

Spin-Off Revenue Procedure and Notice Announcing New No-Rule Areas That Are Under Study

By Laurence M. Bambino*

On September 14th, the IRS released Rev. Proc. 2015-43 (the “Rev. Proc.”) announcing new “no-rule” areas with respect to spin-offs involving substantial amounts of investment assets, small amounts of active trade or business assets, or elections to be treated as real estate investment trusts (“REITs”) or regulated investment companies (“RICs”).¹ In addition, on September 14th, the Treasury Department and the IRS issued Notice 2015-59 (the “Notice”) announcing that these no-rule areas are under study.² The Rev. Proc. applies to all ruling requests submitted on or after September 14th.³

I. Prior Announcements

The Rev. Proc. and Notice update prior announcements by the IRS in May and July of 2015 regarding potential changes in its ruling practice for spin-offs, including with respect to the 5-year active trade or business requirement of Section 355(b) (the “ATB Requirement”).⁴ These announcements generally appear to be in response to recently announced “cash- rich” spin-offs and spin-offs involving corporations electing REIT status.

II. Areas Under Study

The Notice identifies for study spin-offs with any of the following four characteristics: (i) cash, stock and other investment assets of the distributing or controlled corporation (“Investment Assets”) having a substantial value relative to the corporation’s total assets and/or the assets to be relied upon for purposes of the ATB Requirement (“ATB Assets”),⁵ (ii) a significant difference between the Investment Asset ratios of the distributing and controlled corporations, (iii) a small amount of ATB Assets of the distributing or controlled corporation, or (iv) an election by one of the distributing or controlled corporation to be a REIT or RIC (collectively, “Areas Under Study”).⁶

The Treasury and the IRS stated that they have become concerned that spin-offs involving the Areas Under Study may (i) present evidence of device under the spin-off device prohibition (“Device Requirement”), (ii) violate the ATB Requirement or (iii) violate the requirement that a spin-off have a valid non-tax corporate business purpose (“BP

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¹ Rev. Proc. 2015-43, Section 1. (“This revenue procedure supplements Rev. Proc. 2015-3, 2015-1 I.R.B. 129.”).

² I.R.S. Notice 2015-59.

³ See *supra* note 1 at Section 4.

⁴ *Id.* at Section 3.

⁵ See *supra* note 2 at Section 2 (references to the distributing corporation and the controlled corporation include assets of its 80 percent-or-greater direct or indirect corporate subsidiaries (US and non-US)).

⁶ See I.R.S. Notice 2015-59 at Section 1.

Requirement”).⁷ The Treasury and IRS also expressed concern that these spin-offs could circumvent the purposes of Section 311, which requires corporations to recognize any built-in gain upon the distribution of appreciated property to their shareholders.⁸

The Rev. Proc. generally provides that the IRS will not issue any rulings under Section 355 involving any of the Areas Under Study.⁹ Since 2003, the IRS has not issued rulings with respect to the Device Requirement or the BP Requirement.

III. Investment Assets

In general, Section 355(g)(2)(B) defines Investment Assets to include cash, stock and other liquid investments but allows look-through treatment for partnership interests and 20 percent-or-greater stock ownership interests.¹⁰ Section 355(g) was enacted in 2006 in response to “cash-rich” split-off transactions where a large historic shareholder would exchange all of its distributing corporation stock for stock of a controlled corporation with significant Investment Assets and a small amount of ATB Assets. Section 355(g) limits the amount of Investment Assets to 66 percent of the controlled corporation’s total assets.¹¹ Section 355(g), however, does not apply to pro rata spin-offs or, in general, split-offs undertaken by a public company pursuant to an exchange offer, regardless of the amount of Investment Assets.¹²

The Rev. Proc. provides that the IRS will not rule on any Section 355 issue if, following the spin-off, all of the following conditions exist: (i) the Investment Assets of the distributing or controlled corporation represent two-thirds or more of its gross assets, (ii) the gross ATB Assets represent less than 10 percent of its Investment Assets, and (iii) the ratio of the Investment Assets to the non-Investment Assets of the distributing or controlled corporation is at least three times the ratio for the other corporation.¹³ For purposes of this new no-rule area, the look-through exception of Section 355(g) is subject to limitations (e.g., the look-through percentage for publicly-traded stock is increased to 50 percent).¹⁴

IV. Small Amounts of ATB Assets

The Rev. Proc. additionally provides that the IRS ordinarily will not rule on any Section 355 issue if the gross ATB Assets of a distributing or controlled corporation represent less than five percent of its total gross assets.¹⁵ The IRS, however, will consider ruling in unique and compelling circumstances and will focus on whether a substantial portion of the non-ATB Assets would be ATB Assets but for the 5-year active conduct requirement.¹⁶

Rev. Rul. 73-44 specifically states “there is no requirement in section 355(b) that a

⁷ *Id.* at Section 2.

