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KIRKLAND **ALERT**

September 2015

IRS Makes Important Changes to Ruling Policy for Spinoffs

In the wake of Yahoo Inc.'s announcement that the Internal Revenue Service (the "IRS") has declined to issue a private letter ruling with respect to its widely publicized spinoff of its small business unit (which included Yahoo's remaining portfolio position in Alibaba stock),[1] on September 14, 2015, the Department of the Treasury ("Treasury") and the IRS announced a significant shift in IRS ruling policy with respect to certain tax-free distributions under Section 355 of the Internal Revenue Code and, potentially, in the IRS's interpretation of the law applicable to such distributions.[2] On that date, the IRS released Rev. Proc. 2015-43 and Notice 2015-59, which taken together set forth new limitations on taxpayers' ability to obtain private letter rulings for requests filed on or after September 14, 2015 with respect to certain types of spinoff transactions. In addition, Notice 2015-59 describes the issues and concerns that Treasury and the IRS believe are presented by such transactions and requests public comments with respect thereto.

Notice 2015-59 and Rev. Proc. 2015-43 generally address transactions in which either the distributing corporation or the controlled corporation has a significant amount of investment assets.

As described in greater detail below, Notice 2015-59 and Rev. Proc. 2015-43 generally address transactions in which either the distributing corporation or the controlled corporation has a significant amount of investment assets (i.e., passive assets such as cash or publicly traded stock, as further described below) as compared to the value of its active business assets, and transactions where a corporation separates assets eligible for treatment under the real estate investment trust ("REIT") or registered investment company ("RIC") rules from its other assets as part of a plan or series of transactions in which the eligible corporation makes a REIT or RIC election.[3] Treasury and the IRS's primary concerns with such fact patterns appear to be based more on the so-called "device" test relating to the distribution of corporate earnings and profits and the business purpose requirement, rather than the active trade or business requirement, all of which apply under the tax-free spinoff rules.

Notice 2015-59 and Rev. Proc. 2015-43 appear to be motivated by a number of recently announced and highly publicized public company spinoff transactions involving the distribution of substantial quantities of investment assets or real estate. Yahoo Inc.'s proposed spinoff of its stake in Alibaba is an example of such a transaction—at market close on September 14, 2015, Yahoo's approximately 15% stake in Alibaba represented roughly $24.7 billion in value. In its ruling request, Yahoo had proposed to pair this $24.7 billion stake in Alibaba with its small-business services unit that generates approximately $50 million in annual EBIDTA. In addition, there have been several recent transactions in which a corporation has separated (or has announced plans to separate) its real estate assets from its non-real estate assets in a tax-free spinoff, followed by a REIT election for the entity holding the real estate.[4] In such transactions, the real estate company would typically hold a relatively

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small amount of active business assets and lease back all of its real estate assets to the non-real estate operating company.

Notice 2015-59 and Rev. Proc. 2015-43 do not necessarily reflect a substantive change to the tax rules applicable to spinoff transactions. However, taxpayers should now be on notice that Treasury and the IRS are focused on the transactions described in such pronouncements. The pronouncements may be viewed as a shift in the IRS's interpretation of how the factually intensive non-device and business purposes requirements should be evaluated by taxpayers and by courts. Moreover, these pronouncements may reduce the number of situations in which the IRS will grant private letter rulings and, accordingly, increase the number of matters on which a taxpayer may be forced to rely on an opinion of counsel without the certainty of an IRS ruling. In addition, the IRS's indication in Notice 2015-59 of its discomfort with certain positions taken by taxpayers under existing law may, in some cases, negatively impact counsel's ability to provide sufficiently strong opinions to taxpayers on certain of the issues addressed in the guidance. Treasury and the IRS did not indicate whether they intend to make substantive changes to the tax law applicable to spinoff transactions in the future but did request comments.

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Spinoffs Involving Investment Assets

Notice 2015-59 states that Treasury and the IRS are "most concerned" about spinoff transactions in which either a distributing corporation or a controlled corporation: (i) owns a substantial amount of investment assets (generally cash, stock, securities, and certain other passive assets described in the Code), or (ii) owns a disproportionately large ratio of investment assets to other assets relative to the other corporation.

