Treasury Changes Course: Proposed Regulations for Spin-Offs and Other Separation Transactions

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In the waning days of the Biden administration, the IRS and Treasury issued proposed regulations (the "Proposed Regulations") regarding tax-free corporate separations (including spin-offs, split-off and split-up transactions) ("Section 355 Transactions") and other tax-free incorporations and reorganizations. At the same time, the IRS and Treasury also issued proposed regulations requiring multi-year reporting for such transactions.

The Proposed Regulations are a follow-up to guidance issued by the IRS and Treasury last spring (the "Prior Guidance"), that included updated procedures for taxpayers requesting private letter rulings from the IRS on Section 355 Transactions.[1] If finalized in their current form, the Proposed Regulations would make significant changes to the existing rules governing Section 355 Transactions and other reorganizations.

While any final regulations may end up looking different from the Proposed Regulations, the IRS has indicated that it intends to update its current ruling practice to incorporate the Proposed Regulations into the process for obtaining private letter rulings. As such, the Proposed Regulations are relevant for taxpayers currently, although the impact of the Trump administration on IRS ruling practice remains to be seen.

We discuss key elements of the Proposed Regulations below. In this update, we refer to the parent company in a Section 355 Transaction as "Distributing" and the company that holds the spun-off business as "Controlled".

Allocating Group Debt Using Intermediaries

In connection with Section 355 Transactions that are structured as "Divisive Reorganizations", corporations are permitted to allocate historic borrowings among Distributing and Controlled on a tax-free basis using various strategies. Most notably,

[1] The Prior Guidance is discussed in our prior Debevoise In Depth.

Controlled may issue debt securities that are exchanged in satisfaction of historic Distributing debt. Transferring Controlled securities directly to creditors of Distributing is often not practicable, in part because these creditors may not be willing to accept Controlled securities in repayment of historic Distributing debt. To address these practical limitations, prior IRS ruling practice permitted exchanges of Controlled securities for Distributing debt to be effected through an intermediary financial institution in an "intermediated exchange" or a "direct issuance" transaction.

In an "intermediated exchange" transaction, an intermediary financial institution acquires historic Distributing debt in the market and agrees to exchange the acquired historic debt for Controlled securities (which the intermediary then sells into the market). In a "direct issuance" transaction, an intermediary financial institution lends cash directly to Distributing, which Distributing uses to repay its historic debt, and Distributing then repays the intermediary loan using Controlled securities (which the intermediary then sells into the market).

In the Prior Guidance, the IRS expressed concern regarding the application of general tax principles to direct issuance structures and indicated that it would no longer issue rulings on direct issuances.

The Proposed Regulations Reverse Course on Direct Issuances

In a change of course from the Prior Guidance, the Proposed Regulations permit Distributing to satisfy historic Distributing debt with Controlled securities in a direct issuance transaction, but impose a number of requirements on such transactions. Under a facts-and-circumstances-based test, the qualification of a direct issuance as an exchange of Controlled securities for historic Distributing debt (and not a sale of the Controlled Securities to the intermediary for cash) is based on a weighing of various factors. Importantly, under this test, a transfer of Controlled securities to an intermediary in a direct issuance that comprises part of a prearranged, integrated plan with the Section 355 Transaction constitutes substantial evidence of non-qualification.

Debevoise Comment: This factor does not comport with typical market practices in which the securities exchange is typically part of the planning of the broader Section 355 Transaction. As a result, securities exchanges in Section 355 Transactions are likely to move towards the requirements of the safe harbor.

The Proposed Regulations also provide a safe harbor for direct issuances, which requirements include that:

- Distributing does not have legal or practical control over the cash proceeds of the direct issuance debt;

- The intermediary holds the direct issuance debt for a minimum of 30 days; and

- Distributing and Controlled do not participate in any profit realized by the intermediary upon the exchange and the intermediary bears the risk of loss with respect to the direct issuance debt and the Controlled securities that it sells into the market.

Debevoise Comment: While the requirements of the safe harbor overlap with many of the factors in the facts-and-circumstances-based test, the safe harbor does not require the direct issuance to be undertaken independently from the broader Section 355 Transaction.

