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## New IRS Policies and the Future of Tax-Free Spin-Off and Split-Off Transactions

**O**n January 2, 2013, the Internal Revenue Service (the Service) released Rev. Proc. 2013-3, its annual list of areas in which it no longer will issue private letter rulings or determination letters (the 2013 No-Rule List). Of particular importance, the 2013 No-Rule List adds three categories of issues that arise frequently in the context of tax-free spin-off and split-off transactions under Section 355 (Spin-offs). These additions, which depart from sensible Service ruling guidelines that were carefully developed and applied by the Service over the last few years, are likely to impact significantly the execution of business-driven Spin-offs because such transactions typically require a private letter ruling to address the dearth of judicial or administrative guidance on many of the key tax issues that could result in significant potential tax liabilities if the transaction fails to qualify as tax free. It appears that these additions to the no-rule list would not apply to private letter ruling requests that were filed prior to the release of the 2013 No-Rule List.

### Debt-for-Debt Exchanges

Debt-for-debt exchanges, which are a common feature in many Spin-offs, allow a distributing corporation (Distributing) to exchange certain types of debt securities of the controlled corporation (Controlled) for outstanding Distributing debt on a tax-free basis, without regard to the tax basis of Controlled's assets. It should be noted that there have been various legislative proposals in recent years that generally would have, if enacted, limited this flexibility to engage in debt-for-debt exchanges where the amount of Controlled debt securities exceeds the tax basis of Controlled's assets.

Debt-for-debt exchanges generally involve the participation of one or more financial intermediaries, which acquire the Distributing debt instruments some number of days (*i.e.*, at least five days) prior to entering into an exchange agreement governing the debt-for-debt exchange with Distributing. Following the exchange, the financial intermediaries typically sell the Controlled debt securities to third party investors through an underwritten offering. The involvement of financial intermediaries in debt-for-debt exchanges has been driven by the desire of corporations to execute transactions on an efficient economic basis, with as little execution risk as possible.

The Service has issued a number of private letter rulings (*e.g.*, PLRs 200702033 and 200629011), in connection with debt-for-debt exchanges, in which one or more financial intermediaries acquired existing Distributing debt in the market, held such debt without any agreement with Distributing to exchange the debt for a specified number of days, and later exchanged the recently acquired Distributing debt for Controlled debt securities, which Controlled debt securities were sold immediately to third party investors. These structures created various difficulties relating to the costs and uncertainties associated with accumulating sufficient amounts of Distributing debt as well as the determination of permissible categories of Distributing debt. For example, would the Service permit third-party debt incurred by Distributing in the ordinary course of business (*e.g.*, to fund business operations or a newly developed acquisition opportunity), but after the formulation of the Spin-off plan, to be exchanged for Controlled debt securities, or would the Service consider the retirement of such Distributing debt in a debt-for-debt exchange as the equivalent

of a taxable sale of Controlled debt securities? Moreover, would the Service treat the financial intermediary as an agent of Distributing for federal income tax purposes and not as a principal acquiring Distributing debt for its own account?

Importantly, the Service, over the past several years, issued a number of private letter rulings (*e.g.*, PLRs 201232014, 201132009, 201129005, 201032017 and 200802009) permitting Distributing to directly issue new debt to one or more financial intermediaries, rather than mandating that such debt be outstanding debt acquired from third party investors.<sup>1</sup> This directly issued Distributing debt could then be exchanged for Controlled debt securities on a tax-free basis so long as the specified number of days elapsed before entering into any debt-for-debt exchange agreement. This sensible approach provided taxpayers with practical guidance that furthered the policies of business-driven Spin-offs, without causing the parties to assume as many capital markets friction costs and uncertainties.

The Service announced, in the 2013 No-Rule List, that it would no longer rule on whether Section 355 or 361 applies to a distribution of Controlled stock or securities “in exchange for, and in retirement of, any putative [Distributing] debt if such [Distributing] debt is issued in anticipation of the distribution.” Accordingly, the Service will not rule in cases where the Distributing debt to be exchanged in a debt-for-debt exchange was issued (including to a financial intermediary) as part of the Spin-off plan. Our understanding, however, is that until the issuance of formal guidance in the area, the Service will continue to rule on transactions in which financial intermediaries acquire existing Distributing debt from third party holders, which debt is then exchanged for Controlled debt securities. This approach will, unfortunately, reintroduce the type of line drawing, as to whether Distributing debt was in fact issued as part of the Spin-off plan, that the Service wisely eliminated several years ago. Moreover, the Service’s and Treasury’s statements to date indicate that any debt issued after public announcement of the Spin-off will be suspect.

