

# New IRS Ruling Guidelines Significantly Impact Tax-Free Spin-Offs

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May 17, 2024

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On May 1, 2024, the Treasury Department (Treasury) and Internal Revenue Service (IRS) released Revenue Procedure 2024-24 (Revenue Procedure), which sets out substantially revised guidelines for private letter ruling (PLR) requests regarding tax-free spin-off and split-off transactions (collectively, spin-offs) and related debt reallocation transactions.

At the same time, Treasury and the IRS released Notice 2024-38 (Notice), which requests feedback on the Revenue Procedure from companies and other stakeholders and describes the “views and concerns” of Treasury and the IRS with respect to certain aspects of spin-offs and the Revenue Procedure.

## Main Takeaways

Compared to the prior PLR guidelines and relatively recent IRS ruling practice, the Revenue Procedure imposes significantly more stringent standards and much more onerous substantiation burdens on companies seeking PLRs. Importantly, the Revenue Procedure indicates that the IRS will no longer provide PLRs with respect to “debt-for-equity” or “debt-for debt” exchanges (Debt Exchanges) structured as “direct issuance” transactions and other spin-off monetization techniques that were generally permitted by the IRS under the prior PLR guidelines.

It is important to note, however, that the Revenue Procedure only modifies the IRS standards to determine whether or not to grant a PLR with respect to a spin-off. It does not purport to change the currently operative law that applies to these transactions. In situations where it appears that the IRS will not rule, or where a company pursuing a spin-off is unwilling or unable to meet the exacting standards required for a PLR, it may nevertheless be possible to undertake the spin-off on the basis of a tax opinion.

Moreover, the new PLR guidelines, as well as the manner in which they are implemented in the PLR program generally, will likely continue to evolve as companies and their advisers engage with the IRS and Treasury both through the public commenting process and through individual PLR requests on specific transactions.

The Notice, however, outlines several “views” of Treasury and the IRS regarding current law that appear to reflect significant departures from commonly understood interpretations of the spin-off rules. While the Notice, like the Revenue Procedure, does not itself change current law, these pronouncements may presage further regulatory developments in the spin-off area that would, if ultimately issued as a Treasury regulation, have the force of law.

In light of these developments, it is paramount that companies considering spin-offs consult with their advisers as early as possible when planning the transaction.

## Background on Spin-Offs

A spin-off generally involves the separation of a historic business line of a parent company (Parent) into an independent, separately traded entity. Spin-offs are typically structured as “divisive” reorganizations in which the Parent contributes the relevant business to a newly formed subsidiary (Spinco) and then distributes the Spinco’s stock to the Parent’s shareholders.

If the spin-off satisfies certain tax-free qualification requirements, the transaction is not taxable to the Parent, Spinco or shareholders who receive Spinco stock.

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Frequently, the Parent may receive cash proceeds or reallocate some of its existing debt to the Spinco as a way of partially “monetizing” the Parent’s interest in the spun-off business and establishing appropriate capital structures for the two companies going forward. Within prescribed limits, the spin-off rules sanction a variety of tax-free methods of allocating group liabilities between the two separated companies.

The Spinco’s assumption of debt or other liabilities from the Parent is generally tax-free to the extent the amount of liabilities assumed does not exceed the tax basis of the assets that the Parent transfers. Similarly, the Parent’s receipt of cash or other property (referred to as “boot”) from the Spinco is generally tax-free to the extent:

- the value of the boot does not exceed the tax basis of the transferred assets less the amount of liabilities assumed, and
- the Parent “purges” the boot (a Boot Purge) through payments to its shareholders (*e.g.*, as dividends or stock repurchases) or to its creditors (*e.g.*, via repayment of outstanding Parent debt).

Spinco stock and debt “securities”<sup>1</sup> are not treated as boot. The spin-off rules provide flexibility to reallocate or otherwise retire additional Parent debt — in excess of the tax basis of the transferred assets — through a Debt Exchange in which the Parent uses a portion (generally no more than 20%) of the Spinco stock, or newly issued Spinco debt securities, to retire outstanding Parent debt.

Because typical holders of Parent debt are generally unwilling or unable to accept Spinco stock or securities in satisfaction of such debt (*e.g.*, due to their investment criteria and goals or regulatory constraints), Debt Exchanges are usually structured as “intermediated” exchanges with an investment bank or other financial intermediary (Intermediary).

