IRS Expands Scope of Private Letter Ruling Program for Spin-offs

Tax Alert
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On September 21, 2017, the Internal Revenue Service (IRS) introduced a pilot program that expands the scope of letter rulings available for distributions intended to qualify as tax-free spin-offs under section 355.[1] Since 2013, the IRS has limited the scope of letter rulings for these distributions to "significant issues" raised in the distributions.[2] The new pilot program, described in Revenue Procedure 2017-52, allows taxpayers to request letter rulings on the "general federal income tax consequences" of a "covered transaction," rather than just a significant issue in such a transaction.[3] A covered transaction is (i) a transaction intended to qualify as a reorganization under section 368(a)(1)(D) and section 355[4] or (ii) a distribution intended to qualify under section 355(a) and section 355(c).[5] The pilot program will be available for 18 months; upon its expiration on March 21, 2019, the IRS will "evaluate the effectiveness and sustainability of the program and consider whether the program should be extended."[6]

Overview

Under the pilot program, a taxpayer may request a letter ruling on the "general federal income tax consequences" of a covered transaction (a "transactional ruling"). This letter ruling may address the tax consequences of a covered transaction under section 355 and section 368(a)(1)(D) as well as provisions in the Code and regulations governing earnings and profits, assumption of liability, basis, nonrecognition, holding period, and consolidated returns.[7] The pilot program does not change the IRS's policies limiting rulings on certain requirements applicable to transactions intended to qualify as tax-free spin-offs under section 355, namely that (i) the transaction may not be a "device" used principally for the distribution of earnings and profits; (ii) the transaction must be carried out for a corporate business purpose; and (iii) the transaction may not be part of a plan pursuant to which one or more persons acquire a 50 percent or greater interest in the distributing corporation (Distributing) or controlled corporation (Controlled).[8]

In lieu of a transactional ruling, a taxpayer may request a letter ruling on "significant issues" raised in a covered transaction (a "significant issue ruling").[9] If a taxpayer requests a transactional ruling for one of several covered transactions included in a plan, the taxpayer may request a transactional ruling, a significant issue ruling, or no ruling with respect to each of the other covered transactions.[10]

To request either a transactional ruling or a significant issue ruling, a taxpayer generally must follow the requirements in Revenue Procedure 2017-1, subject to modifications set forth in Revenue Procedure 2017-52.[11] In particular, a taxpayer requesting a transactional ruling must (i) provide, among other items, facts and legal analyses of issues with respect to which the IRS will not provide a ruling, such as satisfaction of the "device" and corporate business purpose requirements,[12] and (ii) make the representations listed in the appendix to Revenue Procedure 2017-52.[13]

The Ebb and Flow of Private Letter Rulings under Section 355

Revenue Procedure 2017-52 is a partial reversal from what had been a series of contractions in the IRS's letter ruling policy. Beginning in 2003, the IRS restricted the scope of letter rulings under section 355 by declining to rule on certain issues, including (i) whether there was a valid business purpose; (ii) whether the transaction was a device for the distribution of the earnings and profits of Distributing, Controlled, or both; and (iii) whether section 355(e) applied.[14] In 2009 the IRS, citing a desire for taxpayers to use agency resources more efficiently, allowed taxpayers to request rulings on "significant issues" in a section 355 transaction, rather than on whether the transaction as a whole qualified under section 355.[15] For this purpose, a significant issue meant a legal issue (as opposed to a factual issue) that was unclear under existing law and legally significant and germane to determining the tax consequences of the transaction.[16]

In 2013, the IRS dramatically restricted the scope of its ruling program further in an effort to conserve resources. Under Revenue Procedure 2013-32, the IRS stated that it would no longer rule whether a transaction qualified under sections 332, 351, 355, 368, or 1036, but instead would rule *only* on significant issues with respect to those transactions. Revenue Procedure 2017-52 essentially repeals the 2013 cutback by allowing the IRS to rule on the tax consequences of an entire transaction.

