The IRS recently released long-awaited guidance regarding spin-offs: a revenue procedure involving “high-vote/low-vote” capital structures; and proposed regulations dealing with small five-year “active trades or businesses” and disproportionate allocations of non-business assets.

The Revenue Procedure

Revenue Procedure 2016-40 should facilitate transactions where a corporation wishes to spin off a less than 80% owned subsidiary. The spin-off rules generally require that the distributing corporation distribute stock representing at least 80% of the voting power of the spun-off corporation. Prior to the IRS’ announcement in 2013 that it would no longer rule on such transactions, a long-standing technique had been to recapitalize the corporation to be spun-off such that the distributing corporation would own high-vote shares representing at least 80% of the voting power but less than 80% of the economics of such corporation prior to the spin-off. A question frequently arose as to the timing and circumstances under which the high-vote and low-vote shares could be collapsed into a single class after the spin-off.

Under one safe harbor, the new Revenue Procedure permits collapsing a high-vote/low-vote structure into shares of a single class if no action is taken (including the adoption of any plan or policy) at any time prior to the 24-month anniversary of the spin-off by the spun-off corporation’s Board, management or controlling shareholders that would, if
implemented, result in the unwind of the high-vote/low-vote structure. Under a separate safe harbor, a high-vote/low-vote structure may be unwound at any time after the spin-off if the spun-off corporation engages in an unanticipated third-party transaction (i.e., an acquisition as to which no discussions have occurred during the 24 months prior to the spin-off and there is less than 20% overlapping ownership of the spun-off corporation and the acquirer). The Revenue Procedure, which also ends the IRS’ “no rule” policy with respect to these transactions, is effective for spin-offs occurring on or after August 1, 2016, but may be applied by taxpayers to prior spin-offs.

The Proposed Regulations

In newly proposed regulations, the IRS would mandate that at least five percent of the gross assets of each of the distributing corporation and the spun-off corporation consist of assets (which may include certain cash, described below, that is related to such business) used in a trade or business that has been actively conducted for at least five years.

The proposed regulations would also specify the extent to which non-business assets may be allocated disproportionately in spin-offs (but generally not split-offs) as between the distributing corporation and the spun-off corporation. Non-business assets include cash (other than working capital, cash held pursuant to a legal or contractual obligation to provide for exigencies related to the corporation’s business and cash held for regulatory purposes) and stock in less than 50% owned corporations. If non-business assets are allocated proportionately (i.e., the ratio of non-business assets to total assets of both corporations is approximately the same), the proposed regulations are satisfied. The proposed regulations generally would deny tax-free treatment to spin-offs in which 66 2/3% or more of the gross assets of the distributing or the spun-off corporation are non-business assets, and the relative ownership of non-business assets falls outside specified “bands.” The proposed regulations are proposed to be effective from the date they are finalized.

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