

Spinoffs: Still Remarkably Tax Friendly

November 2010

Dantzer's premise is that spinoffs are tax friendly transactions, and this report discusses some of those friendly aspects. First is the IRS's policy under which it endeavors to issue rulings on spinoffs in 10 weeks, and the fact that it does issue those rulings quickly, if not quite in 10 weeks. Next is the considerable flexibility in the law, and the IRS's application of the law, in meeting the 80-percent-by-vote test of section 355(a)(1)(A). The third area of analysis relates to transactions that, at least to some extent, could be said to constitute a tax-free monetization of the value of a subsidiary business. Finally, the report discusses aspects of the device prohibition that exists regarding spinoffs, particularly the related function test and its applicability to overlapping officers and boards of directors, and concludes that overlapping officers and boards do not generally violate the spinoff rules.

The basic idea of a spinoff and its close cousin, a split-off, is simple. Just recall your high school biology class in which you studied the division of one cell into two cells. The idea is that if a whole company breaks itself into two pieces, and the sum of the two pieces equals the whole, and the same people own the two pieces as owned the whole, nothing has occurred that would justify taxation at either the company level or the shareholder level. Most of us can envision factual circumstances in which that conclusion seems absolutely right and other circumstances in which it seems very

wrong. It is the attempt to define the good and bad circumstances that has occupied Congress, Treasury, and the IRS over the years. Spinoffs first entered the tax law in the 1920s.¹ The point I will try to develop in this report is that despite the accumulation of piles of restrictions on spinoffs over the years, they are still tax friendly—in some cases remarkably so. I will not cover all the tax aspects of spinoffs, which would take a treatise, or even all the friendly tax aspects of spinoffs, but rather will focus on recent developments and particular areas of current interest in which this friendliness is apparent.

Part I will discuss specific aspects of the IRS's current ruling policy. Part II will discuss the flexibility surrounding the 80-percent-by-vote test of section 355(a)(1)(A).² Part III will discuss debt exchanges and other similar transactions that are used in connection with spinoffs and contain a monetization element. Part IV will discuss some aspects of the device prohibition that exists in relation to spinoffs, and particularly the related function test and its applicability to overlapping officers and boards of directors.

Ruling Policy of the IRS

Taxpayers for many years have sought letter rulings from the IRS on spinoff transactions with a greater frequency than on other reorganization transactions.³ Spinoffs are complex transactions from a commercial standpoint, and there is usually sufficient



J. William Dantzer Jr.
White & Case

This material has been previously published and is reproduced with permission of Tax Analysts. Jasper Smith and John C. Bell (eds), *Tax Notes*, Nov. 8, 2010, pp. 1-17.

© 2010 Tax Analysts.
Reprinted with Permission.

¹ See generally Boris I. Bittker and James S. Eustice, *Federal Income Taxation of Corporations & Shareholders*, para. 11.01[2] (7th ed. 2000).

² Section references herein are to the Internal Revenue Code of 1986, as amended.

³ There are many reasons for this, not the least of which is that the tax at risk in many spinoffs is very large compared with the nontax benefits. Put a different way, most spinoffs would not occur if they were taxable.

Spinoffs: Still Remarkably Tax Friendly

time to obtain a ruling. Because of the volume of spinoff rulings, the IRS is adept at handling them and tends to be understanding of the timelines involved in public spinoff transactions. Still, it came as a pleasant surprise in September 2005 when the IRS announced that it will “endeavor” to issue letter rulings on spinoff transactions within 10 weeks from receipt of the request.⁴ Based on a fairly thorough (but not entirely scientific) analysis,⁵ it appears that rulings issued since the announcement have been dated, on average, about 17 weeks from the date of the ruling request. The average drops to about 14 weeks if one excludes from the calculation rulings in which it appears that the taxpayer did not ask for a 10-week ruling.⁶ It seems that the IRS is not exactly meeting the 10-week goal, but it is doing pretty well. The 10-week ruling policy⁷ has been an extraordinary success from the standpoint of taxpayers, and it represents a remarkably customer-friendly approach for the IRS. Even when the period stretches a bit beyond 10 weeks, the time that it now takes to obtain a spinoff ruling is well within the timeline of any public spinoff.

In a more modest but nonetheless notable gesture of friendliness, the IRS in May 2009 included spinoffs in a procedure that allow it to issue rulings on parts of an integrated transaction without ruling on the larger transaction.⁸ Those rulings have been issued.⁹ However, that one can get a full ruling in about 10 weeks makes the prospect of a selective ruling less attractive.

The 80-Percent-by-Vote Test

Section 355(a)(1)(A) requires that the distributing company “control” the controlled company immediately before the distribution. Section 368(c) provides that the term “control” means stock possessing at

least 80 percent of the total combined voting power of all classes of voting and at least 80 percent of the total number of shares of all classes of nonvoting stock of the corporation. This means that the controlled corporation immediately before the spinoff can have two classes of stock, one of which is held by the public and one of which is held by the distributing corporation. As long as the distributing corporation's class has at least 80 percent of the vote, the distributing corporation can distribute that stock in a tax-free spinoff regardless of its value. In 1969 the IRS ruled that a parent could recapitalize its stock in a subsidiary to increase its vote to 80 percent, while not affecting its value, which was less than 80 percent, and then immediately spin off the subsidiary having met the control requirement.¹⁰ This of course is what the statute literally sanctions when it requires only that the distributing company control the controlled company “immediately before the distribution.”¹¹ The IRS also relied on section 355(b)(2)(C), which provides that for purposes of the active business requirement, control can be acquired within the applicable five-year period preceding the spinoff as long as it is not acquired in a transaction in which gain or loss is recognized in whole or in part.¹²

The 1969 ruling emphasized that the approved recapitalization into high-vote stock was neither transitory nor illusory, and that was because the realignment of voting control was “permanent.”¹³ The concern that the vote of the high-vote stock be real, rather than transitory, is fairly obvious. If the controlled corporation in the 1969 ruling had recapitalized itself immediately following the spinoff to eliminate the high-vote stock that enabled the spinoff, it would be easy to say that the short time in which the high vote existed had no substance.¹⁴ It seems relatively clear that the 1969 ruling meant

4 Rev. Proc. 2005-68, 2005-2 C.B. 694, *Doc 2005-18861, 2005 TNT 178-6*. To obtain an expedited ruling, the taxpayer is required to (1) indicate on the first page of the request letter that “Expedited Handling is Requested”; (2) submit a copy of the request letter along with the formal request; (3) provide a draft letter ruling detailing all required information; and (4) comply with the additional requirements of any relevant revenue procedure. *Id.* Information requested by the IRS must be received within 10 days of the request to remain eligible to receive an expedited ruling. *Id.* The most recent annual revenue procedure also requires the submission of Form 2848. See Rev. Proc. 2010-1, 2010-1 IRB 1, *Doc 2009-28611, 2010 TNT 1-21*, corrected by Announcement 2010-5, 2010-6 IRB 402, *Doc 2010-2763, 2010 TNT 25-9*.

5 A ruling was excluded from the calculation if it appeared that the ruling request was received on or before September 14, 2005 (the effective date of the 10-week program), had features that would appear to make it ineligible for the 10-week program, or did not involve full rulings on all the spinoff issues on which the IRS will rule.

6 Rulings dated 25 weeks or more from the date of the ruling request are assumed to be rulings in which the taxpayer did not request the 10-week expedited ruling process.

7 The 10-week ruling policy is now embodied in the annual revenue procedures governing ruling requests. See Rev. Proc. 2010-1.

8 See Rev. Proc. 2009-25, 2009-1 C.B. 1088, *Doc 2009-10065, 2009 TNT 84-24*.

9 See LTR 201007050 (Nov. 13, 2009), *Doc 2010-3708, 2010 TNT 35-17*; LTR 201005022 (Oct. 28, 2009), *Doc 2010-2803, 2010 TNT 25-28*.

10 See Rev. Rul. 69-407, 1969-2 C.B. 50.

11 See section 355(a)(1)(A). The issuance of Rev. Rul. 69-407 was approved in GCM 34122, in which the IRS said that Congress had sanctioned those acquisitions of control on the path to a spinoff and “was not concerned with the proximity of such an acquisition to the date of distribution.” GCM 34122 (May 8, 1969).

12 See Rev. Rul. 69-407, 1969-2 C.B. 50.

13 *Id.*

14 Similarly, Rev. Rul. 69-407 distinguishes Rev. Rul. 63-260, in which there was circular stock — that is, stock was acquired by the distributing company from its shareholder to enable the spinoff and then distributed right back to that shareholder. *Id.*; see Rev. Rul. 63-260, 1963-2 C.B. 147. The IRS held that the

Spinoffs: Still Remarkably Tax Friendly

permanent not in a come-hell-or-high-water sense, but rather in the step transaction sense—that is, that there was no plan or intention to change the high-vote structure. The IRS has issued a handful of private letter rulings over the years in which there was no plan or intention to change the high-vote structure at the time of the spinoff, but such a plan developed later and the change was blessed by the IRS.¹⁵

The McDonald's Corp. spinoff of Chipotle Mexican Grill Inc. illustrates the establishment of a high-vote structure to facilitate a spinoff, and the eventual unwind of that structure at a time safely past the spinoff. McDonald's in January 2006 recapitalized its subsidiary, Chipotle, with class A low-vote and class B high-vote shares, and Chipotle then offered the low-vote shares to the public in an initial public offering.¹⁶ In October 2006 McDonald's split off the class B shares under section 355.¹⁷ Each class of shares carried approximately half the value of Chipotle.¹⁸ In December 2009 the class B shares were converted back to common shares after that conversion was approved by a vote of the shareholders, and since then Chipotle has had only one class of shares outstanding.¹⁹ That timing seems relatively safe from a step transaction standpoint; the unwind was more than three years after the split-off and took place under an intervening shareholder vote.²⁰

What if there is not the three-plus years between spinoff and unwind that existed with Chipotle? What if, in fact, there is a plan or intention at the time of the spinoff to unwind the high-vote structure? In June 2008 MetLife Inc. announced that it would split off its approximately 52 percent stock interest in Reinsurance Group of America Inc. (RGA).²¹ The split-off occurred in September 2008, shortly after RGA's recapitalization of its stock into two classes, with the high-vote stock owned by MetLife and destined for distribution in the splitoff.²² The proxy statement/prospectus stated:

RGA presently expects that, following the divestiture, the RGA board of directors will consider submitting to a shareholder vote a proposal to convert the dual-class structure adopted in the recapitalization into a single class structure. The approval of the conversion would require approval by the holders of a majority of each class of common stock represented in person or by proxy and entitled to vote at the RGA special meeting. There is, however, no binding commitment by the RGA board of directors to, and there can be no assurance that the RGA board of directors will, consider proposing a conversion or resolve to submit such a proposal to RGA shareholders. If submitted, there can be no assurance that the RGA shareholders would approve the conversion.²³

acquisition of the stock did not accomplish its intended purpose of giving the distributing company an 80 percent vote. Rev. Rul. 63-260.

