

May 9, 2024

IRS Issues New Ruling Policy on Spin-Off Transactions

New IRS Revenue Procedure Changes Ruling Practice for Retained Stock and Securities, Tax-Free Stock-for-Debt Exchanges and Debt Securities-for-Debt Exchanges

SUMMARY

On May 1, 2024, the IRS and the Department of the Treasury issued Rev. Proc. 2024-24 (the “New Rev. Proc.”), which establishes revised standards for taxpayers seeking private letter rulings on tax-free spin-offs, focusing in particular on, among other things, issues relating to stock-for-debt exchanges and debt securities-for-debt exchanges (the “Parent Debt Exchanges”) occurring in connection with tax-free spin-offs. The New Rev. Proc. provides the first substantive official guidance on such exchanges following public statements from IRS officials that the IRS was reconsidering its existing ruling policies. In requiring the taxpayer to make certain representations in its ruling request, the New Rev. Proc., among other things:

- effectively requires that, where less than all of the stock or securities of the spun-off company (“SpinCo”) are distributed by the parent corporation (“Parent”) at the time of the initial spin-off (the “First Distribution”), Parent must commit in advance to disposing of such remaining SpinCo stock or securities either in (i) a taxable sale or (ii) a tax-free Parent Debt Exchange or “clean-up” spin-off, without the flexibility to change course;
- requires tax-free Parent Debt Exchanges or “clean-up” spin-offs to be completed within 12 months of the First Distribution;
- prohibits the use of the so-called “direct issuance” mechanism that has been the prevalent model in the market in recent years for accomplishing Parent Debt Exchanges and reverts to the “intermediated exchange” model, which is expected to increase associated transaction costs; and
- prohibits any planned post-spin issuance of new Parent debt that can be viewed as “replacing” historic Parent debt that was satisfied in a Parent Debt Exchange.

The New Rev. Proc. is applicable to all ruling requests made to the IRS after May 31, 2024. Written comments to the New Rev. Proc. are sought by July 30, 2024.

BACKGROUND

In a tax-free spin-off, Parent may distribute less than all of the stock or securities of SpinCo in the First Distribution (if at least 80% or more of SpinCo stock is distributed to shareholders in the First Distribution) and continue to own a portion of SpinCo stock or securities (“Remaining SpinCo Stock or Securities”), as long as such stock or securities are disposed of within a certain time period, and certain other requirements are met. Parent can then use such Remaining SpinCo Stock or Securities to satisfy Parent’s creditors in a Parent Debt Exchange, subject to certain limitations. Parent Debt Exchanges have been a popular feature in many spin-off transactions, because they allow Parent to de-lever in a tax-efficient manner by effectively reallocating Parent debt to SpinCo. Administrative guidance on Parent Debt Exchanges has evolved over the years, often contradicting past guidance.¹ The New Rev. Proc. signals a significant departure from recent ruling practices.

DISCUSSION²

A. Continued Ownership of SpinCo Stock or Securities

1. Taxable vs. Tax-Free Dispositions after the First Distribution

The New Rev. Proc. departs from prior ruling practice on the IRS’s approach to the manner in which Remaining SpinCo Stock or Securities can be disposed.

Parent may generally dispose of Remaining SpinCo Stock or Securities tax-free in one of two ways: through a distribution to Parent’s shareholders or securityholders in a “clean-up” distribution, or through a transfer to Parent’s creditors in exchange for Parent debt in a Parent Debt Exchange (collectively, “Delayed Distributions”). Consistent with prior ruling practice, the New Rev. Proc. requires Delayed Distributions to be completed within 12 months of the First Distribution.³ Prior ruling practice, however, had also permitted Parent the flexibility to alternatively dispose of Remaining SpinCo Stock or Securities in a taxable transaction within 5 years of the First Distribution. The New Rev. Proc. eliminates such flexibility as taxpayers would need to commit, at the time of the ruling request, to either a tax-free or a taxable disposition of the Remaining SpinCo Stock or Securities.⁴ Further, the New Rev. Proc. is silent on the impact to the tax treatment of the spin-off (i.e., whether the First Distribution qualifies as tax-free) if a taxpayer intended to complete a Parent Debt Exchange within 12 months but ultimately takes longer to complete such transaction due to reasons outside of the taxpayer’s control.

As an alternative to Delayed Distributions, Parent may retain Remaining SpinCo Stock with the intent to dispose of such stock or securities in a taxable transaction (“Retention”). The New Rev. Proc. states that Retention creates a rebuttable presumption of a tax avoidance purpose, and requires Parent to submit various information to rebut such presumption.⁵ It is questionable whether all such information would be available to the taxpayer at the time of a ruling request. For example, the taxpayer is required to submit information describing any tax benefit or advantages relating to the Retention, including loss or absorption

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of expiring losses anticipated upon the disposition of Remaining SpinCo Stock or Securities,⁶ which would depend on the future trading price of SpinCo Stock or Securities and/or Parent's future income from other sources that would offset any expiring losses. The New Rev. Proc. also requires the taxpayer to establish, to the satisfaction of the IRS, that a "business exigency" exists that causes the need for Retention if certain listed factors are present in the transaction, even though such factors (for example, overlapping directors and temporary non-arm's length arrangements for transitional services) are common in spin-off transactions with or without Retention.⁷