Consistent with Notice 2015-59, Rev. Proc. 2015-43 announces that, pending further study, the IRS will not rule on a transaction where either the distributing or the controlled corporation meets all three of the following tests:

1. The fair market value ("FMV") of the investment assets of the distributing corporation or the controlled corporation is two-thirds or more of the total FMV of its gross assets;
2. The FMV of the gross assets of the trade(s) or business(es) on which the distributing corporation or the controlled corporation relies to satisfy the active trade or business requirement is less than ten percent of the FMV of its investments assets; and
3. The ratio of the FMV of the investment assets to the FMV of the non-investment assets of the distributing corporation or the controlled is three times or more the ratio for the other corporation.[5]

In addition, pending further study, the IRS will not rule on any issue relating to the qualification, under Section 355 of the Code and related provisions, of a distribution if, as part of a plan or series of related transactions, "investment assets" are disposed of, or property, including property qualifying as an active trade or business

within the meaning of Section 355(b), is acquired with a principal purpose of avoiding the foregoing tests. As mentioned above, these new restrictions do not technically apply to rulings that were requested before September 14, 2015. It can be expected, however, that the IRS will scrutinize "grandfathered" ruling requests, particularly if the facts are not consistent with the new ruling guidelines.

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These new limitations on when the IRS will give rulings are the latest in a continuing trend of Treasury and the IRS's expansion of Section 355 "no-rule" issues. Importantly, if a ruling request falls within the no-ruling position of Rev. Proc. 2015-43, the IRS will not rule on *any* aspect of the proposed transaction pending the issuance of additional guidance.

Small ATB Limitations

Notice 2015-59 and Rev. Proc. 2015-43 also limit the ability of taxpayers to obtain a private letter ruling for transactions in which the trade or business on which either the distributing or controlled corporation will rely in order to satisfy the "active trade or business requirement" will represent less than five percent of the total FMV of such corporation's gross assets immediately after the spinoff. Rev. Proc. 2015-43 and Notice 2015-59 provide that the IRS will make an exception to this policy in the case of "unique and compelling circumstances" and note that in making this determination, the IRS will consider all facts and circumstances, including whether a substantial portion of the non-qualifying assets would satisfy the "active trade or business" but for the five-year requirement under such rules and whether there is a relationship between the business purpose for the distribution and the qualifying active trade or business of the distributing corporation or the controlled corporation. Although the precise contours of this exception are not specified, it appears that the IRS remains willing to grant private letter rulings with respect to transactions, involving a small active trade or business, in which the other assets of the corporation are not primarily investment-type assets, such as cash or portfolio positions.

Treasury and the IRS are hardly breaking new ground in imposing a five-percent requirement with respect to requests for private letter rulings on the active trade or business requirement—Rev. Proc. 96-43[6] had imposed the same restriction prior to June 2003.[7] While the technical foundations for this requirement are not entirely clear in light of a number of IRS Revenue Rulings and internal memoranda suggesting there is no minimum FMV or percentage necessary in order to satisfy the active trade or business requirement,[8] the reinstatement of this limitation comes as less of a surprise than some of the other restrictions set forth in Rev. Proc. 2015-43.

Distributions Involving RICs or REITs

Notice 2015-59 and Rev. Proc. 2015-43 limit the ability of taxpayers to receive a private letter ruling if either of the distributing or the controlled corporation (but not both) intend to be taxed as a REIT or a RIC following the spinoff. Similar to the five-percent rule, the guidance indicates that this is an area where the IRS ordinarily will not rule, but will consider making an exception in light of "unique and compelling circumstances."

This rule appears to be a response to a number of so-called REIT spinoffs, in which an operating entity with substantial real estate assets intends to spin off those real estate assets (or the operating assets) in a transaction governed by Section 355. Because REITs and RICs can take advantage of special rules under the Code that generally permit them to avoid corporate level-tax, these REIT spinoffs can be especially attractive to taxpayers engaged in retail, hospitality, skilled nursing, telecommunications, and similar industries in which large real estate holdings are common. Treasury and the IRS's concerns would appear to stem from concerns regarding the business purposes and device requirements because of the tax-favored status of REITs and RICs as well as the ongoing relationship between the two constituent parties to the spinoff transaction.

