

IRS Publishes Ruling Requirements for Certain Tax-Free Spin-Off Monetization Transactions

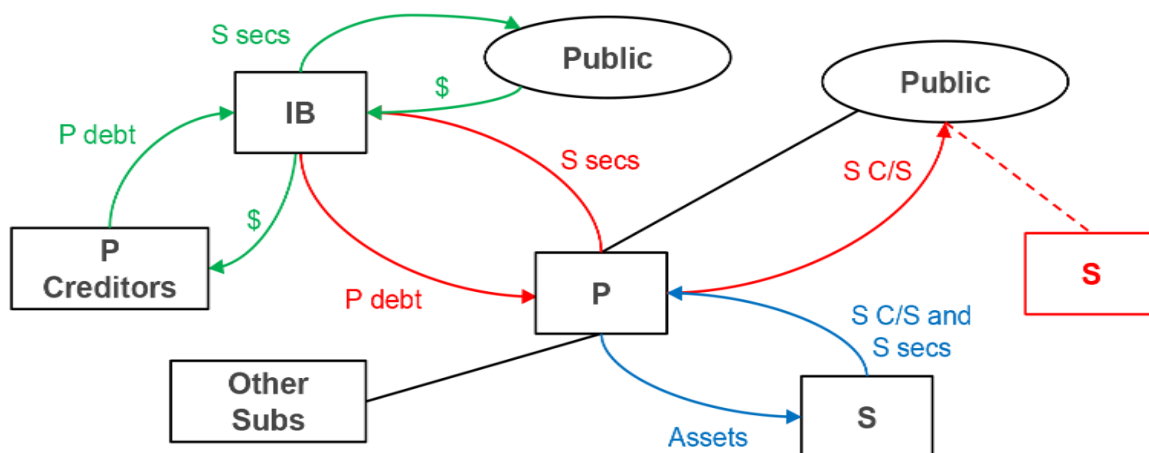
The new guidance is significant given the popularity of debt exchanges as a monetization technique in conjunction with spin-offs.

On October 3, 2018, the Internal Revenue Service (IRS) published Revenue Procedure 2018-53, which, among other things, sets forth requirements to request a private letter ruling regarding certain tax-free spin-off transactions in which the distributing corporation (Parent) uses stock or securities of the controlled corporation (SpinCo) to repay Parent debt, in the form of stock-for-debt or debt-for-debt exchanges.¹

General Structure of Debt-for-Debt and Stock-for-Debt Exchanges

In certain types of spin-off transactions,² Parent can use either SpinCo stock or SpinCo securities (collectively, the SpinCo Consideration) to repay Parent debt without incurring any gain and without being limited by the amount of basis that Parent has in SpinCo and its assets. Consequently, this structure has long been a popular way for Parent to, in effect, extract value from SpinCo on a tax-free basis. As illustrated below, Parent (P) would typically use an intermediary investment bank (IB) to purchase existing Parent debt. Thereafter, Parent would exchange the SpinCo Consideration (S secs) for Parent debt directly with IB (and IB would then sell the SpinCo Consideration into the market).

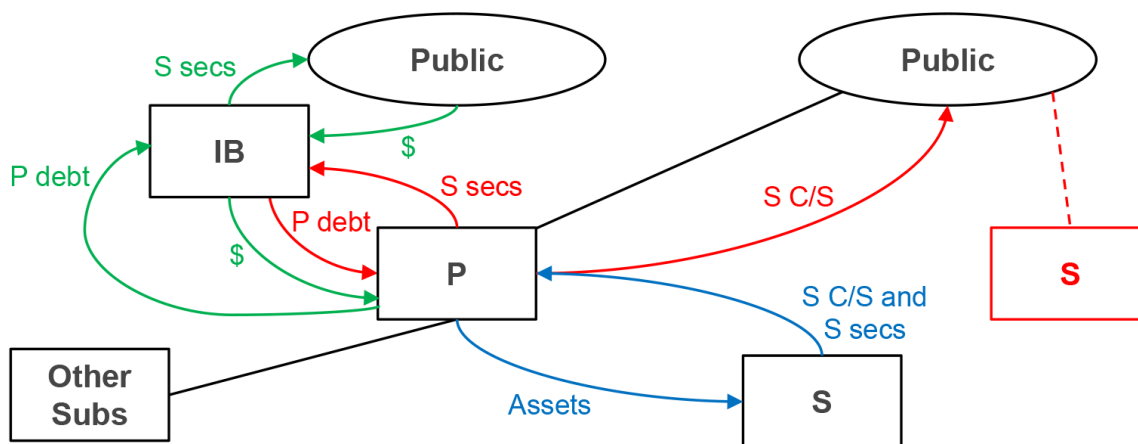
Leveraged Spins – Securities Exchange Technique (Sweep of Existing P Debt)



Typically, the IRS in these rulings would require IB to acquire the Parent debt at least 5 days before entering into an exchange agreement with Parent, and to hold the debt for at least 14 days before closing on the exchange with Parent (the 5-14 Representation).³ In some transactions Parent would execute the debt exchange either prior to or subsequent to the spin-off distribution of SpinCo stock to Parent's shareholders, so long as the debt exchange was treated as occurring in connection with the spin-off.⁴

In certain instances, rather than having IB sweep up existing Parent debt, Parent would issue new debt to IB, and that newly issued debt would then be exchanged for SpinCo Consideration (and IB would then sell the SpinCo Consideration into the market), as illustrated below.

