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THE DEVICE TEST IN A UNIFIED RATE REGIME

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This article explores the impact of the Jobs and Growth Tax Relief Reconciliation Act of 2003 on the policy concerns underlying the section 355 "device test" for tax-free spin-offs. Under the 2003 legislation, individual shareholders generally are taxed on both qualified dividends and long-term capital gains realized on the sale of corporate stock at the same maximum rate — 15 percent. Unification of these rates appears to neutralize the traditional concern that taxpayers may use a tax-free spin-off as a "device" to transform ordinary income into capital gains. This article examines the relevance of the device test in this new unified rate environment. The article concludes that the device test should not be repealed completely, but that, during periods of unified rates, application of the device test should be limited and is not necessary when individual shareholders hold their shares in the distributing and controlled corporations with zero basis.

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I. Introduction

U.S. tax law has historically endeavored to prevent the use of the tax-free spin-off transaction as a device to convert ordinary income into capital gain. Under section 355 of the Internal Revenue Code (the code),[1] a spin-off is denied tax-free treatment if "principally used as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both."[2] The device test under section 355 is designed to thwart shareholders' attempts at extracting earnings and profits of a distributing corporation (Distributing) at capital gains rates without diminishing their ownership interest in Distributing.[3] For example, an individual shareholder receiving shares of a corporation controlled by Distributing (Controlled) in a taxable distribution recognizes income as though he received a dividend (generally at ordinary income rates); in a tax-free spin-off, on the other hand, an individual shareholder can effectively convert that ordinary income into gain taxed at long-term capital gains rates by disposing of the Controlled stock in a taxable sale or exchange after its distribution. As ordinary income rates have traditionally been higher than long-term capital gains rates,[4] tax-free spin-offs have offered an attractive means of "bailing out" earnings and profits at capital gains rates.[5]

Recent legislative changes, however, have dramatically altered the tax rate landscape in which the device test operates. Under the Jobs and Growth Tax Relief Reconciliation Act of 2003 (the 2003 Tax Act),[6] individual shareholders are taxed on qualified dividends and long-term capital gains realized on the sale of corporate stock at the same maximum rate, 15 percent,

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[1]All section references are to the Internal Revenue Code of 1986, as amended, unless otherwise indicated.

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

[3]*See* Part III of this article for a discussion of the policy rationale underlying the device test.

[4]For example, in 2002, individuals in the top federal marginal tax bracket were taxed on ordinary taxable income at a rate of 38.6 percent, but were taxed on long-term capital gains on the sale of stock at a maximum rate of 20 percent.

[5]*See* Howard E. Abrams and Richard L. Doernberg, *Federal Corporate Taxation* 250 (1998) ("All in all, if given a choice, taxpayers prefer lower taxes to higher taxes").

[6]The Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. Law 108-27, 108th Cong. 1st Sess. (2003).

provided that statutory requirements are met.[7] Unification of these rates appears to neutralize the government's concern that individual shareholders will abuse the spin-off provisions to transform ordinary income into capital gains. The 2003 Tax Act now taxes an individual shareholder who receives Controlled stock in a tax-free spin-off (and later recognizes a long-term capital gain by selling that Controlled stock) at the same rate as an individual shareholder who receives the Controlled shares in a taxable distribution. Whereas a tax-free spin-off previously could have enabled some individual shareholders to recognize income at a potential tax rate of 20 percent (tax rate on long-term capital gain) instead of 38.6 percent (highest marginal tax rate on ordinary income), the 2003 Tax Act establishes a 15 percent tax rate for individual shareholders regardless of whether the spin-off is tax free or taxable. Thus, as several commentators have recently questioned, in this unified rate environment, is the device test still relevant?[8]

As several commentators have recently questioned, in this unified rate environment, is the device test still relevant?

This article explores the impact of the unification of individual dividend and long-term capital gains rates on the policy concerns underlying the device test. The article concludes that despite the significant changes made by the 2003 Tax Act, the device test should not be repealed completely. The article cautions, however, that during periods of unified rates, application of the device test should be limited and is not necessary when individual shareholders hold their Distributing and Controlled shares with zero basis.

The structure of the article is as follows: Part II explains briefly the requirements for a tax-free spin-off under section 355; Part III examines the operation and underlying rationale of the device test; Part IV explores the impact of unified dividend and long-term capital gains rates on the policy concerns underlying the device test; Part V presents alternatives to the device test as a result of the 2003 Tax Act; and Part VI is the conclusion.

[7]*Id.*, sections 301(a) and 302(a).

[8]*See, e.g.*, Martin D. Ginsburg and Jack S. Levin, *Mergers, Acquisitions and Buyouts* para. 1006 (June 2003 ed.)("Query how much sense the device test makes after 2002 with both qualified dividend income and [long-term capital gain] taxed to individual shareholders at the same 15 percent top rate"); Robert Rothman, "Back to the Bog: The IRS's New Policy on Spin-off Rulings," 30 *Corp. Tax'n* 5 (September/October 2003)("[T]he elimination of the rate differential between capital gain and dividend income for individual taxpayers reduces the potential shareholder-level benefit of a bailout, and hence also should reduce the likelihood of a device. It remains to be seen how the IRS will deal with the effect of JGTRRA [(the 2003 Tax Act)] on the device restriction").

II. Requirements for a Tax-Free Spin-Off

A spin-off is the distribution by a corporation to its shareholders of the stock of a subsidiary corporation that it controls.[9] Congress initially provided for tax-free spin-offs because those transactions theoretically represented mere changes in the form of shareholders' interests.[10] Wary that overly broad provisions under the code could lead to abuse, Congress provided that a spin-off must satisfy the following requirements before receiving tax-free treatment under section 355: Distributing must distribute a "controlling" amount of stock of Controlled to its shareholders;[11] immediately after the distribution, Distributing and Controlled each must be engaged in an active trade or business;[12] a spin-off must be motivated by one or more corporate business purposes;[13] and last, a spin-off must not be used principally as a device to distribute earnings and

[9]Tax-free distributions under section 355 are also referred to as "split-offs" and "split-ups." A split-off occurs when Distributing distributes Controlled stock to redeem a portion of outstanding Distributing stock on a non-pro rata basis. A split-up occurs when Distributing holds no assets other than the stock of two subsidiaries and liquidates, distributing the stock of the two subsidiaries to its shareholders.

[10]As a reaction to abusive spin-off transactions, such as that illustrated in *Gregory v. Helvering*, 293 U.S. 465 (1935), Congress repealed the tax-free spin-off provisions in 1934. *See* H.R. 7835, Pub. Law No. 216, 73rd Cong., 2nd Sess. (1934). It later reinstated the provisions in 1951, however, reasoning that "it is economically unsound to impede spin-offs which break up businesses into a greater number of enterprises, when undertaken for legitimate business purposes." S. Rep. No. 781, 82nd Cong., 1st Sess. (1951), 1951-2 C.B. 458, 459.

[11]Section 355(a)(1)(D). "Control" consists of at least 80 percent of the voting stock and 80 percent of each other class of stock of Controlled. *Id*. Section 355 applies the control test as defined in section 368(c). If Distributing retains any stock of Controlled, it must demonstrate that it has not retained the stock as part of a plan to avoid federal income tax. Section 355(a)(1)(D)(ii).

