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IRS Issues Proposed Regulations on Spin-Off Transactions and Reorganizations

Proposed Regulations Provide Rules Concerning Retention of SpinCo Stock and Securities, Debt Monetization Transactions and Plans of Reorganization

SUMMARY

On January 13, 2025, the IRS and the Department of the Treasury released proposed regulations (the "Proposed Regulations"), which provide rules concerning tax-free spin-offs, in particular relating to the retention of stock or securities of a controlled subsidiary ("SpinCo"), and debt exchanges involving SpinCo stock or securities ("Debt Exchanges"). The Proposed Regulations also contain certain rules that affect tax-free transactions more generally, including rules regarding plans of reorganization and assumptions of liabilities. The Proposed Regulations expand on and modify the initial guidance provided in Revenue Procedure 2024-24 (the "Rev. Proc.") and Notice 2024-38 (the "Notice"), which were issued on May 1, 2024 (prior alert). The Proposed Regulations represent another signpost in the continuing evolution of the government's views on such matters from its historical practices, and in some cases, a more pragmatic approach than that evidenced in the Rev. Proc. and the Notice. Notable provisions of the Proposed Regulations include:

- Largely eliminating the unpopular "pick a lane" approach, but instead requiring taxpayers to describe their plans regarding retained stock or securities with greater specificity (what is informally referred to as a "stacking" approach involving more granularity regarding "if, then" eventualities);
- Formally subjecting all retention to the anti-avoidance standards, and providing a more elaborated safe harbor, with key limitations on overlapping officers and directors;
- Reversing the Rev. Proc.'s prohibition on "direct issuance" in Debt Exchanges, but apparently subjecting both "direct issuance" and "intermediated exchange" models to a 30-day holding period, which is significantly longer than historical norms;
- Relaxing the Rev. Proc.'s prohibition on refinancings and reborrowings, but with some new requirements, the intentionality or practicability of which are unclear;

- Expansion of what constitutes "liabilities" under the liability assumption rules applicable to both reorganizations and Section 351 transactions, potentially increasing occasions for triggering gain; and
- Imposing significantly more detailed documentation requirements for plans of reorganization and plans of distribution.

The Proposed Regulations would generally apply to transactions occurring after the date the Proposed Regulations are finalized. The IRS has also stated its intent to issue an update to the Rev. Proc. to incorporate the Proposed Regulations into the procedures for obtaining private letter rulings (and to that extent the Proposed Regulations have current relevance). Written comments to the Proposed Regulations are sought by March 17, 2025. This discussion focuses on a few key issues in the Proposed Regulations, and does not address every aspect of the Proposed Regulations.

BACKGROUND[1]

Section 355 permits a corporation ("Parent") to distribute to its shareholders or securityholders the stock and securities of SpinCo without triggering gain to Parent or its shareholders. However, to qualify as tax-free, the transaction must meet a number of requirements, including that Parent must distribute stock of SpinCo constituting "control" (generally, at least 80% of the voting power, and 80% of each class of nonvoting stock) to its shareholders. In addition, if Parent retains any SpinCo stock, it must establish that such retention is not pursuant to a plan that has a principal purpose of avoidance of U.S. federal income tax.

Spin-offs are often a part of a divisive "reorganization," whereby Parent transfers assets to SpinCo, and SpinCo often assumes a portion of Parent's liabilities, tax-free. Where a spin-off is part of a divisive reorganization, various monetization strategies are possible. For example, SpinCo may issue stock or certain debt qualifying as "securities" for distribution to Parent's creditors. SpinCo may also transfer cash, debt not qualifying as securities, or other "boot" to Parent in a divisive reorganization on a tax-free basis, as long as the amount of such boot does not exceed the tax basis of the transferred assets and Parent distributes the boot to its shareholders or creditors pursuant to the plan of reorganization (a "boot purge"). In addition, if SpinCo assumes a portion of Parent's liabilities, such assumption is generally tax-free, subject to the same basis limitation as applies to the receipt of boot. The parameters under which such monetization transactions can be effected have been subject to evolving ruling practice and public guidance from the IRS. The Proposed Regulations address these and certain other rules applicable to spin-offs, split-offs, reorganizations and, to a lesser extent, Section 351 transactions.

