THE M&A Tax Report
VOLUME 10, NUMBER 8
MARCH 2002
THE MONTHLY REVIEW OF TAXES, TRENDS & TECHNIQUES

Spins In The News Again

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Amidst all the Enron fallout, it may be difficult to focus on any other news stories, especially those unfolding even a few weeks before the shredding fiasco. Nevertheless, in the tax world—or at least the world of tax planning as opposed to compliance—the Tyco spinoff plans were a bigger story than the Enron debacle. Late in January, Tyco International, one of the world's biggest conglomerates, announced that it would break itself into four pieces.

Actually, the collapse of Enron predated the Tyco announcement by quite some time, and the two are at least in some respects interrelated. After all, following the collapse of Enron, a new climate of skepticism has crept into financial markets, and Tyco has been accused of aggressive accounting practices as well. (See Larsen, "Tyco to be Split Into Four," *Financial Times*, January 23, 2002, p. 1.) Initial reports on the spinoff were laudatory. When

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Tyco's chairman, Dennis Kozlowski, called for the breakup of the company, he predicted the management could boost shareholder value by 50 percent or more by selling stakes in three of the businesses and quitting the fourth. (See Chaffin, "Shareholder May Rise 50%, Says Head," *Financial Times*, January 23, 2002, p. 18.)

The idea was that the so-called "conglomerate discount" that affects pricing would be eliminated, allowing investors to choose from the particular Tyco industries in which they were most interested. Of course, some have observed that this fit and focus emphasis seems a little odd in light of Tyco's previous emphasis on synergies. In the present economic climate, breaking up may be more fashionable than hard to do, particularly after the considerable emphasis in the past about assembling Tyco's disparate pieces. More than one observer has noted that many of the mergers of the 1990s are becoming grist for today's spinoffs. Tyco, AT&T, Merck, (see below) and Citigroup are all in this category. (See Frank, "More and More, Mergers of '90s Are Becoming Today's Spinoffs," *Wall Street Journal*, Feb. 6, 2002, p. C1.) Citicorp plans to spin off parts of its Travelers Insurance Business.

The stories about Tyco's aims to boost shareholder value were big and brassy at the start. (See "Amid Enron's Fallout, and a Sinking Stock, Tyco Plans a Breakup," *Wall Street Journal*, January 23, 2002, p. A1.) However, that enthusiasm was short-lived. Very quickly, Tyco's boosting of shareholder value seemed to dictate a boost in the opposite direction. The company's falling stock prices caused the *Wall Street Journal* to quip: "Is the sum of the parts worth less than the whole of Tyco International Ltd.?" (See Maremont and Hechinger, "Tyco Breakup Gets Razzed by Investors," *Wall Street Journal*, January 24, 2002, p. C1.) Indeed, Tyco and Enron have been linked, if not exactly joined at the hip—one's foibles being mixed with the other's failings. (See Coggan and Larsen, "Post-Enron Equity Fears Full 'Flight from Risk'," *Financial Times*, Feb. 6, 2002, p. 1.)

Not too long after the initial surprise spinoff announcement, it was reported that Tyco was holding preliminary discussions with a number of prospective buyers for various pieces of the conglomerate. Potential acquirers have flocked to Tyco with the hopes of getting some of its top assets, presumably at some hoped-for bargain prices. (See Frank, "Quiet Tyco Talk of Sale Sets Off Feeding Frenzy," *Wall Street Journal*, January 28, 2002, p. C1.)

Even in the light of significant interest in a number of Tyco's industry operations, Tyco continues to scratch its head about how the planned mega spinoff was supposed to boost shareholder value and get a great reception on Wall Street, but the opposite has seemingly occurred. Nevertheless, Tyco initially did not back off on the plan, if anything seeming more committed than ever to seeing its newly minted divide and conquer strategy bear fruit. (See Hechinger and Johannes, "Tyco Pledges to Hasten Breakup Efforts," *Wall Street Journal*, Feb. 7, 2002, p. A3.) Then, a week later, Tyco shared some ambivalence, not surprisingly bowing to the pressure of the market. Dennis Kozlowski recently said Tyco still plans to spinoff or sell two out of its five units, but it might retain ownership of two others, plus its remaining core company. All this was said by reference to stock market conditions which didn't seem right for the original (considerably more ambitious) spinoff plan. (See Maremont, "Tyco Seems to Back Off from Breakup," *Wall Street Journal*, Feb. 14, 2002, p. A3.) The notable large spinoff still on the drawing board involves Tyco's plan to sell its plastics unit and to spinoff or sell CIT Group, the huge financial arm Tyco acquired last year (Tyco renamed it Tyco Capital before coming back to the CIT name). (*Id.*)

How does this all fit into Section 355 doctrine for us tax folks?

Spinoffs and Business Purpose

It is axiomatic that 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 of the distributing corporation). Moreover, the regulations require a business purpose for the stock distribution itself and for the entity that is split. Since "fit and focus" sounds almost trite, the often-important question is whether cost savings can be achieved. As most *M&A Tax Report* readers will recall, Revenue Procedure 96-30, 1996-1 C.B. 696, gives the Service's blessing on cost savings as a good business purpose. Of course, the savings have to be "significant." Apart from defining just what significant may be, one can also argue exactly what "costs" are, and one can even haggle over the definition of the term "savings."

