NEW YORK STATE BAR ASSOCIATION

One Elk Street, Albany, New York 12207 PH 518.463.3200 www.nysba.org

TAX SECTION

2021-2022 Executive Committee

GORDON E. WARNKE
Chair
KPMG LLP
560 Lexington Avenue
New York, NY 10022-7016
212/954-2458
ROBERT CASSANOS
First Vice-Chair
212/859-8278
PHILIP WAGMAN
Second Vice-Chair
212/878-3133
JIYEON LEE-LIM
Secretary
212/906-1298
COMMITTEE CHAIRS:
Attributes
Andrew Herman
Gary R. Scanlon
Bankruptcy and Operating Losses
Brian Krause
Stuart J. Goldring
Compliance, Practice & Procedure
Megan L. Brackney
Elliot Pisem
Consolidated Returns
William Alexander
Shane J. Kiggen
Corporations
Daniel Z. Altman
Michael T. Mollerus
Cross-Border Capital Markets
Craig M. Horowitz
Andrew R. Walker
Cross-Border M&A
Adam Kool
Ansgar A. Simon
Debt-Financing and Securitization
John T. Lutz
Michael B. Shulman
Estates and Trusts
Austin Bramwell
Alan S. Halperin
Financial Instruments
Lucy W. Farr
Jeffrey Maddrey
"Inbound" U.S. Activities of Foreign Taxpayers
Peter J. Connors
S. Eric Wang
Individuals
Elizabeth T. Kessenides
Brian C. Skarlatos
Investment Funds
James R. Brown
Pamela L. Endreny
New York City Taxes
Alysse McLoughlin
Irwin M. Slomka
New York State Taxes
Paul R. Comeau
Jack Trachtenberg
"Outbound" Foreign Activities of U.S. Taxpayers
William A. Curran
Kara L. Mungovan
Partnerships
Meyer H. Fedida
Amanda H. Nussbaum
Pass-Through Entities
Edward E. Gonzalez
David W. Mayo
Real Property
Marcy Geller
Jonathan R. Talansky
Reorganizations
Lawrence M. Garrett
Joshua M. Holmes
Spin-Offs
Tijana J. Dvornic
Peter A. Furci
Tax Exempt Entities
Dahlia B. Doumar
Stuart Rosow
Taxable Acquisitions
Richard M. Nugent
Sara B. Zablotney
Treaties and Intergovernmental Agreements
David R. Hardy
William L. McRae

MEMBERS-AT-LARGE OF EXECUTIVE COMMITTEE:

Lee E. Allison
Jennifer Alexander
Erin Cleary
Yvonne R. Cort
James L. Coss
Steven A. Dean
Jason R. Factor
Martin T. Hamilton
Eschi Rahimi-Laridjani
Yaron Z. Reich
David M. Rievman
Peter F. G. Schuur
Mark Schwed
Stephen E. Shay
Patrick E. Sigmon
Eric B. Sloan
Andrew P. Solomon
Linda Z. Swartz
Jennifer S. White
Ari M. Zak

Report No. 1454
January 11, 2022

The Honorable Lily Batchelder
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable Thomas C. West, Jr.
Deputy Assistant Secretary
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Mr. Krishna Vallabhaneni
Tax Legislative Counsel
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Re: Report No. 1454 – Report on the Section 355 Device Prohibition and Section 367(a)

Dear Mme. Batchelder and Messrs. West and Vallabhaneni:

I am pleased to submit our Report No. 1454 commenting on certain issues involving the interaction of the device prohibition of Section 355(a)(1)(B) and the gain recognition rules of Section 367(a).

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

Respectfully Submitted,

Gordon E. Warnke
Chair

FORMER CHAIRS OF SECTION:

Peter L. Faber
Alfred D. Youngwood
David Sachs
J. Roger Mentz
Willard B. Taylor
Richard J. Hiegel
Herbert L. Camp
Arthur A. Feder
James M. Peaslee
Peter C. Canellos
Michael L. Schler
Carolyn Joy Lee
Richard L. Reinhold
Steven C. Todrys
Harold R. Handler
Robert H. Scarborough
Samuel J. Dimon
Andrew N. Berg
Lewis R. Steinberg
David P. Hariton
Kimberly S. Blanchard
Patrick C. Gallagher
David S. Miller
Erika W. Nijenhuis
Peter H. Blessing
Jodi J. Schwartz
Andrew W. Needham
Diana L. Wollman
David H. Schnabel
Stephen B. Land
Michael S. Farber
Karen Gilbreath Sowell
Deborah L. Paul
Andrew H. Braiterman

Enclosure

Cc:

Peter Blessing
Associate Chief Counsel (International)
Internal Revenue Service

Colin Campbell
Chief Attorney-Advisor
Department of the Treasury (Office of Tax Policy)

Jose Murillo
Deputy Assistant Secretary
Department of the Treasury

Kevin Nichols
International Tax Counsel
Department of the Treasury (Office of Tax Policy)

The Honorable William M. Paul
Acting Chief Counsel
Internal Revenue Service

James Wang
Attorney-Advisor
Department of the Treasury (Office of Tax Policy)

Robert H. Wellen
Associate Chief Counsel (Corporate)
Internal Revenue Service

Brett York
Deputy Tax Legislative Counsel
Department of the Treasury

Brenda Zent
Special Advisor
Department of the Treasury (Office of Tax Policy)

Report No. 1454

New York State Bar Association Tax Section

Report on the Section 355 Device Prohibition and Section 367(a)

January 11, 2022

Contents

I. Introduction 1

II. Summary of Conclusion and Recommendations 3

III. Concerns Underlying the Device Prohibition 4

A. The Bail-Out Concern 4

B. The Basis Recovery Concern 6

IV. The Sale or Exchange Device Factor, the Reorganization Exception and Section 367(a) Transactions 9

A. The Sale or Exchange Device Factor 9

B. The Reorganization Exception 10

C. Application of the Reorganization Exception to Section 367(a) Acquisitions 11

V. Recommendation 16

New York State Bar Association Tax Section

Report on the Device Prohibition and Section 367(a)

