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IRS Guidance Narrows Spinoffs Available For Preapproval

By **Natalie Olivo**

Law360 (May 31, 2024, 6:56 PM EDT) -- Recent IRS guidance limiting the types of spinoff transactions that revenue officials will approve as tax-free ahead of time leaves practitioners and corporations to determine whether to pursue certain intercompany reorganizations without the agency's blessing.

Revenue Procedure 2024-24, issued May 1, appears to reduce the range of spinoff plans that companies can bring to the Internal Revenue Service for a private letter ruling stating that the transaction would be tax-free under Internal Revenue Code Section 355. For example, the guidance suggests the agency will no longer give PLRs for reorganizations where a parent company wants flexibility when retaining some of its spun-off subsidiary's shares or intends to use them to pay off short-term debt.

Companies can still pursue these spinoffs without a PLR if they feel comfortable that their transactions comply with the tax-free requirements under Section 355 and other provisions, which the IRS hasn't claimed to reinterpret in the revenue procedure. While the agency may take an official stance in future regulations, the guidance — which applies to all transactions submitted after Friday — may put companies at a crossroads in the meantime.

Taxpayers are going to have to decide whether they would rather go forward without a ruling and only on the basis of a legal opinion, according to J. Leonard Teti II, a partner at Cravath Swaine & Moore LLP. Taxpayers will also have to decide whether they would like to continue to seek a ruling even though the IRS has narrowed the factual circumstances on which it will rule, he said.

"This area of practice is extraordinarily complicated, and these changes are making it more and more complicated," Teti said. "The amount of sensitivity and judgment that is required from taxpayers and their advisers to execute these transactions is considerable."

Debt-for-Equity Exchanges

Under the revenue procedure, companies will likely lose their ability to receive PLRs for certain transactions where they use shares of a recently spun-off subsidiary to pay off newly acquired debt — a process that falls under the overall umbrella of debt-for-equity exchanges.

In general, PLRs address how tax laws apply to a specific situation, representing IRS conclusions that don't have the force of regulations and cannot be used as precedents, according to the agency.

The IRS over the years has released guidance for requesting PLRs for spinoffs, which generally occur when a parent company separates a subsidiary into a standalone corporation then gives existing shareholders a stake in that new entity.

Spinoffs must meet several statutory requirements to come without a tax bill, including provisions under Section 355 that are aimed to ensure that a transaction isn't principally used to achieve a disguised dividend, in which earnings and profits are distributed to shareholders tax-free.

Other requirements for tax-free spinoffs fall under IRC Section 361, which covers debt-for-equity exchanges and other transactions tied to intercompany reorganizations. Under one kind of debt-for-equity exchange, known as a direct issuance, the parent uses shares from the spun-off subsidiary to repay recently acquired debt.

According to the revenue procedure, the IRS will only give PLRs covering debt-for-equity exchanges where the debt was acquired at least 60 days prior to the announcement of the spinoff — effectively denying rulings for direct issuances.

The government will no longer allow the direct issuance model involving short-term debt that has been the standard for prior years, according to Karen Gilbreath Sowell, EY's global transaction tax advisory leader. This will result in a loss in value for the parent resulting from increased fees paid to banks and creditors, she said.

Sowell added that the parent's treasury department will also be "handcuffed in its liability management exercise."

Share Retentions

As some see it, the revenue procedure looks askance at spinoffs where a parent company plans to retain some of its subsidiary's shares after the transaction.

According to specialists, past PLR guidance allowed for "backstop" rulings where companies could plan to retain a portion of the spun-off company's stock to pay creditors in a debt-for-equity exchange within 12 months. These rulings involved flexibility that enabled companies to hold onto the stock for up to five years then sell it in a taxable transaction if the initial debt-for-equity exchange wasn't completed in that first year.

The new revenue procedure's elimination of these backstop rulings requires companies to choose upfront whether they want to use the retained stock no later than 12 months from the spinoff date or retain it long-term to sell within five years, according to Sowell. This change has impacted transactions that have been planned for many months and will also impact future transactions, she said.

In addition, Sowell said the elimination of backstop rulings means that "taxpayers will have to live with a ruling that does not provide comfort if they cannot complete the debt-for-equity within 12 months or within the terms provided at the time of the ruling request."

