Current issues and transaction structures for tax-free spin-offs

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Overview

Overview - Section 355 Requirements

- Basic Requirements
  - Control Immediately Before
  - Distribution of Stock and Securities Constituting Control
  - Not a Device for Distribution of E&P
  - Business Purpose
  - Distributing & Controlled Engaged in an Active Trade or Business
- Section 355(d) and (e)
- Section 355(g)

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IRS Ruling Policy for Section 355

Since 2003, the IRS has not issued private letter rulings addressing whether a transaction satisfies the device, business purpose and section 355(e) plan requirements and, consequently, whether a transaction satisfies section 355 generally.

In Rev. Proc. 2013-32, the rulings program for section 355 transactions (among others) was substantially curtailed.

Under the program, which is currently in effect, the IRS will only rule on issues that are "significant."

— "Significant" is defined as an issue that is not essentially free from doubt and that is germane to the tax consequences of the transaction

In Rev. Proc. 2016-45, the IRS changed the ruling program to address "significant legal issues" related to the device and business purpose requirements.

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Section 355 Transactions for Discussion

- Leveraged Spin-Offs
- Sponsored Spin-Offs
- Recapitalization/Dual Classes of Stock

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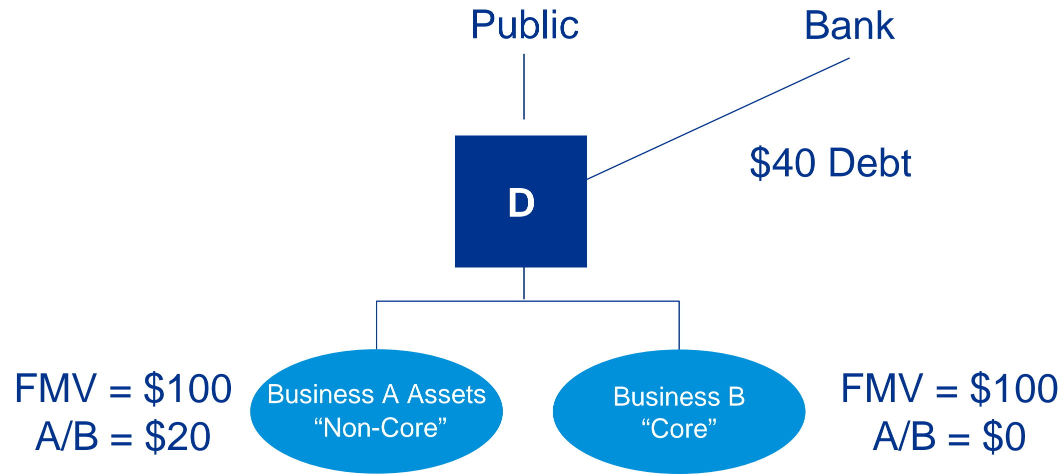
Leveraged Spin-Offs

Divisive D reorganizations



— D intends to contribute Non-Core Business A to newly-formed C and distribute C stock to D shareholders.

— Base Alternatives for Monetizing Non-Core Assets in Spin-Off:

- C assumes $40 of D's debt in connection with D's contribution of Business A
- C borrows $40 and distributes the proceeds to D
- C issues $40 securities to D
- D instead contributes Core Business and cash (financed by Business A) to C which is spun off

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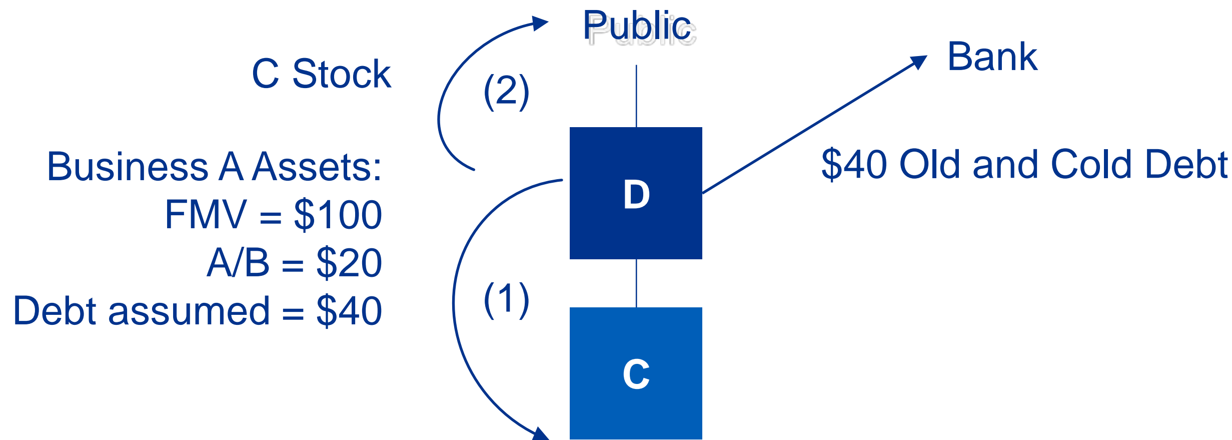
Basic debt assumption



- **General rule:** no gain recognized when C assumes D debt. Section 357(a).
- **Excess Liabilities:** D recognizes gain to the extent debt assumed exceeds D's adjusted basis in the assets. Section 357(c).
- **Result:** D recognizes $20 gain ($40, if Section 357(b) tax avoidance is applicable).
  - Section 357(b) applies if principal purpose of debt assumption (a) was to avoid tax on the exchange, or (b) was not a bona fide business purpose.
- Principle of section 357(c) incorporated into section 361(b)(3) which imposes basis limitations on "boot purge" to D creditors providing for the same tax treatment for cash or "other property" distributions by C used by D to repay its creditors, but not for cash or "other property" distributed to D shareholders.

