CCH®

THE M&A Tax Report

VOLUME 14, NUMBER 2
SEPTEMBER 2005

THE MONTHLY REVIEW OF TAXES, TRENDS & TECHNIQUES

EDITOR-IN-CHIEF
Robert W. Wood
Robert W. Wood, P.C.
San Francisco

ASSOCIATE EDITOR
Joanna Schaller
Tax Institute
San Francisco

ADVISORY BOARD

Dominic L. Daher
University of San Francisco
San Francisco

Paul L. Davies III
The Cambria Group
Menlo Park

Jonathan R. Flora
Lindquist & Vennum
Minneapolis

David R. Gerson
Wilson Sonsini
Goodrich & Rosati
San Francisco

Lawrence B. Gibbs
Miller & Chevalier
Washington

Steven K. Matthias
Deloitte & Touche
San Francisco

Mark A. Muntean
Robert W. Wood, P.C.
San Francisco

Matthew A. Rosen
Skadden, Arps, Slate,
Meagher & Flom
New York

Mark J. Silverman
Steptoe & Johnson
Washington

Robert Willens
Lehman Brothers
New York

Spin-off Rulings Revisited

By Robert W. Wood • San Francisco

In the good old days 20 or 30 years ago, it was almost unheard of to do a spin-off without a ruling. Sadly, times change. Increasingly, taxpayers may not want—or be able—to take this approach. Rulings take time and cost serious money. Plus, there is always the possibility that you will not get the ruling, no matter how deserving you feel yourself to be.

And, since a bell cannot be unrung, if you are truly committed to completing a transaction, sometimes you may not want to ask. As the old adage goes, if you can't stand the answer, don't ask the question. In short, at times you may pursue a spin-off without a ruling, and there's nothing untoward about that. Of course, in some circumstances, the risks of a spin-off going bad are higher than others.

Do You Need A Ruling? A Supplemental Ruling?

A non–*pro rata* spin-off (such as the separation of two divisions between two disparate shareholder groups) generally carries a fairly low risk. It is awfully hard to see how this kind of transaction could be considered a device to distribute earnings and profits. A clearly appropriate and nonabusive transaction such as this with a substantial business purpose usually means that obtaining a ruling won't be difficult.

On the other hand, a clearly appropriate and nonabusive transaction suggests that there may be no particular *reason* (other than the usual belts and suspenders) to bother getting a ruling. After all, there is considerable tension between the need for a ruling and the way our rulings system actually works. The untutored (and logical) masses may assume that you would ask for a ruling where the application of the tax law to your facts is unclear. Ironically, though, you generally can't get a ruling on a question unless the result is eminently clear. It is a real oxymoron.

(continued on page 2)

ALSO IN THIS ISSUE:

Historically—and this is something that *hasn't* changed—if you got a ruling and some facts change, you can no longer rely on the ruling. Both from the government's perspective and the taxpayer's, the sensible thing to do in that situation is to go back and seek a supplemental ruling, bringing down the facts and restating the IRS's conclusions (hopefully the *same* conclusions!). You want the ruling to be accurate, and if the facts or representations change in any material way, it won't be. What you want from the IRS is a letter that says "Yes, it's still OK."

However, there are signs that the IRS doesn't like the supplemental process in the case of spin-offs. In fact, Rev. Proc. 2003-48 [IRB 2003-29, 86] states that the IRS will not issue supplemental rulings on spin-offs based on a mere change of circumstances. In this revenue procedure, the IRS goes methodically through some of the issues that arise under Code Sec. 355. Then, the IRS lists areas in which it does not like to rule.

For example, ordinarily the IRS refrains from issuing letter rulings requesting determinations on issues that are primarily factual. Plus, the IRS generally does not issue "comfort rulings" on transactions which the IRS feels are clearly and adequately addressed in published guidance. Yet, says the IRS, they haven't policed these rules carefully enough in the context of Code Sec. 355. In Rev. Proc. 2003-48, the IRS indicates that it wants to start doing that. This revenue procedure then goes on to describe the issues under Code Sec. 355 that the IRS just doesn't want to address.

But, buried toward the back of this revenue procedure is the statement that the IRS will decline a request for a supplemental letter ruling unless the request presents a "significant issue." The IRS says flatly that "a change in circumstances arising after the transaction ordinarily does not present a significant issue." [*See* Rev. Proc. 2003-48, *supra*, §.06.]

Where There's A Will There's A Way

A recent private letter ruling suggests that there may be a way around this revenue procedure. In LTR 200527004 [July 8, 2005], the IRS considered a fairly typical spin-off fact pattern. The IRS noted that it had issued a ruling in this fact pattern back in 2001, but that now there were difficulties with respect to voting issues. The IRS recites the taxpayer's prior representation (included in the previous letter ruling) which contained representations about certain changes in the company within the ensuing five years.

LTR 200527004 notes the difficulty the controlled corporation experienced after obtaining the ruling as a result of having two classes of publicly traded voting common stock outstanding. LTR 200527004 involves the controlled corporation's request for a supplemental ruling regarding the elimination of the dual-class voting structure.

