Split-ups Are Easy to Do

By Robert W. Wood • Wood & Porter • San Francisco

Spin-offs involve a combination of disciplines, with corporate law, contract drafting, securities law and tax considerations all in the mix. The tax impact of a spin-off gone bad can be catastrophic. For that reason, a ruling from the IRS almost seems a necessity.

I say "almost," since I and many others have done spin-offs without a ruling. Indeed, there have been eras in which spin-offs were often done on the strength of a legal opinion without a ruling. But there are many other spin-offs, generally involving privately held companies, in which many advisers do not seem to worry about a ruling or even an opinion.

I'm talking, of course, about the hostile shareholder type of transaction. With less invective, this is the "let's go our separate ways" transaction, also less colorfully known as a non–*pro rata* spin-off.

There's some difference of opinion about nomenclature, since "spin-off," "split-up" and "split-off" are all terms used to describe variations of the spin-off fact pattern.

Spin Cycle

'"Spin-off" is a generic name, comprising spin-offs, split-offs and split-ups. A spin-off most classically involves a corporate distribution of stock in a subsidiary to the shareholders of the parent, without the shareholders surrendering any of their parent stock.

Split-off

A split-off involves the parent's distribution of stock in a subsidiary to some or all of the parent's shareholders in exchange for some or all of their stock in the parent. This, in other words, involves an explicit exchange.

Split-up

Finally in our triumvirate comes the split-up. It involves the distribution by a parent corporation to its shareholders of stock in two or more subsidiaries. In effect, the stock distribution in a split-up will be made in complete liquidation of the parent. Put differently, a split-up involves the specialized type of spin-off in which the parent disappears.

All are spin-offs, and all seek to qualify for the nonrecognition treatment Internal Revenue Section ("Code Sec.") 355 can afford.

To do a spin-off, here are the basic requirements:

1. Immediately before the distribution, the distributing corporation must control the corporation being distributed. This is tested under a typical reorganization eighty-percent control standard. The subsidiary may be newly created right before the distribution or may be one of longstanding.
2. There must be two separate active businesses, one retained by the distributing corporation and one that will be continued by the spun-off corporation. Classically, this is done with two distinct and quite separate businesses. Yet there have been many successful divisions of what seems really to be one business, such as a separation of Northern California from Southern California operations. Moreover, it may be possible to separate a business along functional lines, such as separating sales from manufacturing.
3. The two businesses each must satisfy a five-year active trade or business requirement (that is, the businesses must have been operated for five years prior to distribution).
4. Immediately after the distribution, each entity must be engaged in the active conduct of a trade or business.
5. There must be a business purpose for the transaction. This requirement is narrowly interpreted by the IRS, and is one reason a non–*pro rata* transaction is much easier. By its very nature, it suggests shareholders want to go their separate ways with their respective businesses.
6. The transaction must not be used primarily as a device to distribute earnings and profits. As in so many other parts of Subchapter C, this concern is amorphous. The fear of a proscribed device to distribute E&P is also the primary reason companies traditionally ask for IRS rulings on spin-offs.
7. The shareholders of the distributing corporation must retain a continuing proprietary interest in each of the two

corporations after the spin-off. Put bluntly, the spin-off cannot be immediately followed by a sale of the stock of either of the two corporations.

8. Controls should be in place to insure there is no acquisition of either the distributing or the controlled corporation for two years after the spin-off, even on a tax-free basis. Any acquisition within two years before or two years after the spin-off is presumed part of a bad plan, although this presumption can be rebutted.

Non–*Pro rata* Transactions

If businesses are divided in a non–*pro rata* fashion, is there a possibility for abuse? Very little, it would seem. Suppose two sides of a family run a family company.

One side wants the widget business, while the other side wants the construction business. Alternatively, one side wants the Northern California real estate sales business. The other side wants the Southern California real estate sales business.

Dropping one business into a subsidiary and distributing the stock of the subsidiary to one shareholder group in exchange for their parent stock can be simple. And assuming one can navigate the list of Code Sec. 355 requirements, it can be relatively foolproof. In this post-*General Utilities* Repeal generation, the *pro rata* spin-off seems somehow suspect, or at least substantially more suspect than its non–*pro rata* cousin.