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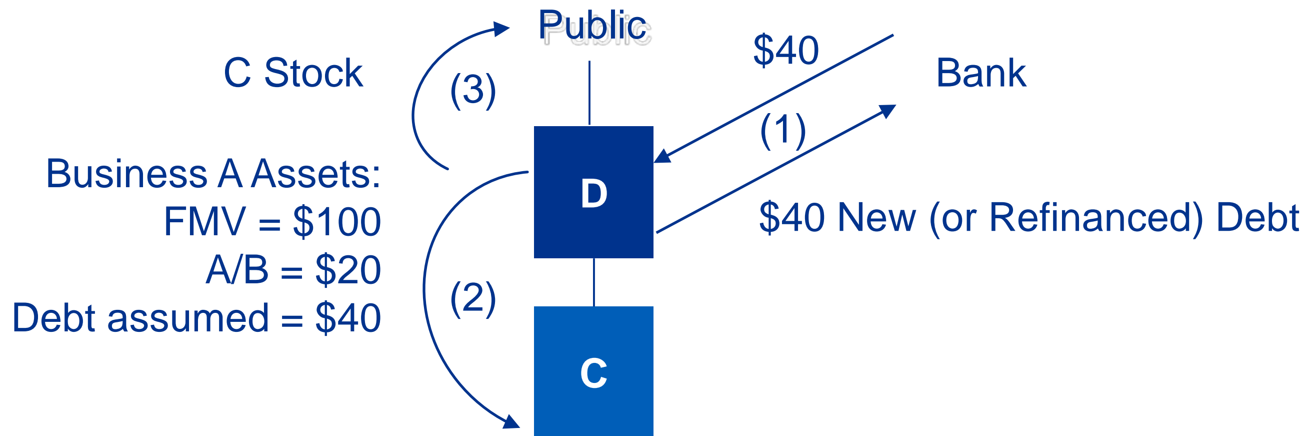
Who is the debtor?



If new (or refinanced) debt is issued by D and subsequently assumed by C, there are two potential characterizations:

— D is treated as debtor prior to debt assumption by C, in which case the 357(b) and (c) are relevant gain recognition provisions

— C is treated as original debtor and debt proceeds distributed to D, in which case the boot purge rule under 361(b) is the relevant gain recognition provision

— Consider Rev. Rul. 79-258, 1979-2 C.B. 143 and *Southwest Consolidated Corp.* 315 U.S. 195 (1942).

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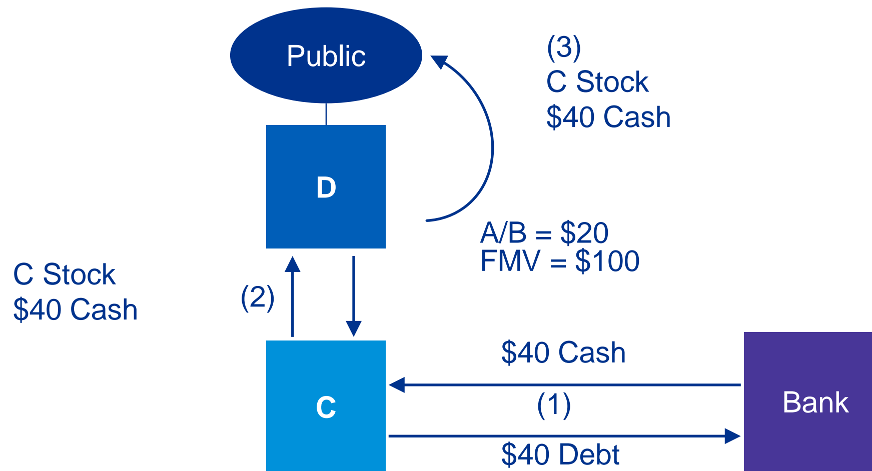
Leveraged distribution to shareholders



— **Cash Retained by D:** D recognizes gain. Section 361(b)(1)(B).

— **Shareholder Distribution:** D does not recognize gain if boot is distributed in pursuance of the plan of reorganization. Section 361(b)(1)(A). "Distribution" includes dividend distribution and redemption/buyback.

- Basis limitation on "boot purge" in Section 361(b)(3) inapplicable since this is a distribution to shareholders (as opposed to repayment of D creditors)
- IRS has not squarely addressed whether cash distributed in excess of stock basis may trigger gain via ELA if D and C consolidate for tax purposes; if not consolidated, risk depends on concepts of negative basis.

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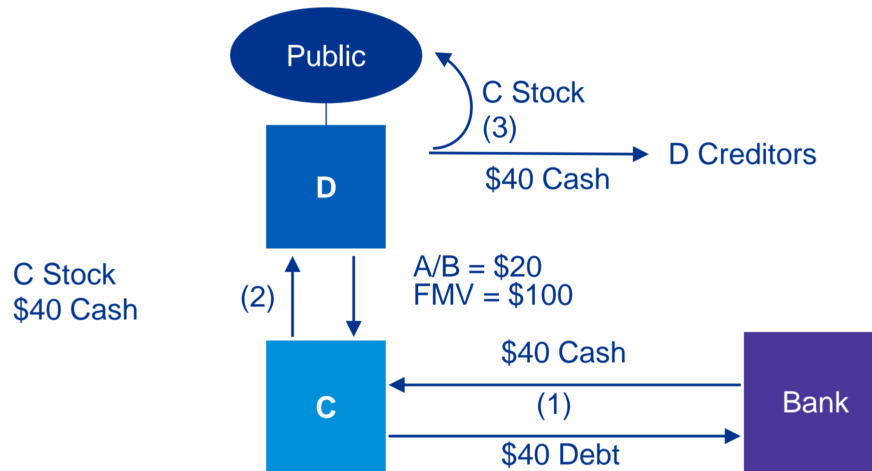
Leveraged distribution to creditors



— **Cash Retained by D:** D will recognize gain. Section 361(b)(1)(B).