In a traditional intermediated exchange, the Intermediary purchases the relevant Parent debt in the secondary markets and, shortly thereafter, exchanges the debt for Spinco stock or securities (which the Intermediary usually sells promptly to investors).

In recent years, a modified format of the intermediated exchange — a so-called “direct issuance” transaction in which the Parent issues new debt directly to an Intermediary, uses the proceeds of the new debt to repay historic debt and then transfers Spinco stock or securities to the Intermediary in satisfaction of the new debt — became the most prevalent structure used to effectuate Debt Exchanges and was sanctioned by the IRS in a number of PLRs.

Direct issuance transactions are generally viewed as reducing some of the friction costs associated with traditional intermediated exchanges, particularly those involving longer-term Parent debt.

In lieu of a Debt Exchange, the spin-off rules also permit the Parent to retain a portion (again, generally no more than 20%) of the Spinco stock (a Retention) and sell the retained stock for cash in taxable sales after the spin-off, provided the Parent establishes to the satisfaction of the IRS that the Retention does not have a principal purpose of tax avoidance (No-Tax-Avoidance Requirement).

If a Retention does not satisfy the No-Tax-Avoidance Requirement, the entire spin-off becomes fully taxable to both the Parent and its shareholders.

## Key Changes

Some of the most important and immediately relevant changes in the Revenue Procedure are as highlighted below.

### Parent Debt Eligible for Boot Purges and Debt Exchanges

For PLR purposes, the ability to satisfy Parent debt with cash in a Boot Purge, or with Spinco stock or securities in a Debt Exchange, has generally been limited to historic or “old and cold” tranches of Parent debt, defined in both the Revenue Procedure and the prior PLR guidelines as debt that was outstanding as of a specified date typically falling well in advance of the spin-off — generally 60 days prior to the announcement of the transaction (Cutoff Date).

The prior PLR guidelines, in line with other published guidance, included a critical exception to this limitation for Parent debt incurred after the Cutoff Date if the proceeds from the new debt were used to retire historic debt that was outstanding as of the Cutoff Date (Refinancing Exception).

The Revenue Procedure removes the Refinancing Exception, indicating that the IRS may only issue PLRs with respect to Boot Purges and Debt Exchanges when the particular Parent debt to be satisfied was itself incurred prior to the Cutoff Date. Accordingly, it appears that the IRS may not rule on Boot Purges or Debt Exchanges involving shorter-term Parent debt (*e.g.*, “rolling” commercial paper) or other new debt incurred to refinance longer-term debt that happens to come due after the Cutoff Date.

This new IRS stance on refinancing debt would also seem to apply to Parent debt that, although in existence as of the Cutoff Date, is deemed to be reissued after the Cutoff Date for tax purposes as a result of a “significant modification” to the terms of the debt.

In light of this marked departure from the prior PLR guidelines and past IRS ruling practice, companies that wish to pursue these types of debt reallocation transactions with the benefit of a PLR

<sup>1</sup> “Security” is a tax law term of art that generally refers to a debt instrument representing a longer-term investment in the issuer.

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should carefully consider and arrange their capital structures in the earliest planning stages of the transaction (and in any event before the Cutoff Date) to maximize the tranches of debt potentially eligible to be satisfied in a Boot Purge or Debt Exchange.

In addition to the removal of the Refinancing Exception, the Revenue Procedure indicates that the IRS will not issue PLRs with respect to Boot Purges or Debt Exchanges involving:

- Parent liabilities other than debt, including contingent liabilities (such as pension plan liabilities) with respect to which the IRS has ruled favorably in the past, or
- obligations incurred in the ordinary course of business pursuant to a bilateral contract, even if otherwise treated as indebtedness for tax purposes (*e.g.*, trade debt).

## Direct Issuance Transactions and Intermediated Exchanges

Consistent with the removal of the Refinancing Exception, the Revenue Procedure provides that the IRS will not issue PLRs with respect to Debt Exchanges that are structured as direct issuance transactions (*i.e.*, where the Parent debt to be satisfied in the Debt Exchange is issued directly to the Intermediary shortly before the exchange, even where the proceeds of the new debt are used to retire historic debt). The only exception to this limitation is a situation where the relevant Parent debt was issued to the Intermediary prior to the Cutoff Date.

