Wachtell Lipton discusses Treasury Department Seeking to Curb "Cash-Rich" and REIT Spin-Offs

By Jodi J. Schwartz, Joshua M. Holmes and David B. Sturgeon **September 16, 2015**

The Treasury Department and the Internal Revenue Service have announced (in Notice 2015-59) that they are studying issues related to the qualification of certain corporate distributions as tax-free under Section 355 of the Internal Revenue Code in situations involving substantial investment assets, reliance on relatively small active businesses, and REIT conversions. The IRS concurrently issued related guidance (Rev. Proc. 2015-43), adding such transactions to its ever-expanding list of areas on which it will not issue private letter rulings. While this expansion of the IRS's "no-rule" areas is not a statement of substantive law, these announcements may have a chilling effect on certain pending and proposed transactions.

Treasury and the IRS are most concerned with transactions that result in (1) the parent or the spun-off corporation owning substantial investment assets (*e.g.*, cash, stock or securities, or other assets held for investment) relative to its business assets and (2) one of the corporations having a significantly higher ratio of investment assets to non-investment assets than the other. Under its new policy, the IRS will no longer rule on any issue relating to the qualification of a distribution for tax-free treatment if, immediately thereafter, (1) the value of the investment assets held by either the parent or the spun-off corporation is two-thirds or more of the value of its total gross assets, (2) the value of the business assets relied upon by the parent or the spun-off corporation to satisfy the active trade or business requirement is less than 10 percent of the value of its investment assets, and (3) the ratio of the value of investment assets to non-investment assets of either corporation is three or more times such ratio of the other. Although the statute denies tax-free treatment only to "cash rich" split-offs, the IRS and Treasury are similarly concerned with "cash-rich" spin-offs. Yahoo-Alibaba type situations—where a very large percentage of the asset value of the parent or the spun-off corporation consists of a non-controlling stake in another publicly traded entity—appear to be directly targeted.

A related area of concern for the IRS and Treasury is the use of businesses having *de minimis* value relative to the corporation's total assets to satisfy the "active trade or business" requirement of Section 355. Under its new policy, which is similar to the ruling policy in effect prior to 2003, absent unique and compelling reasons, the IRS will no longer rule on any issue relating to the tax-free treatment of any distribution in which the value of the business assets relied on by either the parent or the spun-off corporation to satisfy the active trade or business requirement is less than five percent of the value of the total gross assets of such corporation. Smaller businesses frequently have been relied upon in situations in which an existing larger business technically does not qualify (*e.g.*, recently acquired assets or real estate activities of a REIT that are insufficiently "active").

Finally, Treasury and the IRS expressed concern over the increasing number of spin-offs involving the formation of REITs, in particular those in which good REIT assets are separated from an existing non-REIT enterprise to facilitate a REIT election by the parent or the spun-off corporation. In their view, these transactions raise the same policy concerns as the others described in the notice. Under its new policy, absent unique and compelling reasons, the IRS will no longer issue rulings on transactions in which the parent or the spun-off corporation becomes a REIT as part of the spin-off. Helpfully, the notice explicitly states that the above concerns are not present where both the parent and the spun-off corporation will be REITs, or where the parent corporation has been a REIT for a substantial period of time prior to the distribution, and that the IRS will continue to consider ruling on such transactions. The new guidance should provide a restraint on activist activity pressuring "PropCo/OpCo" separations.

The preceding post comes to us from Wachtell, Lipton, Rosen & Katz. It is based on a memorandum circulated by the firm on September 16, 2015.