Spin-offs 2017

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Introduction to Spin-Offs: Tax, Corporate, Securities, and Fraudulent Conveyance Issues

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Chapter 15

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§ 15:1 Scope

This chapter briefly addresses spin-offs. In a spin-off, a parent corporation distributes the stock of a subsidiary corporation to the shareholders of the parent as a dividend. ¹ Thus, before the transaction, the shareholders of the parent hold the stock of the parent, which in

¹ The author thanks Robert A. Clary II of McDermott Will & Emery LLP for his helpful comments on a draft of this chapter. Of course, the author is responsible for any errors.
turn holds the stock of the subsidiary. After the transaction, the shareholders of the parent own stock in the parent and stock in the subsidiary. The subsidiary can either be previously existing or newly formed for the purpose of the spin-off. The principal business reason for a spin-off is the rationalization of the business structure to maximize corporate efficiency and shareholder value. If properly structured, the spin-off transaction can be effectuated on a tax-free basis to the parent, to the subsidiary, and to the parent’s shareholders. Thus, substantial tax benefits arise in a spin-off. A spin-off may be followed by the participation of the parent, or the spun-off subsidiary, in an acquisition, either as an acquirer or a target. Properly structured, both the spin-off and the subsequent acquisition may be tax-free.

Section 15:2 starts the discussion of spin-offs with an examination of the basic principles governing the federal income tax aspects of spin-offs, which were introduced in chapter 9. The purpose of this section is not to address the many “twists and turns” in the tax treatment of spin-offs; the purpose is to focus on those rules that are most likely to have an impact in the structuring of a spin-off that is combined with a post-spin-off tax-free acquisitive reorganization in what is known as a reverse Morris Trust transaction. This type of transaction was utilized by Comcast in its acquisition of AT&T’s broadband properties.

Section 15:3 looks at some of the corporate issues in spin-offs, and section 15:4 considers the federal securities issues, including the question of whether the subsidiary stock distributed in the spin-off is required to be registered under the Securities Act of 1933. Section 15:5 addresses whether a spin-off may be a fraudulent conveyance. Finally, section 15:6 provides a brief introduction to some of the business reasons for effectuating a spin-off or related transaction.

To illustrate some of the principles discussed in this chapter, references are made to the following appendices:

- Appendix 15A, Morgan Stanley’s Spin-Off of Discover,
- Appendix 15B, Discover’s Form 10 Registration Statement Filed Pursuant to Section 12 of the ‘34 Act, and
- Appendix 15C, AT&T–Comcast Spin-Off and Merger

§ 15:1.1 References

For a discussion of tax aspects of spin-offs, see the following sources in the Table of References: Ginsburg and Levin, Mergers and Acquisitions; Bittker and Eustice, Corporate Tax; Thompson, Corporate Tax through the Lens of M&A; Penn State/NYC Bar, Fifth Tax Institute; and PLI, Corporate Tax Strategies.
§ 15:2 Federal Income Tax Impact on Spin-Offs

§ 15:2.1 Introduction

As discussed in chapter 9, tax-free spin-offs can involve the distribution by a parent corporation of (1) the stock of a previously existing subsidiary, or (2) the stock of a newly formed subsidiary. Section 355 alone deals with the spin-off of a previously existing subsidiary, but both sections 368(a)(1)(D) (the “(D) reorganization) and 355 deal with the spin-off of a newly formed subsidiary. Thus, if the assets to be spun off are not in a single subsidiary, such assets can be contributed to a new subsidiary that will be spun off.

In a “(D)” reorganization, a corporation (the “distributing corporation”) transfers all or part of its assets to another corporation (the “controlled corporation”), and immediately after the transfer, the distributing corporation or its shareholders, or a combination thereof, are in control (that is, own at least 80% of the stock) of the controlled corporation. The distribution by the distributing corporation to its shareholders of stock of the controlled corporation must qualify under section 354, 355, or 356. The “(D)” reorganization can be either nondivisive or divisive, but only the divisive “(D),” which must qualify under section 355, is discussed here. The nondivisive “(D)” is examined in chapter 9 in connection with the discussion of asset reorganizations.

Assuming a spin-off qualifies under section 355, there is tax-free treatment to all of the parities. First, under section 355(a), the shareholders of the distributing corporation have tax-free treatment on receipt of the stock of the controlled corporation. Second, under section 361(a), the distributing corporation in a divisive “(D)” reorganization is not taxed on the contribution of its assets to the controlled corporation in exchange for stock of the controlled corporation, and under section 361(c)(1), the distributing corporation is not taxed on the distribution of the stock of the controlled corporation to the shareholders of the distributing corporation in the spin-off segment of the transaction. Also, the controlled corporation can generally assume liabilities of the
distributing corporation in connection with such contributions of property without adverse tax treatment to either party. See section 357[c]. Third, in a distribution of the stock of a previously existing controlled corporation in a spin-off qualifying under section 355, section 355[c] provides that the distributing corporation has no gain.

§ 15:2.2 Types of Section 355 Distributions: Spin-Offs, Split-Offs, and Split-Ups

Section 355 distributions, whether in connection with a divisive "(D)" reorganization or in distributions of stock of a previously existing subsidiary, fall into three broad categories: spin-offs, split-offs, and split-ups. In a spin-off, a distributing corporation distributes to its shareholders the stock of the controlled corporation in a pro rata distribution. The shareholders continue their same pro rata interest but in two corporations rather than one. In a split-off, stock of the distributing corporation is redeemed in exchange for stock of the controlled corporation. Thus, the distribution is not pro rata. This type of transaction in the public company context is effectuated by an issuer exchange offer pursuant to the issuer tender offer rules discussed in chapter 8. In a split-up, the distributing corporation contributes its assets to two or more controlled corporations and then liquidates, distributing the stock to its shareholders. Only the spin-off and split-off are discussed further here.

§ 15:2.3 Conditions for Tax-Free Treatment Under Section 355(a)

For a transaction to be tax-free under section 355[a], the following basic requirements set out in the statute, case law, and regulations must be satisfied:

• The distributing corporation must distribute to its shareholders or security holders “solely” stock or securities (that is, debt instruments) of the controlled corporation (see sections 355[a][1][A] and 355[a][2]); the distribution need not be pro rata. If cash or other property (that is, boot) is distributed, the section 356 boot gain rule will apply (see sections 356[a] and [b]) (only distributions of stock are addressed here);

• The transaction must not be a “device” for the distribution of earnings and profits (that is, the corporation’s after-tax earnings) (see section 355[a][1][B]) (the device test is briefly examined below);
As illustrated in the *Gregory v. Helvering* case, the transaction must have a business purpose (the business purpose test is briefly examined below); 

The transaction must have a continuity of interest (this requirement is briefly examined below); 

A separate active trade or business that has been conducted for at least five years must continue to be conducted after the distribution by each of the distributing and controlled corporations either directly, or by the “separate affiliated group” or “SAG” of each of distributing and controlled corporations (see sections 355(a)(1)(C) and 355(b)) (thus, as discussed further below, a five-year business must be both spun off and retained); and 

The distributing corporation must distribute (1) all of the stock or securities of the controlled corporation, or (2) an amount of stock of the controlled corporation amounting to control (that is, at least 80%), provided that in the latter case it is established that the retention of stock or securities of the controlled corporation is not for tax avoidance purposes (see section 355(a)(1)(D)) (for purposes of the discussion here it is assumed that all of the stock of the controlled corporation is distributed).

A transaction otherwise qualifying under section 355 would not qualify if the distribution involves a “disqualified investment corporation” and certain other conditions specified in section 355(g), discussed below, are satisfied. Also, even if section 355 is otherwise applicable, the distributing corporation may have gain recognition on the distribution under sections 355(d) or (e), both discussed below.

§ 15:2.4 Elaboration on the Treatment of the Parties If the Conditions Are Satisfied

[A] The Treatment of the Shareholders of the Distributing Corporation

As discussed, if the above conditions in section 355 are satisfied, then under section 355(a), the shareholders of the distributing corporation receive nonrecognition treatment on receipt of the stock of the controlled corporation. Thus, section 355 is analogous to section 354, which gives nonrecognition treatment to the shareholders of a target corporation on receipt of stock of an acquirer in an acquisitive reorganization. Under section 358, the shareholder’s

basis of the shares of the distributing corporation prior to the
distribution is after the distribution allocated between the shares
of the distributing corporation and the shares of the controlled
corporation in accordance with their relative fair market values.
(See Treas. Reg. § 1.358-2(a)(2)(iv).)