[12]Section 355(b)(2)(B). These businesses must have been conducted actively for the five years preceding the spin-off and can not have been acquired as a result of a wholly or partially taxable acquisition. To qualify as engaging in an active trade or business, a corporation generally should perform active substantial management and operational functions. Treas. reg. section 1.355-3(b)(2)(iii).

[13]In the past, the Service ruled that the following corporate business purposes for conducting a spin-off satisfied the requirement under section 355: increasing access to capital; improving competitive position; realizing significant cost savings; resolving "fit and focus" conflicts; protecting one of Distributing's businesses from the risks associated with another of its businesses; and enabling Distributing to retain a key employee. *See* Rev. Proc. 96-30; 1996-1 C.B. 696, *Doc 96-11987 (83 pages), 96 TNT 80-9*, Appendix A for a full description of the Service's requirements for a private letter ruling regarding business purpose under Rev. Proc. 96-30. Recently, the Internal Revenue Service effected a major change in ruling policy by announcing that it will no longer issue private letter rulings regarding the business purpose requirement of section 355. *See* Rev. Proc. 2003-48, 2003-29 IRB 86, *Doc 2003-15249 (10 original pages), 2003 TNT 122-4.*

profits of Distributing or Controlled.[14] Congress recently added two additional requirements for tax-free treatment. First, a spin-off will not satisfy section 355 if, immediately after the distribution, any shareholder owns at least 50 percent (by either voting power or value) of the stock of either Distributing or Controlled and this stock was acquired in a taxable transaction within five years before the distribution.[15] Second, under section 355(e), a spin-off cannot be part of a plan or series of related transactions designed to enable one or more persons to acquire a 50-percent-or-greater interest in Distributing or Controlled.[16]

If a spin-off satisfies the requirements described above, both Distributing and its shareholders enjoy tax-free treatment.[17] If a spin-off fails the requirements of section 355, Distributing may recognize gain equal to the excess of the fair market value of the Controlled stock distributed over Distributing's adjusted tax basis in that stock, and its shareholders may be treated as receiving dividend income.

III. The Device Test: Operation and Rationale

The device test has been the centerpiece of the tax-free spin-off provisions for over 50 years. Its operation and rationale are discussed below.

A. Operation of the Device Test

A spin-off will not qualify for tax-free treatment if "used principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both."[18] The mere fact, however, that after the distribution some or all of the stock of Distributing or Controlled is sold or exchanged in a taxable transaction "other than pursuant to an agreement negotiated or agreed upon prior to such distribution"[19] does not necessarily mean that the spin-off was principally used as a device. As will be discussed in more detail, the driving concern behind Congress's passage of the device test was that without the requirement, shareholders could extract earnings and profits from a corporation at preferable long-term capital gains rates.

Whether a spin-off is a device under the Treasury regulations is determined based on "all facts and circumstances"[20] relevant to the transaction. The Treasury regulations adopt a balancing approach that weighs enumerated "device factors" against "nondevice factors" to determine whether a spin-off is a device.[21] The Treasury regulations also specify transactions that will "not ordinarily" be considered a device.[22]

The Treasury regulations consider the presence of any of the following device factors as evidence that a spin-off is a device:

Pro rata distribution. A distribution that is pro rata or substantially pro rata to Distributing's shareholders is evidence of a device. The Treasury regulations comment that the pro rata distribution of Controlled shares to Distributing's shareholders "presents the greatest potential for the avoidance of the dividend provisions of the code and, in contrast to other types of distributions, is more likely to be used principally as a device."[23]

Subsequent sale or exchange. Any subsequent sale or exchange of the Controlled stock distributed in the spin-off, regardless of whether prearranged, is evidence of a device.[24] The Treasury regulations provide that the greater the percentage of stock sold, and the sooner it is sold after the distribution, the greater the evidence of a device.[25] A sale of Controlled stock or securities after the distribution pursuant to a "prearranged" sale is "substantial evidence of a device."[26]

Nature and use of assets. The Treasury regulations deem the presence of assets not used in an active trade or business (including cash and other liquid assets in

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

[15] Section 355(d).

[16] Section 355(e). If the acquisition occurs two years before or after the spin-off, there is a presumption that the spin-off is part of a plan. According to the Treasury regulations, a "plan" under section 355(e) is limited to scenarios in which the distributing corporation, its recently spun-off subsidiary, or the shareholders of the distributing corporation intended that an acquisition occur after the spin-off. Safe harbors and operating rules are also provided in these Treasury regulations. *See* Treas. reg. sections 1.355-7T(b)-(f).

[17] Section 355(a)(1). As an alternative to a tax-free spin-off, Distributing may also ensure the availability of capital gains treatment to its individual shareholders by making a distribution in partial liquidation of Distributing's business (as provided under section 302(b)(4)). Rather than attempting to satisfy the requirements of section 355, Distributing could liquidate an operating subsidiary, sell the subsidiary's assets for cash, and distribute the proceeds to its shareholders in redemption of the shareholders' Distributing shares. If these proceeds are attributable to a "genuine contraction" of Distributing's business, the distribution yields capital gains treatment (and tax-free basis recovery in the shares redeemed) for an individual distributee shareholder in substantially the same manner as a tax-free spin-off followed by the individual shareholder's disposition of Controlled stock received.

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

[19] *Id.*

[20] Treas. reg. section 1.355-2(d)(1).

[21] *Id.*

[22] *Id.*

[23] Treas. reg. section 1.355-2(d)(2)(ii). A taxpayer can overcome this device factor, however, by demonstrating that a strong corporate business purpose motivates the spin-off. *See, e.g.,* Treas. reg. section 1.355-2(d)(4), example 2; *Pulliam v. Comm'r*, 73 T.C.M. 3052, *Doc 97-17875 (27 pages), 97 TNT 117-15* (1997) (Business purpose for spin-off of providing key employee with equity interest overcame presence of device factors).

[24] Treas. reg. section 1.355-2(d)(2)(iii).

[25] Treas. reg. section 1.355-2(d)(2)(iii)(A).

[26] Treas. reg. section 1.355-2(d)(2)(iii)(B). The Treasury regulations clarify that an exchange of the distributed Controlled shares pursuant to a reorganization in which no gain or an insubstantial amount of gain is recognized is not treated as a subsequent sale or exchange. Treas. reg. section 1.355-2(d)(2)(iii)(E).

excess of reasonable business needs) of either Distributing or Controlled as evidence of a device.[27]

The Treasury regulations also list several factors that are considered evidence that a spin-off is not a device. These nondevice factors are weighed against the device factors:

Corporate business purpose. The presence of a legitimate corporate business purpose motivating a spin-off is evidence of a nondevice. The Treasury regulations state that the stronger the device factors, the stronger the corporate business purpose needed to avoid the determination that the spin-off is a device.[28] The Treasury regulations thus clearly link the device test and the business purpose requirement for tax-free treatment under section 355.

