Business Purpose Under Section 355 Expanding?

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It is no surprise that one of the key requirements under Section 355 concerns business purpose. We have catalogued some of these in the past ("To Spin or Not to Spin?" 3 *M&A Tax Report* 3 (October 1994), p. 1). Tax professionals know that very frequently there is an overall business goal (for example, focusing on particular industries) that the tax professionals are then expected to convert into something qualifying for a Section 355 ruling. Far from involving strictly legal considerations, sometimes this can amount to rewriting history.

Interestingly, Treasury has recently received comments from one of the large New York law firms asserting that the "core business" rationale

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should simply be regarded as an acceptable business purpose under Section 355. The authors of the letter to Treasury suggest that this core business notion refers to the strategy by which a company pares back its nonessential operations, thus focusing on those businesses in which it has strategic or competitive expertise. The authors of the letter also suggest that there should be a safe harbor for this kind of a business purpose.

The authors of the letter to Treasury, Kathryn Bristor and Adam Ingber, of Skadden, Arps, Slate, Meagher & Flom, set forth a number of common-sensical views in the letter. They note, for example, that valid business considerations may dictate a separation of non-core businesses from the core business. A separation, for example, can enable management to focus its expertise on the growth and development of the remaining core business. Ditto for the necessary resources of the company.

However, the letter to Treasury focuses upon some aspects that may be viewed as traditional Section 355 ruling grounds. For example, the authors note that businesses may commence competing against one another for access to capital. Alternatively, the poor credit rating of one business may adversely affect the other business' ability to raise capital.

Irreconcilable differences may arise between management teams for each business which are attributable to differences in management style, corporate culture, or vision of the future direction of the combined businesses. The line of business or method of operation of one business may not fit into the long-term business plan of the other.

Safe Harbor Proposed

Perhaps the most helpful contribution made by the authors of the letter to Treasury concerns their suggestion as to a safe harbor. Although one might predict Treasury's response will be less than lukewarm, a safe harbor notion for certain business purposes is an interesting idea that deserves attention. Their goal is to introduce a modicum of certainty into taxpayers relying on a particular business purpose to effectuate a spinoff.

The contemplated "core business safe harbor" as envisioned by the author would basically require satisfying three tests. First, the taxpayer would need to demonstrate that the business to be spun off is a non-core business. Second, the taxpayer seems to be required to provided substantiating documentation that real and substantial business reasons exist for the spinoff. This second requirement would obviate any notion that merely separating a core from a non-core business would itself constitute a business purpose. The third requirement the authors suggest is a "complete separation" requirement, necessitating that the taxpayer demonstrate that the spinoff would result in a complete separation of the businesses.

The authors define a "non-core business" as meeting two subtests. First, it must be a business having its primary operations focused on a market that is distinct from the market in which the remaining business or businesses operate. A second requirement that a business would need to meet in order to be considered a non-core business is that either: (1) the average pre-tax earnings of the business to be spun off over the three years preceding the year of the spinoff must represent 30% or less of the average pre-tax earnings of the remaining business or businesses over the same period of time; *or* (2) the fair market value of the business to be spun off must represent less than 30% of the total fair market value of the company.

There is a question, of course, as to precisely what constitutes a "market" for purposes of this proposed

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safe harbor. The authors suggest that a market should be defined broadly to include not only a particular territorial or geographical region, product line, or stage in the production and distribution cycle. The authors suggest that a business that primarily focuses upon manufacturing product X would be engaged in a different market than a business that primarily focused on selling product X at retail. The primary focus of each business, they argue, would be on different stages of the production cycle in such a case.

Business Purpose, Too

The second proposed test of the safe harbor would be the age-old business purpose test. Here, it is phrased as requiring the taxpayer to substantiate at least one significant non-tax business reason compelling a spinoff of the non-core business. The authors suggest that this test should be satisfied upon the submission by the taxpayer of credible documentation verifying the existence of the problem or problems that the core business strategy is being implemented to address. The authors even enumerate what they envision as satisfying this documentation requirement, including any of the following:

- An outside professional or internal report illustrating the incompatibility of the businesses;
- Outside professional or internal reports documenting a conflict between the management of the businesses;
- Reports from a rating agency demonstrating the favorable effects that a spinoff would have on the credit rating of the remaining or spun off businesses; or
- For a public company, an annual report, press release or other publicly released materials documenting a decision by the company to focus its resources and personnel on its core business.

It stands to reason that many of the items on this list of business purposes will be somewhat weak in the eyes of the government. Particularly the fourth item would seem to fall on deaf ears, since a decision to focus on certain core businesses has historically not been sufficient to constitute a good business purpose.

The final condition of the three-pronged safe harbor proposed by the authors relates to the complete separation of the businesses. Although this separation requirement seems to be a fundamental feature of Section 355, it has sometimes been abrogated. Consequently, the authors suggest that there be a three-year period following the spinoff during which there be a prohibition on the taxpayer, and all persons related to the taxpayer, from owning any interest in a business which operates in the same market in which the spun off business operated. The authors further contemplate that no cross-management would be permitted to any extent.

Final Word?

I would be highly surprised (although delighted) to find that the Treasury Department would adopt the safe harbor, much less the core business rationale itself. Indeed, although this would seem to make an enormously positive contribution to the exceedingly important area of Section 355 transactions, it seems safe to conclude that nothing remotely close to this proposal will be forthcoming in the near term. ■