15 See, e.g., LTR 200527004 (Mar. 24, 2005), *Doc 2005-14584*, 2005 TNT 131-31; LTR 200347013 (Aug. 19, 2003), *Doc 2003-24983*, 2003 TNT 226-24.

16 See prospectus, Chipotle Mexican Grill Inc. (filed Jan. 26, 2006); Amendment 5 to Form S-1, Chipotle Mexican Grill (filed Jan 23, 2006); press release, Chipotle Mexican Grill, "Chipotle Mexican Grill Announces Pricing of its Initial Public Offering" (Jan. 26, 2006); Steve Gelsi, "Chipotle IPO Gains 100 Percent; First Triple-digit Rise in More than Five Years," MarketWatch, Jan. 26, 2006, available at <http://www.marketwatch.com/story/chipotle-deal-rolls-into-history-books-with-100-rise>.

17 See press release, Chipotle Mexican Grill Inc., "Chipotle, McDonald's Complete Separation" (Oct. 13, 2006). Chipotle in its prospectus-offer to exchange said the two-class structure would exist "indefinitely." Prospectus-offer to exchange, Chipotle Mexican Grill (filed Oct. 5, 2006); Amendment 1 to Form S-4, Chipotle Mexican Grill (filed Sept. 29, 2006).

18 See Form 8-K, Chipotle Mexican Grill Inc. (filed Oct. 12, 2006); prospectus-offer to exchange, Chipotle Mexican Grill (filed Oct. 5, 2006); Amendment 1 to Form S-4, Chipotle Mexican Grill (filed Sept. 29, 2006).

19 See press release, Chipotle Mexican Grill Inc., "Chipotle Mexican Grill, Inc. Shareholders Approve Conversion into Single Class of Common Stock" (Dec. 21, 2009).

20 As is fairly common, the original separation agreement between McDonald's and Chipotle provided that the dual-stock structure could not be changed for five years but that following the second anniversary of the split-off, Chipotle could take action to change that structure if a favorable opinion of counsel or private letter ruling was obtained. Definitive proxy statement, Chipotle Mexican Grill Inc. (filed

Nov. 3, 2009). Chipotle did not receive a private letter ruling, but did obtain an opinion from counsel. See *id.*

21 Press release, MetLife, "MetLife to Divest Stake in Reinsurance Group of America Through Tax-Free Split-Off of RGA Stock to MetLife Stockholders" (June 2, 2008).

22 See Form 8-K, Reinsurance Group of America Inc. (RGA) (filed Sept. 12, 2008); press release, Reinsurance Group of America, "Reinsurance Group of America, Incorporated Announces Completion of Recapitalization and Split-Off from MetLife" (Sept. 12, 2008). RGA also put in place various provisions that help to preserve net operating losses but that also seem designed to eliminate the takeover risk from having high-vote stock outstanding, which represents a smaller amount of value. See Form 8-K, RGA (filed Sept. 12, 2008); press release, RGA, "RGA Shareholders Approve Special Meeting Proposals in Connection With Proposed Recapitalization, Split-off" (Sept. 5, 2008). There was a limitation on the amount of high-vote stock that could be voted by a greater-than-15-percent holder of that stock. See Form 8-K, RGA (filed Sept. 12, 2008); press release, RGA, "RGA Shareholders Approve Special Meeting Proposals in Connection With Proposed Recapitalization, Split-off" (Sept. 5, 2008). There was also a section 382 share transfer restriction and a section 382 shareholder rights plan. See Form 8-K, RGA (filed Sept. 12, 2008); press release, RGA, "RGA Shareholders Approve Special Meeting Proposals in Connection With Proposed Recapitalization, Split-off" (Sept. 5, 2008).

23 Proxy statement/prospectus, RGA Inc. (filed Aug. 4, 2008).

Spinoffs: Still Remarkably Tax Friendly

This is close enough to a plan or intention to alarm most tax professionals. Obviously, the envisioned intervening board of director's action and shareholder votes provide some comfort, but I would dare say not enough for a conservative public company. The IRS itself had provided the comfort to MetLife and RGA, however, in a private letter ruling that was received by MetLife before the announcement of the transaction.²⁴ The ruling recited language that was similar to that of the proxy statement/prospectus.²⁵ The taxpayer represented that "Controlled" had no legally binding obligation to propose to collapse the two classes of common stock after the split-off, and the IRS ruled, without caveat or qualification relevant to this issue, that the split-off was tax free under section 355.²⁶ RGA was actually split off by MetLife on September 12, 2008.²⁷ On November 25, 2008, only two and a half months later, RGA shareholders approved, and the company implemented, a collapse of the two classes into one class of class A common stock.²⁸

It is understood that the IRS's primary rationale in taking this stance stems from the enactment of section 355(e) in 1997. In Rev. Rul. 98-27,²⁹ the IRS stated in effect that section 355(e) preempts the area on what post-spinoff transactions are good and bad and that as a result, it will not apply the step transaction doctrine to any subsequent restructuring of the controlled corporation, even if prearranged.³⁰ It is not clear on its face that the unwind of a high-vote structure is the type of restructuring that was intended to be blessed in Rev. Rul. 98-27, and it seems unlikely that such an unwind is the type of perceived abuse that was intended by Congress to be policed by section 355(e) itself. As support for its broad holding, Rev. Rul. 98-27 cited equally broad language from the conference report to the Taxpayer Relief Act of 1997:

The House bill does not change the present-law requirement

under section 355 that the distributing corporation must distribute 80 percent of the voting power and 80 percent of each other class of stock of the controlled corporation. It is expected that this requirement will be applied by the Internal Revenue Service taking account of the provisions of the proposal regarding plans that permit certain types of planned restructuring of the distributing corporation following the distribution, and to treat similar restructurings of the controlled corporation in a similar manner. Thus, the 80-percent control requirement is expected to be administered in a manner that would prevent the tax-free spin-off of a less-than-80-percent controlled subsidiary, but would not generally impose additional restrictions on post-distribution restructurings of the controlled corporation if such restrictions would not apply to the distributing corporation.³¹

The final sentence literally supports an application of the holding of Rev. Rul. 98-27 to a post spinoff unwind of high-vote stock.³² However, section 355(e) is focused on a classic step transaction issue: whether a subsequent acquisition will be stepped together with a spinoff for purposes of determining whether the 80-percent-voting-stock requirement was met by the spinoff. This was the question presented in *Commissioner v. Morris Trust*.³³ In the Morris Trust facts, however, the spinoff is obviously real and the subsequent merger also is obviously real.³⁴ If a distributing company owned high-vote stock in a controlled company that was old and cold, then spun that controlled company off, and then eliminated the control by a recapitalization of the high-vote stock, one might view this as analogous to the *Morris Trust* step transaction issue. In contrast, when the high-vote stock is created on the eve of spinoff and eliminated shortly thereafter, a question more troublesome than the classic step transaction question arises: whether the existence of the high-vote stock was transitory. In applying the broad words of

24 See LTR 200837027 (Mar. 14, 2008), *Doc 2008-19495*, 2008 TNT 179-30; LTR 200841021 (Apr. 29, 2008), *Doc 2008-212790*, 2008 TNT 199-32. These rulings were supplemented by LTR 200850016 (Aug. 28, 2008), *Doc 2008-26176*, 2008 TNT 241-28; and LTR 200909030 (Oct. 30, 2008), *Doc 2009-4358*, 2009 TNT 38-12.

25 *Id.*

26 *Id.*

27 See press release, RGA, "Reinsurance Group of America, Incorporated Announces Completion of Recapitalization and Split-Off from MetLife" (Sept. 12, 2008).

28 See Form 8-K, RGA Inc. (filed Nov. 25, 2008).

29 Rev. Rul. 98-27, 1998-1 C.B. 1159, *Doc 98-15290*, 98 TNT 94-8.

30 See *id.* Rev. Rul. 98-27 says that in situations other than acquisitions and restructurings, the IRS will continue to consider all facts and circumstances and that an independent shareholder vote is one relevant factor to be considered. *Id.* Rev. Rul. 98-27 obsoleted Rev. Rul. 96-30, 1996-1 C.B. 36, *Doc 96-15359*, 96 TNT 102-7, in which the IRS applied a step transaction analysis but concluded that a subsequent acquisition should not be stepped together with a spinoff when the negotiations for the acquisition took place after the spinoff and there was an intervening shareholder vote.

31 Rev. Rul. 98-27 (citing H.R. Rep. No. 105-220, at 529-530 (1997)).

32 See *id.*

33 367 F.2d 794 (4th Cir. 1966).

34 *Id.* at 799.

Spinoffs: Still Remarkably Tax Friendly

Rev. Rul. 98-27 to that issue, the IRS may have gone further than it needed to remain true to section 355(e) and its legislative history.

Debt Exchanges and Similar Transactions

I started this report with an analogy to a single cell dividing into two cells. That analogy may fit (at least roughly) a spinoff in which the only outstanding interest in the distributing company is stock, and the only interest of the controlled company that is distributed is its stock. In fact, most distributing companies have debt that is outstanding and spinoffs are frequently used, at least in part, to apply a portion of the value of the controlled company to satisfy debt of the distributing company. This is referred to by many as a monetizing spinoff.

In a basic monetizing spinoff that involves a D reorganization, the distributing corporation (Distributing) first contributes assets to a new subsidiary (Controlled) in exchange for all the stock of Controlled *and* debt of Controlled.³⁵ (It is the Controlled debt that tees up the monetization.) In the stock portion of the second step, Distributing distributes the stock of Controlled to the shareholders of Distributing. These two steps, considered in the aggregate, qualify as a reorganization under section 368(a)(1)(D).³⁶ Section 361(a) provides that Distributing does not recognize gain or loss on the receipt of Controlled stock. Distributing also does not recognize gain or loss on the receipt of Controlled's debt under section 361, but the provisions that apply to the debt turn on the type of debt issued by

Controlled. Section 361(a) controls as long as the debt qualifies as "securities."³⁷ If the debt fails to qualify as securities, section 361(b)(1)(A) will still provide nonrecognition treatment to the extent that the debt is distributed in pursuance of the plan of reorganization. Section 355(a)(1)(A) ordinarily allows only stock or securities to be distributed under the plan of reorganization, but section 361(b)(3) allows the nonsecurity debt to be distributed to any creditor, and not necessarily a holder of Distributing securities.³⁸ There is one important distinction for Distributing between the receipt and distribution of a Controlled security and the receipt and distribution of Controlled debt that is not a security. If the Controlled debt is not a security, section 361(b)(3) provides that Distributing has a tax-free transaction only to the extent that the value of the debt does not exceed the tax basis of the assets transferred by Distributing to Controlled. If the Controlled debt is a security,³⁹ there is no limitation; Distributing can transfer zero-basis assets to Controlled in exchange for Controlled stock and Controlled securities and distribute those securities in the spinoff without recognizing gain.⁴⁰

Regarding the distribution of Controlled stock, Distributing does not recognize any gain under section 361(c)(1).⁴¹ Regarding the distribution of Controlled debt, whether a security or not, Distributing will not have to recognize gain or loss on the distribution under section 361(c)(1) and (c)(3), because the debt in either case will be characterized as "qualified property."⁴²

35 Controlled will not recognize gain or loss on receipt of the assets in exchange for stock because of section 1032(a), and its basis in the assets will be a carryover basis calculated in accordance with section 362(b).

