

THE M&A TAX REPORT

The Monthly Review of Taxes, Trends & Techniques

Volume 3, Number 3

October 1994



TAX INSTITUTE

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To Spin or Not To Spin?

by Robert W. Wood • San Francisco

Some time ago—specifically, in the November 1992 release of *The M&A Tax Report* (Vol. 1, No. 4)—we devoted virtually an entire issue to spinoffs under section 355. So as not to be accused of being myopic, we do back off from this topic to make an effort to cover the rest of

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the waterfront. Nonetheless, readers of this newsletter are likely well aware that spinoffs crop up in these pages quite frequently. Indeed, see Freier and Kordana, "Petrie Stores: *General Utilities* Rides Again?", Vol. 3, No. 2, M&A Tax Report (September 1994), p. 1. There is, of course, good reason for this coverage. Section 355 remains one of the few remaining avenues—some might say a veritable thoroughfare—around General Utilities repeal.

More Spinoffs Announced

Hospitality Franchise Systems, Inc. entered the fray with the announcement of a spinoff of the company's gambling interests into a new development company. Unlike the normal transaction, though, this distribution was announced as taxable to the shareholders. See "Hospitality Franchise Sets Casino Spinoff," Wall Street Journal, 9/12/94, p. A4.

In the category of current transactions, it was hard to miss the announcement by the gangly-named Price/Costco that it would spin off its real estate operations into a new entity. Apparently prompted primarily by the fallout between management styles of the previously independent Price Co.'s Price Club operations, and that of Costco Wholesale (which merged about a year ago), the spinoff involves the massive chain of Price/Costco warehouse stores staying together, but Price Co. management heading up the soon to be spun off company. The new entity will focus on real estate operations as well as international ventures. (See "Price/Costco's Spinoff Reflects a Difficult Marriage," Wall St. J., 7/19/94, p. B4; See also Price/Costco Plans Spinoff, Changes In Its Management," Wall St. J. 7/18/94, p. B5. See also "Plan to Spin Off Operations, Assets Is Approved

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by Board," Wall St. J. 8/1/94, p. B4.)

Other recent entrants into the spinoff field include Interco, which announced a spinoff of its Florsheim footwear operations and a public offering of its Converse athletic shoe holdings. (See "Interco Plans Spinoff of Florsheim and Public Offering of Converse Stake, Wall St. J., 8/25/94, p. B9.). And Primedex Health Systems Inc. recently approved a spinoff of its Care Advantage Inc. subsidiary. See "Primedex Directors Approve Spinoff Plan for Care Advantage," Wall St. J., 8/29/94, p. B4. Another transaction is the announced AirTran Corp. spinoff of its recently acquired Conquest Sun Airlines. The announcement came after AirTran found that this new acquisition put it into conflict with Northwest Airlines, for which AirTran serves as a commuter link. "See AirTran to Spin Off Jet Subsidiary to End Northwest Conflict," Wall St. J., 7/18/94, p. C16.) Since many of us worry a good deal about whether we have a good business purpose for a spin off, AirTran's statement was particularly poignant: "[We were] informed by Northwest Airlines that the entry by AirTran into jet-carrier service through this separate subsidiary is in conflict with the collective bargaining agreement" between Northwest and its pilots' union." (Wall St. J., 7/18/94, p. C16.).

Spinoffs have become popular on the other side of the Atlantic too, with the giant Thorn EMI PLC having considered a plan to spin off some operations. (See "Thorn EMI Considers Split of Music, Rental Businesses," Wall St. J., 6/9/94, p. B2.)

Business Purpose

Against all this activity, as well as many private companies that do not garner any publicity, we thought it might be helpful to list some common business purposes for a spinoff. While the list is not complete, it certainly hits the high points of the business purpose doctrine in this context.

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Readers with additional business purposes are encouraged to write with their own list (or additions and subtractions) for publication in a future issue. Any takers?

- Tax-Free Reorganization. A valid purpose will exist to the extent that corporate assets are sepa-

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rated 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 also been determined to be a valid business purpose.
- **Dissident Shareholders.** The division of two companies to make it possible for dissident shareholders to separate is a clear business purpose.
- **Inactive shareholders.** The elimination of inactive shareholders satisfies the requirement, if necessary in the particular business (for example, to assure continued compliance with automobile manufacturers' franchise requirements).
- **Shareholder/Owner Business Separation.** A spin-off permitting shareholders to restrict their investment and activities to one activity of the corporate business qualifies.
- **Employee Ownership.** A spin-off enabling employees to acquire an interest or increase an interest in the business can qualify, although the Service has been very critical of this purpose in the last few years.
- **Labor Problems.** A spin-off to avoid labor problems can qualify.
- **Customer Friction and Antitrust Problems.** The separation of two businesses to eliminate customer friction and potential antitrust problems qualifies.
- **Reduce Nonfederal Taxes.** The reduction of state and local taxes has also been held to be a valid business purpose. Under the regulations, however, a purpose to avoid nonfederal taxes will not suffice if (i) the transaction will effect a reduction in both federal and nonfederal taxes because of similarities between federal tax law and state or local tax law, and (ii) the reduction of federal taxes is greater than or substantially coextensive with the reduction of nonfederal taxes.
- **Possible Nationalization.** The spin-off by a first tier foreign subsidiary of a new second tier foreign subsidiary in a different country qualifies, where the spin-off was necessary to avoid possible expropriation of the assets.

- **Compliance With Laws.** Compliance with laws will be a valid business purpose, such as laws requiring a separation of business.
- **Expanded Access to Credit.** Expanded access to credit can be a valid business purpose.
- **Avoiding Takeovers.** A valid business purpose can exist to avoid a hostile takeover.
- **Administrative Costs.** A purpose of avoiding administrative compliance costs will support a spin-off.
- **Securing Capital.** A business of enabling one corporation to secure needed capital will qualify.
- **Improve Securities Sales.** A purpose to separate unprofitable operations from a profitable operation in order for the profitable operation to market its debentures through an underwriter was held to constitute a valid business purpose.
- **Facilitating Rate/Price Increases.** The separation of a subsidiary from a public utility to remove a state-imposed impediment preventing a rate increase was held a valid business purpose.
- **Avoiding Financial Disclosure.** A spin-off to avoid filing financial statements with state authorities has been upheld.
- **Reducing Withholding Tax.** A spin-off to reduce the amount of withholding tax imposed on distributions by a second-tier corporation has been held to satisfy the business purpose requirement. ■

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Tax Institute
P.O. Box 192026
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