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Treasury and IRS Issue Proposed Regulations on Certain Issues Relevant to Nonrecognition Transactions

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On January 16, 2025, the U.S. Department of Treasury and the Internal Revenue Service published long-awaited Proposed Regulations (the "Proposed Regulations") on certain matters relevant to corporate nonrecognition transactions.[1] Although colloquially referred to as the proposed "spin-off" regulations, the Proposed Regulations also provide core definitional and operational provisions that are relevant to a broader set of nonrecognition transactions, including tax-free reorganizations.

The Proposed Regulations are likely to remain in proposed form for some time and any final regulations may look significantly different. Although the Proposed Regulations generally would apply to transactions first announced after the date the regulations are finalized, the IRS has indicated that it intends to follow the Proposed Regulations when it issues private letter rulings for Section 355 transactions (i.e., spin-offs, split-offs, and split-ups) and that it will update its current ruling guidelines as set forth in Rev. Proc. 2024-24 to incorporate the Proposed Regulations into the procedures for requesting such rulings.

If finalized, the Proposed Regulations would provide significant consistency and clarity with respect to transactions that have long been subject to a given IRS Associate Chief Counsel — Corporate's particular private ruling practice. However, the Proposed Regulations also present many issues and unanswered questions, which we hope will be addressed in any final regulations.

Among the issues with respect to which the Proposed Regulations attempt to provide additional clarity and/or certainty are (i) requirements for plans of reorganization and distribution, (ii) retentions of stock of the controlled corporation ("Controlled") by the

distributing corporation ("Distributing"), (iii) assumptions of Distributing debt/liabilities by Controlled, and (iv) facilitated debt-for-debt and debt-for-equity exchanges.

Plan of Reorganization/Distribution

- The Proposed Regulations for the first time introduce detailed definitional provisions and documentation and reporting requirements for the "plan of reorganization" requirement for reorganizations and the "plan of distribution" requirement for Section 355 transactions. These new rules would require taxpayers to plan for, document and commit to all the steps in the overall transaction before undertaking any steps, and appear to provide taxpayers with limited flexibility to subsequently amend their plans.
  - The Proposed Regulations would require taxpayers to file with the IRS the "plan of reorganization" or "plan of distribution" specifying all the steps and transactions that are part of the overall transaction, along with the intended tax treatment and corporate business purpose for each such step or transaction. In order to establish a "definite intent" to execute each of the transactions, taxpayers would be required to adopt the plan in their official records before undertaking any of the transactions.
  - Only the steps listed in the plan filed with the IRS would qualify for nonrecognition treatment, although the IRS would have the ability to identify its own plans so that mere failure to file would not "bust" a reorganization. Taxpayers also would be able to specify in the plan a limited number of alternative steps or transactions to address contingencies or conditions that might prevent the execution of a given step. Post-filing amendments to the plan would be permitted only in response to an "identifiable, unexpected, and material change in market or business conditions," which we believe should be interpreted broadly to also encompass changes in law or administrative guidance, though clarification would be welcome.

- The Proposed Regulations also would impose an "expeditious completion" requirement on plans of distribution, with a 24-month safe harbor that begins on the date of the first step. For transactions extending across multiple taxable years, certain taxpayers would be required to attach a new IRS Form 7216 (Multi-Year Transaction Reporting) to their federal income tax returns, enabling the IRS to monitor the plan's execution.

Retentions of Controlled Stock

- The Proposed Regulations would provide a safe harbor that incorporates “objectively verifiable conditions” under which retentions of Controlled stock would not be treated as pursuant to a plan with a “principal purpose” of tax avoidance. The safe harbor conditions generally are consistent with the representations taxpayers were required to give to obtain retention rulings under Rev. Proc. 2024-24 and appear generally designed to ensure a true separation between Distributing and Controlled. Retentions that do not satisfy the safe harbor would be subject to a facts and circumstances test.
- As under Rev. Proc. 2024-24, the Proposed Regulations would require taxpayers to commit up-front to dispose of all retained stock and to commit to the specific (taxable or nontaxable) manner of such disposition, with the Proposed Regulations requiring this “definite intent” to be reflected in the written plan of reorganization or distribution filed with the IRS. The Proposed Regulations do not, however, adopt Rev. Proc. 2024-24’s overly restrictive “pick-a-lane” ruling policy, under which taxpayers were further required to designate at the outset — often as early as 12 to 18 months prior to the anticipated separation — the precise amount of Controlled stock that would be disposed of in a taxable disposition as a condition for obtaining a ruling that such retention and disposition would not be treated as pursuant to a plan with a “principal purpose” of tax avoidance. Rather, in a welcome expansion of Rev. Proc. 2024-24, the Proposed Regulations would permit Distributing to specify, in order of priority, multiple alternative methods of disposition (e.g., a commitment to first attempt a debt-for-equity exchange and, if unsuccessful, a taxable sale).