The Revenue Procedure does, however, indicate that the IRS will continue to entertain PLR requests with respect to Debt Exchanges structured as traditional intermediated exchanges. The Parent is required to submit extensive supporting information and analysis to validate that the Intermediary is acting as a principal (and not as the Parent's agent) and that the transaction should not be recharacterized under general tax principles.

Under current practice, much of the information required (*e.g.*, the terms of all agreements, understandings and arrangements relating to the Intermediary's acquisition of the relevant Parent debt) is not generated until shortly before the Debt Exchange occurs, by which time the PLR would already have been issued. IRS officials have made clear that adherence to the former "5/14" standard<sup>2</sup> under past IRS ruling practice is neither necessary nor sufficient for establishing the Intermediary's status as a principal.

Even where the IRS is otherwise willing to rule on intermediated exchanges, the removal of the Refinancing Exception means that the Parent debt to be satisfied in the Debt Exchange must

be longer-term debt that was outstanding on the Cutoff Date. As a general matter, we understand that this may entail significantly higher friction costs relative to an intermediated exchange involving commercial paper or other shorter-term debt.

## New PLR Guidelines Related to Retentions

The interplay between Retentions and post-spin-off Debt Exchanges raises a unique challenge. If the Parent continues to own Spinco stock following the spin-off with a view to disposing of the stock in a Debt Exchange, but market dislocations or other external conditions prevent the Parent from completing the Debt Exchange as planned within the time period prescribed in the PLR (generally, but not always, up to 12 months after the spin-off), the Parent's continued ownership of the stock may eventually ripen into a technical Retention that would need to satisfy the No-Tax-Avoidance Requirement to avoid jeopardizing the tax-free status of the entire spin-off.

Under the prior PLR guidelines and past IRS ruling practice, the IRS routinely granted PLRs conditionally blessing a potential Retention if the Parent could not complete the Debt Exchange on a timely basis and instead sold the retained stock in taxable sales.

The Revenue Procedure makes clear that the IRS will no longer grant these types of "backstop" Retention rulings. Generally, the Parent may request a ruling that a planned disposition of Spinco stock in a Debt Exchange qualifies for tax-free treatment, or it may request a ruling that a planned Retention satisfies the No-Tax-Avoidance Requirement, but it may not request both rulings with respect to the same block of Spinco stock.

As a result, if the Parent receives a PLR with respect to a Debt Exchange and is unable to complete it on time, it may be forced to distribute the Spinco stock to its shareholders — a disposition that may be uneconomic as a business matter, as it would not result in deleveraging — prior to the expiration of the prescribed time period in order to preserve the PLR's validity.

In the case of a planned Retention, the Revenue Procedure suggests that the IRS intends to apply more scrutiny to the No-Tax-Avoidance Requirement than it has traditionally, with notable emphasis on:

- continuing arrangements between the Parent and Spinco on non-arm's-length terms (which would appear to be triggered by virtually any customary transition services agreement with "cost" or "cost-plus" pricing elements), and
- overlapping directors, officers or key employees (which would appear to be triggered by even a single overlapping director who serves for a limited transitional period).

<sup>2</sup> Under the 5/14 standard, the Intermediary was required to hold the purchased Parent debt for at least five days before entering into an exchange agreement with the Parent and for at least 14 days in total before consummating the Debt Exchange.

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## 'Reborrowings' by the Parent Following the Spin-Off

Under the prior PLR guidelines, the Parent was generally free to "replace" debt that was assumed by Spinco or retired in a Boot Purge or Debt Exchange by issuing new debt following the

spin-off, as long as the new debt was not "previously committed" (or, if previously committed, was incurred pursuant to a revolving credit agreement or similar ordinary course financing arrangement).

While the Revenue Procedure retains the exception for revolving credit facilities, it also significantly broadens the scope of prohibited Parent reborrowings to include any post-spin-off borrowing that the Parent "anticipates" prior to the spin-off. The broadened reborrowing prohibition may hamper the Parent's flexibility to

obtain new debt financing after the spin-off for real but expected business needs (*e.g.*, due to foreseeable acquisition or capital investment opportunities or business seasonality) and is likely to inject further uncertainty into PLRs involving debt reallocation transactions.

## Effective Date and Deadline for Feedback

The Revenue Procedure generally applies to PLR requests submitted to the IRS after May 31, 2024. The adoption of the new PLR guidelines is not expected to impact previously issued PLRs.

The Notice requests that stakeholders submit feedback by July 30, 2024, and indicates that Treasury and the IRS may also consider subsequently submitted feedback.

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