IRS and Treasury Issue Proposed Regulations for Spin-Off Transactions

On January 13, 2025, the IRS released proposed regulations (the "Proposed Regulations") focused on tax-free spin-off transactions. The Proposed Regulations reflect the IRS's detailed consideration of the relevant issues in these transactions since its publication last year of Rev. Proc. 2024-24 and Notice 2024-38 (the "Prior Guidance"). We wrote about the Prior Guidance last May in the attached memorandum. In this memorandum, we explore how the Proposed Regulations address those issues and present new issues.

INTRODUCTION

Relative to the Prior Guidance, the IRS has softened its position on some issues and hardened its position on others. Taken as a whole, the Proposed Regulations should be viewed as providing a taxpayer-friendly roadmap—most notably in the form of several "safe harbors"—for completing these transactions successfully.

The Proposed Regulations do not have the force of law and therefore may not be used by taxpayers or the IRS as binding legal authority. Nevertheless, IRS officials have informally stated that they will be using the Proposed Regulations as their standard for issuing private letter rulings, and we expect that the Proposed Regulations will change market practice in important ways. It is possible, however, that the Proposed Regulations will be ignored or withdrawn by the new administration.

RETENTIONS OF SPINCO STOCK

In order to be tax-free, a spin-off must result in a so-called "complete separation" of the parent entity ("Parent") and the separated entity ("Spinco"). Generally, this means that Parent must divest all of the Spinco stock it owns. Retaining Spinco stock is not allowed unless Parent demonstrates that the retention is not tax-motivated.

Historically, a Parent seeking to retain Spinco stock has sought a ruling from the IRS to demonstrate this. If Parent could show that it has a good business reason for the retention, the IRS would issue a ruling that allowed Parent to use the Spinco stock to complete a tax-free debt-for-equity exchange ("D4E") within 12 months of the spin-off or, alternatively, to sell Spinco stock within 5 years. These rulings, where taxpayers were given the choice to do either a D4E or a sale, had become known as "backstop retention" rulings.

Increasingly, the IRS expressed extreme skepticism towards retentions. In the Prior Guidance, the IRS announced that it would no longer issue "backstop retention" rulings and would instead force taxpayers to choose between a D4E and a taxable sale of the retained Spinco stock. In addition, the IRS announced that it would apply extra scrutiny to retentions in situations where Parent and Spinco maintained ongoing relationships after the transaction (for example, overlapping directors or executives, or commercial contracts that are not at arm's length).

The IRS's skepticism is apparent throughout the Proposed Regulations, which are principally aimed at policing retentions that the IRS considers abusive but allowing those that it believes are not. The Proposed Regulations achieve this balance by establishing a

rebuttable legal presumption that any retention of Spinco stock by Parent (even for a very short period of time) violates the spin-off rules and therefore makes the entire transaction taxable.

The main exception to this presumption is a "safe harbor" that prohibits Parent and Spinco from having previously common arrangements such as overlapping directors, officers or key employees for more than two years after the spin-off. The safe harbor also prohibits Parent and Spinco from having ongoing commercial relationships that are not arm's-length during the same period. Further, Parent must have a definite intent to dispose of all Spinco stock within five years of the spin-off, and there cannot be a plan to dispose of Spinco stock in a taxable transaction if a sale of the Spinco stock on the spin-off date would have resulted in a tax loss to Parent.

If the taxpayer cannot satisfy the terms of the safe harbor, there is a separate way to overcome the presumption. This requires satisfying a facts-and-circumstances test, however, and taxpayers may find this too risky.

In a taxpayer-friendly reversal of the Prior Guidance, the Proposed Regulations do not require Parent to choose between a non-taxable disposition such as a D4E and a taxable sale when planning the transaction. Instead, while Parent must intend to complete one type of disposition, it can change to an alternative type of disposition as long as there is a good reason for abandoning its original intention. The details around this part of the Proposed Regulations are murky, and taxpayers will rightly question how it is supposed to work in the "real world".

These proposed rules for retentions would give taxpayers certainty in planning their transactions. Assuming facts supporting the safe harbor are met, tax lawyers should feel comfortable issuing opinions on these issues and taxpayers should feel comfortable relying on these opinions rather than seeking private letter rulings from the IRS, as in the past.