I. INTRODUCTION

This report (the "**Report**")[1] of the Tax Section of the New York State Bar Association comments on the application of the device prohibition of Section[2] 355(a)(1)(B) (the "**Device Prohibition**," and a transaction that violates this prohibition, a "**Device**") to a transaction that otherwise qualifies under Section 355 (a "**Spin-Off**") and is followed by an acquisition of the distributing corporation ("**Distributing**") or the controlled corporation ("**Controlled**") by a foreign acquiror ("**Foreign Acquiror**"), where such acquisition otherwise qualifies as a tax-free reorganization but results in gain recognition to U.S. shareholders solely as a result of the application of Section 367(a) (a "**Section 367(a) Acquisition**"). Under the Device Prohibition, Section 355 will not apply to a Spin-Off that is used principally as a device for the distribution of the earnings and profits of Distributing or Controlled or both.[3] Applicable Treasury Regulations under Reg. § 1.355-2(d) (the "**Device Regulations**") provide a further gloss on the Device Prohibition, suggesting that Section 355 will not apply to a transaction that facilitates "the avoidance of the dividend provisions of the Code through a subsequent sale or exchange of stock of one corporation and the retention of the stock of another corporation."[4] In order to determine whether a transaction violates the Device Prohibition, various Device and non-Device factors specified in the Device Regulations are weighed. Although the Device Prohibition's logical and analytical framework have broader implications, this Report addresses the narrow question of whether gain recognition required by Section 367(a) should be a relevant factor in determining whether a Spin-Off that is followed by a Section 367(a) Acquisition is a Device. As described

---

[1] The principal author of this Report was Joshua Holmes with substantial contributions from Rachel Reisberg and Alex Ferrara. Helpful comments were provided by William Alexander, Andrew Braiterman, Peter Connors, Tijana Dvornic, Martin Hamilton, Jonathan Kushner, Stephen Land, Michael Mollerus, Richard Nugent, Deborah Paul, David Rievman, Amit Sachdeva, Michael Schler, David Sicular, Karen Sowell, Linda Swartz, Jonathan Talansky, Shun Tosaka and Gordon Warnke. This Report reflects solely the views of the Tax Section of the New York State Bar Association and not those of the New York State Bar Association's Executive Committee or its House of Delegates.

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

[3] Section 355(a)(1)(B).

[4] Reg. § 1.355-2(d)(1).

below, the Report recommends that the Treasury Department ("**Treasury**") and the Internal Revenue Service (the "**Service**," and, together with Treasury, the "**government**") issue appropriate guidance to provide that, in determining whether a Spin-Off followed by a Section 367(a) Acquisition is a Device, gain recognition resulting from the application of Section 367(a) is disregarded.

Such guidance is warranted because neither the Code nor the Treasury Regulations currently address the interaction between the Device Prohibition and Section 367(a). Further, there is no published guidance that addresses whether gain recognition under Section 367(a) is relevant to the Device analysis. The Service has not specifically ruled on this issue,[5] and government officials have publicly stated that this situation raises a difficult question.[6] As a result, taxpayers are left without statutory, regulatory, administrative, or judicial guidance and must make uncertain judgments as to how Device and non-Device factors will be applied and weighed in these circumstances. In transactions involving a pre-arranged Section 367(a) Acquisition following a Spin-Off, taxpayers are left with the unfortunate result that, in light of the inapplicability of the Reorganization Exception (as defined below), the sale or exchange pursuant to the Section 367(a) Acquisition will be substantial evidence of Device pursuant to the rules discussed below. The resulting impact on the weighing of the various Device and non-Device factors and the ultimate conclusion as to whether the Device Prohibition is violated is

---

[5] Two private letter rulings have involved Spin-Offs followed by Section 367(a) Acquisitions. In Private Letter Ruling 201232014 (Feb. 16, 2012), following a Spin-Off, Controlled was acquired by a Foreign Acquiror in an all-stock transaction intended to qualify as a reorganization under Section 368(a)(1)(B) and to which Section 367(a) applied. Distributing represented that (1) it did not have any knowledge of any plan or intention of any of its shareholders to "sell, exchange, transfer by gift or otherwise dispose" of stock in Foreign Acquiror (with an exception for ordinary market trading and similar activities) and (2) the transaction was not effected "for the purpose of or with a view to facilitating any sales of stock" of Foreign Acquiror by any Controlled shareholders after the acquisition. The Service issued a favorable ruling on the qualification of the Spin-Off under Section 355 (without ruling on the Device issue and other "no-rule" areas). Private Letter Ruling 201817001 (Jan. 26, 2018) addressed a similar situation in which, following a Spin-Off, a newly-formed domestic subsidiary of Foreign Acquiror acquired Controlled stock in exchange for Foreign Acquiror stock in a transaction intended to qualify as a reorganization under Section 368(a)(1)(B). Again, Section 367(a) required U.S. shareholders of Controlled to recognize gain on the exchange of Controlled stock for Foreign Acquiror stock. The Service declined to rule on the Device question and instead accepted a representation from Distributing that, taking into account the acquisition and required gain recognition under Section 367(a), the Spin-Off was not intended to be used principally as a Device.

[6] *See* Emily L. Foster, *Practitioners Urge Changes to Post-Spinoff Transaction Rules*, TAX NOTES FED. 1196 (Nov. 18, 2020) (quoting Robert Wellen at the University of Chicago Law School Federal Tax Conference on November 8, 2020 as stating "This issue is one of the poster children for the IRS decision to start ruling again on certain device issues").

uncertain at best. In fact, in recent years, there has been a divergence among tax advisors on whether (and at what confidence levels) opinions can be given regarding the qualification of Spin-Offs followed by Section 367(a) Acquisitions as tax-free under Section 355. Given that receipt of an opinion regarding the tax-free nature of a transaction is typically a closing condition for a Reverse *Morris Trust* transaction, such uncertainty has created a major commercial point of contention in negotiating closing conditions. In addition, because it is rarely, if ever, possible to restructure a transaction to avoid gain recognition under Section 367(a), such uncertainty impedes real and substantial potential transactions that would otherwise be undertaken for good and valid non-tax corporate business purposes.