Under section 355(a)(3)(B), stock of a controlled corporation
acquired by the distributing corporation in a purchase transaction
occurring within five years of the spin-off is not treated as stock of
the controlled corporation, but as other property, that is, boot. Such
stock is referred to as “hot stock,” and is addressed in Temporary
Regulations issued in December 2008.3 Among other things, these
regulations treat certain stock acquired by one member of a “separate
affiliated group” (SAG) from another as not hot stock.

[B] The Treatment of the Distributing Corporation

[B][1] In General

At the corporate level, the distributing corporation generally has
nonrecognition treatment on the distribution of stock of the controlled
corporation under section 355(c) in the case of the distribution of a
previously existing controlled corporation or under section 361(c) in
the case of a “(D)” reorganization.

[B][2] Potential Gain for the Distributing Corporation
Under Sections 355(d) and 355(e)

The distributing corporation has gain recognition in the case of
certain (1) distributions to a 50% or greater shareholder of the
distributing corporation who recently acquired his stock in the cor-
poration by purchase (section 355(d)), and (2) distributions followed by
certain acquisitions of the distributing corporation or the controlled
corporation (section 355(e)).

Section 355(d), which is designed to prevent, inter alia, an acquirer
from purchasing stock of a distributing corporation and then causing
the distributing corporation to redeem the acquired stock in exchange
for stock of a controlled corporation in a section 355 split-off, is briefly
addressed below. Section 355(e), which can trigger gain for the
distributing corporation if either the distributing corporation or the
controlled corporation engages in a post-distribution acquisition trans-
action, is examined below in connection with the discussion of the
Comcast–AT&T reverse Morris Trust transaction.

3. Guidance Regarding the Treatment of Stock of a Controlled Corporation
under Section 355(a)(3)(B), T.D. 9435, 73 Fed. Reg. 75,946–51 (Dec. 15,
2008).
§ 15:2.5 Diagram of a “(D)” Reorganization Spin-Off

A “(D)” reorganization spin-off under sections 368(a)(1)(D) and 355 is set out in Diagram 15-1:

Diagram 15-1
Divisive Spin-Off Under §§ 368(a)(1)(D) and 355

Old DC Shareholders

[2] Distributes CC Stock as a Pro Rata Dividend

Distributing Corporation (DC)
Retains a 5-Year Active Trade or Business

[1] CC Stock

DC Contributes to CC Certain Assets & Liabilities

Controlled Corporation (CC)
Receives a 5-Year Active Trade or Business

When the Dust Settles
Old DC Shareholders

(Concludes a 5-Year Active Trade or Business)

(Concludes a 5-Year Active Trade or Business)
§ 15:2.6 Results If the Spin-Off Does Not Qualify Under Section 355

If the spin-off does not qualify under section 355, the transaction is taxable to both the distributing corporation on the distribution of the stock of the controlled corporation and to the shareholders of the distributing corporation as a dividend, assuming the distributing corporation has sufficient earnings and profits. Section VI.B of Appendix 15A, Morgan Stanley’s Spin-Off of Discover, contains the following discussion of this potential double tax:

If the distribution were not to qualify for tax-free treatment under sections 355, 368 and related provisions of the Code, Morgan Stanley would recognize taxable gain equal to the excess of the fair market value of our stock over Morgan Stanley’s tax basis in our stock. Under certain circumstances, we would be required under the tax sharing agreement to indemnify Morgan Stanley for all or a portion of this liability. See “Arrangements Between Us and Morgan Stanley—Tax Sharing Agreement.” In addition, each U.S. holder who receives our common stock in the distribution would be treated as receiving a taxable distribution in an amount equal to the fair market value of our common stock received.

It is common in spin-offs for the controlled corporation to indemnify the distributing corporation against any tax liability it incurs in the distribution, including, as discussed below, any liability arising under section 355(e).

§ 15:2.7 Private Rulings Under Section 355

Because of the large tax stakes to both the distributing parent and its shareholders in a spin-off, the distributing parent will, in many cases, condition the transaction on receipt of a private letter ruling from the IRS to the effect that the transaction qualifies under section 355. The Service’s requirements for a private letter ruling on spin-offs are set out in Rev. Proc. 2003-48.4 The general requirement regarding rulings are set out in [1] Rev. Proc. 2016-1,5 explaining how the IRS provides advice to taxpayers on issues under the jurisdiction of the Associate Chief Counsel (Corporate), and [2] Rev. Proc. 2016-3,6 setting forth the issues under the jurisdiction of the Associate Chief Counsel (Corporate) where the IRS will not issue letter rulings. Annually the list of the “no ruling” issues for the IRS are set out in the third revenue procedure of the year, so in 2016, the no ruling

revenue procedure is Rev. Proc. 2016-3. In addition, in Rev. Proc. 2009-25\(^7\) the Service announced a new pilot project pursuant to which it will issue rulings under section 355 on only part of the transaction:

In order to use Service resources more efficiently and to increase the availability of private letter rulings, this revenue procedure allows taxpayers to request rulings on one or more issues that:
1. are solely under the jurisdiction of the Associate Chief Counsel (Corporate),
2. are significant (as defined in section 3.01(38) of Rev. Proc. 2009-3), and
3. involve the tax consequences or characterization of a transaction (or part of a transaction) that occurs in the context of a § 355 distribution. Under this program, taxpayers may request and the Service may issue a ruling on part of a transaction rather than on the larger transaction. \(^8\)

Section VI.B of Appendix 15A, Morgan Stanley’s Spin-Off of Discover, contains the following discussion of the private letter ruling requested for that transaction:

Morgan Stanley has requested a private letter ruling from the IRS to the effect that, among other things, the distribution (including certain related transactions) will be generally tax-free to Morgan Stanley, us and Morgan Stanley stockholders for U.S. Federal income tax purposes under sections 355, 368 and related provisions of the Code. Although a private letter ruling from the IRS generally is binding on the IRS, if the factual assumptions or representations made in the private letter ruling request are untrue or incomplete in any material respect, then Morgan Stanley will not be able to rely on the ruling.

Assuming (i) the continued validity of the private letter ruling from the IRS and (ii) that the distribution of our common stock to Morgan Stanley stockholders in connection with the distribution is not otherwise disqualified as tax-free, the material U.S. Federal income tax consequences of the distribution will be as follows:

- the distribution will not generally result in any taxable income, gain or loss to Morgan Stanley;
- no taxable income, gain or loss will be recognized by any U.S. holder solely as the result of the receipt of our common stock in the distribution;
- the aggregate tax basis of the Morgan Stanley common stock and our common stock in the hands of a U.S. holder immediately after the distribution will be the same as the aggregate tax basis of the Morgan Stanley common stock held by such holder immediately before the distribution, allocated between

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8. Id. § 3.02.
the Morgan Stanley common stock and our common stock in proportion to their relative fair market values on the distribution date; and

- the holding period of our common stock received by a U.S. holder will include the holding period of such holder’s Morgan Stanley common stock, provided that the Morgan Stanley common stock is held as a capital asset on the distribution date.

§ 15:2.8 The No “Device” Requirement

[A] In General

The no “device” requirement is specified in section 355(a)[1][B], which requires that the spin-off 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 [but the mere fact that subsequent to the distribution stock or securities in one or more of such corporations are sold or exchanged by all or some of the distributees (other than pursuant to an arrangement negotiated or agreed upon prior to such distribution) shall not be construed to mean that the transaction was used principally as such a device).

This requirement is addressed in Treas. Reg. section 1.355-2(d), which provides:

Section 355 does not apply to a transaction used principally as a device for the distribution of the earnings and profits of the distributing corporation, the controlled corporation, or both [a “device”]. Section 355 recognizes that a tax-free distribution of the stock of a controlled corporation presents a potential for tax avoidance by facilitating the avoidance of the dividend provisions of the Code through the subsequent sale or exchange of stock of one corporation and the retention of the stock of another corporation. A device can include a transaction that effects a recovery of basis. . . . Generally, the determination of whether a transaction was used principally as a device will be made from all of the facts and circumstances, including, but not limited to, the presence of the device factors specified in paragraph [d][2] of this section (“evidence of device”), and the presence of the nondevice factors specified in paragraph [d][3] of this section (“evidence of nondevice”). However, if a transaction is specified in paragraph [d][5] of this section, then it is ordinarily considered not to have been used principally as a device.9


(Mergers, Rel. #11, 5/16) 15–11
The device factors include (1) a pro rata distribution of stock of a controlled corporation, and (2) a post-spin-off sale of stock of either the distributing corporation or the controlled corporation.\(^{10}\) Thus, in any spin-off (which is naturally a pro rata distribution), it is important to determine if any such post-spin-off sales or dispositions will cause the transaction to fail the no “device” requirement.