Publicly traded and widely held. Evidence of a nondevice also exists if Distributing's stock is publicly traded and no single shareholder is directly or indirectly the beneficial owner of more than 5 percent of any class of Distributing stock.[29]

Distributions to corporate shareholders. A spin-off demonstrates evidence of a nondevice if Controlled stock is distributed to one or more corporate shareholders that, absent section 355, would be entitled to the 100 percent dividends received deduction under section 243(a)(2), 243(a)(3), or 245(b) or to the 80 percent dividends-received deduction under section 243(c).[30]

In addition to the device and nondevice factors, the Treasury regulations specify that the following transactions ordinarily will not be considered a device (despite the presence of any device factors described above):

Absence of earnings and profits. A spin-off will not ordinarily be considered a device if, at the time of the distribution of Controlled stock, neither Distributing nor Controlled has current or accumulated earnings and profits.[31] Further, for this exception to apply, Distributing must hold no property that, if distributed, would cause gain recognition that would result in earnings and profits for the year of the distribution.[32]

Section 302(a) or 303(a) treatment. A spin-off will also not ordinarily be considered a device if, absent section 355, the distribution would have enabled shareholders to receive sale or exchange treatment under section 302(a) (redemption treated as sale or exchange) or 303(a) (distribution in redemption to pay death taxes).[33]

The Service recently announced in Rev. Proc. 2003-48 that it will no longer issue private letter rulings on whether a proposed spin-off satisfies the device test.[34] Instead, a taxpayer requesting a ruling that a proposed spin-off satisfies the requirements of section 355 must submit the following representation: "The transaction is not used principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both."[35] The Service warned that it will decline to issue private letter rulings on the tax-free status of proposed spin-offs "in all cases in which the taxpayer fails to submit the required representation."[36] Before the release of Rev. Proc. 2003-48, the Service would issue device rulings, provided that the taxpayer submitted a series of representations.[37] For example, for public companies, a taxpayer was required to submit a representation that no 5 percent shareholders had any plan or intention to sell or dispose of the stock of Distributing or Controlled after the distribution.[38] A corporate taxpayer also previously had the opportunity to explain any special circumstances indicating evidence of a nondevice.[39] In contrast to the old ruling policy, the new policy prohibits the Service from considering "all facts and circumstances" when applying the device test to particular spin-off ruling requests.

B. Policy Concerns and Rationale

The legislative history of section 355 strongly indicates that Congress's purpose in enacting the device test was to prevent shareholders from converting ordinary income into capital gain. Further, the Treasury regulations under section 355, as well as taxpayer guidance issued by the Service, attempt to dissuade taxpayers from exploiting the tax-free spin-off provisions to avoid dividend treatment.

The policy underlying the device test can be illustrated by the following simple example applying the tax rates in effect *before* enactment of the 2003 Tax Act.

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[27]Treas. reg. section 1.355-2(d)(2)(iv)(A).

[28]Treas. reg. section 1.355-2(d)(3)(ii).

[29]Treas. reg. section 1.355-2(d)(3)(iii).

[30]Treas. reg. section 1.355-2(d)(3)(iv). It should be noted that the Treasury regulations do not include, as evidence of a nondevice, a distribution to a corporate shareholder that, absent section 355, would be entitled to the 70 percent dividends-received deduction under section 243(a)(1).

[31]Treas. reg. sections 1.355-2(d)(5)(ii)(A), (B).

[32]Treas. reg. section 1.355-2(d)(5)(ii)(C).

[33]Treas. reg. section 1.355-2(d)(5)(iii), (iv). This presumption does not apply, however, if the distribution is of the stock of two or more controlled corporations and allows shareholders to avoid dividend treatment by selling or exchanging the shares of one controlled corporation while retaining the stock of the other controlled corporation. Treas. reg. section 1.355-2(d)(5)(v), example 2.

[34]Rev. Proc. 2003-48, 2003-29 IRB 86, note 13 *supra*.

[35]*Id.*, section 4.02(1).

[36]*Id.*

[37]*See* Rev. Proc. 96-30, note 13 *supra*.

[38]*Id.*, section 4.05(1)(a) ("There is no plan or intention by any shareholder who owns 5 percent or more of the stock of the distributing corporation, and the management of the distributing corporation, to its best knowledge, is not aware of any plan or intention on the part of any particular remaining shareholder or security holder of the distributing corporation to sell, exchange, transfer by gift, or otherwise dispose of any stock in, or securities of, either the distributing or controlled corporation after the transaction.").

[39]*Id.*, section 4.05(1)(c)(iii).

Example 1. Shareholder A owns 100 shares of Distributing as a capital asset. On January 1, 2002, Distributing separates its businesses through a pro rata tax-free spin-off. Shareholder A receives 100 shares of Controlled stock as a result of the spin-off distribution. On May 1, 2002, Shareholder A sells his Controlled shares to a third party for $100 cash and is taxed at a rate of 20 percent on his long-term capital gain[40] resulting from the sale. If Shareholder A had received the 100 Controlled shares in a taxable distribution, however, he would have been taxed at the applicable ordinary income rate of 38.6 percent on the fair market value of the Controlled shares distributed as a dividend (assuming that Distributing had sufficient earnings and profits). The tax-free spin-off treatment thus enabled Shareholder A to pay tax at a rate of 20 percent on his gain from his sale of Controlled shares, whereas taxable dividend treatment would have required him to pay tax at a rate of 38.6 percent on the fair market value of the Controlled shares received.

The legislative history of section 355 strongly indicates that Congress's purpose in enacting the device test was to prevent shareholders from converting ordinary income into capital gain.

The legislative history of the tax-free spin-off provisions emphasizes that Congress's rationale in enacting the device test was to prevent such conversion opportunities. Congress was heavily influenced by the U.S. Supreme Court's decision in *Gregory v. Helvering*.[41] Holding that Mrs. Gregory (a distributee shareholder) had willfully arranged for the distribution of appreciated property through a tax-free spin-off, the Court described Mrs. Gregory's spin-off as nothing more than "a mere device which put on the form of a corporate reorganization."[42] The abuses highlighted in the *Gregory* decision motivated Congress's temporary repeal of the tax-free spin-off provisions in 1934.[43]

Congress enacted the current version of the device test as part of the Revenue Act of 1954.[44] Congress was justified in its concern that shareholders might be tempted to use tax-free spin-offs to take advantage of capital gains rates — in 1954 the maximum long-term capital gains tax rate for individuals was 25 percent,[45] and the maximum marginal ordinary income tax rate for individuals in the top income bracket (more than $400,000) was 91 percent.[46] The House of Representatives in its report on the spin-off provisions noted that "[t]here is ample evidence . . . that closely held corporations may undertake these transactions solely in the hope of distributing earnings to shareholders at capital gains rates."[47] The House bill even provided that, regarding a spin-off of a controlled corporation that incurred part of its income from "inactive" (that is, investment) sources, distributee shareholders selling Controlled stock would be taxed at ordinary income rates if they disposed of the stock within 10 years of the distribution. The House report stated that "a new and effective safeguard to preclude the transformation of ordinary income into capital gain is contained in the requirement of your committee's bill that any disposition of such stock (within 10 years of its receipt) by the shareholder . . . will give rise to ordinary income consequences."[48] The Senate rejected the 10-year rule proposed by the House, but included section 355(a)(1)(B) (the device test) in its version of the bill.[49] In the conference committee a small number of House conferees succeeded in adding language to the device test providing that the mere fact that shareholders sell Distributing or Controlled shares after a tax-free distribution under section 355 would not necessarily mean a spin-off is a device.[50] With that proviso, the device test was enacted and has remained largely unaltered since 1954.[51]

The Service has also described Congress's intent underlying the device test as aimed at preventing the transformation of ordinary income into capital gains. In Rev. Rul. 71-383,[52] the Service ruled that a spin-off was not a device because if stock in the controlled corporation had been distributed in a taxable distribution, the shareholders receiving that stock would have been treated as receiving a substantially disproportionate redemption under section 302(b)(2) (resulting in sale or exchange treatment of the distribution to the recipient shareholders). The Service therefore held that "the transaction is not a device to distribute earnings and profits (that is, to convert ordinary income into capital gains)."[53] In addition, several celebrated judi-

[40]Shareholder A "tacks" the holding period of his Distributing shares to the holding period of his Controlled shares under section 1223(1).