In light of the lack of authority and resulting uncertainty, and for the reasons discussed in this Report, we believe that regulatory or other guidance would not only be appropriate and welcome but also is necessary to bring clarity to an important unanswered legal question underpinning oft-considered cross border transactions. We understand that the government is conducting a general assessment of the Device Regulations and the Treasury Regulations relating to the active trade or business requirement of Section 355. However, this Report recommends that, if release of amendments to the Device Regulations is not otherwise imminent, the government release narrowly tailored guidance on the interaction between the Device Prohibition and Section 367(a) in the interim. Such guidance would not interfere with the objectives of such general amendments and, for the reasons noted above, the quick release of such guidance would have an immediate impact on taxpayers' ability to undertake advantageous transactions.

II. Summary of Conclusion and Recommendations

As further outlined in this Report, we believe that gain recognition under Section 367(a) can be evidence of Device only to the extent the overall transaction implicates the same concerns that underlie the Device Prohibition. As discussed further in Part III of this Report, the Device Prohibition is intended to police a set of concerns unique to Section 355 and the historical application (and abuse) thereof. More specifically, the Device Prohibition is meant to prevent taxpayers from effecting a direct or indirect "bail-out" of corporate earnings and profits at capital gains rates, thus avoiding the dividend provisions of the Code (the "**Bail-Out Concern**"). In addition, the Device Prohibition targets transactions that deliver cash to shareholders in a basis recovery transaction in lieu of a dividend transaction (the "**Basis Recovery Concern**"). Accordingly, we believe that the *sine qua non* of a Device is (1) the direct or indirect movement of cash or other property out of corporate solution and into the hands of shareholders, (2) in a transaction that is not treated as a dividend for tax purposes, (3) where shareholders have effectively "cashed out" of all or a portion of their investment. As discussed in Part IV of this Report, Section 367(a) Acquisitions following Spin-Offs do not bear the hallmarks of a Device,

and the gain recognition required by Section 367(a) does not implicate the Bail-Out Concern or the Basis Recovery Concern.

For these reasons, we recommend that the government issue such guidance as is appropriate to provide that, in determining whether a Spin-Off followed by a Section 367(a) Acquisition is a Device, gain recognition resulting from the application of Section 367(a) is disregarded. As noted above, we understand that the government is currently considering general revisions to the Device Regulations. If the Device Regulations remain in their current form, we recommend that the government promulgate proposed or temporary regulations (and such other interim administrative guidance as may be appropriate) that would modify the Device Regulations to:

1. Clarify that, while a "device can include a transaction that effects a recovery of basis,"[7] the recovery of basis solely as a result of the application of Section 367(a) is not relevant to the application of Reg. § 1.355-2(d); and
2. Expand the rule in Reg. § 1.355-2(d)(2)(iii)(E) (the "**Reorganization Exception**"), pursuant to which a sale or exchange of Distributing or Controlled stock subsequent to a Spin-Off is disregarded for purposes of the device factor in Reg. § 1.355-2(d)(2)(iii) (the "**Sale or Exchange Device Factor**") if such stock is exchanged for stock in pursuance of a plan of reorganization and either no gain or loss or only an insubstantial amount of gain is recognized on the exchange, to also disregard gain recognized solely as a result of the application of Section 367(a) for purposes of applying the Reorganization Exception.

If the government believes that issuing such guidance would require a lengthy review, we recommend releasing interim guidance illustrating that a Reverse *Morris Trust* transaction involving a widely-held, publicly-traded domestic distributing corporation and a foreign acquiror, as described in Example 6 below, does not violate the Device Prohibition.

III. CONCERNS UNDERLYING THE DEVICE PROHIBITION

A. The Bail-Out Concern

Gregory v. Helvering is the archetypal example of a transaction raising the Bail-Out Concern; indeed, the Device Prohibition originated as a response to that transaction.[8] In

---

[7] Reg. § 1.355-2(d)(1).

[8] Gregory v. Helvering, 293 U.S. 465 (1935). *See also* N.Y. ST. BA. ASS'N, TAX SEC., *Report on Notice 2015-59 and Revenue Procedure 2015-43 Relating to Substantial Investment Assets, De Minimis Active Trades or Businesses and C-to-RIC Spin-Offs*, Report No. 1342 at 20-28 (Apr. 12, 2016) (discussing the concerns underlying the device prohibition).

Gregory, the taxpayer owned all of the stock of Distributing. Distributing, in addition to other assets, held a minority interest in Monitor Securities Corporation ("**Monitor**"). Mrs. Gregory desired to convert her indirect interest in Monitor into cash, but sought to avoid both corporate tax on the gain as well as dividend tax on the distribution of the proceeds. To that end, Mrs. Gregory caused Distributing to contribute its Monitor stock to Controlled and distribute the Controlled stock to her. Shortly after receipt thereof, and as part of a plan that included the distribution, Mrs. Gregory liquidated Controlled and sold the Monitor stock for cash. The Supreme Court took a dim view of the transaction, describing it as "[a]n operation having no business or corporate purpose—a ***mere device*** which put on the form of a corporate reorganization as a disguise for concealing its real character."[9] Deciding the case on substance over form grounds, the Supreme Court ultimately declined to allow Mrs. Gregory to accomplish indirectly what could not be accomplished directly. Accordingly, Mrs. Gregory was taxed as if Distributing had sold the Monitor stock for cash and paid her a dividend—an economically equivalent (and more natural and direct) recast of the original transaction.

Although the *Gregory* transaction would no longer pass muster for reasons other than the Device Prohibition, it is a useful prism through which to view the Bail-Out Concern. Consider the following example:

> Example 1. *Spin-Off + Sale for Cash.* Distributing is a widely held, publicly traded domestic corporation that conducts Business A and Business B. Distributing determines to separate Business A from Business B by forming a wholly-owned domestic subsidiary, Controlled, contributing to Controlled Business B, and distributing 100% of Controlled stock *pro rata* to the Distributing shareholders. As part of the plan that includes the distribution, an unrelated domestic corporation, X, acquires 100% of Controlled stock from the Controlled shareholders for cash. Without regard to the second-step acquisition, the distribution would have qualified under Section 355.