⁸ *Id.*

⁹ *See* Rev. Proc. 2015-43 at Section 3.

¹⁰ I.R.C. § 355(g) (2014).

¹¹ *Id.*

¹² *Id.*

¹³ *Id.*

¹⁴ *Id.*

¹⁵ *See* Rev. Proc. 2015-43 at Section 2.

¹⁶ *See id.* at Section 3.

specific percentage of the corporation's assets be devoted to the active conduct of a trade or business" but notes that the percentage of ATB Assets is a relevant factor for the Device Requirement.¹⁷ For ruling purposes, beginning in 1996, the IRS required ATB Assets to represent at least 5 percent of the total assets of the corporation (unless facts and circumstances showed that the ATB Assets were not de minimis). This 5 percent ruling requirement was eliminated in 2003, and, until now, the IRS had not appeared to require a minimum percentage of ATB Assets and implied that a "hot dog" stand was sufficient.¹⁸

V. REIT Spin-Offs

In general, there are two types of spin-offs where one of the corporations elect REIT status: (i) a corporation has two different businesses one of which is REIT eligible ("REIT Conversions"), and (ii) real estate is separated from business operations and the REIT-electing corporation leases the real estate to the operating corporation ("OpCo/PropCo Spin-Offs"). While REITs can have sufficient active business activity to satisfy the ATB Requirement (while not violating REIT qualification requirements), real estate subject to triple net leases may not qualify as ATB Assets. As a result, in the case of OpCo/PropCo Spin-offs, to help satisfy the ATB Requirement, a small amount of ATB Assets of the operating corporation could be contributed to the REIT.

The Rev. Proc. provides that the IRS ordinarily will not rule on any Section 355 issue regarding a spin-off where only one corporation elects REIT status.¹⁹ Although the Treasury and the IRS appear to be more focused on OpCo/PropCo Spin-Offs, the no-rule area would also cover REIT Conversions. In contrast, the Treasury and the IRS generally are not concerned where both the distributing and controlled corporations will be REITs or where the distributing corporation has been a REIT for a significant period of time. Spin-offs involving a RIC election are also being studied and are subject to the same no-rule policy.

VI. Request for Comments

Finally, the Treasury and the IRS have requested comments with respect to the Areas Under Study. The Treasury and the IRS, however, did not provide any timeline for future guidance, including any potential effective dates.

The Notice and Rev. Proc. represent an initial formal response by the Treasury and the IRS with respect to the Areas Under Study. The Treasury and IRS appear to be of the view that the spin-offs involving the Areas Under Study could potentially fail to satisfy the Device Requirement or other spin-off requirements under current law. While the Rev. Proc. sets forth new no-ruling policies with respect to the Areas Under Study, the Treasury and the IRS have not actually announced any new substantive rules. As a result, for now, it remains unclear what effect

¹⁷ Rev. Rul. 73-44, 1973-1 C.B. 182.

¹⁸ See Amy S. Elliot, ABA Meeting: Alexander Sets Reachable Bar for Business Purpose in REIT Spinoffs, 2014 TNT 19-5 (Jan. 29, 2014) (quoting William Alexander, former IRS associate chief counsel (corporate): "Today, hot dog stands are bigger than they used to be because most of them are trucks. But if you ever see how hard the people work as they make your sandwich at the truck, that's an active trade or business.").

¹⁹ See *IRS Amends Section 355 Ruling Policy Regarding Active Trade Or Business and REIT/RIC Spinoffs*, PWC (Sept. 23, 2015), <https://www.pwc.com/us/en/tax-services/publications/insights/assets/pwc-irs-amends-section-355-ruling-policy.pdf>.

the Notice and the Rev. Proc. will have on spin-offs, and the timing and content of any future guidance.