[41]293 U.S. 465 (1935).

[42]*Id*. at 468.

[43]*See* H.R. 7835, Pub. L. No. 216, 73rd Cong., 2nd Sess. (1934). In 1951, however, after successful lobbying efforts by corporate constituents, Congress reinstated the provisions by adding section 112(b)(11) of the Internal Revenue Code of 1939. *See* Revenue Act of 1951, H.R. 4473, Pub. Law No. 183, 82nd Cong. 1st Sess. (1951), section 317.

[44]*See* Internal Revenue Code of 1954, H.R. 8300, Pub. Law No. 591, Chapter 736, 83rd Cong., 2nd Sess. (1954).

[45]*See* Department of the Treasury, Office of Tax Policy, *Capital Gains and Taxes Paid on Capital Gains for Returns With Positive Net Capital Gains, 1954-2000* (Nov. 19, 2002).

[46]Internal Revenue Code of 1954, H.R. 8300, Pub. Law No. 591, Chapter 736, 83rd Cong., 2nd Sess. (1954).

[47]H.R. Rep. No. 1337, 83rd Cong. 2nd Sess. (1954).

[48]*Id*.

[49]*See* S. Rep. No. 1622, 83rd Cong., 2nd Sess. (1954).

[50]*See* H.R. Rep. No. 2543, 83rd Cong. 2nd Sess. 38 (1954) (Conference Report).

[51]For an excellent description of the legislative history of section 355 and the device test, see generally Charles S. Whitman III, "Draining the Serbonian Bog: A New Approach to Corporate Separations," 81 *Harv. L. Rev.* 1194 (1968).

[52]Rev. Rul. 71-383, 1971-2 C.B. 180.

[53]*Id*.

cial opinions have expressed similar logic regarding application of the device test.[54]

The Treasury regulations under section 355 generally interpret the device test as a legislative mechanism for preventing bailout of earnings and profits at capital gains rates. The introductory paragraph to the Treasury regulations regarding the device test states that "[s]ection 355 recognizes that a tax-free distribution of the stock of a controlled corporation presents a potential for tax avoidance through the subsequent sale or exchange of stock of one corporation and the retention of stock of another."[55]

In addition to this general introductory language, the Treasury regulations' examples of "transactions not ordinarily considered as a device"[56] imply that the government's objective is to impose the device test on transactions that possess the potential for conversion. For example, the Treasury regulations provide that a spin-off is not ordinarily considered a device when Distributing and Controlled have no current or accumulated earnings and profits, and Distributing holds no appreciated property that would result in earnings and profits if distributed[57] — an extremely rare confluence of facts.[58] The logical explanation for this exception is that the absence of earnings and profits means a tax-free spin-off could not enable shareholders of Distributing to convert ordinary income into capital gain. If a corporation with no current or accumulated earnings and profits distributes Controlled shares to its shareholders in a taxable distribution, the shareholders enjoy sale or exchange treatment on receipt of the shares.[59] The Treasury regulations characterize this transaction as not ordinarily considered a device because the distributee shareholders are taxed at capital gains rates in either a taxable distribution or a tax-free spin-off scenario.

Likewise, the Treasury regulations ordinarily will not consider a spin-off to be a device if section 303(a) (distribution in redemption to pay death taxes) or section 302(a) (redemption treated as a sale or exchange) would have applied to a distributee shareholder in a taxable distribution. In each case, the distributee shareholder would have enjoyed sale or exchange treatment on receipt of the Controlled stock.[60] If the Treasury regulations had not carved out these transactions, they would have treated spin-offs under these circumstances as abusive, even though capital gains treatment results in all cases.

It should be noted that the Treasury regulations include the cautionary statement that "a device can include a transaction that effects a recovery of basis."[61] As a result of this provision, even if a taxable distribution of Controlled shares would have otherwise resulted in capital gains treatment, a spin-off may constitute a device if it provides a shareholder tax-free recovery of his basis in his Controlled shares. This surprising result is discussed in greater detail in the next part of this article.

IV. The Device Test After Rate Unification

The differential between ordinary income and capital gains rates was dramatically affected by the 2003 Tax Act. One of the key changes presented by the 2003 Tax Act is the reduction in individual rates on long-term adjusted net capital gain on the sale or exchange of capital assets such as corporate stock from 20 percent to 15 percent.[62] The 2003 Tax Act applies the new 15 percent rate to long-term capital gain recognized on the sale or exchange of capital assets after May 6, 2003, and before January 1, 2009.[63] Concurrent with the reduction to the long-term capital gains rate, the 2003 Tax Act provides that qualified dividend income received by an individual shareholder from domestic and qualified foreign corporations[64] is taxed at the

[54]*See, e.g., Comm'r v. Wilson*, 353 F.2d 184 (9th Cir. 1965) (the court commented that "Congress early learned, however, that shareholders would select the part of the assets of an original corporation which could most readily be converted into cash or its equivalent, spin off those parts into the second corporation, distribute the stock in that corporation to themselves, and thus have available for sale and capital gains tax treatment the stock in that corporation, though in fact what they sold represented accumulated earnings of the original corporation, which earnings, if they had been paid directly to the shareholders of the original corporation, would have been fully taxable to them as dividend income"); *Rafferty v. Comm'r,* 452 F.2d 767 (1st Cir. 1971) (spin-off treated as a device because "once the stock was distributed, it could potentially be converted into cash without impairing taxpayers' equity interest"); *Gada v. U.S.*, 460 F. Supp. 859 (1978) (a device exists where "the possibility of the shareholder abstracting accumulated earnings at capital gains rates is present").

[55]Treas. reg. section 1.355-2(d)(1).

[56]Treas. reg. section 1.355-2(d)(5).

[57]*Id*.

[58]*See, e.g.,* Martin D. Ginsburg and Jack S. Levin, *Mergers, Acquisitions and Buyouts* para. 1006.3 (June 2003 ed.) ("As a practical matter, however, [Distributing's] ability to take advantage of this rule is limited to circumstances in which [Distributing] has no (appreciated) property that would give rise to current E&P if it were distributed at the time of the distribution of the [Controlled] stock"); Mark J. Silverman, *et al.*, "Operation of the Device and Active Business Requirements of the Section 355 Regs," 70 *J. Tax'n* 324 (June 1989) ("Given this last requirement, the viability of this provision as a safe harbor to the device restriction is effectively eliminated — almost every corporation has at least one appreciated asset").

[59]Section 301(c)(3).

[60]Section 303(a); section 302(a).

[61]Treas. reg. section 1.355-2(d)(1).

[62]The Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. Law 108-27, 108th Cong. 1st Sess. (2003), section 301.

[63]*Id.*, section 303.

[64]A "qualified foreign corporation" is a corporation that is (a) incorporated in a possession of the United States or (b) eligible for benefits of a comprehensive income tax treaty with the United States that includes an exchange of information program. *Id.*

same rates that apply to net capital gains.[65] This provision applies to qualified dividends received after December 31, 2002, and before January 1, 2009.[66] Thus, under the 2003 Tax Act, individuals are now taxed at the same maximum rate of 15 percent on qualified dividends received and on long-term capital gains on the sale or exchange of stock.

