

October 2, 2018

### IRS Considers Giving More Ventures Access to Tax-Free Spinoffs

On September 25, 2018, the IRS announced that it is considering guidance on the treatment of spinoffs involving business ventures engaged in research and development for future profit. The announcement is of special interest to life sciences and other technology ventures actively engaged in R&D for new pharmaceutical, medical device or other technology-based products. In particular, the announcement addresses situations where a company seeks to spin off a historic R&D-based business before its intellectual property has been fully developed or commercialized.

**Attorneys**  
[David H. Saltzman](#)  
[Benjamin Rogers](#)  
[Hudson Todd](#)

A corporate separation must meet several requirements to qualify as a tax-free spinoff, including that both the distributing parent corporation and the spun-off controlled corporation be engaged, immediately after the distribution, in “active trades or businesses” conducted for a minimum of five years. Applicable Treasury regulations provide that an active trade or business “ordinarily must include the collection of income and the payment of expenses.” While the use of the word “ordinarily” suggests that under current law certain business ventures without revenue can qualify as an “active trade or business,” the regulations provide no guidance with respect to situations where the active trade or business requirement would be met without revenue. These regulations date to the mid-1950s, and the existing administrative guidance applying them also predates the emergence of modern-day biotechnology and other high-tech ventures.

The announcement does not propose specific standards for the type of R&D operations that could qualify as an active trade or business, but it notes that these ventures must “incur significant financial expenditures and perform day-to-day operational and managerial functions that historically have evidenced an ‘active’ business.” The emphasis on operational and managerial functions suggests that having employees engaged in management as well as R&D will be critical. The existing regulations treat a business as being actively conducted only if the corporation actively performs the key management and operational functions itself, rather than through independent contractors. This standard is clearly met by biotechnology firms and other technological ventures that bring together research scientists and executives focused on corporate strategy, finance, and other typical management functions. Similarly, the announcement draws a distinction between entrepreneurial activities on the one hand, and investment or other non-business activities on the other.

Significantly, pending completion of its study, the IRS will entertain private letter ruling requests on the issues described in the announcement. This suggests that the IRS believes that under current law at least some businesses without revenue can qualify as active trades or businesses, where every indicator of an active trade or business is present except for the absence of profits in either the parent or the spun-off company following the spinoff. An example might be a spinoff by a mature, revenue-producing technology company of a pre-commercial stage product line, where the pre-commercial business has significant numbers of employees engaged in management as well as R&D functions, and the genesis of the pre-commercial stage business is organic and closely intertwined with the mature, revenue-producing portion of the business that will remain with the parent corporation.

The announcement indicates that the IRS welcomes taxpayer comments on these issues, and that it may be willing to revoke existing administrative guidance, provide new affirmative guidance, and consider “whether an exception should apply to any particular business model due to its unique characteristics.” Changes such as these may permit tax-free spinoffs in situations that previously were unclear. While it is too early to predict the potential outcome of the IRS’s study, the announcement signals recognition of the need to consider how guidance should be understood—or, if necessary, modified—to accommodate 21st-century realities.

\* \* \*

The IRS announcement is available by clicking this [link](#). For further information about the impact of the IRS announcement on your particular situation, please contact your regular Ropes & Gray contact.