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IRS Narrows Spin-off Ruling Practice

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The Treasury Department and the IRS recently released updated guidance (“New Ruling Guidance”) and a request for stakeholder feedback regarding the rules taxpayers must follow to obtain a private letter ruling from the IRS on tax-free corporate spin-off, split-off and split-up transactions (“Section 355 Transactions”).[1]

Section 355 Transactions are important because they permit a parent company to transfer an existing business to its shareholders in a transaction that is tax efficient for both the shareholders and the parent company. In this update, we refer to the parent company as “Distributing” and the company that holds the spin-off business as “Controlled”. If properly structured, these transactions are generally tax-free to Distributing, Controlled and the shareholders of Distributing.

Since the stakes are high, it is common practice for public companies that engage in Section 355 Transactions to obtain a private letter ruling from the IRS that provides comfort on the tax qualification of the transactions. The New Ruling Guidance is significant because it changes the IRS’s ruling practice for Section 355 Transactions in ways that limit flexibility that prior ruling practice afforded taxpayers. These changes are likely to impose additional costs on taxpayers engaging in Section 355 Transactions and may increase uncertainty in planning important aspects of Section 355 Transactions, in particular for:

- Transactions that allocate group leverage among Distributing and Controlled; and
- Transactions in which, following the initial spinoff distribution, Distributing temporarily retains a portion of Controlled stock or securities for commercial reasons.

The government has asked for feedback on the New Ruling Guidance and other issues relating to Section 355 Transactions, and has indicated that it would like to issue

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[1] The revised procedures for obtaining a private letter ruling from the IRS are set out in Revenue Procedure 2024-24. The government’s request for feedback on these matters is set out in Notice 2024-38.

additional guidance that is responsive to current market practices for engaging in Section 355 Transactions. However, the government's framing of this request suggests it has concerns regarding proposals that (in the government's view) may not be consistent with the relevant provisions of the Internal Revenue Code, and that there will be an emphasis on rules that provide certainty for taxpayers and the government over preserving flexibility for taxpayers in structuring a Section 355 Transaction.

The New Ruling Guidance shows willingness on the government's part to review and rule on a variety of fact patterns, including in areas where the government has expressed uneasiness, provided that taxpayers can show that business exigencies drive the particular circumstances of the transaction. This aspect of the new guidance, in contrast to only permitting rulings that fit prescribed scenarios, will hopefully facilitate a nuanced analysis that delivers more predictable outcomes for taxpayers.

We discuss key elements of the New Ruling Guidance below.

Allocating Group Debt Using Intermediaries

In connection with Section 355 Transactions that are structured as "Divisive Reorganizations", corporations are permitted to allocate their historic borrowings among Distributing and Controlled on a tax-free basis using various strategies, including by causing Controlled to issue debt securities which are used to satisfy historic Distributing debt. The ability to use Controlled debt securities to repay Distributing debt is significant because transfers of cash and other property from Controlled to repay Distributing debt, including the proceeds of borrowings that are not in the form of securities, are taxable to Distributing to the extent they exceed the tax basis of property that Distributing transferred to Controlled. Controlled securities are not subject to this tax basis limitation, which allows Distributing to de-lever, in a tax-efficient manner, in excess of the tax basis of the assets that Distributing transfers to Controlled.

Using Controlled securities to satisfy historic Distributing debt may be limited commercially, in part because historic holders of Distributing debt may not be willing or able to accept Controlled securities in repayment of their Distributing debt. Prior IRS ruling practice permitted "Direct Issuance" structures that alleviated this commercial limitation. In a Direct Issuance structure, an intermediary financial institution would lend cash to Distributing, Distributing would repay this loan with Controlled securities and the intermediary would then sell the Controlled securities into the market. Although the loan from the intermediary to Distributing was not historic debt of Distributing, Distributing would commit to use the proceeds of the loan to repay historic Distributing debt. Prior IRS ruling practice in effect allowed the intermediary

loan (which was used to repay historic Distributing debt) to be treated as historic Distributing debt for purposes of the debt-for-securities exchange rules.

No More Direct Issuance Rulings

Under the New Ruling Guidance, the IRS will no longer issue rulings on direct issuances involving intermediaries. The IRS will continue to issue rulings on "Intermediated Exchanges", whereby an intermediary acquires historic Distributing debt from existing holders and agrees to exchange the acquired historic debt for Controlled securities (which the intermediary then sells into the market). The IRS also permitted Intermediated Exchanges under its prior ruling practice (prior to 2018, the IRS generally required the intermediary to hold the acquired Distributing debt for five days prior to entering into an exchange agreement and for 14 days prior to the exchange itself), but the market subsequently moved to Direct Issuance structures that reduce the cost and complexity of these arrangements.

