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Spinoff Changes Announced

by Robert W. Wood • San Francisco

No reader of *The M&A Tax Report* will have failed to notice that Section 355 is covered in these pages with some regularity. After all, regardless of whether one has a generally pro-taxpayer or pro-government perspective, it is impossible to escape the reality that Section 355 represents one of the only remaining ameliorations of *General Utilities* repeal. Indeed, the IRS has been sufficiently concerned with the scope of Section 355, that several amendments over the past two years have been introduced to attempt to curb the tide of Section 355 transactions.

Now, administrative developments have been added that every practitioner should know about. Revenue Procedure 96-30, 1996-19 I.R.B. 1, contains a list of information and representations that taxpayers must provide in order to obtain a Section 355 ruling. The prior guidance had been contained in Revenue Procedure 86-41, 1986-2 C.B. 716.

There are a number of substantive changes in the Revenue Procedure, which seem to solidify current administrative ruling posture. However, due to the many changes in the current Revenue Procedure, the Service does indicate that the old procedure (86-41) is superseded in its entirety.

Business Purpose Focus

Given how controversial the business purpose requirement of Section 355 has been over the past few years, and how subjective the IRS' evaluation of particular business purposes can seem, the most important change is the inclusion of business purpose criteria in an appendix. This appendix contains a list of business purposes that are deemed permissible, the list being expressly made nonexclusive.

In fact, the Revenue Procedure states that if a purpose for a transaction is not described in the appendix, then the taxpayer should follow the procedure for asking whether the distribution does satisfy the business purpose requirement. The Revenue Procedure also states that just because a transaction fails to meet the appendix guidelines for what consitutes a legitimate business purpose does not mean that there is not a legitimate business

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purpose. The Revenue Procedure states that the IRS will consider requests for rulings that do not satisfy these Appendix A guidelines, and may still rule favorably in "appropriate circumstances."

On the other hand, the Revenue Procedure states that the fact that a transaction may fall within the Appendix A business purpose guidelines does not necessarily mean that a favorable ruling will be issued, unless the IRS is satisfied that the transaction is motivated, in whole or in part, by a real and substantial non-federal tax purpose germaine to the business of the distributing corporation, the controlled corporation, or the affiliated group to which the distributing corporation belongs.

This notion seems to cut back on the reliability of the Appendix A list, although perhaps it merely means that the Service wants to be sure a taxpayer is not just parroting compliance with an Appendix A business purpose. Plus, the IRS is still looking to assure itself that the business purpose cannot be achieved through a nontaxable transaction that does not involve the distribution of the controlled corporation's stock, that is neither impractical nor unduly expensive.

With all of these disclaimers, the text of Appendix A to the Revenue Procedure is nonetheless of enormous importance. Let's review the salient features of the specific corporate business purposes the IRS has listed in Appendix A to Revenue Procedure 96-30. The Service breaks down the business purposes into several distinct areas or topic headings.

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I. Key Employee Purposes

Providing equity to key employees has been a controversial business purpose for a number of years, with the Service having long been antagonistic to the idea. Now, the Revenue Procedure lays down some ground rules. To establish that a business purpose for the distribution is to provide equity to employees, the taxpayer ordinarily must demonstrate that:

- The transfer will accomplish a real and substantial purpose, including details about why the individual is a key employee, and why it is necessary to give that individual an equity interest of the type (and amount) proposed.
- Generally, the employee must receive a "significant" amount (in terms of percentage and value of voting stock) within one year of the distribution. The Revenue Procedure indicates that acquiring a significant percentage of the stock may not be required where it would be prohibitively expensive for the employee. In any case, the ruling request must be clear as to exactly when the employee will acquire the stock, and fully describe the terms and method of acquisition.
- The ruling request must indicate why the transfer of equity cannot be accomplished by an alternative nontaxable transaction. For example, the taxpayer must show why another nontaxable transaction, such as a transfer of assets to a partnership or a limited liability company, will neither be impractical nor unduly expensive.

  At least the Revenue Procedure does recognize that an S corporation cannot merely have a subsidiary corporation, since that would destroy the S election. But being potentially required to disprove the ability to use a partnership or limited liability company may be somewhat troubling.

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- If the arrangement calls for options and restricted stock, the Revenue Procedure says that the IRS will scrutinize closely these situations. One concern, of course, is that the real ownership might somehow be disguised or that the employer might be trying to protect the full benefits of ownership from accruing.

II. Stock Offerings

Where a business purpose is to facilitate a stock offering, a number of points must generally be demonstrated.

