section 355.

Another approach would be to issue guidance under Section 337(d) and 355. For example, an approach that could be considered would be to conceive of the Device Requirement as covering not only putative conversions of shareholder dividend income to capital gain and attempted shareholder basis recovery transactions, but also Devices to avoid corporate-level gain recognition. That is, the concept of a bailout of corporate earnings and profits could be conceived as including mechanisms for bailing out potential earnings and profits in the form of unrecognized appreciation in corporate assets[114] without corporate-level tax in transactions that are not within the intendment of Section 355. The language of the statute—"the transaction was not used principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both"—is arguably susceptible of such an interpretation. The statute does not limit itself to a concern with shareholder taxation, but speaks in broader terms.

Thus, if the transaction purports to be a Section 355 transaction but is a "disguise" whose "real character" is "not to reorganize a business or any part of a business"[115] but rather to transfer appreciated Investment Assets out of Distributing without corporate-level tax, it seems arguably appropriate to view such a transaction as failing Section 355(a)(1)(B), the Device test. Just as the concept of Device was reconceived in 1989 to cover transactions that inappropriately effect a recovery of basis, it could be further reconceived to cover transactions that inappropriately avoid corporate-level taxation.

This reconceptualization of Device is arguably supported by the broad grant of regulatory authority under Section 337(d). In 1989, the New York State Bar Association Tax Section Committee on Reorganizations considered whether the Service had authority under Section 337(d) to promulgate regulations to prevent the use of Section 355 distributions to circumvent

[114] Section 312(b) provides that earnings and profits are increased by the excess of fair market value over basis of distributed property.

[115] Gregory, *supra* note 7.

General Utilities repeal. A majority of the Committee concluded that the Service did have this authority.[116] But, there is also an argument that subsequent developments—the enactment of Sections 355(d) and (e)—have undercut the breadth of Section 337(d), that those subsequent legislative enactments suggest that Congress will act to circumscribe corporate-level nonrecognition in Section 355 when it chooses to do so and that the Service should not act by regulation to address perceived *General Utilities* repeal concerns in purported Section 355 transactions.

Approaching the issue under the aegis of Section 337(d) raises the question of whether a shareholder-level tax could or should be imposed, given the focus of Section 337(d) on corporate-level gain. If Device is reconceptualized in the way described above, some transactions might fail Section 355 as a result of a corporate-level Device and thereby apparently result in taxable treatment both to shareholders and Distributing. Section 355 functions as an "on-off" switch. Apart from the application of Sections 355(d) and (e), the special rules of Section 355 apply to shareholders and the corporation or they apply to neither. Section 337(d) alone does not provide authority for imposing shareholder-level tax. However, if the exercise of regulatory authority under Section 337(d) is filtered through the lens of Section 355, shareholder-level tax could potentially be imposed, just as corporate-level tax is imposed under existing rules where a distribution fails for a specifically shareholder-level tax avoidance reason (*e.g.*, traditional Device concerns).

If the Service believes that only corporate-level tax ought to be imposed, then perhaps guidance is best promulgated directly under Section 337(d), rather than the Section 355 Device test. When the New York State Bar Association Tax Section Committee on Reorganizations considered the question in 1989, a majority of the Committee concluded that the Service has the authority to promulgate regulations that impose corporate-level tax even though a distribution otherwise would be tax-free under Section 355 at the shareholder level.[117]

Whether directly under Section 337(d) or also under the rubric of Device, guidance could be targeted at distributions along the lines of those covered by the Substantial Investment Asset No-Rule where there is appreciation in the Investment Assets. Most potential Section 355

[116] N.Y. ST. BA. ASS'N TAX SEC., COMM. ON REORGANIZATIONS, Rep. No. 638, *Report on Proposals for Treasury Regulations under Section 337(d) Relating to Section 355 Distributions* (Dec. 6, 1989). Section 337(d) provides support for promulgating regulations under Section 355 that would address Example 2 independent of how those regulations address Example 1. *But see* Lauren Azebu, Robert Rizzi, Lisa Zarlenga, *A New Role for the Device Test?*, 150 TAX NOTES 1427, at 1440 (Mar. 21, 2016) (arguing that it would be difficult for the Service to police *General Utilities* repeal via the Device test absent legislative change).

[117] *Report on Proposals for Treasury Regulations under Section 337(d) Relating to Section 355 Distributions, supra* note 116.

transactions involve distributions of appreciated assets. But, under the approaches being discussed, most potential Section 355 transactions would nonetheless not be covered by the guidance. Only those that are a "disguise,"[118] those that claim a "trumped-up business purpose"[119] and that are therefore outside the paradigm that Section 355 is meant to protect, would be covered. Just as existing Device rules permit many potential Section 355 transaction even though many such transactions involve distributions of publicly traded stock which can easily be sold in the public markets, any new guidance would need to be appropriately targeted and circumscribed, as discussed below.

(b) Parameters for Guidance

One could posit that the distinction that the Device regulations draw between Qualifying Business Assets, on the one hand, and everything else, on the other hand,[120] obscures the qualitative difference between Investment Assets, on the one hand, and assets that are used in a trade or business but that are not Qualifying Business Assets (such assets that are used in a trade or business but are not Qualifying Business Assets, "**Non-Qualifying Business Assets**"). Distributions involving substantial and disproportionate Investment Assets are more troublesome than transactions involving Non-Qualifying Business Assets. Thus, if guidance is issued, the guidance could include examples or principles that pertain specifically to Investment Assets as distinguished from the more general category of assets that are not Qualifying Business Assets and take into account the extent to which there is a business purpose relating specifically to the allocation of Investment Assets as distinguished from the more general category of assets that are not Qualifying Business Assets.