2. Parent Debt Exchanges

The New Rev. Proc. also modifies specific aspects of prior IRS ruling practice regarding Parent Debt Exchanges.

a. Mechanics of Parent Debt Exchanges

The New Rev. Proc. significantly modifies the mechanics through which Parent Debt Exchanges are accomplished. The prevalent model in the market in recent years, supported by affirmative IRS rulings, was the "direct issuance" model, under which a third party (typically a bank) would loan cash to Parent. Parent would repay such new loan from bank with Remaining SpinCo Stock or Securities, while the cash proceeds from the debt would be used to repay historic Parent debt within 12 months of the First Distribution. The New Rev. Proc. generally prohibits the use of the direct issuance model and reverts to the "intermediated exchange",⁸ which was previously common in the market but more costly. In an intermediated exchange, under the so-called "5/14 standard", the intermediary would purchase historic Parent debt and hold for at least *five days* before entering into an agreement with Parent to exchange such Parent debt with Remaining SpinCo Stock or Securities, and then the actual exchange would occur at least *14 days* after the intermediary had purchased Parent debt.

Even though both models have similar economic effects of replacing Parent debt with SpinCo Stock or Securities, in Notice 2024-38 (the "Notice"),⁹ which accompanied the New Rev. Proc., the IRS states its view that the intermediary in a direct issuance may not be a creditor under general principles of tax law and therefore the transaction would not satisfy the requirements under Section 361 of the Code that SpinCo Stock or Securities be transferred to a creditor. The Notice further states that similar concerns could also exist even in an intermediated exchange model. In light of such concerns, the New Rev. Proc. requires the taxpayer to represent that the intermediary will act for its own account and bear the risk of loss with respect to Parent debt and the SpinCo Stock or Securities held in an intermediated exchange, and expressly prohibits Parent and the intermediary from entering into arrangements such as variable pricing agreements or forward exchange agreements that prior IRS rulings have permitted.¹⁰ The New Rev. Proc. also requires the taxpayer to provide analysis establishing the intermediary as a creditor for tax purposes (and not, for example, an agent of Parent) and that the form of the Parent Debt Exchange should not be recast.¹¹ The IRS notes that the length of time during which the intermediary acquires Parent debt and exchanges it for

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SpinCo Stock or Securities is a “primary factor” in determining whether the form should be respected and that the shorter the length of such time, “the greater the scrutiny the IRS will apply to the ruling request.” The revised mechanics are expected to increase transaction costs associated with Parent Debt Exchanges and increase execution risk.

The Notice states that the IRS is seeking “feedback from Intermediaries to help ensure that future guidance is responsive to the business and market-risk considerations that inform the mechanics of intermediated exchanges and direct issuance transactions, as opposed to mere differences in transaction costs (with the understanding that differences in transaction costs are one consequence of such business and market risk considerations).”

b. Other Ruling Policies regarding Parent Debt Exchanges

The New Rev. Proc. is generally similar to prior IRS official ruling policy¹² regarding which Parent debt may be treated as “historic” debt for purposes of Parent Debt Exchanges and how much historic debt can be repaid.¹³ That said, the IRS now requires the taxpayer to provide certain new representations and related information that likely increases the complexity and costs of preparing for ruling requests.

For example, the taxpayer is now required to make a representation that Parent will not replace any historic Parent debt that is repaid in the Parent Debt Exchange with new borrowing that Parent “anticipates or is committed to, directly or indirectly, before the [spin-off of 80% of SpinCo].”¹⁴ While there are exceptions for certain ordinary course drawdowns on revolving credit facilities or new borrowing incurred due to unanticipated and changed circumstances,¹⁵ the broadly drafted representation would require careful consideration for any anticipated or planned financing that could be viewed as directly or indirectly replacing historic debt repaid in the Parent Debt Exchange.

B. Effect of Transaction Related to the Spin-Off on SpinCo Securities

The New Rev. Proc. and the Notice indicate the IRS’s intent to further consider the impact of the modification (including refinancing) of SpinCo’s debt on the tax-free qualification of the Parent Debt Exchanges. The Notice describes what appears to be a “Reverse Morris Trust” (RMT) transaction in which SpinCo debt is modified in connection with its merger into an acquiror, and states that the tax-free treatment of a purported Parent Debt Exchange occurring in connection with such RMT could be precluded under general principles of Federal income tax law.¹⁶

C. Post-Distribution Payments

The New Rev. Proc. imposes new requirements on the characterization of certain post-spin off payments from SpinCo to Parent that relate to the spin-off (“**Post-Distribution Payments**”).¹⁷ For example, it may be appropriate to treat indemnity payments made by SpinCo to Parent pursuant to the terms of the relevant separation agreement as a payment that relates to the reorganization that effectuated the spin-off. The New Rev. Proc. requires taxpayers to represent that such Post-Distribution Payments must be paid to a

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segregated account and paid to Parent shareholders or to historic creditors within 90 days of receipt.¹⁸ Parent must also provide other information on the tax analysis and treatment of Post-Distribution Payments. Similar to some of the other information being requested by the New Rev. Proc., such requirements appear to be removed from the practical realities of how spin-off transactions are consummated, given that commercial decisions around the possibility of Post-Distribution Payments likely will not have been made as of the time at which the taxpayer needs to submit a ruling request.