DEBT-FOR-EQUITY EXCHANGES ("D4Es")

D4Es are a common monetization strategy pursuant to which, as part of a spin-off or split-off with a retention, Parent uses up to 20% of Spinco's stock to repay some of Parent's debt. When the D4E qualifies for tax-free treatment, Parent is able to use the full value of the Spinco stock to repay debt without recognizing any built-in gain in that stock. Historically, taxpayers have structured D4Es in one of two ways: as a "direct issuance" or an "intermediated exchange". The Proposed Regulations set out new rules for both.

So-called "direct issuance" D4Es, in which Parent issues new debt to a lender (raising new cash to pay down other Parent debt) and repays that new debt with Spinco stock days later, have long confounded the IRS and taxpayers alike because they resemble a sale of Spinco stock for cash. The structure is so risky that taxpayers generally would not complete direct issuance D4Es without receiving private letter rulings from the IRS. The IRS issued many such rulings in recent years. In the Prior Guidance, however, the IRS announced that it would no longer issue rulings on the structure. This essentially ended the practice of direct issuance D4Es while the IRS worked on the Proposed Regulations.

The Proposed Regulations do not prohibit direct issuance D4Es, but they do make them more challenging than under the IRS's recent private letter ruling practice. To qualify as tax-free under the Proposed Regulations, a direct issuance D4E must satisfy the conditions of a safe harbor or a separate facts-and-circumstances test. The safe harbor requires the lender to hold Parent debt for 30 days before the debt is exchanged for Spinco stock. The facts-based test does not require this holding period, but it specifically provides that a holding period of fewer than 30 days is prima facie evidence that the entire D4E does not qualify for tax-free treatment. The idea of a 30-day holding period is a dramatic departure from the IRS's recent ruling practice, which permitted direct issuance D4Es with holding periods of only one or two days.

In an intermediated D4E, one or more financial institutions acquire existing Parent debt and exchange that debt with Parent for Spinco stock. The Proposed Regulations set forth six requirements for an intermediated exchange. These requirements reflect policy concerns that the IRS has articulated in the past, including that intermediary financial institutions, when taking into account all of the relevant facts, may not be true creditors of Parent. Notably, the Proposed Regulations also require intermediaries to hold the debt for at least 30 days prior to an intermediated exchange and to bear the risk of loss during that time. Once again, this 30-day

holding period is a significant departure from prior IRS ruling practice, including in rulings on intermediated exchanges issued after the Prior Guidance was released last year.

How to react to all of this? The government plainly is trying to give taxpayers something useful and actionable, but it is not clear how useful these new rules will be. These transactions never have been structured using a 30-day holding period, and it is not clear whether the market will support them on commercially reasonable terms. If it cannot, then D4Es will be extinct as a practical matter. As with retention issues more generally, however, if transactions can be structured to fit into these safe harbors, then legal opinions should be more readily available than in the past and the need to seek private letter rulings should be largely eliminated.

USE OF PROCEEDS IN "BOOT PURGES"

In a typical spin-off, Spinco will borrow and distribute cash to Parent prior to closing. Parent receives this cash tax-free if Parent transfers the cash to its shareholders or creditors. These transfers are called "Boot Purges".

The Prior Guidance created two new problems with Boot Purges, and the Proposed Regulations reflect an attempt to fix them. The first problem was that the IRS allowed only historic debt to be repaid in a Boot Purge, but any historic debt that was refinanced after the spin-off was publicly announced lost its status as historic debt and therefore was not eligible for a Boot Purge. Under the Proposed Regulations, this refinanced historic debt remains ineligible for a Boot Purge but can be satisfied in a D4E. This strange result is likely due to a drafting glitch, which the IRS could fix in the future.

The second problem was that the Prior Guidance required Boot Purges to occur within 90 days of Parent's receipt of cash unless Parent could establish "substantial business reasons" for a longer delay. The Proposed Regulations eliminate this problem by adopting a simple rule requiring a Boot Purge to occur within 12 months of the receipt of the cash, without any business purpose requirement.

