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WALKING ON THIN ICE: DOES THE REVENUE PROCEDURE 2013-13 SIGNIFY THE DEMISE OF LEVERAGED SPIN-OFFS?

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ABSTRACT

Corporate taxpayers, when weighing leveraged spin-off transactions, have long relied on the comfort of Internal Revenue Service rulings to "bless" the deals. These transactions, when structured properly, are not subject to tax under section 355 of the Internal Revenue Code ("I.R.C.") and can potentially provide great monetizing opportunities to public companies. Recent developments in the Internal Revenue Service's ruling policy, however, removed the safety blanket companies had relied upon, as the Internal Revenue Service announced its decision to cease the issuance of the rulings addressing the deals' qualification for tax-free treatment.

This Note will examine the history and the complex anatomy of leveraged spin-offs and provide an analysis of conflicting views on nonrecognition treatment afforded to the transactions. It will seek to shed light on the complexities involved in the structuring of the transaction and I.R.C.'s current inability to effectively eliminate them.

[*] J.D. 2014, William & Mary Law School. I would like to thank my husband for his unconditional love and support; my family and friends, for their continuous encouragement; and the editors and staff of the *Business Law Review*, for their help and effort in the publication process.

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INTRODUCTION

In 1986, after the Tax Reform Act repealed *General Utilities & Operating Co. v. Helvering,*[1] spin-off transactions under section 355 of the tax code[2] became one of the only ways a corporation could avoid the corporate tax on distribution of its appreciated property.[3] Section 355 was designed to permit a tax-free division of a single corporation into two or more corporations when certain requirements were met,[4] on the theory that the division is merely a change in the form of an enterprise that continues to be owned by the same shareholders.[5] The driving idea behind the tax-free provision was to promote economic growth and encourage companies in extremely competitive markets to improve productivity without burdening businesses with recognition of taxable gain on the transaction.[6]

When a complex tax-free spin-off transaction is structured properly, the Internal Revenue Service ("the Service") will respect its form.[7] However, many tax practitioners, as well as the Service itself, and tax-policymakers, believe that corporate taxpayers engage in structuring transactions, otherwise taxable, as tax-free reorganizations, thus manipulating one of the last remaining tax advantages of corporate restructuring.[8] For instance, in a spin-off

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[1] 296 U.S. 200 (1935). The Supreme Court held that corporations could distribute appreciated property to their shareholders tax-free. *See id.* at 206.

[2] All section references are to the Internal Revenue Code.

[3] Liz Hoffman, *Companies to Lose IRS Blessing On Spinoffs*, LAW360 (Oct. 5, 2014, 11:31 AM), http://www.law360.com/articles/454078/companies-to-lose-irs-blessing-on -spinoffs, *archived at* http://perma.cc/R9ST-3CNG.

[4] *See* Treas. Reg. § 1.355-1(b) (1954).

[5] *See* STEPHEN A. LIND ET AL., FUNDAMENTALS OF BUSINESS ENTERPRISE TAXATION 789 (4th ed. 2008).

[6] *See* H.R. Rep No. 1337, at 1–2 (1954), *reprinted in* 1954 U.S.C.C.A.N. 4017, 4025; *see also* STEPHEN A. LIND ET AL., FUNDAMENTALS OF CORPORATE TAXATION 516 (4th ed. 1997) (describing how Congress intended section 355 to provide corporations with a tax-free mechanism to achieve a division divestiture that would be economically wise to undertake except for the prohibitive tax cost that would otherwise be incurred on a sale of that division).

[7] *See* Alison Bennett, *IRS Encouraging Discussion on Section 355 Deals No-Ruling List*, BNA MERGERS & ACQUISITIONS L. REP. NO.16, at 350 (2013).

[8] *See generally id.* (providing that according to Amie Colwell Breslow, an attorney in IRS Branch 4, one reason for the No-Rule policy is that it "became known" that there is "something special" under tax code section 355); Debra J. Bennett, *Obtaining Value from an Investment in a Controlled Corporation*, 89 TAXES 12, at 9 (2011) (summarizing various section 355 monetizing techniques); *see also* Deborah L. Paul, *Spin-Offs, Leverage and Value Extraction—A Spin by Any Other Name ...*, 91 TAXES 99, 3, at 99–101 (Mar. 2013) (arguing that current law relating to leverage and value extraction in section 355 transactions is form driven, and true reform of the law in this area would require upending concepts such as the identity of the transferor and the realization requirement).

transaction involving securities-for-debt exchange (a leveraged spin-off transaction), a parent corporation uses securities of the controlled corporation (its subsidiary) to pay off the parent's debt, which had been outstanding for some minimum period,[9] and subsequently distributes ("spins-off") the controlled corporation to its shareholders in a tax-free section 355 transaction.[10] Although the Service had generally tolerated such reorganizations, parent corporations "used this technique to raise cash to be retained by the parent" itself—which monetized the transaction.[11] The Service's approval of recent leveraged spin-off transactions despite extremely short redemption periods of the newly issued debt by the parent corporation where the "debt is born only to die"[12] further revealed possibilities for extracting capital from a subsidiary before spinning it off tax-free.[13]

Spin-off transactions are complex, and the potential tax exposures from such transactions that fail to satisfy the requirements for qualification under section 355 can be devastating to the parent corporation and its shareholders.[14] Accordingly, when considering leveraged spin-off transactions, public companies long relied on the comfort of the Service's private letter rulings to bless deals.[15] Historically, private letter rulings could address the entirety of the spin-off transaction, reviewing all of the tax consequences, and providing the Service's standing on whether the transaction

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[9] *See* Paul, *supra* note 8, at 104.

[10] Debt-for-debt exchanges allow the parent corporation to exchange certain types of debt securities of the controlled corporation for the parent's outstanding debt without regard to the tax basis of the assets of the controlled entity. *See* discussion *infra* Part II. There have been various legislative proposals in recent years that generally would have, if enacted, limited this flexibility to engage in debt-for-debt exchanges where the amount of Controlled debt securities exceeds the tax basis of the controlled corporation's assets. *See* Matthew A. Rosen & Thomas F. Wood, *New IRS Policies and the Future of Tax-Free Spin-Off and Split-Off Transactions*, SKADDEN, ARPS, SLATE, MEAGHER & FLOM LLP, at 4 (Feb. 13, 2013), https://www.skadden.com/insights/new-section-355-no-rule-policies, *archived at* http://perma.cc/UR4T-RKUQ.

[11] Jasper L. (Jack) Cummings & Edward Tanenbaum, *Section 355 No-Rule Tightened*, ALSTON & BIRD TAX BLOG, at 2 (Jan. 2, 2013), http://www.alston.com/taxblog/?entry=4775, *archived at* http://perma.cc/5U8F-Z22M [hereinafter Cummings & Tanenbaum].

[12] Amy S. Elliott, *ABA Meeting: Practitioners Consider How Current Code Distorts Leveraged Spinoff Decisions*, 2012 TNT 220-5, 224 (Nov. 14, 2012) [hereinafter Elliott, *ABA Meeting: Code Distorts Leveraged Spin-Off*] (citing Deborah L. Paul of Wachtell, Lipton, Rosen & Katz).

[13] *See id.*; *see also* Robert Rizzi, *IRS Opens the Gates: Sara Lee's Spinoff Ruling*, 40 J. CORP. TAX'N 24, 24 (2013) [hereinafter Rizzi, *IRS Opens the Gates*].

[14] Karen G. Sowell & Shane Kiggen, *Role of the Step Transaction Doctrine in Section 355 Stock Distributions: Control Requirement and North-South Transaction*, N.Y. ST. B. ASS'N TAX SEC. REP. 1292, at 2 (Nov. 5, 2013).

