TAX LAW AND ESTATE PLANNING SERIES

The Corporate Tax Practice Series:
Strategies for Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations & Restructurings 2019

Volume Eighteen

Edited by
Louis S. Freeman
Eric Solomon

To order this book, call (800) 260-4PLI or fax us at (800) 321-0093. Ask our Customer Service Department for PLI Item Number 275014, Dept. BAV5.

Practising Law Institute
1177 Avenue of the Americas
New York, New York 10036

Considerations in Seeking Private Letter Rulings for Spinoffs

Jasper Howard

Hogan Lovells US LLP

Tax Notes, May 27, 2019

© 2019 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

Considerations in Seeking Private Letter Rulings for Spinoffs

by Jasper A. Howard[1]

On March 12, 2019, the IRS announced an extension of its pilot program for "transactional" private letter rulings involving spinoffs.[2] The extension was expected and welcomed by taxpayers. Other recent IRS guidance regarding spinoffs includes (1) updated procedures for spinoff rulings that involve securities-for-debt exchanges, assumption of liabilities and certain payments of boot in connection with spinoffs; (2) annual updates to the IRS's ruling procedures; (3) an announcement that special scrutiny will be applied to some "drop-spin-liquidate/merge" transactions; (4) an announcement of an IRS study of the current "collection of income" requirement in connection with the active trade or business requirement; (5) a revenue ruling that suspends two prior revenue rulings involving the collection of income requirement; and (6) a request for information regarding the activities of entrepreneurial ventures that have not yet reached the collection of income stage. Taxpayers often seek private letter rulings for spinoffs from the IRS because of the dire tax consequences of failing to qualify and the lack of controlling authorities regarding material spinoff-related tax issues. This article summarizes recent changes to the IRS's ruling procedures and discusses considerations for taxpayers that are contemplating a private letter ruling for a spinoff.

Indefinite Extension of the Pilot Program

The IRS's March 12, 2019 announcement extended indefinitely the 18-month pilot program initiated by Rev. Proc. 2017-52, 2017-41 IRB 283, under which taxpayers can obtain a private letter ruling for a spinoff[3] in the form of a "transactional ruling" instead of a "significant issue" ruling. A transactional ruling generally provides that "no gain or loss" will be recognized in connection with the spinoff, while a significant issue ruling addresses only specific issues regarding the spinoff and does not rule more broadly on whether gain or loss is recognized. Examples of recent significant issue rulings include whether activities of specific affiliates can be taken into account in determining whether the "active trade or business" (ATB) requirement will be satisfied and whether specific counting conventions can be used for purposes of determining whether there has been an acquisition of a 50 percent or greater interest for purposes of section 355(e).[4] Transactional rulings for spinoffs were the norm before 2013, when the IRS changed its historic procedures and began limiting spinoff rulings to address only significant issues.[5]

---

[1] Jasper A. Howard is a partner at Hogan Lovells US LLP in Washington and an adjunct professor at Georgetown University Law Center. He thanks Todd Miller and Caitlin Piper for helpful comments on an earlier draft of this article. Any errors are solely the author's.

[2] IRS, "Statement on Private Letter Ruling Pilot Program Extension" (March 12, 2019).

[3] The option to seek a transactional ruling only applies to spinoffs, split-offs or other distributions governed by section 355 (regardless of whether part of a divisive reorganization under section 368(a)(1)(D)) and does not extend to acquisitive reorganizations. The IRS will not provide "comfort" rulings for mergers and other acquisitive reorganizations and similar transactions, which continue to be limited to rulings on "significant issues."

[4] LTR 201818010; LTR 201817001.

[5] Rev. Proc. 2013-32, 2013-28 IRB 55.

The precise number of transactional ruling requests submitted since the pilot program was adopted in 2017 is unknown because many of the rulings requested under the pilot program may still be under consideration or have not yet been publicly released. Roughly a dozen transactional rulings have been publicly released.[6] Not all taxpayers have opted for a transactional ruling instead of a significant issue ruling, but the publicly released rulings suggest that transactional rulings are outnumbering the significant issue rulings at this point. Of course, many spinoffs are undertaken based on opinions of tax advisers without any private letter rulings at all. Taxpayers' willingness to undertake spinoffs based on tax opinions has expanded since 2013 when the IRS stopped its historical practice of issuing transactional rulings. Even though the IRS has now reinstated its transactional ruling process for spinoffs, it seems likely that, at least in spinoffs that do not present material uncertain issues,[7] many taxpayers will continue to use solely tax opinions because of the additional control and flexibility that they give taxpayers over the timing of the transactions and potential concerns taxpayers may have regarding the IRS's requirement to provide an expansive description of all related transactions that are part of a spinoff transaction.