Description of Transactions and Representations

To request a transactional ruling under Revenue Procedure 2017-52, a taxpayer must include a description of each transaction on which it seeks a ruling as well as any other transaction that is part of the same plan or series of related transactions. The request must also include a description and analysis of all legal issues that may affect the requested rulings. This description and analysis must be detailed enough to allow the IRS to determine whether to issue the requested rulings. The taxpayer must provide this information in the body of its request; simply attaching the transaction documents that contain this information to the request is insufficient. The IRS may modify or revoke the ruling if it determines that the taxpayer has misstated or omitted controlling facts in its ruling request.[17]

In addition, a taxpayer generally must make all the representations in the form set forth in the appendix to Revenue Procedure 2017-52, identifying any representations that are not applicable.[18] If a taxpayer cannot make an applicable representation as written in the appendix, the taxpayer must provide an explanation, and where appropriate, make a modified representation.[19] In that case, the taxpayer must also explain why the modification is necessary and why it should not preclude the IRS from issuing the requested ruling.[20]

The representations shown in the appendix are similar to the representations that were previously required for section 355 ruling requests under Revenue Procedure 96-30,[21] as modified by Revenue Procedure 2003-48.[22] However, Revenue Procedure 2017-52 imposes several new requirements.

For example, Revenue Procedure 96-30 provided that where Distributing had foreign shareholders, the ruling request include information relating to *whether* Distributing or Controlled was a "United States real property holding corporation" under section 897(c)(2) (USRPHC).[23] By contrast, Revenue Procedure 2017-52 requires taxpayers to represent specifically that Distributing and Controlled *were not* USRPHCs in the five-year period preceding the distribution and *will not be* USRPHCs immediately after the distribution.[24] Similarly, taxpayers must represent that neither corporation was or will be a "controlled foreign corporation" within the meaning of section 957(c) either immediately before or after the distribution.[25] Another new representation is that there is no loss subject to Treasury regulation section 1.1502-13 that will be taken into account as a result of the transaction.[26]

Some newly-required representations are consistent with recent developments under section 355. In 2016, the IRS issued Revenue Procedure 2016-40, providing two safe harbors for distributions involving steps where (i) Distributing acquires "control" of Controlled, and (ii) Controlled later engages in a transaction that in effect unwinds this acquisition.[27] Therefore, where Revenue Procedure 96-30 asked for information on *whether* Distributing has modified or will modify its ownership of Controlled stock,[28] Revenue Procedure 2017-52 requires a representation to the effect that (among other things) Distributing will not, in anticipation of the distribution, acquire "control" of Controlled, or that Distributing will do so only in accordance with the safe harbors provided in Revenue Procedure 2016-40.[29]

Also in 2016, Treasury and the IRS issued proposed regulations (the "2016 Proposed Regulations") providing that Distributing and Controlled fulfill the "active trade or business" requirement in section 355(b) if the fair market value of assets used in their respective business equals or exceeds 5 percent of the fair market value of all assets in the corporation.[30] The 2016 Proposed Regulations also render a distribution taxable as a "per se device" if (i) for either Distributing or Controlled, the ratio of "nonbusiness assets" to total assets is two-thirds or greater, and (ii) there is a substantial difference between the ratios of Distributing and Controlled, based on specified ratios and bands.[31]

Consistent with these proposed regulations, Revenue Procedure 2017-52 requires a representation to the effect that the fair market value of the gross assets of the business relied on by Distributing and Controlled to satisfy the "active trade or business" requirement will equal or exceed the 5 percent threshold.[32] And in addition to requiring a representation that the distribution is not used principally as a device for the distribution of the earnings and profits of Distributing, Controlled, or both (as was previously required by Revenue Procedure 96-30, as amended by Revenue Procedure 2003-48), Revenue Procedure 2017-52 further directs taxpayers to make one of three alternative representations related to "device."[33] These representations address the fair market values of Distributing and Controlled's investment assets, trade or business assets, and total assets. One of the alternative representations is that immediately after the distribution, the fair market value of the gross investment assets of each of Distributing and Controlled will be less than two-thirds of the fair market value of its total gross assets. Interestingly, however, the other alternative representations do not mirror the other ratios and bands set forth in the 2016 Proposed Regulations for determining that a distribution is a "per se device."

Significance

The pilot program is a welcome development for taxpayers contemplating spin-off transactions because a letter ruling can now provide certainty with respect to the entire transaction. Further, the pilot program should result in the IRS putting forth additional (albeit non-precedential) guidance under sections 355 and 368(a)(1)(D) in the form of publicly-available private letter rulings. The updated list of representations (for the first time in nearly 15 years) also provides greater insight into the factors that the IRS considers significant in evaluating spin-off transactions.