[15] *See* Hoffman, *supra* note 3.

qualifies for tax-free treatment.[16] The government, however, tweaked this benign practice by removing the safety blanket previously available to corporate taxpayers through issuance of Revenue Procedure 2013-3[17] in January of 2013. The Procedure is widely known as the 2013 No-Rule policy and provides a list of areas in which the Service no longer will issue private letter rulings.[18] Specifically, the 2013 No-Rule policy announced that the Service would no longer issue rulings as to whether a debt-for-debt exchange in connection with a leveraged spin-off transaction is tax-free where new debt of the distributing corporation is issued as part of the transaction.[19]

On June 25, 2013, the Service expanded its No-Rule policy with respect to spin-offs through issuing Revenue Ruling 2013-32, which provides that the Service will no longer rule on whether leveraged spin-offs qualify for tax-free treatment, but instead will rule only on significant issues presented in such cases.[20] The Service's decision to expand its No-Rule policy will likely have the most significant impact on public spin-offs as section 355 transactions involving debt-for-debt exchanges are going to be subject to increased complexity and uncertainty.[21] The restrictive policy outlined in this Procedure will apply to all letter-ruling requests received after August 23, 2013 and from that point, as the result of the change in the ruling policy, corporate taxpayers wishing to proceed with the leveraged spin-off transactions will have to rely solely on the opinion of the counsel.[22]

Part I of this Note will give a historical perspective and the policy behind section 355. Part II will discuss the operation of section 355 in the context of leveraged spin-offs and, specifically, the treatment of those transactions by the Service prior to the issuance of Revenue Rulings in 2013. Part II will also discuss the divide amongst tax practitioners on the tax-free treatment afforded to leveraged spin-off transactions. Part III will compare the opinions by tax practitioners who view the transaction as purely tax-motivated with those that find compelling policy reasons to permit

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[16] *See* Sowell & Kiggen, *supra* note 14.

[17] Rev. Proc. 2013-3, 2013-1 I.R.B. 113.

[18] *Id.*

[19] *Id.*

[20] *See* Rev. Proc. 2013-32, 2013-28 I.R.B. 55, 56. *See also IRS Limits Rulings to "Significant Issues" in Certain Corporate Transactions*, 119 J. TAX'N 4 (2013); *Guidance Restricts Scope of Corporate Letter Rulings on Issues Involving Nonrecognition Provisions*, 72 TAX PRAC. 519, § 4 (July 8, 2013).

[21] *See* Thomas R. May & Reza Nader, *IRS Significantly Expands "No-Rule" Policy for Spin-Offs and Other Corporate Transactions*, BAKER & MCKENZIE, at 3 (July 15, 2013), http://www.bakermckenzie.com/files/Publication/6c64895c-80eb-46e0-a037-5419005e2053/Presentation/PublicationAttachment/e377f83e-61f2-4fdd-bb75-ca5bbde03620/al_tax_irs corporatetransactions_jul13.pdf, *archived at* http://perma.cc/UE8Q-DBLL.

[22] *See id.* at 1, 3, 4.

flexibility in the structuring of corporate division. Finally, Part IV will discuss the most recent development in the Service's treatment of the transactions and will address the recent No-Rule policy.

I. HISTORY AND POLICY UNDERLYING SECTION 355 SPIN-OFFS

A spin-off is one of the most common types of tax-free corporate divisions permitted under section 355 of the I.R.C.[23] In a spin-off transaction, a parent corporation forms and contributes some of its assets to a new corporation, a subsidiary.[24] It then distributes the stock of this newly formed corporation to its shareholders on a pro-rata basis with each shareholder emerging as the result of the transaction as an equal owner in each corporation.[25] Because a spin-off transaction involves a distribution of a parent corporation's property—the subsidiary's stock—to shareholders without the surrender of any of their stock in the parent company, the transaction resembles a dividend.[26]

The tax law provided for tax-free treatment of certain forms of corporate separations since the enactment of the first corporate reorganization provisions in the Revenue Act of 1918.[27] The spin-off transactions, however, were not included within the reorganization provisions until the enactment of the Revenue Act of 1924.[28] When spin-offs were originally introduced,

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[23] *See generally* I.R.C. § 355 (describing, in numerous subsections, a spin-off using the terms "distributing corporation" and "controlled corporation" instead of the lay terms parent and subsidiary).

[24] *See* STEPHEN SCHWARZ & DANIEL J. LATHROPE, FUNDAMENTALS OF BUSINESS ENTERPRISE TAXATION 817 (5th ed. 2012).

[25] *Id.* An example of a spin-off would be a corporation (C) that operates two businesses: chicken ranch and winery. *See id.* A and B are equal and the only shareholders of C. *See id.* C transfers all of the chicken ranch assets to a newly formed subsidiary (S), and then distributes S's stock pro-rata to A and B. *See id.* Immediately after the distribution, the same two shareholders, A and B, own the two businesses' operations in the same proportions as before, only now the businesses are contained in two separate entities rather than as divisions of one corporate entity. *See id.*

[26] *Id.* Dividends are distributions of property by a corporation to its shareholders due to their ownership of corporate stock. *Id.* at 524. Although dividends commonly are paid in cash, they may also take a form of stock in a corporation owned by a parent company and generally must be included in the recipient gross income. I.R.C. § 301(c)(1).

[27] Section 202(b) of the Revenue Act of 1918 provided for nonrecognition of gain or loss "when in connection with the reorganization, merger, or consolidation of a corporation a person receives in place of stock or securities owned by him new stock or securities of no greater aggregate par or face value." Pub. L. No. 65-254, § 202(b), 40 Stat. 1057, 1061 (1919).

[28] Section 203(c) of the Revenue Act of 1924 provided that if there was a distribution of stock or securities to a shareholder pursuant to a plan of reorganization without the surrender

the purpose was to permit tax-free separation of one or more active businesses formally operated by a corporation.[29] However, the poorly constructed statute provided taxpayers with a convenient opportunity to distribute assets from a corporate solution without incurring a shareholder-level dividend tax and escaping dividend income. For example, a corporation could transfer its assets to the newly created subsidiary, distribute the stock of the subsidiary to the parent-company shareholders, and then liquidate the subsidiary so the shareholders could obtain the assets. Upon liquidation of the subsidiary, the shareholders would be taxed at capital gains rate rather than ordinary income;[30] thus, the shareholders effectively could utilize the spin-off provisions to convert ordinary income from dividends into capital gains treatment.[31] This statutory blanket exemption from the tax on dividend income remained available until the landmark case *Gregory v. Helvering*[32] promulgated the business purpose test.[33]

Even before *Gregory* reached the Supreme Court, in light of staggering concerns that businesses were being spun off solely for tax-avoidance purposes, Congress rescinded the tax-free treatment formerly accorded to

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of stock or securities by the shareholder, no gain would be recognized by the shareholder from the receipt of stock. Pub. L. No. 68-176, § 203(c), 43 Stat. 253, 256–57 (1924).

[29] House Comm. on Ways and Means, Internal Revenue Bill of 1921, H.R. Rep. No. 350, 67th Cong., 1st Sess. 10–12 (1921), reprinted in 95 INTERNAL REVENUE ACTS OF THE UNITED STATES 1909–1950: LEGISLATIVE HISTORIES, LAWS, AND ADMINISTRATIVE DOCUMENTS (Bernard D. Reams ed., 1979).

