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IRS Announces Expanded "No-Rule" Area for Spinoffs

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On January 27, 2015, Yahoo Inc. announced its intention to seek an IRS private ruling that would confirm its view that the inclusion of a relatively small active business along with its stake in Alibaba Group Holding Ltd. would meet the "active business requirement" for a tax-deferred spinoff under the Internal Revenue Code. In May, the IRS announced that it was reconsidering its policy in that area, and in July it indicated that it was considering issuing new administrative guidance. On September 8, 2015, Yahoo announced that the IRS would not rule favourably on its request and withdrew the ruling request. Now the IRS has officially announced that it will not rule in cases in which the active business of either the distributing or the controlled corporation is too small. What is interesting is the manner in which the IRS concluded not to rule on this issue and, of course, the facts on which the IRS will still rule. The question remains whether opinions of counsel will continue to be issued at the same level of certainty and whether the markets will discount such spinoffs due to additional uncertainty.

When Yahoo announced the intended spinoff of assets, its stake in Alibaba was worth up to $40 billion, and the active business that Yahoo intended to distribute, along with a newly formed U.S. corporation holding the distributed assets, was probably worth no more than $600 million (or less than 1.5% of the total assets to be distributed).

In its new release, Revenue Procedure 2015-43 (the Rev. Proc.), the IRS states that its no-rule policy in the cases described below will apply to rulings submitted on or after September 14, 2015.

Ordinarily no ruling. More specifically, the IRS announced that it will "not ordinarily rule" in proposed spinoffs involving

- a RIC or REIT (other than spinoffs in which both the distributing and the controlled corporations are a RIC or a REIT); or
- cases in which the fair market value of the gross assets of the active trade or business (of either the distributing or controlled corporation) is *less than 5%* of the fair market value of the gross assets of such corporation (other than spinoffs occurring solely within a corporate group).

The "not ordinarily" in this area means that a taxpayer may still seek a ruling if the taxpayer can show that "unique and compelling reasons" justify the issuance of a letter ruling or determination letter.

Temporarily no ruling. The IRS also announced that it would "temporarily not rule" on proposed spinoffs when all three of the following conditions are met (and the spinoff does not occur solely within a corporate group):

I. the fair market value of the investment assets of the distributing or the controlled corporation is two-thirds or more of the total fair market value of its gross assets;

II. the fair market value of the gross assets of the trade or business on which the distributing corporation or the controlled corporation relies to satisfy the active trade or business requirement is less than 10% of the fair market value of its investment assets; and

III. the ratio of the fair market value of the investment assets to the fair market value of the assets other than investment assets of the distributing or controlled corporation is three times or more than such ratio for the other corporation (i.e., the controlled corporation or the distributing corporation, respectively).

Unlike an ordinarily no-rule item, there are no circumstances in which a taxpayer can seek a ruling on an issue subject to the temporary no-rule list.

The addition of RICs and REITs to the no-rule list appears to be targeted at increasingly common transactions in which operating companies seek to reduce their overall effective federal tax rate by spinning off their real estate holdings into a newly formed REIT. These transactions seem to be well received by the markets where the proposed REIT will own hotels, data centres or private prisons.

The ordinarily no-rule item based on the 5% test and the temporarily no-rule item both seem clearly applicable to situations like Yahoo's. Aside from these no-rule areas, the IRS will continue to consider ruling on spinoff-related issues as it had before the Yahoo announcement in January.

For spinoffs caught in the newly expanded no-rule net, one practical question is whether such spinoffs will still occur without a ruling – based solely on opinions of counsel. Those opinions may become even more critical, and, in the case of publicly held companies, the market may act as an arbiter of the soundness of the positions taken by such opinions.

Concurrently with the Rev. Proc., the IRS issued Notice 2015-59, which announces that it is continuing to study issues relating to the newly covered transactions, and it requests comments.

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