Given that the IRS's resources remain limited, it remains to be seen if the IRS will enact similar pilot programs with respect to other transactions currently on its no-rule list, including on whether a transaction qualifies under sections 332, 351, 368, or 1036.

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[1]All section references are to the Internal Revenue Code of 1986 (the Code), as amended and currently in effect.

[2]Rev. Proc. 2013-32, 2013-28 I.R.B. 55 (Jul. 8, 2013).

[3]Rev. Proc. 2017-52, 2017-41 I.R.B. __, §§ 2.03(1)(c), (2) (Sept. 21, 2017).

[4]That is, a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or one or more of its shareholders, is in control of the transferee corporation and pursuant to a plan the transferee corporation is distributed in a transaction which qualifies under section 355.

[5]*Id.* at § 2.03(1)(a). Section 355(a) and section 355(c) provide that certain distributions of the stock of a controlled corporation are tax free to the shareholders/security holders receiving the distribution and the distributing corporation, respectively.

[6]*Id.* at § 6.02.

[7]*See id.* at § 2.03(2). The IRS retains the discretion to decline to issue a ruling under any particular section of the Code or Treasury regulations and to issue rulings under different sections of the Code or Treasury regulations. *Id.*

[8]*Id.* The pilot program also does not alter the IRS's "no-rule" policies in the international context. *Id.* at § 2.03(3).

[9]*Id.* at § 4.

[10]*Id.* at § 2.03(2).

[11]*See id.* at §§ 3.01, 4.

[12]*Id.* at § 3.03(6), (7).

[13]*Id.* at § 3.04.

[14]Rev. Proc. 2003-48, 2003-2 C.B. 86 (June 24, 2003). In addition, it has been the IRS's long-standing practice not to issue rulings with respect to an issue that the Code, regulations, case law, or IRS authorities clearly address. Rev. Proc. 2017-1, § 6.11, 2017-1 I.R.B. 1 (Jan. 3, 2017); Rev. Proc. 2017-3, § 4.02(9), 2017-1 I.R.B. 130 (Jan. 3, 2017).

[15]Rev. Proc. 2009-25, 2009-24 I.R.B. 1088 (May 4, 2009).

[16]Rev. Proc. 2009-3, § 3.01(39), 2009-1 I.R.B. 107 (Jan. 05, 2009)

[17]*See* Rev. Proc. 2017-5, § 3.03(1) and Rev. Proc. 2017-1, 2017-1 I.R.B. 269 § 11.05(1).

[18]Rev. Proc. 2017-52, § 3.04(1).

[19]*Id.*

[20]*Id.*

[21]1996-1 C.B. 696 (Apr. 22, 1996).

[22]2003-29 I.R.B. 86 (Jul. 21, 2003). Before the IRS limited the scope of rulings under section 355 to "significant issues," a taxpayer requesting a ruling for a distribution intended to qualify as a tax-free spin-off under section 355 was required to make the representations listed in Revenue Procedure 96-30, as modified by Revenue Procedure 2003-48.

[23]*See* Rev. Proc. 96-30, § 4.02(2).

[24]Rev. Proc. 2017-52, Appendix, Representation 42.

[25]*Id.*, Representation 43.

[26]*Id.*, Representation 37.

[27]*See* Miller & Chevalier Tax Alert, "Section 355 Guidance Imposes New Minimum Thresholds for Business Assets and Provides Safe Harbors for Control/Unwind Transactions" (Jul. 22, 2016).

[28]Rev. Proc. 96-30, § 4.03(f).

[29]*See* Rev. Proc. 2017-52, Appendix, Representation 3.

[30]*See* Miller & Chevalier Tax Alert, "Section 355 Guidance Imposes New Minimum Thresholds for Business Assets and Provides Safe Harbors for Control/Unwind Transactions" (Jul. 22, 2016). Previously, the IRS has used this 5 percent threshold in identifying distributions for which it ordinarily will not issue a letter ruling under section 355(a)(1). *See, e.g.*, Rev. Proc. 2015-43, 2015-40 I.R.B. 467 (Oct. 5, 2015).

[31]*See* Miller & Chevalier Tax Alert, "Section 355 Guidance Imposes New Minimum Thresholds for Business Assets and Provides Safe Harbors for Control/Unwind Transactions" (Jul. 22, 2016).

[32]Rev. Proc. 2017-52, Appendix, Representation 12.

[33]Rev. Proc. 2017-52, Appendix, Representation 15.