The Service’s new no-rule policy in this area also may extend to cases where Distributing has outstanding “old and cold” intercompany debt to its affiliates that could be exchanged for Controlled debt securities in a debt-for-debt exchange (*e.g.*, PLR 200624001). In these situations, the affiliate creditor could then sell the newly received Controlled debt securities in an underwritten offering to third parties for cash.

These new no-rule guidelines also will affect so-called debt-for-equity exchanges, intended to qualify under Sections 361(b)(3) and (c)(3), in which Distributing distributes Controlled stock (rather than Controlled debt securities) to retire Distributing debt issued in anticipation of the Spin-off. Debt-for-equity exchanges, like debt-for-debt exchanges, typically have involved one or more financial intermediaries acquiring Distributing debt and, therefore, present issues similar to those discussed above.

Until the Service publishes formal guidance in the area, it appears that Section 355 transactions involving debt-for-debt and debt-for-equity exchanges are going to be subject to increased complexity and uncertainty, particularly with respect to identifying which Distributing debt, if any, would be viewed by the Service as not issued “in anticipation” of the Spin-off such that a favorable private letter ruling can be obtained.

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<sup>1</sup> In order to ensure that Distributing did not “artificially” increase its debt levels in anticipation of the Spin-off, the Service required the following representation (or a variant thereof): “the amount of Distributing debt exchanged for Controlled securities in the debt-for-debt exchange will not exceed the weighted quarterly average of the Distributing debt owed to third parties for the 12-month period ending on the close of business on or about the last full business day before the date on which Distributing’s Board of Directors initially discussed the potential Spin Transaction.”

## Recapitalizations into Control

To qualify as tax-free under Section 355, Distributing must own and distribute an amount of Controlled stock representing Section 368(c) control (*i.e.*, at least 80 percent of the total combined voting power of all classes of Controlled's voting stock and at least 80 percent of each class of Controlled nonvoting stock).

There have been a number of Section 355 Spin-offs in which Distributing initially owned less than 80 percent of a single outstanding class of Controlled stock. In these situations, prior to the Spin-off, Controlled recapitalized its outstanding stock into a high-vote class (*i.e.*, a class of stock possessing the right to elect 80 percent or more of the corporation's directors or the right to cast 80 percent or more of the votes for the election of directors) held by Distributing and a low-vote class (with the balance of the voting power) held by Controlled's other shareholders (*e.g.*, PLRs 200837027, 200135039, 200048030, 200046001 and 199940003). In Rev. Rul. 69-407, Distributing owned 70 percent of the single outstanding class of Controlled stock, with the remaining 30 percent owned by third parties. Pursuant to a plan of recapitalization, the Controlled stock was recapitalized into a class of stock representing 80 percent of Controlled's total combined voting power, which was held by Distributing, and a low-vote class representing 20 percent of Controlled's total combined voting power, which was held by the remaining third party Controlled shareholders. The Service determined that Distributing's distribution of the Controlled high-vote stock qualified under Section 355 because it resulted in a "permanent realignment of voting control" and was distinguishable from the transitory arrangement described in Rev. Rul. 63-260. In Rev. Rul. 63-260, Distributing owned 70 percent of the outstanding stock of Controlled and a Distributing shareholder owned the remaining 30 percent. In order to allow the distribution of Controlled stock to qualify under Section 355, the shareholder contributed 10 percent of its Controlled stock to Distributing, which thereafter distributed its Controlled stock in a transaction intended to qualify under Section 355. The Service concluded that the contribution was transitory and held that the distribution did not qualify under Section 355.

There have been shifts over time in the Service's private letter ruling policy with regard to the possibility of a "collapse" of Controlled's two classes of stock into a single class structure following a recapitalization/Spin-off transaction. The Service's positions have included the following: (1) permitting a conversion of high-vote stock into low-vote stock upon the first trade of such high-vote stock, (2) a required representation regarding no plan or intention to execute a conversion (in certain cases for up to five years), and (3) the most recent position under which the Service would rule favorably under Section 355, even if a "collapse" were expected, so long as there was no binding commitment at the time of the distribution to unwind the dual class structure and any decision to do so was subject to the Controlled board's independent determination following the Spin-off to present the issue for a bona fide shareholder vote (*e.g.*, PLRs 201123030 and 200837027). This most recent ruling policy is entirely consistent with Rev. Rul. 98-27 and the legislative history to Section 355(e), which made it clear that "acquisitions" of Distributing and Controlled stock following a Spin-off were to be placed on equal footing and that Section 355(e)'s 50 percent threshold was to be the relevant governing principle with regard to post-Spin-off acquisitions of stock, without regard to step transaction principles, so long as the distribution of control requirement technically was met.

