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Client Alert
Commentary

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IRS Studying Active Trade or Business Requirement for Tax-Free Spin-Offs

The IRS is considering future guidance that could present opportunities for R&D phase businesses.

In a statement issued on September 25, 2018, the Internal Revenue Service (IRS) announced that it is studying the active trade or business requirement for tax-free spin-offs under Section 355 for entrepreneurial ventures whose activities consist of research and development (R&D) in lengthy phases, but have generated little to no income.[1]

Tax-Free Spin-Offs

Section 355 permits a corporation to distribute the stock of its controlled subsidiary to shareholders without the corporation or its shareholders recognizing gain. In order to receive tax-free treatment, Section 355 imposes a number of requirements, including that both the distributing corporation and the controlled subsidiary be engaged in an "active trade or business." Under applicable US Treasury Regulations, an active trade or business "ordinarily" must include the collection of income. There has been some uncertainty as to how the active trade or business requirement would apply to development-stage businesses that are engaged in R&D but are not yet collecting income.

IRS Considering New Guidance

The recent IRS statement addresses the application of the active trade or business requirement to businesses engaged in R&D activities, regardless of whether they currently generate income. The statement notes that the IRS has "observed a significant rise in entrepreneurial ventures whose activities consist of research and development in lengthy phases," during which no income or negligible income is collected. Despite not collecting income, these businesses expend significant financial resources and perform day-to-day operational and managerial functions — factors that the IRS notes have historically evidenced the conduct of an active business. Pharmaceutical and technology businesses are specifically referenced in the statement as examples of such "entrepreneurial ventures."

The IRS and the Treasury Department are now considering issuing guidance as to whether entrepreneurial activities — such as R&D undertaken to earn income in the future — could qualify as an active trade or business, even if no income has yet been collected. The IRS has requested comments on the requirement that an active trade or business ordinarily must include the collection of income, including:

- The scope of the requirement under current law.
- Whether administrative guidance on the active trade or business should be modified or withdrawn.
- Whether the active trade or business should be modified to, for example, include an exemption for certain business models due to their unique characteristics.

Although the statement specifically references pharmaceutical and technology businesses, the IRS and Treasury Department indicate that they do not plan to issue industry-specific guidance.

The IRS further indicates that it will consider requests for private letter rulings regarding the active trade or business requirement for corporations that have not collected income pending the completion of the study.

Conclusion

Potential changes to the active trade or business requirement could allow for additional planning opportunities and operational flexibility for businesses engaged in lengthy R&D phases that have not yet generated any income. In particular, companies developing multiple technologies with potentially different commercialization or exit opportunities may be able to benefit from the IRS' proposed liberalization of the active trade or business rule by separating the two technologies on a tax-free basis even if one or both technologies have not yet generated income.

If you have questions about this *Client Alert*, please contact one of the authors listed below or the Latham lawyer with whom you normally consult:

Laurence J. Stein
larry.stein@lw.com
+1.213.891.8322
Los Angeles

Pardis Zomorodi
pardis.zomorodi@lw.com
+1.213.891.7805
Los Angeles

Joseph J. Curran
joseph.curran@lw.com
+1.617.880.4548
Boston

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Endnotes

[1] References to "Section" refer to sections of the Internal Revenue Code of 1986, as amended.