IRS and Treasury Update Guidelines for Spin-Off Private Letter Rulings, Narrowing IRS Practice

On May 1, 2024, the IRS released Rev. Proc. 2024-24 and Notice 2024-38, which provide updated guidelines for taxpayers requesting private letter rulings from the IRS for tax-free spin-off and split-off transactions under Section 355. The guidelines reflect a significant narrowing of the IRS's current ruling practice. In particular, they restrict several common strategies used to reallocate liabilities of the Parent entity ("Parent") to the separated entity ("Spinco") and to monetize Spinco stock. In addition, the guidelines will require taxpayers to include more information and analysis on sensitive legal issues as part of the ruling process.

The key changes are as follows:

- *Debt-for-Equity Exchange Structuring.* Debt-for-equity exchanges ("D4Es") are a common monetization strategy pursuant to which up to 20% of the Spinco stock is used to repay Parent indebtedness. D4Es are particularly attractive because they allow Parent to dispose of Spinco stock without being taxed, a result that is explicitly contemplated by the tax code.

  In recent years, the IRS commonly issued private letter rulings that allowed taxpayers to effect D4Es by using a "direct issuance" structure. In this structure, Parent would borrow cash from a lender and, a few days later, use Spinco shares to repay that debt. Parent would then use the borrowed cash to repay other debt. This structure allowed Parent to retire historic debt efficiently; it spared Parent the cost of having to solicit its historic debt holders (often credit funds that would not have been permitted to hold Spinco stock) to exchange Parent debt for Spinco stock.

  Under last week's new guidelines, the IRS will no longer issue rulings to taxpayers seeking to use this "direct issuance" structure. This reflects the IRS's skepticism about respecting the short-term debt as true debt; the IRS now believes the "direct issuance" structure too closely resembles a sale.

  As an alternative, the IRS signaled some openness to ruling on a different D4E structure. The alternative, sometimes called an "intermediated" structure, involves one or more financial institutions acquiring existing Parent debt from holders and then exchanging that debt with Parent for Spinco stock. This is less efficient for Parent because the additional risk to the intermediating financial institutions of acquiring and holding existing Parent debt typically results in higher execution costs. This structure also may take longer to execute than the "direct issuance" structure. Importantly, even though the IRS has signaled openness to ruling on the "intermediated" structures, it indicated that it would scrutinize them closely.

  Given the inefficiencies, timing delays and the IRS's expected close scrutiny, it is unclear whether "intermediated" exchanges will be viable alternatives for many taxpayers to use for D4Es going forward. This is a significant change in IRS practice.

- *Use of Proceeds in "Boot Purges".* As part of typical spin-off transactions, Parent often receives a cash distribution from Spinco prior to closing. Parent is not taxed on this cash as long as it uses it to retire debt or make distributions to its shareholders. Using cash in these ways is called a "boot purge".

The new guidelines state that the IRS will rule on boot purges to creditors only if the creditors hold Parent debt that was outstanding prior to announcement of the spin ("historic debt"). Importantly, historic debt that is refinanced after announcement will lose its status as historic debt, and the IRS will not rule that repaying the refinanced debt is a valid boot purge. For this purpose, revolving facilities and commercial paper will be treated as historic debt to the extent amounts are actually owing as of announcement (even though amounts may be repaid and redrawn after announcement). This departure from recent IRS practice will adversely impact the benefit of monetization transactions for taxpayers that have debt maturities approaching between announcement and completion of a spin-off.

Timing is also an issue. The IRS has ruled often that boot purges can be completed up to 12 months after a separation closes. Now, however, the IRS is asking taxpayers to demonstrate that there are "substantial business reasons" that necessitate delaying boot purges beyond 90 days after closing.

- *Contingent Liabilities*. In many prior rulings, the IRS allowed Parent to effect a boot purge by repaying liabilities other than funded debt (*e.g.*, accrued pension liabilities, environmental liabilities and trade payables). Under the new guidelines, however, the IRS will no longer rule that repayments of these liabilities are valid boot purges. In certain circumstances, it may be permissible for Parent to cause Spinco to assume these non-debt liabilities, although there may be other commercial or legal impediments to such an assumption.
- *Retentions of Spinco Stock*. Under the tax code, a spin-off can be tax-free only if it represents a complete separation of Parent and Spinco. Parent may not retain any stock of Spinco unless it receives permission from the IRS. In recent years the IRS frequently ruled to allow Parent to retain a portion of Spinco stock where Parent demonstrated that there was a good business reason for the retention, and the retained stock would then be used for a D4E within 12 months or, instead, sold within 5 years. (The sale would be taxable.)

  The new guidelines, however, express the IRS's significant skepticism toward retentions of Spinco stock by Parent.

  First, the IRS has indicated that it will no longer issue rulings that give taxpayers flexibility to complete either a D4E within 12 months or a taxable sale within 5 years. These rulings were historically sought by taxpayers to protect against the possibility that a planned D4E became impracticable due to market conditions and permitted the taxpayer to undertake either a D4E or a taxable retention in light of future circumstances. Going forward, the IRS will require taxpayers to choose either a D4E or taxable retention (but not both) as part of its submission.

  Second, the guidance states that the IRS will apply extra scrutiny to requests for a retention ruling where certain adverse factors are present that reflect a continuing relationship between Parent and Spinco. The guidance requires additional representations, information disclosure and more rigorous analysis where there is overlap between Parent and Spinco officers, directors and employees or post-spin contractual arrangements that are not at arms' length. Given the prevalence of these features in most transactions, it may be difficult for taxpayers to obtain retention rulings in the future.

These guidelines replace Rev. Proc. 2018-53 and substantially modify Rev. Proc. 2017-52. They will apply to letter rulings postmarked or received by the IRS after May 31, 2024.

These are significant changes in the IRS's ruling practice for spin-offs, and it seems clear that more changes will be coming. Taxpayers and their advisors should continue to seek clarity in the IRS's evolving practice and then decide whether transactions can be structured to accommodate the IRS's ruling guidelines. An alternative is to structure and execute transactions without seeking private letter rulings. To be sure, many spin-offs have been completed without IRS rulings in the past. In the future, that judgment will depend on advisors' confidence in the underlying legal analysis and taxpayers' risk tolerance.

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