If the Service chooses to issue guidance, the Service should be mindful that most real world situations will not be as extreme as Examples 1 or 2. Indeed, the existing Regulations embody several principles that any new guidance should acknowledge. First, the existing Regulations accept an allocation of cash and marketable securities not in excess of the reasonable needs of the business.[121] Second, the existing Regulations accept an allocation of cash and marketable securities in proportion to the value of the respective businesses.[122] These are both sensible principles that should be reflected in any new guidance dealing specifically with Investment Assets.

[118] Gregory, *supra* note 7, at 469.

[119] Remarks of Sen. Hubert H. Humphrey, *supra* notes 43 and 44.

[120] *See* Treas. Reg. § 1.355-2(d)(2)(iv).

[121] Treas. Reg. § 1.355-2(d)(2)(iv)(B); (d)(4), Examples (2) and (3).

[122] *Id.* at (d)(4), Example (2).

As to reasonable needs of the business, an example would be Investment Assets held to pay suppliers or to assure suppliers of the creditworthiness of the business. Another case would be a scenario where the Investment Assets consist of receivables arising in the ordinary course of the trade or business of one of the two companies. In that case, it would seem appropriate to allow those receivables to go with that company, as that company will be in a better position to collect the receivables, has a business relationship with the obligors and is the appropriate company to take the risk of non-collection. (In Part IX.A, as an alternative, we recommend that these receivables not be considered Investment Assets in the first place.)

As to the concept of allocating Investment Assets proportionately, consistent with the existing Regulations' approval of cash and marketable securities allocated in proportion to the size of the businesses, we believe that a division of Investment Assets between Distributing and Controlled in accordance with an objective and independent metric such as relative fair market value of Distributing and Controlled, earnings or revenue should be permitted. Distributing may have substantial Investment Assets on its balance sheet and needs to put them somewhere. It may be that any division of those Investment Assets will be arbitrary and unsupported by a business purpose. Dividing them between Distributing and Controlled in accordance with such a metric seems appropriate as something must be done with the Investment Assets in the distribution.

One could argue to the contrary, namely, that if Investment Assets are large enough, the transaction should be outside Section 355 (or should be subject to Section 337(d) guidance) even if the Investment Assets are allocated proportionately between Distributing and Controlled. Consider the following example:

> Example 4. *Proportionate Allocation of Investment Assets.* Distributing owns Qualifying Business Assets A worth 5, Qualifying Business Assets B worth 5 and Investment Assets (unrelated to either set of Qualifying Business Assets) worth 30. Distributing forms Controlled, contributing Qualifying Business Assets B and 15 of Investment Assets. Distributing thus winds up owning 5 of Qualifying Business Assets A and 15 of Investment Assets, while Controlled owns 5 of Qualifying Business Assets B and 15 of Investment Assets. There is no business purpose supporting the allocation of any of the Investment Assets to either company. Instead, the Investment Assets are allocated in proportion to the fair market values, respectively, of the gross assets (other than Investment Assets) of Distributing and Controlled.

Considering Example 4 under the Substantial Investment Assets No-Rule, the ratio of Investment Asset Ratios is 1:1. Thus, the 3:1 Ratio Prong is not satisfied. Indeed, as well, in each company, the Qualifying Business Assets are worth 33 1/3 percent of its Investment Assets. Thus, the 10 Percent Prong is not satisfied either. Only the Two-Thirds Prong is met, as the

Investment Assets constitute three-fourths of the value of the total gross assets of each of Distributing and Controlled.

It does not seem that Example 4 should be precluded from Section 355 treatment. It may be that Distributing is subject to the accumulated earnings tax of Section 531, but that is arguably not a policy issue that should be monitored by Section 355.

Further, if the Service chooses to promulgate guidance that relates specifically to Investment Assets, a safe harbor should apply that establishes a ratio of Investment Assets to total assets below which any special rules relating to Investment Assets would not apply. As well, guidance should establish a ratio of Investment Asset Ratios below which any special rules would not apply. Indeed, the Substantial Investment Assets No-Rule in effect creates such safe harbors in applying only if each of the Two-Thirds Prong, the 3:1 Ratio Prong and the 10 Percent Prong is satisfied. Some corporations hold substantial amounts of cash and liquid assets. This has a stabilizing effect on their business and can be deployed strategically, for example, to acquire competitors. Some of these assets are located overseas in foreign subsidiaries and cannot be accessed in the United States without incurring significant taxes. Such a safe harbor would not give companies *carte blanche* to engage in transactions typified by Example 1 or 2, but would provide much-needed certainty for otherwise business-motivated Section 355 transactions, even if set at a threshold below the two-thirds ratio in the Substantial Investment Assets No-Rule.

Furthermore, guidance could take into account differences in nature of Investment Assets. For example, if Investment Assets consist of cash and stock of a single issuer, the business purpose underlying the division of those Investment Assets ought to account for how those particular types of Investment Assets are allocated. In Example 4, suppose that the Investment Assets that go to Controlled consist of stock of a single issuer (as in Example 3), while the Investment Assets that go to Distributing consist of cash. While we are not certain that this is a particularly realistic scenario, one could envision special rules to address it.

Also worth considering is whether guidance should take account of the types of assets held by Distributing and Controlled that are neither Investment Assets nor Qualifying Business Assets. In addition to those categories are at least two other categories. One is the category of Non-Qualifying Business Assets. Another category consists of assets that are not used in a trade or business and are not Investment Assets. Real estate or commodities may be in this category. One could consider giving "credit" for Non-Qualifying Business Assets, as these tend to be the most sympathetic, second only to Qualifying Business Assets.

VI. THE ATB REQUIREMENT

Another possible way to address transactions involving substantial and disproportionate investment assets would be to strengthen the ATB Requirement through the adoption of a *de*

minimis requirement. However, we believe that a better approach would be to consider guidance along the lines discussed in Part V above regarding substantial Investment Assets.