Like the transactions in *Gregory*, on its face, the transaction in Example 1 would not appear to implicate the Bail-Out Concern, narrowly construed: no cash or other property (save Business B, indirectly through the distribution of the stock of Controlled) has been removed from Distributing corporate solution and placed in the hands of its shareholders. (It would prove too much to say that the separation of Business B via the Spin-Off itself raises the Bail-Out Concern because, if so, *every* spin-off would, by definition, raise the Bail-Out Concern, even in the absence of a subsequent sale for cash.) Moreover, X, not Distributing, is the source of the cash—which would seem to support the conclusion that the transaction did not effect a bail-out of the earnings and profits of Distributing or Controlled. Unlike *Gregory*, the transactions in

---

9 *Id.* at 469 (emphasis added).

Example 1 lack the flavor of tax avoidance: Controlled's existence is not transitory, one operating business is being separated from another operating business (by hypothesis for a good and valid corporate business purpose), and the separated assets remain in corporate solution and do not find their way into the hands of shareholders.

However, as in *Gregory*, the possibility of an economically equivalent alternative transaction involving a sale for cash, coupled with a dividend, raises the specter of the Spin-Off being used to avoid the dividend provisions of the Code, thus giving rise to the Bail-Out Concern in Example 1. Consider the following alternative transaction:

> Example 2. *Corporate Sale of Business + Distribution of Cash.* Distributing is a widely held, publicly traded domestic corporation that conducts Business A and Business B. Distributing determines to separate Business A from Business B by selling Business B to an unrelated domestic corporation, X, for cash. Distributing distributes the cash proceeds *pro rata* to the Distributing shareholders.

The result of Example 2 is economically equivalent to the result of Example 1. In each case, the historic Distributing shareholders end up owning an indirect interest in Business A through their continuing ownership of Distributing and cash in an amount equal to the value of Business B. In the absence of the Device Prohibition, the parties in Example 1 would have successfully used the Spin-Off and subsequent sale to avoid the dividend provisions of the Code. Furthermore, the fungibility of cash blurs the distinction between the shareholders' receipt of cash from X in Example 1 (which seemingly does not effect a "bail out" of corporate assets) and the clear removal of Distributing's cash from corporate solution in Example 2. As a result of both transactions, X wholly owns Business B (either directly or indirectly through its ownership of Controlled) and, even if the acquisition were accomplished on a "cash-free" basis (i.e., Distributing retained all of the cash and liquid assets related or attributable to Business B), X would depend on Business B to replenish the cash paid, directly or indirectly, to Distributing's shareholders. If the cash paid to Distributing's shareholders is viewed as a corporate asset of Business B, both Examples 1 and 2 effect a direct or indirect distribution of Distributing's corporate assets and thus implicate the Bail-Out Concern. For this reason, the Device Regulations generally treat a sale or exchange negotiated or agreed upon before the Spin-Off as substantial evidence of Device.

B. The Basis Recovery Concern

Historically, the Device Prohibition was primarily concerned with the conversion of dividend income into capital gains. This focus on character conversion was originally animated by the large rate differential in place at the time the Device Prohibition was codified (with

dividends being taxed at much higher rates). Since moving to a unified rate regime for long-term capital gain and qualified dividend income, however, individual taxpayers' incentives to attempt to avoid the dividend provisions of the Code have been dramatically reduced. But those incentives still exist, albeit in muted form. Capital gain treatment, for example, affords shareholders the ability to utilize available capital losses to offset gain, and, for foreign shareholders, the difference between capital gain and dividend treatment is meaningful. Moreover, the basis allocation rules applicable to Spin-Offs will result in a portion of a shareholder's basis in Distributing stock being allocated to Controlled stock received in the Spin-Off.[10] Consequently, so long as a shareholder has some basis in its Distributing stock, gain on a subsequent sale of the Controlled stock will almost always be less than the amount of dividend income that would have been included had the Spin-Off been taxable (assuming Distributing has sufficient earnings and profits to cover the distribution). The 1989 amendment to the Device Regulations acknowledged this more limited potential for tax avoidance by adding that "[a] device can include a transaction that effects a recovery of basis."[11]

Although basis recovery is certainly a focus of the Device Prohibition, basis recovery is not, in and of itself, necessarily a Device, as evidenced by the use of the word "can" in the sentence quoted above. Indeed, a capital gain transaction associated with a Spin-Off is not alone sufficient to implicate the Device Prohibition; the Code and the Device Regulations acknowledge that, by definition, all Spin-Offs permit shareholders to dispose of Distributing or Controlled stock in capital gain/basis recovery transactions. Therefore, only certain transactions permitting "basis recovery" can be problematic from a device perspective (else all Spin-Offs, and especially public Spin-Offs where stock of the companies is an asset readily convertible into cash, would fail the Device Prohibition by facilitating stock sales by shareholders). Thus, the Code and Device Regulations make clear that the "mere fact" that shareholders undertake unplanned stock sales post-spin-off is not alone evidence of Device. Consider the following example:

> Example 3. *Spin-Off + Public Trading.* Distributing is a widely held, publicly traded domestic corporation that conducts Business A and Business B. Distributing determines to separate Business A from Business B by forming a wholly-owned domestic subsidiary, Controlled, contributing to Controlled Business B, and distributing 100% of Controlled stock *pro rata* to the Distributing shareholders in a transaction that otherwise qualifies under Section 355. The distribution is motivated by valid corporate business purposes. Within one month

---

[10] Reg. § 1.358-2(a)(2)(iv).