— **Repayment of Creditors:** D will recognize $20 of gain because basis limitation on "boot purge" in Section 361(b)(3) applies

- Same result as if C assumed $40 liabilities and distributes no cash

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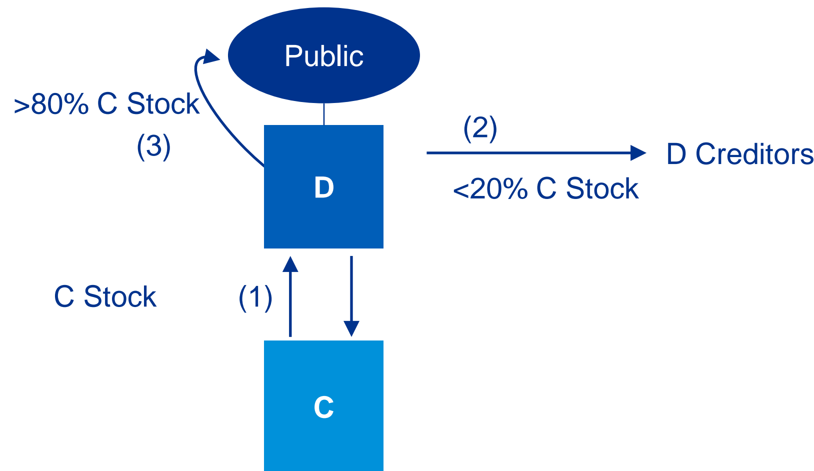
Other Methods to repay D debt



C stock received in the contribution used to repay D's existing creditors

- C stock transferred to creditors should generally not exceed 20% of the sole class of C Stock or else the transaction may fail to satisfy the distribution of control requirement; a high vote/low vote structure, however, can offer the ability to transfer more than 20% of the value of C stock to creditors.
- For purposes of section 361, D may also distribute C stock to a pension plan of which D is a sponsor. *See e.g.*, PLR 20162012.
- D recognizes no gain on a transfer of C stock to creditors in a divisive D reorganization pursuant to Section 361(c)(3).

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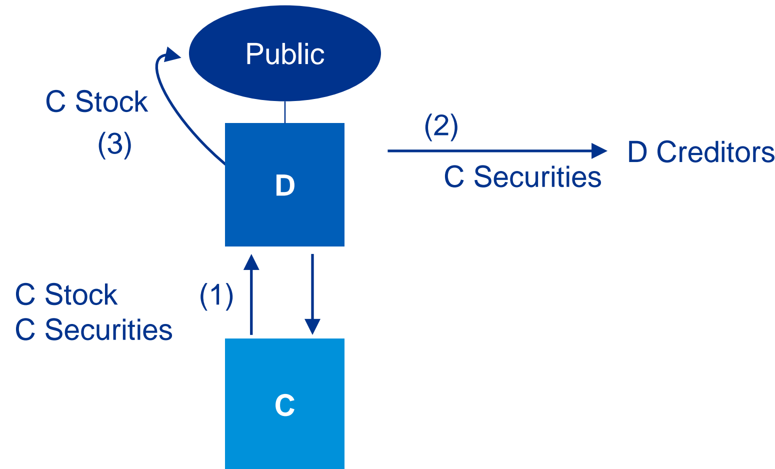
Other Methods to repay D debt (continued)



In exchange for a portion of the assets contributed by D, C issues securities and D uses the C securities to repay D creditors

— No gain recognized by D because securities (and §351(g) NQPS) are not boot for purposes for the boot purge limitation. *But see*, Job Creation and Tax Cut Act of 2010 (S. 3793) ("Baucus Bill") (treating C securities and NQPS as "other property").

— Transfer of "qualified property" to creditors in connection with the reorganization is treated as a distribution to shareholders in pursuance of the plan of reorganization

— Receipt of C securities constituting qualified property does not create or increase an ELA; D allocates it's basis in the assets transferred between the C stock and C securities under section 358.

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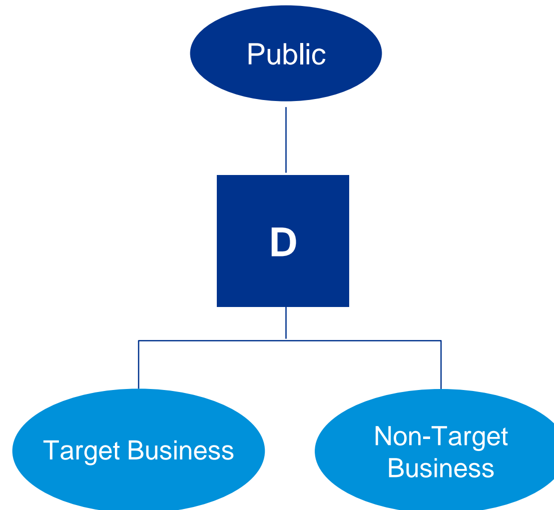
Sponsored Spin-Offs

Opportunity for Sponsored Spin-offs



The typical scenario involves a corporation with two or more lines of business (Target Business and Non-Target Business).

The "Sponsor" would like to acquire an interest in Target Business. D, however, is reluctant to sell the Target Business to Sponsor and incur the corporate tax.

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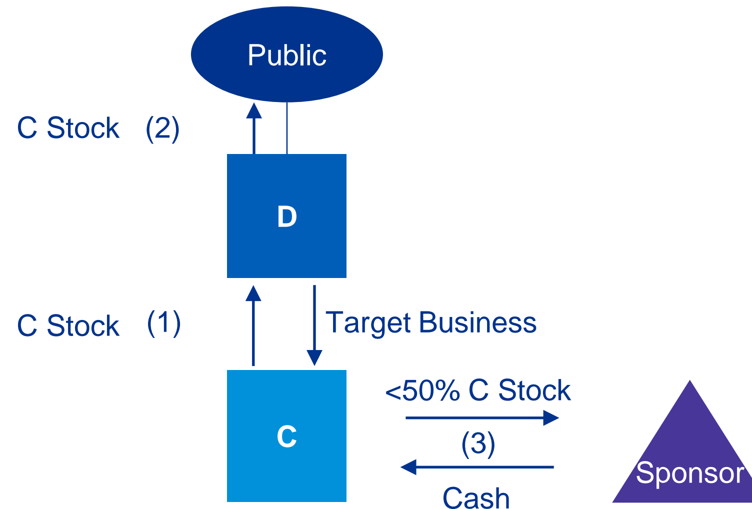
Conventional Sponsored Spin-offs



- To avoid corporate level tax on C stock, Sponsor must acquire less than 50% of C stock for purposes of Section 355(e).
- Typically, D will leverage the C assets through one of the techniques discussed earlier. For example, C may borrow and distribute the loan proceeds to D. Under the boot purging rule, D must use such cash to repay creditors or distribute such cash to shareholders (as a dividend or redemption). C can use the cash contributed by Sponsor to repay the debt or distribute the proceeds to shareholders.