As discussed below, the ATB Requirement has long led a double life, sometimes functioning as little more than a formality and, at other times, expressing a core principle of Section 355. We believe that Section 355(b) does reflect a core principle of Section 355, namely, that Section 355 is meant to apply to genuine separations of businesses. We believe that Section 355(b) should not function as a formality and thereby be read out of the Code. Nevertheless, we do not believe that the ATB Requirement needs to be strengthened through adoption of a *de minimis* threshold. Instead, we believe that any new guidance should focus on substantial Investment Assets, as discussed above in Part V.

A. Purposes of the ATB Requirement

The ATB Requirement serves the purpose articulated in Treasury Regulation Section 1.355-1(b) to the effect that Section 355 is meant to apply to a "separation . . . of one or more existing businesses formerly operated, directly or indirectly, by a single corporation . . . ." As well, the ATB Requirement serves the purpose articulated in Treasury Regulation Section 1.355-1(b) to the effect that "Section 355 contemplates the continued operation of the business or businesses existing prior to the separation." Likewise, Section 355(b) itself requires that each of Distributing and Controlled be engaged in the active conduct of a trade or business "immediately after" the distribution. When the ATB Requirement was first introduced in the 1951 Act, it required that there be an "intention" for each of Distributing and Controlled to continue an active trade or business following the distribution. Some commentators view the ATB Requirement as a substitute for the continuity of business enterprise requirement ("**COBE**") generally applicable to reorganizations.[123]

B. Double Life of the ATB Requirement

Since the 1951 enactment of the "two active business" rule, the statute has not expressly required any specific size for the active trade or business. For a time, the Service required that at

[123] *See, e.g.,* Thomas F. Wessel *et al.*, *Corporate Distributions Under Section 355*, PRACTISING LAW INSTITUTE, 3 THE CORPORATE TAX PRACTICE SERIES: TAX STRATEGIES FOR CORPORATE ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATIONS & RESTRUCTURINGS 3 (2015) (stating that it is "unclear" whether a COBE requirement applies under Section 355 and that the authors understand that the Service's position is that satisfaction of the ATB Requirement is instead sufficient). *See also* T.D. 8760, 63 Fed. Reg. 4174 (Jan. 23, 1998) (refraining from applying final COBE regulations to Section 368(a)(1)(D) or 355 transactions); Murray, *supra* note 45 (stating that COBE is "not considered" by the Service when analyzing Section 355 ruling requests, which instead considers the ATB Requirement) (citations omitted).

least 50 percent of the assets of Distributing and Controlled, respectively, had to be Qualifying Business Assets.[124] But, the Service backed off that position, stating in Revenue Ruling 73-44 that the Code and Regulations:

> require only that the distributing and controlled corporations must each be engaged in the active conduct of a trade or business. There is no requirement in section 355(b) that a specific percentage of the corporation's assets be devoted to the active conduct of a trade or business.[125]

Revenue Ruling 73-44 has been interpreted to mean that the proverbial "candy store" satisfies the ATB Requirement. Furthermore, as discussed below, prior to the enactment of the SAG rules in 2006, satisfaction of the ATB Requirement was highly formalistic in that Qualifying Business Assets had to be located in particular entities within the group. Where Congress has addressed perceived abuses of Section 355 in distributions typified by relatively small ATBs, it has not pursued proposals that would impose a minimum ATB Requirement.[126]

Yet, the ATB Requirement persists. It is in the statute, indeed in some detail. And the legislative history, as discussed in Part IV above, confirms that it is meant to be a meaningful backstop to the Device Requirement. Congress has amended the text of the ATB Requirement several times, suggesting that it considers the requirement to be more than a formality.[127] Indeed,

[124] *See* Rev. Rul. 58-68, 1958-1 C.B. 183 (holding that the contribution by Distributing to Controlled of Controlled debt meant that the active business requirement was not met as the contribution resulted in a more than 100 percent increase in Controlled's net worth). Revenue Ruling 64-102, 1964-1 C.B. 136, distinguished and modified Revenue Ruling 58-68 to remove the implication that the ATB Requirement can never be met where more than 50 percent of the assets of Controlled were acquired by a capital contribution as part of the plan. Revenue Ruling 64-102 involved a non-*pro rata* distribution that was not a Device. Revenue Ruling 83-114, 1983-2 C.B. 66, revoked Revenue Ruling 58-68 and applied a "facts and circumstances" test to conclude that a transaction similar to that in Revenue Ruling 58-68 was not a Device. *See infra* text accompanying note 140 for a discussion of Rev. Rul. 83-114.

[125] Rev. Rul. 73-44, 1973-1 C.B. 182. *See also* Priv. Ltr. Rul. 8712019 (Dec. 18, 1986) (where only six percent of the assets of Controlled was sufficient); G.C.M. 31799 (Sept. 29, 1960) (where two percent of book value of assets was sufficient in a non-*pro rata* distribution that could not be a Device); Lisa M. Nadal, *IRS Official Discusses New Controlled Firm Stock Regs*, 2007 TAX NOTES 94-12 (May 15, 2007) (describing Internal Revenue Service Associate Chief Counsel public statement that the ATB Requirement is "qualitative, not quantitative").

[126] *See, e.g.*, STAFF OF THE JOINT COMMITTEE ON TAXATION, OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES, JCS 02-05, Part V.C, at 156, *reprinted in* TAX NOTES TODAY, 2005 TNT 18-18, (DOC 2005-1714) (Jan. 29, 2005) (discussing the possibility of increasing the active business requirement to 50 percent).

