July 21, 2016

Treasury Proposes Changes to Tax-Free "Spin-Off" Rules

On July 14, 2016, the U.S. Department of Treasury issued proposed regulations and on July 15, 2016 the IRS issued Revenue Procedure 2016-40, both regarding the requirements for a tax-free spin-off pursuant to Section 355 of the Internal Revenue Code (the "Code").[1]

The proposed regulations follow the Treasury's issuance of Notice 2015-59 last October, which many believe was issued in response to Yahoo's proposed spin-off of its stake in Alibaba and which ultimately led to the abandonment of that transaction. Before that notice, most practitioners, as well as the IRS – as evidenced by long-standing ruling practice – had been comfortable with spin-offs where the distributing corporation or the distributed subsidiary had a very small active trade or business in relation to its non-business assets. The notice and proposed regulations are in many respects a departure from prior practice. The Revenue Procedure addresses the requirement that the distributing corporation distribute stock of the distributed subsidiary possessing at least 80% of the total combined voting power and at least 80% of the total number of shares of each non-voting class of stock where a pre-spin-off recapitalization or other transaction is unwound by a subsequent transaction.

Tax-Free Spin-Offs Generally

Absent the tax-free spin-off rules, if a corporation distributes stock of a subsidiary to its shareholders, the distribution is generally taxable to the shareholder as a dividend. In addition, the distributing corporation is taxed on the built-in gain in the stock of the distributed subsidiary. Section 355 provides an exception to these rules for distributions that meet numerous requirements. Under these rules, a corporation ("Distributing") can distribute, or "spin-off," a subsidiary corporation ("Controlled") to its shareholders in a transaction that is tax-free to both the shareholders and the corporation.

Active Business Requirement

The purpose of the spin-off rules is to create an exception to the general rule of shareholder and corporate level taxation described above for business-driven rearrangements of corporate ownership. The paradigm is that a single corporation conducting two businesses will find it beneficial to conduct the businesses in separate corporations, outside of a parent-subsidiary relationship. Accordingly, under Section 355(b) one of the fundamental requirements for a spin-off to qualify for tax-free treatment is that each of Distributing and Controlled must be "engaged immediately after the distribution in the active conduct of a trade or

[1] All "Section" references in this memorandum are to the Code.

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business" that, in each case, was not acquired within the previous five-years in a transaction in which gain or loss was recognized.

In a 1973 Revenue Ruling the IRS took the position that the active trade or business did not need to be of a minimum size: "[t]here is no requirement in section 355(b) that a specific percentage of the corporation's assets be devoted to the active conduct of a trade or business."[2] In 1996, the Treasury adopted a no-rule policy whereby it would ordinarily not issue a ruling on spin-offs if the gross assets of the active business were less than 5% of the total fair market value of the gross assets of the corporation conducting the business. The IRS eliminated this no-rule position in 2003 and over the years (and until relatively recently in private letter rulings) the IRS implicitly took the position that any size active business would satisfy 355(b). For this reason, many practitioners referred to a "hot-dog stand"[3] as being a large enough trade or business to satisfy this requirement. The proposed Yahoo spin-off was premised on this being the case.

In a modification of that "no minimum size rule", following through on the approach discussed in Notice 2015-59, Treasury has proposed that each of Distributing and Controlled must directly (and in certain cases indirectly) operate an active business the gross assets (i.e., not reduced by liabilities) of which are at least 5% of the value of all of its assets.

Device Prohibition

In General. Another statutory requirement for spin-off qualification is that a spin-off cannot be a device for the distribution of earnings and profits. The paradigm here is a transaction that is an attempt to extract corporate earnings without incurring a shareholder-level dividend tax or basis recovery, for example by distributing a subsidiary corporation that holds almost entirely liquid assets, which might then be monetized by shareholders on a tax-advantaged basis.

Under the existing regulations, the determination of whether a spin-off constitutes a "device" for these purposes is a fact-intensive analysis that requires weighing certain listed factors that are evidence that the spin-off *is* a device against certain listed factors that are evidence that it is *not* a device. Factors indicating that a distribution is a "device" are: the distribution is made pro-rata to all shareholders based on their stock ownership, the distribution is followed by a taxable sale of Distributing or Controlled, and the existence of non-business assets in Distributing or Controlled. In the case of widely held public companies, where there is no pre-planned taxable sale of Distributing or Controlled following the spin-off, many practitioners have viewed these factors as ordinarily overcome by the non-device factors of (1) having a corporate business purpose for the distribution and (2) being publicly traded and widely held.

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[2] Rev. Rul. 73-44 (1973-1 CB 182).

[3] Coincidentally (perhaps), the proposed regulations were released on National Hot Dog Day.

