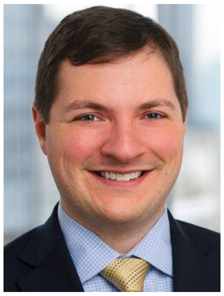
What Updated PLR Procedure May Mean For Stock Spin-Offs

By **Michael Cardella, Nathan Giesselman and Thomas Wood** (May 29, 2024)



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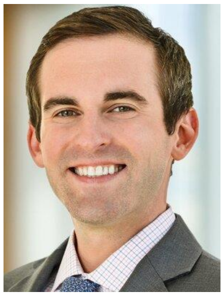

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On May 1, the U.S. Department of the Treasury and the Internal Revenue Service released Revenue Procedure 2024-24, which sets out substantially revised guidelines for private letter ruling, or PLR, requests regarding tax-free spinoff and split-off transactions, and related debt reallocation transactions.

At the same time, the Treasury and the IRS released Notice 2024-38, which requests feedback on the revenue procedure from companies and other stakeholders, and describes the views and concerns of the Treasury Department and the IRS with respect to certain aspects of spinoffs and the revenue procedure.

Background on Spinoff Monetizations

In connection with a spinoff, a parent company may receive cash proceeds or reallocate some of its existing debt to the distributed subsidiary, or 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 spinoff rules sanction a variety of tax-free methods of allocating group liabilities between the two separated companies. Most notably, the parent's receipt of cash or other property — referred to as boot — from the spinco is generally tax-free to the extent that the value of the boot does not exceed the tax basis of the assets transferred to the spinco, less the amount of liabilities assumed by the spinco, and the parent purges the boot 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 — debt instruments representing a longer-term investment in the issuer — are not treated as boot.[1] The spinoff rules provide flexibility to reallocate or otherwise retire additional parent debt — in excess of the tax basis of the transferred assets.

This is done 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.

Debt exchanges are usually structured as so-called intermediated exchanges with an investment bank or other financial intermediary 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.

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 became the most prevalent structure used to effectuate debt exchanges and was sanctioned by the IRS in a number of PLRs.

The modified format is a 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 the spinco stock or securities to the intermediary in satisfaction of the new debt.

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 spinoff rules also permit the parent to retain a portion — again, generally no more than 20% — of the spinco stock, known as a retention, and sell the retained stock for cash in taxable sales after the spinoff, provided the parent establishes to the satisfaction of the IRS that the retention does not have a principal purpose of tax avoidance.

If a retention does not satisfy the no-tax-avoidance requirement, the entire spinoff 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 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.

Debt meeting this criteria is defined in both the revenue procedure and prior PLR guidelines as debt that was outstanding as of a specified cutoff date, typically falling well in advance of the spinoff — generally 60 days prior to the announcement of the transaction.

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 — the 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 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.

Examples of the type of required supporting information and analysis include the terms of all agreements, and understandings and arrangements relating to the intermediary's acquisition of the relevant parent debt.

Under current practice, much of the information required 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 under past IRS ruling practice is neither necessary nor sufficient for establishing the Intermediary's status as a principal. Under this 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.

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-spinoff debt exchanges raises a unique challenge. Generally, but not always, if the parent continues to own spinco stock following the spinoff with a view to disposing of the stock in a debt exchange, the PLR will provide for a period of up to 12 months after the spinoff.

If market dislocations or other external conditions prevent the parent from completing the debt exchange as planned within the time period prescribed in the PLR, 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 spinoff.

Under the prior PLR guidelines and past IRS ruling practice, the IRS routinely granted PLRs that conditionally blessed 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 May 1 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.

Reborrowings by the Parent Following the Spinoff

Under the prior PLR guidelines, the parent was generally free to replace debt that was assumed by the spinco or retired in a boot purge or debt exchange by issuing new debt following the spinoff, 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-spinoff borrowing that the parent anticipates prior to the spinoff.

The broadened reborrowing prohibition may hamper the parent's flexibility to obtain new debt financing after the spinoff 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. The adoption of the new PLR guidelines is not expected to affect previously issued PLRs.

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

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 structured as direct-issuance transactions and other spinoff 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 for determining whether to grant a PLR with respect to a spinoff. 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 spinoff is unwilling or unable to meet the exacting standards required for a PLR, it may nevertheless be possible to undertake the spinoff 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, are likely to continue evolving as companies and their advisers engage with the IRS and the Treasury, both through the public commenting process and through individual PLR requests on specific transactions.

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

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[1] "Security" is a tax law term of art that generally refers to a debt instrument representing a longer-term investment in the issuer.