D. Plan of Reorganization

The New Rev. Proc. also requires taxpayers to make new representations regarding the treatment of transactions as being taken “pursuant to” or “in connection with” a plan of reorganization.”¹⁹ In particular, the taxpayer must represent that each party to the proposed transaction will have adopted a plan of reorganization before the first step in the proposed transaction is taken, and the taxpayer must also submit with the ruling request a copy of the draft plan of reorganization (with updated drafts submitted via supplemental submissions to the IRS).²⁰ The concept of a “plan of reorganization” is not one that is clearly defined in relevant case law, and draft documentation effectuating the spin-off are often not fully prepared until shortly prior to the spin-off. The requirement to provide a draft plan at the time of the ruling request, far in advance of the intended spin-off, and to adopt such plan prior to taking the “first” step, would require greater attention to the timing of approaching the IRS for a ruling as well as what is being communicated as the adopted “plan”, particularly for companies whose circumstances may be evolving over time during the course of preparing for a spin-off.

E. Effective Date and Feedback Period

The New Rev. Proc. will apply to all ruling requests postmarked or, if not mailed, received by the IRS after May 31, 2024.²¹

Notice 2024-38 requests feedback to be submitted by July 30, 2024, but it also states that “consideration will be given to any written feedback submitted after July 30, 2024, if such consideration will not delay the issuance of future published guidance.”²²

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ENDNOTES

- 1 The New Rev. Proc. supersedes Rev. Proc. 2018-53, 2018-43 I.R.B. 667 (Oct. 3, 2018) (revised standards for taxpayers seeking private letter rulings on Parent Debt exchanges, including ruling requirements for “standard” stock-for-debt and securities-for-debt exchanges). See also Rev. Proc. 2013-3, 2013-1 I.R.B. 113 (Jan. 2, 2013), § 5.01(10) (adding to its list of “no-rule” issues whether exchanges of SpinCo stock or securities for Parent debt could qualify for tax-free treatment where such Parent debt was incurred “in anticipation” of the spin-off); Rev. Proc. 2017-38, 2017-22 I.R.B. 1258 (May 9, 2017) (removing such “no-rule” policy); Rev. Proc. 96-30, 1996-19 I.R.B. 8, 1996-1 C.B. 696 (May 6, 1996), Appendix B (setting forth requirements for favorable rulings regarding Parent’s retention of SpinCo stock).
- 2 This discussion focuses on a few key issues in the New Rev. Proc. and the Notice, and does not address every aspect of the revised ruling policy.
- 3 § 3.03(2)(b)(ii), Rev. Proc. 2024-24. In addition, if the Delayed Distributions will take more than 90 days after the First Distribution, the New Rev. Proc. requires the taxpayer to provide information regarding the expected amount of Remaining SpinCo Shares or Securities that will be disposed of more than 90 days after the First Distribution and the amount of time expected to complete all Delayed Distributions. In the case of a Parent Debt Exchange that is completed more than 90 days after the First Distribution, the taxpayer must represent to the IRS that there are “one or substantial business reasons” for the delay, and provide supporting documentation if requested by the IRS. § 3.05(10)(a)(i), Rev. Proc. 2024-24.
- 4 § 3.03(3)(a)(ii)(B), Rev. Proc. 2024-24.
- 5 § 3.03(3)(d) & (e), Rev. Proc. 2024-24.
- 6 § 3.03(3)(d)(ii)(B), Rev. Proc. 2024-24.
- 7 § 3.03(3)(e)(iii)(B), Rev. Proc. 2024-24.
- 8 § 3.05(5)(b)(ii), Rev. Proc. 2024-24.
- 9 The Notice states that it is continuing to study matters relating to Section 355 Transactions for purposes of developing potential published guidance and seeks public feedback on all provisions of the New Rev. Proc., as well as feedback on the IRS’s stated views and concerns on a number of specified issues that are addressed by the New Rev. Proc.
- 10 § 3.05(5), Rev. Proc. 2024-24.
- 11 § 3.05(5)(d)(i), Rev. Proc. 2024-24.
- 12 Rev. Proc. 2018-53.
- 13 § 3.05(6) – (8), Rev. Proc. 2024-24.
- 14 § 3.05(12), Rev. Proc. 2024-24.
- 15 § 3.05(12)(b), Rev. Proc. 2024-24.
- 16 § 2.02(7), Notice 2024-38.
- 17 § 3.05(b), Rev. Proc. 2024-24.
- 18 § 3.05(10)(b), Rev. Proc. 2024-24.
- 19 § 3.05(1), Rev. Proc. 2024-24.
- 20 § 3.05(1)(c), Rev. Proc. 2024-24.
- 21 § 5, Rev. Proc. 2024-24.
- 22 § 3.01, Notice 2024-38.

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