The alignment of long-term capital gains and dividend rates poses several challenges to the traditional justifications for the device test. If the government's purpose in drafting the device test was to prevent individual shareholders from converting ordinary income into capital gain, it is unclear whether application of the device test is necessary when dividend and long-term capital gains rates are the same. Further, does an individual shareholder's basis in his Distributing or Controlled shares change that analysis? These questions are addressed by the following hypothetical applications of the new rates.

Example 2. Shareholder B owns 100 shares of Distributing as a capital asset and with a basis of $100. On July 1, 2003, Distributing conducts a pro rata tax-free spin-off. Shareholder B receives 100 shares of Controlled stock as a result of the spin-off distribution. The fair market value of each Distributing and Controlled share immediately after the distribution is $1. Consequently, Shareholder B allocates his basis in the Distributing shares among his Distributing and Controlled shares proportionately and takes a $50 basis in his Controlled shares and a $50 basis in his Distributing shares.[67] On August 1, 2003, Shareholder B sells his Controlled shares to a third party for $100 cash. As a result of the new tax rates, Shareholder B is taxed at a rate of 15 percent on his long-term capital gain[68] of $50 ($100 purchase price minus $50 basis) realized on the sale of the Controlled shares. If, on the other hand, Shareholder B had been treated as receiving the 100 Controlled shares in a taxable distribution on July 1, 2003, he would have been taxed at a rate of 15 percent on the full fair market value of these shares — $100 — as a dividend (assuming Distributing had sufficient earnings and profits).

It could be argued that application of the device test to Shareholder B is not necessary because (as a result of the new tax rates) Shareholder B is taxed at the same 15 percent rate whether he receives the Controlled shares in a taxable distribution or he sells the shares after receiving them through a tax-free spin-off. In either case the danger of earnings and profits bailout at capital gains rates appears to have been mitigated because the differential between the dividend and long-term capital gains rates has been eliminated. For that reason, during the last period of unified dividend and long-term capital gains rates, from 1986 to 1990 (Congress eliminated the capital gains preference by passing the Tax Reform Act of 1986, but reinstated it four years later[69]), several commentators argued that the government should consider suspending application of the device test.[70] Shareholder B's ability to recover a portion of his basis tax free, however, does not place him in the same position as if he had received the Controlled shares as a taxable dividend. Had Shareholder B received the Controlled shares as a taxable dividend, he would most likely have been taxed on the full $100 at a rate of 15 percent (total tax liability of $15); because Shareholder B received the Controlled shares in a tax-free spin-off and later sold them for $100, he is taxed on only the long-term capital gain of $50 at a rate of 15 percent (total tax liability of $7.50). Although the rate of taxation is the same in either scenario, the tax-free spin-off enables Shareholder B to recover his $50 basis in the Controlled shares tax-free.[71]

[65]To qualify for the new long-term capital gains rates, the individual must hold stock in the corporation distributing a dividend for more than 60 days during the 120-day period beginning 60 days before the ex-dividend date. Other anti-abuse provisions also apply. *Id.*, section 302.

[66]*Id.*, sections 302 and 303.

[67]Under the applicable Treasury regulation, Shareholder B's aggregate basis in his Distributing stock and his Controlled stock equals his aggregate basis in his Distributing stock held immediately before the spin-off distribution, allocated between his Distributing stock and Controlled stock in proportion to the fair market value of each. Treas. reg. section 1.358-2(a)(2); sections 358(b)(2) and 358(c).

[68]Shareholder B "tacks" the holding period of his Distributing shares to the holding period of his Controlled shares under section 1223(1).

[69]*See* Tax Reform Act of 1986, Pub. Law 99-514, 99th Cong. 2nd Sess. (1986); Revenue Reconciliation Act of 1990, Pub. Law 101-508, 101st Cong. 2nd Sess. (1990).

[70] *See, e.g.,* Donald F. Brosnan, "Spin-Offs Before and After the Tax Reform Act," 38 *Buff. L. Rev.* 157 (1990) ("On the simplest analysis, the repeal of the capital gains preference renders the prophylactic purpose of section 355 to prevent bailouts irrelevant. This would suggest elimination of the nondevice, business purpose and 5-year active business sections. . . . My second proposed reform would be radical simplification of section 355 amounting to . . . repeal of section 355(a)(1)(B)(the device test)"); *see also* Karla W. Simon and Daniel L. Simmons, "The Future of Section 355," *Tax Notes*, July 18, 1988, p. 291 ("Without a capital gain preference, the underlying historic purpose behind the 'device' restriction . . . of section 355 largely disappears").

[71]A shareholder who recovers some amount of basis tax free through the sale of Controlled shares after their distribution is not necessarily benefited by tax-free spin-off, rather than taxable dividend, characterization. For example, assume the same facts as those in Example 2, except that Distributing had no current or accumulated earnings and profits at the time of the spin-off distribution (and after taking into account any required increase to Distributing's earnings and profits that results from the spin-off distribution itself). Characterization of the distribution as a taxable dividend would have required Shareholder B to reduce his $100 basis in his Distributing shares to zero (under section 301(c)(2)), resulting in Shareholder B's tax-free recovery of his entire $100 basis. In a tax-free spin-off, however, Shareholder B would have achieved tax-free recovery of only 50 percent of his $100 basis (which would have been allocated to his Controlled shares) on the sale of the Controlled shares. Further, even if Distributing had a small amount of current or accumulated

(Footnote 71 continued on next page.)

As a result of Shareholder B's tax-free recovery of his $50 basis, the Treasury regulations could treat the spin-off in Example 2 as a device. In 1989 the Treasury expanded the traditional definition of a device to include "a transaction that effects a recovery of basis."[72] The government highlighted this provision in its preamble to the Treasury regulations by commenting that "[t]he final regulations also make clear that a device can include a transaction that effects a recovery of basis."[73] The fact that this language was added in 1989, during a period when ordinary income and capital gains rates temporarily were equal, suggests that the Treasury purposefully expanded the device test to address periods of unified rates. Consequently, the device test may still be relevant to Example 2, despite the rate parity, because the use of a tax-free spin-off enables Shareholder B to recover his $50 basis in his Controlled shares tax-free on his sale of those shares.

Although this basis recovery enables the government to collect only a portion of the tax that it would have collected had the distribution been a taxable dividend, the government may collect the remainder of Shareholder B's gain on Shareholder B's taxable disposition of his Distributing shares (in which Shareholder B also holds a $50 basis). If Shareholder B sells his Distributing shares (with a basis of $50) for more than $100, the government could actually collect *more* total tax from Shareholder B than it would have collected if the distribution of the Controlled shares was treated as a taxable dividend.[74] The government's position has merit, however, as Shareholder B may never dispose of his Distributing shares, or may sell them for less than $100. In either of those situations, the government would collect less total tax from Shareholder B than if it had collected the 15 percent tax on the full $100 fair market value of the Controlled shares as a dividend.

It is also interesting to note that even though the Treasury regulations could treat the transaction in Example 2 as a device because of the basis recovery, each of the "transactions that ordinarily will not be considered as a device" described in the Treasury regulations could enable a shareholder to recover basis in distributed Controlled shares tax free by selling the Controlled shares after the distribution. Arguably, the government's policy justifications for these exceptions outweigh any device factor that could be presented as a result of basis recovery.