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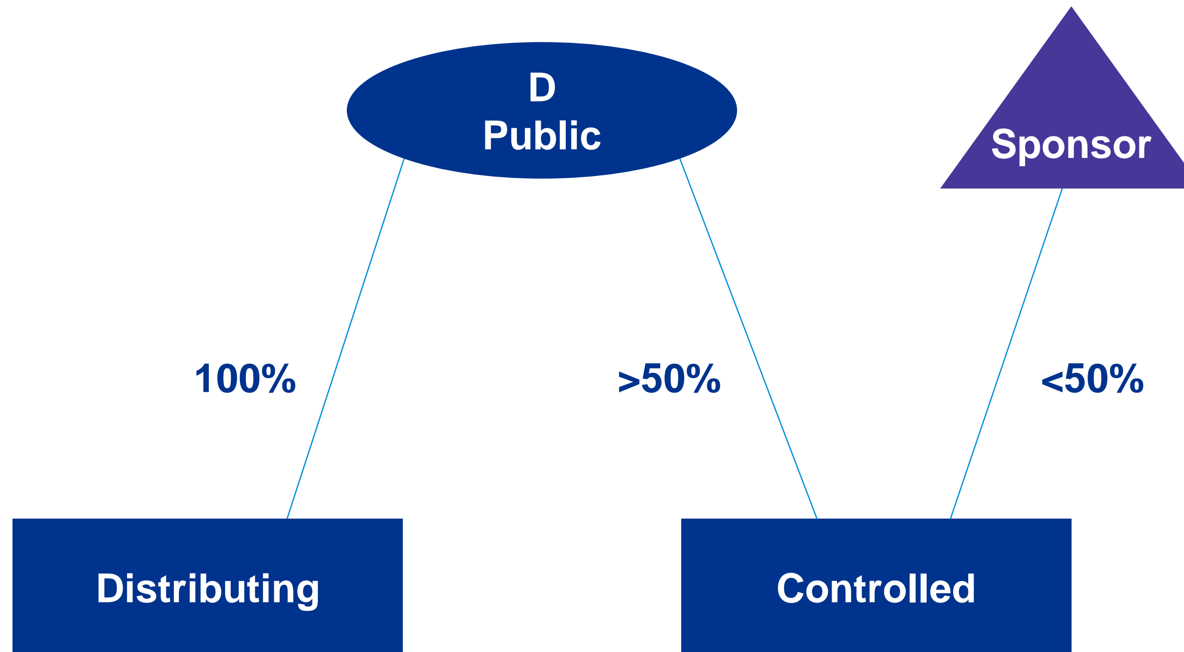
Conventional Sponsored Spin-Off (continued)



Distributing distributes Controlled to D public and pursuant to a prearranged plan, Sponsor purchases less than 50% of Controlled stock from Controlled.

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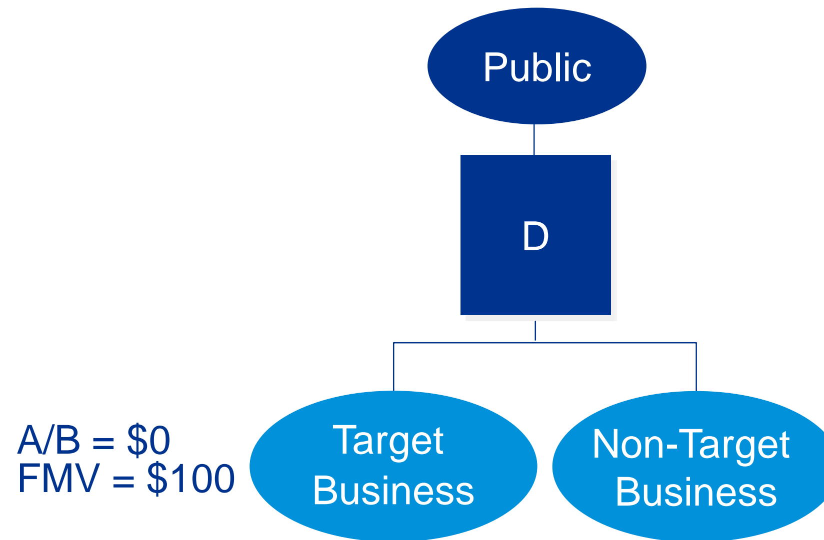
Reverse Sponsored Spin-Off



Low basis in assets of Target business precludes leverage techniques mentioned earlier (e.g., leveraged distribution to creditors, assumption of D debt).

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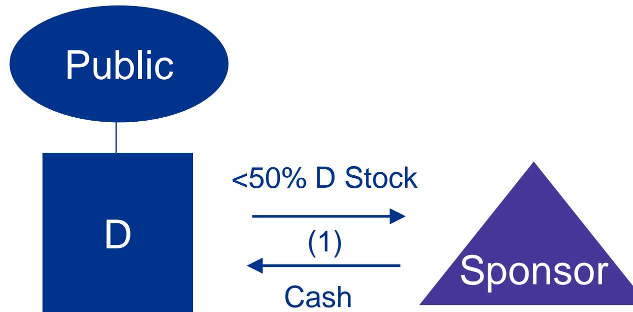
Reverse Sponsored Spin-Off (continued)



- The sponsored spin-off structure is “reversed”, i.e., the Sponsor invests in D rather than C following the spin-off.
- The D shareholders also may receive a cash distribution funded by the contribution from the Sponsor.

