On June 24, the IRS announced it will no longer issue to taxpayers private letter rulings for certain spin-off requirements, including business purpose. Confirming recent public remarks made by certain IRS officials, the IRS announced it would expand its published guidance relating to spin-offs, while reducing (at least on a one-year trial basis) the substantial resources it had been devoting to the spin-off letter ruling process. Further evidencing this new approach, the IRS also issued two spin-off revenue rulings illustrating situations where the business purpose requirement was satisfied.

Background

A qualifying spin-off transaction allows a corporation (the distributing corporation) to distribute to its shareholders the stock of another corporation (the controlled corporation) without triggering any gain or income at either the corporate or shareholder levels. To qualify for tax-free treatment, a spin-off must, among other things, have a valid corporate business purpose and must not be either a "device" for the distribution of corporate earnings and profits (E&P) to shareholders or part of a plan in which persons acquire 50 percent or more of either the distributing or controlled corporation. Because the corporate-level tax liability of a non-qualifying spin-off may be extremely large, taxpayers frequently have sought an IRS letter ruling as a kind of insurance that their proposed spin-off qualified for tax-free treatment. However, before granting a favorable ruling, the IRS required taxpayers to demonstrate satisfaction of each spin-off requirement, and the ruling process typically lasted at least 4 to 6 months from the time the ruling request was submitted. In addition, the IRS' advance ruling guidelines regarding the business purpose requirement frequently imposed substantial evidentiary burdens on taxpayers who were often required to satisfy very specific, numerical criteria, even though the guidelines themselves did not purport to constitute substantive law. Thus, the advance ruling process often required both taxpayers and the IRS to expend substantial resources, especially with respect to the business purpose requirement.

IRS Announces Three New Spin-Off No-Ruling Areas

The IRS announced in Revenue Procedure 2003-48 that it will no longer determine in a private letter ruling whether a spin-off: (i) has a valid corporate business purpose, (ii) is a "device" for the distribution of E&P or (iii) is part of a plan (or series of related transactions) in which one or more persons will acquire a 50 percent or greater interest in the distributing or...
controlled corporations. Instead, when applying for a spin-off ruling under these new procedures, a taxpayer must represent that the spin-off (a) has a corporate business purpose that satisfies the business purpose requirement, (b) is not a “device” and (c) is not part of a plan in which one or more persons will acquire 50 percent or more of either the distributing or controlled corporations.

**Other Ruling Request Changes**

The IRS also stated it will no longer issue supplemental spin-off letter rulings unless the ruling request presents a “significant issue.” A “significant issue” is a legal issue that is not clearly and adequately addressed by legal authority, the resolution of which is not free from doubt and which is legally significant in determining the major tax consequences of the transaction. In addition, the IRS indicated that a change in circumstances arising after a spin-off ordinarily does not present a “significant issue.” Thus, the IRS will now be unlikely to issue to a taxpayer a supplemental ruling that certain changes in circumstances occurring after the taxpayer’s receipt of a ruling does not adversely affect the prior favorable ruling.

In contrast to its no-ruling announcement, the IRS dropped its no-ruling policy regarding whether a business satisfies the active trade or business requirement when its gross assets have a value of less than 5 percent of the value of the total gross assets of the corporation directly conducting the trades or businesses.

**Pilot Program, Effective Dates and Other Matters**

These new procedures generally apply to ruling requests made after August 8 and are intended to be in place for at least one year. After this one-year period, the IRS will consider further procedural changes, including ruling only on “significant issues” (whether in the context of a supplemental ruling or an original ruling). Taxpayers may elect to apply the new procedures to ruling requests filed after June 24. Taxpayers that have been unsuccessful in obtaining a ruling from the IRS on a transaction in one of the three announced no-ruling areas will now be unable to obtain such a ruling with respect to that transaction (or a similar transaction).

**New Business Purpose Revenue Rulings**

Consistent with its announced intention to issue more spin-off published rulings on which taxpayers may rely, the IRS also issued two revenue rulings illustrating the satisfaction of the business purpose requirement. Each ruling presents a fact pattern that clearly would satisfy (without regard to any substantiation requirement) the IRS-approved “fit and focus” business purpose which now only exists for advance ruling purposes until the effective date of the IRS’ no ruling policy regarding the business purpose requirement. These two rulings follow two other recent business purpose revenue rulings regarding a permissible post spin-off change in circumstances and a split-off designed to eliminate disagreement among shareholder family members regarding the operation of two businesses.