[11] T.D. 8238, 1989-1 C.B. 92. This language has remained in the Device Regulations since 1989. *See* Reg. § 1.355-2(d)(1); *see also* Guidance Under Section 355 Concerning Device and Active Trade or Business, REG-134016-15, 81 Fed. Reg. 136 (July 15, 2016).

of the distribution, the entire shareholder base has turned over, and all historic Distributing shareholders have sold their Controlled stock on the secondary market in unplanned and uncoordinated open market transactions.

Example 3 illustrates a transaction in which all Distributing stockholders are permitted to recover their basis in Controlled stock, but does not reflect a transaction undertaken for the purpose of extracting corporate assets in a capital gain transaction. Here, Distributing intended to separate Business A and Business B for valid corporate business purposes in a transaction where each business would continue to be held, in corporate solution, by the historic Distributing shareholders. By virtue of the fact that Controlled stock is readily tradable on a public exchange, the Spin-Off has provided a mechanism for Distributing's historic shareholders to "cash out" of a portion of their overall investment in a basis recovery transaction. From Distributing's perspective, however, this fact is mere happenstance—Distributing was not motivated by a desire to allow shareholders to receive assets previously held in corporate solution, whether directly or indirectly by permitting shareholders to divest of one or both businesses.

Importantly, the Device Prohibition is an intent-based test.[12] The existence of Device factors should not result in a conclusion that a Spin-Off is a Device where it is otherwise evident that Distributing was of "pure" intent. Indeed, Section 355(a)(1)(B) and the Treasury Regulations promulgated thereunder are clear—the "mere fact" of a post-Spin-Off sale or exchange is not enough to implicate the Device Prohibition. In Example 3, Distributing did not intend to strip assets out of corporate solution, and the Distributing shareholders' open market stock dispositions are not funded with cash sourced at Distributing (and could not have been instead structured (or plausibly recast) as a dividend transaction). Accordingly, the Basis Recovery Concern is focused on transactions that are pre-arranged by Distributing as a means of removing assets from corporate solution at capital gains rates as an end-run around the dividend provisions. In that sense, the Basis Recovery Concern is a variation on the theme of the Bail-Out Concern—if the taxpayer could have achieved its end result using a transaction that would have been subject to the dividend provisions of the Code, but instead chooses to facilitate a capital gain transaction that affords shareholders the benefit of basis recovery, the Device Prohibition will be activated.[13]

---

[12] *See, e.g.*, Section 355(a)(1)(B) (transaction must be "used principally as" a Device); Private Letter Ruling 201817001 (Jan. 26, 2018) (taxpayer representation regarding the lack of any intention to use the transaction principally as a Device); Private Letter Ruling 201232014 (Feb. 16, 2012) (taxpayer representations regarding device focused on Distributing's purpose for the transaction and its "knowledge of any plan or intention of any of its shareholders").

[13] This framework may illuminate why the Service has historically indicated that the Device Prohibition may continue to be relevant in fact patterns involving shareholders with zero basis in Distributing stock. *See*

IV. THE SALE OR EXCHANGE DEVICE FACTOR, THE REORGANIZATION EXCEPTION AND SECTION 367(A) TRANSACTIONS

A. The Sale or Exchange Device Factor

As discussed above, a hallmark of Device is enabling historic Distributing shareholders to cash out of at least a portion of their investment in the overall Distributing enterprise. For this reason, the Sale or Exchange Device Factor treats a subsequent sale or exchange of stock of Distributing or Controlled as evidence of Device[14] and treats a sale or exchange negotiated or agreed upon before the Spin-Off (and, ordinarily, a sale or exchange discussed before the Spin-Off that was reasonably to be anticipated to occur) as substantial evidence of Device.[15] However, the concerns underlying the Device Prohibition (including the Bail-Out Concern and the Basis Recovery Concern) are not implicated by *all* pre-arranged sales or exchanges of Distributing or Controlled stock. Indeed, if the transaction does not evidence an intent to facilitate the extraction of assets from corporate solution and the movement of cash into the hands of shareholders, Device concerns should not arise.

> Example 4. *Reverse Morris Trust Transaction with Domestic Acquiror.* Distributing is a widely held, publicly traded domestic corporation that conducts Business A and Business B. Distributing determines to separate Business A from Business B by forming a wholly-owned domestic subsidiary, Controlled, contributing to Controlled Business B, and distributing 100% of Controlled stock *pro rata* to the Distributing shareholders in a transaction that qualifies under Section 355. As part of the plan that includes the distribution, an unrelated domestic corporation, X, acquires 100% of Controlled stock from the Controlled shareholders solely in exchange for X stock in a transaction that qualifies as a tax-

---

Lauren Azebu, Robert Rizzi & Lisa Zarlenga, *A New Role for the Device Test?*, TAX NOTES 1427 (Mar. 21, 2016). Although such situations would not, as a technical matter, involve the recovery of basis (as there is none to be recovered), they may nonetheless reflect capital gain transactions engineered to avoid dividend taxation (and, for example, take advantage the opportunity to offset capital losses). When the Basis Recovery Concern is analyzed as a variation on the Bail-Out Concern theme, its import cannot be understood by narrowly focusing on the question of whether there has been an actual recovery of basis. *See, e.g.*, Joshua D. Blank, *The Device Test in a Unified Rate Regime*, TAX NOTES 520 (Jan. 26, 2004); Peter C. Canellos, *The Section 355 Edifice: Spinoffs Past, Present, and Future*, TAX NOTES, 420 (July 26, 2004).

[14] Reg. § 1.355-2(d)(2)(iii). The greater the percentage of stock sold and the shorter the time between the Spin-Off and the sale, the stronger the evidence of device. Reg. § 1.355-2(d)(2)(iii)(A).

[15] Reg. § 1.355-2(d)(2)(iii)(B), (D).

free reorganization. The second-step acquisition does not cause Section 355(e) to apply to the distribution.