The regulations set out the following general rule regarding subsequent sales or dispositions:

A sale or exchange of stock of the distributing or the controlled corporation after the distribution (a “subsequent sale or exchange”) is evidence of device. Generally, the greater the percentage of the stock sold or exchanged after the distribution, the stronger the evidence of device. In addition, the shorter the period of time between the distribution and the sale or exchange, the stronger the evidence of device.\(^{11}\)

The regulations go on to provide that a “subsequent sale or exchange pursuant to an arrangement negotiated or agreed upon before the distribution is substantial evidence of device,”\(^{12}\) and a “subsequent sale or exchange not pursuant to an arrangement negotiated or agreed upon before the distribution is evidence of device.”\(^{13}\) The regulations take a broad view of what constitutes “negotiated or agreed upon before the distribution”:

[A] sale or exchange is always pursuant to an arrangement negotiated or agreed upon before the distribution if enforceable rights to buy or sell existed before the distribution. If a sale or exchange was discussed by the buyer and the seller before the distribution and was reasonably to be anticipated by both parties, then the sale or exchange will ordinarily be considered to be pursuant to an arrangement negotiated or agreed upon before the distribution.\(^{14}\)

Notwithstanding the general rule, a subsequent disposition of stock of the controlled corporation or the distributing corporation (even pursuant to a pre-spin-off plan) in an acquisitive reorganization generally is not treated as an exchange pursuant to a plan:

\(^{10}\) Treas. Reg. § 1.355-2(d)(2).
\(^{13}\) Treas. Reg. § 1.355-2(d)(2)(iii)(C).
[I]f stock [of the distributing corporation or the controlled corporation] is exchanged for stock in pursuance of a plan of reorganization, and either no gain or loss or only an insubstantial amount of gain is recognized on the exchange, then the exchange is not treated as a subsequent sale or exchange, but the stock received in the exchange is treated as the stock surrendered in the exchange.15

This provision permits the pre-spin-off negotiation of reverse *Morris Trust* transactions, discussed below, without violating the no “device” requirement.

The “nondevice factors” include (1) the presence of a strong business purpose for the spin-off,16 and (2) a distributing corporation that is publicly traded and widely held.17 Both of these elements will generally be present in a reverse *Morris Trust* transaction.

[B] No Private Letter Ruling on the No “Device” Requirement

The Service will not issue a private ruling on the device issue.18 Taxpayers seeking private letter rulings under section 355 must submit the following representation regarding the device requirement:

(1) Dispositions of stock or securities. Submit the following REPRESENTATION: The transaction is not used principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both. See §355(a)(1)(B). The Service will decline to issue a letter ruling in all cases in which the taxpayer fails to submit the required representation. The National Office will not determine whether the transaction is used principally as a device for the distribution of the earnings and profits of the distributing corporation, the controlled corporation, or both. This determination may be made upon an examination of the taxpayer’s return.19

§ 15:2.9 The Business Purpose Requirement

[A] In General

The business purpose requirement is not set out in the statute; it originated in the *Gregory* case and is set out in Treas. Reg. § 1.355-2(b):

19. *Id.*

(Mergers, Rel. #11, 5/16) 15–13

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Section 355 applies to a transaction only if it is carried out for one or more corporate business purposes. A transaction is carried out for a corporate business purpose if it is motivated, in whole or substantial part, by one or more corporate business purposes. The potential for the avoidance of Federal taxes by the distributing or controlled corporations (or a corporation controlled by either) is relevant in determining the extent to which an existing corporate business purpose motivated the distribution. The principal reason for this business purpose requirement is to provide nonrecognition treatment only to distributions that are incident to readjustments of corporate structures required by business exigencies and that effect only readjustments of continuing interests in property under modified corporate forms. This business purpose requirement is independent of the other requirements under section 355.20

The regulations go on to provide that a “corporate business purpose is a real and substantial non-Federal tax purpose germane to the business of the distributing corporation, the controlled corporation, or the affiliated group . . . to which the distributing corporation belongs.”21 The regulations further provide:

The distribution must be carried out for one or more corporate business purposes. . . . If a corporate business purpose can be achieved through a nontaxable transaction that does not involve the distribution of stock of a controlled corporation and which is neither impractical nor unduly expensive, then, for purposes of paragraph (b)(1) of this section, the separation is not carried out for that corporate business purpose.22

[B] No Private Letter Ruling on Business Purpose

In Rev. Proc. 96-30, 1996-1 C.B. 696, the Service had set out significant guidance on what constitutes a business purpose. However, this guidance was revoked in Rev. Proc. 2003-48, which states that the Service will no longer issue private letter rulings on the business purpose of a spin-off. Rather, Rev. Proc. 2003-48 requires that the taxpayer provide in the private ruling request the following description of the business purposes of the transaction:

(1) Detailed Description. Describe in narrative form each corporate business purpose for the distribution of the stock of Controlled. Do not provide any documentation or substantiation in

20. Treas. Reg. § 1.355-2[b][1].
22. Treas. Reg. § 1.355-2[b][3].
support thereof. Submit the following REPRESENTATION: The distribution of the stock, or stock and securities, of the controlled corporation is carried out for the following corporate business purposes: [list these corporate business purposes]. The distribution of the stock, or stock and securities, of the controlled corporation is motivated, in whole or substantial part, by one or more of these corporate business purposes. The Service will decline to issue a letter ruling in all cases in which the taxpayer fails to submit the required representation. The National Office will not determine whether the distribution is being carried out for one or more corporate business purpose. This determination may be made upon an examination of the taxpayer’s return.

[C] General Guidance on Business Purpose

Notwithstanding the repeal of the guidance in Rev. Proc. 96-30 on what constitutes a business purpose, the business purposes listed in Appendix A of the repealed guidelines, including the items set out here, continue to provide helpful guidance on what constitutes a business purpose:

.04 Cost savings. To establish that a Corporate Business Purpose for the distribution is cost savings, ordinarily, the taxpayer must demonstrate to the satisfaction of the Service that the distribution will produce significant cost savings. . . .

.05 Fit and Focus.

(1) General. This section 2.05 of Appendix A provides guidelines for a ruling request in which a Corporate Business Purpose for the distribution is that the separation will enhance the success of the businesses by enabling the corporations to resolve management, systemic, or other problems that arise (or are exacerbated) by the taxpayer’s operation of different businesses within a single corporation or affiliated group. Except as provided in section 2.05(2) of this Appendix A, the Service ordinarily will rule with respect to pro rata as well as non pro rata distributions. . . .

Section V of Appendix 15A, Morgan Stanley’s Spin-Off of Discover, states that one of Morgan Stanley’s business reasons for effectuating that spin-off was “fit and focus”:

In making the determination to separate Discover from Morgan Stanley, Morgan Stanley conducted a strategic review, following which it concluded that Morgan Stanley and Discover could best execute their respective growth strategies as two stand-alone companies with independent boards of directors focused on creating stockholder value.
Morgan Stanley and we [Discover] believe that the distribution will enhance stockholder value and provide numerous opportunities and benefits, including the following:

- **Fit and focus.** Discover and Morgan Stanley management will be able to focus their efforts on more closely aligned respective firm-wide strategic priorities. Discover will be able to continue building its strong brand and scale, and Morgan Stanley will be able to focus on priorities within its institutional securities, global wealth management group and asset management segments.

- **Enhancing competitive position.** Discover and Morgan Stanley expect that the separation of Discover will eliminate the possibility that Morgan Stanley or Discover will be placed at a competitive disadvantage relative to their peers because potential clients and strategic partners view Discover or Morgan Stanley, respectively, as a competitor.

- **Increasing our ability to attract and retain employees.** We believe that incentive compensation arrangements for key employees, directly related to the market performance of our common stock, will provide enhanced incentives for performance. The distribution will enable us to offer our key employees equity-based compensation directly linked to the performance of our business, which we expect to enhance our ability to attract and retain qualified personnel.

- **Improving ability to pursue strategic transactions.** We expect that having a more focused equity currency will improve our ability to pursue strategic initiatives, including acquisitions, joint ventures and investments.