[127] *See* Omnibus Budget Reconciliation Act of 1987, PUB. L. NO. 100-203, 101 STAT. 1330, 1330-411 (1987); Technical and Miscellaneous Revenue Act of 1988, PUB. L. NO. 100-647, 102 STAT. 3342, 3605 (1988);

without a minimum size requirement, one may question whether the ATB Requirement serves any purpose at all. In that vein, the Service has expressed the view that ATBs that are small relative to the overall gross assets of the corporation may present evidence of Device.[128]

Furthermore, Revenue Ruling 73-44 might not support an interpretation that a *de minimis* ATB is sufficient. First, in the ruling, the relevant Qualifying Business Assets "represented a substantial portion" of the value of Controlled's total assets, but less than half of that value. Thus, the holding of the ruling applies only to an ATB representing a "substantial portion" of the assets of the relevant company. Second, the ruling was grappling with whether an ATB had to represent at least half of the company's assets, not with whether a *de minimis* ATB was adequate. The ruling concludes that less than half is adequate:

> In the instant case, therefore, it is not controlling for purposes of the active business requirement that the active business assets of the controlled corporation, Y, represent less than half of the value of the controlled corporation immediately after the distribution.

The facts of the ruling do not raise the question whether an ATB that is less than substantial would be adequate. Third, the statement that a "specific percentage" is not required could mean that the statutory minimum is not meant to be expressed as a flat numerical percentage. It does not necessarily mean that an ATB that is less than "substantial" is adequate.

C. Potential *De Minimis* Requirement

From one perspective, the ATB Requirement should be bolstered so that it serves as a meaningful requirement, limiting Section 355 to separations of businesses, not a mere formality. Congress legislated that Distributing and Controlled should each have a five-year ATB and that requirement should not in effect be read out of the Code by permitting the proverbial "candy store" to satisfy. Furthermore, the more robust the Qualifying Business Assets in Distributing and Controlled, the more likely that the other elements of Section 355 policy are being complied with. ATB size is a good proxy for business purpose, non-Device and absence of circumvention

Tax Increase Prevention and Reconciliation Act of 2005, PUB. L. NO. 109-222, 120 STAT. 345, 348 (2006); Tax Relief and Health Care Act of 2006, PUB. L. NO. 109-432, 120 STAT. 2922, 2963 (2006); and Tax Technical Corrections Act of 2007, PUB. L. NO. 110-172, 121 STAT. 2473, 2476 (2007).

[128] *See, e.g.*, Rev. Rul. 73-44, 1973-1 C.B. 182 (noting that the percentage of the corporation's assets devoted to the active conduct of a trade or business is a "relevant factor" in determining whether the transaction is a Device); G.C.M. 34238 (Dec. 15, 1969), *underlying* Rev. Rul. 73-44 (stating the Service's position that there is "no requirement that a specific percentage of a corporation's assets be devoted to the active conduct of a trade or business" in order to satisfy the ATB Requirement but noting that "the relevancy of the proportion of active business assets required for a spin-off varies with the possibility that the transaction is being used principally as a" Device).

of *General Utilities* repeal. Indeed, the Device regulations already take into account the relative size of the Qualifying Business Assets relied upon by each of Distributing and Controlled.[129]

In support of bolstering the ATB Requirement, one could argue that changes in the rules governing the ATB Requirement have made it easier to satisfy the ATB Requirement, doing away with the most formalistic and burdensome aspects of the requirement, and that therefore it is appropriate to strengthen the ATB Requirement. In 2006, Congress enacted Section 355(b)(3), which treats all members of a corporation's SAG as a single corporation for purposes of the ATB Requirement, and thus eliminated a significant formality that had been inherent in the ATB Requirement. Prior to the enactment of the SAG rules, the ATB Requirement was tested on an entity-by-entity basis. A corporation was treated as engaged in the active conduct of a trade or business only if it *directly* engaged in such conduct, or if "substantially all"[130] of its assets consisted of stock or securities of a corporation or corporations engaged in the active conduct of a trade or business (the so-called "holding company" test).[131] The SAG rules have made the ATB Requirement more flexible, and thus the Service and the Treasury now suggest that distributions involving small ATBs "may have become less justifiable."[132]

On the other hand, an argument could be made that any new rules imposing a *de minimis* test could serve as a roadblock for spins that are generally consistent with the policies of Section 355. Consider the following transaction:

> Example 5. *De Minimis Qualifying Business Assets; Substantial Non-Qualifying Business Assets*. Distributing contributes to Controlled Qualifying Business Assets the fair market value of which constitutes a *de minimis* amount of the fair market value of the gross assets of Controlled. Distributing also contributes to Controlled assets associated with a business that was acquired for cash by Distributing fewer than five years before the distribution of Controlled. These assets constitute the balance of the fair market value of the gross assets of Controlled. The acquisition of that business was not part of the plan with the distribution.

Example 5 reveals a pitfall of adopting a *de minimis* threshold for the ATB Requirement. In this example, there is no special concern with regard to *General Utilities* repeal, the Device

[129] Treas. Reg. § 1.355-2(d)(2)(iv)(B).

[130] For ruling purposes, "substantially all" meant at least 90 percent of the gross assets of a corporation. *See* Rev. Proc. 77-37, 1977-2 C.B. 568; *see also* Rev. Proc. 86-41, 1986-2 C.B. 716.

[131] The Service, on the other hand, showed flexibility where it could by permitting members of a consolidated group to "borrow" employees from other members of the consolidated group for purposes of satisfying the ATB Requirement. *See* Rev. Rul. 80-181, 1980-2 C.B. 121 and Rev. Rul. 79-394, 1979-2 C.B. 141.

[132] Notice 2015-59, § 2.