One new wrinkle (or, rather, a "what's old is new again" wrinkle) in the Proposed Regulations is that taxpayers would be required to hold the cash for a Boot Purge in a segregated account until the Boot Purge occurs. This revives the IRS's ruling position from many years ago, but in recent years the IRS has not required cash to be segregated. Given the reality that cash is fungible, it is not clear why holding cash in a segregated account should be necessary to qualify a Boot Purge as tax-free. Nevertheless, it will be very easy for taxpayers to segregate the cash and satisfy this requirement, although there may be additional costs involved in finding other sources of cash beyond the segregated account to conduct operations before the Boot Purge occurs.

CONTINGENT LIABILITIES

In rulings predating the Prior Guidance, the IRS allowed Parent to effect a Boot Purge by repaying liabilities other than funded debt (*e.g.*, accrued pension liabilities, environmental liabilities or trade payables). Under the Prior Guidance, the IRS indicated that it would not issue rulings for repayments of these types of liabilities.

Consistent with the Prior Guidance, the Proposed Regulations prohibit taxpayers from retiring non-debt liabilities in Boot Purge transactions. There is a limited exception for trade payables incurred in the ordinary course of Parent's business when satisfying the payables is necessary to allocate liabilities properly between Parent and Spinco.

REPLACEMENT OF PARENT DEBT

The Proposed Regulations introduce complex rules governing Parent's ability to repay debt in a Boot Purge or a D4E if Parent replaces the debt with new debt around the same time. These rules focus on whether a Parent's expectation to borrow arises before or after Parent announces the spin-off.

When the expectation for the new debt arises after the announcement, there is no issue. This is very good news for taxpayers, especially those who borrow for significant business investments or for M&A opportunities. When the expectation arises prior to the announcement, however, the rules become more restrictive. If Parent expects to borrow prior to the announcement and actually borrows between the announcement and when the spin-off occurs, it will recognize gain on a D4E or Boot Purge equal to the amount of the new borrowing. In contrast, if Parent expects to borrow prior to the announcement but does not borrow until after the spin-off occurs, the borrowing will not trigger gain as long as it is the result of a change in circumstances

that was not expected before the spin-off occurred. A separate exception applies for debt incurred in the ordinary course of Parent's business that would have been incurred without regard to the spin-off.

PLAN OF REORGANIZATION

Under the tax code, a D4E or Boot Purge must be "in pursuance of a plan of reorganization" to be tax-free. In the Prior Guidance, Treasury and the IRS observed that there is confusion and disagreement about the "plan of reorganization" requirement in spin-offs. The Proposed Regulations fill the gap, imposing a comprehensive compliance and reporting regime on Parent and Spinco to satisfy the "plan of reorganization" requirement.

Prior to the first step of a spin-off, the directors and officers of Parent and Spinco must adopt a plan of reorganization ("Plan") that identifies each transaction to be effected, describes its business purpose and intended tax treatment and evidences a definite intent to complete it. If the spin-off involves a D4E or Boot Purge, the Plan also must identify Parent debt that will be retired in the exchange. The Plan must be memorialized in the official records of Parent and Spinco and filed with the IRS. Parent and Spinco must complete the entire Plan in order for any of the transactions to be tax-free.

Parent and Spinco may amend the Plan after the transactions have begun if unexpected changes in market or business conditions occur and amendments are necessary to achieve one or more business purposes of the transactions. Additionally, Parent may identify alternative transactions in the original Plan as long as Parent has a definite intent to do one of the identified alternatives if feasible. For example, Parent can propose to do a Boot Purge by repaying debt if feasible, or, if not feasible, by making a special dividend distribution to its shareholders. This Plan will be respected as valid as long as Parent plans to pay—and pays—the dividend if the debt repayment is not feasible and therefore does not occur.

In addition, the Proposed Regulations have far-reaching consequences outside of the spin-off space. Any M&A transaction that is intended to be a tax-free reorganization under Section 368 of the Code is subject to certain aspects of the Proposed Regulations, including the requirements pertaining to creating and executing a Plan.

One interesting question is whether taxpayers will begin to comply with the Plan requirements even before the Proposed Regulations are finalized. We suspect that taxpayers will, either because they are seeking private letter rulings that require it or because their advisors (or their auditors) require it as a matter of good practice.