Even Transactional Rulings Leave Gaps

Even with a transactional ruling, the IRS will not rule on several issues that are central to determining the tax consequences of a spinoff, including (1) device, (2) business purpose, and (3) some "plan" issues under section 355(e).[8] Also, the IRS "ordinarily" will not rule on whether the ATB requirement is met if the fair market value of the gross assets of the ATB is less than 5 percent of the FMV of the total gross assets of the corporation or its "separate affiliated group" (SAG).[9] Also, many international provisions continue to be on the IRS's "no-rule" list, and the transactional ruling procedures do not apply to those provisions. Thus, for example, routine or comfort rulings ordinarily will not be issued under section 367 or other international provisions even for a transactional ruling regarding a spinoff.[10]

For the issues on which the IRS will not rule, the taxpayer generally must submit a representation that the relevant requirements will be met. For example, the taxpayer must represent that the spinoff satisfies the requirement that the spinoff is motivated, in whole or

[6] *See e.g.*, LTR 201910004; LTR 201848016; LTR 201839006; LTR 201827006; LTR 201835001; LTR 201836001; LTR 201834006; 201851005; LTR 201851004; and LTR 201845009.
[7] Transactions that are likely to necessitate a ruling include *Morris Trust* and *Reverse Morris Trust* transactions, which often present material uncertain issues regarding the proper methods and allowable assumptions in computing whether the relevant ownership shift in accordance with a plan is less than the 50 percent threshold in section 355(e). *See e.g.*, LTR 201817001; LTR 201801012; and LTR 201801005.
[8] Rev. Proc. 2019-3, 2019-1 IRB 30, section 3.01(58). The IRS will, however, rule on significant issues related to whether the device or business purpose requirements are satisfied if the issue is a legal issue that is not inherently factual in nature. Similarly, the IRS will rule on some section 355(e) plan issues involving redemptions if an adverse ruling would result in a 50 percent or greater acquisition of stock under a plan for purposes of section 355(e). *Id*.
[9] Rev. Proc. 2019-3, section 4.01(30).
[10] Rev. Proc. 2019-7, 2019-1 IRB 268, section 3.02(6).

in part, by corporate business purposes.[11] So, even with a transactional ruling, there are gaps that typically are filled by opinions provided by the tax advisers.

Moreover, even for the enumerated spinoff issues for which the IRS will not rule, Rev. Proc. 2017-52 (which sets forth the requirements for a transactional ruling) requires taxpayers to provide information relevant to the "no-rule" issues.[12] For example, regarding the "device" requirement, a transactional ruling must describe the facts relevant to determining whether the transaction is a device, including a discussion of the device and non-device factors set forth in the regulations.[13] This requirement typically is not terribly burdensome, in part because the taxpayer and its tax adviser generally must go through the same exercise for a tax opinion that analyzes the device regulations and other issues on the no-rule list.

A transactional ruling request also must describe each other transaction that is part of the same plan or series of transactions and must include a description of the federal income tax consequences of all other material transactions related to the request.[14] If the spinoff is part of a large restructuring project, this can add significantly to the size of the submission. Some taxpayers view this requirement as potentially providing some "halo effect" in the event of a later audit by demonstrating that the IRS was made aware of the larger transaction and its intended tax consequences. Other taxpayers view the additional information as only minimally helpful to a future audit while adding material time and expense by requiring a difficult exercise of determining how much detail and analysis to provide regarding the other transactions.

Mixing and Matching Within a Ruling Request

Many spinoff transactions involve multiple internal spinoffs as well as an external spinoff and significant additional restructuring transactions related to transfers and separations of the respective companies' assets in connection with the spinoff. Taxpayers can request a transactional ruling on some spinoffs, but not others, if they so choose.[15] For spinoffs for which the taxpayer does not request a transactional ruling, the taxpayer can either ask for significant issue rulings or forgo any ruling at all. However, if a transactional ruling is requested for one of the spinoffs, the taxpayer must provide a representation regarding the qualification under the relevant Code provisions (such as section 351 or 368(a)) of any other material transactions related to the spinoff.[16] Also, as noted above, if a taxpayer requests a transactional ruling for a spinoff, a potentially significant amount of additional information, analysis and documents may need to be provided, including a description of the federal income tax consequences of all other material transactions related to the spinoff that is the subject of the requested transactional ruling.

[11] Rev. Proc. 2017-52, Appendix section 3 (Representation 16).
[12] Rev. Proc. 2017-52, section 3.03(1).
[13] Rev. Proc. 2017-52, section 3.03(6).
[14] Rev. Proc. 2017-52, section 3.03(1).
[15] Rev. Proc. 2017-52, section 2.03(2).
[16] Rev. Proc. 2017-52, section 3.04(1); *see e.g.,* LTR 201835001 (taxpayer represented that related transaction qualified as a recapitalization).

New Standard Representations

Rev. Proc. 2017-52 requires taxpayers who seek a transactional ruling to make a long list of "standard" representations, including in some cases specified alternative representations. These new representations are especially welcomed by taxpayers in part because the prior procedures and representations required for spinoff rulings were set forth in Rev. Proc. 96-30, 1996-1 C.B. 696,[17] which had become outdated following the legislative changes to section 355 in 2005 and other post-1996 administrative guidance.

Rev. Proc. 2017-52 asks taxpayers not to separately state the representations as part of a transactional ruling request, but instead just include a statement that the taxpayer makes the representations (including any alternative representations). If the taxpayer cannot make the standard representations or must modify the representations, the taxpayer must explain why. This format apparently was intended to provide consistency and streamline the review process for IRS reviewers by making it easy to identify when the taxpayer is departing from the standard representations. The standard representations generally are carefully drafted to ensure that the technical requirements of section 355 will be satisfied. In some cases, if the taxpayer cannot make a standard representation, the submission must include additional legal analysis.[18] For example, if the taxpayer cannot provide specific representations that the relevant companies are not controlled foreign corporations, the submission must discuss the application of sections 367 and 1248 to the proposed spinoff.