Requirement, or business purpose. Moreover, the spin involves only assets of businesses actively conducted. The complication comes from the five-year requirement, in that the business assets acquired fewer than five years before the distribution cannot be used to satisfy the ATB Requirement. Thus, if a *de minimis* active trade or business rule were imposed, this transaction might not qualify, even though this transaction is arguably more consistent with the policy of Section 355 than a transaction involving slightly more than a *de minimis* active trade or business but that involves a substantial amount of cash or other Investment Assets. It seems odd that the five-year timing rule would drive such a perilous result.[133]

Some fact patterns involving *de minimis* Qualifying Business Assets are stronger than others. On the spectrum, a *de minimis* amount of Qualifying Business Assets coupled with only Investment Assets would seem generally to be a worst case from a Section 355 policy perspective (but such a case would likely also be caught by Device test, the business purpose requirement or the Substantial Investment Asset guidance discussed above in Part V.B). Next would be a *de minimis* amount of Qualifying Business Assets coupled with passive assets that are not Investment Assets, such as real estate or commodities in certain circumstances. Example 5 demonstrates that the focus in such cases is more aptly applied to the nature of the assets that are not Qualifying Business Assets, not the relative size of the Qualifying Business Assets.

A *de minimis* threshold would raise a host of new issues, as well, such 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. Moreover, existing law already addresses the issues raised by reliance on a relatively small ATB, both through the Device regulations and the business purpose requirement.

Reliance on a *de minimis* threshold would also exacerbate the pressure on the expansion doctrine. Under current law, the ATB Requirement permits expansions of a business by cash acquisition within the five years prior to the distribution. But this raises the question whether an acquired business is an expansion of Distributing's historic business or a different business altogether. It is not clear that so much should turn on this question. By the same token, organic changes in a business might rise to the level of a new business or might not, creating a similar issue in what is perhaps an even more sympathetic case.

[133] *See* Charles S. Whitman, III, *Draining the Serbonian Bog: A New Approach To Corporate Separations Under The 1954 Code*, 81 HARV. L. REV. 1194, 1208 (1968) (arguing that while the five-year requirement was intended as a "*cordon sanitaire* to prevent" immediate bailouts, it turned out to be "an irrational and inequitable conception").

We believe that, instead of imposing a *de minimis* threshold, consideration should be given to guidance addressing substantial and disproportionate appreciated Investment Assets, as discussed above in Part V.B.

VII. INTRA-GROUP DISTRIBUTIONS

A. Intra-Group Distributions Preparatory to an External Spin

If guidance is issued, it should embody an exception along the lines of the Intra-Group Distribution Exception. Such an exception should apply, as it appears to apply in the Substantial Investment Assets No-Rule, to intra-group distributions that are preparatory to an external distribution that satisfies the rules relating to Investment Assets. Many spin-offs, especially those undertaken by public companies, require a considerable amount of internal restructuring to align the group's assets and businesses prior to the external distribution. Where there is substantial built-in gain in assets or subsidiary stock, a taxpayer will often seek to use tax-free means of moving assets and subsidiaries around its group in order to avoid creating deferred intercompany gain which would be triggered as a result of the external distribution.[134] In many cases, assets move up the chain of ownership in a series of Section 368(a)(1)(D)/355 transactions. Without an exception for intra-group distributions that are preparatory to an external distribution, it is likely that many internal distributions could be caught by the Substantial Investment Asset No-Rule, the *De Minimis* ATB No-Rule or guidance along such lines, creating uncertainty as to the tax-free qualification of the overall transaction.

In addition, we do not view an exception for intra-group distributions that are preparatory to an external distribution as implicating the concerns expressed in the Notice regarding Device, business purpose and *General Utilities* repeal. Where an internal distribution is preparatory to an external distribution, only the external distribution is generally relevant to the question of whether the overall series of transactions is a Device or a circumvention of *General Utilities* repeal or has an adequate business purpose.

As written, the Intra-Group Exception is consistent with that view. We understand that the Service might not be applying the Intra-Group Distribution Exception in this manner, however. In particular, we understand that, in certain cases where internal distributions were preparatory to an external distribution, the Service applied the no-rule guidance at each level, and not solely to the external distribution. We believe that such an application of the Intra-Group Distribution Exception is inconsistent with the literal language of the Revenue Procedure.

[134] *See generall*y Treas. Reg. § 1.1502-13.

B. Intra-Group Distributions Not Preparatory to an External Spin

The following example involving an intra-group distribution that is not preparatory to an external distribution highlights an intersection of *General Utilities* repeal concerns and Device concerns relating to basis. As shown with this example, in contrast with the apparent approach of the Revenue Procedure, intra-group distributions that are not preparatory to an external distribution should not automatically be excluded from guidance regarding Investment Assets or *de minimis* ATBs:

> 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, not as part of the plan with the distribution, an acquiror acquires Controlled from Parent for cash.

In Example 6, Parent's high basis in Distributing is allocated between Parent's stock in Distributing and Controlled after the distribution in accordance with their relative fair market values. Thus, Parent's disposition of Controlled to the acquiror gives rise to less gain than Distributing's sale of the Investment Assets would have given rise to. One could argue that this transaction does not present a *General Utilities* repeal concern in that the Investment Assets remain in corporate solution in the hands of Controlled. However, as discussed above, we believe on balance that this example does raise such a concern. The Investment Assets have been transferred from Distributing's corporate group to the acquiror's group without corporate-level tax. While it is true that no step-up has occurred, permitting Example 6 would undercut *General Utilities* repeal. The Example also presents a Device concern as the transaction appears to be a device to effect a recovery of basis rather than a true separation of businesses.

The Intra-Group Distribution Exception should not apply to Example 6. As written, however, it would appear that the Intra-Group Distribution Exception does apply to Example 6.

