IRS COMMENTS ON NORTH/SOUTH RULING AND CURRENT RULING POSTURE FOR SECTION 355 TRANSACTIONS





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In 2013, the Internal Revenue Service ("IRS") announced that it would no longer issue rulings with respect to three common spin transactions–transactions implicating so-called "north/south" issues, recapitalizations into control in conjunction with spin-offs, and transactions involving debt "issued in anticipation" of a leveraged spin.[1] In July 2016, the IRS removed the "no-rule" designation for recapitalizations into control and provided two limited safe-harbors where the IRS would not challenge an unwind of a high/low voting structure.[2] In May 2017, the IRS also removed the no-rule designation for north/south transactions and for leveraged spin transactions where the distributing corporation (Distributing) issues debt in anticipation of a spin-off and retires the debt with the controlled corporation's (Controlled) stock or securities in the spin-off.[3] At the same time, the IRS issued Revenue Ruling 2017-09 (the "Revenue Ruling"), which provides guidance on the treatment of north/south transactions in the spin-off context.

This Revenue Ruling was a central topic of discussion at an American Bar Association ("ABA") Tax Section corporate tax panel on May 13, 2017.[4] The panel discussion provided some insights into the IRS's thinking and current ruling posture, albeit by a representative of IRS, the associate chief counsel (Corporate), speaking in a non-official setting. Eliminating these no-rule areas has been a stated objective of Robert Wellen, IRS Associate Chief Counsel (Corporate), and removes a pall that has been cast over these transactions.[5]

NORTH/SOUTH TRANSACTIONS BACKGROUND

A typical north/south fact pattern in a spin-off occurs when a parent company (Parent) transfers property to its subsidiary (Distributing) prior to a distribution of

the stock of Controlled by Distributing to Parent in a transaction intended to qualify as a tax-free spin-off of Controlled. If the contribution of the property and the distribution of the stock of Controlled are integrated, Parent would be deemed to have exchanged the property for a portion of the Controlled stock in a section 1001 exchange. To add insult to injury, if the value of the contributed assets is greater than 20 percent of the value of Controlled, then this taxable exchange would disqualify the spin-off of the remaining shares of Controlled.[6]

THE REVENUE RULING—ADDITIONAL GUIDANCE AND RULINGS ON NORTH/SOUTH TRANSACTIONS

The Revenue Ruling describes two situations. In Situation 1, Parent contributed to a business that would meet the active trade or business requirements of section 355(b) ("ATB") to Distributing (a south transaction) prior to a distribution of the Controlled stock by Distributing to Parent. In Situation 2, Controlled distributed property and cash to Distributing (a north transaction) followed by Distributing's contribution of appreciated property to Controlled and distribution of the Controlled stock to Parent pursuant to a plan of reorganization under section 368(a)(1)(D).

In evaluating whether the transactions should be integrated, the IRS did not invoke a traditional step transaction analysis. Instead, the IRS said that it would respect the form of the transaction (as a section 351 contribution and a separate section 355 distribution) unless "(1) there is a compelling alternative policy; (2) the effect of all or part of the steps of the transaction is to avoid a particular result intended by otherwise-applicable Code provisions; or (3) the effect of all or part of the steps of the transaction is inconsistent with the underlying intent of the applicable Code provisions."[7] In the panel discussion, the IRS representative said that, in her view, the IRS was not trying to create a new or different step transaction analysis, but merely articulating how they approach these situations.[8]

After discussing the intent of sections 351 and 355, the IRS determined that the acquisition of the ATB in the south transaction in Situation 1 did not violate any policy underpinnings and should be treated in accordance in its form as "[e]ach step provides for continued ownership in modified corporate form. Additionally, the steps do not resemble a sale, and none of the interests are liquidated or otherwise redeemed." Further, the IRS noted that it would respect the form of the transactions if the contribution had instead been a cross-chain tax-free reorganization.[9]

While the Revenue Ruling's analysis of the south transaction in Situation 1 is helpful, the analysis in these transactions will be fact sensitive. Presumably, the IRS's approach with respect to similar south transactions would apply to the contribution of any property, not just business assets that satisfy the active trade or business test, although this, too, is not explicit. In the ABA panel discussion, the IRS representative noted that the agency was merely trying to present a hard set of facts on integration and that no special significance should be attached to the fact that the assets transferred in the south transaction constituted an ATB. She indicated that the IRS would rule favorably if a taxpayer wanted comfort on a spin-off that involved a transfer of assets that did not constitute an ATB or if the value of the contributed assets were less than 20 percent (i.e., the IRS would not treat the ruling as a comfort ruling). It is unclear whether the IRS will ask for the "no economic compulsion" representations that were common in private letter rulings issued prior to 2013.[10]