DISCUSSION

A. Continued Ownership of SpinCo Stock or Securities

The Code generally permits Parent to retain a portion of SpinCo stock (or securities) and dispose the retained stock (or securities) in transactions separate from the spin-off in transactions traditionally referred

to as "true retentions," provided that Parent establishes, to the satisfaction of the IRS, that the retention does not have a principal purpose of tax avoidance. Parent is also generally permitted to transfer SpinCo stock and securities over a period of time in "delayed transfers," so long as such transfers are considered to be "part of the distribution" and "in pursuance of the plan of the reorganization." It was historically unclear whether the statutory standards for permissible true retentions also applied to delayed transfers, but the IRS has historically drawn a distinction in its prior rulings and public guidance. The Proposed Regulations, however, abandon that distinction, and as a result also abandon the "pick a lane" approach that the IRS began to require for rulings in the recent past (i.e., the requirement that Parent commit to making a delayed tax-free transfer, or to sell retained stock or securities, without any contingent possibility to "switch lanes"). While doing so, however, the Proposed Regulations extend a rebuttable presumption of tax avoidance to both true retentions and delayed transfers.[2] Unless this presumption is rebutted, the entire transaction would be disqualified from being treated as tax-free.[3]

The Proposed Regulations, however, introduce a safe harbor against this presumption.[4] The safe harbor requires, among other items, that Parent has a specific corporate business purpose for the retention as of the date of the adoption of the plan of distribution and that the SpinCo stock be widely held at all times during the retention period.[5] The safe harbor also restricts overlapping officers, directors or key employees unless the overlap of such persons serves the business needs of SpinCo, overlapping directors do not constitute a majority of SpinCo's board and the duration of the overlap of such persons is for an identified, limited period of time, not in excess of two years after the date of the initial distribution of SpinCo stock (the "First Distribution")—and it appears from an example that directors up for reelection after the two-year period would still violate the safe harbor.[6] For taxpayers unable to satisfy the safe harbor, the Proposed Regulations also include a general facts-and-circumstances test, which considers whether a true separation is achieved.[7] Regardless of whether the taxpayer satisfies the safe harbor or the facts-and-circumstances test, the Proposed Regulations require Parent to "echo vote" any retained SpinCo stock in proportion to the votes cast by SpinCo's other shareholders (other than persons related to Parent), apparently regardless of the amount of SpinCo stock retained.[8] Further, since these rules reference not only stock of SpinCo but also that of a member of SpinCo's separate affiliated group,[9] the proposed rules may create a potential trap for the unwary, where, for example, Parent and SpinCo are co-owners of a corporate joint venture, even one that has a relatively low value.

As is generally consistent with prior ruling guidance, the Rev. Proc. required Parent to represent that any delayed transfers will be completed within 12 months of the First Distribution. In contrast, the Proposed Regulations permit Parent to distribute stock constituting control of SpinCo over *two taxable years* without gain recognition, so long as all such dispositions are effectuated pursuant to a binding commitment that is described in the plan of distribution or plan of reorganization, as applicable.[10] This appears to allow spin-offs where less than 80% control is distributed in year 1, followed by a distribution of the rest of the SpinCo

stock in year 2, as long as both are pursuant to a committed plan, although it is questionable how that would interact with the echo vote requirement.[11]

B. Debt Exchanges

The mechanics through which Debt Exchanges are accomplished have varied over time. Historically, IRS private letter ruling practice required the "intermediated exchange" model in which a third party intermediary (typically a bank) would purchase historical Parent debt and hold it for at least five days before entering into an agreement with Parent to exchange such Parent debt with retained SpinCo stock or securities, and then the actual exchange would occur at least 14 days after the intermediary had purchased Parent debt (the so-called "5/14 standard"). The prevalent model in the market in more recent years, as initially supported by positive IRS rulings, was the "direct issuance" model, under which a third party would loan cash to Parent. Parent would repay such new loan from the third party with retained SpinCo stock or securities, while the cash proceeds from the debt would be used to repay historical Parent debt within 12 months of the First Distribution. Under this approach, there would typically be an at least one-day gap between Parent's borrowing and its entering into an exchange agreement to repay such debt with SpinCo stock or securities. The Rev. Proc., however, effectively prohibited the use of the direct issuance model and reverted to the more costly intermediated exchange model, although apparently the IRS permitted the intermediating agent to hold the debt for just one day.[12]

In a departure from the Rev. Proc., the Proposed Regulations permit both direct issuance transactions and intermediated exchanges, albeit now requiring a 30-day holding period. This 30-day period is a safe harbor with respect to direct issuances, but is drafted as a requirement (i.e., no facts and circumstances deviation possible) for intermediated exchanges, which the IRS has informally acknowledged as not necessarily intended.