Leveraged Spins – Securities Exchange Technique (Use of Newly Issued P Debt)



History of IRS Ruling Posture

In January 2013, the IRS, due to concern over the increasing use of newly issued Parent debt in the exchange transactions described, stopped issuing rulings if the Parent debt was incurred “in anticipation” of the spin-off.⁵ Then, in May 2017, the IRS announced that it would resume issuing rulings in this area, but did not elaborate as to any new requirements for such rulings.⁶

Required Representations for Rulings on Debt Exchanges

Revenue Procedure 2018-53 provides the first substantive guidance on debt exchanges since the no rule policy was removed in May 2017. The Revenue Procedure addresses only Parent debt for which Parent is the obligor, that is non-contingent, and that by its terms is payable only in money. The requirements under the Revenue Procedure include eight standard representations that a taxpayer seeking a ruling must make. To the extent that a taxpayer cannot make any of the representations, the taxpayer must provide an explanation and rationale for not making, or modifying, any of the representations. These representations are in addition to the representations normally required to obtain a ruling regarding a tax-free spin-off.

These standard representations generally are as follows:

- Parent is the obligor in substance of the debt being paid off.
- The holder of the debt is not a related person to Parent or SpinCo.

- The holder of the debt will not hold the debt for the benefit of Parent, SpinCo, or a related person.
- If an intermediary is used to acquire the debt from another person, then:
 - The intermediary will not acquire the debt from Parent, SpinCo, or a related person.
 - Parent, SpinCo, and their related persons will not participate in any profit of the intermediary.
 - Such profit will not be limited by agreement or other arrangement.
 - The value of the consideration received by the intermediary in satisfaction of the debt will not exceed the amount to which the holder is entitled under the terms of the debt (collectively, the Intermediary Representation).
- Unless an exception applies, Parent incurred the debt before the submission of a ruling request, and at least 60 days before the earliest of the following dates relating to the spin-off or a similar transaction (the Historic Debt Representation):
 - The date of first public announcement
 - The date of Parent entering into a binding agreement
 - The date of approval by the Parent board of directors
- The debt does not exceed the historic average debt Parent and other members of its affiliated group owed to unrelated persons.
- There are substantial business reasons for any delay in satisfying the debt beyond 30 days after the spin-off, and the debt will be satisfied no later than 180 days after the spin-off (the Delayed Exchange Representation).
- Parent will not replace the debt with previously committed borrowing, other than ordinary course borrowing.

Observations

- Intermediary Representation. This representation has a couple of noteworthy aspects:
 - An intermediary in this context (such as IB in the above illustrations) would typically receive an underwriting spread on the transaction. Therefore, the value of the consideration received by the intermediary from Parent in the exchange would usually exceed the amount that the intermediary would be entitled to receive as a holder of the Parent debt. As written, the Intermediary Representation would appear to prevent such an underwriting spread.
 - Notably, the Intermediary Representation does not contain anything similar to the 5-14 Representation. In this regard, the IRS Associate Chief Counsel (Corporate) said shortly after the issuance of the Revenue Procedure that “[o]ne of the significant purposes of this [procedure] is to turn off the 5-14 idea.” The Associate Chief Counsel also noted that the IRS does not want to insert itself into the mechanics of the transaction, though it does want to understand the intermediary’s role.⁷ Absent the 5-14 Representation, query whether and/or how rulings on debt exchanges will address the duration and nature of IB’s ownership of the Parent debt that IB acquires.
- Historic Debt Representation. The 60-day rule contained in this representation appears to require that the Parent debt being repaid must have been issued earlier than was the case under the IRS’ ruling

practice prior to the issuance of its no rule policy in January 2013. However, an exception to this rule permits new Parent debt to be incurred so long as such new Parent debt is issued to replace historic Parent debt that satisfies the 60-day rule.

- Delayed Exchange Representation. In its past ruling practice, the IRS had accepted representations that tolerated a delay in the debt exchange, sometimes for up to 18 months.⁸ This allowed Parent significant flexibility in terms of executing the exchange when market conditions were optimal. Now, however, Parent must provide “substantial business reasons” for any delay in excess of 30 days, and in any event must execute the exchange within 180 days (absent additional information to establish that the exchange will be “in connection with the plan of reorganization” that includes the spin-off). This represents a potentially significant limitation on the timing flexibility of debt exchanges.

Conclusion

The Revenue Procedure clarifies the representations that will be expected from a company seeking a private letter ruling regarding a tax-free spin-off with a debt exchange component. The Revenue Procedure also effectively provides guidance for companies engaging in such a transaction without the benefit of a ruling, and to their advisors who may be asked to render a tax opinion.

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 / Century City

William A. Kessler

william.kessler@lw.com
+1.213.891.7554
Los Angeles

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Endnotes

- ¹ The Revenue Procedure is a bit broader than debt exchanges, as it also addresses SpinCo’s assumption of liability for a Parent obligation, but this client alert focuses on debt exchanges.
- ² The statutory basis for the tax treatment of debt exchanges is in Section 361 of the Internal Revenue Code of 1986, as amended, and hence these debt exchanges occur pursuant to a divisive “D” reorganization.
- ³ See, for example, PLR 201721002; PLR 201649012; PLR 201601001; PLR 201409002.
- ⁴ See, for example, PLR 201308002 (contemplated that the debt exchange could occur prior to or following the spin-off); PLR 201721002 (allowed Parent the flexibility to distribute the SpinCo Consideration within 18 months of receipt).
- ⁵ Rev. Proc. 2013-3, 2013-1 CB 113.
- ⁶ Rev. Proc. 2017-38, 2017-22 IRB 1258.
- ⁷ Emily L. Foster, *Guidance on Leveraged Spinoff Rulings Designed for Flexibility*, Tax Notes, October 15, 2018.
- ⁸ See, for example, PLR 201721002 (18 months); PLR 201731004 (12 months).