# To Spin or Split: It's All in the Name?

by Robert W. Wood • San Francisco
and Robert Willens • Lehman Brothers

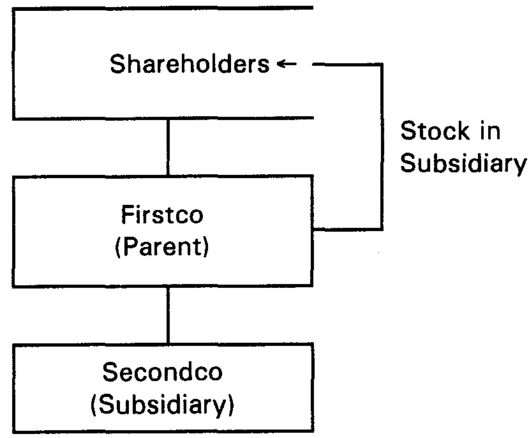
Section 355, a provision that has graced these pages many times, actually provides for the tax-free separation of businesses in several factual settings. Quite apart from the all-important business purpose test, there are several distinct transactions, and even separate monikers for the various transactions. While all of these transactions are generically referred to as spin-offs, some clarification seems in order.

## Spin-offs

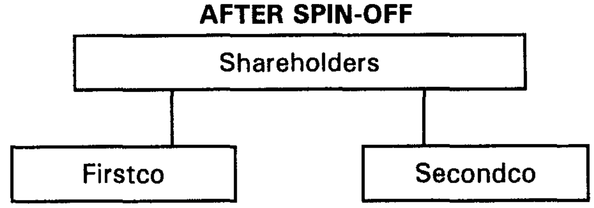
A spin-off involves a corporate distribution of stock in a subsidiary to the shareholders of the parent, without the shareholders surrendering any of their stock in the parent. Before the transaction, the shareholders hold stock only in the parent, the parent in turn holding stock in the subsidiary. After the transaction, the shareholders of the parent also have direct ownership of the shares of the subsidiary.



**BEFORE SPIN-OFF**




**AFTER SPIN-OFF**




**Example:** Shareholders Abe, Betty, and Clyde hold stock in Largeco, which has a subsidiary, Smallco. Largeco makes a pro rata distribution of its Smallco stock to the three shareholders. Abe, Betty, and Clyde now hold stock in Smallco directly as well as continuing to hold stock in Largeco.

## Split-offs

A split-off involves the distribution by a parent of stock in a subsidiary to some or all of the shareholders of the parent in exchange for some or all of their stock in the parent corporation. Before the transaction, the shareholders own the stock in the parent corporation, and the parent in turn owns the stock in the subsidiary. After it, the shareholders of the parent directly own the shares of stock in the subsidiary, but they may have had to give up all or a part of their shares in the parent to receive these shares in the subsidiary. A split-off, therefore, may be planned in order that certain shareholders take stock in the subsidiary and no longer hold shares in

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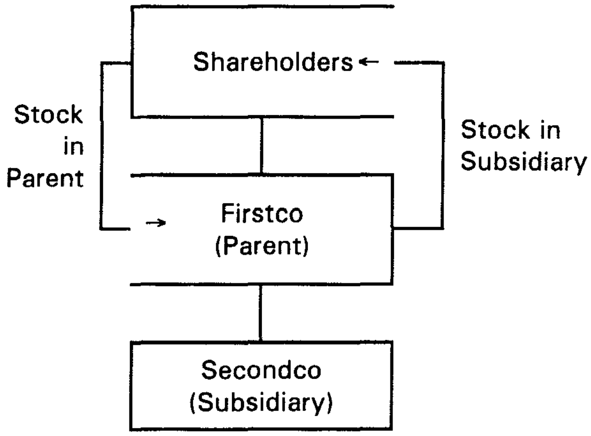
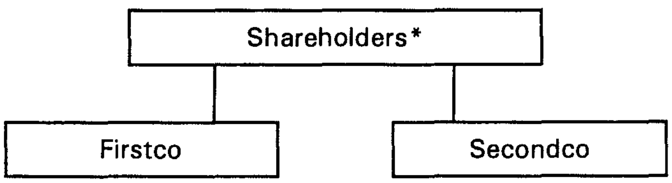
**TO SPIN OR SPLIT** Continued from Page 6

the parent. You can be certain that the make-up of the parent's and subsidiary's shareholders will not be the same after the transaction.

**BEFORE SPLIT-OFF**




**AFTER SPLIT-OFF**




*Although the shareholders will collectively own the stock of both Firstco and Secondco, just as in a spin-off, they may own it in different proportions. For example, one shareholder or group may own all of the stock of Secondco.