36 Both Distributing and Controlled qualify as parties to a reorganization under section 368(b).

37 See section 361(a). Generally, whether an instrument is characterized as a security depends on several considerations, including its maturity date. See generally Bittker and Eustice, *supra* note 1, para. 12.41[3].

38 See section 361(b)(1)(A). Distributing's basis in the property received will be calculated under section 358, applying the term "nonrecognition property" as defined in section 358(f). See section 358. For determining Distributing's basis in the stock and debt received from Controlled, nonrecognition property includes only "stock or securities in another corporation a party to the reorganization." See section 358(f); Bittker and Eustice, *supra* note 1, para. 12.42[4]. Distributing's basis in the controlled stock and debt is irrelevant, however, because no gain or loss on their disposition is recognized under section 361(c). *Id.* at para.12.42[4]. But see *infra* text accompanying note 40.

39 When obtaining a private letter ruling premised on the debt being a security, taxpayers have usually represented that the Controlled debt "will constitute securities for purposes of sections 355(a) and 361(a)." See, e.g., LTR 200732002 (May 11, 2007), *Doc 2007-18638, 2007 TNT 156-18* (including such a statement in representation (t)).

40 However, in 2007 legislation was introduced by House Ways and Means Committee Chair Charles B. Rangel, D-N.Y., that would have imposed on securities and nonqualified preferred stock the same tax basis limit that applies to nonsecurities. See H.R. 3970, 110th Cong. (2007). In the current (111th) Congress, several pieces of legislation have been introduced that, subject to various transition provisions, would amend section 361 by subjecting distributions of securities and nonqualified preferred stock of controlled corporations to the basis limit that currently exists for money and other property. See, e.g., H.R. 5982, 111th Cong. (2010); H.R. 5962, 111th Cong. (2010); S. 3380, 111th Cong. (2010); H.R. 4849, 111th Cong. (2010); H.R. 4486, 111th Cong. (2010).

41 See section 361. The shareholders of Distributing that receive the Controlled stock will not recognize gain or loss under sections 354(a)(1) and 355(a). A shareholder's basis in the Controlled stock and Distributing stock will be calculated in accordance with section 358 and the regulations promulgated thereunder, which generally require an allocation of the basis held in the Distributing stock before the distribution between the two classes of stock held after the exchange in proportion to the relative fair market value of each. Section 358 (a), (b)(2), (c); reg. section 1.358-1, 1.358-2(a)(2)(iv)-(vii), 1.358-2(c), Example 12.

42 See section 361(c). The definition of qualified property includes an "obligation of another corporation which is such a party [to the reorganization] if such . . . obligation is received by the distributing corporation in the exchange." Section

Spinoffs: Still Remarkably Tax Friendly

Finally, there is the tax treatment to Distributing's debt holder to be considered.⁴³ It is at this point that the monetization occurs, and it occurs via the exchange by Distributing of Controlled debt for its outstanding debt. If the Controlled debt and the Distributing debt both qualify as securities, the exchanging holder will not recognize gain on the receipt of the Controlled securities to the extent that Distributing securities are surrendered in the exchange, as long as the aggregate principal amount of the Distributing securities surrendered equals or exceeds the aggregate principal amount of Controlled securities received.⁴⁴

The above example assumes that a historic creditor of Distributing actually exchanges debt of Distributing for debt of Controlled.

Such a debt-for-debt exchange by a creditor may not be realistic for several practical reasons. In many spinoffs, for example, the debt of Controlled is more speculative than the debt of Distributing, and the type of holder that holds Distributing debt may not be the same type of holder that would want to hold Controlled debt.⁴⁵ Enter the investment banker and another friendly IRS policy. In the early 1980s, the debt of many corporations was trading at a discount, and there was a wave of stock-for-debt exchanges designed to qualify as such under section 108 as it then existed.⁴⁶ This meant that there

361(c)(2)(B). See, e.g., LTR 200840006 (Apr. 14, 2008), *Doc 2008-21261, 2008 TNT 194-30* ("no gain or loss will be recognized by Distributing3 on the distribution of Controlled2 Stock, the Controlled2 Securities, and the Controlled2 Term Loan A Debt"); LTR 200839024 (June 20, 2008), *Doc 2008-20623, 2008 TNT 189-35* ("no gain or loss will be recognized by Distributing 3 on the distribution of the Controlled2 Stock and the Controlled2 Securities"). The rule of nonrecognition as a result of the distribution does not protect Distributing from recognizing income in other ways. For example, Distributing could have cancellation of indebtedness income if there is a difference in the issue prices of the Controlled debt and the Distributing debt for which it is exchanged. See generally section 108(e)(10). In this connection, a number of private letter rulings have listed areas in which Distributing may have to recognize gain when exchanging the Controlled securities for Distributing securities. One ruling stated:

Taking into account the intercompany transaction regulations and their impact on, among other things, the deconsolidation of Controlled and the subsequent planned dispositions of the Controlled Securities, Distributing will not recognize any income, gain, loss, or deduction with respect to the Controlled Securities, other than any (i) amount of income, gain, loss, or deduction that offsets Controlled's corresponding amount of income, gain, loss, or deduction upon the deemed satisfaction of the Controlled Securities, (ii) deductions attributable to the fact that Distributing debt obligations may be redeemed at a premium, (iii) income attributable to the fact that Distributing debt obligations may be redeemed at a discount, (iv) interest expense accrued with respect to the Distributing debt obligations, and (v) income or gain realized on the transfer of the Controlled Securities in the Debt Exchange attributable to appreciation in the Controlled Securities while held by Distributing following the Distribution.

LTR 200629001 (Apr. 7, 2006), *Doc 2006-15301, 2006 TNT 157-38*, supplemented by LTR 200644010 (July 12, 2006), *Doc 2006-22460, 2006 TNT 214-26*. Another ruling explained the implications for a distributing corporation that intended to exchange the debt securities of Controlled that it held for securities of a second-tier subsidiary that it had assumed for federal income tax purposes, and which were held by investment banks:

Distributing will not recognize any income, gain, loss or deduction with respect to the Controlled Securities and the Debt Exchange other than any (i) deductions attributable to the fact that Sub 2 Exchange Debt may be redeemed at a premium, (ii) interest expense accrued with respect to Sub 2 Exchange Debt, and (iii) income or gain realized on the transfer of the Controlled Securities in the Debt Exchange attributable to appreciation in the Controlled Securities while held by Distributing following the Distribution. Section 361(c).

LTR 200747012 (Aug. 28, 2007), *Doc 2007-25970, 2007 TNT 227-10*. Also, in a

transaction in which a debt exchange, which involved the exchange of Controlled securities and cash for senior subordinated notes, was to be conducted between Distributing and either the note holders or a financial institution, the IRS ruled:

Provided that the Controlled Securities received in the Contribution are transferred by Distributing on the date of the Distribution (or shortly thereafter in connection with the Debt Exchange), (i) any income, gain, deduction or loss recognized by Distributing on the deemed satisfaction of the Controlled Securities described in Treas. Reg. section 1.1502-13(g) immediately prior to the Distribution (the deemed satisfaction) will be redetermined to be excluded from Distributing's gross income (Treas. Reg. section 1.1502-13(c)(1) and (c)(6)), except to the extent of any such income, gain, or loss equal to an offsetting amount of income, gain, deduction or loss taken into account by Controlled from the deemed satisfaction (attributable to any difference between the adjusted issue price and fair market value of the Controlled Securities at the time of the deemed satisfaction). . . . No gain or loss will be recognized by Distributing on the distribution of the Controlled Securities in the Debt Exchange. Section 361(c)(3). (To the extent permitted or required under general tax principles, Distributing will recognize any (i) deductions attributable to the fact that the Notes may be redeemed at a premium, (ii) income attributable to the fact that the Notes may be redeemed at a discount, and (iii) deductions related to costs associated with the redemption of the Notes.)

LTR 200732002.

- 43 It is not generally possible to distribute Controlled debt to a Distributing stockholder on a tax-free basis. Section 354(a)(2)(A)(ii) provides that nonrecognition is unavailable in that case. The shareholder nonrecognition rule of section 355(a)(1)(A) is no help because section 355(a)(3)(A) has a similar restriction. The opposite is possible, however. See *infra* text accompanying notes 61-68.
- 44 See sections 354(a)(2)(A)(i), 355(a)(1)(A)(ii), 355(a)(3)(A). See LTR 200139009 (June 27, 2001), *Doc 2001-24949, 2001 TNT 190-33*, supplemented by LTR 200303036 (Oct. 10, 2002), *Doc 2003-1596, 2003 TNT 13-30* (discussing tax implications for holders of Distributing debt who exchange their debt for debt instruments of Controlled held by Distributing).
- 45 See LTR 200732002. In this ruling, the taxpayer indicated that "the Debt Exchange is intended to be conducted as a direct exchange between Distributing and the holders of the Distributing Notes. However, it may be necessary or appropriate to accomplish the Debt Exchange through intermediation by a financial institution."
- 46 Section 108(e)(8), before its amendment in 1993, acknowledged the existence of a debt-for-equity exception to cancellation of indebtedness income that was based in case law. See generally Bittker and Eustice, *supra* note 1, para. 4.25[3].