Although the permissibility of direct issuances is a more taxpayer-friendly development, other provisions of the Proposed Regulations raise further questions about the holding period. For example, it is not clear why the 30-day period should apply to intermediated exchanges (for which the historical practice varies from one day to "5/14"). In addition, the holding period apparently needs to be satisfied in a period prior to the "control distribution date" (i.e., the date on which Parent divests an amount of SpinCo stock constituting control),[13] which may be impractical in many debt exchanges (e.g., those involving retained securities).

1. Parent Debt Qualifying as Historical

The IRS's historical ruling guidelines generally limited Parent's ability to satisfy Parent debt with cash in a boot purge or with SpinCo stock or securities in a Debt Exchange to "historical" Parent debt (generally, debt that was outstanding as of a specified date falling well in advance of the spin-off). In a departure from prior public guidance, the Rev. Proc. suggested that historical debt refinanced after the announcement of the spin-off may not be viewed as eligible.[14] The Proposed Regulations, however, allow certain refinanced Parent debt to qualify as historical Parent debt if, among other requirements, (i) the original debt (prior to

the refinancing) has a maturity date ending after the contribution date and (ii) the refinancing (and related monetization transaction) are clearly described and identified in the plan of reorganization (or any amendments).[15]

In addition, the Proposed Regulations introduce the limitation that Parent debt held by parties related to Parent is not eligible to be repaid or exchanged in a monetization transaction, unless the proceeds of such repayment are ultimately paid to a third party.[16] This may raise questions for internal spin-offs.

Further, as is generally consistent with the Rev. Proc. and prior public guidance, the Proposed Regulations restrict the amount of Parent debt that can be satisfied with SpinCo stock or securities or assumed by SpinCo to the historical average amount of Parent debt owed to third party creditors outstanding as of the close of each of the eight fiscal quarters ending immediately before the earliest applicable date (generally, the date that is the earliest of the date of the first public announcement, the date of entry by the taxpayer into a written agreement and the date of approval by Parent's board of directors).[17]

2. Limitations on the Replacement of Monetized Parent Debt

Prior to the Rev. Proc., the IRS's ruling guidelines generally allowed Parent to "replace" debt assumed by SpinCo or retired in a boot purge or Debt Exchange by issuing new debt after the spin-off, provided the new debt was not "previously committed" (or, if previously committed, incurred pursuant to a revolving credit agreement or similar ordinary course financing arrangement). While the Rev. Proc. generally preserved the exception for revolving credit facilities, it expanded the scope of prohibited reborrowings to cover borrowings that Parent merely "anticipates" prior to the spin-off.[18] The Proposed Regulations, however, take the approach of permitting reborrowings where (i) the replacement debt is incurred in the ordinary course of Parent's business and would have been incurred without regard to the spin-off or (ii) the borrowing results from an event unrelated to the spin-off outside of the ordinary course of Parent's business and a change in circumstance not expected prior to the control distribution date.[19]

C. Liability Assumptions

Section 357, which applies to both the assumption of liabilities in reorganizations as well as tax-free contributions qualifying under Section 351, generally permits SpinCo to assume a portion of Parent's liabilities in connection with a divisive reorganization without the recognition of gain to Parent, unless the principal purpose of the assumption is the avoidance of federal income tax or not a bona fide business purpose; provided, that Parent will recognize gain to the extent that the liabilities assumed by SpinCo exceed the basis of Parent's assets contributed to SpinCo (the "basis limitation"). The Proposed Regulations introduce the presumption than a principal purpose of tax avoidance exists if the assumed liability was not incurred in the ordinary course of a business of the transferor.[20] In addition, with respect to divisive reorganization transactions only, the Proposed Regulations introduce the presumption that any Parent liability assumed by SpinCo has the principal purpose of tax avoidance unless such liability is (i) described in the plan of reorganization, (ii) incurred in the ordinary course of Parent's business and (iii)

necessary to ensure the transfer to SpinCo of all liabilities properly associated with the transferred business and result in SpinCo assuming liabilities in an amount that properly relates to its business operations.[21] It is unclear how such rules would apply if Parent had undertaken debt at the enterprise level to acquire a "RemainCo" business, but supported by the credit of the SpinCo business.