- The issuer needs to raise a substantial amount of capital, for specific uses (operations, acquisitions, debt retirement, etc.).
- The stock offering will be more advantageous (*i.e.*, will raise more money!) if the 355 separation occurs. Ordinarily, a substantiation of this in the form of professional analysis needs to be submitted. This analysis can refer to other market data.

  Happily, though, the Revenue Procedure indicates that the Service will acknowledge (without extensive substantiation) that an offering of publicly-traded stock by a widely-held corporation with no significant shareholders will raise more money per share than an offering by the same company as a controlled subsidiary.
- The funds must be used for the business needs of the distributing or controlled corporations, or the affiliated group to which the distributing corporation belongs.
- The stock offering has to be completed within one year of the distribution.
- If the stock of a corporation with one or more significant shareholders is to be purchased by a limited number of investors as a condition of their participation, that must be substantiated.

III. Borrowing Purposes

Where a business purpose is to facilitate borrowing, the following must generally be established.

- The distributing or controlled corporation needs to raise substantial funds for operations, capital expenditures, acquisitions, etc.
- The separation will enable one of the companies to borrow significantly more money on significantly better non-financial terms. This must be substantiated by a professional analysis.
- The use of the funds (by the distributing or controlled corporations, or the distributing corporation's affiliated group) must be substantiated.
- The borrowing must be completed within one year of the distribution.

IV. Cost Savings

One of the more controversial business purposes has been the extent to which a distribution will produce significant cost savings. Again, the Revenue Procedure indicates that a submission for a ruling should include an analysis based on professional judgment of persons qualified to speak on this matter.

Examples of such qualified persons include an insurance company regarding insurance savings, an investment banker for borrowing costs, and in appropriate cases, the taxpayer's employees. The analysis must explain why the savings cannot be achieved through a nontaxable transaction that does not involve a 355 distribution, and which is neither impractical nor unduly expensive.

What is considered "significant cost savings"? Generally, the Revenue Procedure says that a cost savings equal to at least one percent of the base period net income of the affiliated group will be considered significant. One generally projects the total anticipated future cost savings to the corporations for the three-year period following the distribution, reduced by transactions costs and any anticipated additional direct or indirect costs.

All savings and all additional costs are aggregated. The base period net income is the total net consolidated financial income of the affiliated group for the three-year period before the distribution. The taxpayer can choose to use a five-year period preceding and following the distribution for the base period and projection period, instead of using three years before and after.

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Obviously, this cost savings projection can be somewhat subjective, and the Revenue Procedure indicates that the IRS may apply different guidelines in various situations.

V. Fit and Focus

If so-called "cost savings" can be considered controversial as a business purpose, then this is true in spades for the somewhat catchy "fit and focus" business purpose. The *Wall Street Journal* has long been full of business reports that large conglomerates are shedding divisions via Section 355 in order to fit and focus their operations upon particular segments of their business. It has often been the job of tax advisors to mold such understandable business concepts into a business purpose that is acceptable to the IRS.

Now, Revenue Procedure 96-30 explicitly recognizes that a business purpose may be this important fit and focus concept. The ruling request would have as its business purpose that the separation will enhance the success of the business by enabling the corporations to resolve management, systemic or other problems that arise (or are exacerbated) by the taxpayer's operation of different businesses within a single corporation or affiliated group. Interestingly, the Revenue Procedure indicates that this purpose can apply to pro rata and non-pro rata distributions alike.

Different standards apply depending on whether the distributing corporation is publicly or nonpublicly traded. If the distributing corporation is not publicly traded, or is publicly traded but has a significant shareholder, the IRS will ordinarily not rule unless the distribution is non-pro rata to enable a significant shareholder (or shareholder group) to concentrate on a particular business, or unless the distribution effects an internal restructuring within an affiliated group.

For this purpose, a significant shareholder is considered to be any person who directly or indirectly (or with related persons) owns 5% or more of any class of stock of the distributing or controlled entities, and who actively participates in management or operations. Apparently someone who meets or exceeds the 5% threshold will be scrutinized as to whether they actively participated in management or operations, and the ruling request will need to prove that they did not if this contention is made.

To a greater extent than elsewhere in the Revenue Procedure, this "fit and focus" business purpose states that documentary substantiation is essential. According to the Appendix, the documentation should describe in detail the problems associated with the current corporate structure, demonstrating why the distribution will lessen or eliminate them. Internal reports and studies and analyses based upon professional judgment of investment bankers or management consultants are examples of helpful documentation.