Limitations on Intermediated Exchanges

The New Ruling Guidance includes representations that may impose significant constraints on Intermediated Exchanges. In particular, taxpayers must represent that:

- The exchange of Controlled securities for Distributing debt between Distributing and the intermediary will be on arm's-length terms;
- Distributing and Controlled will not participate in any profit gained by the intermediary; and
- The intermediary will act for its own account and bear the risk of loss with respect to the Distributing debt that it acquires and the Controlled securities that it sells into the market.

These representations represent an incremental tightening of the requirements and impose a heightened burden on taxpayers seeking a ruling to establish that an intermediary is a creditor of Distributing that participates as a principal acting for its own account in the exchange. The New Ruling Guidance does not include specific holding period requirements for intermediaries. The taxpayer's analysis, however, must establish that an expected short holding period does not cause the form of the transactions to be recast as a cash purchase by Distributing of its own debt. The shorter the time period, the greater degree of scrutiny the IRS will apply to the ruling request.

Debevoise Comments

- Intermediaries will be required to acquire and hold debt at their own risk. Unlike historic ruling practice which recognized the "5/14" standard described above, the

New Ruling Guidance does not specify the minimum amount of time that the intermediary must be at risk.

- Variable pricing or similar arrangements between Distributing and the intermediary are not permitted. However, an intermediary may hedge its position with third parties.

- The cost to the intermediary of hedging its position (and any cost associated with the risk of imperfect hedging) will presumably be passed along to taxpayers, thereby creating additional economic friction for Intermediated Exchanges.

IRS Commentary on Direct Issuances

In its request for feedback, the government states that structures involving an issuance and redemption of debt in close temporal proximity could be recast under general principles of tax law so that the intermediary bank is not treated as a creditor for purposes of the Divisive Reorganization rules.

Debevoise Comment

- It is surprising to see the New Ruling Guidance raise questions regarding structures on which the IRS previously ruled.

Delayed Distributions and Retentions

Delayed Distributions

In a Section 355 Transaction, Distributing must distribute all of the stock and securities in Controlled that it owns to Distributing's shareholders and security holders. However, Distributing may engage in a "delayed distribution", where it distributes some of the Controlled stock or securities following the initial distribution. A delayed distribution may be advantageous, for example, because it affords Distributing flexibility to use Controlled stock to repurchase Distributing stock or to repay Distributing debt after the initial distribution, at a time when a stable trading price has developed for Controlled stock.

Retentions

Distributing may also temporarily retain a portion of the stock or securities of Controlled if Distributing distributes at least 80% of the stock of Controlled and it is established to the satisfaction of the Secretary that the retention was not in pursuance of a plan having as one of its principal purposes the avoidance of federal income tax.

The New Ruling Guidance permits a retention if the taxpayer represents that the Controlled stock will be widely held, there is a business purpose for the retention that is not speculative or contingent, the retained stock or securities will be disposed of as soon as warranted, consistent with the business purpose and in any event within five years, and Distributing will vote the retained shares in proportion to the votes cast by Controlled's other shareholders.

The New Ruling Guidance also creates a rebuttable presumption in transactions with a retention where certain factors exist (for example overlapping directors and continuing contractual arrangements), that taxpayers may overcome by demonstrating to the satisfaction of the IRS that a business exigency exists that causes the need for such a retention.

Debevoise Comment

- While the factors that the IRS will weigh in assessing whether a taxpayer has overcome the rebuttable presumption are similar to factors from the IRS's prior ruling practice, the New Ruling Guidance appears to impose a heightened burden on taxpayers to demonstrate that Controlled stock or securities were retained for appropriate business purposes.

Narrower Ruling Practice on Choosing Between Delayed Distributions and Retentions

Under prior ruling practice, the IRS permitted Distributing to distribute stock or securities of Controlled within the 12-month period following the initial distribution or retain the Controlled stock or securities after the 12-month period, so long as Distributing disposed of the retained stock or securities as soon as commercially practicable, in any event within five years. While such a later disposition would not be tax-free as with a delayed distribution, it would not affect the tax treatment of the overall spin-off.

The New Ruling Guidance does not permit taxpayers to get a ruling on a fallback retention. Instead, taxpayers must choose up front the Controlled stock or securities that will be distributed in a delayed distribution and the Controlled stock or securities that will be subject to the retention rules.