The IRS recites the statements of policy from Rev. Proc. 2003-48 against issuing supplemental rulings, unless the request for same represents a "significant issue." A change in circumstances arising after the transaction, the IRS notes, ordinarily does not present a significant issue. The IRS states that an original

THE M&A Tax Report
THE MONTHLY REVIEW OF TAXES, TRENDS & TECHNIQUES

EDITOR-IN-CHIEF
Robert W. Wood

MANAGING EDITOR
Kurt Diefenbach

COORDINATING EDITOR
Tara Fenske

PUBLISHER
Mark Fried

PRODUCTION EDITOR
Craig Arritola

M&A Tax Report is designed to provide accurate and authoritative information in regard to the subject matter covered. It is sold with the understanding that the publisher is not engaged in rendering legal, accounting, or other professional service. If legal advice or other expert assistance is required, the services of a competent professional person should be sought—From a Declaration of Principles jointly adopted by a Committee of the American Bar Association and a Committee of Publishers.

THE M&A TAX REPORT (ISSN 1085-3693) is published monthly by CCH INCORPORATED, 4025 W. Peterson Ave., Chicago, Illinois 60646. Subscription inquiries should be directed to 4025 W. Peterson Ave., Chicago, IL 60646. Telephone: (800) 449-8114. Fax: (773) 866-3895. Email: cust_serv@cch.com. Copyright © 2004, CCH INCORPORATED, A WoltersKluwer Company.

Permissions requests: Requests for permission to reproduce content should be directed to CCH INCORPORATED, permissions@cch.com.

Photocopying or reproducing in any form in whole or in part is a violation of federal copyright law and is strictly forbidden without the publisher's consent. No claim is made to original governmental works; however, within this product or publication, the following are subject to CCH's copyright: (1) the gathering, compilation, and arrangement of such government materials; (2) the magnetic translation and digital conversion of data, if applicable; (3) the historical, statutory, and other notes and references; and (4) the commentary and other materials.

letter ruling might contain a representation that there is no plan or intention to undertake a particular action.

Conversely, the ruling might state that management of the controlled corporation would not take the specified actions. In the latter case, notes the IRS, even if there is a changed circumstance (and even if the taxpayer has a darned good reason), the representation would expressly be violated. In that kind of situation, as occurred in this private letter ruling, the IRS says that it will issue the supplemental ruling.

Interestingly, the exact language of the prior letter ruling (PLR-127310-00, dated May 24, 2001) had both the "no plan or intent" language, and the more adamant representation language. I'd call the latter a kind of flat, "we won't do it" commitment. The prior ruling had included the representation that "[t]he management of Controlled has no plan or intention to, and for a period of five years beginning on the date of the Distribution will not, propose or support any plan or recapitalization." The "will not" made the IRS step in and issue the supplemental ruling, even though the IRS clearly doesn't like to do it.

This interesting "double whammy" language turns out to benefit the taxpayer, given the IRS's unique (and arguably not so cooperative) view that it won't issue supplemental rulings in many cases.

Gaming the System?

At its most fundamental level, I suppose what this ruling teaches us is that sometimes representations in letter rulings might be better made *more* rather than *less* stringent. In other words, suppose you represent in an original ruling submission that "the taxpayer has no plan or intention to change the voting structure of the company." If circumstances later change and the taxpayer does determine to change its voting structure, it may be debatable whether this would affect the conclusion of the ruling. We might need more facts to make a decision.

At a minimum, though, there would be a factual question whether the circumstances changed (and if it was the change in circumstances that produced the desire to change voting rights), or whether the taxpayer had the prohibited plan or intention from the get go. If it did, this would violate the ruling.

In contrast, if the original ruling submission stated flatly that "the taxpayer will not change its voting structure," then one would truly need to ask for a supplemental ruling. It is difficult to see how the IRS could wiggle out of this one (based on Rev. Proc. 2003-48 or any other argument), in such a case. After all, that seems to be what happened in LTR 200527004, and the IRS did not have a problem issuing the supplemental ruling there.

What to Do

Most of the issues here will simply involve judgment and communication. How much of a change in facts, or circumstances (or representations) is necessary before you feel exposed that the ruling you already obtained is in jeopardy. And, since the "will not" versus "don't now intend to" choice discussed here must be made in the original ruling request submission (so by definition you can't then know how likely it is that the facts will turn out differently), which way should you jump on this question?

Some of this will involve knowing your client, and how likely (or unlikely) it seems that the client will have a problem down the road post-ruling. Then, based on that likelihood of a problem, you try to factor in how likely it is that the client will want to ask for a supplement to the ruling. This will involve quite a lot of communication between lawyer and client. That can be difficult on issues like this that are so prospective in scope. Everyone's main focus will be getting the ruling, not worrying what will happen thereafter.

Perhaps this will involve too much crystal ball gazing for most of us. After all, it may put a lump in your throat if you find that you are saying "I won't do ____ no matter what" as opposed to saying "I currently have no plan or intention of doing ____." Most taxpayers are going to feel a lot more comfortable representing the latter, and would rather run the risk that, if circumstances do change, their ruling is still (in all likelihood) going to be OK.

Still, in at least some circumstances, it may be permissible to game the IRS's "no supplemental ruling" policy. But, full and careful discussions between the company and the tax advisors who are preparing the ruling request are essential.