A Spin in the Right Direction: Treasury Issues Partial Withdrawal of Proposed Section 355 Device Rules

October 26, 2026

On October 21, 2026, the IRS and the Treasury Department withdrew part of the proposed but not yet finalized Treasury regulations issued in 2016 (the "Proposed Regulations") relating to requirements for tax-free corporate separations (including spin-offs, split-offs and split-ups) ("Section 355 Transactions").[1]

The withdrawal removes some of the problematic aspects of the Proposed Regulations relating to the device prohibition and the active trade or business ("ATB") requirement of Section 355 Transactions:

- An inflexible *per se* test that would have treated a distribution as violating the device prohibition if the distributing corporation's or controlled corporation's non-business assets exceeded designated percentages; and

- Two anti-abuse rules that would have applied to a transaction or series of transactions with a principal purpose of affecting non-business asset percentages or the minimum five percent ATB requirement in the Proposed Regulations.

The rest of the Proposed Regulations remain outstanding, and the IRS and Treasury continue to study the issues that those regulations address.

The guidance makes clear that, notwithstanding the withdrawal of the *per se* device test and the anti-abuse rules, other rules and judicial doctrines may apply to relevant fact patterns to yield similar results. In particular, the guidance states that the withdrawal does not affect the potential application of doctrines such as substance-over-form and step transaction, which Treasury and the IRS could invoke to police Section 355 Transactions.

Although recent IRS guidance does not address how Treasury and the IRS will act on the portions of the Proposed Regulations that remain unfinalized, in recent years, IRS officials have signaled a shift to a more flexible approach to private letter ruling practice

[1] We analyzed the Proposed Regulations in a prior update, available here.

surrounding Section 355 Transactions, including an openness to confer with taxpayers prior to seeking a ruling. And on May 5, 2026, the IRS reinstated a significant issue ruling program under which taxpayers may request a ruling on one or more "significant issues" arising in Section 355 Transactions, without requiring the IRS to rule on the entire transaction.

Background on Section 355 Transactions and the Proposed Regulations

The Device Prohibition and the ATB Requirement

Section 355 generally permits a distributing corporation ("Distributing") to distribute stock of a controlled corporation ("Controlled") to its shareholders without recognition of gain or loss by Distributing or its shareholders, provided that certain statutory and regulatory requirements are satisfied.

One of these requirements is that a distribution must not be used "principally as a device" for the distribution of the earnings and profits of Distributing, Controlled, or both (the "Device Prohibition"). The Device Prohibition is intended to prevent corporations from using Section 355 Transactions as a mechanism to distribute accumulated earnings and profits to shareholders without incurring the tax consequences of a dividend. Whether a distribution is considered to have been used principally as a device is determined based on all the facts and circumstances, weighing "evidence of device" against "evidence of nondevice." Existing Treasury regulations generally consider the nature and use of assets of Distributing and Controlled, with cash and other liquid assets that are not related to the reasonable needs of a business treated as evidence of device.

Section 355 also requires Distributing and Controlled each to be engaged in the active conduct of a trade or business immediately after the distribution. For this requirement to be satisfied, a trade or business must have been actively conducted throughout the previous five-year period (the "ATB Requirement").

The Proposed Regulations

The drafters of the Proposed Regulations attempted to provide greater clarity for taxpayers engaging in Section 355 Transactions by modifying elements of both the Device Prohibition and the ATB Requirement.

The Proposed Regulations sought to clarify the Device Prohibition by introducing the concepts of "business assets" and "nonbusiness assets" and establishing a facts-and-circumstances test and a *per se* test that relate to these concepts. Under the Proposed

Regulations, business assets are defined as gross assets used in one or more businesses (determined without regard to the five-year requirement). Business assets include reasonable amounts of cash and cash equivalents held for working capital and assets required to be held for exigencies or regulatory purposes relating to the relevant businesses. Nonbusiness assets are defined as gross assets other than business assets. Subject to special rules that apply to stock of 50%-owned corporations and certain look-through partnerships, corporate stock and partnership interests are generally treated as nonbusiness assets.

The Proposed Regulations were issued against a backdrop of heightened IRS and Treasury scrutiny of taxpayers seeking to secure tax-free treatment for spin-offs or cash-rich split-offs that involved distributions of substantial nonbusiness assets coupled with relatively small active business units that were not subject to the rules in Section 355(g) regarding disqualified investment corporations.[2] Historically, there were no statutory or regulatory requirements relating to the relative size of an ATB that would be required to meet the ATB Requirement. This was widely referred to as the "hot dog stand" rule, where a de minimis ATB (*e.g.*, a hot dog stand) could theoretically support a large tax-free distribution of passive investment assets.