The Proposed Regulations Continue to Permit Intermediated Exchanges

Consistent with prior IRS ruling practice, the Proposed Regulations continue to permit "intermediated exchanges". Qualifying intermediated exchanges must satisfy certain requirements, including that (i) the intermediary holds the acquired historic debt for at least 30 days, (ii) the intermediated exchange is on arm's length terms, (iii) Distributing and Controlled do not participate in any profit realized by the intermediary upon the exchange and (iv) the intermediary bears the risk of loss with respect to the acquired historic debt and the Controlled securities that it sells into the market.

Debevoise Comment: Unlike direct issuances, the Proposed Regulations do not provide a facts-and-circumstances-based test or a separate safe harbor for intermediated exchanges, though many of the requirements for an intermediated exchange overlap with the requirements of the direct issuance safe harbor.

Debevoise Comment: A required 30-day holding period by the intermediary is significantly longer than the pre-2018 IRS ruling practice, which required the intermediary to hold the acquired Distributing debt for five days prior to entering into an exchange agreement and for 14 days prior to the exchange itself (the so-called "5/14 Rule"). For both intermediated exchanges and direct issuance structures, a 30-day holding period is likely to result in additional costs to the intermediary, which presumably add to the transaction costs of spin-offs.

Delayed Distributions and Retentions

In a Section 355 Transaction, Distributing ordinarily must distribute all of the stock and securities in Controlled that it owns to Distributing's shareholders and security holders. Distributing may engage in a "delayed distribution," where it distributes some of the Controlled stock or securities in one or more distributions following the initial

distribution. Alternatively, Distributing may temporarily retain up to 20% of the stock of Controlled, if it is established to the satisfaction of the Secretary that the retention was not in pursuance of a plan having as one of its principal purposes the avoidance of federal income tax.

The Proposed Regulations eliminate the distinction between delayed distributions and retentions, with the IRS and Treasury agreeing with stakeholder feedback that the labels give rise to a "distinction without a difference" in finding a genuine separation of Distributing and Controlled. As such, the Proposed Regulations require any Controlled stock not distributed as part of the initial distribution to satisfy the requirements for a retention. However, the Proposed Regulations also provide additional flexibility with respect to the timeframe for distributing 80% control of Controlled.

Comment: While the Prior Guidance required taxpayers to identify upfront the specific Controlled stock or securities that would be distributed in a delayed distribution and those that would be retained and disposed of in a taxable transaction, the Proposed Regulations permit some level of contingency planning. Taxpayers must still evidence a definite intent in the plan of reorganization to undertake a particular manner of disposition of the retained Controlled stock or securities (e.g., a stock-for-debt exchange), but may identify a contingency (or layered contingencies) requiring a change in course (e.g., a follow-on spin-off as a contingency plan in the event that the stock-for-debt exchange was not successful).

Comment: Prior IRS ruling policy generally required Distributing to distribute all of its Controlled stock within 12 months of the date of the initial distribution to qualify as part of the Section 355 distribution. Under the Proposed Regulations, Distributing is required to distribute at least 80% of the stock of Controlled either (i) within a single taxable year or (ii) over two taxable years, as long as the distributions are made pursuant to a binding commitment described in a plan of distribution or plan of reorganization.

The Proposed Regulations permit a retention if a taxpayer can satisfy either a safe harbor or a facts-and-circumstances-based test, each of which requires a multi-pronged analysis. Both tests require a sufficient corporate business purpose for a retention and limit overlap between officers, directors and key employees of Distributing and Controlled, as well as non-arm's length continuing arrangements between Distributing and Controlled.

The safe harbor provides a two-year limitation on any non-arm's length continuing arrangements and any overlap of directors between Distributing and Controlled. Any overlap of officers, directors or key employees among Distributing and Controlled during the period of retention must be to accommodate Controlled' s business needs and overlapping directors cannot run for reelection after the two-year term expires.

Under the facts and circumstances test, the extent of overlapping directors, officers and key employees and the existence of continuing arrangements between Controlled and Distributing will be key, but not individually sufficient, factors in determining genuine separation.

