First No-Income Business Spinoff Ruling Appears Pharma-Driven

by Emily L. Foster

The IRS's inaugural letter ruling involving the spinoff of a research-intensive business that hasn't generated income seems to pave the way for the pharmaceutical industry, but leaves open questions for entrepreneurial high-tech companies.

A letter ruling (LTR 202009002) dated September 4, 2019, and released February 28 showcased the IRS's first decision concerning spinoffs of research and development businesses that otherwise wouldn't qualify for tax-free treatment absent a five-year track record of income collection.

Since 2018 the IRS has been studying whether and to what extent corporations may use a section 355 tax-free spinoff to separate established businesses from newer entrepreneurial ventures — or to separate two or more R&D segments of a stand-alone entrepreneurial venture — if the business hasn't collected income but has engaged in substantial R&D and other activities.

The facts of the ruling, such as the taxpayer's formal process and multiple steps involved in getting a product to market, suggest that the taxpayer is in a regulated business and is likely a pharmaceutical company, according to practitioners who spoke to *Tax Notes*.

> ***The ruling raises the question of how the IRS will extend the principles to other types of R&D ventures that aren't regulated and don't require a product development process that is as challenging and rigid, Singer said.***

Based on the taxpayer's representations, the IRS ruled that the absence of income collection of the spun-off business doesn't prevent the transaction from satisfying the section 355 active trade or business requirement.

The ruling "moves the ball significantly" for spinoffs involving research-intensive businesses that haven't generated income, but raises the question of how the IRS will extend the principles to other types of R&D ventures that aren't regulated and don't require a product development process that is as challenging and rigid, Jay M. Singer of Shearman & Sterling said.

Singer pointed to unique facts in the letter ruling, such as the distributing company being able to provide a list from an investment banker of recent transactions involving companies in similar situations that had been able to earn income at the same stage of development.

Pharmaceutical companies generally follow a well-developed process repeatedly, which is unlike technology companies' more complicated processes that evolve over time and are less regulated, Singer said. That means more work is needed for the IRS to issue a ruling in those situations, he added.

Taxpayer Particulars

The taxpayer in LTR 202009002 is a publicly traded corporation (Distributing) that conducts research, development, testing, and regulatory functions to transform new products it develops into items for ultimate commercialization.

Distributing intends to separate its two businesses (businesses 1 and 2) concerning "item 1" in a section 368(a)(1)(D) and section 355 transaction by forming a corporation (Controlled), contributing the business 2 assets to that entity in exchange for all the stock of Controlled, and distributing that stock to Distributing's shareholders. The end result is that Distributing will continue to conduct business 1 and Controlled will conduct business 2.

Business 1 conducts several steps — referred to as steps 1 through 2C1 — to identify and develop new products that are tested and modified to create specific items. Business 1 has consistently generated income for more than five years through third-party research-oriented contracts and licensing arrangements. For example, under collaboration agreements, Distributing received an upfront cash licensing fee and annual amounts for a specified number of years.

Item 1 has progressed through step 2C1, which includes being "tested in a variety of possible conditions."

For Item 1, Distributing "decided to [forgo] immediate collection of income from Business 2 in favor of the prospect of collecting significantly greater income after Step 3 is completed," according to the ruling.

Distributing intends to conduct business 2 (steps 2C2 through 3) and accomplish step 4 through a partner or collaborator. After step 4, step 3 activities still need to be conducted.

Business 2 intends to partner or collaborate with industry partners with the desired experience, knowledge, and sales force to advance item 1 through the next steps. "Business 2 will then generate income at this step through receipts of royalties, milestone payments, or profit-splits."

Factors Considered

Under section 355, a corporation may generally distribute the stock of a controlled corporation to its shareholders without recognizing gain or loss if specific requirements are met. The active trade or business (ATB) rules require that the distributing and controlled corporations be engaged in an ATB immediately after the distribution and that they both satisfy the five-year active business test ending on the distribution date.

Reg. section 1.355-3(b)(2)(ii) specifies that a corporation engages in a trade or business if it performs activities for the purpose of earning income or profit, and states that those activities "ordinarily must include the collection of income and the payment of expenses."

The taxpayer seems to have substantially satisfied the six potential guideposts that the IRS, while it was reviewing the ruling request, revealed in 2019 to extend tax-free spinoffs to research-intensive industries, according to David W. Zimmerman of Miller & Chevalier Chtd.

> ***Zimmerman said that as the IRS issues more rulings, he hopes more guidance will surface on when entrepreneurial activities constitute an ATB.***

The taxpayer requested the ruling in February 2018, the IRS announced its program in September 2018, and a few weeks later the agency revealed the factors, which included the ability to enter into income-producing arrangements.

Thus, it appears that the taxpayer's ruling request prompted the factors, so it's difficult to tell the extent to which they all must be satisfied for R&D businesses that haven't generated income, Zimmerman said.

Zimmerman said that as the IRS issues more rulings, he hopes more guidance will surface on when entrepreneurial activities constitute an ATB.

A helpful fact for the taxpayer appears to be that business 2 represented a further progression of the start-up R&D activities in business 1, according to Zimmerman. He also pointed to other beneficial facts, including that business 1 had generated income and that Controlled could enter into similar income-producing arrangements with the same counterparties as did business 1.

Richard M. Nugent of Jones Day highlighted other material facts that the IRS relied on to demonstrate ATB compliance for the controlled business, including that the taxpayer devoted "significant employee time and salary and wage expense" to business 2 and that the taxpayer believed the controlled corporation could earn income even though it hadn't.

But What If?

The letter ruling is useful for situations in which the business hasn't generated income for the five-year period, but it isn't clear what the IRS might require in terms of potential revenue streams from the R&D activities, according to Lisa M. Zarlenga of Steptoe & Johnson LLP.

Zarlenga pointed to the taxpayer's ability to generate income at multiple points throughout the development cycle, noting that it's unclear how much the IRS relied on that. She also asked how the IRS's conclusion would change for a taxpayer engaged in a business that doesn't have opportunities to enter into a license agreement or otherwise generate income in early stages. ■