In an ideal case, a taxpayer would simply state in its submission that the taxpayer makes all of the standard representations (including any alternative representations) and keep the ruling request short and simple. So far, most of the published transactional rulings are not that straightforward – which is likely why the taxpayer was seeking a ruling in the first place. The transactional rulings published so far typically affirmatively state that the taxpayer makes the standard representations, but then list exceptions from the standard representations by grouping them into categories in which: (1) the taxpayer makes the preapproved alternative representations; (2) the taxpayer does not make a standard representation because it does not apply to the transactions in question; (3) the taxpayer does not make a standard representation but has provided the required explanation for why it cannot be made; (4) the taxpayer modified a standard representation; and (5) the taxpayer provided additional representations.[19] So, while the new procedures may not always be short and simple, they are much improved over the more cumbersome format of restating all the required representations without an easy way to identify when exceptions or modifications are being made.

For practitioners who attempt to decipher private letter rulings to try to glean the IRS's posture on spinoff issues, the new format with standard representations makes it much easier in many instances to determine the nature of the parties (for example, whether a party is real estate investment trust, S corporation, CFC or other type of entity), some other aspects of the transactions (such as spinoff versus split-off) and areas in which the IRS may be willing to budge from the standard representations. On the other hand, in

[17] Superseded by Rev. Proc. 2017-52.
[18] Rev. Proc. 2017-52, section 3.04(1).
[19] *See e.g.*, LTR 201851005.

some cases the standard representations format may result in private letter rulings providing less detail regarding aspects of the transactions that otherwise might be useful for taxpayers that are drafting future ruling requests.[20]

When a taxpayer cannot make one of the standard representations or specified alternative representations, it may be a sign that the transaction poses material issues that should be vetted with the IRS and, at a minimum, the transaction may be a good candidate for a significant issue ruling. Based on the few published transactional rulings since the pilot program was instituted, at least in some cases the IRS seems willing to accept modified representations or to omit representations in which the taxpayer provides sufficient explanation for the departure. Unfortunately, the rulings do not describe the "sufficient explanation," and thus it is not always apparent what factors might persuade the IRS to accept the deviation from the standard representations. In most cases, the prudent course of action is to address any material deviations from the standard representations, or one of the specified alternative representations, in a prefiling conference.

If a taxpayer decides to seek a significant issue ruling instead of a transactional ruling, the ruling request need not have all the standard representations. However, to the extent the significant issue ruling relates to a specific requirement for which Rev. Proc. 2017-52 contains standard representations, the taxpayer must make those representations.

Historically, when drafting a tax opinion for a spinoff, tax opinion preparers have largely adopted the representations requested by the IRS in connection with requests for private letter rulings. Thus, taxpayers that forgo a private letter ruling often will find that the IRS's standard representations are a good starting point for what their tax opinion preparers will expect.

Active Trade or Business Cannot be De Minimis

A key part of any spinoff is establishing that the ATB requirements of section 355(b) are met regarding both the distributing corporation and the controlled corporation (SpinCo). Taxpayers historically have taken the position that there is no minimum size requirement for the ATB. For purposes of obtaining a private letter ruling, the IRS's position on whether there is a minimum size requirement has flip-flopped over the years. In 1996, IRS letter ruling procedures were amended to provide that the IRS "ordinarily" would not issue a ruling in a spinoff if the gross assets of the ATB would have an FMV that was less than 5 percent of the total assets of the relevant corporation.[21] In 2013, the 5 percent minimum requirement was withdrawn as part of the IRS's decision to stop issuing transactional rulings.[22] In 2015, the IRS reversed course and again modified its ruling procedures to provide

[20] For example, when a taxpayer provides the standard representation that a spinoff is undertaken for a sufficient business purpose, the ruling may not provide any further detail regarding the business reasons for the spinoff. *See. e.g.,* LTR 201835001; *compare with* LTR 201834006 where the "Summary of Facts" provides a robust description of the business reasons in addition to noting that the taxpayer generally makes the standard representations.
[21] Rev. Proc. 96-43, 1996-2 C.B. 330.
[22] Rev. Proc. 2013-32.

that the service "ordinarily" will not rule if the gross ATB assets of the relevant corporation are less than 5 percent of the total FMV of all of the corporation's gross assets.[23]

The IRS also issued proposed regulations in 2016 that would adopt the 5 percent threshold as a bright-line rule so that the ATB requirement would not be satisfied if the 5 percent threshold was not met.[24] The proposed regulations reportedly were in part in response to transactions such as Yahoo's proposed spinoff in which the principal asset of the relevant SAG was a minority interest in Alibaba, and the qualifying ATB assets of the SpinCo were much less than 5 percent of the total assets of SpinCo.

Despite the bright-line rule in the proposed regulations, the IRS's current list of no-rule items continues to provide that the IRS "ordinarily" will not rule (as opposed to will not rule) if the 5 percent test is not met.[25] Consistent with this position, the standard representations added by Rev. Proc. 2017-52 include a representation that the FMV of the gross assets of the distributing corporation and SpinCo and their respective SAGs that satisfy the ATB requirement will be at least 5 percent of the total FMV of the assets of the respective corporation (or its SAG).

