

New IRS Guidance Limits Future Rulings on Tax-Free Spin-Off Transactions

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On September 14, 2015, the IRS issued Notice 2015-59 and Revenue Procedure 2015-43 (the “Spin-Off Guidance”). The Spin-Off Guidance limits the circumstances in which the IRS will issue private letter rulings relating to spin-off transactions in which either the distributing corporation or the controlled corporation owns relatively large amounts of cash, securities, and other investment assets. The Spin-Off Guidance also significantly circumscribes the issuance of private letter rulings where the spin-off involves a real estate investment trust (“REIT”) or a regulated investment company (“RIC”).

Overview of Tax-Free Spin-Off Transactions

A spin-off transaction occurs when a corporation (the “distributing corporation”) distributes the stock of a controlled subsidiary corporation (the “controlled corporation”) to the distributing corporation’s shareholders. The controlled corporation could either be an existing subsidiary that is already conducting the business to be spun-off or a newly formed subsidiary to which the spun-off business is transferred. Immediately following a spin-off, the distributing corporation and the controlled corporation become brother-sister corporations owned by the same shareholders in the same proportions.

In general, if a corporation distributes property (including stock of another corporation) to its shareholders, the corporation is subject to tax on the built-in gain in the property,¹ and the shareholders generally are subject to tax on the fair market value of the distributed property.² However, if a spin-off transaction meets the requirements of Section 355 of the Internal Revenue Code,³ the transaction will not be subject to tax either at the corporate or shareholder level. Rather, any gain on the controlled corporation stock is deferred, and the shareholders of the distributing corporation will recognize gain only upon a later disposition of their stock.

The basic statutory requirements for a spin-off transaction to qualify under Section 355 are as follows:

1. *Control* – The distributing corporation must be in control of the controlled corporation immediately before the distribution.⁴ For this purpose, a corporation has control of another corporation if it owns stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of each of the other classes of stock of the corporation.⁵

¹ I.R.C. § 311(b)(1).

² I.R.C. § 301.

³ Except as otherwise stated, all Section references are to the Internal Revenue Code.

⁴ I.R.C. § 355(a)(1)(A).

⁵ I.R.C. § 368(c).

2. *Device* – The distribution of the controlled corporation’s stock cannot be principally a device for the distribution of earnings and profits of the distributing corporation, the controlled corporation, or both corporations.⁶ Whether a transaction is used principally as a device for the distribution of earnings and profits is determined based on all the facts and circumstances.⁷ In determining whether a distribution is a device, consideration is given to the nature, kind, amount, and use of the assets of the distributing and controlled corporation. The existence of assets that are not used in an active trade or business, such as cash and other liquid assets, are evidence of a device. The existence of a device depends in part on the ratio for each corporation of the value of the assets not used in an active trade or business to the value of the assets used in an active trade or business.⁸

3. *Active Trade or Business* – The distributing corporation and the controlled corporation must each be engaged in an active trade or business immediately after the distribution.⁹ A corporation is treated as engaged in the active conduct of a trade or business if (1) the corporation is currently engaged in the active conduct of a trade or business, (2) the trade or business has been actively conducted throughout the five-year period ending on the date of distribution, (3) the trade or business was not acquired during the five-year period ending on the date of the distribution in a transaction in which any gain or loss was recognized, and (4) control of a corporation conducting such trade or business was not acquired by the distributing corporation during the five-year period preceding the distribution in a transaction in which any gain or loss was recognized.¹⁰ An active trade or business is broadly defined. However, the active conduct of a trade or business does not include the holding for investment purposes of stock, securities, land, or other property, or the ownership and operation (including leasing) of real or personal property used in a trade or business, unless the owner performs significant services with respect to the operation and management of the property.¹¹

4. *Distribution* – In general, the distributing corporation must distribute all of the stock and securities in the controlling corporation to the distributing corporation’s shareholders.¹²

In addition to the statutory requirements, courts have also imposed the following judicial requirements that must be satisfied for a spin-off to qualify as a tax-free transaction:

1. *Business Purpose* – The spin-off transaction must be carried out for one or more corporate business purposes.¹³

⁶ I.R.C. § 355(a)(1)(B).

⁷ Treas. Reg. § 1.355-2(d)(1).

⁸ Treas. Reg. § 1.355-2(d)(2)(iv).

⁹ I.R.C. § 355(b)(1)(A).

¹⁰ I.R.C. § 355(b)(2).

¹¹ Treas. Reg. § 1.355-3(b)(2).

¹² I.R.C. § 355(a)(1)(D)(i).

¹³ Treas. Reg. § 1.355-2(b)(1).