As a result of the transaction in Example 4, Distributing shareholders hold stock of Distributing (which holds Business A), on the one hand, and stock of X (which holds Business B, together with X's historic business), on the other hand. Compare this transaction to the prototypical Device in Example 1, and there are clear and meaningful distinctions: the historic Distributing shareholders have maintained an investment in the historic Distributing assets through their ownership of Distributing and X, and the transaction is not structured to avoid (and could not have been tax-efficiently structured in a manner that would have been subject to) tax as a dividend.[16] In other words, Example 4 does not implicate the Bail-Out Concern or the Basis Recovery Concern. Indeed, Example 4 more closely resembles a straightforward Spin-Off as a result of which Distributing shareholders would hold stock of Distributing (holding Business A), on the one hand, and stock of Controlled (holding Business B), on the other hand. Like a straightforward Spin-Off, the Reverse *Morris Trust* transaction in Example 4 is intended to allow the historic Distributing assets to continue to be held in corporate solution indirectly by historic Distributing shareholders, albeit in modified corporate form.[17]

B. The Reorganization Exception

It is no surprise, then, that the Reorganization Exception (pursuant to which a sale or exchange of Distributing or Controlled stock subsequent to a Spin-Off is disregarded for purposes of the Sale or Exchange Device Factor) applies in the case of Example 4; even though Distributing shareholders have engaged in a pre-arranged exchange of Controlled stock for X stock, the exchange is not treated as a "sale or exchange" for purposes of the Sale or Exchange Device Factor. Rather, for purposes of testing the transaction's continued compliance with the Device Prohibition, the X stock is treated as the Controlled stock that was surrendered therefor. In other words, the overall transaction is not given a "free pass" on the Device Prohibition in perpetuity simply by virtue of the fact that the acquisition of Controlled by X does not itself, alone, present evidence of Device; subsequent sales or exchanges of X stock may yet implicate the Sale or Exchange Device Factor.[18]

---

[16] Distributing instead could have exchanged Controlled stock for X stock (in a tax-free reorganization) and then distributed X stock to its shareholders via a *pro rata* dividend, though that would not be as tax efficient.

[17] *See, e.g.*, Rev. Rul. 75-406, 1975-2 C.B. 125 (finding no Device because Distributing shareholders maintained their continuing ownership in Controlled by owning the stock of the acquiror of Controlled).

[18] *See, e.g.*, Boris I. Bittker and James S. Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶11.06[3] (Thomas H. Brantley, 7th ed. 2015) (In a situation where Distributing, rather than Controlled

Example 5. *Reverse Morris Trust Transaction with Domestic Acquiror + Sale of Acquiror for Cash.* Distributing is a widely-held, publicly-traded domestic corporation that conducts Business A and Business B. Distributing determines to separate Business A from Business B by forming a wholly-owned domestic subsidiary, Controlled, contributing to Controlled Business B, and distributing 100% of Controlled stock *pro rata* to the Distributing shareholders. As part of the plan that includes the distribution, an unrelated domestic corporation, X, acquires 100% of Controlled stock from the Controlled shareholders in exchange for X stock in a transaction that is a tax-free reorganization. After X's acquisition of Controlled, an unrelated domestic corporation, Y, acquires 100% of the X stock for cash. Without regard to the acquisition by Y, the distribution would have qualified under Section 355.

Under the Reorganization Exception, the X stock received in exchange for the Controlled stock surrendered in Example 5 is treated as such Controlled stock for purpose of applying the Sale or Exchange Device Factor. Therefore, the sale of X stock to Y is treated as a post-Spin-Off sale or exchange of Controlled stock that is not eligible for the Reorganization Exception—*i.e.*, the second-step sale presents evidence of Device. The Device Regulations, therefore, permit exchanges of Distributing or Controlled stock in connection with a Spin-Off in transactions that do not raise the Bail-Out Concern or Basis Recovery Concern, while preserving the ability to subsequently disqualify the Spin-Off by testing future dispositions of stock for evidence of Device.

C. Application of the Reorganization Exception to Section 367(a) Acquisitions

The Reorganization Exception only operates to disregard an exchange of Distributing or Controlled stock if either no gain or loss, or no more than an insubstantial amount of gain, is recognized thereon. However, where, in an otherwise tax-free reorganization, a Foreign Acquiror acquires Distributing or Controlled stock in a transaction that results in historic U.S. shareholders of Distributing owning more than fifty percent of the combined company, Section 367(a) requires shareholder-level gain recognition.[19] Accordingly, on its face, the

---

is acquired, Distributing's historic earnings and profits "remain embedded in corporate solution, the ownership of which is still represented by shares of stock held by the pre-distribution stockholders of the distributing…[corporation]—that is, they have not 'cashed out.' That [acquiror] stock is substituted, however, for the distributing corporation stock for purposes of the device test, and *its* subsequent sale may evidence a device").

[19] Reg. § 1.367(a)-3(a)(1) and Reg. § 1.367(a)-3(c)(1), (2). Although less of a practical concern (because it is unlikely to impede consummation of a transaction), Section 367(a) also requires shareholder-level gain

Reorganization Exception is not available with respect to a Spin-Off followed by a Section 367(a) Acquisition.[20]

This Report questions whether this is the appropriate and intended result (and ultimately concludes that it is not). The relevant inquiry is whether a Section 367(a) Acquisition directly or indirectly moves cash or historic Distributing assets out of corporate solution and into the hands of shareholders in a manner that avoids dividend taxation and instead allows shareholders to exit a portion of their investment in historic Distributing assets. If the answer is "no," the Reorganization Exception should apply to disregard an exchange of Distributing or Controlled stock for Foreign Acquiror stock, regardless of gain recognition under Section 367(a). Only if the answer is "yes" should an exchange of stock pursuant to a Section 367(a) Acquisition be evidence of Device under the Sale or Exchange Device Factor.

> Example 6. *Reverse Morris Trust Transaction with Foreign Acquiror.* Distributing is a widely-held, publicly-traded domestic corporation that conducts Business A and Business B. Distributing determines to separate Business A from Business B by forming a wholly-owned domestic subsidiary, Controlled, contributing to Controlled Business B, and distributing 100% of Controlled stock *pro rata* to the Distributing shareholders. As part of the plan that includes the distribution, an unrelated foreign corporation, FA, acquires 100% of Controlled stock from the Controlled shareholders solely in exchange for FA stock in a transaction in which gain recognition is required under Section 367(a) but that otherwise qualifies as a tax-free reorganization. Without regard to the acquisition by FA, the distribution would have qualified under Section 355.