But by including the issue on the "ordinarily will not rule" list, at least for now the IRS seems to have left open the door to the possibility that an ATB below the 5 percent threshold could suffice. However, the stated threshold to overcome the "ordinarily will not rule" position is that the facts must be "unique and compelling."[26] Given the IRS's position on Yahoo's proposed spinoff, convincing the IRS to depart from the 5 percent minimum requirement could be a longshot, and the taxpayer may find that the required device representations (discussed below) end any hope for a ruling in any event.

Device and Investment Assets

In 2003 the IRS announced that it would no longer rule on whether a spinoff was used principally as a device for purposes of section 355.[27] In 2015 the IRS announced in Notice 2015-59, 2015-40 IRB 459, that some transactions, including transactions in which the distributing corporation or SpinCo owned substantial investment assets or the ratio of investment assets of one corporation was significantly higher than the other, were under study in part because the transactions present evidence of device. The IRS simultaneously amended its no-rule revenue procedures to add a new category of transactions that are under study and thus would be ineligible for a private letter ruling. Specifically, a ruling is not available if all three of the following are present (1) the FMV of the investment assets of the distributing corporation or SpinCo is two-thirds or more of the FMV of its total gross assets; (2) the FMV of the gross assets of the trades or businesses on which the distributing corporation or SpinCo relies to satisfy the ATB requirement is less than 10 percent of the FMV of its gross investment assets; and (3) the ratio of the FMV of the investment assets to the FMV of the assets other than the gross investment assets of the

[23] Rev. Proc. 2015-43, 2015-40 IRB 467.
[24] *See* prop. reg. section 1.355-9(b).
[25] Rev. Proc. 2019-3, section 4.01(30) (the IRS "ordinarily" will not rule when the 5 percent test is not satisfied).
[26] Rev. Proc. 2019-3, section 2.
[27] Rev. Proc. 2003-48, 2003-2 C.B. 86.

distributing corporation or SpinCo is three times or more of that ratio for the other corporation (collectively, the "Investment Asset Tests").[28]

The Investment Asset Tests reflect a concern with excessive amounts of investment assets, a small ATB relative to the amount of investment assets and a disproportionate allocation of investment assets. The new scrutiny and new Investment Asset Tests reportedly were in part in response to the proposed Yahoo-Alibaba transaction discussed above. The Investment Asset Tests do not apply to an internal spinoff in which all of the relevant corporations remain members of the same affiliated group.[29]

In 2016, the IRS issued proposed regulations that would significantly modify the existing device regulations.[30] The proposed regulations provide that the ownership of "nonbusiness assets" can be evidence of a device and material differences between the corporations' percentages of nonbusiness assets can be evidence of device. More significantly, the proposed regulations would add a new "per se device" test that would treat a transaction as failing the device requirement in cases in which (1) either the distributing corporation's or SpinCo's percentage of nonbusiness assets was 66 2/3 percent or more, and (2) the corporations' percentages of nonbusiness assets materially differ and fall within certain bands.[31] The proposed regulations shift in focus from "investment assets" as announced in Rev. Proc. 2015-43 to "nonbusiness assets" would allow cash used as working capital and other assets required to be held to provide for exigencies or regulatory purposes to count as "business assets" (that is, on the "good" side of the ledger). However, the proposed regulations put a premium on valuations of the assets and add other complexities in the new formulas.

The principles of the proposed regulations have not yet been incorporated in the procedures for ruling requests. Instead, Rev. Proc. 2019-3 continues the IRS's position since 2015 that the question of device is an area under study for which rulings will not be issued if the Investment Asset Tests are not satisfied.[32] Rev. Proc. 2017-52 basically enforces this no-rule position by requiring taxpayers to make a series of representations that ensure that the Investment Asset Tests are satisfied.[33] Unlike the 5 percent minimum gross asset test that is included in the "ordinarily" will not rule category, a taxpayer's inability to represent that the Investment Asset Tests are satisfied apparently forecloses *any* possibility of a favorable ruling. Presumably, the IRS would be sympathetic to a case in which the Investment Asset Tests are not satisfied but the various nonbusiness asset tests in the proposed regulations are satisfied.

While the Investment Asset Tests generally are less complex than the new factors and per se device tests contained in the proposed regulations, all the tests require valuations of the companies' assets. If the relevant values come close to exceeding the acceptable ratios or percentages, taxpayers have to decide how much time and expense is warranted in making potentially difficult valuations of the underlying assets. The risk of

---

[28] Rev. Proc. 2015-43, 2015-40 IRB 467. The tests are now incorporated in Rev. Proc. 2019-3.
[29] Rev. Proc. 2019-3, section 5.01(3).
[30] *See* prop. reg. section 1.355-2(d).
[31] Prop. reg. section 1.355-2(d)(5)(iii).
[32] Rev. Proc. 2019-3, section 5.01(3).
[33] Rev. Proc. 2017-52, Appendix section 3 (Representation 15).

incorrectly valuing the assets is that the taxpayer's representation that the tests are satisfied might later be determined by the IRS to be inaccurate, potentially undermining the taxpayer's ability to rely on its private letter ruling.