CONCLUSION

The Proposed Regulations were issued mere days before the Trump administration was inaugurated. It is unclear whether the Trump administration will finalize these rules or, rather, ignore or withdraw them. Doubtless there are tax and economic policy priorities for the Trump administration other than the Proposed Regulations, and at a macro-political level it is uncertain whether the Proposed Regulations will be viewed as "good" or "bad" for business.

In the meantime, the Proposed Regulations may well have rewritten the roadmap for executing spin-offs. In our view, this new roadmap should not be viewed as problematic for taxpayers and their advisors. To the contrary, the creation of safe harbors and the introduction of flexibility where the Prior Guidance required rigidity are taxpayer-friendly. The Proposed Regulations reflect the IRS's good-faith attempt not merely to allow but also to facilitate non-abusive spin-offs. In time these rules, if given the force of law, may reduce the need for IRS private letter rulings on spin-offs while still providing taxpayers with certainty in their planning.

NEW YORK

J. Leonard Teti II
+1-212-474-1896
lteti@cravath.com

Andrew T. Davis
+1-212-474- 1272
adavis@cravath.com

CRAVATH, SWAINE & MOORE LLP

NEW YORK

Two Manhattan West
375 Ninth Avenue
New York, NY 10001
+1-212-474-1000

LONDON

CityPoint
One Ropemaker Street
London EC2Y 9HR
+44-20-7453-1000

WASHINGTON, D.C.

1601 K Street NW
Washington, D.C. 20006-1682
+1-202-869-7700

cravath.com

IRS and Treasury Update Guidelines for Spin-Off Private Letter Rulings, Narrowing IRS Practice

On May 1, 2024, the IRS released Rev. Proc. 2024-24 and Notice 2024-38, which provide updated guidelines for taxpayers requesting private letter rulings from the IRS for tax-free spin-off and split-off transactions under Section 355. The guidelines reflect a significant narrowing of the IRS's current ruling practice. In particular, they restrict several common strategies used to reallocate liabilities of the Parent entity ("Parent") to the separated entity ("Spinco") and to monetize Spinco stock. In addition, the guidelines will require taxpayers to include more information and analysis on sensitive legal issues as part of the ruling process.

The key changes are as follows:

- *Debt-for-Equity Exchange Structuring*. Debt-for-equity exchanges ("D4Es") are a common monetization strategy pursuant to which up to 20% of the Spinco stock is used to repay Parent indebtedness. D4Es are particularly attractive because they allow Parent to dispose of Spinco stock without being taxed, a result that is explicitly contemplated by the tax code.

  In recent years, the IRS commonly issued private letter rulings that allowed taxpayers to effect D4Es by using a "direct issuance" structure. In this structure, Parent would borrow cash from a lender and, a few days later, use Spinco shares to repay that debt. Parent would then use the borrowed cash to repay other debt. This structure allowed Parent to retire historic debt efficiently; it spared Parent the cost of having to solicit its historic debt holders (often credit funds that would not have been permitted to hold Spinco stock) to exchange Parent debt for Spinco stock.

  Under last week's new guidelines, the IRS will no longer issue rulings to taxpayers seeking to use this "direct issuance" structure. This reflects the IRS's skepticism about respecting the short-term debt as true debt; the IRS now believes the "direct issuance" structure too closely resembles a sale.

  As an alternative, the IRS signaled some openness to ruling on a different D4E structure. The alternative, sometimes called an "intermediated" structure, involves one or more financial institutions acquiring existing Parent debt from holders and then exchanging that debt with Parent for Spinco stock. This is less efficient for Parent because the additional risk to the intermediating financial institutions of acquiring and holding existing Parent debt typically results in higher execution costs. This structure also may take longer to execute than the "direct issuance" structure. Importantly, even though the IRS has signaled openness to ruling on the "intermediated" structures, it indicated that it would scrutinize them closely.

  Given the inefficiencies, timing delays and the IRS's expected close scrutiny, it is unclear whether "intermediated" exchanges will be viable alternatives for many taxpayers to use for D4Es going forward. This is a significant change in IRS practice.