In light of the government's basis recovery concerns, there may still be justification for applying the device test to shareholders who hold some amount of basis in their Distributing shares, despite the unification of the rates. Conversely, the new tax rates make application of the device test unnecessary to a shareholder holding *zero* basis in his Distributing shares. Consider the following example:

Example 3. Shareholder C owns 100 Distributing shares as a capital asset and holds them with a basis of zero. On September 1, 2003, Distributing conducts a pro rata tax-free spin-off. Shareholder C receives 100 shares of Controlled stock as a result of the spin-off distribution. The fair market value of each Distributing and Controlled share immediately after the distribution is $1. Because Shareholder C has zero basis in his Distributing shares, there is no basis to apportion between his Distributing and Controlled shares.[75] On October 1, 2003, Shareholder C sells his Controlled shares to a third party for $100 cash. As a result of the new tax rates, Shareholder C is taxed at a rate of 15 percent on his long-term capital gain[76] of $100 ($100 purchase price minus zero basis) realized on the sale of the Controlled shares. If, however, Shareholder C had been treated as receiving the 100 Controlled shares in a taxable distribution on September 1, 2003, he would have been taxed at a rate of 15 percent on the full fair market value of these shares — $100 — as a dividend (assuming Distributing had sufficient earnings and profits) and would have been taxed at a maximum rate of 15 percent on this amount.

As Shareholder C pays the same total tax whether he receives the Controlled shares as a taxable dividend or sells the shares after receiving them in a tax-free spin-off, application of the device test is difficult to justify in this scenario. There are several instances in which a shareholder could hold stock with zero basis: A shareholder receiving Controlled shares in a tax-free spin-off could have also received boot in the distribution, which would require basis reduction (but no corresponding basis increase, assuming Distributing had no current or accumulated earnings and profits at the time of the distribution);[77] a shareholder could have received distributions on his Distributing shares that were characterized as return of capital, which would

earnings and profits at the time of the spin-off distribution, Shareholder B still may have recovered a greater percentage of his $100 basis had the spin-off been treated as a taxable dividend instead of a tax-free spin-off. These results may be additional justification for the Treasury regulations' provision that a spin-off will not ordinarily be considered a device if Distributing has no current or accumulated earnings and profits at the time of the distribution. Treas. reg. section 1.355-2(d)(5)(ii)(A), (B).

[72]Treas. reg. section 1.355-2(d)(1).

[73]Treasury Decision 8238 (Jan. 5, 1989).

[74]For example, if Shareholder B eventually were to sell his Distributing shares for $200, Shareholder B would recognize a long-term capital gain of $150 ($200 purchase price minus $50 basis). Between his sales of Distributing and Controlled shares, therefore, Shareholder B would pay a 15 percent tax on a total of $200 of long-term capital gain ($150 gain on sale of Distributing shares plus $50 gain on sale of Controlled shares). In this instance, the government would collect total tax of $30. If, on the other hand, the government had treated the distribution on July 1, 2003, as a taxable dividend, it would have collected total tax of only $15 ($100 dividend tax at a 15 percent rate).

[75]*See* note 67 *supra*.

[76]Shareholder C "tacks" the holding period of his Distributing shares to the holding period of his Controlled shares under section 1223(1).

[77]*See* section 358(a)(1).

require basis reduction under section 301(c)(2);[78] or a shareholder may have obtained his Distributing shares originally in a section 351 transfer in exchange for property subject to liability.[79] In Example 3 there is no opportunity for the conversion of dividend income into capital gain because the tax rate is the same in both cases. More importantly, because Shareholder C has zero basis in his Controlled shares, there is no possibility of tax-free basis recovery on his disposition of the shares. Shareholder C does not violate the Treasury regulations' cautionary statement that a spin-off can be a device if it effects recovery of basis. On the contrary, because Shareholder C has no basis to recover, the government would collect the same $15 of tax from Shareholder C whether he received the shares as a taxable dividend or sold them after receiving them in a tax-free spin-off. The device test therefore does not seem relevant in a situation involving a shareholder holding his Distributing or Controlled shares with zero basis.

An argument in favor of retaining the device test even for a shareholder with zero basis is that the device test provides the government with a valuable timing benefit.[80] A dividend is taxed currently, whereas a long-term capital gain realized on the sale of Controlled shares is not taxed until the disposition of the Controlled shares. Consequently, it could be argued that even though the government collects the same total tax in Example 3, whether the transaction is a taxable dividend or a tax-free spin-off, the device test should still be applied. Dividend characterization would allow the government to collect the $15 of tax on September 1, 2003, while tax-free spin-off characterization would prevent the government from collecting this amount until October 1, 2003. The timing argument should be rejected for several reasons. First, in the vast body of legislative history of section 355, Congress did not express concerns about the timing detriments that tax-free spin-offs pose to the government.[81] Rather, it focused on shareholder attempts to use section 355 to exploit the ordinary income/capital gains rate differential. Second, the government has not expressed concern that tax-free spin-offs could delay its receipt of revenue. The Treasury regulations declare that a device is evidenced by a *quick* sale of Controlled shares after their distribution. The sooner that a sale occurs after a tax-free spin-off, the greater the evidence of a device. It would be contradictory for the government to argue that the device test is necessary because without it, tax-free spin-off treatment could prolong income recognition; rather, the government is most troubled by sales that occur soon after a tax-free distribution. Those sales result in equally speedy recognition of income by the selling shareholders. Arguably, without the device test, shareholders would sell their Controlled shares with even greater expedience. The device test is not necessary to ensure that income recognition occur in a timely manner.

For the reasons indicated above, the device test creates unnecessary and onerous burdens for corporate taxpayers attempting tax-free spin-offs in which Controlled shares are distributed to shareholders with zero basis. The recently issued Rev. Proc. 2003-48, for example, now requires corporate taxpayers seeking spin-off rulings to represent to the Service that the transaction is not used principally as a device.[82] To submit this representation, these corporate taxpayers typically seek written confirmation from their large shareholders that they do not intend to dispose of their Controlled or Distributing shares after the distribution.[83] As a result of the new tax rates, there does not appear to be a persuasive justification for that confirmation, even from large shareholders, if they hold their Distributing shares with zero basis. Without this required representation, however, the Service will refuse to rule on the tax-free status of a proposed spin-off.

Further, as described previously in Part III, a corporate taxpayer faces a heightened business purpose standard if its shareholders plan to sell their Controlled or Distributing shares after the distribution. The Treasury regulations provide that evidence of a legitimate corporate business purpose is a factor that can overcome the presence of those shareholder sales in the analysis

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[78]If Distributing has no current or accumulated earnings and profits, a distribution of cash or property will be tax-free to a recipient shareholder until his basis in the corporation's stock is reduced to zero. After the shareholder's basis is reduced to zero, any amount of the distribution in excess of his basis is taxed as capital gain. Sections 301(c)(2), (3). Thus, it is possible that a shareholder of Distributing could hold his Distributing shares with zero basis as a result of those previous distributions.

[79]A shareholder must reduce basis in stock received in a section 351 transfer by the amount of liability assumed by the transferee corporation. Sections 358(a)(1), (d)(1). For example, if a shareholder contributes property in which he holds a basis of $20,000 — but which is subject to a liability of $20,000 — to a corporation in a section 351 transfer in exchange for stock with a fair market value of $100,000, the shareholder must reduce his basis in the stock received by $20,000 (the amount of the liability assumed) to zero.