New Rules for Debt Allocation Transactions

In many spinoffs, the optimal capital structure for the distributing corporation and SpinCo can be achieved by either having SpinCo assume a portion of the distributing corporation's debt or by having SpinCo incur new debt and distribute the proceeds to the distributing corporation, which uses the proceeds to repay its debt. These techniques generally can achieve tax-free treatment as part of a spinoff if the cash proceeds and debt assumption do not exceed the tax basis of SpinCo's assets. If the assets transferred to SpinCo as part of the spinoff lack sufficient tax basis for one of these techniques, the preferred tax-free solution generally is to have SpinCo issue securities to the distributing corporation, which uses the securities to repay its debt. An investment bank typically facilitates this securities-for-debt exchange by acquiring the distributing corporation's debt so that the actual exchange is between the distributing corporation and the investment bank.

In Rev. Proc. 2018-53, 2018-43 IRB 667, the IRS provided detailed representations that are required in connection with requests for transactional and significant issue rulings involving spinoffs that contain securities-for-debt exchanges or other transactions that allocate leverage between SpinCo and the distributing corporation. In the past, the IRS has issued many rulings regarding these types of transactions.[34] Because these transactions became popular only after Rev. Proc. 96-30 (which provided procedures and representations for spinoff rulings), historically there were no standard representations or other formal guidance regarding the acceptable structure of these transactions. The only restriction on securities-for-debt exchanges generally was the IRS's addition to its "no-rule" list in 2013 of a provision stating that the IRS would not rule that a distributing corporation's distribution of SpinCo stock or securities in exchange for the distributing corporation's debt would be tax free under sections 355 and 361 if the distributing corporation's debt was issued "in anticipation of the distribution."[35]

That no-rule position was removed in 2017 by Rev. Proc. 2017-38, 2017-22 IRB 1258, without explanation, and Rev. Proc. 2017-52 did not provide any specific representations for securities-for-debt exchanges or similar transactions. Thus, before Rev. Proc. 2018-53, the representations and other requirements for obtaining a ruling for these types of transactions generally had to be gleaned from the IRS's position in prior private letter rulings. The new representations and other guidance provided in Rev. Proc. 2018-53 are especially helpful in providing taxpayers with relatively clear, uniform guidelines for the various leverage-shifting transactions. However, as noted below, the new representations also introduce many questions and issues.

One of the most significant changes made by Rev. Proc. 2018-53 regarding securities-for-debt exchanges was a change to the IRS's informal ruling practice requiring

---

[34] *See e.g.*, LTR 200747012; LTR 201032017.

[35] Rev. Proc. 2013-3, 2013-1 IRB 113, section 5.01(10). Taxpayers could still obtain rulings regarding their securities-for-debt exchanges, although taxpayers often represented that the applicable debt was not incurred in anticipation of the exchange. *See e.g.*, LTR 201613008.

that the investment bank must hold the distributing corporation's debt for at least 14 days and not enter into an exchange agreement with the distributing corporation until at least 5 days after acquiring the debt.[36] Rev. Proc. 2018-53 adds several new representations that in part seem to function as a proxy for the old "5-14" requirement to ensure that the investment bank acquires the debt for its own account. Among the new representations are representations that (1) the distributing corporation is in substance the obligor of the debt that is exchanged, (2) the holder of the distributing corporation's debt will not hold the debt for the benefit of the distributing corporation, SpinCo or any related person, (3) neither the distributing corporation, SpinCo nor any related person will participate in any profit gained by the investment bank, nor will any profit be limited by agreement or other arrangement, and (4) the value of the securities received by the investment bank in satisfaction of the distributing corporation's debt will not exceed the amount to which the holder is entitled under the terms of the debt. These new, specific representations set forth helpful parameters in structuring an exchange. However, practitioners have raised questions regarding the new representations, such as the uncertainty surrounding what factors are critical to establish that the investment bank is not holding the debt "for the benefit of" the distributing corporation and whether reimbursement of the investment bank's expenses is consistent with the new representations.

The IRS has released only one private letter ruling that incorporates the new representations in Rev. Proc. 2018-53. In LTR 201910004, the taxpayer gave all of the new representations in Rev. Proc. 2018-53 except for the representation that the value of the consideration received by the investment bank in satisfaction of the distributing corporation's debt will not exceed the amount to which the holder of the debt is entitled under the terms of the debt. Instead, the taxpayer represented that the consideration received by the investment bank in satisfaction of the debt was determined in accordance with arm's-length negotiations.[37] It is yet to be seen whether the IRS will accept other meaningful modifications to the representations or whether the modified representation in LTR 201910004 will become the norm for other rulings.

Another notable feature of LTR 201910004 is that the facts state that the investment bank will purchase the distributing corporation's debt at least "h" days (which likely is 14 days) before the exchange, but the ruling does not specifically state the timing of execution of the exchange agreement between the distributing corporation and the investment bank. Time will tell whether the IRS will require the investment bank to hold the debt for at least 14 days or whether taxpayers will continue to use the 5-14 days standard as a proxy for establishing that the investment bank is acquiring the distributing corporation's debt for its own account. Alternatively, taxpayers that can make the new representations and believe that their transactions fall within Rev. Proc. 2018-53's guidelines ultimately may decide not to seek a ruling on the securities-for-debt exchange.

Rev. Proc. 2018-53 also adds other new representations that seemingly reflect changes in the IRS's prior ruling practice and that may make it harder for taxpayers to execute some leverage-shifting transactions. For example, one of the representations provides that the distributing corporation's debt that will be satisfied was incurred before specified events that are typically well in advance of the spinoff (for example, the first public

---

[36] *See e.g.*, LTR 201613008; LTR 201512001.