According to Notice 2024-38, which the agency released alongside the revenue procedure, a parent company's retention of the spun-off subsidiary's stock doesn't qualify as tax-free under Section 355 unless the parent shows the transaction doesn't have a principal purpose of avoiding tax.

"Therefore, the statute effectively creates a rebuttable presumption that any retention evidences a plan to achieve a federal income tax avoidance purpose," the notice said.

Some practitioners have interpreted the "rebuttable presumption" language as an indication of the IRS' suspicion toward retained stock. If companies want flexibility when holding onto a portion of the subsidiary's stock after the spinoff and don't get the IRS' blessing under the revenue procedure, they may face difficulties down the road.

"Certainly, the IRS believes a ruling is required," Linda Swartz, a partner at Cadwalader Wickersham & Taft LLP and chair of the firm's tax group, said. "So if the transaction is audited, and you haven't gotten a ruling, that complicates things a bit."

Other Transactions

The revenue procedure outlines additional situations where the IRS has indicated it won't provide a ruling, including some transactions where a parent company receives cash from the subsidiary prior to a spinoff.

Under the revenue procedure, the agency will no longer provide PLRs where a parent company uses a subsidiary's cash to pay off debt that was refinanced after the announcement of the spinoff. The guidance also disallows rulings for situations where a parent uses cash from the subsidiary to pay certain nondebt liabilities.

In general, the guidance reads as though the government is suspicious of past practices in this area, which were based on prior IRS ruling guidance and typically executed with a PLR, according to Sowell. The prior transactions generally were done with the involvement of the agency and were not the work of taxpayers and practitioners developing standards in private, she said.

"These are business-driven transactions that are important for the competitiveness of U.S. corporations as they need to divide operations and their balance sheet in an appropriate way," Sowell said. "Spinoffs are not abusive tax planning transactions and should be viewed from that perspective when rules are being devised."

The path that companies take going forward may depend on several factors, including their tolerance for potential risks.

According to Swartz, whether companies choose to pursue certain spinoffs without a PLR "will depend on each company's facts, their appetite for any risk and their counsel's degree of comfort."

A spokesperson for the IRS who asked not to be named told Law360 that the intention for this revenue procedure is not to reduce the number of PLR requests, but rather to lay out clearly the circumstances under which the agency can issue a favorable PLR.

"The IRS looks forward to continuing having a robust PLR program and invites taxpayers to use the presubmission process when they consider bringing in a PLR request," the spokesperson said.

Future Guidance

The positions taken in the revenue procedure have prompted some practitioners to question what approach the IRS may take in future regulations that outline whether a transaction would qualify for tax-free status, rather than merely what the agency will rule on in advance.

According to the notice, the U.S. Treasury Department and the IRS are continuing to study "matters relating to Section 355 transactions" to develop potential guidance and are requesting public feedback on the revenue procedure.

The IRS spokesperson told Law360 that "the intention would be to study any such comments with an eye towards possible future guidance, including regulations."

According to Cravath's Teti, the tax community is bracing for proposed regulations on some of these issues.

"That would obviously change the conversation from merely what the IRS' administrative ruling practice is to something much more profound," which is what the agency thinks the law is, he said.

Teti added, "That discussion is a much more consequential discussion in many ways."

Meanwhile, concerns about changes in the IRS' approach to rulings were highlighted by the New York State Bar Association's Tax Section ahead of the procedure's publication.

In a report submitted to the U.S. Treasury Department and the IRS in early March, the NYSBA said it had recently learned that the government was considering certain PLR positions that are critical to carrying out spinoffs. These transactions include spinoffs "that have been in the planning stages for many months without notice of a reconsideration," the group said.

The group included several recommendations for upcoming guidance on ruling requests. At the top of the list, the NYSBA asked Treasury and the IRS to describe changes to the ruling guidelines they are considering, "with a request for comments that would be considered before these important PLR standards are modified."

According to Swartz, the revenue procedure and notice represent a "sea change," with the notice's "aggressive limiting tone," which applies to a breadth of issues, raising the biggest concern.

"In my experience, it is not typical to have a tax avoidance purpose for many of the actions the IRS is worried about," she said.

Swartz added that she is concerned that complying with the standards that the government may promulgate in future proposed regulations "will make spinoffs very difficult to accomplish with an IRS ruling, even when they're permitted under the statute and case law."

--Editing by Tim Ruel and Neil Cohen.