[30] Taxpayers paid 46 percent taxes for dividends at the highest tax rate, while capital gains were taxed only at 12.5 percent. Revenue Act of 1924, Pub. L. No. 68-176, §§ 210, 211, 214, 43 Stat. 253, 264–71 (1924) (codified at I.R.C. §§ 210, 211, 214 (1924)). *See also* Karim H. Hanafy, *Section 355 Spin-Off + Section 368 Reorganization [Not Equal to] Section 355(e). It's Simple Math: The Anti-Morris Trust Bill Simply Does Not Add Up*, 1 H. BUS. & TAX L.J. 119, 123 n.18 (2001).

[31] *See* discussion *infra* note 32.

[32] 293 U.S. 465 (1935). In *Gregory*, the taxpayer owned all of the stock of a corporation, which in turn owned certain securities the taxpayer wished to sell. *Id.* at 467. Rather than distributing these securities as taxable dividend, the taxpayer caused the corporation to transfer the securities to a newly formed corporation in exchange for its stock and then distribute such stock to the taxpayer. *Id.* The taxpayer asserted that the described transactions qualified as a divisive reorganization, even though three days after receiving the stock she liquidated the newly formed corporation to get hold of the securities, and reported a capital gain on the liquidation. *Id.* The Board of Tax Appeals agreed based on the fact that the transaction fully complied with the literal language of the reorganization provisions. *Id.* at 468. The Second Circuit in *Helvering v. Gregory*, 69 F.2d 809, 811 (2d Cir. 1934), and the Supreme Court in *Gregory v. Helvering*, 293 U.S. 465, 469 (1935), both reversed with the latter basing its decision on the theory that the transaction was a "mere device" for bailing out Distributing's earnings and profits at capital gain rates, not a genuine business-motivated restructuring as contemplated by the reorganization provision.

[33] *See Gregory*, 293 U.S. at 469.

spin-offs.[34] After several proposals to reinstate the spin-off as a vehicle for tax-free reorganizations, Congress finally amended the Code in 1951[35] to provide for a tax-free spin-off, taking the position that it was "economically unsound to impede spin-offs which break up businesses into a greater number of enterprises, when undertaken for legitimate business purposes."[36] However, Congress incorporated the device test to deter tax avoidance practices,[37] which was finally replaced three years later by section 355, in substantially its current form.[38]

There were no significant legislative changes to section 355 for thirty years until the repeal of the *General Utilities* doctrine[39] by the Tax Reform Act of 1986.[40] The *General Utilities* doctrine provided that a corporation generally could distribute appreciated property[41] to its shareholders without recognizing any income at the corporate level.[42] Congress repealed the doctrine by imposing a corporate level tax on the distribution of appreciated property to shareholders, as if the corporation had sold such property for its fair market value.[43] After the repeal of the *General Utilities* doctrine, section 355 became "the most significant remaining statutory exception"[44] to the rule that all corporate distributions of appreciated property are subject to

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[34] *See* Revenue Act of 1934, Pub. L. No. 73-216, 48 Stat. 680.

[35] *Compare id.*, *with* Revenue Act of 1951, Pub. L. No. 82-183, § 317, 65 Stat. 452, 493 (1951).

[36] S. REP. NO. 82-781, 2029 (1951), *reprinted in* 1951 U.S.C.C.A.N. 1968, 2019.

[37] To cure the infirmities revealed by *Gregory*, the Act subjected spin-off transactions to section 39.112(b)(11), under which a spin-off was presumed to be tax-free unless it appeared that a corporation that was a party to a reorganization "was not intended to continue the active conduct of a trade or business after such a reorganization or ... the corporation whose stock [was] distributed was used principally as a device for the distribution of earnings and profits to shareholders." I.R.C. § 39.112(b)(11) (1954).

[38] *See* Revenue Act of 1954, Pub. L. No. 83-591, § 355(b), 68A Stat. 114 (1954); *see also* Donald F. Bronson, *Spin-Offs Before and After the Tax Reform Act*, 38 BUFF. L. REV. 157, 162 (1990) (stating the requirements of the section generally resembled those placed on corporations since *Gregory*, with the objective to prevent the use of spin-offs as a means of converting shareholder-level dividend income into capital gain).

[39] *See* General Utilities & Operating Co. v. Helvering, 296 U.S. 200, 206 (1935). The doctrine had been codified under section 311(a)(2) of the Revenue Act of 1954. *See* SCHWARZ & LATHROPE, *supra* note 24, at 541.

[40] *See* Pub. L. No. 99-514 §§ 631–33, 100 Stat. 2085 (codified in I.R.C. §§ 311, 336, 337).

[41] Appreciated property is property that has a fair market value in excess of its basis. *See* I.R.C. § 311(b)(1)(B). Property's basis is its cost. I.R.C. § 1012.

[42] *See General Utilities*, 296 U.S. at 206.

[43] *See* I.R.C. § 311(b).

[44] John R. Wilson, *A New Spin on Corporate Spin-offs: Rev. Proc. 96-30*, 25 CORP. LAW. 109, 111 n.1 (1996).

double taxation.[45] Retaining the tax-free principle as its core, section 355 has been the primary means of effecting spin-off transactions.[46]

Naturally, Congress feared that after 1986 "tax-free spin-offs could be utilized as an escape hatch to distribute appreciated property ... out of corporate solution tax-free."[47] In response to this concern, in the following years, Congress amended section 355 to deny tax-free treatment when shareholders or the parent corporation itself has acquired control of the subsidiary during the five-year period preceding the spin-off.[48] The section was further revised to render certain distribution taxable to distributing corporation[49] so as to capture all of the transactions it intended to prevent.

II. Mechanics of Leveraged Spin-Offs

As discussed in Part I of this Note, section 355 generally permits a corporation to distribute appreciated stock of a subsidiary corporation to its shareholders without triggering any gain at either the corporate or shareholder level if the transaction meets an intricate set of statutory and judicial requirements.[50] The fundamental tax policy principle underlying tax-free treatment of spin-offs is that the division is "merely a change in the form of an enterprise that continues to be owned by the same shareholders."[51] While current law does impose constraints, depending on how the spin-off

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[45] *Id*.

[46] *Id.* at 109. In the absence of section 355, if the fair market value of a subsidiary's stock were to exceed the adjusted basis in the hands of a parent corporation, section 311(b) would require that the parent recognize a gain equivalent to the appreciation of the distributed stock. I.R.C. § 311(b). In addition, the shareholders of the parent corporation would have to include in their income the fair market value of the stock, which would be taxable as a dividend. § 301. Section 355, however, steps in to provide that no gain or loss will be recognized by the shareholder of a corporation who receives stock of the corporate subsidiary, so long as the transaction meets certain conditions. § 355(a). Thus, the tax on such distribution would be completely deferred until the shareholders sell the stock. On receipt of the stock, the shareholders take a carryover basis under section 368(a), and they would be subject to only one level of tax, at capital gain rates, upon disposition. I.R.C. § 368(a)(1)(D), (2)(H)(ii).

[47] Hanafy, *supra* note 30, at 125.

[48] I.R.C. § 355(b)(2)(D).

[49] I.R.C. § 355(d)(2)(A)–(B). Section 355(d) applies where a person purchases stock of a parent corporation within five years preceding the spin-off of a corporate subsidiary, and such stock either: (1) represents 50 percent or more of the parent's outstanding stock after the spin-off, or (2) results in the purchaser receiving 50 percent or more of the outstanding subsidiary's stock in the spin-off. *Id.*

[50] *See* I.R.C. § 355.