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Application of Rules to Both Public and Private Transactions

Notice 2015-59 makes clear that the new restrictions on the availability of letter rulings apply equally to publicly traded and private distributing corporations. The Notice also indicates that these rules apply whether a distribution of the stock of a controlled corporation is pro rata or non-pro rata.

Conclusion and Key Takeaways

- The availability of private letter rulings for any aspect of a spinoff transaction in which there is a relatively small active trade or business or in which either the distributing or controlled corporation will make an election to be taxed as a REIT or a RIC will be sharply reduced.

- Private letter rulings filed before September 14, 2015 will technically be grandfathered from the new policy, but can expect to be subject to careful review in which meeting the new ruling guidelines would significantly increase the likelihood of obtaining a ruling.

- Treasury and the IRS have made it very clear that they will study the transactions described in the Notice and Revenue Procedure. Their primary issues and concerns would appear to be based on the application of the highly fact-intensive business purpose and non-device requirements under the spinoff rules, although they have not foreclosed the possibility of issues under the active trade or business requirement.

- While there technically has not been a change of law applicable to spinoff transactions, the Treasury and IRS have provided clear notice to taxpayers that "distributions involving small [active trade or businesses] may have become less justifiable" and that "transactions [involving REITs and RICs] involve significant concerns relating to the device prohibition, and the business purpose and active trade or business requirements under [Section] 355, as well as the Code

provisions intended to repeal the General Utilities decision."

- The question, which only time will tell, is whether taxpayers will be comfortable moving forward with a variety of affected transactions on the basis of opinions of counsel in the face of these pronouncements and the significant downside tax exposure that often exists if such transactions fail to qualify as tax free.

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1 Yahoo! Inc., Form 8-K (filed Sept. 8, 2015).

2 Although this Alert refers to such distributions as "spinoffs," the discussion herein applies to both pro rata spinoffs and non-pro rata split-offs.

3 Notice 2015-59, § 2 (Sept. 14, 2015); Rev. Proc. 2015-43, §3 (Sept. 14, 2015). These rules generally do not apply to internal spinoff transactions that take place within a consolidated group of corporations.

4 See, e.g., Darden Restaurants to Separate Some Real Estate Assets, Wall Street Journal (June 23, 2015), available at http://www.wsj.com/articles/darden-restaurants-to-spin-off-some-real-estate-assets-1435058666; Windstream to Distribute 80% of Shares in Planned REIT, Wall Street Journal (Dec. 18, 2014); Penn National Jumps on Breakup Plan to Create Casino REIT, BloombergBusiness (Nov. 16, 2012), available at http://www.bloomberg.com/news/articles/2012-11-15/penn-national-planning-split-to-create-first-casino-focused-reit; see also Sears Moves to Raise $2.5 Billion By Selling Real Estate, Wall Street Journal (Apr. 1, 2015), available at http://www.wsj.com/articles/sears-to-partner-with-general-growth-properties-on-real-estate-joint-venture-1427885417.

5 Rev. Proc. 2015-43, § 3.02.

6 1996-2 CB 330 (Aug. 8, 1996).

7 See Rev. Proc. 2003-48, 2003-2 CB 86 (June 24, 2003) (abandoning the 5% limitation).

8 See, e.g., Rev. Rul. 73-44, 1973-1 CB 182 ("There is no requirement in section 355(b) that a specific percentage of the corporation's assets be devoted to the active conduct of a trade or business."); GCM 34238 (Dec. 15, 1969) ("It is the position of this office that there is no requirement that a specific percentage of a corporation's assets be devoted to the active conduct of a trade or business in order that the corporation meet the test in section 355(b)(2)(A) of the Code, and this is so whether the distribution in issue is pro rata or non pro rata.").

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