Spinoffs: Still Remarkably Tax Friendly

was no cancellation of indebtedness income. In a series of technical advice memorandums, the IRS acquiesced in a structure whereby an investment banker bought the outstanding debt, swapped it for the stock, and then resold the stock.⁴⁷ When the banker purchased the outstanding debt, there typically was no binding obligation of the banker to consummate the exchange, although there obviously was a clear expectation by all parties that the exchange would occur. This technique has now been imported to the spinoff area.⁴⁸

In the classic case, investment bankers purchase debt of Distributing on the open market, and do so before the distribution; purchases made at least 14 days before the distribution have been approved in private letter rulings.⁴⁹ Distributing and the investment bankers also enter into an exchange agreement detailing the terms of the exchange. In one ruling, the taxpayer represented that Distributing and the investment bankers would enter into an agreement to exchange the debt “no sooner than five days after acquiring the [debt] in the marketplace and at least nine days prior to the Distribution.”⁵⁰ Two rulings stated that the Distributing debt would be acquired by the bankers “as principals for their account” at least 14 days before the spinoff and that the exchange agreement between Distributing and the bankers would be entered into no

sooner than five days after the bankers acquired the Distributing debt.⁵¹ Another ruling indicated that an exchange agreement would be executed “at some time during the seven-day period prior to the date of the Holdco Spin-off” in which the investment bank would represent that it acquired the debt “for its own account.”⁵² Then, at the effective time of the spinoff, Distributing transfers the Controlled debt to the investment bankers in exchange for the Distributing debt that has been purchased on the open market.⁵³ Finally, the investment bankers sell the Controlled debt in the market.

The above transaction is sometimes referred to as a monetizing spinoff because Distributing has in effect monetized a portion of its investment in Controlled. Assume that the assets of Controlled are worth 300x and that those assets are transferred by Distributing to Controlled in exchange for Controlled stock worth 100x and Controlled debt of 200x. If Distributing then spins off the Controlled stock to its stockholders and exchanges the Controlled debt for its own debt, Distributing has, as to the 200x, achieved the same result as if it sold the assets of Controlled and used the proceeds to pay off debt. The difference is that a sale of assets is a taxable transaction and it is only the after-tax cash that would be available to pay off debt. In contrast, the monetizing part of the spinoff allows debt to

47 See TAM 8738003 (May 22, 1987); TAM 8735007 (May 18, 1987); TAM 8735006 (May 18, 1987).

48 See Martin D. Ginsburg and Jack S. Levin, *Mergers, Acquisitions and Buyouts: A Transactional Analysis of the Governing Tax, Legal, and Accounting Considerations*, para. 1012.2 (Jan. 2010 ed.) (detailing some of the precautions, drawn from the technical advice memorandums, that should be taken to avoid the characterization that the investment bankers are merely agents of Distributing).

49 See, e.g., LTR 200832001 (Apr. 30, 2008), *Doc 2008-17314, 2008 TNT 155-17* (indicating that, subject to some exceptions, no gain will be recognized on the transfer of the securities in the external debt exchange); LTR 200802009 (Oct. 5, 2007), *Doc 2008-645, 2008 TNT 9-15* (indicating that, subject to some exceptions, no gain will be recognized on the transfer of the securities in the external debt exchange); LTR 200629001, supplemented by LTR 200644010 (indicating that, subject to some exceptions, Distributing would not recognize any gain on the Controlled securities); Ginsburg and Levin, *supra* note 48, para. 1012.2 (citing LTR 200137011 (June 4, 2001), *Doc 2001-23711, 2001 TNT 180-28*).

50 LTR 200629001, supplemented by LTR 200644010.

51 LTR 200832001 (understood to relate to the Kraft Foods Inc. split-off of its Post cereals business); LTR 200802009.

52 LTR 200701010 (Sept. 1, 2006), *Doc 2007-520, 2007 TNT 5-18*.

53 See, e.g., LTR 200832001 (stating that the external debt exchange would occur “on the date of the proposed transaction, or as soon as reasonably practicable thereafter”). In one transaction, an extra step was added: The taxpayer indicated that “solely in order to comply with covenants under Distributing’s senior note indentures, Distributing may be required to sell the retired Distributing debt back to the [investment banks] immediately after the Debt Exchange and then use the cash proceeds from that sale to immediately repurchase such Distributing Debt

from the [investment banks]. Any such purchase and sale will be accomplished by means of accounting entries between Distributing” and the investment banks. See LTR 200810024 (Dec. 3, 2007), *Doc 2008-5012, 2008 TNT 47-33*; LTR 200810018 (Dec. 3, 2007), *Doc 2008-5006, 2008 TNT 47-32*; LTR 200810001 (Nov. 7, 2007), *Doc 2008-4989, 2008 TNT 47-31*; LTR 200808006 (Nov. 7, 2007), *Doc 2008-3729, 2008 TNT 37-21*. The prior four rulings were collectively supplemented by LTR 200926019 (Feb. 26, 2009), *Doc 2009-14553, 2009 TNT 122-72*; LTR 200926020 (Feb. 26, 2009), *Doc 2009-14554, 2009 TNT 122-73*; LTR 200927007 (Feb. 26, 2009), *Doc 2009-15100, 2009 TNT 126-22*; LTR 200927008 (Feb. 26, 2009), *Doc 2009-15101, 2009 TNT 126-23*; LTR 200927009 (Feb. 26, 2009), *Doc 2009-15102, 2009 TNT 126-24*; LTR 200927010 (Feb. 26, 2009), *Doc 2009-15103, 2009 TNT 126-25*; LTR 200927011 (Feb. 26, 2009), *Doc 2009-15104, 2009 TNT 126-26*. Both sets of prior rulings were supplemented by LTR 201030007 (Mar. 23, 2010), *Doc 2010-16989, 2010 TNT 147-24*; LTR 201030008 (Mar. 23, 2010), *Doc 2010-16990, 2010 TNT 147-25*; LTR 201030009 (Mar. 23, 2010), *Doc 2010-16991, 2010 TNT 147-26*; LTR 201030010 (Mar. 23, 2010), *Doc 2010-16992, 2010 TNT 147-27*; LTR 201030011 (Mar. 23, 2010), *Doc 2010-16993, 2010 TNT 147-28*; LTR 201030012 (Mar. 23, 2010), *Doc 2010-16994, 2010 TNT 147-29*; and LTR 201030013 (Mar. 23, 2010), *Doc 2010-16995, 2010 TNT 147-30*.

Spinoffs: Still Remarkably Tax Friendly

be paid from pretax proceeds. There is no limit in the tax law on the portion of the transaction that represents, in essence, a tax-free sale of assets. The tax basis of the assets is not a limitation provided that, as noted above, Controlled securities are received and then exchanged for Distributing securities. The only limitation is the practical one of Controlled's ability to bear and service the debt.

The transaction described above is an exchange of Controlled debt for Distributing debt. The same economic result can be achieved in other ways, notably the assumption of Distributing debt by Controlled and a leveraging up of Controlled with a distribution of the cash to Distributing.⁵⁴ It is relatively common for Controlled to assume debt of Distributing. It can occur by Controlled's assumption of trade debt and business liabilities associated with the assets that are contributed in exchange for its stock, or by Controlled's assumption of Distributing debt not specifically related to those assets.⁵⁵ If Controlled assumes debt of Distributing, section 357(a) provides that the assumption does not prevent the exchange of assets for Controlled stock from being tax free under section 361. Section 357(c)(1) introduces a limitation on this rule: The amount of the liabilities assumed cannot exceed the tax basis of the assets transferred by Distributing to Controlled.

Thus an assumption of Distributing debt by Controlled has the same tax result as the exchange by Distributing of nonsecurity Controlled debt for Distributing debt; the transaction is tax free to Distributing, but the tax basis of the assets transferred by Distributing to Controlled is a limit. Controlled also can borrow money and use the cash proceeds in partial exchange for the assets transferred by Distributing to Controlled in the D reorganization.⁵⁶ Section 361(b)(1)(A) allows the cash to be received by Distributing without tax if

the cash is paid to a creditor of Distributing in pursuance of the plan of reorganization.⁵⁷ As with a debt instrument that is not a security, the cash that can be received by Distributing without tax and used by it to pay debt is limited to the tax basis of the assets transferred by Distributing to Controlled.⁵⁸ If Distributing decides to use the cash to pay a dividend to its stockholders, however, section 361(b)(3) does not limit the cash to the tax basis of the assets transferred to Controlled, and section 361(b)(1) still applies as a result of the distribution of the cash. This is a special form of monetizing transaction that depends on a desire to pay a special dividend, but the economic result is the same as the more common forms of the transaction — pretax proceeds from the disposition of assets are used to pay the dividend.

There is a step transaction issue if the cash from Controlled is used to pay Distributing debt that was incurred in anticipation of or in proximity to the D reorganization. That debt could be used, in effect, to allow Distributing to keep the cash that was received from Controlled. The IRS appears to be sensitive to this issue. For example, in a recent private letter ruling involving a nonpublic company with a lender (presumably a bank), the distributing company represented that the bank debt to be paid with cash received from Controlled would not exceed the weighted quarterly average of the distributing company's debt owed to unrelated parties for the 12 months preceding board authorization of the spinoff, and that neither the distributing company nor any related party would borrow any money from the same bank for a period that would begin on the date of the first internal spinoff of Controlled and

54 These techniques can be combined. In May 2009 Verizon Communications Inc. announced a spinoff of its rural landlines business. News release, Verizon Communications Inc., "Verizon to Divest Wireline Businesses in 14 States" (May 13, 2009). In addition to equity of an acquiring company (the transaction is a reverse *Morris Trust* transaction qualifying under section 355(e)), valued at approximately \$5.3 billion, Verizon itself will receive approximately \$3.3 billion through a combination of cash payments, new securities, and debt to be assumed by Controlled. *See id.*

55 *See, e.g.*, LTR 201017031 (Dec. 10, 2009), *Doc 2010-9613, 2010 TNT 84-27* (indicating that Controlled would assume specified amounts of indebtedness, including bank debt and an interest-bearing promissory note, stemming from a merger that involved Distributing and occurred before the split-off); LTR 200906033 (Oct. 16, 2008), *Doc 2009-2600, 2009 TNT 24-23*. There are many variations on debt assumption. *See, e.g.*, LTR 200217006 (Dec. 27, 2001), *Doc 2002-10126, 2002 TNT 82-34* ("Distributing debt will be allocated to Controlled through a combination of new debt issuances and exchange offers for Distributing debt . . . to establish appropriate capital structures for Distributing and Controlled").

56 *See* LTR 201032017 (Feb. 5, 2010), *Doc 2010-18070, 2010 TNT 157-22* (indicating that on its receipt of a special dividend from Controlled, the funds for which Controlled would obtain from either unrelated financial institutions or in capital markets transactions, Distributing intended to (1) pay a dividend to its shareholders, (2) repurchase outstanding Distributing common stock, or (3) repay outstanding Distributing debt).