- *Use of Proceeds in "Boot Purges"*. As part of typical spin-off transactions, Parent often receives a cash distribution from Spinco prior to closing. Parent is not taxed on this cash as long as it uses it to retire debt or make distributions to its shareholders. Using cash in these ways is called a "boot purge".

The new guidelines state that the IRS will rule on boot purges to creditors only if the creditors hold Parent debt that was outstanding prior to announcement of the spin ("historic debt"). Importantly, historic debt that is refinanced after announcement will lose its status as historic debt, and the IRS will not rule that repaying the refinanced debt is a valid boot purge. For this purpose, revolving facilities and commercial paper will be treated as historic debt to the extent amounts are actually owing as of announcement (even though amounts may be repaid and redrawn after announcement). This departure from recent IRS practice will adversely impact the benefit of monetization transactions for taxpayers that have debt maturities approaching between announcement and completion of a spin-off.

Timing is also an issue. The IRS has ruled often that boot purges can be completed up to 12 months after a separation closes. Now, however, the IRS is asking taxpayers to demonstrate that there are "substantial business reasons" that necessitate delaying boot purges beyond 90 days after closing.

- *Contingent Liabilities*. In many prior rulings, the IRS allowed Parent to effect a boot purge by repaying liabilities other than funded debt (*e.g.*, accrued pension liabilities, environmental liabilities and trade payables). Under the new guidelines, however, the IRS will no longer rule that repayments of these liabilities are valid boot purges. In certain circumstances, it may be permissible for Parent to cause Spinco to assume these non-debt liabilities, although there may be other commercial or legal impediments to such an assumption.
- *Retentions of Spinco Stock.* Under the tax code, a spin-off can be tax-free only if it represents a complete separation of Parent and Spinco. Parent may not retain any stock of Spinco unless it receives permission from the IRS. In recent years the IRS frequently ruled to allow Parent to retain a portion of Spinco stock where Parent demonstrated that there was a good business reason for the retention, and the retained stock would then be used for a D4E within 12 months or, instead, sold within 5 years. (The sale would be taxable.)

  The new guidelines, however, express the IRS's significant skepticism toward retentions of Spinco stock by Parent.

  First, the IRS has indicated that it will no longer issue rulings that give taxpayers flexibility to complete either a D4E within 12 months or a taxable sale within 5 years. These rulings were historically sought by taxpayers to protect against the possibility that a planned D4E became impracticable due to market conditions and permitted the taxpayer to undertake either a D4E or a taxable retention in light of future circumstances. Going forward, the IRS will require taxpayers to choose either a D4E or taxable retention (but not both) as part of its submission.

  Second, the guidance states that the IRS will apply extra scrutiny to requests for a retention ruling where certain adverse factors are present that reflect a continuing relationship between Parent and Spinco. The guidance requires additional representations, information disclosure and more rigorous analysis where there is overlap between Parent and Spinco officers, directors and employees or post-spin contractual arrangements that are not at arms' length. Given the prevalence of these features in most transactions, it may be difficult for taxpayers to obtain retention rulings in the future.

These guidelines replace Rev. Proc. 2018-53 and substantially modify Rev. Proc. 2017-52. They will apply to letter rulings postmarked or received by the IRS after May 31, 2024.

These are significant changes in the IRS's ruling practice for spin-offs, and it seems clear that more changes will be coming. Taxpayers and their advisors should continue to seek clarity in the IRS's evolving practice and then decide whether transactions can be structured to accommodate the IRS's ruling guidelines. An alternative is to structure and execute transactions without seeking private letter rulings. To be sure, many spin-offs have been completed without IRS rulings in the past. In the future, that judgment will depend on advisors' confidence in the underlying legal analysis and taxpayers' risk tolerance.

NEW YORK

J. Leonard Teti II
+1-212-474-1896
lteti@cravath.com

Andrew T. Davis
+1-212-474-1272
adavis@cravath.com

CRAVATH, SWAINE & MOORE LLP

NEW YORK

Two Manhattan West
375 Ninth Avenue
New York, NY 10001
+1-212-474-1000

LONDON

CityPoint
One Ropemaker Street
London EC2Y 9HR
+44-20-7453-1000

WASHINGTON, D.C.

1601 K Street NW
Washington, D.C. 20006-1682
+1-202-869-7700

cravath.com