Debevoise Comment

- The New Ruling Guidance limits taxpayer flexibility with respect to Controlled stock or securities not distributed in the initial distribution and could place taxpayers at risk of not being able to comply with the terms of their IRS ruling if they are not able to complete a delayed distribution within the 12-month period. As a practical

matter, this limitation may force taxpayers to seek a supplemental ruling from the IRS on short notice or to rely on opinion comfort from advisors.

Genuine Separation of Distributing and Controlled

A Section 355 Transaction contemplates a true separation of Distributing and Controlled. The spinoff retention rules are sensitive to continuing overlap of Distributing and Controlled directors, officers and key employees, and to the existence of continuing contractual arrangements between Distributing and Controlled which include provisions that are not at arm's length.

Debevoise Comment

- The government's request for feedback expresses the view that overlapping officers, directors or key employees and the existence of continuing relationships that are not at arm's-length between Distributing and Controlled could also weigh against tax qualification of a Section 355 Transaction that does not involve a retention, particularly if the spin-off is motivated by a fit and focus business purpose.

Plan of Reorganization

In a Section 355 Transaction that is structured as a Divisive Reorganization, Distributing transfers the spin-off business to Controlled in exchange for Controlled stock or securities and potentially other property or cash. Distributing does not recognize gain on the other property or cash that it receives if Distributing distributes the property or cash in pursuance of the plan of reorganization (which includes a transfer of the property or cash to Distributing's creditors). This transfer of property or cash pursuant to a plan of reorganization is called a "boot purge".

The boot purge rules provide Distributing with flexibility to use cash from borrowings by Controlled to repay selected historic debt of Distributing, provided the repayment is pursuant to the plan of reorganization that governs the Divisive Reorganization.

The New Ruling Guidance expresses concerns that case law fails to provide sufficient consistency or clarity for the administration or enforcement of the plan of reorganization rules. To address this perceived lack of consistency and clarity, the New Ruling Guidance requires that taxpayers:

- Specify and describe clearly each specific step in the plan of reorganization; and

- Represent that each step is (i) necessary to effectuate the business purposes of the transaction; (ii) carried out for reasons germane to the continuance of the business of each corporation; and (iii) directly a part of the proposed transaction.

Debevoise Comment

- The New Ruling Guidance recognizes that some degree of flexibility will be permitted, including steps that are subject to a contingency or alternative. However, it appears that the failure to include a potential step in the plan with a sufficient degree of specificity could disqualify the step from being treated as part of the plan of reorganization.

- The New Ruling Guidance appears to place a premium on a detailed plan of reorganization that maps out all potential permutations, including alternative pathways that depend on contingencies. This may lead taxpayers to include schedules or spreadsheets for certain steps covering all of the possibilities, such as a debt schedule listing all historic Distributing debt that may be satisfied in a boot purge or debt exchange.

Boot Purge to Creditors Limited to Debt Obligations

The New Ruling Guidance provides that the boot purge rules do not apply to property that Distributing uses to satisfy liabilities that do not qualify as debt for federal income tax purposes.

Debevoise Comment

- This change reverses prior IRS ruling practice that permitted boot purge treatment for certain debt-like obligations, including pension plan liabilities.

Boot Purge and Debt Exchanges Limited to Historic Distributing Debt

The New Ruling Guidance limits the Distributing debt that may be satisfied with cash in a boot purge or with Controlled stock or securities in a debt exchange to historic Distributing debt, which the guidance defines as debt incurred 60 days before the earliest to occur of (i) the first public announcement of the transaction; (ii) the date of entry into a binding agreement to engage in the transaction; or (iii) the date of approval of the transaction.

Debevoise Comment

- These rules may limit a taxpayer's ability to repay commercial paper or other short-term debt obligations in a boot purge or debt exchange.

Solvency and Continued Viability of Distributing and Controlled

The New Ruling Guidance expresses the view that in the case of Divisive Reorganizations, tax-free spin-off qualification is limited to transactions after which Distributing and Controlled are capable of carrying on sustained businesses, and that Controlled should not be burdened with excessive leverage, jeopardizing its ability to continue as a viable going concern.

Under the New Ruling Guidance, Distributing must represent that Controlled will be adequately capitalized and therefore is expected to have the means to satisfy liabilities incurred as part of a plan of reorganization and continue to be an economically viable entity.

Debevoise Comment

- The New Ruling Guidance goes beyond prior IRS ruling practice in looking to the continued ability of Controlled to satisfy its debts, rather than just looking at whether the fair market value of the assets of Controlled exceeds its liabilities.

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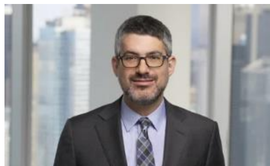
Please do not hesitate to contact us with any questions.



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