57 *See* section 361(b)(1)(A) and (b)(3). It may be possible to keep the cash in Distributing's group while complying with this rule. In LTR 200624001 (July 20, 2005), *Doc 2006-11732, 2006 TNT 117-22*, the IRS allowed the cash to be used to pay an internal creditor — a wholly owned subsidiary of Distributing to which Distributing owed money. *See* LTR 200624001, supplemented by LTR 200626011 (Feb. 27, 2006), *Doc 2006-14281, 2006 TNT 146-29*, supplemented by LTR 200632008 (May 12, 2006), *Doc 2006-15388, 2006 TNT 157-41*, supplemented by LTR 200644012 (July 21, 2006), *Doc 2006-22462, 2006 TNT 214-24*, supplemented by LTR 200708064 (Oct. 19, 2006), *Doc 2007-4764, 2007 TNT 38-92*, supplemented by LTR 200802016 (Oct. 9, 2007), *Doc 2008-652, 2008 TNT 9-14*.

58 *See* section 361(b)(3).

Spinoffs: Still Remarkably Tax Friendly

would end 12 months after the debt to the lender was repaid.⁵⁹ The step transaction issue may not be viewed as the same as in an assumption of Distributing debt by Controlled. In that case, it may be possible for Distributing to receive cash indirectly from a Controlled borrowing without having to distribute that cash to its creditors. In the split-off by Kraft Foods Inc. of its Post cereals business, Kraft received \$300 million in cash proceeds from a new bank borrowing, and Controlled then assumed that debt in the reorganization.⁶⁰

There is an additional path that Distributing can take to reduce its level of debt while participating in a spinoff: the equity-for-debt exchange. Generally, in such a transaction, Distributing exchanges a portion of its Controlled stock for its outstanding debt securities. Sections 354(a)(1) and 355(a)(1)(A) allow that exchange to be tax free to the exchanging holder as long as the debt constitutes securities. More importantly, the exchange is tax free to Distributing under sections 355(c) and 361(c).⁶¹

Exchanges of Controlled equity for Distributing debt have been executed in ways that parallel those of the Controlled debt exchanges discussed above. Distributing can participate in an exchange directly with the holder of Distributing debt.⁶² An investment banker can also help facilitate those exchanges by independently acquiring Distributing debt.⁶³ It is unrealistic,

generally, in the case of a public company that holders of Distributing securities will want instead to hold Controlled stock. The intermediate role of the investment banker, which can acquire the Distributing securities from their holders for cash and resell the Controlled stock for cash to different persons, bridges that practical gulf. Rulings have indicated, in several variations, that the debt would be obtained by investment bankers and financial institutions "in their capacity as principals acting for their own accounts."⁶⁴ Rulings that did not redact specific date information indicated that the debt would be acquired by the investment bankers not less than 14 days before the anticipated exchange.⁶⁵ One indicated that the exchange agreement between Distributing and the financial institution would be executed no sooner than five days after the debt was acquired and at least nine days before the exchange was to be consummated.⁶⁶ It is often stated that the investment bankers and financial institutions intend to sell the Controlled stock received in the exchange in a public offering.⁶⁷ The time of the debt-for-equity exchanges within the scope of the larger transaction appears to be varied; some exchanges are scheduled to occur before Distributing's distribution of Controlled stock to its shareholders, while others are to occur afterward.⁶⁸

A special form of a monetization spinoff depends on a desire

59 LTR 200823004 (Mar. 3, 2008), *Doc 2008-12534*, *2008 TNT 111-16*.

60 See prospectus-offer to exchange, Kraft Foods Inc. (June 25, 2008). See also LTR 200832001 (appears to relate to Kraft transaction).

61 It is the receipt of Controlled stock in the D reorganization and its subsequent exchange for Distributing's securities that is tax free to Distributing. There may be ancillary tax consequences. A recent letter ruling stated:

No gain or loss will be recognized by Distributing 1 on any Debt-for-Equity Exchange to the extent Distributing 1 exchanges the Retained Stock for Distributing 1 Debt, whether in the manner described above or in an exchange directly with a historic holder of Distributing 1 Debt other than (i) deductions attributable to the fact that the Distributing 1 Debt may be redeemed at a premium, (ii) income attributable to the fact that the Distributing 1 Debt may be redeemed at a discount and (iii) interest expense accrued with respect to the Distributing 1 Debt (section 361(c)).

LTR 200944026 (June 29, 2009), *Doc 2009-23908*, *2009 TNT 209-22*.

62 See LTR 200303036, supplementing LTR 200139009; LTR 200301011 (July 2, 2002), *Doc 2003-601*, *2003 TNT 3-10*.

63 See LTR 200944026; LTR 200837027; LTR 200841021, jointly supplemented by LTR 200850016, jointly supplemented by LTR 200909030; LTR 200345050 (Sept. 30, 2002), *Doc 2003-24110*, *2003 TNT 217-41*, ruling withdrawn because of changed factual circumstances in LTR 200344018 (July 14, 2003), *Doc 2003-23548*, *2003 TNT 212-19*; LTR 200219025 (Feb. 8, 2002), *Doc 2002-11425*,

2002 TNT 92-62; LTR 200137011, supplemented by LTR 200303004 (Sept. 12, 2002), *Doc 2003-1564*, *2003 TNT 13-27*.

64 See LTR 200837027; LTR 200841021, jointly supplemented by LTR 200850016, jointly supplemented by LTR 200909030; see also LTR 200944026; LTR 200345050, ruling withdrawn in part because of changed factual circumstances in LTR 200344018; LTR 200219025. *But see* LTR 200125011 (Mar. 14, 2001), *Doc 2001-17291*, *2001 TNT 122-41* (appearing to accept that Investment Bank was acting as principal but no ruling was given on the issue), supplemented by LTR 200133035 (May 17, 2001), *Doc 2001-21905*, *2001 TNT 161-32*, supplemented by LTR 200205035 (Oct. 31, 2001), *Doc 2002-2605*, *2002 TNT 23-33*.

65 See LTR 200944026; LTR 200345050, ruling withdrawn in part because of changed factual circumstances in LTR 200344018; LTR 200137011, supplemented by LTR 200303004.

66 LTR 200944026.

67 See LTR 200944026; LTR 200837027; LTR 200841021, jointly supplemented by LTR 200850016, jointly supplemented by LTR 200909030; LTR 200345050, ruling withdrawn in part because of changed factual circumstances in LTR 200344018; LTR 200219025; LTR 200137011, supplemented by LTR 200303004 (indicating that the stock would be sold "in a firm commitment underwriting or otherwise"); LTR 200125011, supplemented by LTR 200133035, supplemented by LTR 200205035 (stating that "Investment Bank will attempt to sell to the public" the stock received on the exchange).

68 Compare LTR 200345050, ruling withdrawn in part because of changed factual

Spinoffs: Still Remarkably Tax Friendly

by Distributing to use cash to buy back its shares. In that case, Distributing can generate cash from a portion of the value of the assets transferred to Controlled in the D reorganization and use that cash on a pretax basis to redeem its shares. Section 361(b)(1)(A) allows the cash to be received by Distributing from Controlled on a tax-free basis as long as the cash is then distributed in pursuance of the plan of reorganization. That cash can be used by Distributing to repurchase its stock privately, under an offer to purchase, or in the open market.⁶⁹ Because the cash is used by Distributing to repurchase stock rather than debt, section 361(b)(3) does not apply and the tax basis of the assets transferred by Distributing to Controlled in the D reorganization does not limit the cash that can be so used.⁷⁰

Most spinoffs are preceded by a D reorganization. It is possible, however, that Controlled already exists as a subsidiary of Distributing. In that case, Controlled can borrow money and

distribute that cash to Distributing.⁷¹ The distribution by Controlled to Distributing would reduce Distributing's tax basis in the Controlled stock,⁷² and if the distribution exceeded the basis, an excess loss account would result, which would then be triggered on the spinoff.⁷³ Thus in this scenario tax basis also operates as a practical limit, although in this case it is the tax basis in the Controlled stock, which might be different from Controlled's tax basis in its assets. Controlled also could distribute its securities to Distributing.⁷⁴ Then, Distributing distributes its Controlled stock to the Distributing shareholders and exchanges the Controlled securities for existing Distributing securities. Distributing does not recognize gain or loss on the distribution of the Controlled stock or the exchange of Controlled securities under section 355(c)(1).⁷⁵ The Distributing shareholders that receive Controlled stock in the distribution do not recognize gain under section 355(a). As before, the holders of Distributing securities that receive Controlled securities are obligated

circumstances in LTR 200344018 and LTR 200125011, supplemented by LTR 200133035, supplemented by LTR 200205035 (debt-for-equity exchanges occurring before the distribution of stock by Distributing) with LTR 200837027; LTR 200841021, jointly supplemented by LTR 200850016, jointly supplemented by LTR 200909030 (debt-for-equity exchange occurring after the initial split-off). Additional subsequent transactions designed to further reduce Distributing's level of indebtedness have also been detailed in several of the rulings. These transactions range from additional rounds of debt-for-equity exchanges to outright sales of Controlled stock, the proceeds of which would be devoted to the reduction of Distributing's debt. See, e.g., LTR 200345050, ruling withdrawn in part because of changed factual circumstances in LTR 200344018 (exchanges could occur "at one or more times" before the distribution of Controlled stock); LTR 200303036, supplementing LTR 200139009 (a debt-for-debt exchange would be executed as an alternative or Controlled would incur debt and give the resulting funds to Distributing if the first two transactions could not be completed); LTR 200301011 ("one or more transactions" would take place); LTR 200125011, supplemented by LTR 200133035, supplemented by LTR 200205035 (exchanges would occur "at one or more times" before the distribution). One set of rulings stated a series of transactions as follows:

To the extent Distributing does not distribute any or all of the Remaining Controlled Class B Common Stock in the Initial Debt Exchange, it may initiate and engage in (1) additional private debt exchanges having generally similar terms to those of the Initial Debt Exchange (the "Subsequent Private Debt Exchanges"), (2) one or more public debt exchanges (the "Subsequent Public Debt Exchanges" . . .) that is or is required to be registered under the Securities Act, pursuant to which the offeree of such Subsequent Public Debt Exchange shall exchange Debt Securities for shares of Controlled Class B Common Stock, or (3) exchange any remaining shares of Controlled Class B Common Stock with Distributing shareholders for outstanding Distributing Common Stock in a subsequent exchange offer (either public or private) . . . until all of the Controlled Class B Common Stock held by Distributing has been exchanged for Debt Securities or Distributing Common Stock and Distributing no longer holds any Controlled Class B Common Stock.

