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Spinoffs and Filling the Business Purpose Requirement

by Robert W. Wood • San Francisco

In the past few months (indeed, in the past few years!) the pages of *The M&A Tax Report* have been filled frequently with articles about spinoffs contemplated; spinoffs curtailed; spinoffs desired; and spinoffs consummated. The tax laws have changed several times during the last few years, and it seems ever to be thus. For recent coverage, see Wood, "Amended Spinoff Law: How Bad Is It?" Vol. 6, No. 3, *M&A Tax Report* (Oct. 1997), p. 1; Wood, "Spin Count," Vol. 6, No. 3, *M&A Tax Report* (Oct. 1997), p. 7; Willens, "When is Control Really Control?" Vol. 6, No. 5, *M&A Tax Report* (Dec. 1997), p. 1; and Wood, "Spinoff Rulings; *Morris Trust* Repealed?" Vol. 5, No. 10, *M&A Tax Report* (May 1997), p. 1.

While it is obvious that there is still substantial interest in Section 355, this month we look at several topics that may seem a little out of the ordinary in this venue. True, there are the usual announcements of contemplated spinoffs. See Quebecor's announcement that "Donahue and Printing Unit Stakes May be Spun Off," *Wall Street Journal*, Oct. 8, 1997, p. B2.

However, some of the discussion is in the regular business press about that dreadfully misused word "loophole." In the November 24, 1997 issue of *Business*

Week, the Congressional ban on *Morris Trust* transactions is describing as having just such one loophole, supposedly now being used by two creative companies.

According to the article, "A New Spin on Tax-Free Spin-offs," *Business Week*, Nov. 24, 1997, p. 6, nursing home operator Beverly Enterprises planned a transaction with its Pharmacy Corporation of America to transfer the pharmacy unit to Capstone Pharmacy Services. Beverly Enterprises shareholders are to own 57% of Capstone. Similarly, once W.R. Grace spins off its packaging operation to Sealed Air (the maker of bubble wrap), W.R. Grace Shareholders will control 63% of Sealed Air.

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M&A Tax Report Advisory Board member (and Lehman Brothers tax expert), Bob Willens, is quoted by *Business Week* as saying he expects more of these deals to get around. The disadvantage (at least from the perspective of the buyer's shareholders) is that their stakes in the company are diluted. The advantage, on the other hand, is that they own stock in a presumably more valuable company.

Whose Purpose Is It Anyway?

One of the main requirements for tax-free treatment under Section 355 is that there be a legitimate corporate business purpose for the transaction. Not surprisingly, a good deal of learning has gone into the identification of such good purposes. Obviously, even the best enumerated corporate purpose will not be sufficient if it is wholly inappropriate on the facts. The corporate business purpose has to be true, and has to fit within the taxpayer's (and the government's) view of reality.

That said, there are still plenty of choices in determining a valid corporate business purpose. Several years ago, we included a list of corporate business purposes in *The M&A Tax Report*. Back more or less by popular demand, we are repeating it here. Bear in mind, of course, that this predates the Service's own diatribe on business purpose which

came out in Revenue Procedure 96-30, 1996-19 I.R.B. 1. (For discussion, see Wood, "Spinoff Changes Announced," Vol. 4, No. 11, *M&A Tax Report* (June 1996), p. 1.) With that caveat, the list follows:

- **Tax-Free Reorganization.** A valid purpose will exist to the extent that corporate assets are separated into two corporations in order that one of the resulting entities can participate in a tax-free reorganization.
- **Stock for Acquisitions.** The stated necessity of allowing a subsidiary to use its own stock in making acquisitions has also been determined to be a valid business purpose.
- **Dissident Shareholders.** The division of two companies to make it possible for dissident shareholders to separate is a clear business purpose.
- **Inactive Shareholders.** The elimination of inactive shareholders satisfies the requirement, if necessary in the particular business (for example, to assure continued compliance with automobile manufacturers' franchise requirements).
- **Shareholder/Owner Business Separation.** A spinoff permitting shareholders to restrict their investment and activities to one activity of the corporate business qualifies.
- **Employee Ownership.** A spinoff enabling employees to acquire an interest or increase an interest in the business can qualify, although the Service has been very critical of this purpose in the last few years.
- **Labor Problems.** A spinoff to avoid labor problems can qualify.
- **Customer Friction and Antitrust Problems.** The separation of two businesses to eliminate customer friction and potential antitrust problems qualifies.
- **Reduce Nonfederal Taxes.** The reduction of state and local taxes has also been held to be a valid business purpose. Under the regulations, however, a purpose to avoid nonfederal taxes

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will not suffice if (i) the transaction will effect a reduction in both federal and nonfederal

- **Possible Nationalization.** The spinoff by a first tier foreign subsidiary of a new second tier foreign subsidiary in a different country qualifies, where the spinoff was necessary to avoid possible expropriation of the assets.
- **Compliance With Laws.** Compliance with laws will be a valid business purpose, such as laws requiring a separation of business.
- **Expanded Access to Credit.** Expanded access to credit can be a valid business purpose.
- **Avoiding Takeovers.** A valid business purpose can exist to avoid a hostile takeover.
- **Administrative Costs.** A purpose of avoiding administrative compliance costs will support a spinoff.
- **Securing Capital.** A business of enabling one corporation to secure needed capital will qualify.
- **Improve Securities Sales.** A purpose to separate unprofitable operations from a profitable operation in order for the profitable operation to market its debentures through an underwriter was held to constitute a valid business purpose.
- **Facilitating Rate/Price Increases.** The separation of a subsidiary from a public utility to remove a state-imposed impediment preventing a rate increase was held a valid business purpose.
- **Avoiding Financial Disclosure.** A spinoff to avoid filling financial statements with state authorities has been upheld.
- **Reducing Withholding Tax.** A spinoff to reduce the amount of withholding tax imposed on distributions by a second tier corporation has been held to satisfy the business purpose requirement.

