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Spinoffs Trends: Business Purpose, Serial Spinoffs and Capital Transactions

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We all know that one of the essential elements of a Section 355 spinoff is a legitimate business purpose. Whitman's spinoff of Hussman (it is also distributing Midas) relies primarily on "fit and focus" as a business purpose. The same business purpose has been used to justify many of the larger spinoffs that have taken place over the recent past.

First memorialized by the IRS in Revenue Ruling 56-450, the "fit and focus" business purpose is usually referred to merely by this very descriptive name. Although at times it has been controversial, it is frequently available to multi-industry groups. This business purpose can arise in cases where customers of one of the corporations within the group happen to be competitors of another corporation within the group.

My Fit, Your Focus?

In Whitman's case, for example, Coca-Cola is a competitor of Whitman (a Pepsi bottler). Naturally, because of Pepsi's affiliation with Whitman, various companies expressed reluctance to purchase refrigeration equipment from Hussman (in turn, because Hussman and Whitman are affiliated). The corporate separation is expected to increase Hussman's sales to Pepsi competitors. Incidentally, lest this seem like an isolated incident, this business purpose was also prominent in AT&T's spinoff of Lucent and NCR, in General Motors' splitoff of EDS, and in Pepsi's spinoff of its own restaurant operations.

To justify a spinoff on these grounds—in an advance ruling context anyway—substantial documentation must be provided to the IRS, including representations from customers that they are reluctant to do business with a firm owned by the competitor, and that they are highly likely to increase their purchases once their supplier is separated from the

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competitor. This documentation is the proof that the business purpose is really real, not conjured up by some creative advisor.

First "Serial" Crimes, Now "Serial" Spinoffs

With Dun & Bradstreet's recent spinoff announcement, we are beginning to see increasing numbers of "serial" spinoffs. A serial spinoff occurs when a corporation that was the subject of a previous spinoff decides to divide itself again through another spinoff. Although it may sound a bit exotic, like dividing cells in an experiment, the technical requirements for a spinoff can certainly be met a second time around.

For example, although the transaction was ultimately not consummated, ITT considered this scenario. ITT had previously separated its automotive and insurance segments from its gaming, education and information units. Then, it was planning a serial spinoff in which the residual businesses would be divided. Other corporations that have undertaken serial spinoffs include Rockwell, Promus, and Marriott International.

Serial spinoffs are subject only to the "normal" requirements attending spinoffs. The fact that the distributing corporation in a spinoff was, itself, recently a spun off corporation should not be an impediment. At the same time, it is rather obvious that the IRS might be expected to inquire as to why the business purpose supporting the second spinoff was not apparent to the corporations at the time of the initial corporate separation.

Morris Trust Redux

The rules restricting Morris Trust transactions have made it difficult to couple a spinoff with an ensuing capital transaction. Section 355(e) provides that the spinoff is not tax-free if it occurs in conjunction with a transaction in which 50% of the stock of either party to the spinoff winds up in the hands of new parties in interest.

Whether a corporation is considered to be acquired under these rules is basically determined in the manner prescribed by Section 355(d). However, acquisitions are not restricted to so-called "purchase" transactions. Thus, an acquisition occurs if one or more persons acquire, directly or indirectly, 50% or more of the vote or value of the stock of the controlled or distributing corporation pursuant to a "plan or arrangement." I.R.C. §355(e)(2)(A).

Acquisitions occurring within the four-year period beginning two years before the date of distribution (and continuing two years after) are presumed to have occurred pursuant to a plan or arrangement. Taxpayers can avoid gain recognition by showing that an acquisition occurring during this four-year period was unrelated to the distribution. I.R.C. §355(e)(2)(B). Thus, the four-year presumption is rebuttable.

More Presumptions

If the assets of the distributing or controlled corporation are acquired by a successor in an A, C or D reorganization, or in any other transaction specified in regulations, the shareholders immediately before the acquisition of the corporation acquiring those assets will be treated as acquiring stock in the corporation from which the assets were acquired. I.R.C. §355(e)(3)(B). If the former shareholders of the distributing or controlled corporation receive stock in a successor or in a new controlling corporation, though, the stock is apparently not treated as acquired stock if: (1) it is attributable to the

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plan or arrangement to acquire 50% or more of the successor or other corporation. I.R.C. §355(e)(3)(A). (For further discussion, see Wood, "Amended Spinoff Law: How Bad Is It?" Vol. 6, No. 3 *M&A Tax Report* (October 1997), p. 1; and Willens, "Marriott's Morris Trust," Vol. 6, No. 6 *M&A Tax Report* (January 1998), p. 1.)

Independent Acquisition

Despite these rules, in limited circumstances, a spinoff can still be followed by a transaction which shifts the ownership of one (or both) of the participants. Let's look at some of the transactions that can follow a spinoff even under the current more restrictive rules.