LTR 200837027; LTR 200841021, jointly supplemented by LTR 200850016, jointly supplemented by LTR 200909030. Another ruling explained:

Regarding any Retained Common Stock held by Distributing after the Debt-for-Equity Exchange, Distributing intends (i) to effect other debt-for-equity exchanges similar to the Debt-for-Equity Exchange (but involving Distributing debt other than the Notes) on or before the sixth month after step (xlix) above, or (ii) to issue its own debt securities that are exchangeable into the remaining Retained Common Stock and use the proceeds of such an issuance to repay debt, or (iii) if market conditions are unfavorable for either of these two alternatives, to sell the remaining Retained Common Stock in the open market and use the proceeds to pay down debt.

LTR 200137011, supplemented by LTR 200303004. However, in LTR 200137011, the IRS expressly declined to express an opinion on "the treatment under section 361(c)(3) (or any other provision of the Code or regulations) of the disposition of any Retained Common Stock other than in the Debt-for-Equity Exchange." *Id.*

69 See, e.g., LTR 200737017 (May 31, 2007), *Doc 2007-21046, 2007 TNT 180-23* (Distributing will, within one year of the D reorganization, use cash in the same amount to "make distributions to its shareholders (either by repurchasing shares of Distributing common stock or by making dividend distributions to holders of Distributing common stock) and/or repay liabilities owed to unrelated third-party creditors of Distributing").

70 *Id.* (making clear, in representation (jjjjj), the tax-basis distinction between cash used to buy Distributing stock and cash used to repay Distributing Debt).

71 There is a step transaction issue if the cash is a dividend distribution and contemporaneous with a transfer of assets from Distributing to Controlled. In that case, it is easy to view the cash as being in exchange for the assets. If Controlled has intercompany debt already outstanding to Distributing, the cash can be used to repay that debt without step transaction concerns.

72 See *reg.* section 1.1502-32(b)(3)(v).

73 See *reg.* section 1.1502-19(b). Section 355 does not trump this rule. See *reg.* section 1.1502-19(b)(2)(ii).

74 Such a distribution will reduce the tax basis of Distributing in the stock of Controlled under the consolidated return regulations in the same way that a cash distribution would.

Spinoffs: Still Remarkably Tax Friendly

to surrender their Distributing securities to avoid recognizing gain on the exchange; the principal amount of securities surrendered must exceed the principal amount of those received to preserve the nonrecognition status of the exchange.⁷⁶ The important distinction between a monetizing spinoff involving a D reorganization and one that does not is that it is the D reorganization that enables tax-free monetization in excess of the tax basis of the assets or stock of the controlled corporation.

The application of all the foregoing rules is very much dependent on the relative positions of Distributing as the distributing corporation and Controlled as the controlled corporation. In real life, however, if business A is to be separated from business B in a spinoff, either business can occupy either position. This fact is recognized in section 355(e)(2)(A)(ii), which treats acquisitions of Distributing and Controlled the same. It is important to realize that if the business conceptually thought of as Controlled instead occupies the Distributing position, there is no tax restriction on the amount of debt that it can carry or the cash that can be left or put in the other business. The IRS's attitude in policing the monetization aspects of the standard spinoff format may be shaped by the knowledge that there is no way under current law to police those monetization aspects in the reverse format.

Overlapping Directors and Officers as a Device

In June 2003 the IRS announced that it would no longer rule on whether a spinoff constitutes a device.⁷⁷ On the surface, this would seem to be a taxpayer unfriendly move because it exposes a taxpayer undertaking a spinoff to additional tax risk. While those taxpayers now routinely obtain an opinion from counsel that the

spinoff is not a device, such an opinion, no matter how solid, does not provide the insurance of a ruling from the IRS. There is one respect, however, in which I believe the IRS's policy to not rule on whether a spinoff constitutes a device has turned out to be taxpayer friendly.

The device test is exceedingly murky. Section 355(a)(1)(B) requires only that the spinoff not be used "principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both." There is an obvious potential for a device any time in which there is a lower tax rate on capital gains than on dividends. That is because the post-spinoff shareholder can sell the stock of Distributing or Controlled at a capital gains tax rate and, if the underlying facts support it, have achieved the same pretax result as if Distributing had distributed to the shareholder cash that would have been taxed at higher rates. Even if the tax rates are the same, as they are now for individuals at generally 15 percent,⁷⁸ the device test polices the recovery of basis that takes place in a capital gains transaction as opposed to a dividend transaction.⁷⁹

For many years, particularly when the IRS issued rulings on device, there was thought to be a requirement that the distributing and controlled companies be completely separated after the spinoff, subject to specific exceptions that had been blessed by the IRS. Continuing common management or overlapping boards of directors, other than on a transitional basis and for a good reason, were thought to present a problem. There is no basis in the statute or regulations for the simple idea that a distributing corporation and a controlled corporation should be independent in operation or governance after the spinoff.⁸⁰ Consider, for example, a spinoff in

75 See section 355(c)(1). This nonrecognition treatment applies to the extent that appreciated nonqualified property is not distributed. Section 355(c)(2)(A). "Qualified property" is defined as "any stock or securities in the controlled corporation," but is subject to further limitations within section 355. Section 355(c)(2)(B); see section 355(a)(3); 355(d)-(e); Boris Bittker and Lawrence Lokken, *Federal Taxation of Income, Estates, and Gifts*, paras. 96.8.1-3 (3d ed. 2003 and Supp. 2010).

76 See section 355(a)(1)(A)(iii), 355(a)(3)(A). However, a security holder must recognize income "to the extent any stock- . . . securities, or other property received is attributable to interest which has accrued on securities on or after the beginning of the holder's holding period." Section 355(a)(3)(C).

77 Rev. Proc. 2003-48, 2003-2 C.B. 86, *Doc 2003-15249, 2003 TNT 122-4*. The IRS also announced that it would no longer rule on the legitimacy for tax purposes of the business purpose for a spinoff transaction and on the question whether a spinoff and a related acquisition are part of a plan under section 355(e). *Id.* Those no-ruling areas are now listed in Rev. Proc. 2010-3, section 3.01(39). However, "the Service may issue a ruling regarding the effect of redemptions under section 355(e) pending the issuance of temporary or final regulations regarding

redemptions under section 355(e) if an adverse ruling on such question would result in there being a direct or indirect acquisition by one or more persons of stock representing a 50-percent or greater interest in the distributing corporation or the controlled corporation that is part of a plan under section 355(e)." Rev. Proc. 2010-3.

78 See section 1(h).

79 See reg. section 1.355-2(d)(1).

80 In contrast, if there were no substance at all to the brother/sister status of Distributing and Controlled after a spinoff, it would be possible to conclude that the distribution required by section 355 did not actually occur. Perhaps the clearest indication that post-spinoff independence is not required, at least by the device prohibition, is the rule in reg. section 1.355-2(d)(5)(ii) and (v), Example 1, that there is almost per se no device if there are no earnings and profits.

Lack of independence, of course, could impugn a purported business purpose for the spinoff, or depending on the facts, cause a business not to be sufficiently

Spinoffs: Still Remarkably Tax Friendly

which Controlled and Distributing have precisely overlapping boards of directors after the spinoff. That fact does not clearly violate any provision in the regulations, and in fact it is analogous to a single-shareholder company that spins off a subsidiary to that shareholder.⁸¹

The closest that the regulations come to addressing this issue is in the related function rule of reg. section 1.355-2(d)(2)(iv)(C). Under that rule, there is evidence of a device if either the distributing or controlled corporation operates a business (1) the principal function of which is to serve a business operated by the other and (2) that can be sold without adversely affecting the business of the other.⁸² In a spinoff by a public company in which there is a complete separation of the distributing and controlled companies, it would seem automatically to follow that the businesses can be separated without adversely affecting the business of the other, because that is precisely what is happening. The presence of a controlling shareholder or overlapping board might be said to negate that assumption because of their presumed power to cause one business to continue to serve the other.

One might even argue that a controlling shareholder or an overlapping board is tantamount to a binding long-term contract between the companies. It is useful as a comparison to consider that case. Take, for example, a spinoff in which the principal activity of the controlled company is to provide raw material for the distributing company, and before the spinoff the two companies put in place a long-term contract that ensures the raw material will be supplied. That would seem to be a classic case of a “related function” device. Note that a sale of the controlled company by the shareholders after the spinoff would in effect monetize a stream of revenue from the distributing company over the life of the contract. The situation is starkest if the long-term contract is assumed to be

a cost-plus one in which a predictable profit will be earned by the controlled company.

But what about common management or an overlapping board of directors in a situation where there is no long-term contractual relationship? Perhaps the idea is that even in the absence of a long-term contract, overlapping ownership or an overlapping board might ensure the same result, although this is difficult to see as an analogy to monetization. The regulations do not help much. There is an example in the regulations in which Controlled conducts research and development solely for Distributing, which is said to present possible evidence of a device.⁸³ In another example, Controlled purchases for resale the products manufactured by Distributing, which is said to be possible evidence of a device.⁸⁴ Finally, in a third example,⁸⁵ Controlled operates a coal mine for the sole purpose of supplying the coal requirements of Distributing, which is a steel manufacturer. This also is said to be possible evidence of a device.⁸⁶ Interestingly, none of the three examples states that there was a long-term contract in place between the companies, and thus it is unclear what potential for monetization there might have been. The examples also do not mention any overlapping control after the spinoff. All three examples make it clear that the device possibly evidenced by the facts is a related function device. The facts in the three examples arguably meet the first requirement for a related function device, which is that the principal function of one company is to serve another company. None of the examples addresses the other requirement for the related function device, which is that one business can be sold without adversely affecting the business of the other.⁸⁷ It is the second requirement that if addressed, might have

active. These possibilities, discussed later in this report, do not seem likely. A possible source for inferring an independence rule is the rule in section 355(a)(1)(D)(ii) that any stock in Controlled that is retained by Distributing must not have been so retained “in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax.” Perhaps in an egregious case, a post-spinoff lack of independence could be said to be tantamount to a retention of stock. This would seem strained in most cases, however.

81 Reg. section 1.355-2(d)(4), Example (1), is such a situation, except that the purpose for the spinoff was so that an employee could acquire stock in the Distributing company; it is not stated how much stock, but it was “significant.” That the employee bought his stock from the shareholder was evidence of a device, with the clear implication that there would have been no device if the employee had bought newly issued stock from Distributing. See Reg. section 1.355-2(d)(4), Example 1.

82 See reg. section 1.355-2(d)(2)(iv)(C). The former requirement must continue to exist for “a significant period” after the spinoff, which means that the requirement

could be met on a transitional basis without a problem. See *id.*

83 Reg. section 1.355-3(c), Example (9). A substantially similar example is in prop. reg. section 1.355-3(d)(2), Example 16. 72 FR. 26,012 and 26,032 (May 8, 2007); 72 FR. 31,021 and 31,021 (June 5, 2007).

