

Does the IRS's New Ruling Policy on Spin-Offs Enhance the Desirability of Tax Insurance?

By Nemo Perera

Various forms of spin-offs remain popular tools for unlocking hidden corporate value and improving financial performance. Under an IRS pilot program, however, those seeking tax-advantaged spin-offs under section 355 of the Internal Revenue Code face new uncertainty in respect of the tax consequences of the transaction.

Specifically, in Revenue Procedure 2003-48, the Internal Revenue Service announced a one-year pilot program under which it will no longer issue advance rulings on key issues arising under section 355. Previously, such so-called comfort rulings were available to resolve questions such as (i) whether a spin-off has an adequate corporate business purpose, (ii) whether a spin-off will be regarded as used principally as a device for the distribution of earnings and profits, and (iii) whether a spin-off and any prior or subsequent acquisition of stock in the Parent or the Spinco are part of a plan under section 355(e).

According to the revenue procedure, which was released on June 23, 2003, the IRS will continue to issue private letter rulings concluding that transactions qualify under section 355, but will base those rulings on the taxpayer's representations that the foregoing three core requirements are satisfied. Thus, the IRS may later question whether these requirements in fact were satisfied upon an audit of the corporation's or shareholders' tax returns. (The new policy does not apply to ruling requests postmarked or received by August 8, 2003.)

What lies behind the IRS's pilot program? Although the tax agency has generally eschewed the granting of advance rulings on essentially factual issues, section 355 rulings historically have been an exception. The IRS has concluded that it can better serve taxpayers by reallocating resources to promulgating (widely applicable) rulings and regulations to address open questions under section 355, rather than devoting those resources to rulings on specific factual questions relevant to only a single transaction.

The new policy will affect companies that are considering spin-offs, split-offs, reverse Morris Trust transactions, or other transactions intended to qualify as tax-free to the corporation or its shareholders under section 355. Companies must now proceed without the assurance provided by an IRS advance determination that the requirements of section 355 are satisfied.

The representation on business purpose requires a company to list each corporate business purpose for the spin-off. The IRS has offered three alternative representations the company may make with respect to whether a spin-off and an acquisition of shares in the Parent or Spinco before or after the spin-off are part of a plan under section 355(e). The IRS has indicated that it continues to consider, and requests comments on, the appropriate language for the section 355(e) representation. These representations, like the ruling request itself, must be made under penalties of perjury.

The IRS has also stated it will no longer issue supplemental letter rulings under section 355 unless the request represents a significant issue, adding a change in circumstances after the spin-off will ordinarily not represent a significant issue.

Finally, section 355 also imposes other requirements for tax-free treatment in a spin-off in addition to those that are subject to the new ruling policy, such as the five-year active business requirement. The IRS will continue to issue private letter rulings on whether these other requirements have been satisfied.

This new ruling policy presents a major challenge to corporations contemplating spin-off transactions. In many cases, it will be clear that the requirements of section 355 are met, but each of the three factual issues on which the IRS refuses to rule

— (i) adequacy of a company's business purpose; (ii) whether the transaction is a device for distribution of earnings and profits; and (iii) whether the spin-off is part of a broader plan — is inherently uncertain. Each involves a certain degree of subjectivity, and the resolution of all three depends on a detailed analysis of the facts and circumstances in light of a broad body of administrative authority and case law. In many cases, even the most sophisticated tax adviser will be unable to predict the tax outcome with certainty. More fundamentally, the potential tax liability may be so great that the company's management may choose to forgo the transaction rather than assume a tax risk they may be unable to quantify.

One approach to this situation would be for a corporation to procure an opinion from its tax adviser on the ability of a proposed spin to withstand review by the IRS. Because an opinion cannot provide certainty, only comfort, some companies may consider the possibility of obtaining tax risk insurance.

A tax insurance solution reinforces the professional opinion obtained and removes all financial uncertainty by insuring any contingent tax exposure against a future challenge by the IRS. Thus, in appropriate cases, tax liability insurance can provide tax certainty when a private letter ruling is not available. The coverage could include taxes due, penalties, interest, legal costs, and even gross ups if needed.

The tax law is constantly changing, and it is often difficult to identify and comprehend all its implications. As uncertainty increases and the cost of non-compliance grows, it may prove valuable for companies to explore new approaches to managing risks and minimizing the adverse effects of unexpected IRS enforcement actions. Tax insurance can be an important tool for companies that wish to mitigate these risks while undertaking the corporate restructurings for the benefit of their shareholders.

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