Treasury Believes Taxpayers Have Incorrectly Applied Device Factors. In the preamble to the proposed regulations, Treasury notes that historically in determining whether a distribution is a device, taxpayers have not given enough weight to the device factor of non-business assets being included in a spin-off. For example, in the preamble Treasury indicated that it does not agree with the position that taxpayers have taken that in the case of publicly traded distributing corporations, a weak corporate business purpose outweighs the presence of non-business assets in spin-off transactions separating business assets from non-business assets. Until the proposed Yahoo spin-off, the IRS was known to issue rulings where the parties to the transaction held quite substantial non-business assets. The proposed Yahoo spin, however, appears to have led Treasury to refocus on the operation of the device rule, and to propose much more robust rules regarding the role of non-business assets in the device analysis.

Enhanced "Device" Factor to Prevent Spin-offs Involving Non Business Assets.

- Specific Focus on Non-Business Assets. Under the proposed regulations, the ownership of non-business assets by Distributing or Controlled continues to be evidence of device, and the greater the proportion of non-business assets to business assets, the stronger the evidence of device. Similarly, a disparity between the proportion of non-business assets owned by Distributing and Controlled is also evidence of device, and the greater the disparity between the two the stronger the evidence of device.

- *De Minimis* Standards. To implement this new focus, Treasury has set some *de minimis* standards for the analysis:

  - First, if both Distributing and Controlled have less than 20% non-business assets, there is ordinarily no evidence of device.

  - Second, if the difference between the percentage of non-business assets owned by Distributing and Controlled is less than 10 percentage points there is ordinarily no evidence of device.

- *Per Se* Rule. At the other end of the spectrum, the proposal also adopts a *per se* device test under which a spin-off will be a device (and therefore not qualify for tax-free treatment) regardless of the presence of any nondevice factors (including a strong corporate business purposes) if:

  (1) either Distributing or Controlled has at least 66⅔% non-business assets, *and*

  (2) if (a) one of the corporations has between 66⅔% and 80% non-business assets and the other corporation has less than 30% non-business assets, (b) one corporation has between 80% and 90% non-business assets and the other corporation has less than 40% non-business assets *or* (c) one corporation has more than 90% non-business assets and the other corporation has less than 50% non-business assets.

Timing

The proposed regulations provide that for purposes of determining whether a spin-off constitutes a device and whether an active business meets the 5% minimum size requirement, assets can be valued (at the parties' election on a consistent basis) at one of four times: (1) immediately before the distribution, (2) on any date within the 60-day period before the distribution, (3) on the date of an agreement with respect to the distribution that was binding on the distributing corporation on such date and at all times thereafter, or (4) on the date of a public announcement or filing with the Securities and Exchange Commission with respect to the distribution. Moreover, Distributing and Controlled must determine whether assets are business or non-business assets immediately after the spin-off.

Effective Date of Proposed Regulations

Generally, these proposed regulations will apply to transactions occurring on or after the date the regulations are published as final regulations in the Federal Register. The rules, however, will not apply to any distribution (1) pursuant to an agreement, resolution, or other corporate action that is binding on or before the date the final regulations are published in the Federal Register and at all times thereafter, (2) described in a ruling request submitted to the IRS on or before July 15, 2016, or (3) described in a public announcement or filing with the Securities and Exchange Commission on or before the date the final regulations are published in the Federal Register.

Revenue Procedure 2016-40

Section 355(a)(1)(D) provides that in order to qualify as tax-free spin-off, Distributing must distribute an amount of Controlled stock possessing at least 80% of the total combined voting power and at least 80% of the total number of shares of each non-voting class of stock of Controlled. Revenue Procedure 2016-40 provides new rules where the IRS will disregard certain transactions where Controlled engages in a recapitalization or other transaction that provides Distributing with high vote stock so that it then has sufficient Controlled stock to meet the requirement for a tax-free spin-off and, following the spin-off, engages in a transaction that undoes the effect of the recapitalization. The Revenue Procedure includes two safe harbors under which the IRS will not challenge a pre-spin-off recapitalization: the first is for recapitalizations that are not unwound for 24 months after the spin-off, and the second is for certain unanticipated transactions with third parties that occur after the spin-off which result in the unwind of the recapitalization.

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We will continue to monitor developments and keep our clients informed regarding these and other proposals.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

Richard J. Bronstein
212-373-3744
rbronstein@paulweiss.com

Patrick N. Karsnitz
212-373-3084
pkarsnitz@paulweiss.com

David W. Mayo
212-373-3324
dmayo@paulweiss.com

Brad R. Okun
212-373-3727
bokun@paulweiss.com

Jeffrey B. Samuels
212-373-3112
jsamuels@paulweiss.com

David R. Sicular
212-373-3082
dsicular@paulweiss.com

Scott M. Sontag
212-373-3015
ssontag@paulweiss.com

Associate Robert Killip contributed to this client alert.