84 Reg. section 1.355-3(c), Example (10). A substantially similar example is in prop. reg. section 1.355-3(d)(2), Example 17. 72 FR. 26,012 and 26,032 (May 8, 2007); 72 FR. 31,021 (June 5, 2007).

85 Reg. section 1.355-3(c), Example (11). This example was not included in the 51 examples in prop. reg. section 1.355-3. See generally 72 FR. 26,012 and 26,030 (May 8, 2007); 72 FR. 31,021 (June 5, 2007).

86 Reg. section 1.355-3(c), Example (11).

87 This fact is recognized in the reference to two of the examples in reg. section 1.355-2(d)(2)(iv)(C).

Spinoffs: Still Remarkably Tax Friendly

shed some light on the relative importance of an overlapping board or common management.

The history of the related function regulations in the examples is interesting, and it explains why the second related function device requirement is not addressed in the examples. Regulations promulgated in connection with the spinoff provisions added by the Revenue Act of 1951 contained a device limitation but did not contain a related function limitation.⁸⁸ Promulgated in 1955,⁸⁹ the first regulations under section 355 contained a reference to the device test,⁹⁰ but there was no related function rule. The 1955 regulations had three examples that are very similar to those in the current regulations,⁹¹ but they illustrated a former restriction that a single business could not be horizontally divided into two businesses.⁹²

In 1977 the IRS proposed new and more extensive regulations under section 355.⁹³ Those proposed regulations introduced the related function rule, but only what is now the first requirement of it. The regulations said that a related function, considered to be evidence of a device, exists if the principal function of one company is to serve the other company and that status continues after the spinoff.⁹⁴ The 1977 proposed regulations dropped the prohibition on

horizontal divisions of a business, but kept the three examples in modified form,⁹⁵ now stating that those examples are permissible horizontal divisions of a business and also stating that two of the three examples might present evidence of a device.⁹⁶ There is no explanation in the preamble to the 1977 regulations of what the IRS might have been thinking, but it seems likely that it was trying to achieve the no-horizontal-division result in a different way.

Finally, the current related function regulations were enacted in 1989.⁹⁷ As discussed above, the current regulations add a second requirement to the related function rule and state that two of the three examples provide evidence of a device if the second requirement is also met, but they do not address the circumstances under which the second requirement might be met.⁹⁸ While the preamble to the 1989 regulations does not say so, it seems likely that the second requirement is derived from *Rafferty v. Commissioner*.⁹⁹ Mr. and Mrs. Rafferty owned a company that operated a steel business. The company had a subsidiary that held real estate that was leased to the steel business.¹⁰⁰ The steel company spun off the real estate company based on tax advice that Mr. Rafferty received in connection with his desire to provide income

88 See T.D. 5990. Section 317(a) of the Revenue Act of 1951 reintroduced provisions (in section 112 of the then-Internal Revenue Code) that provided for the nonrecognition of gain by a shareholder on the receipt of stock in some reorganizations in which the stockholder did not surrender any stock. See PL. 82-183, 65 Stat. 452, 493; Herman Wolff Jr., "Divisive Reorganizations as Affected by the Revenue Act of 1951," 31 *Taxes* 716, 717 (1953). It may be that the device limitation in the regulations, which contained language similar to that of the provisions added by the Revenue Act of 1951, was motivated in part by the Supreme Court's opinion in *Gregory v. Helvering*, 293 U.S. 465 (1935). See Bittker and Eustice, *supra* note 1, para. 11.01[2] ("the 1951 legislation is notable mainly for its cautious reinstatement of the tax-free spin-off, with statutory restrictions that are reminiscent of the *Gregory* case"); Wolff, *supra*, at 718 ("in the enactment of Section 112(b)(11), by the addition of clauses (A) and (B) [the device limitation], an attempt was made to codify the basic requirements of all reorganizations which the courts have developed").

89 See T.D. 6152.

90 Reg. section 1.355-2(b) (1955).

91 See reg. section 1.355-1(d), examples (5), (11), and (12) (1955).

92 The 1955 regulations provided that activities that are part of a business but that are not themselves independently producing income do not constitute an active business. Reg. section 1.355-1(c)(3). The three examples thus evidence spinoffs that could not be done because the controlled companies serve the distributing companies rather than independently producing income. See *id.*; reg. section 1.355-1(d), examples (5), (11), and (12) (1955). *United States v. Marett and Coady v. Commissioner* rejected the notion that a single business could not be divided in a transaction in which gain or loss was not recognized under section 355, as well as the section of the regulations detailing this position. See *United States v.*

Marett, 325 F.2d 28, 31 (5th Cir. 1963) (finding, in a case involving a vertical division of a single business, that "Section 1.355-1(a) is invalid to the extent that it provides 'Section 1.355-1(a) does not apply to the division of a single business'"), *aff'g* 11 A.F.T.R.2d 1542 (N.D. Ga. 1962); *Coady v. Commissioner*, 33 T.C. 771, 779-780 (1960) (in a case involving the vertical division of a single business, the court rejected the portion of regulations promulgated under section 355 that disallowed nonrecognition treatment for transactions involving the division of a single business), *aff'd*, 289 F.2d 490 (6th Cir. 1961). The IRS announced that it would follow those two cases in Rev. Rul. 64-147 "to the extent they hold that Section 1.355-1(a) of the Income Tax Regulations, providing that section 355 of the Internal Revenue Code of 1954 does not apply to the division of a single business, is invalid." Rev. Rul. 64-147, 1964-1 C.B. 136, *revoking* Rev. Rul. 61-198, 1961 C.B. 61, *obsoleted by* Rev. Rul. 2003-99, 2003-2 C.B. 88, *Doc 2003-18199, 2003 TNT 164-9*. The IRS also withdrew its nonacquiescence to the *Coady* decision and indicated acquiescence. See 1965-2 C.B. 4, *withdrawing nonacquiescence of* 1960-2 C.B. 8.

93 See prop. reg. section 1.355-1-1.355-4, 42 F.R. 3,866 (Jan. 21, 1977).

94 See prop. reg. section 1.355-2(c)(3)(iv), 42 F.R. 3,866 and 3,868 (Jan. 21, 1977).

95 See prop. reg. section 1.355-3(c), examples (8), (9), and (14), 42 F.R. 3,866 and 3,871 (Jan. 21, 1977).

96 See prop. reg. section 1.355-2(c)(3)(iv), 42 F.R. 3,866 and 3,868 (Jan. 21, 1977).

97 See T.D. 8238, 54 F.R. 5,577 (Feb. 3, 1989); 57 F.R. 28,462 (June 25, 1992).

98 See reg. section 1.355-2(d)(2)(iv)(C).

99 452 F.2d 767 (1st Cir. 1971), *cert. denied*, 408 U.S. 922 (1972).

100 *Id.* at 768.

Spinoffs: Still Remarkably Tax Friendly

to his daughters while transferring the steel company ultimately to his sons.¹⁰¹ The court held that the spinoff was a device, noting that the shares of the real estate company could be sold, or the real estate company could be liquidated, without impairing the steel business in any material way, and that the daughters thereby could access cash.¹⁰²

The point of this history of the related function rule in the current regulations is that the second requirement was put there for a purpose, and that purpose stems very much from the idea that it is met when the controlled company can be converted to cash after the spinoff. There is nothing about overlapping management or boards of directors that would satisfy the second requirement of the related function rule when it is thought of in this way. Indeed, it is almost the opposite: the presence of overlapping officers and boards of directors might make it more difficult to separate the two businesses, thereby making it easier to come out on the good side of the related function rule.

Rev. Rul. 2003-74¹⁰³ evaluates a so-called fit and focus business purpose—that is, a purpose to enable the senior management of each of Distributing and Controlled to focus on its own business. The ruling notes that there are no post-spinoff common officers of Distributing and Controlled, but two of Distributing's eight directors will also serve on Controlled's six-person board.¹⁰⁴ The ruling includes in its facts a rationale for the two overlapping directors and a statement that their terms will expire after two years and six years, respectively, and that the six-year director may seek reelection but the two-year director may not.¹⁰⁵ Both of the overlapping directors are also post-spinoff officers of Distributing.¹⁰⁶ The ruling states:

Although the continuing relationship between Distributing and Controlled evidenced by the two common directors appears inconsistent with the assertion that the software business and the paper products business require independent management teams, this relationship does not conflict with the business

purpose for the separation. Director A will serve for only a short period and will further that purpose by aiding in the creation of two independently administered operations. Director B will assist the separation by calming market concerns that might otherwise adversely affect one or both businesses. Further, the two directors together constitute only a minority of each board.¹⁰⁷

The above analysis is not entirely coherent in its intended context, which is evaluating the adequacy of the fit and focus business purpose. The important point for this report, however, is that the overlapping directors are presented only as a potential business purpose problem—not a potential device problem. In fact, the ruling states that the distribution meets all the requirements of section 355 apart from the business purpose requirement.¹⁰⁸

About all that can be said under the existing law is that overlapping shareholders and directors do not seem to be a bar to a tax-free spinoff. This is the way that the IRS's policy not to rule on device issues has been helpful, because it has freed companies from notions of device that seem to have existed in folklore, and perhaps in ruling practice at the Service, but which have little or no basis in the law.

Several private letter rulings involving spinoffs have detailed transactions that involve the overlap of officers and directors in various ways. Some rulings have indicated that specified directors would serve on the boards of both Controlled and Distributing.¹⁰⁹ One ruling explained that after a publicly traded company distributes its subsidiary's stock to its shareholders, "it is expected that three current directors of Distributing 2 will serve as directors of Controlled 3. No such director will be an officer or employee of Distributing 2. The Distributing 2 Directors who serve as directors of Controlled 3 will constitute less than half of the total number

101 *Id.* at 769.

102 *Id.* at 770-771.

103 Rev. Rul. 2003-74, 2003-2 C.B. 77, *Doc 2003-15246*, 2003 *TNT* 122-5.

104 *Id.*

105 *Id.*

106 *Id.*

107 *Id.*

108 *Id.* Many business purposes for a spinoff would seem to be unaffected by

overlapping shareholders and directors. In LTR 201010018 (Oct. 23, 2009), *Doc 2010-5391*, 2010 *TNT* 49-26, for example, the spinoff was undertaken for reasons having mostly to do with capital access and equity compensation programs, and there were overlapping directors and officers.