[80]*See* Mark J. Silverman, note 58 *supra* ("[T]he device issue remains relevant because (1) dividend distributions are taxed currently while a section 355 transaction is tax free . . . ").

[81]*See* Part III *supra* for a discussion of Congress's concerns leading up to the enactment of the device test.

[82]The Service caveats in Rev. Proc. 2003-48 that it "will decline to issue a letter ruling in all cases in which the taxpayer fails to submit the required representation. The National Office will not determine whether the transaction is used principally as a device for the distribution of earnings and profits of the distributing corporation, the controlled corporation, or both."

[83]*See, e.g.,* Michael L. Schler, "Simplifying and Rationalizing the Spinoff Rules," 56 *S.M.U. Law Rev.* 239 (Winter 2003). The author argues that the management of a distributing corporation with a mutual fund as a large shareholder "will have no idea whether a fund will even continue to hold its [distributing corporation] stock until the time of the spin-off, let alone whether it will sell its [distributing corporation] or [controlled corporation] stock after the spin-off." *Id.* Consequently, "because [distributing corporation] cannot give the representation required by the IRS without obtaining a representation from the fund, the result is to put the fund in the position of having veto power over a spin-off." *Id.*

of whether a spin-off is a device.[84] Thus, a corporate taxpayer aware of planned distributee shareholder sales may be forced to produce a stronger, more convincing corporate business purpose for the spin-off. A corporate taxpayer with zero basis shareholders who plan to sell their Controlled shares shortly after a spin-off should not be required to meet a higher business purpose standard than usual during a period of unified rates.

V. Alternatives and Solutions

The enactment of unified rates raises significant questions about the policy behind the device test. In response to this development, however, the device test should not be repealed completely. Rather, the government should modify its application.

A. Relevance of the Device Test

Although shareholders receiving Controlled shares in a tax-free spin-off are now subject to the same tax rate on dividend and long-term capital gain income, the device test still rests on some solid policy grounds. First, the Treasury regulations explicitly expanded the scope of the device test in 1989 by including the presence of tax-free recovery of basis as evidence of a device.[85] In any scenario in which a distributee shareholder holds any amount of basis (greater than zero) in his Controlled shares, a tax-free spin-off invites the opportunity for tax-free basis recovery. While basis recovery was not a concern regarding the spin-off provisions voiced by the *Gregory* Court or Congress, the Treasury made this factor part of the device test under its legislative grant of authority to write regulations interpreting the code's provisions.[86] It is a well-settled principle that "[t]reasury regulations and interpretations long continued without substantial changes, applying to unamended or substantially reenacted statutes, are deemed to have received congressional approval and have the effect of law."[87] Perhaps the government could modify its approach during this period of unified rates by ruling that the greater the amount of basis recovered, the greater the evidence of a device. Second, the device test should not be repealed completely because the unified 15 percent tax rate on dividend and long-term capital gain income is scheduled to sunset on January 1, 2009.[88] Although Congress may extend the current term of the new rates, it is equally possible that the new rates will expire, reinstating the differential between dividend and long-term capital gain rates. In that event, the device test will once again be necessary to prevent abusive use of the tax-free spin-off provisions to convert dividend income into capital gain.

Application of the device test to distributee shareholders who hold their Distributing and Controlled shares with zero basis is not necessary, however, given the government's policy concerns. As Example 3 above demonstrates, in a zero basis scenario, a distributee shareholder with zero basis in his Distributing shares may be in the same tax position whether the distribution of Controlled shares is treated as a taxable dividend or a tax-free spin-off. This scenario creates no opportunity for tax-free basis recovery because there is zero basis for shareholders to recover. Consequently, the government should indicate that the sale of Distributing or Controlled shares after a tax-free spin-off by a zero basis shareholder is not evidence of a device.

B. Taxpayer Guidance

A practical and effective solution could be an insertion in Treasury reg. section 1.355-2(d)(5), "Transactions ordinarily not considered as a device." As described previously, that provision discusses transactions that would result in capital gain treatment to a distributee shareholder regardless of whether distribution of the Controlled shares is treated as a tax-free spin-off. Similarly, a distribution of Controlled shares to a zero-basis shareholder results in the taxation of the full amount of the distribution or sale (assuming adequate holding periods) at a maximum rate of 15 percent. The "transactions ordinarily not considered as a device" provisions (Treasury reg. section 1.355-2(d)(5)) could be revised to include the following:

> **(v) Zero basis.** A distribution occurring on or after May 6, 2003, and before January 1, 2009, is ordinarily considered not to have been used principally as a device with respect to an individual shareholder if such shareholder's basis in its stock of the distributing corporation making such distribution is zero at the time of such distribution.

An insertion along these lines would carve out the distribution to zero-basis shareholders from device treatment and would limit the effective term for this provision to the current term of unified rates. The proposed insertion is not the only means of addressing the zero basis issue. An introductory sentence of Treasury reg. section 1.355-2(d)(1), which now reads, "A device can include a transaction that effects a recovery of basis," could be followed by language to this effect: "A distribution to an individual shareholder who holds a basis of zero in its stock in the distributing corporation is not such a transaction."

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[84]*See* Treas. reg. section 1.355-2(d)(3), which provides that "[t]he corporate business purpose for the transaction is evidence of nondevice. The stronger the evidence of device . . . the stronger the corporate business purpose required to prevent the determination that the transaction was used principally as a device."

[85]*See* Part IV *supra* for further discussion of this expansion of the device test.

[86]*See* section 7805(a) (" . . . the Secretary shall prescribe all needful rules and regulations as may be necessary by reason of any alteration of law in relation to internal revenue").

[87]*Helvering v. Winmill*, 305 U.S. 79, 83 (1938).

[88]The Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. Law 108-27, 108th Cong. 1st Sess. (2003), section 303.

In addition, the Service could issue taxpayer guidance signaling that the device test will be enforced less strictly during the period of unified rates. That taxpayer guidance could appear in the form of a formal IRS notice announcing that in light of recent legislative changes, the government's concerns about the use of tax-free spin-offs as devices have lessened significantly and that until 2009, only in the most egregious cases (for example, involving distributions to shareholders with very high basis in their Distributing stock) will the government enforce the device test.

There is precedent for such government action. After the Tax Reform Act of 1986 repealed the capital gains rate differential,[89] the Service announced that application of section 1248(e) would be suspended during periods when there is no capital gains preference. Under section 1248(a), any gain realized by a U.S. shareholder on the disposition of the stock of a controlled foreign corporation (CFC) is treated as dividend income, rather than capital gain, to the extent of the CFC's earnings and profits (other than those previously included in the U.S. shareholder's income under subpart F).[90] Section 1248(e) was enacted as an antiabuse mechanism. The section provides that when a taxpayer sells the stock of a domestic corporation that was "formed or availed of" principally for holding, directly or indirectly, the stock of a CFC, the U.S. shareholder is treated as if it sold the stock of the CFC directly and must report the gain as dividend income.[91] In 1987 the Service issued Notice 87-64,[92] announcing that regulations would be issued suspending the application of section 1248(e) "for periods during which there is no capital gain differential in the code."[93] The notice explained that "the repeal of the capital gains rate differential eliminate[d] the need for section 1248(e)."[94] Contrary to the Service's characterization, repeal of section 1248(e) had significant adverse tax consequences for taxpayers. Application of section 1248(e) could have permitted a U.S. shareholder to offset foreign tax credits against the gain recognized on the sale or exchange of the domestic corporation's stock (because deemed dividends under section 1248 carry indirect foreign tax credits).[95] As one commentator noted, "The suspension of section 1248(e) not only is far from neutral in effect, but can produce significant anti-taxpayer results."[96]

The government's temporary retirement of section 1248(e) should be viewed as analogous to the suspension of the device test's application. The government, in its treatment of section 1248(e), used the unification of capital gains and dividend rates to justify its decision to suspend the availability of a provision that could provide a benefit to taxpayers. It should also consider suspending the application of the device test, which could pose an obstacle to taxpayers, in some situations described in this article.