Significantly, though, if the distribution is to be non-pro rata to an equally significant shareholder or shareholder group to concentrate on a particular business, the IRS ordinarily will not require third party documentation or detailed studies.

Although it could logically apply across the board, the "fit and focus" business purpose is to be subjected to "special scrutiny" according to the Appendix. The following situations are particularly to be watched by the IRS:

- Continuing Relationship—any continuing relationship between the distributing and controlled corporations, even including common directors, officers or key employees, the

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provision of goods or services, etc.

- Cross-Ownership—any direct or indirect continuing interest in both the distributing and controlled corporations by a significant shareholder or, for nonpublicly traded companies, any other shareholder.
- Certain Internal Restructurings—any internal restructuring in which the distributee is not entitled to eliminate, exclude or receive a 100% dividends received deduction with respect to a distribution from the distributing company.

VI. Competition

The Appendix recognizes that a valid corporate business purpose may be to resolve problems with customers or suppliers who object to the distributing and controlled companies being associated with one another because one competes with the customer or supplier. To demonstrate this purpose, one should submit evidence that one or more suppliers have significantly reduced or will significantly reduce their purchases or sales because of this issue. It also should be shown that the distribution will cure this problem, and that the customers or suppliers will increase their purchases or sales after the distribution.

One can well imagine this issue could require some fancy footwork with the customers or suppliers. Indeed, it should be shown that the customers or suppliers will not object to the planned ownership after the spin.

Finally, the sales to these customers or purchases from suppliers must represent a "meaningful amount" of sales or purchases after the distribution. Substantiation of all of this will be required.

VII. Facilitating an Acquisition of Distributing

An acquisition of the distributing company has long been an acceptable corporate business purpose. The Appendix on this part is not terribly surprising, listing requirements that the acquisition will not be completed unless the separation occurs; that the acquisition cannot be accomplished by an alternative nontaxable transaction that is neither impractical nor unduly expensive; and that the acquiring corporation is not related to either the distributing or controlled entity. Except in unusual circumstances, the resulting acquisition must be completed within one year after the distribution.

VIII. Acquisition by Distributing or Controlled

If the business purpose of the transaction is so that there can be a subsequent tax-free acquisition of another corporation by the distributing or controlled corporation, the taxpayer must satisfactorily demonstrate that:

- the combination of the target with the distributing or controlled entity will not be undertaken unless the separation occurs;
- the acquisition cannot be accomplished by an alternative nontaxable transaction that does not involve the distribution of the stock and is neither impractical nor unduly expensive;
- the target corporation is not related to either the distributing or controlled one (although in some cases a ruling can still be available where there is a relationship); and
- the acquisition will be completed (except in unusual circumstances) within one year of the distribution.

IX. Risk Reduction

Finally, the Appendix includes a business purpose to protect one business from the risks and vicissitudes of another business. This relatively stock business purpose has recently been used with somewhat more frequency. To obtain a ruling on this point, the IRS needs to know:

- The nature and magnitude of the risks faced by what the Appendix cleverly terms the "risky business." This information must include claims history, etc.
- Whether the assets and insurance associated with the risky business are sufficient to meet reasonably anticipated claims arising from the risky business. The submission must include book value and fair market value of net assets, including intangibles, of the risky business. Other factors (such as non-balance sheet liabilities) that affect the value should also be described. Insurance coverage and costs of additional coverage should be listed. Third-party

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substantiation regarding insurance will likely be required.

- A discussion of local law concerning the enhanced protection that will be obtained by a separation should also be included. There should be discussion whether an alternative transaction not involving distribution could be accomplished under applicable law which would neither be impractical nor unduly expensive. The submission should include an analysis of the application of the law to the facts, and an opinion of counsel may also be required.

  Interestingly, however, the Appendix indicates that "[i]t is not necessary for the taxpayer to establish conclusively that, under applicable law, the proposed transaction will afford adequate protection or that an alternative transaction would not afford adequate protection. However, the taxpayer must convince the Service that, based on objective analysis of the law and its application to the facts, risk reduction is a real and substantial purpose for the transaction."

Conclusion

All in all, the list of acceptable business purposes, together with some of the nuances that the IRS will examine, should materially help practitioners in submitting rulings in this inherently factual area. Revenue Procedure 96-30 helps level the playing field between experienced and less experienced practitioners. More fundamentally, it should tell us all that Section 355 remains alive and well. Go out there and get a ruling and enjoy it! ■