109 See, e.g., LTR 200841020 (July 8, 2008), *Doc 2008-21789*, 2008 *TNT* 199-31; LTR 200823022 (Feb. 29, 2008), *Doc 2008-12552*, 2008 *TNT* 111-17; LTR 200805010 (Nov. 7, 2007), *Doc 2008-2154*, 2008 *TNT* 23-22; LTR 200805011 (Oct. 30, 2007), *Doc 2008-2155*, 2008 *TNT* 23-21. Another ruling, which involved the spinoff of newly formed Controlled, discussed the possibility of an overlap in board membership in its representations. LTR 200732002. This same ruling stated that the Controlled CEO would serve as a consultant to Distributing. *Id.*

Spinoffs: Still Remarkably Tax Friendly

of Controlled 3 directors.¹¹⁰ Two additional rulings stated that while there would be overlap between the two boards following the distribution of the Controlled corporation, it would constitute “less than a majority.”¹¹¹ A ruling in which the common parent of an affiliated group of corporations spun off two of its subsidiaries detailed the future overlap in board membership as follows:

Following the External Distributions, it is expected that one current director and officer of Distributing 2 will serve as a director of both Controlled 1 and Controlled 2 but will resign as a director and officer of Distributing 2. It is also expected that one current director of Distributing 2 will continue to serve as a director of Distributing 2 and will also serve as one of the g directors of Controlled 1. Two other current directors of Distributing 2 will continue to serve as directors of Distributing 2 and will also serve as two of the g directors of Controlled 2. No director will serve on all of the boards of Distributing 2, Controlled 1, and Controlled 2.¹¹²

Another ruling indicated that four individuals (two of whom also serve as officers of Distributing) that had been serving as directors of Distributing would continue to do so after the distribution of Controlled stock, while also serving as directors of Controlled.¹¹³ Finally, one ruling detailed a transaction in which Parent distributed the stock of Distributing to its shareholders and stated that Parent and Distributing might maintain the same chairman of the board of directors for a length of time.¹¹⁴

Other rulings have described transactions that involve overlapping officers. One ruling provided that after the distribution of the Controlled class A and class B stock by Distributing, “Overlapping Directors and Officers” would work for both Distributing and Controlled.¹¹⁵ In contrast, one ruling indicated that only one officer position would involve overlap between Distributing and Controlled

after the distribution of Controlled stock.¹¹⁶ Another ruling provided that one of the shareholders who was exchanging some or all of her Distributing stock for Controlled stock would continue to serve as the president and CEO of both corporations after the distribution.¹¹⁷

Additional rulings have detailed circumstances in which the overlap period was limited. One ruling represented that three officers would work for both Distributing and Controlled for a period of “no longer than z months” after the distribution.¹¹⁸ Another ruling provided that after the distribution, one member of the Distributing board would serve on the Controlled board for a “transition period.”¹¹⁹ However, that individual would “not hold any other position in Controlled as an officer or otherwise, and he [would] not be involved in the day to-day operations of Controlled.”¹²⁰ Another ruling discussed the role to be played by “Person A,” who would temporarily serve as both an officer of Distributing and a board member of Controlled after the distribution:

Person A is currently Officer X of Distributing and expects to continue in such a position for no more than eighteen months after the External Distribution. Person B, Officer Y of Distributing, intends to retire within six months after the External Distribution, thus, the primary reason for Person A continuing as Officer X of Distributing after the External Distribution is to avoid causing Distributing to have insufficient executive-level guidance on financial matters until new or existing executives can be prepared to assume such responsibility.¹²¹

Another ruling stated that after the stock of Controlled was distributed, two individuals would have overlapping officer roles for no more than one year.¹²²

One final pair of rulings detailed the overlapping roles of specified

110 LTR 200841020.

111 LTR 200823022; LTR 200805010.

112 LTR 200805011.

113 LTR 201015029 (Jan. 7, 2009), *Doc 2010-8468*, 2010 TNT 74-24. Both the Distributing and Controlled boards of directors would each also have five independent directors. The ruling provided that none of the new Controlled independent directors would overlap with any of the current Distributing independent directors. *See id.* Also, one officer position would involve overlap between Distributing and Controlled. *See infra* text accompanying note 116.

114 LTR 201030005 (Apr. 28, 2010), *Doc 2010-16987*, 2010 TNT 147-31. The ruling provided that, “at a minimum, Parent expects the chairman’s term to be consistent with the guidance provided in Rev. Rul. 2003-74, 2003-2 C.B. 77.” *Id.*

115 LTR 201010018.

116 LTR 201015029.

117 LTR 201010023 (Nov. 25, 2009), *Doc 2010-5396*, 2010 TNT 49-27.

118 LTR 200834002 (May 13, 2008), *Doc 2008-18203*, 2008 TNT 165-17.

119 LTR 200736019 (May 17, 2007), *Doc 2007-20591*, 2007 TNT 175-22. The ruling stated that with the exception of the individual mentioned above, there would be no additional overlap between the companies. *Id.*

120 *Id.*

121 LTR 200743007 (July 10, 2007), *Doc 2007-23888*, 2007 TNT 209-30. Other than Person A, no officer, director, or key employee would overlap in such a capacity. *Id.*

122 LTR 200802015 (Oct. 5, 2007), *Doc 2008-651*, 2008 TNT 9-17. The ruling indicated that one individual would continue to serve as a director for both companies.

Spinoffs: Still Remarkably Tax Friendly

individuals in transactions in which Controlled was distributed to Distributing's parent shareholders. The first explained that after Distributing distributed the Controlled stock to its shareholders, "certain executives will continue to oversee the Distributing and Controlled active businesses."¹²³ The second indicated that after distributing Controlled to its Parent, the "Distributing president will serve as vice-chairman of the Controlled board of directors."¹²⁴ These interactions were deemed to be a component of the entities' "continuing transactions" and "continuing relationships," respectively, by the rulings.¹²⁵

While beyond the scope of this report, it is important to note that directors have fiduciary duties to their shareholders, and in situations in which both the distributing and the controlled companies are public, these duties are likely to be taken seriously. At a minimum, there will usually be a self-imposed requirement that post-spinoff transactions between Distributing and Controlled be approved by independent, rather than the overlapping, directors of the two companies. Thus in the absence of a long-term contract that is put in place before the spinoff (a time in which those fiduciary conflicts are not usually present), it would seem that overlapping, but not congruent, boards present little opportunity for a related function device in most cases. A possible exception might be a situation in which one company has no practical alternative except to serve the other company.

There is a similar issue, even in the absence of common control or overlapping boards, with post-spinoff transactions between the distributing company and the controlled company. Continuing transactions between Distributing and Controlled may present a problem if they are inconsistent with the purported business purpose for the spinoff, and those transactions may also present an issue of whether the business that is relying on the transactions is an active business under section 355(b). The more interesting question, however, is whether those relationships could lead to the existence of a device. Consider, for example, a situation in which

both Distributing and Controlled use the same brand name and are separated in a spinoff, but with a long-term contract under which one of the companies owns the name but the other can use it too. What if, in addition, the value of the name is supported by their joint marketing efforts? Is this a device? Other facts surrounding the business may present a related function device problem, but the mere sharing of the trademark would not seem to do so. If both Controlled and Distributing have active businesses, it would seem unlikely that the value of either of them would stem principally from the trademark, in which case it would seem unlikely that the sale of the stock of one of them could in effect be the monetization of a stream of revenue under a license agreement.

Rev. Rul. 2003-75¹²⁶ addresses the business purpose requirement of a spinoff,¹²⁷ and specifically whether eliminating a competition for capital is sufficient. The ruling states that there will be postspinoff transitional agreements between Distributing and Controlled regarding information technology, benefits administration, and accounting and tax issues.¹²⁸ The ruling says that with the exception of the tax matters agreement, those agreements will terminate after two years absent extraordinary circumstances, in which case the affected agreement may be extended on arm's-length terms for a limited period.¹²⁹ The ruling states:

The limited continuing relationship between Distributing and Controlled evidenced by the various administrative agreements and the loan for working capital is not incompatible with the extent of separation contemplated by section 355. The administrative agreements, except for the tax matters agreement, and the loan are transitional and short-term, and all are designed to facilitate, rather than impede, the separation of the pharmaceuticals business from the cosmetics business.¹³⁰

See id.

123 LTR 200813035 (Dec. 17, 2007), *Doc 2008-6870, 2008 TNT 62-25*. Salaries were to be paid by the entities in accordance with their respective share of services obtained from the executives. *Id.*

124 LTR 200922028 (Feb. 20, 2009), *Doc 2009-12116, 2009 TNT 102-18*. The salary was apportioned between the entities based on the value of services received. *Id.*

125 LTR 200813035; LTR 200922028.

126 Rev. Rul. 2003-75, 2003-2 C.B. 79, *Doc 2003-15247, 2003 TNT 122-6*.

127 *See reg. section 1.355-2(b)*.

128 Rev. Rul. 2003-75.

129 *Id.*

130 *Id.*

Spinoffs: Still Remarkably Tax Friendly

Again, what is said is fairly incoherent—it does not seem possible that continuing information technology, human resources, and accounting relationships could negate a business purpose based on eliminating a competition for capital. The more important point from the perspective of this report is the statement that, as a general principle, there is a “separation contemplated by section 355.” The ruling does not indicate where in section 355 that separation is contemplated.

Again, about all that can be said under the law that exists is that continuing contractual relationships between the distributing and controlled corporations would not seem to be a bar to a tax-free spinoff. Further, while continuing relationships might in particular factual circumstances raise a question about the business purpose for a spinoff or whether an active business is sufficiently active, it is difficult to see how those continuing relationships could give rise to a device. In particular, the continuing relationships that in real life exist between companies post-spinoff tend to be non-core functions, such as the information technology, human resources, and accounting functions in Rev. Rul. 2003-75. It does not appear that those functions rationally could violate the related function rule, because they probably are not businesses, and if they are, they probably could be sold without adversely affecting the business of the service recipient. Thus continuing relationships below the board and officer level seem, like overlapping stockholders and directors, unlikely to be evidence of a device.

Conclusion

It should now be apparent that the one-cell-into-two analogy with which I started this report is inapt. Spinoffs are far more complicated than can be captured in that analogy, and this report has touched on only a few of the complications. But I still believe in the premise with which I started this report, which is that spinoffs—as evidenced by the recent developments and items of current interest that are discussed in this report—are remarkably flexible and friendly to taxpayers.

J. William Dantzer Jr. is a partner in the New York office of White & Case LLP and is the head of the Firm’s global tax practice. The research assistance of Stephanie L. Mariconda, a tax associate at White & Case, is gratefully acknowledged.

*The information in this article is for educational purposes only; it should not be construed as legal advice.
Copyright © 2010 White & Case LLP*

In this publication, White & Case means the international legal practice comprising White & Case LLP, a New York State registered limited liability partnership, White & Case LLP, a limited liability partnership incorporated under English law and all other affiliated partnerships, corporations and undertakings.
NYC 1035