Under the Proposed Regulations, any payment by SpinCo on an assumed liability will be treated as a payment of boot to Parent, and Section 357 will not govern the tax consequences of such payment, to the extent that Parent has "legal or practical dominion or control over the payment."[22] In a divisive reorganization, boot, unlike liability assumptions under Section 357, must be "purged" by a distribution to Parent's shareholders or creditors. Under the Proposed Regulations, payments made by SpinCo pursuant to certain indemnification agreements could give rise to boot as well, although there is a safe harbor (albeit drafted narrowly to address only situations where SpinCo is "legally prohibited from the underlying liability directly") that is apparently intended to avoid such a result.[23]

It is also worth noting that the Proposed Regulations define "liability" broadly for these purposes to cover "a debt, a contingent liability, or any other fixed or contingent obligation."[24] Broadening the scope of what constitutes a liability generally could have the effect of limiting the amount of Parent debt that can be assumed by SpinCo tax-free.

D. Plan of Reorganization and Plan of Distribution

Acknowledging that current guidance regarding the meaning of "plan of reorganization" is unclear, the Proposed Regulations also would provide criteria for establishing and adopting a plan of reorganization as well as requirements for executing the plan of reorganization (including in the event of a change in circumstances following its adoption).[25] The Proposed Regulations also create a substantially identical set of rules for "plans of distribution" applicable specifically to Section 355 transactions.[26]

A plan of reorganization must identify all parties to the plan, as well as all transactions included and liabilities assumed in the plan.[27] The plan must also describe the intended federal income tax treatment of those transactions and the corporate business purpose for each transaction.[28] In addition, the Proposed Regulations would require that, prior to the first step of the reorganization, a plan of reorganization be finalized and adopted by the party to the reorganization.[29] The Proposed Regulations would also require that the plan be completed as expeditiously as reasonably practicable, which is presumed to be the case if the plan is completed within 24 months.[30] Failure to determine a plan of reorganization under these rules, however, is not sufficient to bust tax-free treatment, since, under the Proposed Regulations, a plan of reorganization may be identified by the IRS if not correctly filed by the taxpayer.[31] If finalized, these requirements are likely to impose significant additional filing requirements for all reorganizations (even those having nothing to do with a spin-off), and the practical granularity of what needs to be identified would likely need to be further developed.

Under the Proposed Regulations, a transaction would be properly included in the plan if, prior to the first step of the plan, one or more parties to the reorganization evidences a definite intent to carry out the transaction.[32] In addition, each transaction must have a "proximate relationship" to the plan. A transaction has a proximate relationship to the plan if it is an integral part of a series of transactions carried out to satisfy the requirements of the definitional provision intended to apply to the reorganization, is necessary to satisfy one or more requirements of the definitional provision, or would not have occurred but for the reorganization covered by the plan ("but for" test).[33] The Proposed Regulations notably include examples (again in a departure from prior ruling practice) indicating that if Parent uses cash received from SpinCo to fund either a repurchase of Parent stock post-spin-off pursuant to a preexisting stock repurchase program or an ordinary course dividend pursuant to Parent's preexisting dividend payment policy, such cash would not be considered purged (apparently for failing the "but for" test).[34] Finally, the transaction would need to be consistent with, and directly related to, one or more corporate business purposes for the reorganization.[35]

The Proposed Regulations permit a taxpayer to amend a plan of reorganization after the first step of the original plan only if the amendment is in direct response to an identifiable, unexpected, and material change in market or business conditions that occurs after the date on which the original plan of reorganization is adopted by the party to the reorganization.[36] In addition, the amendment must be necessary to effectuate the reorganization, and the amended plan of reorganization must satisfy all requirements applicable to an original plan of reorganization.[37]

In addition, the Proposed Regulations introduce new multi-year tax reporting requirements for corporate separations and related transactions.[38]

E. Effective Date and Feedback Period

The Proposed Regulations would apply to transactions occurring after the date of publication of final regulations, but only if the earliest of the following dates with respect to the transaction occurs after the publication date: (1) the date of the first public announcement; (2) the date of entry by the taxpayer into a written agreement; (3) the date of approval by the board of directors of the taxpayer; (4) the date of a court order (or a plan confirmed, or a sale approved, by order of a court) in a title 11 or similar case, only if the taxpayer was a debtor in a case before such court; or (5) the date a ruling request is submitted to the IRS.[39]

Written comments to the Proposed Regulations are sought by March 17, 2025.