VIII. THE "PRINCIPAL PURPOSE" EXCEPTION

We believe that the Principal Purpose Exception is too blunt. Whether an acquisition of non-Investment Assets should be a problem depends on whether the transaction is, in effect, a purchase by the corporation of non-Investment Assets for or on behalf of the shareholders. If the corporation distributed Investment Assets to shareholders who used the Investment Assets to buy non-Investment Assets, the shareholders would realize dividend income. That result should not be able to be avoided by having the corporation purchase those assets for the shareholders,

package them in Controlled and distribute Controlled to shareholders. But, many transactions in which Distributing uses Investment Assets to purchase non-Investment Assets do not have this quality of the corporation purchasing non-Investment Assets for the shareholders, even if the purchase is part of the plan with the distribution. In many cases, the shareholders are not "calling the shots" and have no discretion as to the purchase. Thus, we do not believe that acquisitions undertaken pursuant to the plan with a principal purpose of achieving an acceptable composition of assets in Distributing or Controlled should always run afoul of whatever Investment Asset guidance may be promulgated.

A. Relationship with Intra-Group Distribution Exception

First, the relationship between the Principal Purpose Exception (or any variation thereof) and the Intra-Group Distribution Exception should be clarified. The Principal Purpose Exception should not taint internal distributions on account of transfers of assets historically held within the Section 243 Affiliated Group. On the other hand, if assets are acquired prior to an internal distribution that is preparatory to an external distribution and they are acquired from outside the Section 243 Affiliated Group in a manner that runs afoul of the Principal Purpose Exception, a question arises whether the Principal Purpose Exception taints only the internal distribution, only the external distribution or both.

B. Allocation of Existing Assets

Second, in any distribution, decisions are made as to which assets should go to Controlled and which should stay with Distributing. If Distributing owns significant Investment Assets, a decision will have to be made as to whether the Investment Assets stay or go in whole or in part. In many cases, that decision will be made in a manner that aims to stay outside substantial Investment Asset guidance. Taxpayers should not be penalized for doing so. Thus, allocating existing assets held by Distributing or its subsidiaries between Distributing and Controlled should not be subject to the Principal Purpose Exception (or variation thereof).

C. Dispositions with a "Bad" Principal Purpose

Third, the Principal Purpose Exception applies to dispositions of Investment Assets even in the absence of an acquisition of non-Investment Assets, yet the case for penalizing dispositions that are not accompanied by an acquisition seems weak. Consider the following:

> Example 7. *Disposition of Investment Assets; No Acquisition of Non-Investment Assets.* Same facts as Example 2, except that, in order to avoid being under the guidance relating to substantial Investment Assets, Distributing sells a sufficient quantity of Investment Assets and uses the proceeds either for a Section

> 301 distribution to Distributing's shareholders, share buybacks or payments to creditors.

The fact that the appreciated Investment Assets are sold and corporate tax incurred on the gain would seem to address concerns over *General Utilities* repeal avoidance. As to Device, a distribution to shareholders under Section 301 would address Device concerns. A payment to creditors does not seem to implicate Device. A share buyback within the usual parameters for share buybacks[135] does not seem to raise special concerns. Furthermore, the transitory ownership concern discussed below in connection with Example 8 does not apply in Example 7. In Example 7, once the Investment Assets are sold and the cash distributed, there is nothing either Distributing or Controlled can do to turn back the clock.

D. Acquisitions with a "Bad" Principal Purpose

Going to the heart of the Principal Purpose Exception, the question arises how to account for non-Investment Assets acquired using Investment Assets as part of the plan with the spin. Consider the following:

> Example 8. *Acquisition of Business Assets with a "Bad" Principal Purpose*. Same facts as Example 2, except that, to avoid the application of Investment Asset guidance, Distributing disposes of sufficient Investment Assets for cash and uses the cash to acquire Non-Qualifying Business Assets. Distributing contributes the Non-Qualifying Business Assets and the remaining Investment Assets to Controlled in addition to contributing a small amount of Qualifying Business Assets and distributes the stock of Controlled *pro rata* to Distributing's shareholders.

One could argue that Example 8 raises Device concerns on the view that the steps could have happened in a different order. The transaction could in theory have been accomplished by the following steps: Distributing distributes some Investment Assets to its shareholders; Distributing contributes the Qualifying Business Assets and remaining Investment Assets to Controlled; Distributing distributes Controlled to Distributing's shareholders; and then the shareholders buy the Non-Qualifying Business Assets (using the Investment Assets that were distributed to them, or the proceeds of the sale of those Investment Assets) and contribute them to Controlled. In such a case, the receipt of the Investment Assets would be dividend income to the shareholders (up to the amount of earnings and profits). Indeed, in Treasury Regulation § 1.355-2(d)(4), Example (4), the Service held a distribution to be a Device where, instead of Distributing contributing cash to Controlled (which would have been a Device), Distributing

[135] *See* Rev. Proc. 96-30.

purchased operating assets unrelated to Controlled's other business and contributed those operating assets to Controlled.

A further concern could be that Controlled's ownership of the Non-Qualifying Business Assets is meant to be transitory as those assets were acquired as part of the plan in order to qualify the distribution under Section 355. Controlled might intend to sell the Non-Qualifying Business Assets and reinvest in Investment Assets furthering Device concerns.

Indeed, these types of Device concerns seem to lie behind the five year requirements of Sections 355(b)(2)(B), 355(b)(2)(C) and 355(b)(2)(D). Section 355(b)(2)(B) requires that the trade or business relied upon to satisfy the ATB Requirement have been conducted for the five-year period ending on the date of distribution, thus preventing a corporation from temporarily investing its excess Investment Assets in a new business. Sections 355(b)(2)(C) and (b)(2)(D), meanwhile, prevent a corporation from satisfying the five-year requirement by purchasing, respectively, in a transaction in which gain or loss is recognized, an active trade or business with a five-year operating history or control of a corporation conducting such a business.[136] The permission under these provisions to acquire an active trade or business in a nonrecognition transaction suggests that Congress was concerned about acquisitions of a business using excess cash, which would appear to be a Device concern.