In Situation 2, the IRS integrated the distribution of property and cash from Controlled to Distributing in the north transaction with the divisive D reorganization, which was unsurprising because in the facts, the distribution was made pursuant to the same plan of reorganization as the property contribution and spin. As such, the distribution was treated as boot in the D reorganization rather than as a separate dividend. This characterization of the distribution as boot meant that Distributing would recognize gain on the contribution of property to Controlled to the extent of the value of the property and cash it received from Controlled under section 361(b)(1).[11]

SECTION 355 RECENTLY ISSUED DEBT TRANSACTIONS BACKGROUND

Prior to 2013, it was relatively common for a spin-off to be used to retire newly issued debt of Distributing. Under the ruling practice that existed prior to 2013, the IRS imposed certain limitations on the amount of debt and on how long it would need to be outstanding before the holder (usually an investment banker) could agree to exchange it for stock or securities of Controlled in the spin.[12]

THE REVENUE PROCEDURE—RULINGS ON RECENTLY ISSUED DEBT TRANSACTIONS

The Revenue Procedure provides that the IRS will again issue rulings concerning whether Distributing's redemption of debt, issued in anticipation of a redemption or exchange of such debt for stock of Controlled, qualifies for tax-free treatment under sections 355 and 361.[13] Unlike the Revenue Ruling, the Revenue Procedure does not provide any examples or analysis. At this point it is unclear whether the IRS will issue guidance in this area or whether this will be governed by the private letter ruling process. In the ABA panel discussion, the IRS representative indicated that they hoped to issue additional guidance in the near term and that they would likely approach rulings in this area operating on a clean slate, although presumably the pre-2013 ruling practice would serve as a starting point.

Notes

1 See Rev. Proc. 2013-3, 2013-1 C.B. 113, sections 5.01(9), 5.01(10), and 5.02(2). In 2013 the IRS also limited their rulings to "significant issues" rather than the entire transaction under section 355. Rev. Proc. 2013-32, 2013-2 C.B. 55.

2 Rev. Proc. 2016-40, 2016-2 C.B. 228.

3 Rev. Rul. 2017-09, 2017-21 I.R.B. 1244; Rev. Proc. 2017-38, 2017-22 I.R.B. 1258 (the "Revenue Procedure").

4 See Emily L. Foster, "IRS Clarifies Spinoff Guidance, Welcomes Pre-ruling Calls," 2017 Tax Notes Today 93-1 (May 16, 2017).

5 Amy S. Elliot, "Significant Issue Spinoff Rulings to Stay, Recap Guidance Near," 150 Tax Notes 515 (Feb. 1, 2016) (citing Robert Wellen at the January 2017 New York State Bar Association Tax Section as saying "Personally, I really dislike no-rules. And our group is working actively on guidance projects that we hope will get rid of a lot of these rules.").

6 I.R.C. §§ 355(a)(1)(D); 368(c).

7 In certain circumstances, the IRS has been hesitant to respect the form of the transaction. For example, the IRS has always considered a related-party spin involving a transitory Controlled to be problematic. See, e.g., Emily L. Foster, "IRS Grapples With General Utilities Issues, Considers Rulings," 2017 Tax Notes Today 97-1 (May 22, 2017) (panel discussion on a transaction in which "D1 drops some of its assets into C and distributes its C stock up to D2, and then C merges into D2").

8 See also Rev. Rul. 2015-10, 2015-21 I.R.B. 973 (triple drop and check with a similar step transaction analysis).

9 See Rev. Rul. 74-79, 1974-1 C.B. 81.

10 See, e.g., Priv. Ltr. Rul. 201034005 (May 20, 2010); Priv. Ltr. Rul. 201033007 (May 21, 2010).

11 Note that in the Revenue Ruling, Distributing retained the property and cash received from Controlled. If Distributing had distributed such property and cash to its creditors or to its shareholders, it would not have recognized gain. I.R.C. §§ 361(b)(1)(A), 368(a)(1)(D).

12 See, e.g., Priv. Ltr. Rul. 201123030 (Nov. 15, 2010) (exchange of newly-issued Distributing debt with a maturity of 30 days or longer for shares of Controlled did not prevent the distribution of the balance of Controlled stock to Distributing shareholders from meeting the requirements of section 355 and section 368(a)(1)(D); the debt-holders and Distributing agreed to consummate the exchange no sooner than five days after the acquisition of the debt, and the exchange was to close no less than 14 days after such acquisition).

13 Rev. Proc. 2017-38, 2017-22 I.R.B. 1258.

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