[37] LTR 201910004 at Representation (l).

announcement of the spinoff or approval by the board of directors).[38] At least in some prior rulings, the IRS did not impose these time constraints on when the relevant debt was incurred.[39] Another representation required by Rev. Proc. 2018-53 provides that the distributing corporation's debt that will be satisfied will not exceed a specific historic average amount of the SAG's debt owed to unrelated persons computed by reference to the amounts outstanding at the close of the eight fiscal quarters preceding the approval of the spinoff by the distributing corporation's board of directors.[40] The IRS's prior ruling practice varied, but often did not reach back eight quarters in computing the amount of the distributing corporation's historic debt.[41]

Another new representation provides that in transactions in which any consideration received by the distributing corporation as part of the exchange with SpinCo (which the revenue procedure refers to as "Section 361 Consideration") will be used to satisfy the distributing corporation's debt, the debt will be satisfied within 30 days after the spinoff unless the taxpayer represents that there are "substantial business reasons" for the delay. In contrast, in some prior private letter rulings the IRS seemed to show more flexibility by accepting taxpayer representations that a debt-for-securities exchange would occur no later than a specified time after SpinCo filed its first full-quarter financial results.[42] The IRS's shortening of the allowable period for debt repayment was previewed in an IRS Statement released on October 13, 2017 in which the IRS advised that it would "increase its scrutiny" of transactions in which the distributing corporation's distribution of stock, securities or other property to the distributing corporation's creditors is "substantially delayed."[43]

Some practitioners have expressed concerns that the new 30 day requirement may be especially problematic in some securities-for-debt exchanges, although the taxpayer in LTR 201910004 apparently was able to fit within the 30 day period.[44] Even if the taxpayer can avoid the 30 day limit by establishing "substantial business reasons" for a delayed distribution, the new standard representations further provide that the debt must be satisfied no later than 180 days after the spinoff. Most transactions should be able to fit their exchange within a 180 day period unless unexpected conditions develop, in which case the taxpayers likely will be back at the IRS's doorstep.

Alternatively, if the taxpayer cannot make the representation that the Section 361 Consideration will be used to repay the distributing corporation's debt within 180 days after the spinoff, Rev. Proc. 2018-53 requests that the taxpayer submit information and analysis to establish that, based on the facts and circumstances, the satisfaction will be "in connection with" the plan of reorganization, which is a requirement to qualify for tax-free treatment under section 361(c)(3). The IRS's request for this information evidences some

---

[38] Rev. Proc. 2018-53, section 3.04(4).
[39] *See LTR* 201702035.
[40] Rev. Proc. 2018-53, section 3.04(5).
[41] *See* LTR 201216023 (amount of debt measured by the weighted quarterly average of the distributing corporation's external debt for the 12-month period ending on the close of business on the last day of the calendar quarter before the date on which the distributing corporation's board of directors approved the spinoff).
[42] *See* LTR 201851005.
[43] IRS, "Statement Regarding Private Letter Rulings on Certain Corporate Transactions" (Oct. 13, 2017).
[44] *See* LTR 201910004, Representation (o).

healthy IRS skepticism that a distribution of Section 361 Consideration more than 180 days after the spinoff should be treated as in connection with the spinoff. Taxpayers that are not able to persuade the IRS that a delayed distribution of SpinCo stock or securities will be in connection with the spinoff likely will need to establish that the retention of SpinCo stock or securities satisfies the guidelines in Appendix B of Rev. Proc. 96-30. Those guidelines are used by the IRS to establish that the distributing corporation's retention of SpinCo stock or securities does not have as one of its principal purposes the avoidance of federal income tax,[45] and they generally require, among other things, that the retained stock or securities be disposed of within five years after the spinoff.[46]

Similar to the standard representations in Rev. Proc. 2017-52, it remains to be seen how much flexibility the IRS will show in accepting deviations from the 30 day and 180 day time limits for distributions of Section 361 Consideration. The standard representations required by Rev. Proc. 2018-53 are likely to evolve as the IRS receives ruling requests from taxpayers that request exceptions from the representations.

Triggered Losses

Rev. Proc. 2017-52 includes a representation that, "there is no loss subject to reg. section 1.1502-13 that will be taken into account as a result of a transaction related to the Distribution."[47] Before 2017, the IRS issued some rulings that intercompany losses would be taken into account immediately before a spinoff, although the IRS seems to have required that the taxpayer represent that the spinoff "is not being engaged in or structured with a principal purpose to avoid the provisions of section 267(f)."[48] It is not clear why the IRS added this new representation or what factors might persuade the IRS to issue a ruling without requiring the representation. Perhaps the IRS believes that, in the context of a spinoff, taxpayers should not selectively choose to recognize built-in losses while obtaining nonrecognition treatment for corresponding built-in gains. However, when triggered losses were recognized and deferred in transactions unrelated to the spinoff, taking the losses into account at the time of a spinoff in which the relevant companies become unrelated under section 267 seems unobjectionable.

---

[45] The October 13, 2017 statement provides that, even though Rev. Proc. 96-30 has been superseded, the IRS will continue to follow the guidelines in Appendix B.