After all, in a *pro rata* spin-off, a shareholder who was previously holding a share of one company may end up holding two separate shares of constituent companies. Done correctly, there is no corporate tax and no individual shareholder tax. Yet obviously, with two shares in the holder's hands post transaction, the shareholder is in a far more flexible position. Of course, the two companies are in more flexible positions too.

The contrast to a non–*pro rata* transaction could not be more sharp. A non–*pro rata* transaction seems so sensible on the surface. Whether or not the shareholders are feuding, the division is complete.

Ruling Policy

Sensibly, the IRS seems to like such transactions. Thus, in LTR 201113003 (Nov. 1, 2010), the IRS considered the division of a corporation's business among its feuding shareholders. Interestingly, the IRS seemed to have no problem with the need for the transaction and its mechanics.

Yet in accordance with recent policy, the IRS expressed no opinion on a number of issues. These included whether the distributions satisfy Reg. §1.355-2(b)'s business-purpose requirement. Arguably, of course, the business purpose was part and parcel of the entire transaction.

The IRS also did not consider or rule on whether the transaction was being used principally as a device for distributing the earnings and profits of the distributing or controlled corporations. The facts involved an active business with two activities in two distinct locations.

Shareholder 1 and Shareholder 1's children beneficially own an undisclosed percentage of both the total value and total number of shares of the distributing corporation's outstanding stock. Shareholder 2 and her lineal descendants own LLC 1 and beneficially own an undisclosed percentage of both the total value and total number of shares of the distributing corporation's outstanding stock.

Due to continuing disagreements among the shareholders and their descendants, the distributing corporation dropped one set of business activities into subsidiaries, and then distributed shares to one shareholder group in exchange for that group's stock in the distributing corporation. When the smoke cleared, the result was corporate separation and perhaps even family harmony.

Business Purpose?

Much has been written about business purpose, something that these days seems somehow to raise the specter of economic substance too. In some ways one of the most difficult criteria to meet in order to feel comfortable under Code Sec. 355 is business purpose. At least a few business purposes have been invoked creatively to justify something that may have been planned for other purposes.

Here, though, shareholder hostility is about as good as it gets. Indeed, even without the soap opera of family hostility, there's simply nothing to suggest anything untoward about a non–*pro rata* transaction involving one group of shareholders going one way and another group going another. How could there not be a good business purpose?

However, in LTR 201113003 the IRS cautioned that it was expressing no opinion on other aspects of the transaction. Most advisors would probably not worry about the business purpose element here. Indeed, that is probably true with the device issue too, something inherently tied in with the business purpose inquiry.

Partially Non–*Pro rata*?

I confess to being myopic in my approach that non–*pro rata* spin-offs are abuse-free. I am talking of clean break transactions, where the possibility of abuse does seem remote. Yet it is important to note that there is non–*pro rata* in a big way and there is what one might call non–*pro rata* in a de minimis way.

Suppose that two brothers, Cain and Able, are the two 50-percent owners of Family Farms, Inc. In a putative separation of lettuce from pepper operations in two parts of the state, Cain is to turn in some of his shares in what will be the lettuce company in exchange for a larger share of what will be the pepper company. The smoke clears to reveal Cain owning 54 percent of California Peppers, Inc., and 46 percent of Lettuce Salad You, Inc. Able, in turn, owns 46 perecent of California Peppers and 54 percent of Lettuce Salad You.

Surely this is a non–*pro rata* exchange, but it is rather obviously only partially so. Any putative business purpose of shareholders and businesses going separate ways can never ring true in quite the same way as it does with a completely non–*pro rata* division. While board votes and other such matters may certainly be altered even in the case of Cain and Able, this kind of partial *pro rata* transaction requires a much more nuanced and cautious view.

And understandably, there will likely be vastly more concern with such a transaction on the part of the IRS. There could of course be a good business purpose, just as there could be a good business purpose for an entirely *pro rata* exchange. Yet with the Cain and Able partially non–*pro rata* example above, the business purpose does not leap off the page (or the lettuce leaf) the way it would if Cain and Able truly separated, perhaps even revealing hostility for good measure.

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