The Service announced, in the 2013 No-Rule List, that it would no longer rule on whether the control requirement is satisfied if, in anticipation of the distribution, (i) Distributing acquires putative control of Controlled in any transaction (including a recapitalization) involving an exchange of high-vote stock for stock with lesser voting power or (ii) the putative Controlled corporation issues stock with a different voting power per share (*i.e.*, low-vote stock) than the stock held by Distributing. This new no-rule policy is extremely broad and, importantly, is not limited to situations in which Controlled may anticipate unwinding its high-vote/low-vote structure following a Spin-off. Moreover, by its

terms, the new policy is not limited to recapitalization/Spin-off transactions and would appear to apply to situations where a newly formed or preexisting Controlled issues low-vote stock in an IPO, even if Distributing always maintained Section 368(c) control of Controlled prior to the Spin-off. The Service's and Treasury's statements to date indicate that the no rule policy relating to dual class structures may be even broader than the language of the 2013 No-Rule List, although it is not clear what other situations may be implicated.

As a practical matter, however, in some cases it should be possible to pursue Spin-offs where Section 368(c) control of a subsidiary is acquired or maintained, in connection with a high-vote/low-vote structure, on the basis of a tax opinion reflecting current law, as opposed to the Service's private letter ruling policies. The ability to proceed with the transaction on the basis of an opinion reflecting current law can be expected to take on increased importance because the Service's initial position appears to be that no ruling will be available with regard to any of the issues that might be present in a particular Spin-off transaction if the no-rule issues discussed above are present. In other words, the Service may not accept a representation regarding, or otherwise caveat, the control requirement while still issuing a private letter ruling on the broader transaction. This restrictive approach would be quite inconsistent with how the Service has approached issues of this type in the past (*e.g.*, the Service will generally accept a representation that a debt instrument is a security for federal income tax purposes and as a matter of policy will caveat the application of the business purpose requirement, the device requirement and Section 355(e) to a transaction it otherwise rules on). While we hope the Service will reconsider the breadth of its no-rule position in order not to chill the market for business-driven Spin-off transactions, it appears that corporations will not be able to pursue recapitalization/Spin-off transactions or high-vote/low-vote structures on the basis of a private letter ruling until the Service issues formal guidance in the area. Moreover, to the extent such transactions do proceed on the basis of an opinion in accordance with current law, one key issue will relate to the ability of Controlled to unwind its dual class structure, whether on some anticipated basis or on the basis of future unanticipated circumstances.

### **North-South Transactions**

For any number of commercial or legal reasons, a Distributing shareholder (including a corporate shareholder) may wish to contribute assets (including cash) to Distributing at or around the time of a Spin-off of Controlled stock to the shareholder (or some other distribution to the shareholder) (a so-called North-South Transaction). The issue in these situations is whether the contribution (*i.e.*, the transfer South) and the Spin-off or other distribution (the transfer North) could be integrated and treated as a taxable exchange, which potentially could cause a Spin-off to fail to qualify as tax-free under Section 355 (*i.e.*, if more than 20 percent of the stock of Controlled is deemed exchanged for the assets contributed by the shareholder) or cause the shareholder to recognize gain on the transfer of assets to Distributing.

The Service's recent ruling policy, in the Spin-off context, was not to integrate the North and South legs of these transactions so long as the taxpayer provided the following representation (or a variant thereof): "There is no regulatory, legal or economic compulsion or requirement that the [Contribution] be made as a condition of the [Spin-off]. The fact that the value of Distributing will decrease as a result of the [Spin-off] was not a consideration in the decision to contribute property to Distributing. The [Spin-off] is not contingent on there being contributed to Distributing assets having a specified (or a roughly specified) value." This ruling policy provided taxpayers with needed comfort in many cases that an asset contribution that was independent of a Spin-off from a legal and economic perspective potentially would not be recast into a taxable exchange by Distributing or Distributing's shareholder or both.

The Service announced, in the 2013 No-Rule List, that it would no longer rule on whether the North and South transfers that are intended to be treated independently of the other will in fact be respected as separate transfers for federal income tax purposes. (If the North and South transfers are intended to be integrated (*e.g.*, a downstream transfer of assets for stock and “boot”), it appears that the Service will continue to rule on the treatment of the transaction.) While North-South issues arise most frequently in the Spin-off context, the new no-rule policy is not limited to rulings under Section 355 and would appear to cover any situation in which assets are contributed to a corporation that also is making a distribution with respect to its stock. The Service’s and Treasury’s statements to date indicate that the entire area is under review and that a range of different standards and tests are currently under consideration. Until the issuance of definitive guidance addressing North-South Transactions, taxpayers will have significantly less certainty and flexibility with respect to the restructuring of the assets of a corporate group in connection with a larger corporate separation (*i.e.*, public company Spin-off).

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The new no-rule areas raise many issues relating to the availability of rulings and the proper treatment under current law of proposed Spin-off transactions.