A spinoff can precede an outright acquisition of either of the parties if, objectively, the acquisition is not part of a plan or series of related transactions of which the spinoff is a component. It seems clear that such a dastardly plan does not exist if, at the time of the spinoff, acquisition negotiations had not yet commenced. Indeed, if one applies a kind of traditional step transaction doctrine approach, there would not seem to be a problem, even if there were inklings that there would be negotiations.

After all, under traditional step transaction doctrine authorities, what you clearly must not have is a binding commitment to take any of the subsequent steps, nor may the steps be interdependent. A little talk is a long way short of this kind of standard. Still, it remains to be seen how strictly the IRS will view this area. The IRS may well not agree that the step transaction genre binding commitment test is all that is relevant.

Majority Control Maintained

Morris Trust transactions are also still viable if, as exemplified by the Marriott and W.R. Grace situations, the shareholders of the distributing entity end up owning more than 50% of the stock of the acquirer (by vote and value). (Regarding Marriott, see Willens, "Marriott's Morris Trust," Vol. 6, No. 6 *M&A Tax Report* (January 1998), p. 1.) Moreover, the new rules are not applicable with respect to gain at the shareholder level. Thus, a Morris Trust transaction will be tax-free to the parent's shareholders.

That means the transaction still may be highly attractive where, because the distributed subsidiary has a high tax basis, Section 355(e) imposes a "manageable" gain at the parent level. In other words, if the parent's tax is not too bad, the other benefits of the transaction (both tax and nontax benefits) may still render the deal relatively attractive.

Prearranged Investments In Spun Off Sub

The law has also been altered to liberalize the "control" requirements heretofore attending a spinoff that is part of a "D" reorganization. Concurrently, the IRS revoked Rev. Proc. 96-39. In plain English, this means that it is now actually easier to have a prearranged investment (of up to 49.9%) in the spun off subsidiary (or the parent) than it used to be.

Take the Viacom/TCI transaction, in which a spinoff is promptly followed by a pre-planned purchase of primary shares in either the parent or subsidiary. This arrangement can now proceed with absolute safety. In fact, as with Viacom, the purchaser's insistence that the investee be an independent entity—before it will invest—can form the business purpose for the spinoff. (See also Willens, "When is Control Really Control?"

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Vol. 6, No. 5 *M&A Tax Report* (December 1997), p. 1.)

A business purpose is really the linchpin for a spinoff, so finding a good one such as this is a major accomplishment.

Another Serial Spinoff Announced

Returning for a moment to serial spinoffs, just as this issue goes to press, Cognizant Corp., a so-called "crown jewel" created by the three-way break-up of Dun & Bradstreet Corp. is itself splitting up. (See Lipin, "Cognizant, A D&B Spinoff, To Split in Two," *Wall Street Journal*, January 15, 1998, p. A-3.)

The just announced Cognizant deal says that the market research business (with a stock value of a whopping $7.3 billion) is planning to split up into two separately traded companies to be known as IMS Health, the company's healthcare information business, and Nielsen Media Research, the famous survey that tracks audiences for television ratings. The *Wall Street Journal* reports state that the company believes the businesses will be better off after the separation because they have different customers and different opportunities.

The Dun & Bradstreet announcement of the original three-way breakup came in January of 1996, concluding (correctly) that the sum of the parts would be worth more than the whole company. Now, the Cognizant deal would be accomplished as another spinoff after that three-way 1996 transaction, Cognizant being further bifurcated into IMS Health and Nielsen Media.

But apparently the type of corporate parenting is not occurring only in this wing of the Dun & Bradstreet empire, but in the core business as well. The Dun & Bradstreet business had announced nearly a month ago that it would split up again by spinning off its Reuben H. Donnelley Corp. division (marketing yellow pages in the U.S.). The remaining Dun & Bradstreet will consist of the ratings concern, Moody's Investors Service, Inc., and Dun & Bradstreet Credit Analysis, the original business that Dun & Bradstreet started in the 19th century. The third original spinoff from Dun & Bradstreet was A.C. Nielsen, tracking consumer retail purchases. It is said to compete separately from Nielsen Media.

Fragmentation?

Viewed as a whole, the latest announcement means that when the dust finally settles, a total of five separately traded companies will be left out of the old Dun & Bradstreet empire. That means, of course, that the five separate companies will have five boards of directors, five chief executive officers, and five corporate headquarters. This largely (if not completely) moves to eradicate the company's acquisition strategy of years past.

The first three-part breakup occurred in November 1996. The figures were staggering, reporting gains all around. Now, Cognizant hopes that its solomonic split into IMS Health and Nielsen Media will have a similar financial reward to its constituent pieces. (Further details are included in the January 15, 1998 *Wall Street Journal* article cited above, p. A-3.) ■