We agree that a temporary investment of Investment Assets in Non-Qualifying Business Assets only to have those Non-Qualifying Business Assets resold does not assuage Device or other concerns. But, transitory ownership would be a concern in any distribution in measuring values of the various categories of assets. Regardless of whether a company had to tailor its way out of the no-rules or other guidance in the first place, the company could dispose of assets after the transaction. We believe that the various tests and metrics should be analyzed on the basis of assets that are meant to be held indefinitely (or disposed of in the ordinary course of business) regardless of when they were acquired.

If the ownership of the Non-Qualifying Business Assets is not transitory, we do not believe that the fact that the steps could, in theory, have occurred in a different order means the transaction is a Device. Buying Non-Qualifying Business Assets is generally an involved undertaking. Numerous "frictions" would normally get in the way of structuring the transaction as a distribution of Investment Assets followed by an acquisition of the Non-Qualifying Business Assets. Thus, it is too quick to say that in all cases the transaction is a Device because the steps

[136] *See* G.C.M. 35476, *supra* note 45 (arguing that the five-year requirement was intended to diminish the incentive to use a new trade or business for tax avoidance purposes and that Section 355(b)(2)(C) and (D) were intended to prevent Distributing from purchasing a business which had been in existence for over five years and then distributing its stock in place of a dividend).

could have been reversed. We would expect that in most cases, the steps could not have been reversed as a third party is involved.

On some facts, though, an acquisition as part of the plan could be evidence of Device. For example, in a closely held context with a single shareholder or a unified shareholder group, one could envision a situation where the shareholders tell Distributing what assets they would like to own, and Distributing goes out and purchases these at the behest of the shareholders using Distributing's Investment Assets. The third-party seller does not care, on these facts, whether it sells to Distributing, Controlled or the shareholders. Further, in the private company context, it may be difficult to prove that the purchase was not at the request or direction of the shareholders because, presumably, it will at least be at the request of a majority of the shareholders, even if the other shareholders are indifferent to or unhappy with such acquisition. Even on these facts, though, it is not entirely clear that the transaction should be viewed as a Device, as the Non-Qualifying Business Assets only have value through their continued management in corporate solution. The shareholders cannot access or consume them in the same way they can a pool of Investment Assets.

In the case of a public company, it seems strained to view Distributing as buying assets for the shareholders to own through Controlled (even if an activist shareholder has advocated purchasing certain assets). In a public company, most or all shareholders would have little or no voice or sway over what is purchased. An acquisition done at the request of an acquiror in a reverse *Morris Trust* transaction or an acquisition and spin-off that are cross-conditioned could raise abuse concerns, however.

A non-*pro rata* exchange involving a single shareholder or a unified group of shareholders presents a more likely context in which Distributing could be viewed as acquiring assets at the request of a shareholder.[137] But, that is generally the province of Section 355(g). Treasury already has a grant of regulatory authority under Section 355(g) to promulgate Regulations to carry out the purposes and prevent the avoidance of Section 355(g), including by treating "assets unrelated to the trade or business of a corporation as investment assets if, prior to the distribution, investment assets were used to acquire such unrelated assets."[138]

Further, as to corporate-level tax concerns, in some cases, the acquisition of the assets would be for cash. Accordingly, Distributing would be replacing one basis-equals-value asset (cash) with another fair market value-basis asset. As such, the distribution of Controlled does not look any worse (or better) from a *General Utilities* repeal perspective. If appreciated Investment

[137] N.Y.ST. BA. ASS'N, TAX SEC., Rep. No. 1131, *Report on Disqualified Investment Corporations as Defined in Section 355(g)* (Jul. 7, 2007).

[138] Section 355(g)(5)(A)(ii).

Assets are used to acquire the Non-Qualifying Business Assets, all the better from a *General Utilities* repeal perspective as the appreciation in the Investment Assets would be recognized.

It is not plain that a fact pattern like Example 8 should always fail Section 355 because, in some cases, both a business purpose and a purpose of reducing Investment Assets in favor of non-Investment Assets may be at play.[139] In Rev. Rul. 83-114,[140] Parent *P* cancelled indebtedness owed to it by a controlled subsidiary *S* immediately prior to distributing the stock of *S pro rata* to its shareholders in a Section 355 distribution. The debt forgiveness, which was treated as a capital contribution by *P* to *S* and appears to have been viewed as akin to a purchase of assets by *S* for purposes of the Device test, had the effect of more than doubling the net worth of *S*. The ruling explained that "[w]hile it was not necessary for *P* to cancel the indebtedness of *S* in order for *S* to continue its business," a major capital expansion planned by *S* made it "virtually impossible" that *S* would repay the debt. In spite of the evidence of Device presented by the cancellation of indebtedness, the Service observed that "it is necessary to look at all of the facts and circumstances surrounding the spin-off before it can be concluded that the stock distribution was used principally as a device." Based on the business reasons for the debt forgiveness and the distribution, the Service ruled that the transaction was not used principally as a Device. The general counsel memorandum underlying the ruling states that "the presence of a dominant, overriding business purpose makes it impossible to say that the spin-off was used principally as a Device for the distribution of earnings and profits."[141]

Admittedly, permitting a taxpayer to acquire Non-Qualifying Business Assets to avoid the application of substantial Investment Asset guidance is in tension with an aspect of the legislative evolution of Section 355. Recall that, under the 1951 Act, a taxpayer could satisfy the predecessor of the ATB Requirement by acquiring a business following the distribution. The 1954 Act eliminated this expedient and tightened the ATB Requirement by imposing the five-year historic active conduct requirement. Nevertheless, we believe that, on balance, if at the time of the distribution, Distributing and Controlled hold an appropriate composition of assets (and those assets are not held on a transitory basis), the fact that some or all of those assets were

[139] *See* T.D. 8238, 54 Fed. Reg. 283 (Jan. 5, 1989) (providing for weighing of evidence of device presented by a disproportionate allocation of assets that are not Qualifying Business Assets against corporate business purpose for that allocation). *See also* Rev. Rul. 86-4, 1986-1 C.B. 174 (clarifying that the business purpose underlying a transfer of assets not used in a trade or business needs to be considered in light of the business purpose underlying such transfer).

