Spinoff Ruling Revoked

by Robert W. Wood • San Francisco

From time to time, this newsletter has been accused of unduly focusing on Section 355, that magical provision that serves as one of the few remaining holes in the now established *General Utilities* repeal. Although Section 355 has been in existence for many decades, it was only in 1986 that practitioners began to think it truly momentous in light of the 1986 repeal of many other tax-favored transactions.

Whether Section 355 is central to the reader's psyche or not, few would argue with the proposition that it is one of those few transactions that one undertakes typically only with an advance ruling from the IRS. In recent years opinions have supplanted rulings, in some cases. However, it is still true that many companies simply will not proceed with a Section 355 spinoff without the benefit of an IRS ruling.

It is rote that taxpayers must accurately state the facts in a ruling request, and must in fact carry out whatever transaction they describe in the ruling. It is often debated among tax lawyers exactly how minor a change in the transaction as executed must be reported to the IRS (with the hopeful question that the ruling which was granted by the Service has not been affected by the subsequent change in the facts).

A recent letter ruling should serve as a caution that the IRS *does* check. In Letter Ruling 9806002, an IRS Technical Advice Memorandum, the Service

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retroactively revoked a prior ruling that had permitted a splitoff under Section 355. The reason? Material facts were misstated, and the transaction was not carried out substantially as proposed.

In fact, to obtain the favorable ruling on the distribution of a controlled corporation to a dissenting shareholder group, the distributing corporation changed a representation in the ruling request that it and the controlled corporation *would* elect S status after the splitoff to a representation that they *would **not*** elect S status. The distributing corporation had also represented that only cash would be contributed to the controlled entity before the splitoff.

Close Enough?

In fact, when the transaction was consummated, the controlled corporation wound up with debt, and the distributing and controlled corporations both elected S status. Consequently, the distributing corporation's cash distribution ended up paying off the note after the splitoff in a nontaxable manner to the shareholders (under Section 1368(b)(1) and (c)(1)).

When the distributing corporation failed to seek a supplemental ruling on the changed facts, and did not attach a copy of the ruling that was obtained to its return (was this the critical failure?), the IRS District initiated the Technical Advice procedure. Without considering whether the business purpose requirement had been satisfied notwithstanding the change in facts, the National Office retroactively revoked the prior ruling.

Take Heed

TAM 9806002 should provide practitioners with several lessons. First, it should reinforce the conventional wisdom that one should be accurate in one's representations to the IRS. Second, it should reinforce the sensible notion that one should carry out the originally planned transaction as represented. Of course, if a change in the transaction does become necessary (as it not infrequently does) then what is necessary (fortunately or not) is to go to the Service with a supplemental ruling request seeking the determination that the ruling is not affected by the change. In my experience, as long as the change is one that does not fundamentally alter the structure or the nature of the transaction planned, the supplemental ruling will likely be issued.

In abusive cases, such as that presented in this TAM, one has little doubt that not only will the ruling be pulled, but that an examining office may well attack the transaction as outside the scope of Section 355 altogether. That presents the interesting question of how different the standards really are between the advance ruling context and the interpretations of Section 355 prevailing in court cases. They are undoubtedly quite different standards.

This clear difference in standards may indicate that one should not apply for a ruling if one is close to the line. After all, there is great truth in the old addage, "If you can't stand the answer, don't ask the question." However, if one does ask questions, one must follow procedures and follow-up hat in hand in the event the facts change. ■