---

recognition for U.S. shareholders that own five percent of more of the Foreign Acquiror ("five-percent transferee shareholders") after the transaction when U.S. shareholders of Distributing receive fifty percent or less of the stock of Foreign Acquiror in an otherwise tax-free reorganization but either (x) the five-percent transferee shareholder fails to enter into a gain recognition agreement (a "**GRA**") or (y) the five-percent transferee shareholder enters into a GRA, but Foreign Acquiror disposes of a prescribed amount of the stock or assets acquired in the transaction within five years. We believe that this specific case (gain recognition under Section 367(a) by one or more five-percent transferee shareholders) is a subset of the more general case (gain recognition under Section 367(a) by all shareholders) and, accordingly, the same logic and conclusions discussed below apply.

[20] Because a Spin-Off is subject to corporate-level gain recognition under Section 355(e) only if there is an acquisition of a fifty percent or greater interest in Distributing or Controlled as part of a plan (or series of related transactions) that includes the Spin-Off, a Spin-Off followed by a Section 367(a) Acquisition could, absent the Device issue, remain tax-free at the corporate level under Section 355 while resulting in gain recognition to shareholders under Section 367(a). Note that this Report assumes that Section 7874 is inapplicable to the transactions discussed.

The transaction in Example 6 is identical to Example 4, other than that the acquiror is a foreign, not domestic, corporation. The transaction effected in Example 6 is the economic equivalent of, and produces the same end result as, the transaction in Example 4, with the sole difference being gain recognition to Controlled shareholders resulting from the application of Section 367(a). However, under the current Device Regulations, this gain recognition eliminates the protection of the Reorganization Exception, requiring the exchange of Controlled stock for FA stock to be analyzed under the Sale or Exchange Device Factor. Moreover, because the second-step acquisition by FA occurs pursuant to an arrangement negotiated or agreed upon before the Spin-Off, the exchange is substantial evidence of Device. Recall that Example 4 also involves a situation where Controlled stock is subsequently exchanged (for X stock) pursuant to an arrangement negotiated or agreed upon before the Spin-Off. However, because the exchange is a reorganization that is tax-free at both the corporate and shareholder levels, the Reorganization Exception applies and permits the exchange to be disregarded for purposes of applying the Sale or Exchange Device Factor in its entirety. Is the mere recognition of gain as a result of the introduction of a foreign, not domestic, acquiror and the application of Section 367(a) enough to warrant a different result from the economically equivalent domestic Reverse *Morris Trust* transaction?[21]

We believe the answer is "no." Section 367(a) Acquisitions following Spin-Offs, such as the transaction in Example 6, do not implicate the Bail-Out Concern or the Basis Recovery Concern. None of the historic Distributing assets directly or indirectly leave corporate solution, the historic Distributing shareholders do not dispose of any portion of their investment in such assets, and the transaction is not structured to avoid tax as a dividend. The transaction effects a genuine separation of businesses under modified corporate form—precisely the type of transaction intended to be governed by Section 355.

Moreover, there is nothing germane to the gain recognition provisions of Section 367(a) suggesting that a Section 367(a) Acquisition is evidence of Device or that gain recognition under Section 367(a) should be determinative of or relevant to the qualification of a Spin-Off under

[21] One could ask the same question regarding the recognition of gain as a result of the failure of an all-stock acquisition by a domestic corporation to qualify as tax-free. While a discussion of the merits of permitting the Reorganization Exception to apply to such taxable all-stock acquisitions is beyond the scope of this Report, we believe many of the considerations in this Part IV.C apply to both Section 367(a) Acquisitions and taxable all-stock acquisitions. We note, however, that as a practical matter, the potential failure of an all-stock acquisition by a domestic corporation to qualify as tax-free is rarely fatal to the tax-free nature of the transaction and can generally be addressed through planning and restructuring (i.e., changing the direction of the merger or the parties to the reorganization); it is generally not possible to restructure a Section 367(a) Transaction to avoid gain recognition.

Section 355. Gain recognition under Section 367(a) is wholly unrelated to the Section 355 regime, including the Device Prohibition, and nothing in either the current regulations promulgated under Section 367(a), prior versions of the statutory provisions, or relevant prior administrative guidance indicates that gain recognition under Section 367(a) implicates the Device Prohibition.[22] Rather, Section 367(a) is a provision that is intended to prevent the expatriation of corporate assets by imposing an exit tax on U.S. shareholders of the departing domestic corporation. Given the motivations underlying this provision, there is no principled reason why gain recognition under Section 367(a) should cause an otherwise Section 355-compliant transaction to be treated as a Device, triggering both shareholder and corporate-level tax. The Device Prohibition is not intended to, and should not be used as a mechanism to, impose corporate-level tax on transactions simply because those transactions violate the anti-inversion rules of the Code. Rather, corporate-level penalties are adequately addressed by specific rules dealing with expatriation transactions, namely, Section 7874.

A post-Spin-Off Section 367(a) Acquisition does implicate basis recovery—the transaction enables Distributing shareholders to recover their basis in Controlled stock. However, as discussed in Part III.B. above, basis recovery in a vacuum is not abusive, nor is it the target of the Device Prohibition. The Basis Recovery Concern is applicable only where the transaction is motivated by an intent to afford shareholders the benefit of receiving cash (or other corporate assets) in a capital return transaction (*e.g.*, offsetting basis against taxable gain, offsetting capital losses against capital gain, etc.) where the alternative, economically equivalent transaction would have been taxed as a dividend without a return of capital component.[23] In Example 1, that alternative is clear. In Example 6, like in Example 4, the Basis Recovery Concern is not present because the transaction is intended to allow the historic Distributing shareholders to retain their investment in FA stock, a subsequent sale of which can (and will) be tested under the Device Prohibition (as in Example 5).[24]

---

[22] *See, e.g.*, Rev. Rul. 68-23, 1968-1 C.B. 821 (1968); Tax Reform Act of 1976, Pub. L. 94-455, section 1042 (Oct. 4, 1976).

