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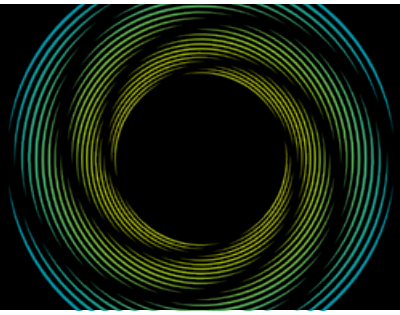

Tax-free spin-offs for pre-revenue businesses

The tax-free spin-off rules provide the sole ability for a corporation to separate its businesses without corporate or shareholder-level tax. However, pre-revenue businesses were generally excluded from these types of transactions because of their inability to satisfy the "active trade or business requirement" ("ATOB") to obtain tax-free treatment.

Under new guidance, pre-revenue businesses may be able to meet this requirement, opening the door to engage in these types of transactions. This may be particularly impactful for R&D intense businesses (e.g., pharma, technology/software etc.).

What is the ATOB requirement?

Among the many tests for a spin-off to qualify for tax-free treatment is the ATOB requirement, which requires the distributing company and the company whose stock is distributed (referred to as "spinco") each to be engaged in the active conduct of a trade or business for five years preceding the spin-off.

The primary purpose of this rule is to distinguish "entrepreneurial endeavors" from "mere passive investments." Accordingly, Treasury regulations provide that business activities ordinarily must include the collection of revenue and the payment of expenses to qualify as an ATOB (although there is no profit generation requirement), and the IRS generally required the taxpayer to provide financial information evidencing revenue and expenses for the five years preceding the spin-off in order to obtain a private letter ruling ("PLR").

The start of something new

In September 2018, the IRS announced that it would consider whether the absence of revenue collection prevents a business from constituting a "trade or business" for purposes of satisfying the ATOB requirement. This change invited taxpayers to request a PLR on the ATOB requirement where, historically, the requirements may not have been met due to the absence of revenue.

PLR 202009002, dated September 4, 2019 -- and published in February 2020 -- is the first ruling to be publicly released under this program.

Key factors of PLR 202009002

The ruling focused on a company that proposed to spin-off a business that did not generate any revenue. The IRS ruled in this PLR that the absence of revenue did not, on its own, prevent the spun-off business from satisfying the ATOB requirement to qualify as a tax-free spin-off.

Some of the key facts discussed in the PLR include:

- The distributing company ("Distributing") operates two separate businesses ("Business A" and "Business B"), which had been operational for more than five-years prior to the proposed spin-off.
- Typically, for Distributing's products to be commercialized, they go through a four-step process. For Business A's products, Distributing typically conducted the initial steps before licensing the IP to a third party for further development. For Business B's products, however, Distributing conducted more of the steps internally, and would not license the IP.
- Distributing spun-off Business B, which had not generated revenue at any point prior to the spin-off. However, Distributing had incurred significant salary and wage expenses in connection with Business B.

Distributing believed (at the time of the spin-off) that Business B had the ability to generate revenue through licensing certain rights or partnering with certain companies to market and sell its products. However, Distributing had decided to forego immediate revenue collection from Business B in favor of, potentially, collecting significantly greater revenue once Business B's products were further developed.

Key takeaways: No revenue, no problem?

In R&D-intensive businesses (e.g., pharma, technology/software, etc.), the ATOB's revenue-generation requirement often presented a significant hurdle to separating businesses through tax-free spin-offs.

This PLR signals that this may no longer necessarily be the case, opening the door to achieve these business separations in a tax-efficient manner.

Because each PLR is specific to the facts and circumstances of the taxpayer requesting the PLR, it is crucial for a taxpayer and its advisors to work closely with the IRS, especially with respect

to verifying and substantiating certain factual representations on which the PLR will be predicated. Without the obvious presence of revenue, it is still unclear what factors the IRS will now use to distinguish entrepreneurial endeavors from passive investment.

We expect that the IRS may look for third-party input on certain qualitative representations relating to foregone or future revenue collection, including potential input from investment bankers and other financial advisors. In PLR 202009002, for example, Distributing obtained advice from an investment banker to support the proposition that the spun-off business (i.e., Business B) was an economically viable business entity by providing a list of comparable businesses that had engaged in third-party transactions and collected revenue during similar stages of development.

Although the guidelines for defining whether a taxpayer meets the ATOB requirements in spinning off a pre-revenue business are yet to be determined, taxpayers should look to this PLR as a potential opportunity to achieve certain business separations in a tax-efficient manner that were previously thought to be prohibited.

Conclusion

In light of these changes, it may now be possible to spin-off a pre-revenue company and remain in compliance with the ATOB requirement. However, the requirements of the new ruling policy are nuanced and complex, and since obtaining a PLR is critical in such situations, it is important for taxpayers to determine how the IRS may react. Accordingly, it is key for a business' tax advisor to be actively engaged early in the process to consider whether a spin-off is feasible and practical.

Want to learn more?
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