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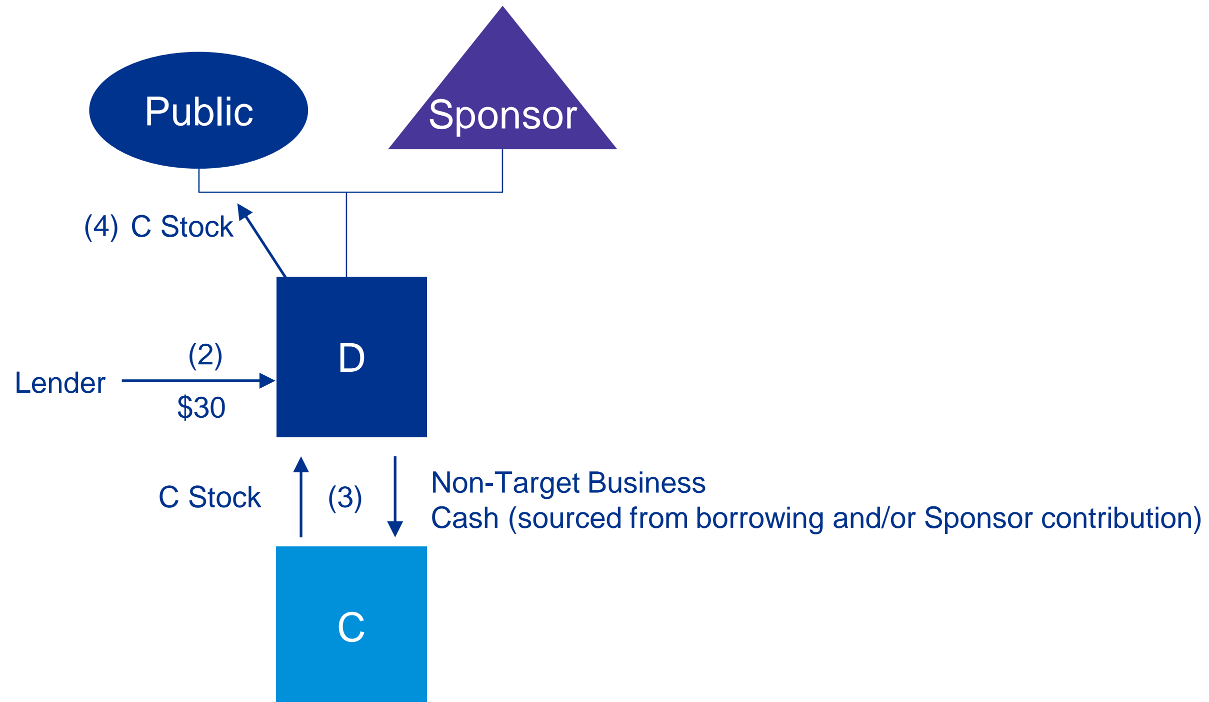
Reverse Sponsored Spin-Off



— D can borrow and contribute the proceeds to C along with Non-Target Business.

— D distributes C stock to D public in a non-pro rata split-off.

— Certain rules require consideration (such as the device limitation and Section 355(g)).

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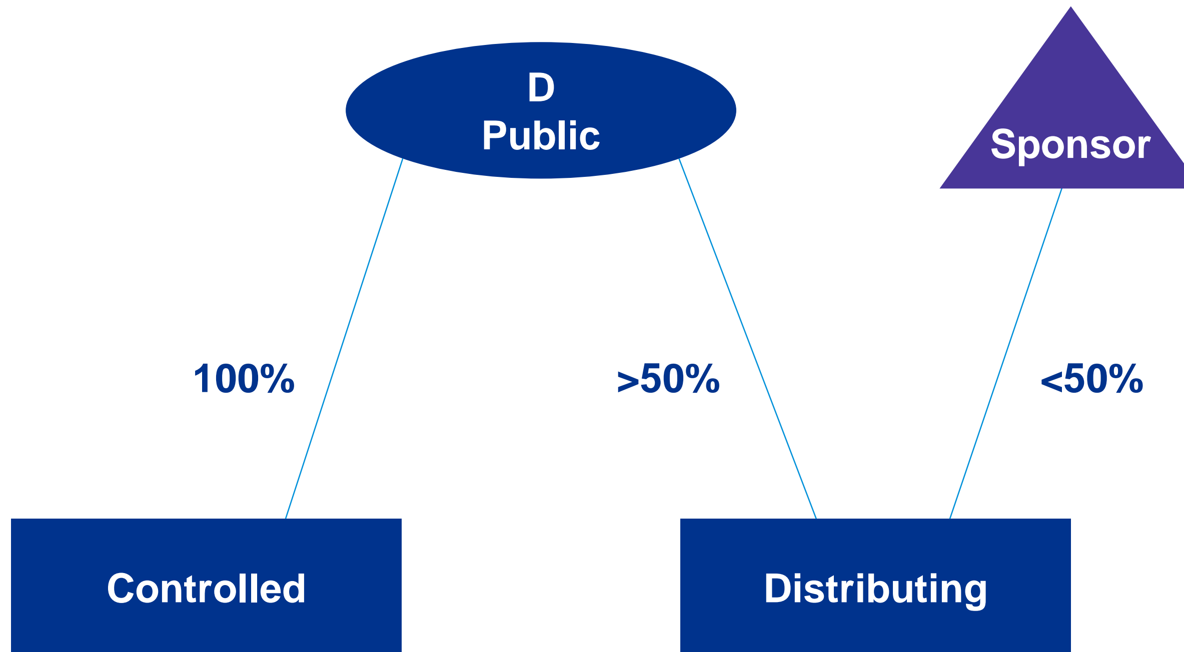
Reverse Sponsored Spin-Off (continued)



