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Client Alert Commentary

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IRS Adds Certain Spin Transactions to the "No Rule" List

Treasury and IRS announce that certain "cash rich" and REIT/RIC conversion spin-offs are under study and are added to the "no rule" list.

On September 14, 2015, the United States Treasury Department (the Treasury) and the United States Internal Revenue Service (the IRS) issued Notice 2015-59 (the Notice) in which they announced that certain types of spin-offs involving relatively substantial investment assets, relatively small active businesses and conversions into real estate investment trusts (REITs) or regulated investment companies (RICs) are under study and may raise concerns under the various requirements of Section 355,[1] which governs the tax-free status of spin-off transactions. The IRS also issued Revenue Procedure 2015-43, pursuant to which these types of spins were added to the "no-rule" lists so that, depending on the nature of the transaction, the IRS will either ordinarily not issue rulings on such spins absent unique and compelling reasons or will temporarily not issue rulings regardless of the circumstances pending the outcome of the study.

Background

Section 355 generally provides that if certain requirements are satisfied, a distributing corporation (P) may distribute the stock of a controlled corporation (S) to P's shareholders in a spin-off transaction (a Spin) without P or its shareholders recognizing taxable income, gain or loss on the Spin. The Spin must satisfy a number of requirements to qualify under Section 355, including the following:

- The Spin must not be used principally as a device for the distribution of earnings and profits of P, S or both (the Device test).
  - The Device test generally involves a weighing of device and nondevice factors. One nondevice factor is if P is publicly traded and has no 5% shareholder (the Public Trading Nondevice Factor).
  - A Spin ordinarily is not a Device if the Spin would be a taxable exchange (rather than a dividend) under Section 302(a) if it did not qualify under Section 355 (the Exchange Exception).
- Each of P and S must be engaged in the active conduct of a trade or business immediately after the Spin and generally must have conducted such business for five years preceding the Spin (the ATB test).
- The Spin must be carried out for one or more corporate business purposes (the Business Purpose test).

The Treasury and the IRS believe that the Spins described in the Notice may present issues under the Device, ATB, and Business Purpose tests, as well as other tests under Section 355. In particular, the Treasury and the IRS believe that these Spins may potentially not satisfy the Device test even if they satisfy the Public Trading Nondevice Factor and the Exchange Exception.

Spins of Concern to Treasury and the IRS

Spins with Excessive Investment Assets

The Treasury and the IRS are "most concerned" about Spins that result in both (i) P or S owning a substantial amount of cash, portfolio stock or securities or similar assets (Investment Assets) and (ii) P or S having a significantly higher ratio of Investment Assets to non-Investment Assets than the other corporation. Accordingly, the IRS is studying these matters and, in the interim, will no longer issue rulings on a Spin if immediately after the distribution, all of the following conditions exist:

- The fair market value of the Investment Assets of P or S is at least 2/3 of the total fair market value of its gross assets;
- The fair market value of the business on which P or S relies to satisfy the ATB Test is less than 10% of the fair market value of its Investment Assets; and
- The ratio of the fair market value of the Investment Assets to the fair market value of the non-Investment Assets of either P or S is at least three times the ratio for the other corporation.

Spins with Relatively Small Active Businesses

The Treasury and the IRS are also "concerned" about Spins in which P or S is relying on a business (Qualifying Business) of small value to meet the ATB Test as compared to its other assets. The Treasury and the IRS have concluded that under current law, Spins involving small Qualifying Businesses "may have become less justifiable." Accordingly, absent unique and compelling circumstances, the IRS will not issue rulings on a Spin if the fair market value of the gross assets of the business on which P or S relies to satisfy the ATB Test (the Qualifying Business Assets) is less than 5% of the total fair market value of the gross assets of such corporation.[2] In determining whether the circumstances justify issuing a ruling, the IRS will consider whether a substantial portion of the non-Qualifying Business Assets would be Qualifying Business Assets but for the five-year-history requirement, and whether there is a relationship between the business purpose for the Spin and the Qualifying Business at issue.

Spins Involving RICs or REITs

The Treasury and the IRS also have "significant concerns" relating to the Device Test, the Business Purpose Test and the ATB Test in connection with Spins involving REITs and RICs. With respect to REIT Spins, these typically involve corporations that intend to separate REIT-qualifying assets from other assets that do not so qualify such that P or S can meet the requirements to be a REIT. Accordingly, the IRS has stated that absent unique and compelling circumstances, it will not issue rulings on a Spin in which P or S (but not both) elect to be either a REIT or a RIC in conjunction with the Spin.

Conclusion

The main purpose of the guidance issued on Spins is to place certain types of Spins on the no rule list and to put taxpayers on notice that the IRS has a variety of concerns regarding these Spins and is considering changing certain rules with respect to such Spins. At the same time, the IRS has stressed that while the Notice may well lead to future guidance, the IRS has not made any decisions about the type or content of guidance it might issue.[3] Moreover, the Notice does not provide for a retroactive date for any eventual guidance to the date of the Notice (as compared, for example, with Notices in the inversion area which frequently contain an immediate retroactive date). On the other hand, when a practitioner asked at a recent DC Bar meeting whether the concerns reflected in the Notice could lead the IRS to

challenge certain spin-off transactions under current law, the IRS Chief Counsel (Corporate) responded "that's correct."[4]. Thus, taxpayers are left to evaluate the risks under current law of pursuing one of the Spins identified in the Notice. Caution is advised.

If you have questions or ideas about *Client Alert* processes or best practices, please contact:

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1 All Section references herein are to the Internal Revenue Code of 1986, as amended (the Code).

2 For purposes of determining the fair market value of the gross assets of P or S, all members of a separate affiliated group shall be treated as one corporation.

3 *See* Laura Davison, *IRS Spinoff Concerns Won't Manifest Retroactive Regulations*, Daily Tax Rep., Sept. 22, 2015, 18 DTR G-1 (BNA).

4 *See* Amy S. Elliott, *Official's Comments Fuel Market Fears Over Spinoff Challenges*, Tax Notes Today, Sept. 30, 2015, 2015 TNT 189-1.