

IRS ANNOUNCES THAT IT WILL NO LONGER ISSUE ADVANCE RULINGS ON SIGNIFICANT SPIN-OFF TOPICS

The Internal Revenue Service announced yesterday, in Revenue Procedure 2003-48, that it will no longer issue private letter rulings on several issues that determine whether a corporate spin-off qualifies as tax-free under Internal Revenue Code section 355. The announcement had been predicted for some time by senior government officials, and was made over the objection of many tax practitioners.

Issues that the Service will no longer rule on are:

- Whether a distribution is motivated by an adequate non-tax business purpose.
- Whether a distribution is principally a “device” for the distribution of the distributing corporation’s earnings and profits.
- Whether a distribution and a change of control of the distributing company or the spun-off company are part of a “plan (or series of related transactions)” that triggers tax liability under IRC section 355(e).

Each of these issues is largely fact-driven, and, in many cases, the facts will be subject to differing interpretations. The corporate community has therefore found it extremely helpful to be able to obtain an advance ruling from the IRS on these issues, especially given the potentially catastrophic tax consequences that can attend a failed spin-off.¹ While it is true that a significant number of spin-offs previously went forward based on an opinion of counsel, that approach will now become the general practice.

The IRS describes the no-rule position as a “pilot program” that will remain in effect for ruling requests that are received (or postmarked) after August 8, 2003, so there is an opportunity to obtain rulings on the indicated topics if the ruling request is submitted prior to that date.

¹ A spin-off that satisfies IRC § 355 generally is tax-free both to the shareholders receiving shares of the spun-off company, as well as to the company making the distribution. A spin-off that fails to qualify triggers (1) dividend income to shareholders, based on the value of the shares of the spun company received, and (2) taxable gain to the distributing company, generally as if it had disposed of the spun company at fair market value. Note that the new 15% rate of tax on dividend income will ameliorate the cost of a failed spin-off to some degree. In the case of an IRC section 355(e) violation, only the corporate level tax is triggered.

However, once it takes effect, the no-rule position will be absolute. Unlike other situations in which the Service reserves the right to rule in particular cases, rulings will never be provided on the indicated issues.

In connection with the no-rule announcement, the IRS released three related items of guidance:

- i. Minimum active business. Since 1996, it has been the position of the IRS that it would ordinarily not rule whether a business satisfies the IRC section 355(b) “active trade or business” test if the assets comprising the 5-year active trade or business had a gross value of less than 5% of the gross value of the assets of the distributing company, or the spun-off company, as applicable.² Rev. Proc. 2003-48 removes this issue from the no-ruling list, indicating, apparently, that the IRS is now prepared to consider ruling in situations in which the 5-year active business represents less than 5% of the assets of the distributing or spun-off company.
- ii. “Fit and focus” ruling. Revenue Ruling 2003-74 holds that a software company’s spin-off of a paper products business satisfies the IRC section 355 business purpose requirement, since the distribution was motivated by a desire to allow senior management of the distributing company “to concentrate its efforts on the software business, which it believes presents better opportunities for growth, and allow the management of the paper products business to secure for that business the management resources needed for its full development.”

Although the ruling is not particularly noteworthy from a substantive perspective, it represents the Service’s first published guidance addressing the so-called fit and focus business purpose.³ The ruling also indicates that in some situations, the existence of common directors of the distributing company and the spun-off company will not impair reliance on the fit and focus business purpose.

- iii. Resolution of capital allocations between distributing and spun-off companies; continuing relationships between companies. Revenue Ruling 2003-75 confirms that certain continuing relationships between the distributing and spun-off companies will not jeopardize a tax-free spin-off. In

² See Rev. Proc. 2003-3, 2003-1 I.R.B. 113 §4.01(30), prior to amendment by Rev. Proc. 2003-48. Under IRC section 355(b) both the distributing company and the spun-off company must be actively engaged in a trade or business that has been conducted for at least 5 years prior to the spin-off.

³ Rev. Proc. 96-30, 1996-1 C.B. 696, Appendix A, had set forth the criteria for advance rulings dealing with the fit and focus business purpose, but the revenue procedure is modified to delete the criteria as part of the no-rule program laid down by Rev. Proc. 2003-48.

the facts of the ruling, the distribution was made to resolve issues relating to competition for capital between two businesses. After the spin-off, transitional agreements relating to information technology, benefits administration and accounting and tax matters were entered into, and will generally continue for a period of two years absent extraordinary circumstances, in which case the agreement would be re-negotiated on arm's length terms for a limited period. The Service also stated there would be no cross-guarantee or cross-collateralization of debt between the two companies, although a working capital loan would be in existence for a period of two years. A "tax agreement" – presumably allocating tax costs and risks associated with the spin-off (such as tax due to subsequent change of control of one of the companies under IRC section 355(e)) – would remain in effect.

Again, the ruling is not particularly interesting from a substantive perspective. However, arrangements between the distributing company and the spun-off company that extend materially beyond 2 years could be at risk of an IRS challenge by reason of the ruling.

Observations

It seems likely that interested parties will object to the new no-rule position. The inability to obtain advance rulings in spin-offs can expose the participants to significant risks of liability, of a type that has little other analogue in tax planning for ordinary commercial transactions. Presumably most transaction participants would be only too happy to reimburse the government's expenses of issuing rulings in this area. At the same time, these arguments have already been made to government officials and to date have been unavailing.

If the no-rule policy stands – as it appears that it will, at least for the time being – it will obviously place significant pressure on practitioners to determine whether proposed spin-off transactions can satisfy the IRC section 355 criteria. An opinion, however, can never provide a definitive resolution of issues it addresses. It remains to be seen, but one can imagine that the inability to obtain definitive resolution of issues relating to business purpose, device, or IRC section 355(e) plan will mean that the transaction structures may need to be adjusted, or other steps taken, in order to proceed with a desired transaction.

Please feel free to call Henry M. Cohn, Andrew W. Needham, Richard L. Reinhold or Jeffrey Van Hove if you wish to discuss the new revenue procedure, or related rulings.

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June 25, 2003

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