

Memorandum

Internal Revenue Service Announces Changes to Ruling Policy for Spinoffs

September 16, 2015

Introduction

Earlier this week, the Internal Revenue Service (the “IRS”) and Treasury Department announced the IRS will generally stop issuing private rulings blessing tax-free treatment for certain spinoffs, including those involving large amounts of investment assets or small active businesses and those creating a real estate investment trust (“REIT”). Although the announcement does not change the substantive tax rules, and such transactions may still proceed on the basis of an opinion from a company’s legal advisers, the shift in ruling policy may lead some companies to reevaluate their spinoff plans (including accelerating the completion of a spinoff before further guidance is issued).

Background

Section 355 of the Internal Revenue Code of 1986, as amended (the “Code”),¹ generally provides that, if certain requirements are satisfied, a corporation making a distribution to shareholders (the “distributing corporation”) may distribute the stock of a spinco corporation (the “controlled corporation”) in a tax-free transaction. However, Section 355 does not apply to a distribution if the transaction is used principally as a “device” for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both (the “device prohibition”). In addition, the distributing corporation and the controlled corporation must each be engaged in the active conduct of a trade or business immediately after the distribution (the “active trade or business requirement”), and the transaction must be carried out for one or more corporate business purposes (the “business purpose requirement”). Under Section 355(g), tax-free treatment does not apply in so-called “cash-rich” *non-pro rata* splitoffs in which a shareholder acquires a 50% or greater interest in a distributing corporation or controlled corporation that owns significant

¹ Unless otherwise noted, all “Section” references are to the Code.

investment assets (“Investment Assets”).²

Prior to 2003, the IRS would not issue a favorable ruling under Section 355 if the fair market value of the gross assets used in an active trade or business (“Active Trade or Business Assets”) of the distributing corporation or the controlled corporation was less than 5% of the total fair market value of the gross assets of such corporation.³ This ruling policy, however, was revoked in 2003.⁴

A spinoff in connection with an election by the distributing corporation or the controlled corporation to convert to regulated investment company (“RIC”) or REIT status can result in significant tax benefits, since an entity qualifying as a RIC or REIT generally does not pay US federal income tax on its distributed earnings. In recent years, the IRS has issued favorable rulings regarding qualification under Section 355 to a number of publicly traded corporations that spun off a controlled corporation that elects REIT status.⁵

Spinoffs Involving Significant Investment Assets or a Small Active Trade or Business

Investment Assets. Revenue Procedure 2015-43 (the “Revenue Procedure”) provides that the IRS will not ordinarily issue a letter ruling under Section 355 if all of the following conditions exist:

- the fair market value of the Investment Assets of the distributing corporation or the controlled corporation is two-thirds or more of the total fair market value of its gross assets;
- the fair market value of the gross Active Trade or Business Assets of the distributing corporation or the controlled corporation is less than 10% of the fair market value of the Investment Assets of such corporation; and
- the ratio of the fair market value of the Investment Assets to the fair market value of non-Investment Assets of the distributing corporation or the controlled corporation is three times or more of such ratio for the other corporation.

The IRS and the Treasury Department are concerned with transactions outside of an affiliated group of corporations, and accordingly the no-rule policy does not apply to spinoffs that occur solely within an affiliated group and are not part of a plan that includes an external spinoff (the “Internal Distribution

² “Investment Assets” generally include cash, stock or securities in a corporation, any interest in a partnership, debt instruments, derivatives, foreign currency and similar assets. The statute and guidance provide for “look-through” rules for interests in certain entities in which the corporation owns a significant equity interest.

³ See Rev. Proc. 96-43, 1996-2 C.B. 330.

⁴ See Rev. Proc. 2003-48, 2003-2 C.B. 86.

⁵ For example, the IRS issued letters ruling with respect to Penn National Gaming Inc.’s 2013 spinoff of Gaming and Leisure Properties Inc., the Ensign Group Inc.’s 2014 spinoff of CareTrust REIT Inc., CBS Corp.’s 2014 spinoff of CBS Outdoor Americas Inc. and Windstream Holdings Inc.’s 2015 spinoff of Communications Sales & Leasing Inc.

Exception”).

Notice 2015-59 (the “Notice”) states that the IRS and Treasury Department’s concerns (and the no-rule policy) apply in both pro rata and non-pro rata spinoffs and regardless of whether any person acquires a 50% or greater interest in either the distributing corporation or the controlled corporation.⁶ Thus, the policies reflected in the Notice and the Revenue Procedure could affect cash-rich spinoffs or splitoffs involving widely held corporations that would not run afoul of Section 355(g) (the cash-rich splitoff rule noted above).