§ 15:2.10 Continuity of Interest

The continuity of interest requirement, which will normally be satisfied in a traditional spin-off, is set out in Treas. Reg. section 1.355-2(c)(1):

Section 355 applies to a separation that effects only a readjustment of continuing interests in the property of the distributing and controlled corporations. In this regard section 355 requires that one or more persons who, directly or indirectly, were the owners of the enterprise prior to the distribution or exchange own, in the aggregate, an amount of stock establishing a continuity of interest in each of the modified corporate forms in which the enterprise is conducted after the separation. This continuity of interest requirement is independent of the other requirements under section 355.

Like the device requirement, the continuity of interest requirement makes it difficult for the shareholders of the distributing or controlled corporation to dispose of the shares in a taxable transaction shortly after the spin-off.
§ 15:2.11 The Active Trade or Business Requirement

[A] Introduction

Under the active trade or business requirement of section 355(b), both the distributing and controlled corporations must be engaged, immediately after the distribution, in the active conduct of a trade or business that has been conducted for at least five years. Also, the business must not have been acquired in a taxable transaction during such period. Under section 355(b)(3), which was added to the Code in 2006, the active business test is determined by reference to the separate affiliated group (SAG), which consists of the distributing corporation or the controlled corporation, as the case may be, as the common parent and all corporations affiliated with it through the 80% stock ownership test described in section 1504(a)(1)(B) (regardless of whether the corporations are includible corporations under section 1504(b), for example, foreign corporations).

In most transactions in which a spin-off is combined with a post-spin reverse Morris Trust transaction, it will be clear that both the distributing corporation and the controlled corporation satisfy the active trade or business requirement. For this reason, this requirement, which contains several nuances not discussed here, is not examined further.

[B] Small Amounts of Qualifying Business Assets

[B][1] Background: The Yahoo Planned, but Abandoned, Spin-Off of Its Stock in Alibaba

As discussed above, section 355(b) sets out an active trade or business requirement for a spin-off. One question has been: How big must the active trade or business be? This issue was important in Yahoo’s planned, but abandoned, spin-off of its stake in Alibaba, because the active business Yahoo planned to include in the spin-off was very small relative to its $40 billion stake in Alibaba. If the transaction did not qualify as a tax-free spin-off, both Yahoo and its shareholders would be subject to tax, with Yahoo having a $10 billion plus tax bill.

An article in Tax Notes provides the following background on the issue:

Yahoo announced in January 2015 that it plans to spin off its holdings in Alibaba and Yahoo Small Business (to be renamed Aabaco Small Business LLC) into SpinCo (to be named Aabaco Holdings Inc.). . . .

The filing confirmed that the transaction will implicate the small active trade or business (ATB) issue, stating that the anticipated
value of Aabaco Holdings’ “Alibaba Shares will exceed 95 percent of the value of its total assets immediately after the Spin-Off.”

Aabaco Holdings’ registration statement mentioned the additional risk associated with the ATB size study underway at the IRS Office of Associate Chief Counsel (Corporate). “The IRS recently announced that it is reconsidering its ruling policy with respect to certain issues under Section 355 of the Code, which could potentially impact Yahoo’s ability to obtain the IRS Ruling. Accordingly, there is a risk that the IRS might not issue the IRS Ruling or might determine to promulgate new administrative guidance prior to the Spin-Off that could adversely impact the tax-free treatment of the Spin-Off even if Yahoo previously received the IRS Ruling,” according to the statement.

An article in Tax Notes Today provides the following helpful discussion of the background of the technical aspects of the size of trade or business issue:

Some tax attorneys well versed in the many requirements of section 355 insist that ATB size doesn’t matter, citing Rev. Rul. 73-44, 1973-1 C.B. 182. But are they certain enough to issue will-level opinions on the whole tax-free spinoff absent a ruling? Maybe so.

The so-called hot dog stand, or de minimis, ATB issue is about more than just the ATB requirement in section 355(b), which practitioners believe can fairly easily be dispensed with by spinning off an operating business with at least two employees who perform “active and substantial managerial and operational activity.” (See Rev. Rul. 73-234, 1973-1 C.B. 180, and Rev. Rul. 86-126, 1986-2 C.B. 58.)

For taxpayers to get a section 355 ruling, the IRS used to require [Rev. Proc. 96-43, 1996-2 C.B. 330 [Doc 96-22469]] that the assets of the ATB make up at least 5 percent of the total assets of the newly separated entity [SpinCo, spun off from Distributing]—or it required a showing “based upon all relevant facts and circumstances” that the ATB wasn’t “de minimis compared with the other assets or activities of the corporation and its subsidiaries.”

But that threshold was eliminated in Rev. Proc. 2003-48, 2003-2 C.B. 86 [Doc 2003-15249], and Rev. Rul. 73-44 states that “there 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.”

If ATB size arguably doesn’t matter for section 355(b), it nevertheless plays an important role in the statutory non-device requirement (section 355(a)(1)(B)) [see § 15:2.8 for a discussion of the device test], which was designed to police the avoidance of dividend treatment by those seeking to convert dividends (which had been taxed at ordinary rates but can now sometimes qualify for a preferential rate) into a sale or exchange with a return of capital. With the rate differential gone, the conversion could still need policing given that return of capital reduces basis.\textsuperscript{22.2}

*Tax Notes* reported that as of late July Yahoo had announced that it was planning to close the spin-off asserting that it has “sole and absolute discretion” to waive in whole or in part the condition that it receive a favorable letter ruling from the IRS on some tax aspects of the spinoff and that it also can “waive the condition that it receive an opinion from Skadden, Arps, Slate, Meagher & Flom LLP providing that the spinoff ‘will qualify as a tax-free transaction to Yahoo and its stockholders[].’”

In the fall 2015 summary for this chapter, I expressed the view that “Yahoo is playing chicken with the IRS, and Yahoo will in no case proceed with the current structure of the spin-off without an IRS ruling or an ironclad tax opinion from Skadden or another comparable law firm, which under the current state of the law it will not receive.” I also said: “If Yahoo were to proceed and ultimately lose to the IRS on the issue, its corporate tax bill could possibly bankrupt the company.” As discussed in the next section, in October 2015, the IRS responded to Yahoo’s bluff with a notice and revenue procedure addressing, inter alia, the size of business issue presented in Yahoo’s planned spin-off. As reported widely by the press in December 2015, after the issuance of these IRS pronouncements, Yahoo abandoned its plan to spin off its stake in Alibaba.

\textbf{[B][2] 2015 IRS Notice and Revenue Procedure on Active Trade of Business}

At least in part in response to Yahoo’s planned spin-off, in October 2015 the IRS issued Notice 2015-59\textsuperscript{22.3} and Rev. Proc. 2015-44\textsuperscript{22.4} relating to “Areas under Study Relating to §§ 337(d) and 355 of the Internal Revenue Code.” Rev. Proc. 2015–43 supplemented Rev. Proc.

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2015–3, the “no rulings” revenue procedure, which has been succeeded by Rev. Proc. 2016-3\textsuperscript{22.5} by adding certain transactions to the list of no-rule areas. The notice explains as follows the purpose of these two documents:

The Treasury Department and the Internal Revenue Service (Service) are studying issues under §§ 337(d) and 355 of the Internal Revenue Code (Code) relating to transactions having one or more of the following characteristics: (i) ownership by the distributing corporation or the controlled corporation of investment assets, within the meaning of § 355(g)(2)(B), with modifications (Investment Assets), having substantial value in relation to (a) the value of all of such corporation's assets and (b) the value of the assets of the active trade(s) or business(es) on which the distributing corporation or the controlled corporation relies to satisfy the requirements of § 355(b) (a Qualifying Business or Qualifying Business Assets); (ii) a significant difference between the distributing corporation's ratio of Investment Assets to assets other than Investment Assets and such ratio of the controlled corporation; (iii) ownership by the distributing corporation or the controlled corporation of a small amount of Qualifying Business Assets in relation to all of its assets; and (iv) an election by the distributing corporation or the controlled corporation (but not both) to be a regulated investment company (RIC), within the meaning of § 851, or a real estate investment trust (REIT), within the meaning of § 856.

The portion of these documents dealing with RICs and REITs are not discussed further here; however, 2015 legislation dealing with REIT spin-offs is discussed briefly in the next section.