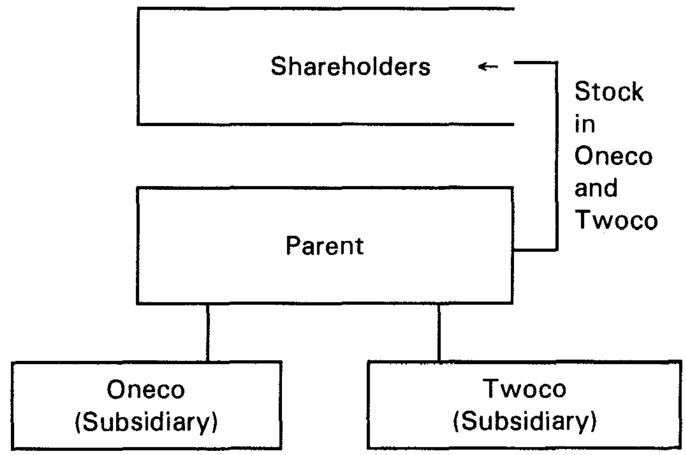
**Example:** Shareholders Sam, Saul, and Ted own stock in Retailco. Retailco has a subsidiary, Discountco. Sam and Saul surrender their Retailco stock to Retailco, and receive Discountco stock in exchange. After the exchange, the stock in Retailco is owned by Ted, and the stock in Discountco is owned by Sam and Saul.

## Split-Ups

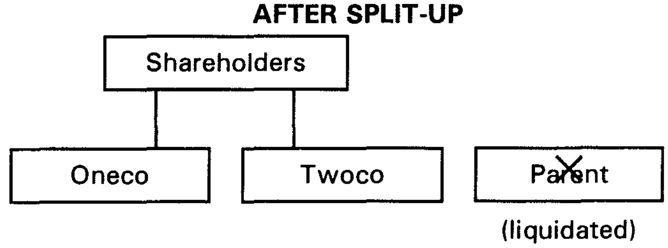
A split-up involves the distribution by a parent corporation to its shareholders of stock in two or more subsidiaries. In effect, the distribution of stock in a split-up will be in complete liquidation of the parent corporation. Before the transaction, the stock in the parent is held by the shareholders, and the parent, in turn, owns the stock of two or more subsidiaries. After the transaction, the parent has been liquidated and the shareholders that were previously shareholders only of the parent now own shares in the subsidiaries directly.



**BEFORE SPLIT-UP**




**AFTER SPLIT-UP**




**Example:** Shareholders Betty, Bob, and Bart own all the stock in Holdings, Inc. Holdings, in turn has two wholly owned subsidiaries, Makerco and Sellerco. Holdings distributes the stock of Makerco and Sellerco to its shareholders, Betty, Bob, and Bart, in exchange for their Holdings shares, and Holdings is then liquidated. Betty, Bob, and Bart now hold stock only in Makerco and Sellerco.

## Split-Offs On the Rise

Split-offs now seem more popular than ever before. The one difficult element of a split-off is the distribution requirement. Under Section 355, the parent must distribute an amount of stock in the

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subsidiary that constitutes control (at least 80%).

Of course, the distributing company must be in control of the subsidiary before the split-off, too. Thus, it must own 80% of the total combined voting power of all outstanding voting stock, and 80% of the number of shares of each class of nonvoting stock. Furthermore, if the parent retains any stock of the subsidiary following the split-off, it must establish to the IRS' satisfaction that this retention is not part of a tax avoidance plan.

Another requirement that must be met in order for the split-off to achieve tax-free treatment under Section 355 is the active business requirement. Both companies must be actively engaged in the conduct of a trade or business for the prior five years, and the business cannot have been acquired within that five-year period in a wholly or partly taxable transaction. Likewise, the business purpose test must be met (the split-off must be undertaken for reasons germane to the business of either the parent, the subsidiary, or both). Finally—and most amorphously—the split-off cannot be used principally as a device for distributing earnings and profits. Fortunately, the IRS has determined that a tax-free distribution that would have given rise to a capital gain if it were instead taxable (as would be the case with non-pro rata split-offs) will not be treated as evidence of a device.

### Meeting Requirements for Split-offs

Because the shareholders are not required to participate, such a transaction is akin to a dutch auction, where tendering shareholders make their best offer to the company, which, in turn, sets a price for the buyback, taking those shares that meet its price. Distributing companies are faced with the task of where to set the exchange ratio. The parent may feel the need to offer an "excessive" amount of subsidiary stock in exchange for its stock. This highly favorable ratio may merely seem an effective way in which to insure that at least 80% of the parent's stock in its subsidiary is taken. However, the amount deemed excessive may give rise to taxable compensation or dividend income to the participating shareholders. Tax-free treatment does not extend to stock received in an otherwise tax-free exchange that represents a payment for something other than the stock surrendered. This possibility would seem to be a potential roadblock for companies looking to insure that enough stock is taken in the initial stages of a split-off.

Another option is to inspire shareholders to participate in the split-off by using a little coercion. In all split-offs, the parent company must distribute the balance of unexchanged shares. Typically, this is done through a pro rata distribution to shareholders of the parent's remaining subsidiary shares. While it is not a terribly popular strategy, in light of the highly unflattering press Time Warner got with regard to its rights offering of several years ago, it should be possible to structure the transaction so that only those shareholders who participate in the exchange will receive remainder shares. However, most companies would think twice before laying themselves open to such fierce criticism.

Regardless of the slight difficulty stemming from uncertainty over the distribution requirement, this transaction is a very tax-efficient way for a parent company to shed a subsidiary while also retiring stock. This structure removes the need for a taxable transaction (i.e., a sale of the subsidiary) in order to raise money for a buyback and also provides an opportunity to rid oneself of an incompatible shareholder, as in the Time Warner/Turner situation. ■