> ***By requiring that taxpayers submit a broad device representation as a prerequisite to receiving a ruling, Rev. Proc. 2003-48 sets the device bar higher at a time when it should be lowered.***

Last, rather than require an all-encompassing device representation (such as that required by Rev. Proc. 2003-48) from taxpayers requesting tax-free spin-off rulings, the Service could outline scenarios in which that taxpayer representation is *not* needed. In the "no ruling" environment that Rev. Proc. 2003-48 creates, any taxpayer guidance regarding tax-free spin-offs is of critical importance. By requiring that taxpayers submit such a broad device representation as a prerequisite to receiving a ruling, Rev. Proc. 2003-48 does not provide that guidance and instead sets the device bar higher at a time when it should be lowered.

C. The Section 355(e) Alternative

The government could also look to section 355(e) as a viable alternative to the device test. That section causes a spin-off to be taxable if it occurs pursuant to a plan under which the spin-off is followed by the acquisition of a 50-percent-or-greater interest in either Distributing or Controlled.[97] If the government limits application of the device test as a result of the rate unification, it still can deter significant dispositions of either Distributing or Controlled stock that occur after a tax-free spin-off. Although tax-free spin-offs followed by prearranged acquisitions do not present conversion opportunities, they do present an opportunity for taxpayers to avoid corporate-level tax on appreciation inherent in distributed Controlled stock. That potential abuse should motivate the government to focus on section 355(e) rather than the device test.

While the device test is aimed at preventing shareholders' conversion attempts, section 355(e) is designed to prevent corporate-level appreciation from escaping taxation. Under this section, a spin-off that

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[89] *See* Tax Reform Act of 1986, Pub. Law 99-514, 99th Cong. 2nd Sess. (1986), sections 301(a) and 311.

[90] Section 1248(a) (flush language).

[91] Section 1248(e).

[92] Notice 87-64, 1987-2 C.B. 375.

[93] *Id.* Although the notice provides that the regulations would be effective as of September 21, 1987, no regulations were issued.

[94] *Id*.

[95] For discussion of the mechanics of section 1248, see Lowell D. Yoder, "Section 1248: Taxation of the Disposition of Stock of a CFC," *Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations & Restructurings 2002*, 549 *PLI/Tax* 527 (Oct.-Nov. 2002).

[96] James P. Fuller, "U.S. Tax Consequences of International Acquisitions," *Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations & Restructurings 2001*, 514 *PLI/Tax* 665 (Oct.-Nov. 2001).

[97] Section 355(e)(2)(A)(ii).

occurs pursuant to a "plan or (series of related transactions)" designed to enable one or more persons to acquire, directly or indirectly, a 50-percent-or-greater stock interest (measured by vote or value) in either Distributing or Controlled is taxable to Distributing (but not to Distributing's shareholders).[98] The code provides a rebuttable presumption that the spin-off was part of a plan if the acquisitions occur within the two-year period before and after the spin-off.[99] In other words, section 355(e) imposes a corporate-level tax on any gain that Distributing would have otherwise recognized as a result of the distribution of Controlled shares. In 2001 the Treasury issued temporary regulations providing safe harbors that, if satisfied, shorten the period during which the acquisition of Distributing or Controlled automatically will be presumed to be part of a plan.[100]

> ***The mechanics of section 355(e) so closely resemble those of the device test that the government should consider relying on this provision rather than the device test during a period of unified rates.***

The mechanics of section 355(e) so closely resemble those of the device test that the government should consider relying on this provision rather than the device test during a period of unified rates. Section 355(e) considers a subsequent acquisition to be part of a plan, just as the device test treats a subsequent sale or exchange as evidence of a device. The importance of negotiations or arrangements before a spin-off under section 355(e) is similar to that of pre-arranged sales as a device factor under the device test. Both provisions also adopt a "facts and circumstances" approach.

The availability of section 355(e) as an alternative mechanism for deterring large dispositions of Controlled or Distributing shares should further persuade the government to limit application of the device test. Unification of the rates does not reduce corporate-level incentives for avoiding tax liability on appreciation in Controlled shares (in spite of the *General Utilities* repeal).[101] Increased reliance on section 355(e) therefore should be considered.

D. Future Treasury Study

In addition to the suggestions described above, the Treasury and the Service should commit to examine, and seek taxpayer comments regarding, the relevance of the device test during a period of unified rates.[102] Not only would a study prove useful in addressing the role of the device test during the current period of unified rates, but it also would be relevant to any other future period in which Congress equalizes the maximum tax rates on dividends and long-term capital gains.

VI. Conclusion

The unification of individual dividend and long-term capital gains rates shakes the policy foundation of the device test. In response to questions about the current and future relevance of the device test, this article contends that the device test should not be repealed completely because, among other reasons, a shareholder receiving Controlled shares in a tax-free spin-off can still recover his basis tax free. The applicable Treasury regulations expressly describe basis recovery as a possible device factor. Given that basis recovery is now the only major difference between a taxable dividend and a tax-free spin-off, however, the government should consider limiting its enforcement of the device test, especially for individual shareholders with zero basis in their Distributing and Controlled shares who pose no risk of basis recovery. The government should consider these issues in determining whether continued application of the device test during a period of unified rates is sound policy.

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[98] *Id.*

[99] Section 355(e)(2)(B).

[100] The applicable Treasury regulations provide several safe harbors under which a spin-off and subsequent acquisition will not be treated as part of a single plan. For example, a spin-off and subsequent acquisition are not considered part of a single plan if "the acquisition occurred more than 6 months after the distribution and there was no agreement, understanding, arrangement, or substantial negotiations concerning the acquisition or a similar acquisition during the period that begins 1 year before the distribution and ends 6 months thereafter" and the spin-off is motivated by a corporate business purpose other than to facilitate an acquisition. Treas. reg. section 1.355-7T(d)(1)(ii).

[101] *See* Deborah L. Paul, "Triple Taxation," 56 *Tax Law.* 571 (2003) regarding the purpose of section 355(e) ("The enactment of section 355(e), like the repeal of *General Utilities*, appears to be an effort to make the corporate tax regime internally consistent. Repeal of *General Utilities* made sense on the view that if sales by a corporation of its assets . . . are taxed, then distributions of corporate assets should also be taxed. Section 355(e) makes sense on the view that if a sale of subsidiary stock is taxed, then a spin-off followed by a planned sale should also be taxed").

[102] The Treasury could note in its annual Priority Guidance Plan, for example, that it plans to examine this issue and possibly release taxpayer guidance regarding its findings.