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Recent Release of Updated Procedures for Section 355 Private Letter Rulings

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The US Department of the Treasury (Treasury Department) and the IRS recently released Revenue Procedure 2024-24 (Revenue Procedure) and Notice 2024-38 (Notice) establishing revised standards and procedures for taxpayers seeking private letter rulings for spin-offs intended to qualify for tax-free treatment under Section 355 of the Internal Revenue Code (Code). Much of the Revenue Procedure and Notice revolve around the treatment of debt of the distributing corporation (Distributing) and the distributed corporation (Controlled) in a tax-free spin-off.[1] The Notice describes the views and concerns of the Treasury Department and the IRS relating to certain matters addressed in the Revenue Procedure, many of which represent departures from the IRS's previous ruling practice, particularly with respect to the treatment of Distributing and Controlled debt in a tax-free spin-off. The changes generally make it more difficult to obtain a private letter ruling with respect to certain spin-off issues. Taxpayers, therefore, may need to rely on tax opinions rather than private letter rulings in certain spin-offs, resulting in less certainty.

A spin-off under Section 355 is generally the mechanism for a tax-free separation of two businesses housed in a single corporation. Subject to various requirements that are beyond the scope of this alert, Distributing must distribute stock constituting "control" (as defined in Section 368(c) of the Code) of Controlled to the shareholders or securityholders of Distributing. If the distribution satisfies the spin-off requirements of Section 355, Distributing, Controlled, and the shareholders and securityholders of Distributing generally do not recognize gain or loss.

If Distributing transfers assets to Controlled before the spin-off – as is usually the case – that asset transfer can qualify as a "reorganization" under Section 368(a)(1)(D) of the Code (divisive reorganization). If the spin-off is pursuant to a "plan of reorganization," Section 361(c) of the Code allows Distributing to transfer stock of Controlled received in the divisive reorganization to either its shareholders or its creditors without recognizing gain or loss. Similarly, Section 361(b) of the Code generally allows Distributing to receive "boot," such as cash or a debt obligation, from Controlled in the reorganization and transfer the boot to either its shareholders or its creditors without recognizing gain or loss.

A spin-off with a divisive reorganization provides significant flexibility to leverage and deleverage Distributing and Controlled, enabling Distributing to use the reorganization provisions to calibrate the post-spin capital structure of both entities. Controlled can issue a combination of stock and debt securities to Distributing in exchange for assets transferred in the divisive reorganization, and that stock and securities can be distributed to Distributing's shareholders or creditors. To similar effect, Controlled can borrow money from a third party before the spin-off and distribute the proceeds to Distributing, which uses those proceeds to repay its own creditors (known as a "boot purge"). Either of these transactions would effectively "push down" existing Distributing debt to Controlled. A common transactional pattern is for a third-party bank to acquire debt securities of Distributing before the spin-off and exchange those securities for Controlled debt issued in the reorganization. These types of transactions are a major focus of the Notice and the Revenue Procedure.

Distinction between delayed distributions of controlled stock and securities and retentions

The IRS has maintained a long-standing policy that a tax-free spin-off must effect a genuine separation between Distributing and Controlled. Notwithstanding the fact that the statute only requires a distribution of "control" of Controlled (which need not be 100%), any retention of Controlled stock is permitted only if Distributing establishes that a reason for the retention was not the avoidance of tax. The Notice draws a distinction between delayed distribution of stock or securities of Controlled and retentions of such stock or securities. Although Section 355 generally contemplates that Distributing will distribute all of the stock and securities of Controlled that it owns, delayed distributions and retentions may be permitted under certain circumstances without altering the tax-free nature of the transaction.

In general, this has provided Distributing with some flexibility to use the Controlled stock or securities to deleverage by distributing the Controlled stock or securities to Distributing securityholders, or otherwise exchanging it for Distributing debt. Sections 3.03(2) and (3) and Section 3.05(10) of the Revenue Procedure set forth the representations and other information relating to delayed distributions and retentions that the IRS will require for ruling purposes. Notably, the Revenue Procedure states that the IRS will not entertain a simultaneous request for both a delayed distribution ruling and a retention ruling, which under prior ruling practice had been pursued in case Distributing was unable to execute its plan for delayed distribution to ensure that an unplanned retention would not prevent tax-free treatment for the spin-off.