The notice explains as follows the reasons the Treasury and Service are concerned about these transactions:

The Treasury Department and the Service have become aware, in part through requests for letter rulings, that some taxpayers are taking the position that certain distributions that have one or more of the characteristics described in section 1 of this notice satisfy the requirements of § 355. The Treasury Department and the Service believe that these transactions may present evidence of device for the distribution of earnings and profits [see §15:2.8], may lack an adequate business purpose or a Qualifying Business, or may violate other § 355 requirements. In addition, these transactions may circumvent the purposes of Code provisions intended to repeal the Supreme Court’s decision in General

\textsuperscript{22.5} As discussed previously, annually the list of the “no ruling” issues for the IRS are set out in the third revenue procedure of the year, so in 2016, the no ruling revenue procedure is Rev. Proc. 2016-3.
Under a section of the Notice titled “Nature of Assets of Distributing Corporation and Controlled Corporation,” the Treasury and IRS explain:

The Treasury Department and the Service are most concerned about transactions that result in (i) the distributing corporation or the controlled corporation owning a substantial amount of cash, portfolio stock or securities, or other Investment Assets, in relation to the value of all of its assets and its Qualifying Business Assets, and (ii) one of the corporations having a significantly higher ratio of Investment Assets to Non-Investment Assets than the other corporation. While these matters are under study, the Service will not rule on any issue that relates to the qualification of a distribution under § 355 and related provisions and is presented in a distribution described in section 5.01(26) of Rev. Proc. 2015–3 [now section 5.01(4) of Rev. Proc. 2016-3].

Section 5.01(5) of the no ruling Rev. Proc. 2016-3 sets out the following basic rule governing spin-offs where either the distributing corporation or the controlled corporation owns significant investment assets:

SECTION 5. AREAS UNDER STUDY IN WHICH RULINGS OR DETERMINATION LETTERS WILL NOT BE ISSUED UNTIL THE SERVICE RESOLVES THE ISSUE THROUGH PUBLICATION OF A REVENUE RULING, A REVENUE PROCEDURE, REGULATIONS, OR OTHERWISE

.01 Specific Questions and Problems. . . .

[5] Section 355.—Distribution of Stock and Securities of a Controlled Corporation.—Any issue relating to the qualification, under § 355 and related provisions, of a distribution, or another distribution which is part of the same plan or series of related transactions, if, immediately after any such distribution, all of the following conditions exist: (i) the fair market value of the gross investment assets of the distributing corporation or the controlled corporation is two-thirds or more of the fair market value of its total gross assets; (ii) the fair market value of the gross assets of the trade[s] or business[es] on which the distributing corporation or the controlled corporation relies to satisfy the active trade or business requirement of § 355(b) is less than 10 percent of the fair market value of its gross investment assets; and (iii) the ratio of the fair market value of the gross investment assets to the fair market value of the gross assets other than the gross investment
assets of the distributing corporation or the controlled corporation is three times or more of such ratio for the other corporation (i.e., the controlled corporation or the distributing corporation, respectively).

Special rules are provided for determining “the fair market value of the distributing corporation’s and the controlled corporation’s gross investment assets, gross assets other than gross investment assets, gross assets of the trade or business, and total gross assets.” Subject to certain exceptions, the term “investment assets” has the meaning given such term by section 355(g)(2)(B), which deals with distributions involving disqualified investment companies. This provision also says that the Service “will not rule on any issue relating to the qualification, under § 355 and related provisions, of a distribution if, as part of a plan or series of related transactions, investment assets are disposed of, or property, including property qualifying as an active trade or business within the meaning of § 355(b), is acquired with a principal purpose of avoiding this section 5.01(5).

Under a section of the Notice titled “Small Amounts of Qualifying Business Assets,” the Treasury and Service explain their concerns as follows:

The Treasury Department and the Service are also concerned about transactions in which the distributing corporation or the controlled corporation owns a small amount of Qualifying Business Assets compared to its other assets (non-Qualifying Business Assets). Before enactment of § 355(b)(3), such transactions were common due to the restrictive nature of the “holding company” rule (§ 355(b)(2)(A) prior to its amendment by the Technical Corrections Act of 2007, Pub. L. No. 110–172, § 4(b)(1), 121 Stat. 2473, 2476 [2007]). The Treasury Department and the Service have concluded that, under current law, distributions involving small Qualifying Businesses may have become less justifiable. Accordingly, the Service ordinarily will not rule on any issue that relates to the qualification of a distribution under § 355 and related provisions and is presented in a distribution described in section 4.01(58) of Rev. Proc. 2015–3 [now section 4.01(31) of Rev. Proc. 2016-3], but will consider ruling in unique and compelling circumstances.

In determining whether unique and compelling circumstances exist to justify the issuance of a ruling or determination letter, the Service will consider all facts and circumstances, including whether a substantial portion of the non-Qualifying Business Assets would be Qualifying Business Assets but for the five-year requirement of § 355(b)(2)(B) and whether there is a relationship
between the business purpose for the distribution and the Qualifying Business of the distributing corporation or the controlled corporation.

Section 4.01.31 of Rev. Proc. 2016-3, which implements the above rule, provides:

**SECTION 4. AREAS IN WHICH RULINGS OR DETERMINATION LETTERS WILL NOT ORDINARILY BE ISSUED**

.01 Specific Questions and Problems. . . .

[31] Section 355.—Distribution of Stock and Securities of a Controlled Corporation.—Any issue relating to the qualification, under § 355 and related provisions, of a distribution, or another distribution which is part of the same plan or series of related transactions, if, immediately after any such distribution, the fair market value of the gross assets of the trade[s] or business(es] on which the distributing corporation or the controlled corporation relies to satisfy the active trade or business requirement of § 355[b] is less than five percent of the fair market value of the total gross assets of such corporation.

There is an “Exception for Certain Intra-Group Distributions.” Special rules are provided for “purposes of determining the fair market value of the total gross assets of such corporation and of the gross assets of such trade[s] or business(es].”

As indicated above, Yahoo abandoned its planned spin-off; however, shortly after the issuance of the notice and revenue procedure, Yahoo made the following disclosure concerning the spin-off:

On September 8, 2015, Yahoo! Inc. ("Yahoo" or the "Company") filed a Current Report on Form 8-K (the "September 8 Form 8-K") disclosing, among other things, that the Internal Revenue Service ("IRS") had notified Yahoo’s counsel that it had determined, in the exercise of its discretion and without ruling adversely, not to grant Yahoo’s request for a private letter ruling regarding certain aspects of its previously announced plan for a spin-off to Yahoo’s stockholders of all of the stock of Aabaco Holdings, Inc. ("Aabaco"), a newly formed independent registered investment company, which will hold all of Yahoo’s remaining holdings in Alibaba Group Holding Limited ("Alibaba") and Aabaco Small Business, LLC [a newly formed entity which will own Yahoo Small Business]. Yahoo further disclosed in the September 8 Form 8-K that work was proceeding on the Aabaco spin-off plan, and that Yahoo’s Board of Directors would continue to carefully consider the Company’s options, including proceeding with the spin-off transaction on the basis of an opinion of counsel.
On September 14, 2015, the IRS issued a formal “no-rule” policy with respect to certain transactions similar to the Aabaco spin-off and, in a notice released on the same day, indicated that the IRS and U.S. Department of the Treasury are studying the possibility of promulgating new guidance with respect to such transactions in the future. Neither this ongoing guidance project nor the IRS’s decision not to rule with respect to the Aabaco spin-off transaction changes the current law applicable to the proposed spin-off. In addition, on September 19, 2015, an IRS official indicated in a public statement that any future guidance issued as part of the project would not apply retroactively to transactions completed prior to the issuance of such guidance.

On September 23, 2015, Yahoo’s Board of Directors authorized the Company to continue to pursue the plan for the Aabaco spin-off transaction as previously disclosed, except that completion of the spin-off will not be conditioned upon receipt of a favorable ruling from the IRS. The spin-off transaction will continue to be subject to certain other conditions, including final approval by Yahoo’s Board of Directors, receipt of a legal opinion with respect to the tax-free treatment of the transaction under U.S. federal tax laws and regulations.[22.6]

### [B][3] 2015 Legislation Dealing with REIT Spin-Offs

The 2015 Tax Act significantly restricted spin-offs involving REITs, thus making at least some of the Service’s “no ruling” position on REITs superfluous. A summary of this provision explains:[22.7]

Section 311. Restriction on tax-free spinoffs involving REITs. The provision provides that a spin-off involving a REIT will qualify as tax-free only if immediately after the distribution both the distributing and controlled corporation are REITs. In addition, neither a distributing nor a controlled corporation would be permitted to elect to be treated as a REIT for ten years following a tax-free spin-off transaction.