2. *Continuity of Interest* – One or more persons who were the owners of the enterprise before the distribution or exchange must own in the aggregate an amount of stock sufficient to establish a continuity of interest in each of the modified corporate forms in which the enterprise is conducted after the distribution.¹⁴
3. *Continuity of Business Enterprise* – Section 355 contemplates the continued ownership and operation of the businesses of both the distributing corporation and the controlled corporation that existed prior to the distribution.¹⁵

Notice 2015-59

Notice 2015-59 provides that the IRS is studying issues regarding spin-off transactions with one or more of the following characteristics:

1. Ownership by the distributing corporation or the controlled corporation of a substantial amount of “investment assets” in relation to (i) the value of all of such corporation’s assets and (ii) the value of the assets of the active trade or business on which the corporation relies to satisfy the active trade or business requirement described above. Investment assets generally include cash, stock, securities, indebtedness, foreign currency, and similar assets.¹⁶
2. A significant difference between the distributing corporation’s ratio of investment assets to non-investment assets and such ratio of the controlled corporation.
3. Ownership by the distributing corporation or the controlled corporation of a small amount of active trade or business assets when compared to its total assets.
4. An election by the distributing corporation or the controlled corporation (but not both) to be a REIT or a RIC.

The IRS is concerned that transactions with these characteristics may not satisfy the requirements of Section 355. In particular, Notice 2015-59 states that such transactions may present evidence of a device for the distribution of earnings and profits, may lack an adequate business purpose, may not meet the active trade or business requirement, or may violate other requirements of Section 355. The IRS noted that such transactions may circumvent the tax rules that impose a corporate level tax upon a distribution of property with a built-in gain.

The IRS also noted that it has observed an increasing number of spin-off transactions involving a distributing corporation or a controlled corporation that elects to be a REIT. Such spin-off transactions may involve corporations that, prior to the distribution, do not meet the requirements to be REITs and intend to separate REIT-qualifying assets from non-qualifying assets so that the distributing corporation or the controlled corporation can meet the requirements

¹⁴ Treas. Reg. § 1.355-2(c)(1).

¹⁵ Treas. Reg. § 1.355-1(b).

¹⁶ I.R.C. § 355(g)(2)(B).

to be a REIT. Such transactions raise concerns relating to the device prohibition, the business purpose requirement, and the active trade or business requirement.

The IRS also requested comments concerning the transactions described in Notice 2015-59.

Revenue Procedure 2015-43

There are certain areas where the IRS will not issue private letter rulings because the issues are inherently factual or for other reasons. The IRS publishes annual guidance that sets forth those “no-rule” areas. The most recent list of no-rule areas are contained in Revenue Procedure 2015-3. Section 4 of Revenue Procedure 2015-3 sets forth areas in which the IRS ordinarily will not issue rulings, unless unique and compelling reasons justify the issuance of the ruling. Section 5 of Revenue Procedure 2015-3 lists areas in which the IRS temporarily will not issue rulings because the areas are under study.

In Revenue Procedure 2015-43, the IRS added two no-rule areas to Section 4 of Revenue Procedure 2015-3. The first new no-rule area involves any issue relating to a spin-off transaction where the distributing corporation or the controlled corporation becomes a REIT or a RIC in connection with the spin-off. The second no-rule area involves any issue relating to a spin-off transaction if, immediately after the distribution, the fair market value of the active trade or business assets of the distributing corporation or the controlled corporation is less than 5% of the fair market value of its total gross assets. Thus, for ruling requests postmarked after September 14, 2015, the IRS ordinarily will not rule on these two issues absent unique and compelling reasons.

Revenue Procedure 2015-43 also makes one addition to Section 5 of Revenue Procedure 2015-3. Accordingly, the IRS is studying, and will not rule on, any issue relating to a spin-off transaction if, immediately after the distribution (1) the fair market value of the investment assets of the distributing corporation or the controlled corporation is two-thirds or more of the fair market value of its total gross assets, (2) the fair market value of the gross assets of the active trade or business of the distributing corporation or the controlled corporation is less than 10% of the fair market value of its investment assets, and (3) the ratio of the fair market value of the investment assets to the fair market value of the assets other than investment assets of the distributing corporation or the controlled corporation is three times or more than the ratio of the other corporation. In contrast to the no-rule areas added to Section 4 in which the IRS may issue a ruling if there are unique and compelling reasons, there are no circumstances in which the IRS will issue a ruling on the areas listed in Section 5.

Impact of the Spin-Off Guidance

Through the Spin-Off Guidance, the IRS has expressed a degree of concern regarding the qualification of the various spin-off transactions described above. However, the IRS has not given a clear indication of the path it intends to take after completing its study. The IRS might issue new regulations limiting the scope of permitted spin-off transactions, or it could ultimately decide to make no changes to the existing regulations.

In the meantime, due to the additional no-rule areas contained in Revenue Procedure 2015-43, taxpayers desiring to complete spin-off transactions described in the Spin-Off Guidance will have to do so without the comfort of a private letter ruling and generally will need to rely on the opinions of tax counsel.