Assumptions of Distributing Debt/Liabilities by Controlled

- The Proposed Regulations would adopt Rev. Proc. 2024-24’s expansive “dominion or control” rule, turning off the general nonrecognition treatment under Section 357 for Controlled’s repayment of assumed Distributing liabilities where Distributing has “legal or practical dominion or control” over any part of such payment. The effect of this rule would be to treat such repayments as a receipt of property by Distributing under either Section 351(b) or 361(b) in the repayment year, which could be a later taxable year than the assumption. A facts and circumstances analysis generally would apply to determine whether Distributing has the requisite dominion or control, although the Proposed Regulations specify certain circumstances in which the rule would be either deemed or not deemed to have been met.
- Under the Proposed Regulations, Controlled’s assumption of Distributing liabilities would be presumed to have a “principal purpose” of tax avoidance unless the assumed liabilities meet certain eligibility requirements, including that they were

incurred in the ordinary course of business, are described in the original plan of reorganization filed with the IRS, and are related to the distributed business.

- The Proposed Regulations would expand the types of Distributing debt ("Eligible Debt") that can be eliminated, whether through an assumption by Controlled, a "boot purge," or a facilitated debt exchange. Eligible Debt would include third-party "historic" Distributing debt, which the Proposed Regulations generally define as debt incurred prior to the Section 355 transaction's announcement — a liberalization of Rev. Proc. 2024-24, which required that the debt have been incurred 60 days prior to announcement. In another welcome expansion of Rev. Proc. 2024-24, the Proposed Regulations would treat as Eligible Debt certain new Distributing debt used to refinance "historic" Distributing debt and certain ordinary-course trade payables, revolving credit facilities, and related-party debt instruments. Consistent with Rev. Proc. 2024-24, the Proposed Regulations generally would limit the amount of Eligible Debt that can be eliminated to its historical average level for the eight fiscal quarters preceding the Section 355 transaction's announcement.
- The Proposed Regulations would strictly limit Distributing's ability to reborrow eliminated debt without triggering gain by reducing the amount of consideration treated as having been distributed to creditors (and, by extension, treated as having been distributed pursuant to the plan of reorganization) to the extent the debt is "transitorily eliminated." Whether debt is "transitorily eliminated" would be determined under an "expects or is committed to undertake" standard, with exceptions for certain ordinary course and unexpected circumstances borrowings.

Facilitated Debt-for-Debt and Debt-for-Equity Exchanges

- The Proposed Regulations would permit certain facilitated debt-for-debt and debt-for-equity exchanges — whether structured as "direct issuances" or "intermediated exchanges." This is a welcome expansion of Rev. Proc. 2024-24, under which the IRS would not issue rulings on direct issuances.
    - In a direct issuance, Distributing issues new debt directly to an intermediary, uses the proceeds of that debt to repay Eligible Debt and then repays the new debt with Controlled securities (which the intermediary then sells into the market). In an intermediated exchange, the intermediary acquires Eligible Debt from existing holders and then exchanges the acquired debt for Controlled securities (which the intermediary then sells into the market).

- Under Rev. Proc. 2024-24, the IRS was willing to issue rulings on certain intermediated exchanges but required taxpayers to make several constraining representations generally aimed at validating that the intermediary was not acting

as Distributing's agent and that the transaction should not be recharacterized under general tax principles (including the substance-over-form doctrine). The Proposed Regulations would permit both direct issuances and intermediated exchanges meeting certain requirements that generally are consistent with the representations taxpayers were required to make to obtain intermediated exchange rulings under Rev. Proc. 2024-24.

  - With respect to direct issuances, the Proposed Regulations establish a safe harbor requiring, among other things, that the intermediary hold the new Distributing debt for at least 30 days prior to the Section 355 transaction. IRS and Treasury officials have informally indicated that their intention was to create a minimum holding period preceding *the debt exchange* and that this will be fixed in any final regulations. Direct issuances that do not satisfy the safe harbor would be subject to a facts and circumstances test.
  - Intermediated exchanges must satisfy rules similar to the direct issuance safe harbor, including a requirement that the intermediary must hold the Eligible Debt for at least 30 days. This bright-line rule represents a departure from the facts and circumstances approach set forth in Rev. Proc. 2024-24.

Potential Implications for Ruling Practice

- It has long been common practice for public companies that engage in Section 355 transactions to obtain a private letter ruling from the IRS that provides comfort on the transaction's eligibility for nonrecognition treatment. The Proposed Regulations reflect the IRS's and Treasury's intention to publish binding, comprehensive guidance that will obviate the need for taxpayers to obtain private letter rulings for Section 355 transactions that fall within their scope.
- While the Proposed Regulations provide welcome clarity and certainty with respect to many significant issues, they also leave open many questions and fail to address several relatively common scenarios. Accordingly, the impact on ruling practices will depend in part on the extent to which any final regulations deviate from the Proposed Regulations.

For questions regarding the application of the Proposed Regulations, please reach out to any member of the Kirkland tax team, including the authors below.

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1. Section references are to the Internal Revenue Code of 1986, as amended. The Proposed Regulations were accompanied by a separate set of proposed regulations under Section 355 that would require multi-year reporting

for corporate spin-offs and related transactions and the release of a new draft Form 7216, Multi-Year Transaction Reporting, which taxpayers would use to report information to support nonrecognition treatment. ↩

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