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ENDNOTES

[1] References herein to a "Section" are to sections of the Internal Revenue Code and the Treasury regulations ("Treasury Regulations" or "Treas. Reg.") promulgated thereunder.

[2] *See* Explanation of Provisions I.C.5; Prop. Treas. Reg. § 1.355-10(c)(1).

[3] Prop. Treas. Reg. § 1.355-10(a).

[4] Prop. Treas. Reg. § 1.355-10(c)(3).

[5] *Id.*

[6] Prop. Treas. Reg. § 1.355-10(d)(3)(iii) (*Example 3*).

[7] Prop. Treas. Reg. § 1.355-10(c)(2)(ii). *See also* Prop. Treas. Reg. § 1.355-10(d)(4) (*Example 4*), which permits the retention of SpinCo stock or securities over a six-year period under the facts-and-circumstances test because, among other things, there was a sufficient corporate business purpose for the retention as of the date on which the plan of distribution was adopted and at all times during the period of retention.

[8] Prop. Treas. Reg. § 1.355-10(c)(2)(iii).

[9] *See* Prop. Treas. Reg. § 1.355-10(b)(1), which defines "CSAG" as the separate affiliated group of which SpinCo is the common parent, and Prop. Treas. Reg. § 1.355-10(b)(7)(i), which defines retention to cover stock or securities of SpinCo or another member of SpinCo's CSAG.

[10] Rev. Proc. 2024-24, § 3.03(2)(b).

[11] *See* Prop. Treas. Reg. § 1.355-2(e)(2)(ii).

[12] *See* Rev. Proc. 2024-24, § 3.05(5)(b)(ii).

[13] *See* Prop. Treas. Reg. § 1.361-5(e)(3)(vi) and Prop. Treas. Reg. § 1.361-5(e)(4)(iii)(B).

[14] In contrast to prior public guidance, the Rev. Proc. contains no explicit reference to refinancing debt. The absence of explicit relief for refinancing debt, taken together with certain public statements from Treasury and IRS officials, have led to the understanding that the IRS would take an unfavorable view on refinancing debt for purposes of obtaining private letter rulings.

[15] Prop. Treas. Reg. § 1.361-5(c)(2)(ii).

[16] Prop. Treas. Reg. § 1.361-5(b)(2).

[17] Prop. Treas. Reg. § 1.361-5(d)(2).

[18] Rev. Proc. 2024-24, § 3.05(12).

[19] Prop. Treas. Reg. § 1.361-5(f)(2).

[20] Explanation of Provisions VIII.C.1; Prop. Treas. Reg. § 1.357-3(a)(2).

[21] Explanation of Provisions VIII.C.2 and Prop. Treas. Reg. § 1.357-3(d)(3). *See also* Prop. Treas. Reg. § 1.357-3(e)(5) (*Example 5*).

[22] Prop. Treas. Reg. § 1.357-2(e).

[23] Prop. Treas. Reg. § 1.357-2(e)(2)(iii)(A).

[24] Prop. Treas. Reg. § 1.357-1(b)(15).

[25] *See generally* Prop. Treas. Reg. § 1.368-4.

[26] *See generally* Prop. Treas. Reg. § 1.355-4.

[27] Prop. Treas. Reg. § 1.368-4(d)(1)(i)–(iv).

[28] Prop. Treas. Reg. § 1.368-4(d)(1)(v)–(vi).

ENDNOTES (CONTINUED)

[29] Prop. Treas. Reg. § 1.368-4(d)(2).

[30] Prop. Treas. Reg. § 1.368-4(d)(3)(i)(A), -(ii)(A).

[31] Prop. Treas. Reg. § 1.368-4(a)(2)(i)–(ii).

[32] Prop. Treas. Reg. § 1.368-4(e)(1)(i).

[33] Prop. Treas. Reg. § 1.368-4(e)(2)(i)(A), -(B).

[34] *See* Prop. Treas. Reg. § 1.361-3(f)(3) (*Example 3*) (*ordinary course distribution*) and -(f)(5) (*Example 5*) (*existing stock repurchase program*).

[35] Prop. Treas. Reg. § 1.368-4(e)(3).

[36] Prop. Treas. Reg. § 1.368-4(f)(1)(i).

[37] Prop. Treas. Reg. §1.368-4(f)(1)(ii)–(iii).

[38] *See* Prop. Treas. Reg. §1.355-5 and new IRS Form 7216.

[39] *See* Explanation of Provisions (Proposed Applicability Dates).

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