Comment: Careful attention should be paid to any transition service agreements between Distributing and Controlled, which can span longer than two years and may have bespoke pricing arrangements. The treatment of overlapping directors is materially more stringent than prior IRS ruling practice, which had ruled favorably on a six-year term without any limits on seeking reelection. It's unclear why directors' abilities to be reelected by the Controlled shareholders post-distribution would impede a separation of the businesses.

To qualify for the safe harbor under the Proposed Regulations, stock of Controlled must be widely held and the plan of distribution or reorganization must reflect a definite intent to dispose of the retained Controlled stock within five years (the same timeframe permitted under prior IRS ruling practice with respect to retentions).

Comment: Private equity-backed and other privately-held companies generally would not satisfy the widely-held requirement of the safe harbor and would need to qualify under the facts-and-circumstance test.

Plan of Reorganization

Divisive Section 355 Transactions and other tax-deferred reorganizations must occur pursuant to a "plan of reorganization" to qualify for nonrecognition treatment. Current regulations do not provide specifics regarding the form and content of the plan. In a significant change from existing law, the Proposed Regulations set forth elaborate rules for establishing and carrying out a plan of reorganization (or plan of distribution for non-divisive spin-offs), applicable to both Section 355 Transactions and other reorganizations. New rules also cover whether transactions are properly included in the plan of reorganization (even if specified in the plan document), and thus eligible for nonrecognition. Under the Proposed Regulations, if a plan of reorganization is deficient or is not properly filed, the IRS has the authority to correct the plan or identify an otherwise absent plan and has broad leeway to interpret the plan.

Requirements for a Plan of Reorganization

Under the Proposed Regulations, a plan of reorganization, in a single, comprehensive document, must include granular level details on all steps of the proposed transaction, including, among other requirements:

- Identification of the parties and the transactions properly included in the reorganization, along with the business purpose and intended federal income tax treatment of each transaction; and

- Identification of any liabilities assumed and any debt (along with identity of creditors) to be satisfied with certain stock, securities or property.

The plan of reorganization must be filed with the IRS and new rules will also require ongoing reporting by taxpayers for five years after a spin-off occurs, such that the IRS can monitor compliance with the plan.

Comment: Under the Proposed Regulations the plan is a critical document that cannot be left for post-transaction memorialization. Taxpayers may prefer to use a contract agreed by the parties to avoid inconsistency. The degree of detail that the IRS would require in the written plan remains a key question.

Scope of the Plan

Under the Proposed Regulations, a transaction must satisfy multiple tests to be properly included in a reorganization, including the following:

- Definite Intent Requirement. The plan must establish, in a written commitment, a definite intent to carry out the transaction. The plan may specify contingencies if a transaction cannot be carried out, however "mere contemplation" that a transaction may occur (including flexibility to choose among multiple options) is insufficient.

  Comment: The rigidity of these rules suggests that taxpayers would need to provide a "decision tree" of potential contingencies and committed fallback plans for the plan to remain valid without falling into the strict amended plan rules.

- Proximate Relationship Requirement. The Proposed Regulations generally require that a transaction either (i) be integral to the transactions that meet the reorganization requirements, or (ii) would not occur "but for" the reorganization. Temporal proximity is insufficient.

Amendments to a Plan of Reorganization

The Proposed Regulations permit amendments to a finalized plan of reorganization only for "identifiable, material and unexpected changes in market or business conditions" that occur after the adoption of the original plan. Any changes must be necessary to effectuate the reorganization. If an amendment fails this test, the IRS may itself determine the content of the updated plan based on its interpretation of the facts and circumstances.

Comment: Under the Proposed Regulations, it may be unclear whether changes in transactions to adapt to changing circumstances could jeopardize a given reorganization without a supplemental private letter ruling. It is also unclear whether the standard for permitting amendments includes relevant changes in law (particularly evolving tax requirements) or whether a particular change in fact specific to the taxpayer would qualify.

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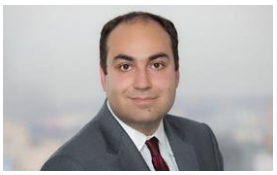

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