Solvency and continued viability of Distributing and Controlled

The Notice highlights the Treasury Department's and the IRS's views that qualification of a transaction as a spin-off pursuant to Section 355 is limited to situations where each of Distributing and Controlled can conduct a sustained business following the spin-off, and that the rules set forth in Section 355 and related Code sections were not enacted to provide corporations with nonrecognition treatment for spin-offs in which Distributing causes Controlled to bear so much debt that Controlled's viability as a going concern is jeopardized. Section 3.03(5) of the Revenue Procedure sets forth the representations and other information relating to solvency and viability with respect to Distributing and Controlled that the IRS will require for ruling purposes.

Application of substance over form, agency and other relevant theories to intermediated exchanges and direct issuance transactions

Signaling a significant change to the recent IRS ruling practices discussed above, the Notice indicates that the Treasury Department and the IRS are considering the application of the Code and general principals of federal income tax law (e.g., substance over form, agency and other relevant theories) to "intermediated exchanges" and "direct issuance transactions" involving Distributing debt that is retired in exchange for Controlled stock or securities. Section 3.05(5) of the Revenue Procedure sets forth required representations relating to any such transactions, including representations that effectively make private letter rulings unavailable with respect to direct issuance transactions.

This aspect of the Revenue Procedure is expected to result in taxpayers' structuring spin-offs to include intermediated debt exchanges rather than direct issuances in order to obtain private letter rulings, which may significantly increase transaction costs for such debt exchanges. In a direct issuance transaction, Distributing debt is issued to a bank in exchange for cash and is redeemed a few days later using Controlled stock or securities. Distributing uses the cash proceeds to retire other outstanding Distributing debt. In an intermediated exchange, a bank purchases existing Distributing debt, holds it for a relatively short time and exchanges it for Controlled stock or securities.

The Notice indicates the view of the Treasury Department and the IRS that general principles of federal income tax law could recast such transactions so that the bank would not be respected as a creditor of Distributing or would be treated as Distributing's agent, meaning that the transactions would not be tax-deferred pursuant to Section 361 of the Code. The Notice requests feedback from intermediaries "to help ensure that future guidance is responsive to the business and market-risk considerations that inform the mechanics of intermediated exchanges and direct issuance transactions …"

Federal income tax treatment and consequences of post-distribution payments

As discussed above, in a divisive reorganization, Distributing may receive "boot" from Controlled, which will be tax-free to Distributing if distributed to Distributing's shareholders or securityholders. Any boot retained by

Distributing will result in recognized gain. In either case, under certain circumstances, boot may be received by Distributing after the spin-off. The Revenue Procedure requires any such consideration to be placed in a segregated escrow account and transferred to Distributing's shareholders or creditors within 90 days of receipt.

In addition, in order for a post-distribution payment to be tax-free to Distributing, Distributing must establish that:

- Each post-distribution payment is consideration in the divisive reorganization.
- The fair market value of Distributing's right to receive the post-distribution payment will not be readily ascertainable at the time of the earliest distribution that is part of the proposed transaction.
- The post-distribution payment will be properly accounted for when received.

Section 3.05(10)(b) and (c)(ii) of the Revenue Procedure set forth the required representations relating to post-distribution payments.

Effect of transaction related to divisive reorganization on Controlled securities

In an apparent reference to a reverse Morris Trust (RMT) transaction in which Controlled is acquired in a tax-free transaction after the spin-off, the Treasury Department and the IRS are considering whether a modification of Controlled securities or other debt as a result of such a transaction should impact qualification of such Controlled securities or debt under Section 361. The Treasury Department and the IRS expressed the view that general principles of federal income tax law (e.g., substance over form and other relevant theories) could apply to recast the transactions to preclude treating the Controlled securities or other debt as property that can be received tax-free by Distributing in a divisive reorganization and used to satisfy Distributing debt. Section 3.05(11) of the Revenue Procedure sets forth the representations and other information that the IRS will require for ruling purposes with respect to transactions relating to the spin-off that may affect Controlled's securities or other property received by Distributing in a divisive reorganization. The Notice specifically states that Rev. Rul. 98-27, which addresses whether Controlled was a "controlled corporation" under Section 355(a) immediately before the spin-off when it was acquired in an RMT transaction after the spin-off, is not relevant to the potential recast described above.