[46] An IRS ruling that the retention of SpinCo stock does not have a principal purpose of tax evasion allows the initial spinoff of at least 80 percent of SpinCo's stock to qualify for tax-free treatment. *See* section 355(a)(1)(D)(ii). However, absent a ruling that a later distribution of the retained stock or securities either (1) is to shareholders "in pursuance of the plan of reorganization," or (2) is to creditors "in connection with the reorganization," the distributing corporation's subsequent disposition of the stock or securities presumably will be taxable. *See e.g.*, LTR 201818010 which was issued prior to Rev. Proc. 2018-53. The ruling holds that the SpinCo stock that was retained for up to five years was not retained for tax avoidance purposes. The facts state that the retained stock may be exchanged during a certain "Permitted Period" in some stock-for-debt exchanges (which presumably would qualify as tax-free exchanges under section 361), but that the distributing corporation also could sell the retained shares through taxable sales at any time during the five-year period after the spinoff.

[47] Rev. Proc. 2017-52, Appendix at section 3 (Representation 37).

[48] *See e.g.*, LTR 201603002; *see also* LTR 201818010 (taxpayer represented that the spinoff would be pursued regardless of whether the loss would be triggered).

No Income? No Problem

Last Fall, the IRS announced it is studying whether a business can satisfy the ATB requirement when the business has not yet generated income.[49] Existing regulations provide that the ATB "ordinarily must include the collection of income and the payment of expenses."[50] In Rev. Rul. 57-492, 1957-2 C.B. 247, the IRS ruled that substantial expenditures and activities in connection with oil exploration and production activities did not constitute an active business because, "before oil was discovered in commercial quantities . . ., the venture . . . did not include any income producing activity or source of income." Similarly, in Rev. Rul. 57-464, 1957-2 C.B. 244, the IRS ruled that some rental activities did not satisfy the ATB requirement when the activities produced only nominal rent and negligible net income. Consistent with these authorities, Rev. Proc. 2017-52 provides that the information submitted to the IRS as part of the ruling request "should establish that each active business engages in the collection of income and the payment of expenses."[51] Thus, businesses that have not yet reached the income production stage historically have faced significant hurdles in achieving ATB status.

On March 22, 2019, the IRS released Rev. Rul. 2019-9, 2019-14 IRB 925, which suspended Rev. Rul. 57-464 and Rev. Rul. 57-492 pending completion of the previously announced study of the collection of income requirement. The suspension of these rulings presumably makes it easier for the IRS to rule favorably when the business in question has not yet generated income because the IRS would not need to distinguish the analysis or holdings in these rulings.

The IRS announcement and Rev. Rul. 2019-9 are positive developments for pharmaceutical and biotechnology companies that often go through many years of research and development activities before the generation of revenues. Also, while pharmaceutical and biotechnology companies may be the most likely beneficiaries, the IRS announcement provides that the guidance is not expected to be industry-specific. Thus, technology or any other businesses with significant research and development stages may be able to qualify for a tax-free spinoff before generating revenues.

Also, with the suspension of Rev. Rul. 57-492 and Rev. Rul. 57-464, oil and gas exploration and rental real estate activities could qualify in appropriate circumstances. The IRS announcement requested comments and encouraged taxpayers to submit private letter ruling requests that implicate the collection of income requirement. Informal discussions with the IRS indicate that the IRS is eager to learn about the types of fact patterns that exist, including the nature of the research or other activities performed, the types and timing of future income and any other considerations that indicate that a pre-revenue business is sufficiently "active." The prudent course of action is to seek a prefiling conference before submission of a ruling request that implicates the collection of income requirement.

At an American Bar Association Section of Taxation meeting last Fall, the IRS associate chief counsel (corporate) provided several of "guideposts" that are being

[49] IRS, "Statement Regarding the Active Trade or Business Requirement for Section 355 Distributions" (Sept. 25, 2018).
[50] Reg. section 1.355-3(b)(2)(ii).
[51] Rev. Proc. 2017-52, section 3.03(3)(a).

considered for guidance relating to businesses that have not yet generated income, including (1) regular, continuing expenses for research and related activities, (2) regular, continuing research and related activities by a significant number of full-time management and operational employees, (3) significant progress toward developing an income-producing product, (4) holding out that the business is available to enter into an income-producing arrangement, (5) an actual offer or specific expression of interest made or received by the business to enter into an income-producing arrangement, and (6) similarly situated businesses entering into income-producing arrangements with research that has progressed to a similar level as the taxpayer's research.[52]

More recently, the IRS issued a request for information regarding the activities of entrepreneurial ventures that have not yet reached the collection of income stage.[53] The request asks for information with respect to more than 20 specific topics regarding pre-income ventures, including (1) what industries or sectors other than the pharmaceutical or technology industries have ventures that involve significant R&D phases? (2) what types of managerial and operational activities generally are conducted by the ventures? (3) what types of regulatory approvals typically are required, and how do the approvals vary by industry? (4) what opportunities do the ventures typically have to collect income before producing a marketable product? (5) what types of funding do the ventures generally receive? and (6) what activities other than R&D typically are performed by these ventures? The request also notes that the IRS study is considering the extent to which the ATB requirement could be satisfied in the case of a separation of two or more segments of a standalone entrepreneurial venture from each other. Put another way, it seems that the IRS is considering whether both the distributing corporation's and SpinCo's ATB could be in the pre-collection of income stage.

