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IRS GREEN-LIGHTS PRE-REVENUE SPINOFF
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A private letter ruling made public last week signaled the IRS's increasing willingness to approve spinoffs involving early-stage ventures. The ruling is especially significant to industries like pharmaceuticals and biotechnology, where products come to market through research, development, and regulatory-approval pipelines that can extend for many (unprofitable) years.

BACKGROUND

In a typical spinoff, a corporation (the "Parent") contributes an active business to a new subsidiary (the "Spinco") and then distributes shares in Spinco to its own shareholders. To obtain tax-free treatment, section 355 imposes myriad requirements to ensure (among other things) that the transaction is being used to separate two active businesses for valid corporate business purposes. One of these rules mandates that both Parent and Spinco be "engaged in the active conduct of a trade or business" (an "ATOB") for the five-year period preceding the transaction.

Under longstanding regulations, the tested ATOB activities "ordinarily must include the collection of income and the payment of expenses." Until very recently, the phrase had been interpreted as an absolute requirement that the ATOB in question must be actively producing income. The regulation thus effectively served as a ban on spinoffs involving ventures with extended pre-revenue lead times, like pharmaceutical products, which take years to develop and must go through extensive testing in order to obtain regulatory approval. Only when a product was commercialized and earning income could a tax-free spinoff be considered, and that would frequently occur too late in the venture's lifecycle to effectuate a good business purpose, particularly when "fit and focus" was the goal. Likewise, a spinoff earlier in a venture's lifecycle could offer greater access to marketplace capital, eliminating the potential Spinco's reliance on the Parent, whose other lines of business and overall balance sheet may differ significantly and complicate efforts to finance the fledgling business.

The ground underneath the income requirement began to shift in September 2018, when the IRS issued a statement expressing its understanding of the issue faced by these "entrepreneurial ventures" and signaling its intent to further study the income requirement. Notably, the IRS simultaneously indicated its willingness to entertain private letter ruling requests regarding the qualification, under the ATOB test, of corporations that have not collected income. The private letter ruling released last week (PLR 202009002) is the first PLR to address this topic. Although it was issued to a particular taxpayer and thus carries no formal precedential value, the ruling provides a window into the IRS's emerging analysis of the ATOB issue.

THE RULING

The taxpayer in the ruling proposed to separate Business 1 and Business 2 by contributing assets comprising Business 2 to a new subsidiary and then distributing shares in the subsidiary in a transaction qualifying under section 355. Although not explicitly stated, the taxpayer appears to be a pharmaceutical company, based on the ruling's description of an extended, four-step approval process applicable to the taxpayer's products, as well as the types of commercialization arrangements noted as typical in the taxpayer's industry. The taxpayer represented away all other section 355 qualification issues, so the sole issue for the IRS's consideration was whether the absence of income collection prevented Business 2 from constituting an ATOB.

The taxpayer developed products that were required to go through a multi-step approval process in order to be marketed. In Business 1, the taxpayer would take products through the first two stages and then monetize the work it had done thus far by partnering with unrelated companies to complete the approval process and commercialize the products. Business 2 was different in that it involved a product line that the taxpayer wanted to take farther through the testing and approval process on its own, waiting to partner with another company until reaching the final stages of regulatory approval.

The IRS concluded that the lack of income was not fatal to the planned spinoff of Business 2. Although the ruling lacks explanation, several facts and representations appear to have been determinative:

- The taxpayer had devoted significant (and increasing) managerial and operational employee time to supporting Business 2, and thus had incurred significant salary and wage expense.
- The taxpayer intended to earn income by commercializing the product line in development in Business 2 by partnering with another company at a later point in the development process.
- The taxpayer believed that the product line already had the ability to generate income, based both on its own experience in the industry as well as on a list of deals it provided the IRS that involved similar products commercialized by other companies at the same stage of development.
- The taxpayer was holding out on current monetization of the product line because it believed it could collect "significantly greater income" after it had completed more development steps. The taxpayer represented that it "is easier to obtain income" the further the Business 2 product line progressed through the development steps.

TAKEAWAYS

Although the IRS has yet to issue formal guidance in this area, the ruling recalls a list of possible factors for analyzing pre-revenue ATOB issues presented by IRS Associate Chief Counsel (Corporate) Robert Wellen in an October 2018 speech.[1] According to Wellen, the "guideposts" under consideration at the time included:

1. Regular, continuing research by a significant number of full-time employees (operational and managerial);
2. Regular, continuing R&D expense;
3. Significant progress towards developing an income-producing product;
4. A showing that business is holding itself out as available to enter into an income-producing arrangement;
5. Indicia of an actual offer or expression of interest in commercialization made to or by a third party; and
6. A showing that similarly situated businesses have entered into income-producing arrangements at a similar stage of development.

The taxpayer in the ruling appears to have met some, if not all, of the factors cited by Wellen. Therefore, even assuming that these factors are currently relevant to the IRS's ruling practice, it remains unclear whether the presence or absence of any particular factor would be dispositive, or whether they should be weighed in any particular way.

It is also unclear whether the analysis would be similar in an industry with a less formal, prescribed approval process, or how it could be applied to an emerging area where the taxpayer would be unable to point to comparable income-producing transactions, either of its own or of third parties.

While these significant questions remain, the ruling represents a positive step by the IRS towards an appropriately flexible view of the ATOB requirement as applied to pre-revenue ventures. A corporate tax department need no longer be the automatic "department of 'NO'" when contacted by its C-suite with good (nontax) reasons to separate a pre-revenue business. Instead, in-house tax principals should consider discussing their facts with an outside advisor to vet the potential viability of the proposed transaction and analyze whether the IRS ruling process might help bring certainty to it.

[1] See "'Guideposts' Revealed for R&D-Intensive Business Spinoffs," Emily L. Foster, *Tax Notes Today*, Oct. 10, 2018.