Anyone care to write or e-mail in their additions (or deletions) to this list?

Shareholder Purpose?

Against this background, some practitioners and academics have begun to question anew (for this question is not really a new question), just *whose* purpose it has to be. In a recent Tax Court case, *Clark D. Pulliam v. Commissioner*, T.C. Memo 1997-274 (1997), Mr. Pulliam owned 100% of the stock of Pulliam Funeral Homes, P.C., which operated three funeral homes in eastern Illinois. The key employee at one of the three facilities had various disagreements with Mr. Pulliam regarding the operation, and proceeded to take steps to open his own funeral home in the same neighborhood. Finding out what was up, Mr. Pulliam fired the man.

Shortly thereafter, though, the two men met and reached an informal agreement under which the malcontent would be allowed to acquire a 49% interest in the one funeral home in which he had worked. Of course, he would be re-employed and given a bonus. So far this sounds like a classic case for a non-*pro rata* spinoff. There was employee hostility, and the need for equity, all rolled into one.

The first step, obviously, was for the assets of the disputed funeral home to be transferred under Section 351. Interestingly, although this transaction could have been easily handled by an issuance of 49% of the stock from the spun off company to the employee (a spin to Pulliam and new issuance of shares to the disgruntled mortician), this is not what occurred. Instead, Mr. Pulliam transferred 490 shares that he owned in the company to an escrow agent to effect an installment sale of the 490 shares to the employee (Mr. Deckard).

Since the sale of the 490 shares was agreed on before the spun off company was even formed, the Tax Court concluded that substantial evidence of a "device to distribute earnings and profits" was present. ("Device" is one of those words like loopholes that gets thrown around a lot.) To offset this presumption of device, the Tax Court then required the taxpayer to produce strong evidence of a compelling business purpose, both for what was done and for *how* it was done to prevent the conclusion

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that the transaction was principally used a device to distribute earnings and profits.

Undertake a Plan

On reviewing these facts, no small businessperson would likely disagree with the notion that there was quite a strong business purpose for creating the subsidiary and then allowing the employee, Deckard, to acquire 49% of the stock. He was not just *saying* he was unhappy without equity; he had already taken steps to open a competing funeral home, and then got fired! Of course, it was the mechanics of all this that bothered the IRS. Arranging the transaction so that the proceeds of the sale of the shares would go to Mr. Pulliam individually rather than to the company did not further a corporate purpose. That, said the IRS, furthered a shareholder purpose.

Au contraire, Mr. Pulliam responded that the new company was an Illinois professional service corporation, and that Mr. Pulliam reasonably believed that Illinois law required shareholders of a funeral home to be individuals who were licensed as funeral directors and embalmers. Pulliam believed that the parent company could not be anything but a momentary shareholder of the spun off entity, and that a distribution of the spun off company stock to himself, as sole shareholder, was mandated by state law.

The IRS did not advance much of a response to this clever argument by the taxpayer, other than to say that making the company a professional corporation did not change anything. Indeed, the IRS was lackluster in its legal analysis, as evidenced by the fact that the Tax Court concluded that Mr. Pulliam, his attorney, and his CPA all reasonably believed that the spun off entity had to be a professional service corporation to engage in the funeral parlor and embalming business. According to the court, therefore, the distribution of the stock to Mr. Pulliam had a definite business purpose. As such, the court agreed with the taxpayer that neither the corporation nor Pulliam had any taxable income from this reorganization.

A Spin's A Spin

Of course, it is easy to get confused when talking about shareholder and corporate business purpose in a particular transaction. Here, there was undeniably a

corporate business purpose in achieving the spinoff in the first place. The shareholder business purpose question only came about because of the particular *manner* in which the transaction was consummated.

There are various other issues raised by the *Pulliam* case, and an aficionado of Section 355 should really review the opinion itself. Furthermore, an excellent discussion of *Pulliam* and its various ramifications appears in Raby and Raby, "Spin-off Business Purpose: Corporate or Shareholder?" *Tax Notes* (Dec. 1, 1997), p. 1049.

Negotiate to Win?

One last observation (which Raby and Raby also noted in the course of their more extensive discussion) is that Mr. Pulliam did not seek an advance ruling on the divisive reorganization involving his funeral parlors. The conventional wisdom, of course, is that one does not stick one's toes into the alternatively tepid or boiling water of Section 355 without obtaining a ruling from the IRS. If no ruling is obtained and the IRS is successful (as it tried to be in the Tax Court in *Pulliam*) in denying the benefits of Section 355, the results can be truly disastrous. That is a reason, correctly say Raby and Raby, for seeking a ruling.

Plus, they assert, there is a give and take in a ruling request so that the taxpayer might restructure the proposed transaction to avoid the kind of confrontation that occurred in *Pulliam*. It is this last point, although quite true, that is most thought-provoking.

Because of the perceived problems with the professional corporation law in the state of Illinois law, Mr. Pulliam was able to get the cash in his hands rather than in the hands of the corporation. That would be far more attractive to most clients than the alternative of having to bonus the money out in some form (or use it for something else). Suppose Mr. Pulliam had asked for a ruling instead. One suspects that if the process of give and take had occurred in a ruling discussion (as indeed it can), Mr. Pulliam might not have received everything he wanted.

Post Script

It is still certainly true that rulings (or these days,

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perhaps even opinion letters) ought to be obtained. Nonetheless, it is interesting (at least occasionally) to see a taxpayer go it alone and win. ■