[51] Jeffrey M. Trinklein & Kathryn A. Kelly, *Overview of US Corporate Taxation in 2012–2013*, *in* Corporate Tax 188 (William Watson ed., Global Legal Group 2013) (citing to various subsections of I.R.C. § 355).

is structured,[52] taxpayers often may extract value from the controlled subsidiary by utilizing permissible alternative transactions.[53] For example, if a subsidiary transfers cash to the parent corporation, the cash is tax-free only to the extent of the parent's tax basis in the controlled subsidiary;[54] on the other hand, debt securities can be distributed tax-free without the same basis limitation.[55]

Absent basis limitation, leveraged spin-off transactions generally provide the most beneficial results to taxpayers.[56] In the typical leveraged spin-off, a subsidiary issues its debt securities to the parent corporation[57] and the parent corporation then exchanges those debt securities with the parent's debt holders for its own debt.[58] For example, the parent corporation issues short-term debt to a lender (e.g., an investment bank) in exchange for cash and subsequently transfers some assets to its subsidiary in exchange for subsidiary's stock or securities.[59] The parent corporation then retires incremental amounts of its newly issued debt by exchanging it with the lender for the subsidiary's stock or securities.[60] At the same time, the parent corporation distributes the remaining subsidiary's stock or securities to the parent's shareholders in a tax-free section 355 spin-off. [61] Ultimately, the

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[52] To qualify as a tax-free spin-off under section 355, a corporate division must satisfy a number of statutory requirements: A parent corporation must control the stock or securities of a subsidiary immediately prior to spin-off, and it also must distribute all of the subsidiary's stock or securities or an amount of stock sufficient to constitute control. I.R.C. §§ 355(a)(1)(A), (D). The "control" requirement is defined as an ownership of 80 percent of the total combined voting power and 80 percent of the total number of shares of all classes of stock. § 368(c). Furthermore, both the parent corporation and subsidiary must be engaged immediately after the spin-off in an actively conducted trade or business, which has been so conducted throughout the five-year period ending on the date of the spin-off. §§ 355(a)(1)(C), (b). The spin-off transaction may not be used "principally as a device for the distribution of the earnings and profits" of either the parent or subsidiary. § 355(a)(1)(B). In addition to statutory tests, a spin-off transaction must satisfy judicially created limitations: first, nonrecognition is available only if the distribution is carried out for an independent corporate business purpose, Treas. Reg. § 1.355-2(b) (2011); second, the shareholders prior to the spin maintain adequate continuity of interest in both the parent and subsidiary; and third, the continuity of business enterprise is maintained after the spin. Treas. Reg. §§ 1.355-1(b), 1.355-2(c) (2011).

[53] *See* Paul, *supra* note 8, at 104.

[54] *Id*.

[55] *Id*.

[56] *Id*.

[57] *See* Trinklein & Kelly, *supra* note 51, at 189.

[58] *Id*.

[59] Amy Chapman, *IRS Issues "No-Rule" Order on Several Section 355 Transactions*, KPMG REPORT, at 4 (June 17, 2013), http://www.kpmg.com/US/en/IssuesAndInsights/ArticlesPublications/taxnewsflash/Documents/061713-no-rule-355.pdf, *archived at* http://perma.cc/43CR-778U.

[60] *Id.*

[61] *Id.*

parent corporation retains the cash from the debt issuance while its related debt has been retired using the subsidiary's securities.

No basis limitation is imposed on the parent's receipt of the subsidiary's securities regardless of what the basis of the parent corporation in the subsidiary's assets is.[62] Accordingly, the parent corporation is able to extract value from its subsidiary to the extent that its newly issued debt exceeds the subsidiary's assets basis, in circumstances that would otherwise trigger the recognition of gain to the parent.[63]

Because of the inherently difficult nature of the leveraged spin-off transactions and careful tax planning involved, the Service, until recently, has been willing to provide the corporate taxpayers and their advisors with some guidance in the form of private letter rulings formulating the Service's stand on a particular transaction.[64] Numerous private rulings have approved leveraged spin-off structure.[65] At the beginning, the Service issued such rulings only when the debt of the parent corporation that was exchanged for the subsidiary's debt was historic debt, not incurred as part of the transaction, and only when the parent corporation did not increase its debt in contemplation of the transaction "other than in the ordinary course of its business as necessary to meet its working capital and similar needs."[66] As a practical matter, however, holders of the historic debt could well be reluctant to swap the parent's debt for the debt of the subsidiary—such debt generally would involve a different issuer in a different business and terms of maturity, interest rate, and other characteristics that are different from those of the parent's debt.[67] In light of these concerns, a practice emerged for a "friendly" investment bank to purchase the parent's historic debt from the existing holders and exchange it for the subsidiary's debt.[68]

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[62] The parent corporation will not recognize gain or loss on the transfer of the subsidiary's stock or securities in exchange for the parent's debt, provided that all conditions are satisfied. I.R.C. § 361(a). If the parent's debt is a security and holders receive no "excess principal amount," then the exchange is also tax-free to the parent's debt holders. I.R.C. § 355(a)(3)(A).

[63] Trinklein & Kelly, *supra* note 51, at 189.

[64] *See* discussion *infra* Part IV.

[65] *See infra* notes 67, 69.

[66] Chapman, *supra* note 59, at 4 (citing Treas. Reg. § 1.382-9(d) (1994)). *See also, e.g.*, I.R.S. Priv. Ltr. Rul. 2003-45-050 (Nov. 7, 2003); I.R.S. Priv. Ltr. Rul. 2007-16-024 (Apr. 20, 2007).

[67] *See* Paul, *supra* note 8, at 104.

[68] *See id.*; *see, e.g.*, I.R.S. Priv. Ltr. Rul. 2008-32-001 (Apr. 30, 2008) (step 5); I.R.S. Priv. Ltr. Rul. 2007-47-012 (Aug. 28, 2007) (step (6)); I.R.S. Priv. Ltr. Rul. 2007-32-002 (May 11, 2007). The Service permitted these transactions by referencing to a practice, which had evolved years earlier in the area of stock-for-debt exchanges under section 108. *See* Gary B. Wilcox, *Issuing Mixed Consideration in Troubled Debt Restructuring*, 10 VA. TAX REV. 357, 371–75 (1990). Prior to the enactment of section 108(e)(10) pursuant to the Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 59, 98 Stat. 494 (1984),

Recent incarnations of the debt-for-debt exchange transactions which were approved by the Service—the so-called 5/14 Plans—involved scenarios in which the parent corporation issued short-term debt to an investment bank, in exchange for cash, for five days.[69] The parent corporation and the bank then would enter into a debt-for-debt exchange agreement, under which they would agree in another eleven days to exchange the newly issued parent's debt for the subsidiary's securities, which the bank subsequently would sell in the market.[70] The Service consistently concluded that such transactions will be allowed a tax-free treatment so long as the taxpayer represented that the parent corporation did not artificially increase its leverage in anticipation of the spin-off[71] and the parties respected the five-day interval between the debt issuance and the entry into the exchange agreement, as well as the fourteen-day interval between the debt issuance and the debt repurchase.[72] The importance placed upon the day-counting representations by the corporate

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the issuance by a corporation of stock in exchange for its own debt generally did not result in cancellation of debt income. *See id.* Accordingly, a corporation that wanted to take advantage of this rule would issue stock to a friendly investment bank that had recently purchased the corporation's debt from the existing third-party debt holders. *See* Paul, *supra* note 8, at 104. In response, by enacting section 108(e)(10), the Service required the investment bank to hold the debt for a period of time in order to demonstrate that they were true creditors. *See* I.R.S. Tech. Adv. Mem. 87-38-003 (May 22, 1987); I.R.S. Tech. Adv. Mem. 87-35-007 (May 18, 1987); I.R.S. Tech. Adv. Mem. 87-35-006 (May 18, 1987) (the bank's acquisition of debt preceded execution of the exchange agreement by anywhere from three days to over four months). *See also* J. William Dantzler Jr., *Spinoffs: Still Remarkably Tax Friendly*, 129 TAX NOTES 683, 689 (2010), *available at* http://www.whitecase.com/files/Publication/86b9a23d-00ac-4550-b3c9-bb0b7ba20c9f/Presentation/PublicationAttachment/0cab9161-7498-4074-994d-c43ad0b2aaf1/Article_Spinoffs_Still_Remarkably_Tax_Friendly.pdf, *archived at* http://perma.cc/E537-SMLE (noting that the techniques of the early 1980s, under which banks purchased the outstanding debt prior to any binding obligation to consummate the exchange, have been applied to spin-offs).