In addition, these new rulings provide, for the first time, published guidance regarding acceptable examples of certain common post-spin-off arrangements and agreements between the distributing and controlled corporations, including overlapping directors and transitional service agreements. Although the rulings’ guidance in this regard is certainly helpful, inevitable line-drawing issues regarding these arrangements and agreements will persist.

In one ruling, the IRS stated that a spin-off satisfied the business purpose requirement because it enabled the management of each of the distributing and controlled corporations to concentrate on their own business (a software business and a paper products business, respectively). In the ruling, management of the publicly-traded distributing corporation wished to concentrate solely...
on its higher-growth software business, which already commanded most of management’s time, but management was unable to do so because of the need to service the paper products business. On the other hand, management of the paper products business believed that this business was being deprived of the management resources it needed to develop fully because of the priority accorded the software business. Because there was no other nontaxable transaction that would permit the corporations to accomplish the management objectives relating to each business, the IRS concluded that the business purpose requirement was satisfied.

The IRS also assessed in this ruling whether the business purpose of permitting the management of each corporation to focus on its respective business was adversely affected by two directors of the distributing corporation serving, after the spin-off, on the controlled corporation’s six-person board. One director was to assist with administrative matters for only a two-year term, while the other director, with corporate finance expertise, was to serve for at least an initial six-year term in order to provide continuity that would presumably reassure the financial markets. These ongoing director relationships were not viewed by the IRS as conflicting with the taxpayer’s avowed business purpose because the directors were only officers of the distributing corporation and not the controlled corporation, they constituted only a minority of each corporation’s board, one director was limited to only a two-year term and the directors’ presence on the controlled corporation’s board accomplished important objectives.

In the second ruling, the IRS concluded that a spin-off had a qualifying business purpose where it eliminated capital allocation problems between the distributing corporation’s pharmaceutical business and a cosmetic business conducted by the controlled corporation. The publicly-traded distributing corporation did all the borrowing for its consolidated group and made all decisions regarding the allocation of capital spending. Because the necessary aggregate capital spending of both businesses exceeded their internally generated cash flow in recent years, capital expenditures had to be limited in order to maintain the distributing corporation’s credit rating. Although the distributing corporation’s senior management usually favored the pharmaceutical business when allocating capital spending because of that business’ higher rate of growth and profit margin, the management of each corporation believed that its particular business was not able to pursue its appropriate development strategies in light of this competition for capital that would continue as long as the two businesses were part of the same consolidated group. In addition, a spin-off would provide the controlled corporation with direct access to the capital markets. The IRS concluded that a spin-off was the only nontaxable transaction that would resolve this capital allocation problem and thus the business purpose requirement was satisfied.

To facilitate the spin-off, the corporations entered into transitional agreements relating to information technology, benefits administration, and accounting and tax matters which were generally, absent extraordinary circumstances, limited to a two-year period, except for the tax matters agreement. In addition, in connection with the spin-off, the distributing corporation made an arm’s-length working capital loan to the controlled corporation for a two-year term. The IRS concluded that the transitional agreements and loan were not incompatible with the degree of separation necessary for a tax-free spin-off because of their generally short-term duration and transitional nature and because they were designed to facilitate, rather than impede, the separation of the two businesses.

Both of these new rulings (and the two other revenue rulings issued earlier this year that are referred to above) illustrate business purposes that would have almost certainly satisfied the IRS’ advance ruling guidelines. It is unclear whether the IRS intends to issue
published guidance that expands upon the rather narrow set of specific business purposes and related limitations set forth in such guidelines. Until such guidance is forthcoming, taxpayers will need to carefully evaluate any business purpose that would not satisfy such ruling guidelines. Although the business purpose requirement may in theory be satisfied by a transaction that would not necessarily satisfy the specific ruling guidelines, because of the potentially high economic stakes at issue, taxpayers will likely not want to stray too far from such guidelines or earlier published guidance.

**Conclusion**

In light of the no-ruling areas announced by the IRS, taxpayers contemplating a spin-off must now carefully consider whether an advance ruling is worth the necessary time and expense in light of its now limited nature. Taxpayers will almost certainly be more inclined to undertake spin-offs based only on a favorable opinion from tax counsel, given that IRS approval of many important spin-off requirements—especially business purpose—will occur only upon audit of the transaction. Even if a favorable IRS ruling is obtained, most taxpayers now will likely also wish to obtain an opinion from tax counsel to obtain sufficient comfort that the business purpose and “device” requirements are satisfied. Although taxpayers will now face greater legal uncertainty with respect to a spin-off, taxpayers that decide to avoid the ruling process will be able to proceed much more quickly with their desired transaction.