The detailed request for additional information suggests that the IRS is taking a hard look at providing relief from the current collection of income requirement, at least in select yet-to-be identified situations. On the other hand, the request suggests that the IRS may be having difficulty drawing appropriate lines and deciding what factors should control the determination of ATB status in cases where the business has not yet reached the collection of income stage. Hopefully, more guidance will be coming soon, but until then the good news is that the IRS announcement, Rev. Rul. 2019-9 and the request for information clearly signal that the IRS may be more willing than in the past to provide a favorable ruling.

Not So Fast For Drop-Spin-Liquidate

The IRS has issued several private letter rulings in which a corporate subsidiary moves part of its assets upstream to an affiliated corporation through a series of transactions in which the subsidiary first transfers assets to a newly formed SpinCo and distributes the SpinCo stock upstream to its corporate parent, which then liquidates or merges SpinCo with an affiliate.[54] These types of transactions are tax-efficient means of

[52] *See* Emily L. Foster, "Guideposts" Revealed for R&D-Intensive Business Spinoffs," *Tax Notes,* October 15, 2018, p. 385.
[53] IRS, "Request for Information Regarding the Active Trade or Business Requirement for Section 355 Separations of Entrepreneurial Ventures" (May 6, 2019).
[54] *See e.g.*, LTR 201538015 and LTR 201426008.

effectuating an upstream transfer of a portion of a subsidiary's assets without causing the distributing subsidiary to recognize gain on a distribution of appreciated assets under section 311(b). In the IRS October 2017 Statement, the agency announced it is reconsidering its views on these transactions and will increase its scrutiny of the transactions.

At least so far, the IRS has not added these transactions to its no-rule list in Rev. Proc. 2019-3. However, the IRS October 2017 Statement cautions that the agency will continue to rule on such transactions "only based on substantial scrutiny of the facts and circumstances and full consideration of the legal issues and the effects of a ruling on federal tax administration." This is basically a fancy way of saying that the IRS is having heartburn that those transactions could be viewed as inappropriately circumventing the repeal of the *General Utilities* doctrine by allowing upstream asset transfers without requiring gain recognition under section 311(b).

Given the IRS's newfound skepticism expressed in the IRS October 2017 Statement, taxpayers may receive a cool reception when asking for these rulings in the future. At a minimum, a prefiling conference should be sought, and a taxpayer should be ready to put forth compelling business reasons for the transactions. Alternatively, although the IRS's prior private letter rulings are not authority for other taxpayers,[55] there are significant existing authorities that support the position that a post-spinoff merger (and arguably a liquidation of SpinCo) should not prevent a spinoff from qualifying for tax-free treatment under section 355.[56] Thus, more adventurous taxpayers may be willing to forgo a private letter ruling and rely on tax opinions in appropriate cases.

Finally, an important limitation to the IRS's new significant scrutiny of these transactions is regarding *Morris Trust* or *Reverse Morris Trust* transactions, which are frequently used to effectuate post-spinoff combinations of the distributing corporation or SpinCo with another corporation. The IRS October 2017 Statement provides that the IRS will continue to rule in accordance with prior practice regarding *Morris Trust* and *Reverse Morris Trust* transactions in which the post-spinoff merger of the distributing corporation or SpinCo is with an unrelated corporation. Thus, the new "increase in scrutiny" does not apply to the typical *Morris Trust/Reverse Morris Trust* transactions with an unrelated public company, and instead applies only when SpinCo combines with another corporation in the distributing corporation's affiliated group.

Six Months to Get a Private Letter Ruling?

One of the first questions a client always asks when exploring a request for a private letter ruling is "how long will it take?" Historically, the IRS has issued rulings within about six months after receipt of the taxpayer submission, with some taking a bit longer and others a bit shorter. Although there have only been a limited number of transactional rulings released since the program was revived in 2017, the submission and release dates of the rulings indicate that the IRS generally continues to meet this informal six-month timeline even for transactional rulings. Given the flurry of regulatory guidance required by

---

[55] Section 6110(k)(3).

[56] *See* H.R. Rep. No. 105-220, at 529-530 (1997); Rev. Rul. 98-27, 1998-1 C.B. 1159; Rev Rul. 2003-79, 2003-2 C.B. 80.

the recent Tax Cuts and Jobs Act, the IRS's ability to stay within the historic timelines for spinoff rulings is commendable. Rev. Proc. 2017-52 further provides that the IRS will attempt to accommodate reasonable requests made in a timely manner to issue a ruling on or before a specified deadline, but the IRS will not guarantee that a letter ruling will be issued by a requested date.[57]

Conclusion

Taxpayers that are contemplating requesting a private letter ruling in connection with a spinoff need to be familiar with the standard procedures and no-rule positions in Rev. Procs. 2019-1 and 2019-3, as well as the more specific requirements and representations set forth in Rev. Procs. 2017-52 and 2018-53. In many cases, the revenue procedures not only provide standard procedural requirements for a submission, but also provide important substantive guidance in structuring a spinoff and related transactions (such as a securities-for-debt exchange) in a manner that will allow the taxpayer to receive a favorable ruling. Other recent IRS guidance also offers warnings of "increased scrutiny" for certain transactions (such as drop-spin-liquidate) or the potential for a more sympathetic reception (such as a lack of income) depending on the nature of the proposed spinoff. Taxpayers need to keep these IRS positions in mind in considering whether to seek a private letter ruling and in formulating their ruling requests.

[57] Rev. Proc. 2017-52, section 3.01.

NOTES