Tax Insights
from Mergers and Acquisitions

IRS overhauls process and requirements for spin-off ruling requests

May 15, 2024

In brief

What happened?

The IRS and Treasury released Rev. Proc. 2024-24 (the revenue procedure) and Notice 2024-38 (the notice) on May 1, 2024. The revenue procedure contains significant changes to the procedures required for filing a private letter ruling (PLR) request under Section 355 and related provisions (spin-off transactions). The revenue procedure is applicable to all PLR requests submitted after May 31, 2024. The notice requests public feedback on the revenue procedure and highlights numerous specific areas for comment. Comments are due by July 30, 2024.

Why is it relevant?

The revenue procedure represents more than a procedural update, as it requires substantial new information requests, representations, supporting information, documentation, and analysis that taxpayers must provide to the IRS to obtain a PLR. The new representations, data, and analysis will require significant additional time to submit a request for a ruling, resulting in additional expense for taxpayers to receive a PLR.

Action to consider

Taxpayers should consult with their advisor regarding the implications of this new guidance on upcoming transactions and PLR requests. In addition, taxpayers may want to provide comments to Treasury on areas of particular concern.

In detail

Background

Generally, a spin-off transaction involves the distribution by a corporation (distributing) of stock in a subsidiary (controlled) to the shareholders of distributing. The revenue procedure represents a meaningful overhaul of the process and requirements for requesting a PLR from the IRS regarding the tax treatment of spin-off transactions by the parties involved. The revenue procedure still requires taxpayers to make representations similar to those contained in Rev. Proc. 2017-52, however a number of those representations have been updated. For divisive reorganizations (including spin-off transactions) that include an assumption or satisfaction of distributing debt, Rev. Proc. 2018-53 has been superseded by the revenue procedure and a new set of representations now are required. Similarly, for transactions that involve a retention of controlled stock, new representations under the revenue procedure replace prior retention requirements.

Observation: Based on public comments by the IRS, the revenue procedure did not supersede Rev. Proc. 2017-52 because Treasury currently is working on guidance relating to the active trade or business requirement and the device restriction so certain representations contained in Rev. Proc. 2017-52 will continue to apply to PLR requests filed under the new revenue procedure. Treasury Department officials have stated in public comments and in the notice that the notice and revenue procedure reflect the current views of the government on certain issues under Section 355; however, they are asking for formal comments on such issues.

In general

The revenue procedure includes substantial new information requests, representations, supporting information, documentation, and analysis that taxpayers must provide to the IRS to obtain a PLR. These changes represent more than a procedural update, as the new representations and requirements will require a significant amount of additional data and analysis to be provided in a PLR submission.

Observation: The new data and analysis required will necessitate significant additional time to prepare and submit a request for a ruling, likely resulting in additional expense for taxpayers. Further, the revenue procedure requests documentation that may not be available at the time a PLR request is submitted. For example, the revenue procedure requires taxpayers to submit a detailed plan of reorganization, which often is not prepared until later in the spin-off transaction life cycle. The revenue procedure does permit taxpayers to file drafts of certain requested documents.

The revenue procedure appears to make substantive changes to a taxpayer's ability to plan for and structure spin-off transactions and obtain a PLR. Among the most significant changes are (1) the increased detail required to be set forth in the plan of reorganization, (2) the restrictions on delayed distributions, and (3) the restrictions on the use of intermediaries to acquire distributing debt.

Plan of reorganization

The notice states that the required representations, information, and analysis are intended to ensure that a plan of reorganization for purported divisive reorganizations provides adequate specificity and clarity to satisfy the requirements set forth in current Treasury regulations. The notice highlights the IRS's view that some tax advisors incorrectly view the applicability of the plan of reorganization requirement to be potentially obviated by the temporal requirements that were set forth in section 3.04(6) of Rev. Proc. 2018-53 (generally requiring that distributing debt is satisfied no later than 180 days after the distribution).

The IRS's view as stated in the notice is that, while the plan of reorganization requirement incorporates a degree of transactional flexibility, such flexibility is limited under current regulations. In particular, the IRS views the plan of reorganization requirement as helpful to ensure that delayed distributions are not used to avoid the application of the repeal of General Utilities.

For distributions involving a series of planned distributions of controlled stock or securities, a key distinction is whether subsequent distributions are treated as (1) "part of the distribution," (2) "in pursuance of the plan of reorganization" receiving nonrecognition treatment, or (3) as a Section 355(c) distribution whereby distributing continues to own controlled stock or securities (a "retention"). The plan of reorganization requirement is important in determining whether any delayed distributions of controlled stock are part of the distribution or the divisive reorganization or treated as a "true" retention.

Observation: The IRS previously has issued rulings to taxpayers that presented a plan of reorganization with a degree of optionality for the taxpayer to either (1) distribute 100% of or at least Section 368(c) control of controlled stock, (2) retain controlled stock to be used in a debt-for-equity exchange, (3) distribute retained controlled stock as a pro-rata dividend or in redemption of distributing stock in a delayed distribution for up to 12 months, or (4) if market conditions at the time dictated, to retain controlled stock for up to five years in a retention. To the extent the retained stock ultimately was disposed of within 12 months, the delayed distribution of the retained stock could be treated as a distribution pursuant to a plan of reorganization.

Under the revenue procedure, the IRS will not entertain simultaneous requests for rulings on retained stock as either a delayed distribution or a retention with respect to the same controlled stock or securities. Taxpayers can still request rulings on a delayed distribution and retention for separate controlled stock in the same transaction. For example, if distributing initially distributes 80% of the controlled stock, it can request a delayed distribution ruling for 10% of controlled stock and a retention ruling on the other remaining 10% of controlled stock.