In response, the Proposed Regulations would modify the ATB Requirement to mandate that each of Distributing and Controlled have a minimum percentage of gross assets used in one or more ATBs of at least five percent (the "Minimum ATB Threshold"). This requirement built on older IRS guidance that was reinstated in September 2015, in which the IRS announced that it would decline to issue private letter rulings for Section 355 Transactions where the fair market value of the gross assets attributable to the ATB Requirement of either Distributing or Controlled represented less than five percent of that corporation's total value.[3]

The Proposed Regulations would also introduce percentage-based tests that treat as evidence of device the presence of excessive nonbusiness assets, or a disproportionate share of nonbusiness assets held by Distributing as compared to Controlled (or vice versa). Pursuant to these proposed tests, owning nonbusiness assets would ordinarily not be treated as evidence of device if less than 20 percent of the assets of each of Distributing and Controlled are nonbusiness assets. Separately, a difference of less than 10 percentage points between the nonbusiness asset percentages of Distributing and Controlled would ordinarily not be treated as evidence of device, subject to special rules

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[2] This concern was publicized by the IRS's decision to decline to rule, either favorably or adversely, on the tax treatment of Yahoo! Inc.'s proposed spin-off of its minority interest in Alibaba.

[3] This Minimum ATB Threshold continues to appear in the IRS's annual list of no-rule areas, which covers issues relating to the qualification under Section 355 for distributions in which the fair market value of gross assets of either Distributing or Controlled that relate to the ATB Requirement is less than five percent of the fair market value of the total gross assets of such corporation. *See* Rev. Proc. 2026-3.

in the context of non pro rata distributions. For purposes of these tests, a higher nonbusiness asset percentage or a greater difference between nonbusiness asset percentages signals stronger evidence of device.

What the Guidance Withdraws

The *Per Se* Device Test

In addition to the percentage-based tests for evidence of device, the Proposed Regulations introduced a *per se* device test, which has been withdrawn. Under the *per se* device test, a distribution would have been treated as a device (and therefore taxable) if at least 66⅔ percent of either Distributing's or Controlled's total assets were nonbusiness assets and the two corporations' respective nonbusiness asset percentages fell within one of three specified bands. Those bands applied where one corporation's nonbusiness assets measured against total assets constituted (i) 66⅔ percent to less than 80 percent and the other's less than 30 percent, (ii) 80 percent to less than 90 percent and the other's less than 40 percent or (iii) 90 percent or more and the other's less than 50 percent. The *per se* device test would not have applied to every Section 355 Transaction. It included certain carve-outs, including for distributions to a corporate distributee that would have been entitled to a dividends received deduction absent Section 355 and for categories of distributions that are ordinarily not considered a device under the existing regulations.

Comment: The *per se* device test has arbitrary cliff effects that would have placed increased pressure on the characterization of assets as business or nonbusiness assets and on valuations of these assets. The withdrawal of the *per se* device test is a helpful development that eliminates some friction in an already complicated area. However, although the mechanical rules of the *per se* device test will not apply to an otherwise qualifying transaction, the facts-and-circumstances test introduced in the Proposed Regulations has not been withdrawn and would still require taxpayers to identify and measure against prescribed percentage thresholds of business and nonbusiness assets.

The Anti-Abuse Rules

In connection with introducing the concepts of "business assets" and "nonbusiness assets," the Proposed Regulations included a related anti-abuse rule under which a transaction or series of transactions (such as a change in the form of ownership of an asset; an issuance, assumption or repayment of indebtedness; or an issuance or redemption of stock) would be disregarded if undertaken with a principal purpose of affecting the percentage of "nonbusiness assets" to avoid the Device Prohibition.

The Proposed Regulations also included an anti-abuse rule under which a transaction or series of transactions undertaken with a principal purpose of affecting the five-year-active business asset percentage of Distributing and/or Controlled would be disregarded for purposes of applying the Minimum ATB Threshold (the "ATB Anti-Abuse Rule").

The guidance withdraws both anti-abuse rules, citing feedback from stakeholders that was generally critical of those rules and of the *per se* device test. Following the issuance of the Proposed Regulations, practitioners expressed particular concern that the anti-abuse rules, although not intended to apply to non-transitory asset acquisitions or dispositions or non-transitory transfers between Distributing and Controlled, were vague as to their application to transactions surrounding a distribution.

Comment: The withdrawal of the anti-abuse rules removes an element of unneeded potential for second-guessing around the already nuanced Device Prohibition as well as the ATB Requirement.

What the Guidance Leaves in Place

The Nonbusiness Assets Facts-and-Circumstances Test. The Proposed Regulations continue to include the percentage-based tests for evidence of device described above.

The Corporate Business Purpose Limitation. Under existing law, a corporate business purpose is treated as evidence of nondevice and a strong business purpose can potentially outweigh other evidence of device. However, under the Proposed Regulations, a corporate business purpose relating to the separation of nonbusiness assets from one or more businesses or business assets is not considered evidence of nondevice unless it involves an exigency requiring an investment or other use of the nonbusiness assets in one or more businesses. This proposed rule was not withdrawn or otherwise modified. Under this rule, a transaction with a strong business purpose could fail the device test if the presence of nonbusiness assets creates evidence of device under the Proposed Regulations.

Comment: The Proposed Regulations would deny nondevice credit to a business purpose for separating nonbusiness assets unless an "exigency" requires that those assets be invested or otherwise used in a business. This proposal has been criticized. The Proposed Regulations do not define "exigency" and the examples in the preamble suggest that the term is meant to be defined narrowly.

The Minimum ATB Threshold. Because the guidance withdraws only the related ATB Anti-Abuse Rule, the proposal that each of Distributing and Controlled have a five-year-

active business asset percentage of at least five percent remains in the Proposed Regulations.

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