SULLIVAN & CROMWELL LLP

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Debt Exchanges in Spin-Off Transactions

New IRS Revenue Procedure Defines Ruling Practice for Tax-Free Stock-for-Debt and Securities-for-Debt Exchanges in Spin-Offs

SUMMARY

On October 3, 2018, the Internal Revenue Service (the "IRS") issued Revenue Procedure 2018-53 (the "New Revenue Procedure"),[1] which establishes revised standards for taxpayers seeking private letter rulings on stock-for-debt and securities-for-debt exchanges in connection with tax-free spin-offs. The New Revenue Procedure provides the first substantive public guidance on such exchanges since the removal in 2017 of a 2013 "no-rule" policy under which the IRS would not rule on the tax-free nature of such exchanges unless the debt satisfied was "old and cold." The New Revenue Procedure effectively sets forth the IRS's ruling requirements for "standard" stock-for-debt and securities-for-debt exchanges, returning in many ways to pre-2013 practice that is generally favorable to taxpayers. However, the New Revenue Procedure also appears to set limits on so-called "slow motion" exchanges.

BACKGROUND

Stock-for-debt and securities-for-debt exchanges have been a popular feature in many spin-off transactions to monetize, in a tax-efficient manner, the appreciated value of stock of a spun-off company ("SpinCo"). Typically, the company distributing SpinCo stock ("Parent") in connection with a spin-off structured as a "divisive reorganization" would also distribute SpinCo stock or securities (*i.e.*, long-term debt) to Parent's creditors, often with a bank serving as an intermediary. The popularity of such exchanges led the IRS in 2013 to add 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.[2] In 2017, the IRS removed this "no-rule" without giving any specific substantive guidance in the area.[3]

NEW REVENUE PROCEDURE

The New Revenue Procedure returns in many ways to IRS practice prior to the 2013 "no-rule" policy and describes elements required for a "standard" debt exchange ruling. Under the New Revenue Procedure, the standard stock-for-debt or securities-for-debt exchange is generally limited to Parent debt that is non-contingent and payable only in money.[4] So-called "traveling debt" (that by its terms may be satisfied by SpinCo stock) is not encompassed. In addition, the debt must be held by a person unrelated to both Parent and SpinCo (or must be used ultimately to satisfy an obligation owed to such an unrelated person).[5] Intermediated exchanges (through a bank, in accordance with IRS ruling practice reflected in numerous private letter rulings[6]) appear to be recognized as valid, although the intermediary may not receive SpinCo stock or securities that has a value in excess of the intermediary's entitlement under the Parent debt.[7]

The New Revenue Procedure creates a more objective standard for "old and cold" debt than the "issued in anticipation" standard contained in the 2013 "no-rule" policy. Under the New Revenue Procedure, Parent debt generally is "old and cold" if the debt is incurred before the private letter ruling request is submitted and at least 60 days before the earliest to occur of: (1) the first public announcement of the spin-off transaction or a similar transaction, (2) the entry into a binding agreement to effectuate such transaction, and (3) the approval of such transaction by the board of directors.[8] However, later-incurred debt appears to be eligible to be treated as "old and cold" if the debt is issued to replace "old and cold" debt.[9]

In addition, the New Revenue Procedure requires that the amount of Parent debt satisfied in a "standard" debt exchange not exceed the historical average of Parent's non-contingent third-party debt (determined as an eight-quarter average before the approval of the spin-off transaction by Parent's board of directors).[10] Parent also must not replace the debt thus reduced with a pre-committed borrowing, other than by borrowings in the ordinary course pursuant to a revolver or similar arrangement.[11]

Finally, the New Revenue Procedure limits the use of SpinCo stock and securities for so-called "slow motion" exchanges by providing that a "standard" stock-for-debt or securities-for-debt exchange: (1) must generally occur within 30 days of the initial distribution of SpinCo stock to Parent shareholders unless there are "substantial business reasons" for the delay, and (2) must occur in any event within 180 days (absent a showing that the exchange is part of a "plan" that includes the spin-off of SpinCo).[12] The New Revenue Procedure requires taxpayers applying for a private letter ruling to submit information and analysis on the substantial business reasons for any delay beyond 30 days.

The New Revenue Procedure does not prevent the IRS from ruling on stock-for-debt or securities-for-debt exchanges that do not meet the guidelines for treatment as a "standard" exchange. However, where the taxpayer cannot give the representations required by the New Revenue Procedure for such an exchange,

the taxpayer may be required to provide additional representations, information or analysis as the IRS may require.[13]

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ENDNOTES

1 I.R.B. 2018-43 (Oct. 3, 2018).

2 Rev. Proc. 2013-3, 2013-1 I.R.B. 113 (Jan. 2, 2013), § 5.01(10).

3 *See* Rev. Proc. 2017-38, 2017-22 I.R.B. 1258 (May 9, 2017). Later in 2017, the IRS released a brief statement indicating that rulings would not be issued with respect to so-called "slow motion" stock-for-debt or securities-debt-exchanges following a spin-off solely based on the length of the delay between the spin-off and exchange, and that the IRS would only issue rulings in such transactions following "substantial scrutiny" of the facts and circumstances and full consideration of relevant legal issues and impacts on federal tax administration. 2017 A.R.D. 201-4 (Oct. 13, 2017).

4 *See* New Revenue Procedure, § 3.01.

5 *See* New Revenue Procedure, § 3.04(2).

6 *See*, *e.g.*, Priv. Ltr. Rul. 201721002 (May 26, 2017); Priv. Ltr. Rul. 201651010 (Dec. 16, 2016); Priv. Ltr. Rul. 201349006 (Sep. 10, 2013); Priv. Ltr. Rul. 201216023 (Jan. 19, 2012).

7 *See* New Revenue Procedure, § 3.04(3).

8 *See* New Revenue Procedure, § 3.04(4).

9 *See id.* (taxpayer may establish under the facts and circumstances that the exchange will result in an allocation of historic Parent debt between Parent and SpinCo or an exchange of historic Parent debt for SpinCo stock, including if the proceeds of more-recently incurred Parent debt were used to satisfy other Parent debt that was "old and cold" or such proceeds were or will be used in SpinCo's business).

10 *See* New Revenue Procedure, § 3.04(5). The historic average of Parent debt includes debt of other members of Parent's "separate affiliated group" (which excludes debt of SpinCo and its subsidiaries).

11 *See* New Revenue Procedure, § 3.04(7).

12 *See* New Revenue Procedure, § 3.04(6).

13 *See* New Revenue Procedure, §§ 3.02, 3.04.

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