[69] *See* Trinklein & Kelly, *supra* note 51, at 189; *see also* Chapman, *supra* note 59.

[70] *See* Trinklein & Kelly, *supra* note 51, at 189. To obtain an approval from the Service for these types of transactions, corporate taxpayers would have to represent that the spin-off would not take place until at least five days following the issuance of the parent's debt, and that this newly issued debt would be held for at least fourteen days before the parent's debt lenders were redeemed out for the subsidiary's securities. *See* Rizzi, *IRS Opens the Gates*, *supra* note 13, at 26.

[71] Generally, taxpayers would be able to prove the legitimacy of the transaction by demonstrating that the total amount of the debt exchanged in the transaction does not exceed the average amount of the parent's debt outstanding in the previous year. *See* Elliott, *ABA Meeting: Code Distorts Leveraged Spin-Off*, *supra* note 12; *see also* Robert Willens, *Ralcorp's Plans for Its Retained Post Shares Revealed in Ruling*, 134 TAX NOTES 1273 (2012), http://www.robertwillens.com/index.cfm/fuseaction/report.detail/articleID/f899110b-b85a-4d7e-b103-576360741f53.

[72] *See* I.R.S. Priv. Ltr. Rul. 2012-32-014 (Aug. 10, 2012); I.R.S. Priv. Ltr. Rul. 2011-32-009 (Aug. 12, 2011); I.R.S. Priv. Ltr. Rul. 2011-29-005 (July 22, 2011); I.R.S. Priv. Ltr. Rul. 2010-32-017 (Aug. 13, 2010); I.R.S. Priv. Ltr. Rul. 2008-02-009 (Jan. 11, 2008).

taxpayers reflects an attempt by the Service to test whether the parties to the transaction—the parent corporation, subsidiary, and debt lender(s)—should be treated as bearing real economic risk, with the focus on whether the parent's debt could be safely treated for tax purposes as actually "owned" by the debt lenders acting for their own account.[73]

It appears then that in approving 5/14 Plan structures, the Service has applied a narrow version of the step transaction doctrine,[74] which permits an integration or re-characterization of a series of separate transactional steps for federal income tax purposes "if the steps are closely related and undertaken with a view to a common objective."[75] Under a traditional step transaction doctrine analysis, the newly issued parent's debt would not be respected generally if it is issued only to be subsequently redeemed.[76] Accordingly then, one could argue that under the 5/14 Plan, although the agreement with the lending bank to exchange debt is not entered into until five days after the issuance of the parent's debt, the redemption of the debt may be viewed as the end result, and the issuance and redemption of the debt as mutually interdependent.[77] This suggests the possibility of an application of the step transaction doctrine to the 5/14 structures, under which the newly issued debt would not be respected.[78]

The Service, however, seems to take the view that, because the debt lenders subject themselves to the risks for fourteen days and there is no binding agreement to future exchange at the time the debt is issued since the exchange agreement is entered only five days after the issuance of the new debt, the step transaction doctrine would respect the debt.[79] The readily apparent availability of these types of logical-on-their-surface arguments, however, lie at the heart of the disagreement among tax practitioners with respect to

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[73] *See* Rizzi, *IRS Opens the Gates*, *supra* note 13, at 26.

[74] *See* Paul, *supra* note 8, at 105.

[75] *See* Sowell & Kiggen, *supra* note 14, at 4. The step transaction doctrine is a judicially created doctrine originating from a principal established and discussed in Part I of the case *Gregory v. Helvering*, 293 U.S. 465 (1935), which allowed the court to re-characterize a tax-motivated transaction. *See* Sowell & Kiggen, *supra* note 14, at 13. Where the doctrine applies to integrate a series of formally separate transactional steps, it operates to prevent the division of a single transaction into its parts in a manner that frustrates the purposes of a given Code provision. *See* Sowell & Kiggen, *supra* note 14, at 5. Additionally, the doctrine applies to re-characterize a transaction as a different, but economically equivalent, transaction, by ignoring the intervening stops in a multi-step transaction. *Id.*

[76] *See* Paul, *supra* note 8, at 105.

[77] *Id.*

[78] *Id.*

[79] *Id.* Indeed, in *Comm'r v. Gordon*, 391 U.S. 83, 96 (1968), the Supreme Court stated that in order for there to be a "first step" in a step transaction, "there must be a binding commitment to take the later steps."

the tax-free treatment of the leveraged spin-offs,[80] and perhaps, inflicted the recent No-Rule policy development.[81]

III. DISAGREEMENT AMONG PRACTITIONERS

The recent developments in the treatment of the leveraged spin-off transactions led to disagreements among practitioners about whether the taxpayer-favorable position taken by the Service in the 5/14 Plan rulings and other similar rulings dealing with corporate divisions were consistent with fundamental tax principles that would generally indicate taxable exchange treatment for these transactions.[82]

At the root of the division among the practitioners' views is the intricate relationship between two fundamental tax policy principles.[83] On one hand, the Code provided incentives for corporate restructurings by affording tax-free treatment for spin-offs and corporate reorganizations.[84] On the other, the Code imposes tax where a taxpayer disposes of property and receives cash in excess of the taxpayer's basis in such property.[85] With this background in mind, some practitioners argue that the parent's shift of debt to the subsidiary in excess of the parent's basis is equivalent to the receipt of cash in excess of basis and thus is a squarely appropriate circumstance for imposition of tax.[86] Accordingly, they argue, leveraged spin-off transactions can be purely tax motivated.[87] Those practitioners supporting the current tax-free treatment of the transactions counter that there are compelling policy reasons to permit flexibility in the structuring of corporate divisions.[88] This Note summarizes the reasoning of both groups below.

A. Arguments Supporting the Tax-Free Treatment of Leveraged Spin-Off Transactions

Strong arguments can be made in support of the current tax-free treatment of the leveraged spin-off transactions.[89] Despite the obvious tax benefits

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[80] *See* Paul, *supra* note 8, at 99.
[81] *Id*.
[82] *Id.* at 100.
[83] *See* Trinklein & Kelly, *supra* note 51, at 188.
[84] I.R.C. §§ 355, 368 (2012).
[85] I.R.C. § 1001 (2012).
[86] *See infra* Part III.B.
[87] *See* Paul, *supra* note 8, at 105; *see also* Elliott, *ABA Meeting: Code Distorts Leveraged Spin-Off*, *supra* note 12.
[88] *See* Elliott, *ABA Meeting: Code Distorts Leveraged Spin-Off*, *supra* note 12.
[89] *See, e.g.*, Candace A. Ridgeway, *Myths and Legends of "RMT" Spinoffs*, 53 TAX MGM'T MEMO. 179, 180 (2012) (arguing that even spin-offs coupled with mergers represent

of spin-offs, numerous reasons indicate why companies pursue these transactions, most of which are consistent with directors' and officers' fiduciary duty to maximize shareholder value and have nothing to do with federal taxation.[90] By virtue of the "business purpose" requirement,[91] spin-offs always have a legitimate business purpose and stem from legitimate business considerations rather than tax planning alone.[92] In fact, many tax practitioners support the view that imposing a basis limitation on the amount of leverage that can be shifted to a subsidiary may interfere with the *bona fide* business and economic capital structure for the parent company and the corporation it controls.[93] After all, as the parent company reduces its asset base, as an economic matter, it should be able to shed some of the corporate group's debt and business considerations, rather than the Code setting an artificial limit on the basis, and it should determine the amount of debt that is shifted.[94]

Another strong argument supporting the current tax-free treatment of leveraged spin-off transactions is that, in line with the general policy behind

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readjustments in structure that generally should be entitled to tax deferral); Neil J. Barr, *Uncertainty Regarding the Tax Treatment of Liabilities in Divisive Reorgs Survives the AJCA*, 105 TAX NOTES 1125, 1130 (2004) (arguing that where the parent corporation exchanges subsidiary's securities for its own debt, the holders retain "a continuing economic interest in a historic distributing corporation's business, which, under general principals is not the occasion for a recognition event").