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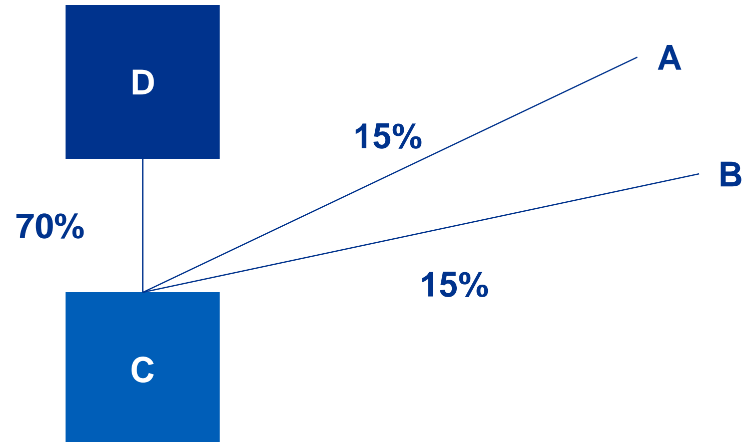
Recapitalizations/ Dual class of stock

Recap into control and subsequent unwind



- D does not own section 368(c) control of C
- Permanent change in capital structure, together with business purpose for recapitalization including a purpose other than merely obtaining control to effect spin-off tax-free.
  - D's 70% recapped into Class B – 80% vote.
  - A and B's 30% recapped into Class A – 20% vote.
  - Business Purpose to create stock for key employee and to facilitate transaction
- Reverts to 70/30 ratio in 20 years; 10 years; 5 years; 46 days?

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Safe harbors under Rev. Proc. 2016-40

- Rev. Proc. 2016-40 provides two safe harbors with respect to certain issuances of Controlled stock that result in Distributing obtaining control in anticipation of a distribution where such transactions are subsequently unwound, "in actuality or in effect, [where the unwind] substantially restores (a) C[ontrolled]'s shareholders to the relative interests, direct or indirect, they would have held in C[ontrolled] (or a successor to C[ontrolled]) had the issuance not occurred; and/or (b) the relative voting rights and value of the C[ontrolled] classes of stock that were present prior to the issuance (an unwind)."
  - What of low vote stock issued to preserve control?
  - What implications for recapitalizations that are not unwound?
- If either of the two safe harbors apply, the Service will not assert that the recap lacks substance for purposes of section 355(a)(1)(A).
- However, no inference should be drawn with respect to the federal income tax treatment of a transaction for failure to qualify for the safe harbors.
- Note the exception for recapitalization in the proposed ATB regulations prohibiting use of Distributing assets to acquire control. Prop. Reg. §1.355–3(b)(4)(ii)(A).

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Safe harbors under Rev. Proc. 2016-40 (continued)

— ***Safe Harbor #1 (No Action Taken within 24 Months):*** No action is taken (including adoption of any plan or policy), at any time prior to 24 months after the distribution, by C's board of directors, C's management, or any of C's controlling shareholders (as defined in Reg. § 1.355-7(h)(3)) that would (if implemented) actually or effectively result in an unwind.

- What constitutes an "action," e.g., internal discussions of a possible unwind prior to or during the 24 months following the distribution, a question from the CEO to the company tax advisor or investment advisor as to whether and when an unwind is permitted, the mere expectation that an unwind will occur immediately after the 2 year window, a public statement that there is no plan or intent to consider an unwind for the 24-month period following the distribution, etc.?
- Absent the application of Safe Harbor #2, could the Service sign-off on a structure under audit within 24 months of the distribution (e.g., for a taxpayer in the CAP program with its accelerated audits)?

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Safe harbors under Rev. Proc. 2016-40 (continued)

— ***Safe Harbor #2 (Third Party Transaction):*** C engages in a transaction with one or more persons (for example, a merger of C with another corporation) that results in an unwind, regardless of when it takes place, provided that: (i) the transaction or similar transaction was not the subject of an "agreement, understanding, arrangement, or substantial negotiations" or "discussions (within the meaning of [Reg.] § 1.355-7(h)(6))" at any time during the 24-month period ending on the date of the distribution; and (ii) at any time, including after the 24-month period, one person (treating corporations or investment funds as a person) does not own more than 20 percent (by vote or value) of both C and the third party that engaged in the unwind transaction.

  - Does the safe harbor apply to a "hot market" in which a post-distribution acquisition is anticipated? *Cf.* Reg. § 1.355-7(j) (Ex. 3) (Super Safe Harbor application to hot market).

— Availability of both safe harbors depend upon the date of the distribution – how are they applied when the distribution occurs on more than one date?

