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Viacom 355 Ruling Sparks Praise and Criticism

by Robert W. Wood • San Francisco

The long-awaited IRS private letter ruling concerning Viacom's spinoff of its cable operations to Tele-Communications, Inc. (TCI) has generated a good deal of verbiage. Although there are decidedly naysayers about the wisdom of the IRS in granting this ruling, most readers of *The M&A Tax Report* are

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probably applauding the grant of the ruling.

Given how large a transaction this is, and how difficult even relatively more modest Section 355 rulings can be to obtain, it is worth noting precisely what was involved in this now blessed transaction. (The transaction is scheduled to close this month.)

Big Deal

The peripatetic Sumner Redstone owns 25% of the stock of Viacom through his company, National Amusements, Inc. The other 75% of the Viacom stock is publicly held. Viacom, in turn, operates a number of businesses through a subsidiary known as Viacom International, Inc. ("International"). The businesses operated by International are at least five years old, and include the cable business. International, in turn, holds a second-tier subsidiary. The basic structure of the transaction is as follows:

International will retain its cable business, but contribute all of its other businesses to the second-tier subsidiary. International will then borrow $1.7 billion from banks, and contribute the loan proceeds also to the second-tier subsidiary. The second-tier subsidiary, though, will assume another $1.7 billion of International's liabilities (other than the $1.7 billion in recent borrowing). International will distribute the shares of the second-tier subsidiary to Viacom as its parent. The recently issued private letter ruling determines that this distribution of stock by International to its parent Viacom will be tax-free under Section 355.

Then, Viacom will recapitalize International to provide for a second class of common stock. The first class of common will automatically convert to preferred when the second class is issued to TCI. In a dutch auction procedure, Viacom is to offer to exchange all of International's first class of common for Viacom shares. The Sumner Redstone entity will not participate in this exchange. However, if enough other shareholders do participate, all of International's first class of common is to be distributed to them. As a result, Viacom would own no more of that class of stock.

After this exchange offer is completed, TCI will then contribute $350 million to International in exchange for all of International's second class of common stock. International will remain legally responsible for its $1.7 billion in debt, but it can certainly be argued that the loan nominally held by International was borrowed on TCI's credit (and was evidently negotiated by TCI).

If the exchange offer does not occur, International will be unable to draw down the loan proceeds. Plus, International's first class of common would convert to nonvoting preferred (thus leaving he holders of the second class of common with voting control). The issuer has the option to pay dividends on the preferred either in cash or in TCI shares. The preferred will be exchangeable for TCI common at the holder's option beginning after five years.

Furthermore, the preferred will be callable for cash or for TCI shares (at the option of the issuer) after five years. The preferred will be subject to a mandatory redemption for cash or TCI shares (at the issuer's option) after ten years. It appears, therefore, that eventually the exchanging shareholders will all have either cash or TCI shares.

The Viacom second distribution is also covered by

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Section 355. In fact, most of the press about the ruling involved this second distribution. While taxpayers in the investment community should applaud the grant of the ruling, well-known tax writer Lee Sheppard of *Tax Notes* (who generally writes as if the repeal of the *General Utilities* doctrine should have wiped out Section 355) said this about the ruling:

> "In issuing the ruling, the IRS ignored the fact that TCI is an outside purchaser that will obtain control of Viacom International. The ruling characterizes TCI as an equity investor, which is literally true, but TCI will immediately become much more than just another equity investor when the exchanging Viacom shareholders are deprived of their voting rights. Though there is no explanation, it appears as though the IRS took a snapshot of the deal at the time of the second distribution without asking what would happen a nanosecond later. The IRS made TCI promise not to dispose of the equity interest in Viacom International that it will acquire in the transaction—which is past the point. That TCI is ready and waiting to assume control is the point; the IRS should have asked that TCI not increase or change its interest in Viacom International.
>
> If TCI can be regarded as a mere equity investor, then the revenue rulings conceivably would not apply, because TCI's investment would be like a participant in an initial public offering. In Letter Ruling 9446023, the IRS approved a Section 355 distribution even though the controlled corporation planned to issue additional shares representing 40 percent of the total outstanding after the public offering. (See also Letter Ruling 9006056, in which the public offering represented 30 percent of the total outstanding after the public offering.) But in no published ruling has the IRS permitted a Section 355 distribution when the participants in a subsequent public offering would get voting control of the distributed corporation." See Sheppard, "The Inexplicable Viacom Ruling; or Did Aliens Kidnap IRS Lawyers?" *Tax Notes*, July 1, 1996, p. 15.

Since Ms. Sheppard also criticizes Sumner Redston for referring to the transaction as a "sale," arguing from this that somehow such casual references should control the result of an admittedly complex transaction, one should also beware that, at least in some circles, casual off-hand references (in the case in point, quoted in the social pages!) might be viewed as telling. ■