Internal Revenue Service Limits Rulings on Tax-Free Spinoffs

The Treasury Department and IRS Issue Notice and Revenue Procedure to Expand Area of “No Rule” for Letter Rulings for Certain REIT Spinoffs and “Cash-Rich” Spinoffs

SUMMARY

The Treasury Department and the Internal Revenue Service (the “IRS”) issued guidance regarding certain spinoffs, with particular relevance to certain opco/propco spinoffs involving REIT conversions, and to certain so-called “cash-rich” spinoffs. In Notice 2015-59, the IRS announced a study (and stated its concerns) in respect of certain spinoff transactions (known as Section 355 distributions under the Internal Revenue Code (the “Code”)) with one or more of the following characteristics: (i) ownership by the distributing corporation or controlled corporation of investment assets having substantial value in relation to the value of all of the corporation’s assets and the value of the “active trade or business” (“ATB”) on which the distributing corporation or controlled corporation is relying to meet the requirements for tax-free treatment discussed below; (ii) a significant difference between the ratio of investment assets to non-investment assets of the distributing corporation and such ratio of the controlled corporation; (iii) ownership by the distributing corporation or the controlled corporation of a small ATB in relation to all of its assets; and (iv) a conversion by the distributing corporation or controlled corporation to be a regulated investment company (a “RIC”) or a real estate investment trust (a “REIT”).

Concurrently with the issuance of Notice 2015-59, the IRS issued Revenue Procedure 2015-43, which provides that the IRS will generally not issue letter rulings under Section 355 in respect of the following: (a) Section 355 distributions involving a RIC or REIT conversion, (b) Section 355 distributions involving an ATB that is less than 5% of the gross assets of the relevant corporation, and (c) Section 355 distributions involving substantial investment assets that are “skewed” between the distributing and the controlled
corporations and involving an ATB that is less than 10% of the fair market value of such corporation’s investment assets.

BACKGROUND

Section 355 of the Code generally provides that, if certain requirements are satisfied, a distributing corporation may distribute the stock (or stock and securities) of a controlled corporation to its shareholders and security holders without the distributing corporation, its shareholders, or its security holders recognizing income, gain, or loss on the distribution. Among many requirements, (1) a Section 355 distribution must be carried out for one or more corporate business purposes (“Business Purpose Requirement”), (2) the distribution must not be used principally as a “device” for the distribution of the earnings and profits of the distributing corporation and/or the controlled corporation, and (3) the distributing corporation and the controlled corporation each must be engaged in a qualifying ATB (the “ATB Requirement”).

Under Revenue Procedure 96-30, the IRS had a prior practice of requiring, for letter ruling purposes, that the ATB be at least 5% of the fair market value of the total assets of each relevant corporation. This procedural requirement was abandoned in Revenue Procedure 2003-48, and in the years hence the IRS has issued numerous rulings approving of transactions where the size of the ATB was significantly below the 5% benchmark and IRS personnel have stated, in numerous public fora, as well as in the letter ruling context, that there was no minimum size required for ATBs (some IRS officials were quoted publicly as saying a “hot dog stand” could qualify as an ATB).

In reinstating a “size of ATB” requirement for letter ruling purposes, the Notice states that distributions with the characteristics listed above in the summary “may present evidence of device for the distribution of earnings and profits, may lack an adequate business purpose or Qualifying [ATB], or may violate other Section 355 requirements.” The Notice also states that such transactions may circumvent the purposes of the General Utilities repeal (which generally imposes tax on distributions of appreciated assets to a corporation’s shareholders).

The Notice states that these concerns apply to both spinoffs (pro rata distributions) and splitoffs (non pro rata distributions), even for publicly traded and widely held corporations, notwithstanding that (i) “public

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1 See, e.g., Amy S. Elliot, Alexander Sets Reachable Bar for Business Purpose in REIT Spinoffs, 2014 TNT 19-5 (Feb. 3, 2014) (“Today, hot dog stands are bigger than they used to be because most of them are trucks. But if you ever see how hard the people work as they make your sandwich at the truck, that’s an active trade or business.’ [Bill] Alexander said.”); Amy S. Elliot, Business Purpose Requirement for REIT, S Corp Spinoff Clarified, 2014 TNT 115-7 (June 16, 2014) (“[Bill] Alexander said the ATB ‘need not be the core business’ of the REIT, but simply a ‘relatively complete business.’ He said the IRS’s enforcement viewpoint is that ‘if something is an active trade or business in the hands of a small business, it would also be an active trade or business in the hands of a larger business, even if [it has] other operations or other assets that are much larger.’”).
trading” and non pro rata distributions are both nondevice factors under current regulations and
(ii) Congress specifically amended the Code in 2006 to limit tax-free treatment of a narrowly defined type
of splitoff transactions. The Notice states that “certain characteristics of a transaction,” including those
listed in the summary above, “may overcome both . . . nondevice factor[s].” The Notice states that these
characteristics may make it “less likely that a nontax business purpose for the distribution will satisfy the
independent business purpose requirement . . . or will qualify as a strong corporate business purpose
constituting a nondevice factor.”