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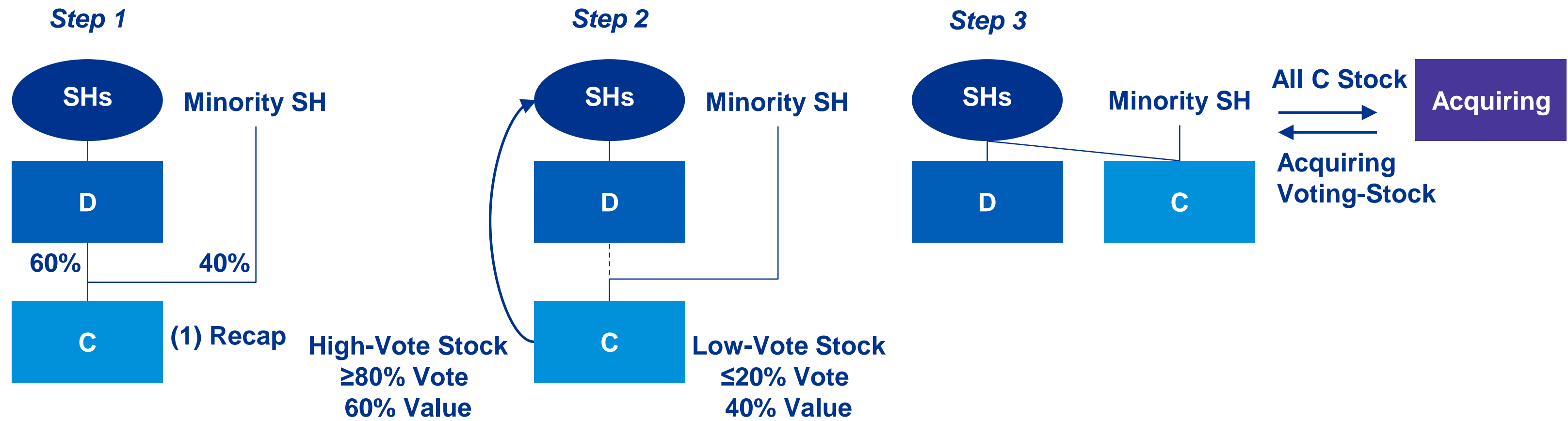
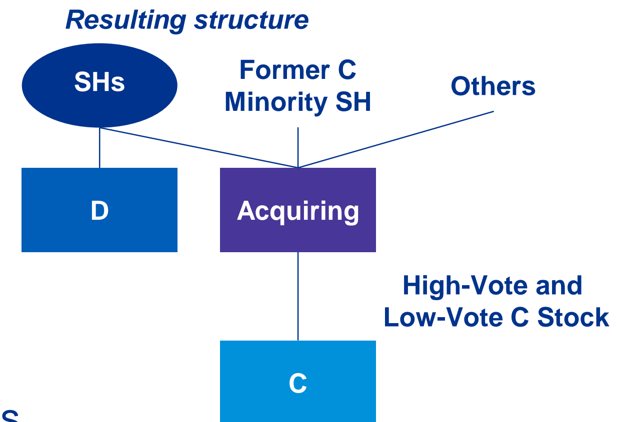
What constitutes an unwind?





Steps:

1. C recapitalizes its stock into high-vote and low-vote stock, such that D owns stock representing at least 80% of the voting power of C stock.
2. D distributes all of its C stock pro rata to its shareholders.
3. Three months after the Distribution, Acquiring acquires all of the stock of C in a reorganization qualifying under section 368(a)(1)(B).

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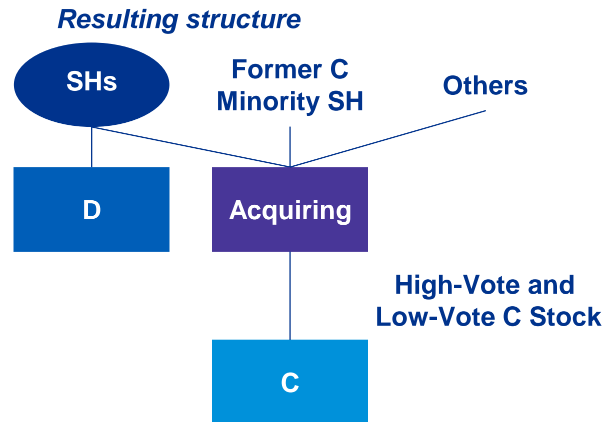
What constitutes an unwind (continued)



Safe harbor qualification

- Is the Recapitalization unwound by virtue of the acquisition of all the C stock in the B reorganization?
- Alternatively, what if there were discussions related to the acquisition before the Distribution?

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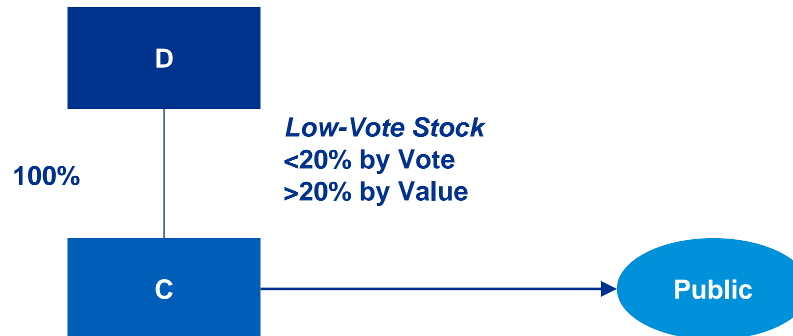
Pre-spin IPO in dual class structure



Facts: **D owns all 100 outstanding shares of C common stock, each with 1 vote per share. C issues 50 shares of a new class of C common stock having 1/10th of a vote per share. The new class of C stock represents 1/3 by value and approximately 4.76% by vote of the C stock.**

Questions:

— Does Rev. Proc. 2016-40 apply where low vote stock is issued or other corporate mechanics are implemented to maintain control?

— If inapplicable, how might the underlying premises of Rev. Proc. 2016-40 be applied in the context of a private letter ruling application?

- Presumably the dual class structure would be blessed after the passage of some 24-month period after the distribution if “no action” is taken.
- When should the 24-month period commence in the case of a distribution that occurs on multiple dates – the date of the first transfer, the date on which the distribution requirement would be satisfied or the date on which D disposes of the last of its remaining C shares?

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Proposed Device and ATB Regulations

The Proposed Device Regulations

The Proposed Device Regulations include several new provisions, including the following:

— The “nature and use of assets” factor of the Device Requirement would distinguish between Business and Nonbusiness Assets (newly defined terms) rather than active trade or business (“ATB”) and non-ATB assets

— Draft guidance regarding the determination of when the presence of Nonbusiness Assets or a difference between the ratios of the Business Assets to Nonbusiness Assets of D and C constitutes evidence of device

— A proposed per se device rule for certain situations involving high percentages of Nonbusiness Assets in one of D or C and a significant difference between the percentages of Nonbusiness Assets of D and C

— A business purpose that relates to the separation of Business Assets from Nonbusiness Assets may no longer be evidence of non-device under the proposed rules

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Key Definitions

The proposed regulations add the following defined terms:

“Business” generally means the active conduct of a trade or business for Section 355(b) purposes without regard to certain requirements, such as the five-year active conduct requirement and the collection-of-income requirement.