Replacement of Distributing debt

The Notice further indicates that the Treasury Department and the IRS are concerned that Distributing debt that was satisfied with Controlled stock or securities or other property received from Controlled in a divisive reorganization may be replaced with newly incurred debt. This debt replacement "can be used as an artifice for increasing the aggregate [d]ebt and other [l]iabilities of Distributing and Controlled," releveraging Distributing and effectively replicating a sale of a portion of Controlled. The Notice states that the Treasury Department and the IRS do not believe such a result should qualify for nonrecognition under Section 361 of the Code. Section 3.05(12) of the Revenue Procedure sets forth the representations and other information relating to the absence of any replacement of Distributing debt that the IRS will require for ruling purposes.

Separate and distinct relevance and application of Section 357 and 361

Section 357 of the Code provides for general nonrecognition treatment in instances where Controlled assumes a liability of Distributing, but Section 357(c) modifies this and requires gain recognition to the extent liabilities assumed exceed the transferor's aggregate tax basis in the assets transferred. Section 361 does not impose this basis limitation, and instead provides for nonrecognition to Distributing in a divisive reorganization upon a transfer of Controlled securities or money or other property received from Controlled to Distributing's creditors in connection with the divisive reorganization.[2] The Notice indicates that the Treasury Department and the IRS believe Sections 357 and 361 of the Code are not being properly interpreted by some tax advisers, in particular with respect to the relevant basis limitations. Section 3.05(3) of the Revenue Procedure sets forth representations and other information relating to asset basis limitations that the IRS will require for ruling purposes.

Degree of connection between Distributing and Controlled that prevents genuine separations

As discussed above, the IRS has a policy that a tax-free spin-off must effect a genuine separation between Distributing and Controlled. The Notice indicates that the Treasury Department and the IRS are considering the degree to which continuing connections between Distributing and Controlled would prevent a genuine separation of the two businesses, with a particular focus on overlapping key employees, directors and officers, and the existence of continuing contractual arrangements between Distributing and Controlled that include non-arm's-length provisions. The Notice further states the view of the Treasury Department and the IRS that these connections weigh against qualification under Section 355, particularly if the purported business purpose for the spin-off was "fit-and-focus" to enable Distributing and Controlled "to resolve management, systemic, or other problems that arise (or are exacerbated) by … operation of different businesses within a single corporation or affiliated group."[3]

The retention of stock or securities of Controlled by Distributing creates a rebuttable presumption that a transaction has a principal purpose of avoiding federal income tax, which must be overcome to qualify under Section 355. Section 3.03(3) of the Revenue Procedure describes several factors that tend to indicate a tax avoidance purpose, including ascertainable tax benefits or advantages, one or more overlapping key employees between Distributing and Controlled after the transaction, one or more overlapping directors or officers of Distributing and Controlled after the transaction, and the existence of continuing contractual arrangements between Distributing and Controlled that are not at arm's length. The existence of any one factor will cause the IRS to apply significantly increased scrutiny to any ruling request regarding a retention. In the event that two or more of these factors are present, the taxpayer must demonstrate the existence of a business exigency that directly requires the retention, and convince the IRS that such business exigency outweighs evidence of a tax avoidance purpose.

Plan of reorganization requirement for divisive reorganizations

The Notice alludes to confusion and disagreement among practitioners regarding the applicability of the plan of reorganization requirement to divisive reorganizations. The Treasury Department and the IRS are of the view that any divisive reorganization must be undertaken in accordance with a plan of reorganization that satisfies the requirements of applicable Treasury regulations. Section 3.05(1) of the Revenue Procedure sets forth representations and other information relating to the plan of reorganization that the IRS will require for ruling purposes, including representations that Distributing and Controlled will adopt a plan of reorganization before the first step of the proposed transaction, which will specify and clearly describe each step of the proposed transaction – including any step that is a contemplated possibility by any party to the reorganization, such as a step that is subject to a contingency or alternative. In addition, the Revenue Procedure requires representations that each specific step of the proposed transaction is necessary to accomplish the business purposes of the proposed transaction and germane to the continuing businesses of Distributing and Controlled.

[1] A Section 355 distribution may be pro rata to all Distributing shareholders (known as a "spin-off"), non-pro rata in redemption of a portion of Distributing's shares (a "split-off"), or a distribution of multiple Controlleds in liquidation of Distributing (a "split-up"). For convenience, we refer to "spin-offs" in this alert, but the considerations described in this alert are generally applicable to all such distributions.

[2] Sections 357(a), 361(b)(3) and 361(c)(3).

[3] Rev. Proc. 96-30, Appendix A, Section 5, 1996-1 C.B. 696.

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