[90] *See* Edward S. Adams & Arijit Mukherji, *Spin-Offs, Fiduciary Duty, and the Law*, 68 FORDHAM L. REV. 15, 16, 39 (1999) [hereinafter Adams & Mukherji].

[91] Treas. Reg. § 1.355-2(b) (2011).

[92] *See* Paul, *supra* note 8, at 101.

[93] *See* Amy S. Elliott, *Practitioners Wary on Transportation Bill's Anti Reverse Morris Trust Provision*, 134 TAX NOTES 1371, 1372 (2012) [hereinafter Elliott, *Practitioners Wary*] (citing the view of a mergers and acquisition tax practitioner that the perception that taxpayers are using leverage to enable "a cashing out" fundamentally fails to appreciate the economics of a separation and the policy of section 361 because a parent corporation must divide its debt between the parent and subsidiary in order to effectuate the distribution). "[T]here are policy reasons for the tax law to facilitate corporate separations when the two businesses have different capital structures." *See* Elliott, *ABA Meeting: Code Distorts Leveraged Spin-Off*, *supra* note 12 (citing Thomas F. Wessel of KPMG LLP).

[94] *See* Elliott, *ABA Meeting: Code Distorts Leveraged Spin-Off*, *supra* note 12 (citing Thomas F. Wessel of KPMG LLP). Supporters of this view additionally refer to the fact that in enacting section 355(e), designed to prevent the avoidance of corporate tax on prearranged sales of corporate stock, Congress avoided imposition of any additional restrictions on the amount or proportion of liabilities that could be shifted in connection with a spin-off transaction. *See* Robert A. Rizzi, *Debt to Creditors: The Ongoing Debate Over Nonstock Payoffs in Spinoffs*, J. CORP. TAX'N 18, 23 (2011) [hereinafter Rizzi, *Debt to Creditors*]. Thus, it appears that Congress avoided second-guessing allocations of indebtedness between and among parties to spin-off transactions presumably in part due to the fact that tax regulators were suspicious of imposing their own standards on the appropriate terms of commercial financial transactions, whether within a corporate family or between corporations and third-party lenders. *Id.*

section 355, the Code should not stand in the way of divisive transactions, which can make businesses smaller, more manageable, and, thus, more competitive.[95] Indeed, in a large industrialized society such as ours, it is beneficial for corporations to disaggregate their assets without significant tax impediments, as the businesses' larger sizes are not always optimal from the operational and capital structure perspectives.[96] This is especially true in the context of publicly traded companies, which often desire to separate the parent and its subsidiaries so they each can devote their attention to a single line of business.[97] Indeed, a more narrowly focused company may have greater success and increased incentive for managers to perform due to its ability to devote more energy and attention to the single enterprise.[98] Accordingly, one can argue that, based on these business considerations, the Code should promote divisive transactions[99] just as it facilitates acquisitive reorganizations.[100]

Additionally, it is often the case that corporate parties use spin-off transactions as an integral part of acquisitive reorganizations with spin-off transactions being a first step in restructuring the relevant businesses so the acquisitive reorganization can occur.[101] Retaining the tax-free treatment of the spin-offs then appears to be perfectly sensible in light of the Code's general policy of facilitating acquisitive transactions.[102]

The example of yet another argument supporting the current tax-free regime is based on the notion that spin-off transactions do not deplete the corporate tax basis, as no assets leave the corporate solution.[103] In a spin-off transaction, income from the assets that both were transferred by the parent company to its subsidiary and remained in the parent company is still subject to the corporate-level tax, and thus it would be senseless to trigger gain

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[95] *See* Bennett, *supra* note 8.

[96] *See* Paul, *supra* note 8, at 101.

[97] *See* SCHWARZ & LATHROPE, *supra* note 24, at 819.

[98] *Id.*

[99] *See* Karla W. Simmon & Daniel L. Simmons, *The Future of Section 355*, 40 TAX NOTES 291, 293 (1988) (arguing that the degree to which the corporate shareholder's relationship to corporate assets is changed in the corporate "divorce" does not differ significantly from the change in the shareholders' relationship to corporate assets in corporate "marriage," thus the logic that supports the nonrecognition treatment in acquisitive reorganizations should equally apply to divisive transactions).

[100] I.R.C. §§ 361(a), 368 (2012).

[101] *See* Paul, *supra* note 8, at 102.

[102] *Id.* (reasoning that such argument could be rationally entertained where the target business is separated from another business previously held under the same corporate umbrella in order to facilitate the consolidation of such target business with the acquirer, and both steps are motivated by an identical, genuine business rationale).

[103] "It isn't a sale transaction but a new corporation with some of the same assets and all of the same shareholders ...." Elliott, *ABA Meeting: Code Distorts Leveraged Spin-Off*, *supra* note 12 (citing Matthew A. Rosen of Skadden, Arps, Slate, Meagher & Flom LLP).

recognition at the time of the spin-off.[104] Accordingly, while the repeal of *General Utilities* stands for the proposition that gain should be recognized when assets leave corporate solution, the policy has been to disregard spin-offs as proper occasion for recognizing gain.[105] Similarly, in the context of leveraged spin-offs, to effect a distribution, the debt must be divided between a parent corporation and a subsidiary and debt transferred to the subsidiary in excess of basis merely represents a portion of the gain in the parent's stock, which Congress did not intend to tax at the time of a spin-off.[106]

B. Arguments Supporting the Taxation of Leveraged Spin-Off Transactions

Corporate taxpayers favor a debt-for-debt exchange in the context of the leveraged spin-off transactions because section 355[107] does not limit the amount of securities that the subsidiary can issue, or the amount of historic debt that the parent company can retire with the subsidiary's securities.[108] Thus, the parent corporation can maximize the value it extracts from its subsidiary by utilizing a debt-for-debt exchange as part of a combination of monetization strategies.[109]

Practitioners, however, disagree about whether the taxpayer-favorable position of the Service in the 5/14 Plan rulings, and in the similar rulings

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[104] *See* Paul, *supra* note 8, at 102.

[105] *See, e.g.*, Robert A. Rizzi, *The Fuss About Morris Trust: Spin-Off Transactions As Acquisition Techniques*, 23 J. CORP. TAX'N 303, 306 (1997) [hereinafter Rizzi, *Fuss About Morris Trust*] (describing the view that the repeal of *General Utilities* "only means that gain should be recognized when corporate assets leave 'corporate solution,'" because when assets remain in corporate solution, basis is preserved).

[106] *See* Elliott, *Practitioners Wary*, *supra* note 93 .

[107] In conjunction with section 368.