Small Active Trade or Business Size. The Revenue Procedure provides that (unless the Internal Distribution Exception is met) the IRS will not ordinarily issue a letter ruling under Section 355 if the fair market value of the gross Active Trade or Business Assets of the distributing corporation or the controlled corporation is less than 5% of the total fair market value of the gross assets of such corporation, but will consider ruling in unique and compelling circumstances.⁷ **This represents a return to the ruling policy in place prior to 2003 and reflects the IRS’s renewed focus on taxpayers’ reliance on relatively small active trades or businesses.**

Spinoffs Involving RICs or REITs

The Notice states that the IRS and Treasury Department are concerned that an increasing number of spinoffs intended to qualify under Section 355 involve a REIT conversion, and that these transactions may raise significant concerns under the device prohibition, the active trade or business requirement and the business purpose requirement. Accordingly, the Revenue Procedure provides that the IRS will not ordinarily issue a letter ruling under Section 355 if property owned by any distributing corporation or any controlled corporation becomes the property of a RIC or REIT. The no-rule policy does not apply, however, if *both* the distributing corporation and the controlled corporation will be RICs or REITs immediately after the spinoff.

Conclusion

The Notice and the Revenue Procedure provide insight into the IRS and Treasury Department’s views on cash-rich spinoffs and spinoffs involving REIT conversions and immediately impact IRS ruling policy. The Notice and the Revenue Procedure, however, do not purport to alter existing law in the spinoff area. Pending further guidance, we recommend that clients pursuing a potential spinoff transaction carefully consider whether the transaction implicates any of the concerns addressed in the Notice and the Revenue Procedure.

We will continue to monitor developments in this area, which remains subject to continued study by the IRS and Treasury Department.

⁶ In addition, the definition of Investment Assets used in the Revenue Procedure is broader than the definition that applies under Section 355(g).

⁷ The Notice suggests that the presence of a substantial portion of non-Active Trade or Business Assets that would be Active Trade or Business Assets but for the 5-year requirement of Section 355(b)(2)(B) would be an example of such unique and compelling circumstances.

For further information about the Notice and the Revenue Procedure, please contact one of the following members of the Firm's Tax Department.

John C. Hart

+1-212-455-2830

jhart@stblaw.com

Robert E. Holo

+1-212-455-2514

rholo@stblaw.com

Gary B. Mandel

+1-212-455-7693

gmandel@stblaw.com

The contents of this publication are for informational purposes only. Neither this publication nor the lawyers who authored it are rendering legal or other professional advice or opinions on specific facts or matters, nor does the distribution of this publication to any person constitute the establishment of an attorney-client relationship. Simpson Thacher & Bartlett LLP assumes no liability in connection with the use of this publication. Please contact your relationship partner if we can be of assistance regarding these important developments. The names and office locations of all of our partners, as well as our recent memoranda, can be obtained from our website, www.simpsonthacher.com.



UNITED STATES

New York
425 Lexington Avenue
New York, NY 10017
+1-212-455-2000

Houston
600 Travis Street, Suite 5400
Houston, TX 77002
+1-713-821-5650

Los Angeles
1999 Avenue of the Stars
Los Angeles, CA 90067
+1-310-407-7500

Palo Alto
2475 Hanover Street
Palo Alto, CA 94304
+1-650-251-5000

Washington, D.C.
900 G Street, NW
Washington, D.C. 20001
+1-202-636-5500

EUROPE

London
CityPoint
One Ropemaker Street
London EC2Y 9HU
England
+44-(0)20-7275-6500

ASIA

Beijing
3901 China World Tower
1 Jian Guo Men Wai Avenue
Beijing 100004
China
+86-10-5965-2999

Hong Kong
ICBC Tower
3 Garden Road, Central
Hong Kong
+852-2514-7600

Seoul
25th Floor, West Tower
Mirae Asset Center 1
26 Eulji-ro 5-Gil, Jung-Gu
Seoul 100-210
Korea
+82-2-6030-3800

Tokyo
Ark Hills Sengokuyama Mori Tower
9-10, Roppongi 1-Chome
Minato-Ku, Tokyo 106-0032
Japan
+81-3-5562-6200

SOUTH AMERICA

São Paulo
Av. Presidente Juscelino
Kubitschek, 1455
São Paulo, SP 04543-011
Brazil
+55-11-3546-1000