### § 15:2.12 Avoiding Gain Under Section 355(d)

The purpose of this section is to introduce the basic principles of section 355(d). Under section 355(d)(1), the distributing corporation realizes gain on the distribution of appreciated stock of the controlled corporation if the distribution is a “disqualified distribution.” Section 355(d)(2) defines the term “disqualified distribution”:

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The term “disqualified distribution” means any distribution to which this section (or so much of section 356 as relates to this section) applies if, immediately after the distribution—

(A) any person holds disqualified stock in the distributing corporation which constitutes a 50-percent or greater interest in such corporation, or

(B) any person holds disqualified stock in the controlled corporation . . . which constitutes a 50-percent or greater interest in such corporation.

The term “disqualified stock” is defined in section 355(d)(3) to mean, inter alia, (1) any stock of the distributing corporation acquired in a purchase transaction (that is, the purchaser takes a cost basis) during the five-year period ending on the date of the distribution, and (2) any stock of the controlled corporation “received in the distribution to the extent attributable to distributions on . . . stock described in [item (1), i.e., purchased stock of the distributing corporation]. . . .”

Pursuant to section 355(d)(4), the term “50-percent or greater interest” is defined as “stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all classes of stock.”

The following is an example of a prototypical transaction that would give rise to gain recognition for the distributing corporation under section 355(d). Assume that Target Corporation, a publicly held corporation, has two businesses: Wanted Business and Unwanted Business, both of which have a fair market value of $100M and a basis of $10M. Acquirer wants to acquire the Unwanted Business, but Target Corporation does not want to trigger a corporate level taxable gain on the disposition of the business. Consequently, a transaction is structured in which the following steps occur. First, Acquirer purchases on the open market $100M of Target’s stock. Second, Target transfers the Unwanted Business to a newly formed Controlled Corporation. Third, Target distributes the stock of the Controlled Corporation to Acquirer in redemption of its stock in Target in a transaction intended to qualify as a divisive “[D] reorganization split-off under section 355.

Even if all of the conditions of section 355 are satisfied, Target has gain recognition on the distribution; the distribution is a disqualified distribution because immediately after the distribution, Acquirer “holds disqualified stock in the controlled corporation . . . which constitutes a 50-percent or greater interest in such corporation.” Further, the transaction would constitute a disqualified distribution even if Acquirer purchased less than 50% of Target’s stock, say 25%, because the Unwanted Business constituted only 25%
of Target’s assets. In such case, Acquirer would still hold immediately after the distribution “disqualified stock in the controlled corporation . . . which constitutes a 50-percent or greater interest in such corporation.”

§ 15:2.13 Avoiding Gain Under Section 355(e)—The Reverse Morris Trust Transaction

[A] Generally

The discussion here assumes that all of the conditions in section 355(a) have been satisfied, and the only issue with the spin-off is whether, as a result of a post-spin-off acquisitive reorganization involving the distributing corporation or the controlled corporation, section 355(e) will cause the distributing corporation to recognize gain on the distribution of the controlled corporation.

Under Commissioner v. Morris Trust, it is possible to structure a tax-free spin-off followed by a tax-free acquisition of either the distributing corporation or the controlled corporation in an acquisitive reorganization. (See chapter 9 for a discussion of acquisitive reorganizations.) In Morris Trust, a state bank was to be acquired by a national bank in a merger qualifying under section 368(a)(1)(A) as a tax-free reorganization. The state bank conducted an insurance business that the national bank could not legally acquire. Therefore, prior to the merger, the state bank contributed the insurance business to a newly formed subsidiary and distributed the stock of the subsidiary to the shareholders of the state bank in what was intended to qualify as a tax-free spin-off under section 368(a)(1)(D) and section 355. After the spin-off, the state bank merged into the national bank in a transaction the Service acknowledged was a reorganization under section 368(a)(1)(A).

Rejecting the Service’s position that section 355 could not be utilized in this manner, the court stated that it could not find in the “Code any support for the Commissioner’s suggestion of incompatibility between substantially contemporaneous divisive and amalgamating reorganizations.” The Service subsequently stated that it would follow Morris Trust. Also, the Service has made it clear that (1) in the post-spin-off reorganization, the distributing corporation and the controlled corporation may generally act as either the target or the acquirer in the reorganization, and (2) the post-spin-off transaction may be part of an integrated plan negotiated prior to the spin-off.

24. Id. at 800.
The ability of the distributing corporation or the controlled corporation to participate in a post-spin-off acquisitive reorganization is subject to the limits of section 355(e), which could cause such a reorganization to trigger gain to the distributing corporation on the distribution of the stock of the controlled corporation. Thus, section 355(e) imposes a corporate level tax and does not tamper with the tax-free treatment otherwise available to the shareholders of the distributing corporation under section 355(a).

Under section 355(e), the distributing corporation recognizes gain on the distribution of appreciated stock of the controlled corporation if, pursuant to a plan in existence at the time of the spin-off, there is a change in control (measured at 50%) of either the distributing corporation or the controlled corporation. Specifically, section 355(e) applies if [1] the conditions of section 355(a) are met, and [2] the distribution is “part of a plan (or series of related transactions) pursuant to which 1 or more persons acquire, directly or indirectly, stock representing a 50-percent or greater interest in the distributing corporation or any controlled corporation.” (section 355(e)(2)(A)(ii).) The term “a 50-percent or greater interest” is defined in section 355(d)(4) to mean “stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all classes of stock.”

Under section 355(e)(2)(B), a plan is presumed to exist if the acquisition of control occurs within a four-year period:

If 1 or more persons acquire directly or indirectly stock representing a 50-percent or greater interest in the distributing corporation or any controlled corporation during the 4-year period beginning on the date which is 2 years before the date of the distribution, such acquisition shall be treated as pursuant to a plan described in subparagraph [A](ii) unless it is established that the distribution and the acquisition are not pursuant to a plan or series of related transactions. Although the regulations under section 355(e) can provide some helpful guidance for ensuring that a distribution and subsequent acquisition are not part of a plan, as a practical matter, any *Morris Trust* type transaction negotiated prior to the distribution will constitute a plan. This is seen from the following safe harbor from the “plan” concept in the section 355(e) regulations, which would not apply to a *Morris Trust* transaction:

1. Safe Harbor I.—A distribution and an acquisition occurring after the distribution will not be considered part of a plan if—
   1. The distribution was motivated in whole or substantial part by a corporate business purpose [within the

(Mergers, Rel. #11, 5/16) 15–27
meaning of §1.355-2(b)), other than a business purpose to facilitate an acquisition of the acquired corporation (Distributing or Controlled); and

(ii) The acquisition occurred more than six months after the distribution and there was no agreement, understanding, arrangement, or substantial negotiations concerning the acquisition or a similar acquisition during the period that begins one year before the distribution and ends six months thereafter.27

The above principles can be illustrated as follows. Assume that pursuant to a plan negotiated between a distributing corporation and an acquirer, the distributing corporation distributed the stock of a controlled corporation in a spin-off qualifying under section 355, and immediately thereafter the controlled corporation was acquired by the acquirer in an acquisitive reorganization in exchange for 20% of the acquirer’s stock. In such case, because there is a change of control of the controlled corporation, the distribution would be taxable to the distributing corporation to the extent of the appreciation in the stock of the controlled corporation. The shareholders of the distributing corporation would, however, have tax-free treatment under section 355(a). Thus, there is only taxable gain at the distributing level, but this tax is most certainly a deal killer. On the other hand, if in the acquisition the shareholders of the controlled corporation received 50% or more of the stock of the acquirer, measured by both vote and value, both the distribution and the acquisition would be tax-free.

Fortunately, the control test in section 355(e) focuses on the economics of the transaction, and even if the distributing corporation or the controlled corporation are acquired in a post spin-off reorganization, section 355(e) does not apply as long as the shareholders of the acquired corporation (that is, the distributing corporation or the controlled corporation) satisfy the 50% control test with respect to the acquiring corporation, which was the case in the AT&T–Comcast transaction, discussed next.

[B] The AT&T Comcast Spin-Off Followed by Merger—A Reverse Morris Trust Transaction

In this transaction, pursuant to a plan negotiated between AT&T and Comcast, AT&T effectuated a spin-off of its broadband cable properties, and this company and Comcast were merged in exchange for the stock of a new holding company. The AT&T shareholders received more than 50% of the stock of the new holding company, but

27. Treas. Reg. § 1.355-7(d)[1].

15–28
the management of Comcast controlled the holding company. Since the AT&T shareholders received more than 50% of the stock, section 355[e] did not apply, and consequently, all parties received tax-free treatment in what is known as a “reverse Morris Trust” transaction. The transaction is referred to as a reverse Morris Trust transaction because the shareholders of the distributing or controlled corporation end up controlling the resulting corporation.