[108] I.R.C. §§ 361(b)(3), 357(c) (2012); *see generally* Robert Willens, *Corporate Reorganizations: Careful Negotiation of Rules Required in Retiring Debt in Connection with Spin Off*, BNA DAILY TAX REP., at J-1 (July 7, 2008). *But see* Tax Reduction and Reform Act of 2007, H.R. 3970, 110th Cong. § 3703 (2007) (proposal by Rep. Rangel, Chairman of the House Ways and Means Committee, to treat controlled securities as money or other property, which would limit the amount of controlled securities (and any other boot) to the basis in the assets that the parent company contributes to the subsidiary in the D reorganization under section 368(a)(1)(D), a reorganization in which the parent corporation, after transferring substantially all of its assets to the subsidiary, completely liquidates); The American Jobs and Closing Tax Loopholes Act of 2010, H.R. 4213, 111th Cong. (2010) (proposal to treat debt securities issued by a controlled subsidiary in a divisive D reorganization that exceed asset basis as triggering gain recognition). Eric Solomon, a former Treasury official, however, believes that such change in law would be an unwarranted extension of the section 357(c) policy, requiring recognition of gain where the liability to which contributed to a newly formed subsidiary property is subject exceeds the basis of all property contributed, because the stock basis of the controlled corporation disappears in section 355 distribution. *See* Amy S. Elliott, *Extenders Proposal Targets Debt Securities Issues in Spinoffs*, 2010 TNT 191-1 (Oct. 4, 2010).

[109] *See* Paul, *supra* note 8, at 104.

concerning leveraged spin-offs, is consistent with fundamental tax principles that would generally indicate taxable exchange treatment for such transactions.[110] Perhaps the strongest argument supporting the view that leveraged spin-offs can be purely tax motivated is that where the parent company shifts its debt to its subsidiary in excess of basis, it monetizes all or some part of its investment because such a transfer involves a disposition for cash in excess of basis—a straightforward case for recognition of gain.[111]

Additionally, responding to the business purpose argument against current taxation of the leveraged spin-offs, some practitioners argue that "the existence of a business purpose and the fact that economic pressures drive capital structure" and the proper imposition of tax are not mutually exclusive events.[112] Moreover, in response to the argument that the Code should facilitate divisive corporate restructurings, one may argue that promotion of "divorces" of the companies should not lead to giving a "free pass" when the parent company is cashing out as the result of the spin-off.[113]

Responding in the same manner to the argument that all assets remain in the corporate solution, one can counter that if the Code were to include a concept aimed at affording tax-free treatment to the transaction between related corporations as long as assets remained in corporate domain, then sale transactions by a corporation to another corporation would not be taxed, contrary to the current law.[114] Accordingly, where the parent company receives cash in excess of basis as the result of the spin-off transaction, the fact that assets do not leave the corporate domain should not prevent taxation of the transaction.[115]

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[110] *See* Elliott, *ABA Meeting: Code Distorts Leveraged Spin-Off*, *supra* note 12.

[111] *See, e.g.*, Rizzi, *Debt to Creditors*, *supra* note 94, at 18 (arguing that where the parent company repays its debt with securities of its subsidiary, it improves its balance sheet on a pretax basis: "[The parent] is able indirectly to use assets with built-in gain, translated through the medium of [Subsidiary] debt securities, to monetize its investment without triggering tax"). In fact, some practitioners point out that the Service ought to impose a basis limitation on the leveraged spin-offs involving securities-for-debt exchanges. *See* Paul, *supra* note 8, at 100. Such an amendment would not be desirable for those who support the view that the Code should facilitate leverage shifts in spin-offs, as the imposition of basis limitation on the transactions would undermine corporate taxpayers' abilities to achieve desirable capital structures for the parent company and the subsidiary. *Id.*

[112] *See* Paul, *supra* note 8, at 102 (pointing out that most sale transactions have a business purpose which does not preclude its taxable treatment).

[113] *Id.*

[114] "The Code does not view the corporate tax base as a whole as a single taxpayer such that assets may be moved around within it without triggering tax." Paul, *supra* note 8. Each corporation is treated as a separate taxpayer and dispositions by a single corporation of appreciated assets is a recognition event, regardless of whether the assets remain in the corporate domain. I.R.C. §§ 11(a), 1001 (2012).

[115] *See, e.g.*, Rizzi, *Fuss About Morris Trust*, *supra* note 105, at 305–06 (describing the view of many commentators and individuals in the Service and Treasury that "any movement of assets from the corporate owner, unless such movement falls within a specific statutory

One of the practitioners suggested that if lawmakers were to rewrite the law, they might consider one of four possible approaches to determining the result when the parent corporation received cash exceeding its basis in spinning off the subsidiary: first, the alter ego theory, under which the spin-off is not taxable because both the parent company and subsidiary remain in corporate solution with essentially the same shareholders; second, the sale theory Variant One, under which the spin-off would be taxable if the parent company receives cash in excess of its basis in the subsidiary; third, the sale theory Variant Two, under which the spin-off would be taxable if there is a separate pool of assets combining with one of the two companies; and fourth, the sale theory Variant Three, under which the spin-off would be taxable if the parent company received cash in excess of its basis in the subsidiary and there is a separate pool of assets combining with the leveraged company.[116] Regardless of their consistency with each other, the Service has not embraced any of the approaches and none of them is reflected in the current law.[117]

While the different views regarding the leveraged spin-offs were floating around in the tax community for quite some time, the Service's position on the tax-free treatment of the transactions remained intact provided the transactions were structured in a manner eligible for beneficial tax treatment.[118] Thus, the corporate taxpayers weighing tax-free spin-offs have long relied on comforting rulings from the Service.[119] Recently, however, the Service announced significant limitations to its ruling policy with respect to spin-offs—the development that stumped many practitioners and left the companies more reliant on the judgment of tax advisors, rather than the blessings of regulators, when structuring deals as spin-offs.[120]

IV. THE 2013 NO-RULE LIST: IMPLICATIONS FOR LEVERAGED SPIN-OFF TRANSACTIONS

As discussed in Part II of this Note, many leveraged spin-off transactions, especially in the public context, have proceeded on the basis of receiving a favorable letter ruling from the Service addressing the transactions' qualifications under section 355.[121] In January 2013, however, the Service

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scheme, should trigger corporate-level gain" even if the assets do not leave corporate solution). *See also* Melissa C. McCann, *Section 355 in a Post-*General Utilities *World: The Victim of an Overreaction?*, 23 J. CORP. TAX'N 137, 158 (1996) (acknowledging that deferral is a tax benefit that should be available only in special circumstances).

[116] *See* Paul, *supra* note 8, at 103.

[117] *See* Elliott, *ABA Meeting: Code Distorts Leveraged Spin Off*, *supra* note 12.

[118] *See* Hoffman, *supra* note 3.

[119] *Id*.

[120] *Id.*

[121] *See* discussion *infra* Part II.

announced significant limitations to its ruling policy with respect to spin-offs by updating its so-called No-Rule policy—an annual revenue procedure listing the matters on which the Service will not issue private letter rulings.[122] The Revenue Procedure 2013-3 listed three new "areas under study in which rulings ... will not be issued until the Service resolves the issue through publication of a revenue ruling, a revenue procedure, regulation, or otherwise."[123] Specifically, the 2013 No-Rule List announced that the Service will no longer issue rulings concerning whether a debt-for-debt exchange in connection with a leveraged spin-off transaction is tax-free where new debt of the parent corporation is issued as part of the transaction under the 5/14 Plan, or otherwise "in anticipation of the distribution."[124]

Although the announcement that the issue was under study did not change the tax-free treatment of leveraged spin-offs, to many tax practitioners the news was significant as it signaled that the Service potentially viewed the transactions as problematic, causing great uncertainty regarding their future treatment.[125] Indeed, the comments from the Service's officials addressing the ruling were not particularly comforting and suggested that the limitations stem from the concerns discussed in Part III.[126] For example, one of the Service's corporate counsels explained that the No-Rule announcement meant that the Service would be rethinking the transaction "pretty much from scratch" and that, as the result of the study, "[the Service] might come out in a different place" and is "not going to be bound by where [the Service was]."[127] Similarly, another Service's counsel referred to the Service becoming aware of "something special" under section 355 as one of the reasons for the No-Rule policy.[128] It appears that the Service's identification of "something special" began with the increased

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[122] Rev. Proc. 2013-3, 2013-1 I.R.B. 113 (Jan. 2, 2013).