“Business Assets” of a corporation are its gross assets used in one or more Businesses.

— Strict test for characterizing cash and cash equivalents as “Business Assets”

“Nonbusiness Assets” of a corporation are its gross assets other than Business Assets.

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Presence of Nonbusiness Assets & Relative Proportions

Presence of Nonbusiness Assets and their relative proportions can constitute evidence of device.

Amount of nonbusiness assets

— Ownership of Nonbusiness Assets by D or C is evidence of device.

— The strength of the evidence will be based on all the facts and circumstances, including the Nonbusiness Asset Percentage for each corporation.

— The larger the Nonbusiness Asset Percentage of either corporation, the stronger is the evidence of device.

— Safe Harbor: Ownership of Nonbusiness Assets ordinarily is not evidence of device if the Nonbusiness Asset Percentage of each of D and C is less than 20 percent.

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Presence of Nonbusiness Assets & Relative Proportions (continued)

Proportion of nonbusiness asset percentages

- A difference between the Nonbusiness Asset Percentage of D and the Nonbusiness Asset Percentage of C is evidence of device, and the larger the difference, the stronger is the evidence of device.
- Safe Harbor: Such a difference ordinarily is not itself evidence of device (but may be considered in determining the presence or the strength of other device factors) if –
  - The difference is less than 10 percentage points; or
  - The difference is in a split-off to equalize values.

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Per Se Device Rule

The Proposed Regulations add a Per Se Rule, which provides that the Device Requirement is violated if:

1. The Nonbusiness Asset Percentage of either D or C is 66 ⅔ percent or more; and
2. A specified level of disproportionality exists between D's and C's Nonbusiness Asset Percentages as follows:
   - *Nonbusiness Assets between 66 ⅔ percent and 80 percent*. Both (1) the Nonbusiness Asset Percentage of either D or C is greater than or equal to 66 ⅔ percent and less than 80 percent and (2) the Nonbusiness Asset Percentage of the other corporation is less than 30 percent;
   - *Nonbusiness Assets between 80 percent and 90 percent*. Both (1) the Nonbusiness Asset Percentage of either D or C is greater than or equal to 80 percent and less than 90 percent and (2) the Nonbusiness Asset Percentage of the other corporation is less than 40 percent; or
   - *Nonbusiness Assets 90 percent or Above*. Both (1) the Nonbusiness Asset Percentage of either D or C is greater than or equal to 90 percent and (2) the Nonbusiness Asset Percentage of the other corporation is less than 50 percent

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Exceptions to the Per Se Device Rule

Exceptions to the Per Se Rule exist for two categories of transactions:

1. Dividends Received Deduction
2. Section 302(a) and No E&P
   - Certain distributions are “ordinarily” not considered to have been used principally as a device (e.g., absence of E&P, capital gain treatment in the absence of Section 355 with respect to each distributee)

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Active Trade or Business Test – Size of D's and C's ATB Relative to Other Assets

No specific reference to absolute or relative size of the ATB.

— Section 355(b) and Treas. Reg. section 1.355-3(b)

"There is no requirement in section 355(b) that a specific percentage of the corporation's assets be devoted to the active conduct of a trade or business. In the instant case, therefore, it is not controlling for purposes of the [ATB] requirement that the active business assets of [C] represent less than half of the value of [C] immediately after the distribution."

— Rev. Rul. 73-44

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Proposed ATB Regulations - Small ATBs

The preamble states that adopting a minimum size requirement for ATBs is appropriate and consistent with prior guidance:

Permitting section 355(b) to be satisfied with an ATB that is economically insignificant in relation to the other assets of D or C is not consistent with the congressional purpose of section 355 because it would permit the separation of inactive assets from a business, rather than the separation of different businesses.

Recent changes to section 355, particularly the SAG rules, make compliance with the minimum size requirement simpler than it would have been prior to those changes.

Rev. Rul. 73-44 is consistent with the minimum size requirement as the ruling concludes there is no requirement that a specific percentage of a corporation's assets be devoted to the ATB (rather than holding that an economically insignificant ATB satisfies section 355(b))

— The IRS will modify the statement in Rev. Rul. 73-44 regarding a minimum percentage.

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Proposed ATB Regulations – Minimum Size Requirement

In order to satisfy the minimum size requirement, the percentages of D's and C's gross assets that are ATB Assets must both be at least 5%. Prop. Treas. § 1.355-9(a)(3), (b).

Assets used in a Business that is not an ATB are not ATB Assets, even though they are Business Assets for the nature and use of assets factor of the No Device Requirement.

ATB Assets include:

- Reasonable working capital for one or more ATBs;
- Assets that are required to be held to provide for exigencies related to the ATB;
- Assets that are required to be held to secure or otherwise provide for a financial obligation reasonably expected to arise from an ATB; and
- Assets held to implement a binding commitment to expend funds to expand or improve an ATB. Prop. Treas. § 1.355-9(a)(3)

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Proposed ATB Regulations – Operating Rules

All members of the CSAG and all members of the DSAG are treated as single corporations

— The 50-Percent Member rule from the proposed No Device Requirement modifications does not apply because an ATB of such 50-Percent Member would not be attributed to D or C under the current SAG rules. See Prop. Treas. § 1.355-9(c)(1)

Partnership interests owned by D or C:

— The fair market value of an interest in an ATB Partnership will be allocated between ATB Assets and other assets in proportion to the percentage of ATB Assets held by the ATB Partnership. No other partnership interests are ATB Assets. See Prop. Treas. § 1.355-9(c)(3)

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Anti-Abuse Rules

A transaction or series of transactions undertaken with a principal purpose of affecting the Nonbusiness Asset Percentage of any corporation will not be given effect for purposes of the device factors described above.

Similarly, a transaction or series of transactions undertaken with a principal purpose of affecting the percentage of any corporation’s assets that are used in an ATB will not be given effect for purposes of the minimum size requirement.

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