Revenue Procedure 96-30 does offer some guidance and some comparative language and even percentages to help one over these various humps. One of the tricky points, though, is that in addition to demonstrating why the spin will result in "significant cost savings," one must be cognizant that there may be "available alternatives" other than the spin. That, of course, will make the spinoff (at least on a tax-free basis) unavailable if those available alternatives are "neither impractical nor unduly expensive." Here, again, there can be a host of definitional problems. (For details, see Wood, "Spinoffs and Cost Savings: Is it *the* Business Purpose?" Vol. 7, No. 12, *M&A Tax Report*, July 1999, p. 1.)

Is Breaking Up Hard or Easy?

At a time like this, the old saw that "breaking up is hard to do" is bound to get lots of media play. (See Sullivan, "Why Breaking Up is Hard to Do," *Financial Times*, January 28, 2002, p. 22.) And so it goes. But ultimately, no one knows if a market reaction such as has occurred with Tyco will eventually mean that spinoff doctrine needs to be changed. That seems unlikely. Yet one wonders whether the usual drill about fit and focus will receive the same reception from the Service. Think this will come up in your next ruling conference?

DuPont has also announced that it will sell or spinoff its core nylon, polyester, and Lycra businesses by the end of 2003. Although presumably not too many readers (other than *M&A Tax Report* readers!) are worried about business purpose and other Section 355 niceties in such public announcements, DuPont has been under pressure to sluff off the slower growing businesses and to instead concentrate on high growth prospects. The latter include electronics, chemicals, biotechnology, and specialized plastics. (See Warren, "DuPont Co. to Shed by End of Next Year Businesses in Nylon, Polyester and Lycra," *Wall Street Journal*, Feb. 12, 2002, p. A2.) DuPont hired Morgan Stanley to advise it on this ambitious plan, a plan that would create the world's largest integrated textile fibers group with $6.5 billion in annual sales. (See Bowe, "DuPont to Spin Off Textiles Units in Bid for Growth," *Financial Times*, Feb. 12, 2002, p. 17.)

Other Spins

Before leaving spinoffs, we need to note a few announcements aside from the Tyco behemoth. Allergan has announced plans to spin off its optical device maker. The idea? To allow the optical device business to better focus on the fast-growing market for specialty drugs. The optical business, to be called Advanced Medical Optics, Inc., is to be distributed as a tax-free dividend to shareholders in mid-2002.

Interestingly, this announcement by Allergan came only hours before the Tyco monster. (See Frank, "Allergan to Spin Off Optical-Device Maker in Effort to Sharpen Specialty-Drug Focus," *Wall Street Journal*, January 22, 2002, p. A4.)

Also in the related fields of pharmacy, drugs, and related businesses, Merck has announced that it plans to spin off Medco, its "pharmacy benefit manager." Interestingly, there is concern that there should *not* be synergies between the manufacturing of drugs and the processing of prescriptions (evidently the reason why Eli Lilly and the old SmithKline Beecham originally got rid of their own pharmacy benefit managers years ago). (See "Splitting Headache," *Financial Times*, January 30, 2002, p. 14.)

Along the same lines, GlaxoSmithKline is considering the sale of a large part of its research operations in a spinoff. GlaxoSmithKline is the world's second-largest pharmaceuticals group, and announced that it may spin off its six research centers focused on the development of new medicines. The company is supposedly studying whether these operations are being "smothered" by being part of a big organization (an interesting turn of phrase). (See Dyer, "GSK Considers Spinning Off Its Research Units," *Financial Times*, January 25, 2002, p. 15.)

Of course, just what makes a successful spinoff (and I'm not talking compliance with Section 355, but rather "successful" from a financial and market viewpoint), is not easy to say. Merck's announcement that it would spinoff its Medco division (see below) reflects the notion of splitting a big company into "pure plays" in the hopes of creating value for shareholders. One view is that investors need deep pockets to profit from these spins.

Indeed, an investor buying into every spinoff during the 1990s, one study suggests, would have beaten the annual returns of the S&P 500 by 3.5 percentage points. But, other statistics suggest that median performing spinoffs generated returns 5.7 percent below the S&P. Hmmm...for an interesting study in these statistics, see Lucier and Bellaire, "Three Steps to a Successful Spin," *Financial Times*, Feb. 20, 2002, p. 11. I've always thought that statistics can be used to show just about anything (or the reverse of just about anything!), but some of the numbers in this article are quite interesting nonetheless.

Elsewhere in the world, Hitachi, the Japanese electronics giant, has announced plans to spin off its consumer electronics business and some of its industrial equipment operations as part of a cost-cutting drive. (See Harney, "Hitcachi to Spin Off Units in Cost-Cutting Move," *Financial Times*, September 28, 2001, p. 23.)

Conclusion

In closing, let's return to the Tyco-Enron symbiosis (with a dash of Arthur Andersen). Fellow accounting industry player Deloitte Touche Tohmatsu has bowed to the pressure, saying it will separate its audit and consulting businesses. Structure (spin?) hasn't yet been decided. (See Silverman, "Deloittte to Separate Consulting Services from Audit Business," *Wall Street Journal*, Feb. 6, 2002, p.A8.)