The revenue procedure effectively eliminates the potential for a taxpayer to present the IRS with contemplated options for retained controlled stock and forces the taxpayer to specify one concrete path in order to receive rulings that a delayed distribution will be pursuant to a plan of reorganization, or a retention that will not be in pursuance of a plan having as one of its principal purposes the avoidance of federal income tax. Practically, if a taxpayer requests a delayed distribution ruling and ultimately does not distribute the retained controlled stock within 12 months, it will need to request a supplemental ruling to treat the retained controlled stock as a retention.

The revenue procedure includes an increased focus on continuing relationships between distributing and controlled that will significantly inform the IRS's view on whether a retention would be in pursuance of a plan having as one of its principal purposes the avoidance of federal income tax.

Delayed distributions

The revenue procedure includes additional IRS scrutiny on delayed distributions of more than 90 days that purport to be part of the plan of reorganization.

Under the revenue procedure, if distributing does not distribute 100% of the controlled stock and securities it holds on the same day, the taxpayer will be required to represent that the distribution period will be no longer than the period of time necessary to complete all distributions, but in any event the final distribution date will be no later than 12 months after the first distribution date.

If the final distribution date is more than 90 days after the first distribution date, the taxpayer also must submit the expected percentage of controlled stock or securities that will not be distributed in the first 90 days, and provide the business reasons for this percentage and duration (including any regulatory, business, or market constraints that require the extended duration). In addition, the taxpayer must submit relevant facts and analysis to establish that each distribution is, as applicable, “part of the distribution” or “in pursuance of the plan of reorganization.” The IRS also states that it will not treat the length of time between distributions in a distribution period lasting more than 90 days alone as preventing a distribution from being part of the plan of reorganization, but such length of time will be the primary factor the IRS will consider.

Observation: While the IRS will accept valid business reasons for delayed distributions of more than 90 days, it could be extremely difficult if not impossible to receive a delayed distribution ruling for a delayed distribution of more than one year. The IRS’ view as stated in public comments is that a distribution more than one year later generally cannot be treated as part of the distribution or plan of reorganization.

Direct issuances of distributing debt

Under the revenue procedure, a taxpayer must submit information and analysis to establish that, under general principles of federal income tax law, the transaction should not be recast, recharacterized, or otherwise treated as one or more transactions that would not qualify under relevant provisions of the Code.

Observation: While the IRS appears to focus on potential recasts or recharacterizations in the context of intermediated exchanges (discussed below), the requirement in the revenue procedure to address potential recasts or recharacterizations is not limited and has the potential to have a much broader application.

In the notice, the IRS highlighted its concerns with a potential recast or recharacterization of direct issuance transactions. Generally, in a divisive reorganization, distributing may distribute Section 361 consideration (e.g., controlled stock, controlled securities, controlled non-security debt, money, other property) to its creditors in satisfaction of distributing debt without the recognition of gain or loss. A direct issuance transaction is a transaction in which distributing debt is issued to an intermediary (such as a bank) and satisfied with Section 361 consideration in close temporal proximity. The notice states that it is the view of the IRS that general principles of federal income tax law could recast a direct issuance such that the intermediary (that is, the direct holder of the issuance) is not treated as a creditor and distributing would not be treated as exchanging Section 361 consideration for distributing debt, thus disallowing nonrecognition for the exchange between distributing and the intermediary. The notice requests feedback to ensure that future guidance is responsive to the business and market-risk considerations that inform the mechanics of intermediated exchanges and direct issuance transactions.

To prohibit direct issuance transactions, the revenue procedure includes two new representations that require taxpayers to represent that either (1) an intermediary will not acquire any distributing debt (that will be satisfied with Section 361 consideration) from distributing, controlled, or from any related person, or alternatively represent that (2) all distributing debt directly acquired by an intermediary from distributing, controlled, or a related person (that will be satisfied with Section 361 consideration) will be acquired before the earliest applicable date.

For these purposes, the earliest applicable date means the date that is 60 days before the earliest of the following dates: (1) the date of the first public announcement of the divisive reorganization or a similar transaction; (2) the date of entry by distributing into a binding agreement to engage in the divisive reorganization or a similar transaction; and (3) the date of approval of the divisive reorganization or a similar transaction by the board of directors of distributing.

The notice also states that the IRS is considering the impact of the application of general principles of federal income tax law (including substance over form and other relevant theories) to post-spin modifications (including refinancing) of controlled’s securities or debt on such securities or debt’s qualification as Section 361 consideration. The notice provides the example of a merger of controlled into an acquiring corporation following the distribution of controlled for transactions in which controlled had issued controlled securities that were treated by the taxpayer as “purported Section 361 consideration” in exchange for distributing debt. The notice states that the IRS’s view is that substance over form or other relevant theories could apply to recast such a transaction to preclude qualification as tax-free and thus require recognition of gain on the exchange of controlled securities or distributing debt pursuant to the divisive reorganization.

Observation: Rev. Proc. 2018-53, citing Rev. Rul. 79-258, specifically allowed distributing to refinance its historic debt and treat such refinanced debt as “old and cold” distributing debt that was eligible for tax-free treatment. The IRS has indicated in public comments that it no longer believes Rev. Rul. 79-258, which addressed refinancing in the context of assumption of liabilities in non-recognition transactions, is applicable to reorganization transactions. Therefore, it does not appear that taxpayers will be allowed to refinance distributing’s historic debt prior to the transaction and still treat the new refinanced debt as historic debt. This may have an impact on how these transactions are carried out, as often taxpayers will refinance distributing’s debt to facilitate a debt for equity exchange.

Let’s talk

For a deeper discussion of how this guidance might affect your business, please contact:

Mergers & Acquisitions

Derek Cain
+1 (703) 408-9431
derek.cain@pwc.com

Bruce Decker
+1 (703) 655-6943
bruce.a.decker@pwc.com