[140] 1983-2 C.B. 66.

[141] G.C.M. 36450 (Oct. 1, 1975). The significance of this Ruling is debatable, however. It may be that the reason that the transaction should not be viewed as a Device is that a cancellation of debt of Controlled owned by Distributing is less of a concern from a Device perspective than ownership of Investment Assets by Distributing or Controlled.

acquired with a "bad" principal purpose should not taint the distribution unless the assets are 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.

IX. MISCELLANEOUS

A. Definition of Investment Assets

As noted in Part II.F, the Revenue Procedure largely assimilates partnership interests to stock for purposes of defining Investment Assets. As well, the Revenue Procedure adopts look-through treatment for publicly traded subsidiaries only if they are at least 50 percent owned, as distinguished from the 20 percent owned threshold for subsidiaries that are not publicly traded.

To begin with, it is unclear how the ownership tests prescribed by the Revenue Procedure apply in the case of partnerships. Under the Revenue Procedure, Investment Asset status turns on whether Distributing or Controlled owns either 20 percent or 50 percent of the relevant partnership (other than a Reliance Partnership). Those 20 percent and 50 percent tests are set forth in Section 355(g)(2)(B)(iv)(III) which in turn refers to the ownership test in Section 1504(a)(2). Section 1504(a)(2) is a voting power and value test. Typically, tests regarding ownership of a partnership relate to ownership of capital and/or profits interests.

Second, it is worth noting that insofar as Example 3, involving stock of a single issuer, is a concern from a *General Utilities* repeal perspective on account of the potential to eliminate the corporate-level gain in the stock of the Issuer through an acquisition of Controlled by the Issuer, the concern is less distinct where the Issuer is a publicly traded partnership because Controlled cannot be merged into the Issuer without triggering corporate-level gain. The Issuer could acquire Controlled resulting in indefinitely held hook stock, however.

Third, it is debatable whether a large block of publicly traded stock (or partnership interests) should be treated differently from a large block of stock (or interests) of a corporation (or partnership) that is not publicly traded. In Example 3, the ability for Issuer (or a subsidiary of Issuer) to acquire Controlled after the distribution does not turn on the Issuer being publicly traded. On the other hand, the marketability of publicly traded stock (and partnership interests) arguably makes a distribution of Controlled holding a substantial amount of such assets look more like a Device. If Controlled owns a large block of publicly traded stock, then presumably Controlled stock may be readily converted to cash.

Fourth, all types of debt are Investment Assets. Certain exceptions should apply, however. The Service should clarify that debt of another member of the SAG is not an Investment Asset. The principle that all members of the SAG are treated as a single corporation supports this treatment. Further, debt that relates to a business of Distributing or Controlled, such

as receivables that arose in the ordinary course of its trade or business, should arguably not be considered an Investment Asset.[142] Finally, cash that is intended to be paid out to shareholders or creditors as part of the plan should not be considered an Investment Asset. Many Section 355 distributions aim to delever Distributing, consistent with reducing the asset base of Distributing pursuant to the transaction. Other Section 355 distributions contemplate a cash distribution to Distributing shareholders as part of the plan. In either case, cash may be held by Distributing for a period of time after the distribution prior to its being paid over to shareholders or creditors. As such payment over is part of the plan, the cash should not be taken into account in measuring Investment Assets of the company. We note that these recommendations are consistent with the New York State Bar Association's recommendations regarding the definition of "Investment Assets" for purposes of Section 355(g).[143]

B. Technical Clarification: Distributing or Controlled

Assuming the three-prong approach of the Substantial Investment Asset No-Rule is retained, the Service should clarify that the guidance applies solely to transactions in which either Distributing satisfies all three conditions or Controlled satisfies all three conditions. As drafted, the no-rule applies so long as the three conditions are satisfied, regardless of which entity satisfies which condition. A literal reading of the no-rule would result in it applying to a different type of transaction than that described in the Notice. Specifically, as pertains to substantial Investment Assets, the Notice characterizes the transactions of concern as those:

> that result in (i) the distributing corporation or the controlled corporation owning a substantial amount of cash, portfolio stock or securities, or other Investment Assets, in relation to the value of all of its assets and its Qualifying Business Assets, and (ii) one of the corporations having a significantly higher ratio of Investment Assets to Non-Investment Assets than the other corporation.

The clear implication of clause (i) is that Treasury and the Service were concerned with transactions where either Distributing or Controlled owned substantial amounts of Investment Assets relative both to such corporation's Total Assets and Qualifying Business Assets and meant for both conditions to be satisfied by the same corporation. Clause (ii) is not so clear cut. It could be read literally as saying that the corporation with the significantly higher Investment

[142] Alternatively, if such receivables are considered to be Investment Assets, they should be able to be allocated to the business that generated them under our recommendation, as discussed above in Part V.B.4.

[143] *Report on Disqualified Investment Corporations as Defined in Section 355(g)*, *supra* note 137.

Asset Ratio does not have to be the same one described in clause (i). We believe a more logical reading is that clauses (i) and (ii) characterize the same corporation.[144]

[144] *See* Amy S. Elliot, *IRS Official Gives Direct Answers To No-Rule Guidance Questions*, 149 TAX NOTES 25 (Oct. 5, 2015) (reporting a comment of a Service official that "the same corporation has to flunk all three tests.").