[123] *Id.* § 5.

[124] *Id.* § 5.01(10) of Rev. Proc. 2013-3 stated that Private Letter Rulings will not be issued on "[w]hether either § 355 or § 361 applies to a distributing corporation's distribution of stock or securities of a controlled corporation in exchange for and in retirement of, any *putative* debt of the distributing corporation if such distributing corporation debt is issued *in anticipation of the distribution*."

[125] *See, e.g.*, Hoffman, *supra* note 3 (citing Steve Gordon's comparison of the leveraged spin-off rulings to a security blanket absent which companies would hesitate to engage in the transaction); Cummings, *supra* note 11 (stating that the changes brought about by the 2013 No-Rule List are significant in that they can signal that the Service may think the transaction is problematic).

[126] *See* discussion *infra* Part III.

[127] *See* Amy S. Elliott, *ABA Meeting: Practitioners Parse Implications of Expanded Corporate No-Rule Policy*, 2013 TNT 19-1 (Jan. 29, 2013) [hereinafter Elliott, *ABA Meeting: Expanded Corporate No-Rule Policy*] (citing Mark Weiss, branch 6 attorney, IRS Office of Associate Chief Counsel (Corporate)).

[128] *See* Bennett, *supra* note 7.

interest of practitioners in the transaction.[129] Both counsels admitted that, while the Service does not intend to provide a bright-line rule on what is considered "in anticipation of the distribution," it will be "skeptical" of any debt issued at any time following a taxpayer's announcement to do a spin-off.[130] To add to practitioners' concerns, one of the counsels suggested that in structuring a leveraged spin-off transaction, the mere uncertainty on the part of a structuring counsel of whether issuance of debt falls within a broad definition of words "issued in anticipation of the distribution," most likely means that, in fact, the debt was issued "in anticipation of the distribution" and the transaction is within the scope of the No-Rule ruling.[131]

Despite the concerns raised by the new No-Rule policy, the leveraged spin-off transactions that would fall within the scope of the ruling are not necessarily unworkable as lawyers may still be able to render opinions regarding their structure.[132] Proceeding with a particularly complex leveraged spin-off transaction solely on the basis of a counsel's opinion and without any significant input from the Service, however, is problematic and may cause companies' hesitation in engaging in these transactions.[133] In fact, the trend of a "chilling effect" on leveraged spin-off deals was noticed immediately after the ruling was issued.[134]

The Service significantly expanded the No-Rule policy in June 2013 when it issued a revenue procedure,[135] which significantly restricted the circumstances under which the Service was willing to issue the rulings on whether a corporate separation satisfied the requirements for section 355 tax-free treatment.[136] The Service expressed that the purpose of this change was to conserve the Service's resources[137] though taxpayers could still seek a letter ruling if the corporate separation involved a "significant issue."[138]

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[129] According to IRS Associate Chief Counsel William Alexander, if the transaction is "that interesting, then obviously that's going to cause [the Service] to take another look at [it]." Elliott, *ABA Meeting: Expanded Corporate No-Rule Policy*, *supra* note 127.

[130] *See* Bennett, *supra* note 7. It is possible, however, that the Service would not consider "old and cold" debt to be issued in anticipation of distribution. *Id.*

[131] *See* Elliott, *ABA Meeting: Expanded Corporate No-Rule Policy*, *supra* note 127 (citing Mark Weiss).

[132] *See id.*

[133] According to one tax practitioner, "[o]pinion letters [from counsel] only get you so far, especially in an environment where companies are afraid of finding themselves on the front page of the Wall Street Journal for having a deal that's challenged." *See* Hoffman, *supra* note 3 (citing Gregory Kidder, a tax partner with Steptoe & Johnson LLP).

[134] *Id.*

[135] Rev. Proc. 2013-32, 2013-28 I.R.B. 55 (July 8, 2013).

[136] *Id*.

[137] *Id.* at § 1.

[138] *Id.* § 2.01. The No-Rule ruling defined the term "significant issue" as an issue that is not clearly and adequately addressed by a statute, regulation, or other authority; the

By strengthening the standard under which the issuance of private letter rulings was allowed for section 355 transactions generally, the Service clarified when the taxpayers were still able to obtain a favorable ruling on certain crucial aspects of their corporate separations.[139] The procedure, however, provided no such clarification regarding the issuance of the rulings on leveraged spin-off transactions and the effect of the No-Rule policy regarding those transactions has yet to be fully determined.[140] The No-Rule policy changes for spin-off transactions were later incorporated in the Revenue Procedure 2014-3.[141] Meanwhile, some practitioners logically suggest that the Service should consider issuing published guidance in areas relevant to leveraged spin-off transactions yet continue to rule privately, at least until taxpayers become more familiar with the published guidance standards.[142]

CONCLUSION

Proponents of leveraged spin-off transactions endorse their longevity because they promote economic efficiency and encourage expansion in an extremely competitive market.[143] Opponents of the transactions disapprove of how inventive tax planners have wielded them to take appreciated assets out of a corporation tax-free.[144] The changes brought about by the No-Rule policy are significant as they may signal that the Service thinks the transaction is problematic. Indeed, the changes reflect the first administrative cut back on the "burgeoning expansion" of section 355 as a preferred tax relief section in a long time.[145]

There is much worry among practitioners surrounding the implication of the recent changes and the fact remains that the system is inefficient and

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resolution of which is not essentially free from doubt; and that is legally significant and germane to determining the tax consequences of the transaction. Rev. Proc. 2013-3 § 3.01(41) (Jan. 2, 2013). The Revenue Procedure 2013-32 expanded the definition by eliminating the requirement that the issue be one that is not clearly and adequately addressed by the authorities but required the taxpayers to provide an analysis of relevant law most closely related to the issue and explain why these authorities do not resolve it. Rev. Proc. 2013-32 §§ 4.01(3), 5.01(1) (July 8, 2013).

139 Rev. Proc. 2013-32 §§ 4.01(3), 5.01(1) (July 8, 2013).

140 *See* May & Nader, *supra* note 21.

141 Rev. Proc. 2014-3 §3.01(45) (Jan 2, 2014).

142 *See* Paul, *supra* note 8. Paul, citing to Revenue Procedure 2003-48, supports this argument by referring to the replacement of the Service's historical practice of issuing private letter rulings determining whether a particular transaction satisfied the "business purpose" requirement, with a published guidance in 2003. *Id.*

143 *See* Adams & Mukherji, *supra* note 90, at 16.

144 *See* Paul, *supra* note 8, at 102–03.

145 *See* Cummings & Tanenbaum, *supra* note 11.

uncertain because many of the rules are inherent in the Service's ruling practice. Corporate taxpayers must incur the time and expense of seeking rulings for many transactions, because advisors applying traditional doctrine and analyses would not be able to provide the level of comfort the parties seek. Under the circumstances, the tax world would be better off if the Service provided more guidance regarding the treatment of the leveraged spin-off transactions.