A. NATURE OF ASSETS OF DISTRIBUTING CORPORATION AND CONTROLLED CORPORATION

The Notice states the IRS is most concerned about transactions that result in (i) the distributing
corporation or the controlled corporation owning a substantial amount of cash, portfolio stock or
securities, or other investment assets, in relation to the value of all of its assets and its ATB, and (ii) one
of the corporations having a significantly higher ratio of investment assets to non-investment assets than
the other corporation. The concern is primarily directed at distributions outside of the affiliated group (i.e.,
external spins), and the guidance provides an exception for distributions within an affiliated group, 2
provided such distributions do not result in an external spin (“Affiliate Exception”). The IRS provided in
Revenue Procedure 2015-43 that the IRS will not issue letter rulings for any such distribution if: (i) the fair
market value of the investment assets of the distributing corporation or the controlled corporation is two-
thirds or more of the total fair market value of its gross assets; (ii) the fair market value of the gross assets
of the trade(s) or business(es) on which the distributing or controlled corporation relies to satisfy the ATB
Requirement is less than 10% of the fair market value of its investment assets; and (iii) the ratio of the fair
market value of the investment assets to the fair market value of the assets other than investment assets
of the distributing corporation or the controlled corporation is three times or more of such ratio for the
other corporation (i.e., the controlled corporation or the distributing corporation, respectively). 3

B. SMALL ACTIVE TRADE OR BUSINESS

The Notice also expressed concern about transactions in which the distributing corporation or the
controlled corporation owns a relatively small ATB (other than distributions within the Affiliate Exception).

2 See § 243.

3 For these purposes, “investment assets” generally has the meaning given to such term in Section
355(g)(2)(B), subject to certain modifications. Such modifications include: (i) in the case of stock or
securities in a corporation any stock of which is publicly traded, Section 355(g)(2)(B)(iv) shall be
applied by substituting “50-percent” for “20-percent”; (ii) except as provided in clause (iv) of this
sentence, an interest in a publicly traded partnership shall be treated in the same manner as publicly
traded stock; (iii) except as provided in clause (iv) of this sentence, an interest in a partnership that is
not a publicly traded partnership shall be treated in the same manner as stock which is not publicly
traded stock; and (iv) in the case of an interest in a partnership (other than a publicly traded partnership
treated as a corporation pursuant to § 7704(a)), the ATB of which is relied upon by the
distributing corporation or the controlled corporation, or would be taken into account without regard to
the five-year requirement of Section 355(b)(2)(B), clauses (ii) and (iii) of this sentence shall not apply.
Accordingly, the IRS provided in Revenue Procedure 2015-43 that, other than in “unique and compelling” circumstances, the IRS “ordinarily will not rule” on any issue that relates to the qualification of a distribution under Section 355 if the fair market value of the gross assets of the trade(s) or business(es) on which the distributing corporation or the controlled corporation relies to satisfy the ATB Requirement is less than 5% of the total fair market value of the gross assets of such corporation. One example that the Notice gives as an “unusual and compelling” circumstance is whether, based on the facts and circumstances, a substantial portion of the non-ATB assets would be ATB assets but for the five-year requirement, and whether there is a relationship between the business purpose for the distribution and the ATB. As noted above, this returns the IRS to a position that the IRS had in place prior to the publication of Revenue Procedure 2003-48.

C. DISTRIBUTIONS INVOLVING REITS OR RICS

The Notice also expressed concern with respect to transactions in which a distributing corporation or a controlled corporation (but not both) elects to be a REIT or a RIC (other than distributions within the Affiliate Exception) in connection with, or shortly after, the spinoff or splitoff. Accordingly, other than in “unique and compelling” circumstances, the IRS ordinarily will not rule on any issue that relates to the qualification of a distribution under Section 355 if, as part of the same plan or series of related transactions, property owned by either the distributing corporation or controlled corporation becomes the property of a REIT or a RIC, and the REIT or the RIC does not elect to immediately recognize gain in its assets. The IRS will, however, continue to rule if both the distributing corporation and the controlled corporation are REITs or RICs.

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