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2005 Tax Act Offers Good News And Bad News For Spinoffs

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Changing the beauty and the beast. The latest tax legislation to impact spinoffs—the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA)—amends Internal Revenue Code Section 355, the beauty and the beast of tax law for tax-free spinoffs. The "beauty" is the wherewithal to structure a new corporation owned by the same shareholders as the old, without any significant tax obligation. The "beast" is the many strict requirements for doing so, explains tax attorney Robert Wood. For example, a qualifying transaction must include entities that had operating businesses which were active for five years. In addition, the deal must not be a device to distribute accumulated profits tax-free. Holding companies sometimes have difficulty meeting the qualifying requirements.

TIPRA eases burden for some spinoffs. In the past, the IRS closely scrutinized holding companies and applied gross-asset tests to determine if they could pass the active business test. The new legislation provides a window for holding companies to do so. TIPRA treats all of the companies that constitute the corporation's *separate affiliated group* as one company. This new rule is especially important for insurance companies and foreign entities, which were previously excluded from many Section 355 provisions. With the new legislation, Congress has made it easier for those entities that use holding companies in their corporate organization to complete a

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spinoff. However, what Congress gives, it also takes away. The new lax rules for passing the active business test evaporate after 2010. Despite the transition rules and exceptions, the author nevertheless views this section of the act as positive for tax-minded businesses and professionals.

New rules restrict investment companies. Along with the positive aspects comes some not-so-good news for spinoffs. In a complex maneuver, TIPRA restricts tax-free treatment if either company becomes a majority-owned disqualified investment corporation" after the deal is completed. This provision erects another roadblock for a company attempting to distribute profits tax-free. Previously, even if the company owned significant non-business assets, the deal could still qualify if the taxpayer demonstrated a strong active-business purpose. Those days are apparently gone, the author fears. In describing an "investment corporation," the new rules consider investment assets the company owns, including cash, stock, partnerships, and debt instruments. Real estate is not included, and there are other exclusions as well. Since the restriction applies only when someone achieves a majority ownership in the investment corporation, publicly held companies will not be significantly affected by this provision, but it will be detrimental to private companies' spinoffs.

Implications of changes. The investment company rules herald a significant change in tax practice. In the past, a major (but not over 50%) stockholder could exchange stock for stock in a new subsidiary that would also be blessed with lots of cash and a business that was minimally active. Now, the IRS will be watching to see if these deals fall under the "disqualified investment corporation" sections. The author anticipates lots of new and complex regulations on these sections, and there is no sunset provision. With the 1986 demise of the *General Utilities* doctrine, Section 355 remains a major avenue for companies to structure tax-free spinoffs. Tax practitioners and attorneys can take advantage, but be aware that the IRS still closely scrutinizes these transactions.

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