How To Satisfy The Business Purpose Test For Tax-Free Spinoffs

(M&A Tax Report)

The only means to the end. To qualify a spinoff for tax-free treatment under IRC Section 355, the CFO needs to offer a valid business purpose, which must be other than saving federal income taxes. In fact, IRS regulations indicate that if the company can solve its problem in any way other than by spinning off, it fails the business purpose test (and the spinoff will not qualify as a tax-free event). The stock distribution must be, in effect, the only means to the end. To illustrate, picture a company in the toy and candy business. Hoping to separate the candy business from the risks involved in the toy business, the company establishes a new subsidiary and distributes its stock to the parent's shareholders. Since the separate incorporation in and of itself removes the risk, the spinoff cannot meet the business purpose test. Suppose a subsidiary buys another company, using its parent's short-term borrowing power. To pay off the debt and save the interest costs, the parent arranges to spin the sub's stock off in a public offering. If the transaction is to be tax-free, the parties must convince the IRS that the public sale could not proceed while the issuer was still a subsidiary.

Some classic business purposes. A 1996 IRS revenue procedure approves cost savings (provided they are significant) as an acceptable business purpose. Other tried-and-true purposes that have passed muster include: separating business assets into two units, then allowing one to participate in a tax-free reorganization or to use its stock for acquisitions; dividing companies to dispose of dissident or inactive shareholders; spinning off to avoid labor problems, customer friction, or antitrust violations. Surprisingly, a spinoff is acceptable if the company saves state or local taxes but not if federal income taxes are also involved. This method works often when the company is subject to a specific local tax.

No other method available. Occasionally, a spinoff will give a company access to more debt or capital markets. Companies must plan very carefully if they want to use additional debt or capital capacity as the business purpose. A few rather specialized purposes have also been found acceptable. The IRS allowed a public utility to spin off a subsidiary because, by doing so, it avoided a state operating restriction. In another case, the divesting company could avoid filing financial disclosures with state authorities if it divested. Each time, the taxpayer was able to convince the IRS that no other method was available to satisfy the particular corporate need.

Spinoffs And The All-Important Business Purpose, by Robert Wood. ***M&A Tax Report,*** Vol. 7, No. 5, Pgs. 1, 4-5. Panel Publishers, 1185 Avenue of the Americas, New York, NY 10036.