The transaction is described as follows in section II, Appendix 15C, AT&T–Comcast Spin-Off and Merger:

**The Structure of the AT&T Comcast Transaction.** The AT&T Comcast transaction will occur in several steps. First, AT&T will transfer the assets and liabilities of AT&T’s broadband business to AT&T Broadband, a holding company formed for the purpose of effectuating the AT&T Comcast transaction. Second, AT&T will spin-off AT&T Broadband to its shareholders. [This transfer to AT&T Broadband and the spin-off of its stock should qualify as a divisive “[D]” reorganization under sections 368[a][1][D] and 355] Third, Comcast and AT&T Broadband will each merge with a different, wholly owned subsidiary of AT&T Comcast. In the AT&T Comcast transaction, Comcast and AT&T shareholders will receive the consideration described below. The merger agreement provides for all of the steps described above to occur on the closing date for the mergers. [This is permissible as a result of Rev. Rul. 98-27, 1998-22 I.R.B. 4. As will be seen below the mergers are structured as reverse subsidiary mergers that are designed to qualify as a single Section 351 transaction. This is the horizontal double dummy structure discussed in chapter 9]

The tax consequences of first, the spin-off, and then, the holding company mergers, are described as follows in section IV of Appendix 15C:

Subject to the limitations and qualifications described in “The AT&T Comcast Transaction—Material Federal Income Tax Consequences,” it is the opinion of Wachtell, Lipton, Rosen & Katz, counsel to AT&T, that the AT&T Broadband spin-off will qualify as a tax-free reorganization. As a result, (1) no gain or loss will be recognized by AT&T or AT&T Broadband upon the separation and the AT&T Broadband spin-off . . . and (2) no gain or loss will be recognized by U.S. holders of AT&T common stock upon their receipt of shares of AT&T Broadband common stock in the AT&T Broadband spin-off.

Subject to the limitations and qualifications described in “The AT&T Comcast Transaction—Material Federal Income Tax Consequences,” it is the opinion of Wachtell, Lipton, Rosen
& Katz, counsel to AT&T, and Davis Polk & Wardwell, counsel to Comcast, that the mergers will constitute an exchange to which section 351 of the Internal Revenue Code applies. As a result, (1) no gain or loss will be recognized by Comcast, AT&T Broadband, the AT&T Broadband merger subsidiary, or the Comcast merger subsidiary upon the mergers and (2) except for gain or loss with respect to cash received instead of fractional shares, no gain or loss will be recognized by U.S. holders of AT&T Broadband common stock or Comcast common stock on the exchange of such stock for AT&T Comcast common stock.

[C] Controlled Corporation’s Indemnification of Distributing Corporation Against Section 355(e) Liability

As indicated above, it is common for the controlled corporation to indemnify the distributing corporation against tax liability in the distribution, including tax liability arising under section 355(e) as a result of a post-spin-off acquisition of the controlled corporation. Section VI.C of Appendix 15A, Morgan Stanley’s Spin-Off of Discover, contains the following discussion of the indemnification Discover provided to Morgan Stanley with respect to the potential section 355(e) liability:

Effect of Certain Acquisitions of Morgan Stanley Common Stock or Our Common Stock

Even if the distribution otherwise qualifies as a tax-free distribution under section 355 of the Code, the distribution may result in significant U.S. Federal income tax liabilities to Morgan Stanley if 50% or more of Morgan Stanley stock or our (Discover) stock (in each case by vote or value) is acquired, directly or indirectly, by one or more persons as part of a plan (or series of related transactions) that includes the distribution. For purposes of this test, any acquisitions of Morgan Stanley stock or our stock, or any agreement, understanding, arrangement or substantial negotiations regarding an acquisition of Morgan Stanley stock or our stock within two years before or after the distribution are subject to special scrutiny.

The process for determining whether a change in control prohibited under the foregoing rules has occurred is complex, inherently factual and subject to interpretation of the facts and circumstances of a particular case. If a direct or indirect acquisition of Morgan Stanley stock or our stock resulted in a change in control prohibited under those rules, Morgan Stanley (but not its stockholders) would recognize taxable gain as described above. Under certain circumstances, we (Discover) would be required under the tax sharing agreement to indemnify Morgan Stanley for this liability.
See “Arrangements Between Us and Morgan Stanley—Tax Sharing Agreement.”

[D] No Private Letter Ruling on Section 355(e)

Rev. Proc. 2003-48 provides that the Service will not issue a ruling on a section 355(e) issue. This Revenue Procedure requires that the taxpayer set forth the following representation in the ruling request regarding the absence of a section 355(e) issue:

(12) Distributions in Connection with Acquisitions. Regarding whether there is a plan [or series of related transactions] under § 355(e)(2)(A)(ii), submit one of the following REPRESENTATIONS: (i) There is no acquisition of stock of the distributing corporation or any controlled corporation [including any predecessor or successor of any such corporation] that is part of a plan or series of related transactions [within the meaning of § 1.355-7T] that includes the distribution of the controlled corporation stock; (ii) Each of the following acquisitions of stock of the distributing corporation or any controlled corporation [including any predecessor or successor of any such corporation] is or may be part of a plan or series of related transactions [within the meaning of § 1.355-7T] that includes the distribution of controlled corporation stock: [DESCRIBE ACQUISITIONS HERE]. Taking all of these acquisitions into account, stock representing a 50-percent or greater interest [within the meaning of § 355(d)(4)] in the distributing or controlled corporation [including any predecessor or successor of any such corporation] will not be acquired by any person or persons; or (iii) The distribution is not part of a plan [or series of related transactions] pursuant to which one or more persons will acquire directly or indirectly stock representing a 50-percent or greater interest [within the meaning of § 355(d)(4)] in Distributing or Controlled [including any predecessor or successor of any such corporation]. If a representation cannot be submitted exactly as requested, an explanation must be given. The taxpayer must submit one of the three representations set forth above [as set forth above or in appropriately modified form to the satisfaction of the Service] before the Service will issue a letter ruling. While the National Office will not determine whether a distribution and an acquisition are part of a plan [or series of related transactions] under § 355(e)(2)(A)(ii), the Service may rule on related significant issues [as defined in section 3.01(29) of Rev. Proc. 2003]. The determination of whether a distribution and an acquisition are part of a plan [or series of related transactions] may be made upon an examination of the taxpayer’s return.
§ 15:2.14 Disqualified Investment Companies and the Cash-Rich Split-Off

[A] In General

Pursuant to section 355(g), section 355 does not apply to a distribution involving a “disqualified investment company,” which generally encompasses a distributing or controlled corporation whose investment assets amount to two-thirds or more of its total assets, if “any person holds, immediately after the transaction, a 50-percent or greater interest in [the] disqualified investment corporation, but only if such person did not hold such an interest in such corporation immediately before the transaction.” (Section 355(g)(1)) Investment assets include cash, and consequently, assuming all of the other conditions of section 355 are satisfied, just under two-thirds of the distributing or controlled corporation’s assets could consist of cash or other investment assets.

Although the purported purpose of section 355(g), which was enacted in 2006, was to curtail what is referred to as “cash-rich split-offs,” as a practical matter, the statute allows such transactions as long as the cash and investment assets stay below the two-thirds limit. For example, the following transaction would not be prohibited by the provision. Assume that Hostile Shareholder has owned 25% of the stock of Distributing Corporation, a publicly held corporation, for more than five years, so that there is no potential applicability of section 355(d), discussed previously. The aggregate trading value of Distributing Corporation’s stock is $100M. Hostile Shareholder has proposed that Distributing Corporation distribute to Hostile Shareholder all of the stock of a newly formed Controlled Corporation in exchange for the stock of Distributing Corporation held by Hostile Shareholder in a transaction intended to qualify under section 355.

Specifically, Hostile Shareholder has proposed that as part of a divisive “[D]” split-off, Distributing Corporation first contribute to Controlled Corporation [1] Business B, an active trade or business that has been conducted by Distributing Corporation for more than five years that has a fair market value of $10M, plus [2] cash of $15M. Thus, Controlled Corporation would have assets with a total fair-market value of $25M. After these transfers to Controlled Corporation, Distributing Corporation would then distribute all of the stock of Controlled Corporation to Hostile Shareholder in redemption of all of Hostile Shareholder’s stock interest in Distributing Corporation. Assuming all of the conditions of section 355 are otherwise satisfied, the transaction will be tax-free to both Distributing
Corporation and Hostile Shareholder; section 355(g) is not applicable because Controlled Corporation is not a disqualified investment company because less than two-thirds of its assets are investment assets, that is, cash.

