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SPINOFFS AND THE ALL-IMPORTANT BUSINESS PURPOSE

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Under Sec. 355, for a spinoff to qualify for tax-free treatment the distribution must be undertaken for real and substantial non-federal tax purposes that are germane to the business of the distributing corporation and/or the controlled corporation, or the affiliated group to which the distributing corporation belongs. Moreover, the regulations require a business purpose for the stock distribution itself and for the entity that is split. If the business purpose sought to be accomplished can be achieved without effecting a stock distribution, no matter how compelling that business purpose may be, any such distribution will not fall within the ambit of Sec. 355. (See Reg. Sec. 1.355-2(b)(3).)

(continued on page 4)

ALSO IN THIS ISSUE:

Spinoffs and the All-Important Business Purpose

(continued from page 1)

A textbook example of this "available alternatives" principle involves a company that is engaged in the toy and candy business. The toy business is quite risky and the corporation wishes to insulate the latter from the risks and vicissitudes of the candy business. Therefore, the risky business is dropped into a new subsidiary and its stock is distributed to the parent's shareholders. Such a distribution does not qualify under Sec. 355 because the business purpose requirement is not satisfied. Why?

The risk protection problem can be solved merely by the separate incorporation (the creditors of the risky subsidiary cannot reach the assets of the stable parent). Thus, the stock distribution after the separate incorporation is gratuitous. (See Reg. Sec. 1.355-2(b)(5), Example (3).) So the mere presence of a business purpose is not, in itself, sufficient. A taxpayer is constrained to demonstrate that the purpose cannot be achieved *without* the distribution.

A real-life example of this problem is contained in Letter Ruling 9842050. There, a subsidiary of a holding company accomplished an acquisition that was entirely funded with short-term debt incurred by the holding company. The holding company, in turn, lent the proceeds to the acquiring subsidiary at a typical interest rate. To raise funds to satisfy the debt and, in the process, to reduce or eliminate the interest payments, a public offering of the subsidiary's stock was planned (a spinoff via a public offering of the subsidiary's stock). A business purpose existed, namely, the attainment of significant cost savings via the reduction or elimination of interest expense.

However, the IRS might well feel that this laudable business purpose would not qualify under Section 355 because it did not call for a distribution of the subsidiary's stock. According to the IRS, the offering could apparently proceed while the issuer remains a subsidiary of the holding company. So no spinoff ruling, at least on first blush.

Can 'Cost Savings' Suffice?

Revenue Procedure 96-30 approves cost savings as an acceptable business purpose for a spinoff. To qualify, the total anticipated cost savings for the three- (or five) year period following the distribution (net of transactions costs) must equal at least one percent of net consolidated financial income of the distributing group for the three- (or five) year period preceding such distribution. See also Rev. Rul. 88-33. With this in mind, let's go back to Letter Ruling 9842050.

In light of Rev. Proc. 96-30, the corporation's investment bankers proceeded to supply the business justification for the spinoff. They opined that the subsidiary's earnings would be accorded a higher multiple if it was separated from its parent so that the offering would raise significantly more funds per share than would be the case if the separation was not consummated. Accordingly, notwithstanding the efficacy of cost savings as a business purpose for a spinoff, in this particular case that purpose standing alone would not have justified the spinoff.

The spinoff became viable from a tax viewpoint only after the receipt of the opinion from the investment bankers that the amount of cost savings could be enhanced if the offering was accompanied by a complete separation of the subsidiary from the parent's affiliated group. The offering, after all, was to be the vehicle for achieving the cost savings through the use of the proceeds to repay debt). One opinion (from the investment bankers) effectively led to another (from the IRS).

Business Purpose Catalog

So that those in search of a suitable Section 355 business purpose will have a ready supply, here's a list of a few of the more well-known (and well-practiced) business purposes:

- **Tax-free Reorganization.** A valid purpose exists if corporate assets are separated into two corporations in order that one of the resulting entities can participate in a tax-free reorganization.
- **Stock for Acquisitions.** The stated necessity of allowing a subsidiary to use its own stock in making acquisitions has been determined to be a valid business purpose.
- **Dissident Shareholders.** A division to make it possible for dissident shareholders to separate will work.
- **Inactive Shareholders.** The elimination of inactive shareholders will suffice, if necessary in the particular business (for example, to assure continued compliance with an automobile manufacturer's franchise requirements).
- **Shareholder/Owner Business Separation.** A spin permitting shareholders to restrict their investment and activities to one activity of the corporate business may qualify.
- **Employee Ownership.** This has always been a hot button with the IRS; in some cases, though, a spinoff enabling an employee to increase his interest in a business qualifies.
- **Labor Problems.** A spinoff to avoid labor problems will qualify.
- **Customer Friction and Anti-trust Problems.** The separation of two businesses to eliminate customer friction and potential antitrust violations qualifies.

Spinoffs and the All-Important Business Purpose

(continued from page 4)

- **Reduce Non-federal Taxes.** A purpose to reduce state and local taxes will work as long as the reduction of federal taxes is not commensurate (there has to be a special state and local savings).
- **Possible Nationalization.** A spinoff by a first-tier foreign subsidiary of a new second-tier foreign subsidiary in a different country will qualify if needed to avoid expropriation of the assets.
- **Compliance With Laws.** Compliance with laws will be a valid business purpose.
- **Expanded Access to Credit.** This business purpose has been thrown around a great deal, but in appropriate circumstances it can work.
- **Avoiding Takeovers.** A valid business purpose can exist to avoid a hostile takeover.
- **Administrative Costs.** A purpose to avoid administrative compliance costs can support a spinoff, but only within certain guidelines.
- **Securing Capital.** Here again, this business purpose has been used (and abused), so be careful.
- **Improved Securities Sales.** A purpose to separate unprofitable operations from profitable ones in order to market the profitable business's securities has been held a valid business purpose.
- **Rate/Price Increases.** In the case of public utilities, a separation to remove a state-imposed impediment preventing rate increases has been viewed as valid.
- **Avoiding Financial Disclosure.** A spinoff to avoid filing financial statements with state authorities may be valid.
- **Reducing Withholding Tax.** A spinoff to reduce the amount of withholding tax imposed on distributions by a second-tier corporation has been held to satisfy the requirement.

This is only a partial list, of course. The business purpose is one of the most fundamental requirements of Section 355. Readers who would like to enumerate other business purposes, please write to the Editor at the address in the Editor's Box on page 2.