[23] Even though it may result in a step-up in basis, gain recognition to U.S. shareholder as a result of the application of Section 367(a) is never the intended goal of a Section 367(a) Acquisition; rather, it is a frictional tax cost that raises the bar for the successful negotiation of a transaction and must be overcome and outweighed by other benefits.

[24] Even if a subsequent sale of FA stock were not to result in gain recognition to former Distributing shareholders (*i.e.*, because there had been no further appreciation of FA stock since the date of the Section 367(a) Acquisition), the subsequent sale should still present evidence of Device under the Sale or Exchange Device Factor.

In addition, imagine that, in Example 6, historic U.S. shareholders of Distributing own 50.1% of the combined company, implicating Section 367(a).[25] Now, consider an alternative to Example 6 involving identical facts, except that historic U.S. shareholders of Distributing own 49.9% of the combined company, such that Section 367(a) does not apply and no gain is required to be recognized by such shareholders. Assume further that, without regard to Section 367(a), the Spin-Off in each scenario would qualify under Section 355.[26] The 0.2% fluctuation in ownership by historic U.S. shareholders of Distributing—a fact that is irrelevant to the concerns underlying the Device Prohibition—would result in one acquisition qualifying for the Reorganization Exception (and the Spin-Off qualifying under Section 355) and the other becoming ineligible for the Reorganization Exception (and the Spin-Off presenting substantial evidence of Device). This "cliff effect" is especially odd in the context of a determination that ordinarily relies on a balanced weighing of various factors. Moreover, we do not see why small differences in ownership (or an inability to rebut the presumption created by Reg. § 1.367(a)-3(c)(2) that the historic owners of Controlled are U.S persons) implicate the Bail-Out Concern, the Basis Recovery Concern or the polices animating the Device Prohibition.

Although Distributing, in each of the previous examples, has been widely held and publicly traded, we believe that the same arguments apply when Section 367(a) requires shareholder-level gain recognition in a transaction that would otherwise qualify as a tax-free reorganization involving a privately-owned Distributing.

> Example 7. *Reverse Morris Trust Transaction with Private Distributing and Foreign Acquiror.* Distributing is a domestic corporation that is owned by five U.S, shareholders and that conducts Business A and Business B. Distributing determines to separate Business A from Business B by forming a wholly-owned domestic subsidiary, Controlled, contributing to Controlled Business B, and distributing 100% of Controlled stock *pro rata* to the Distributing shareholders. As part of the plan that includes the distribution, an unrelated foreign corporation, FA, acquires 100% of Controlled stock from the Controlled shareholders solely in exchange for FA stock in a transaction in which gain recognition is required under Section 367(a) but that otherwise qualifies as a tax-free reorganization. Without

[25] Note that those who transfer stock or securities of a U.S. target company in exchange for stock of the transferee foreign corporation are presumed to be U.S. persons. Reg. § 1.367(a)-3(c)(2). This presumption can be rebutted by ownership statements showing ownership of more than 50% of the target company by non-U.S. persons. Reg. § 1.367(a)-3(c)(7).

[26] For example, shareholder overlap between Controlled and FA may mean that there has not been a 50% or greater change in ownership of Controlled for purposes of Section 355(e).

regard to the acquisition by FA, the distribution would have qualified under Section 355.

As in Example 6, Example 7 produces the same end result as the transaction in Example 4, other than the gain recognition to Controlled shareholders due to the application of Section 367(a). Again, Example 7 does not implicate the Bail-Out Concern or the Basis Recovery Concern. Although Distributing is privately owned, the historic Distributing shareholders still retain their investment in FA stock, a subsequent sale of which can (and will) be tested under the Device Prohibition. We see no reason why the fact that Distributing is privately owned should alter the analysis when a reorganization is undertaken for a valid business purpose and with "pure" intent. Indeed, there is no requirement in the Reorganization Exception that Distributing must be publicly owned.[27]

The Reorganization Exception reflects the government's acknowledgement that sales or exchanges that do not implicate the Bail-Out Concern or the Basis Recovery Concern should be disregarded for purposes of the Sale or Exchange Device Factor. As the above examples make clear, the "mere fact" that an otherwise tax-free reorganization following a Spin-Off requires shareholder-level gain recognition under Section 367(a) does not implicate any of the concerns underlying the Device Prohibition. Therefore, we believe that the application of Section 367(a) to a transaction that would otherwise be eligible for the Reorganization Exception should not change this result.

V. RECOMMENDATION

In light of the discussion above, we recommend that the government issue appropriate guidance to provide that, in determining whether a Spin-Off followed by a Section 367(a) Acquisition is a Device, gain recognition resulting from the application of Section 367(a) is disregarded. Given the existing uncertainty and its impact on desirable transactions, we recommend that the government promulgate guidance on this narrow point prior to the completion of its general review of the Device Regulations. In the event that the Device Regulations are retained in their current form, this recommendation can be implemented through two straightforward amendments to the Device Regulations. First, the statement in Reg. § 1.355-2(d) that a "device can include a transaction that effects a recovery of basis" should be clarified to indicate that a recovery of basis solely as a result of the application of Section 367(a) is not relevant to the application of the Device Regulations. Second, the Reorganization Exception should be amended to disregard gain recognized on the exchange solely as a result of the

[27] We note that, while the fact that Distributing is publicly traded and widely held is a non-Device factor under the Device Regulations, this is simply one factor to be considered in the weighing of the Device and non-Device factors, and it is not determinative of whether a Device exists. Reg. § 1.355-2(d)(3)(iii).

application of Section 367(a). If the government wishes to conduct a lengthy review before introducing this guidance, we recommend releasing interim guidance illustrating the fact that transactions resembling Example 6 do not violate the Device Prohibition. We believe that promptly implementing these measures will provide taxpayers with the certainty required to confidently undertake similar transactions, eliminating the existing confusion regarding the interaction between the Device Prohibition and Section 367(a).