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Sears' Spinoff: In the Land of the Giants

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If anyone ever needed proof that Section 355 is one of *the* most—perhaps *the* most—important provision in the Code, the recent announcement by Sears, Roebuck & Co. that it would dismantle its financial services empire brick-by-brick under Section 355 should resolve any doubt. Among the corporate children to be partially divested (at least one of them by a spinoff) are Sears' Dean Witter Financial Services Group, Allstate Insurance Group, and Coldwell Banker Real Estate Group.

The dollars involved are somewhat staggering. Analysts reckon that if Sears distributes the stock of these entities to shareholders and then sells a 20% stake in each to investors, the 20% stake in Allstate might fetch $1.6 to 2 billion; a 20% stock interest in Dean Witter could generate $600 or $700 million; and a 20% chunk of Coldwell Banker—even with the decline in the real estate market—could garner $500 or $600 million. (See "Sears Stock Rally Stalls as Enthusiasm Wanes for Proposal to Spin Off Lines," *Wall St. J.*, 10/1/92, p. A4.)

Sears' decision to undertake this rather extraordinary action has been viewed disparately by different constituencies. For example, the view of certain shareholder rights activists is that Sears finally capitulated to its shareholders after a period in which a "long-term underperformance was attributable to a poor mix of business and a lack of accountability to owners." (See "Sears and the Shareholder," *Wall St. J.*, 10/1/92, p. A14.) According to others, a key factor in the momentous decision to spin off these gargantuan operations was concerns about an impending debt downgrade by Moody's Investors Service Inc. (See "Sears Breakup Decision Took

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Months, Was Partly Instigated by Newcomers," *Wall St. J.*, 10/2/92, p. A3.)

Running the Tax Gauntlet

Whatever the financial and political factors influencing Sears' corporate culture to invoke such a high-profile triple play, only the most sanguine tax aficionados will refrain from wondering how this deal will really come off. After all, Sears has publicly announced that it will at least seek an IRS ruling on the tax-qualified nature of the spinoff of Dean Witter, and to do that, it must show a good business purpose. (For a discussion of the mirthful notion that a business purpose really need not be shown under Section 355, see "Business Purpose For a Spinoff: Is Nothing Sacred?," p. 6, this issue.) Since no one involved in the planning stages of the Sears transaction will talk about it yet, we can only speculate, but several conclusions seem clear.

- As far as the IRS is likely to be concerned, the notion about avoiding a downgrading of Sears' Moody's rating is unlikely to carry the day. Besides, at least one report indicated that this plan was put in place *before* Moody's announced that there might be a downgrade. (See "Sears Suddenly Undoes Years of Diversifying Beyond Retailing Field," *Wall St. J.*, 9/30/92, p. A1.)
- Likewise, the argument that the throngs of hostile shareholders really "made management do it" will undoubtedly fall on deaf ears in the IRS National Office. Arguably, this point is related to the more amorphous "enhancing shareholder value" goal, discussed below.

Enhancing Shareholder Value

Is the "enhancement of shareholder value" notion persuasive? Despite its nice ring, the IRS marches to a different drummer on this point. Just because Sears figures that it will be better off, and because the market stages a rally agreeing with the concept, does not mean that there is a good business purpose. (This is the point in the meeting between the business types and the tax types in which the tax advisor is hard-pressed to explain how come the IRS just does not think this counts.)

The apparent lack of parity between the tax rules and the real world is particularly irksome to many in corporate management who, quite rightly, view one of their prime functions to be maintaining (and increasing) the company's stock value. Of course, while nothing remains the same forever, understandably it might be difficult for the IRS to accept all the market hoopla given the repeated (and relatively recent) assertions by Sears' management in proxy materials that the businesses were "more valuable to the shareholders when operating as segments of a single company than they would be if divested." (See "Sears Suddenly Undoes Years of Diversifying Beyond Retailing Field," *Wall St. J.*, 9/30/92, p. A1.)

Spins To Accommodate Investment

As discussed above, after the anticipated spin, 20% of Dean Witter will be sold to the public. Although it is pure speculation, it has to be assumed that Sears is looking to rely on the age-old spinoff notion that a good business purpose will exist where new capital can be solicited only by consummating the corporate division. Indeed, a 20% carve-out of a spun-off entity would be just the right number: not enough to break 80% control by Sears on any drop-down of assets (although drop-downs are probably unnecessary here), but enough to indicate a strong stake by the new investors.

Not to mention that such sales will generate large dollars. In fact, the aggregate investment for a 20% stake in each of the three Sears entities could exceed $3 billion. (However, Coldwell Banker will be sold outright, without trying to accomplish a spin.) In any case, the ability to raise that kind of money would surely seem to most people to have a good "business purpose," even if it might not in the eyes of the IRS.

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One issue, after all, relates to how the money would be raised. The contemplated Sears transaction does not seem like one in which an outside investor wants to invest in one division, say Coldwell Banker, but refuses to do so unless it is spun off. Stated differently, with a contemplated public offering after the spin, it is harder to argue that investors demand that the spinoff occur.

Stay Tuned

With the ink barely dry on Sears' press releases, it is far too early to say what will happen with this transaction, much less the specific reason(s) to be asserted by Sears as to why the IRS should bless this major American dismantling. Nonetheless, the latter promises to be an interesting issue both on its own merits, and as an IRS vs. taxpayer playing field (one that is not entirely level) over what is certainly one of the most active Code provisions. ■