Client Alert

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New IRS Guidance Limits Tax-Free Spin-Off Rulings – Implications for REIT Spin-Offs

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On September 14, 2015, the Internal Revenue Service ("**IRS**") issued Notice 2015-59 (the "**Notice**") and Revenue Procedure 2015-43 (the "**Rev Proc**"; together with the Notice, the "**Spin-Off Guidance**"). Under the Spin-Off Guidance, the IRS has significantly limited the circumstances under which it will issue a private letter ruling with respect to spin-off or split-off transactions that are considered "cash-rich"[1] or that involve real estate investment trusts ("**REITs**") or regulated investment companies ("**RICs**").[2]

Although the Spin-Off Guidance does not change the law that currently applies to spin-off transactions, it will nevertheless be a significant consideration for any company contemplating such a transaction. The Spin-Off Guidance not only eliminates the certainty of an IRS ruling for transactions within its ambit, but also indicates a potential heightened risk of an IRS challenge under current law, as well as the prospect of future changes to the applicable rules.

I. SUMMARY OF THE NOTICE

In the Notice, the IRS states that it is studying issues regarding the tax-free qualification of spin-offs with one or more of the following characteristics:

1) Ownership by the distributing corporation ("**Distributing**") or controlled corporation ("**Controlled**") of a substantial amount of "**Investment Assets**" (which generally includes cash, stock, securities and similar assets and should be determined by their fair market value) when compared to (i) its total assets or (ii) the assets that it relies on to satisfy the "five-year active trade or business" requirement of the tax-free spin-off rules ("**Business Assets**");

2) A significant difference between Distributing's ratio of Investment Assets to non-Investment Assets and such ratio of Controlled;

3) Ownership by Distributing or Controlled of a small amount of Business Assets compared to its total assets;

[1] For this purpose, "cash-rich" distributions include distributions in which the distributing or controlled corporation has significant Investment Assets as defined below.

[2] For purpose of this client alert, "spin-off" includes both pro rata spin-off distributions and non pro rata split off exchanges. As explained below, the IRS does not distinguish between these two types of transactions for purpose of the study and the revised ruling standards.

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4) Election by Distributing or Controlled (but not both) to be a REIT or a RIC.

The IRS is concerned that spin-offs with one or more of these characteristics might not satisfy the various requirements for tax-free treatment. For example, according to the IRS, such a spin-off might not have an adequate "business purpose," Distributing or Controlled might lack a sufficient "active trade or business," or the transaction might be seen as being used principally as a "device" for the tax-free distribution of the earnings and profits of Distributing or Controlled that would otherwise be taxable. More broadly, the IRS expresses concern that spin-offs having any of these characteristics might evade existing rules that are intended to impose corporate-level tax when a corporation distributes built-in gain assets to its shareholders. The spin-off rules provide a key exception to triggering corporate-level tax on such a distribution.

The IRS also observes that "an increasing number" of spin-offs intended for tax-free treatment involve Distributing or Controlled becoming a REIT. The IRS notes that such transactions "may involve corporations that, prior to the distribution, do not meet the requirements to be REITs and intend to separate REIT-qualifying assets from non-qualifying assets so that [Distributing] or [Controlled] can meet the requirements to be a REIT." The IRS is concerned that these spin-offs also might not satisfy the requirements for tax-free treatment (including the "active trade or business" requirement, the "business purpose" requirement, and the "device" prohibition), particularly because they may involve a relatively small "active trade or business" as well as the retention of control or use of the REIT's assets through long-term leases or other arrangements. The IRS also requests comments regarding these issues.

The rules that govern non pro rata split-off exchanges are sufficiently different from those that apply to pro rata spin-off distributions that one might have expected split-offs to fall outside the reach of the IRS study. Despite acknowledging those differences, the IRS expressly states in the Notice that split-off transactions are also under study and subject to the same revised ruling standards described below.

II. SUMMARY OF THE REV PROC

Historically, the IRS has declined to issue private letter rulings or determination letters regarding certain areas of U.S. tax law, "because the issues are inherently factual or for other reasons." These "no-rule areas" are generally published annually in Revenue Procedures.

The IRS has expanded these no-rule areas to include certain spin-off transactions, as explained in the Notice. Specifically, under the Rev Proc, the IRS ordinarily will not issue rulings on the following issues unless the taxpayer can demonstrate "unique and compelling" reasons to justify the rulings:

- ***Any issue*** relating to the tax-free treatment of a distribution (or series of distributions) if Distributing or Controlled becomes a RIC or REIT (or contributes properties to a RIC or REIT) in connection with the distribution; *and*

- ***Any issue*** relating to the tax-free treatment of a distribution (or series of distributions) if, immediately after the distribution, the fair market value of the Business Assets of Distributing or Controlled is less than 5% of the fair market value of its total gross assets.

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The IRS will take into account all of the facts and circumstances in evaluating whether there exists a "unique and compelling" reason to justify a ruling where the 5% standard is not met. In that regard, the Notice specifically cites situations in which a substantial portion of a corporation's assets would qualify as Business Assets but for the lack of a five-year business history, and where the Business Assets involved, though not satisfying the 5% standard, bear a particular relationship to the business purpose for the distribution.

In addition, the IRS temporarily will not issue rulings on the following issue, because the area is under study:

- ***Any issue*** relating to the tax-free treatment of a distribution (or series of distributions) if, immediately after the distribution, all of the following conditions exist:

  (i) The fair market value of the Investment Assets of Distributing or Controlled is two-thirds or more of the fair market value of its total gross assets;

  (ii) The fair market value of the Business Assets of Distributing or Controlled is less than 10% of the fair market value of its Investment Assets; *and*

  (iii) The ratio of the fair market value of Investment Assets to the fair market value of non-Investment Assets of Distributing or Controlled is three times or more than the ratio of the other corporation.

The Rev Proc is effective for all ruling requests that are postmarked or, if not mailed, received on or after September 14, 2015.

III. LOOKING AHEAD

At this time, it is impossible to predict how long the IRS will study the issues identified and what the ultimate outcome will be. Notably, and somewhat unusually for IRS guidance of this sort, the IRS has not affirmatively indicated that it intends to change the existing spin-off requirements or issue new regulations to address the transactions covered by the Spin-Off Guidance, nor has it even provided a deadline by which the public must submit comments on these issues.

Interestingly, the key concerns noted by the IRS in the Notice (the "active trade or business" requirement, the "business purpose" requirement, and the "device" prohibition) are issues on which the IRS ordinarily has been unwilling to rule in recent years, even prior to the Spin-Off Guidance. However, corporations have been able to obtain IRS rulings on other aspects of their spin-offs, and there has been some general perception that the transaction as a whole might therefore be less likely to attract IRS scrutiny even as to aspects not covered by the IRS ruling. The expansion of the no-rule policy on these transactions denies the possibility of this so-called halo effect, and eliminates the potential for an IRS ruling on other issues that might be raised by a spin-off falling within the new no-rule policy.

Without the ability to obtain an IRS ruling, market participants will have to rely more heavily on their outside advisors and, as a practical matter, might face a greater likelihood of IRS scrutiny of their transaction, even though the legal standards currently remain the same. Therefore, while the area remains under study by the IRS, companies may become more cautious in pursuing a cash-rich spin-off or a spin-off involving a REIT or RIC if it falls within the ambit of the no-rule policy.

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