[B] Liberty Media’s Use of Cash-Rich Split-Off

Liberty Media, controlled by John Malone, entered into at least two “cash-rich split-offs”: one with Rupert Murdoch’s News Corp., in which Liberty acquired an interest in DirecTV plus cash, and one with Time Warner, where Liberty acquired the Atlanta Braves plus cash. A 2006 article in the Wall Street Journal describes the acquisition of the Braves:

Liberty is in talks to buy the Braves from Time Warner Inc., in exchange for about 63% of Liberty’s 4% stake in Time Warner. In addition to the ball club, valued at about $460 million, Time Warner would transfer about $1.38 billion in cash to Liberty. The deal is in the final stages of negotiation, and could be announced in the next few weeks, according to people familiar with the situation.

But this is no typical sale. Under normal circumstances, a company would face a corporate income-tax bill of roughly 39% if it sold stock it owned in another company for cash. Instead, Liberty is expected to completely avoid any taxes on the roughly $1.84 billion in Time Warner stock it is shedding in the deal, likely saving more than $600 million in taxes. Time Warner, meanwhile, would get back its stock, but also would avoid a big tax bill, this time on the appreciation in the value of the Braves.

The article goes on to explain that the deal is structured as a “cash-rich split-off“ which is sanctioned by the enactment of section 355(g) in 2006, “a provision, lobbied on by Time Warner and others, that essentially codifies the controversial structure, and is likely to make such deals more common.” In a May 17, 2007 press release, Liberty announced the completion of the deal:

Liberty Media Corporation (Nasdaq: LINTA, LCAPA) (“Liberty”) and Time Warner Inc. (NYSE: TWX) announced today that they completed a transaction on May 16, 2007, in which Liberty exchanged approximately 68.5 million shares of Time Warner common stock, subject to a working capital adjustment, for a newly created subsidiary of Time Warner which holds the Atlanta Braves, Time Inc.’s Leisure Arts, Inc. and $960 million of cash.

Berkshire Hathaway (BHI), a publicly held firm controlled by Warren Buffett, was a shareholder of Graham Holdings (GHC, formerly the Washington Post), a publicly held firm. GHC was also a shareholder of BHI. The stock held by each of BHI and GHC had appreciated in value. As discussed by Bob Willens in a 2014 article, the companies swapped their stock in each other in what appears to be a cash rich spin-off. The article describes the transaction as follows:

To eliminate that cross-holding, GHC will create a subsidiary, NewSub, to which it will convey (1) WPLG, a Miami-based television station, (2) shares of BHI . . . stock held by GHC, and (3) cash in exchange for the shares of GHC’s . . . stock owned by BHI.

Willens explains as follows why the transaction appears to qualify for tax-free treatment under section 355:

The instant BHI-GHC transaction appears to satisfy the requirements of section 355. GHC is distributing to a shareholder solely stock of a corporation [NewSub] that it controls. Both GHC and NewSub are engaged in the active conduct of a trade or business that has been actively conducted throughout the five-year period ending on the date of the distribution [hence the need for WPLG to be included in the assets of NewSub: It satisfies the active business requirement]; the distribution, because it’s not pro rata, cannot be used principally as a device for distributing earnings and profits; GHC is distributing all of its NewSub stock; and the distribution is carried out for one or more corporate business purposes.

However, pursuant to section 355(g), section 355 does not apply, and the transaction will be taxable if NewSub is a “disqualified investment corporation,” which is defined as follows in section 355(g)(2):

The term “disqualified investment corporation” means any . . . controlled corporation [NewSub] if the fair market value of the investment assets of the corporation [for example, stock and cash] is . . . 2/3 or more of the fair market value of all assets of the corporation[.]

Willens explains as follows how NewSub can avoid being characterized as a “disqualified investment corporation:”

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NewSub will have three categories of assets: (1) its active business asset, WPLG; (2) cash; and (3) BHI class A and class B common stock. The parties are valuing WPLG at $364 million. Accordingly, on the date of the distribution of NewSub’s stock, it is crucial that the value of the BHI stock and the cash that make up the balance of NewSub’s assets do not equal or exceed $728 million. If the value of the investment assets is kept below that level and the value of WPLG remains at $364 million, NewSub will not be a disqualified investment corporation, and the parties will accomplish their unwinding goals on the desired tax-free basis.

[D] Berkshire–P&G Cash Rich Split-Off

Berkshire Hathaway was a significant shareholder in P&G, a publicly held firm. P&G owned Duracell, a battery company. In a transaction announced in November 2014, P&G agreed with Berkshire to transfer the stock of Duracell to Berkshire in exchange for Berkshire’s stock in P&G. The transaction is structured as a cash rich split-off, because before the split-off, P&G will make a substantial contribution of cash to Duracell. The P&G press release on the deal gives the following insights into the transaction:

[P&G] plans to execute a split transaction, in which it will exchange a recapitalized Duracell Company for Berkshire Hathaway’s shares of P&G stock. . . .

Berkshire’s stock ownership [in P&G] is currently valued at approximately $4.7 billion. P&G said it expects to contribute approximately $1.8 billion in cash to the Duracell Company in the pre-transaction recapitalization.

P&G said the transaction maximizes the after-tax value of the Duracell business and is tax efficient for P&G [that is, permits P&G to dispose of Duracell without paying tax].

The Daily Tax Report gave the following insights into the tax benefit to Berkshire Hathaway:

Warren Buffett is again showing how to use the U.S. tax code to his advantage. For the third time in a year, the billionaire chairman of Berkshire Hathaway Inc. has structured a deal in which he buys businesses in exchange for stock that has appreciated. The transactions, called cash-rich split-offs, allow him to avoid capital gains taxes that would be incurred if he sold the shares in the open market.

Berkshire [will] turn over about $4.7 billion in Procter & Gamble Co. stock in exchange for P&G’s Duracell battery business, which will be infused with about $1.7 billion in cash.

Since Buffett’s cost basis on the shares was about $336 million, and corporate capital gains are typically taxed at 35 percent, structuring the deal in this way could save Berkshire more than $1 billion.\(^{28.3}\)

§ 15:2.15 **Leveraged Spin-Offs**

In structuring a spin-off, the distributing corporation will in many cases want, for example, the controlled corporation to (1) assume some of the debt of the distributing corporation, or (2) incur debt and pay the proceeds to the distributing corporation, which the distributing corporation would use to pay down its debt. These are two variants of what are commonly called leveraged spin-offs. Properly structured, they can be effectuated on a tax-free basis.

For example, if in connection with a divisive “[D]” reorganization, a controlled corporation assumes debt of the distributing corporation, under section 357(c), the distributing corporation will not realize gain as long as (1) the debt assumed does not exceed the adjusted basis of the assets contributed by distributing corporation to the controlled corporation, and (2) the debt was not assumed for a tax avoidance purpose as defined in section 357(b).

Assume that instead of an assumption of liabilities by the controlled corporation, as part of the transaction, the controlled corporation borrows cash which it transfers, in addition to its stock, to the distributing corporation in the exchange. In such case, under section 361(b)(3), the distributing corporation does not have gain (except to the extent the cash exceeds the basis of the contributed properties), provided the distributing corporation uses the cash to repay its creditors.

If the controlled corporation is previously existing and included in a consolidated return with the distributing corporation, the controlled corporation could incur debt and pay a pre-spin-off dividend to the distributing corporation, which the distributing corporation could use to repay its debt. As long as the dividend did not exceed the basis the distributing corporation had in the stock of the controlled corporation, the dividend and the spin-off would be tax-free. If the dividend exceeded the basis, there would be an excess loss account (ELA) (see chapter 9), which would cause the distributing corporation to recognize gain in the amount of the ELA on the distribution, because the

controlled corporation would no longer be a member of the consolidated group.

In each of the above scenarios, the distributing corporation can, without recognizing gain, extract cash from the controlled subsidiary to pay down its debt or have the subsidiary assume debt, but not in excess of the distributing corporation’s basis in the stock of the subsidiary or in the assets contributed to the subsidiary.

§ 15:3 Corporate Issues in Spin-Offs

§ 15:3.1 In General

A spin-off is a distribution, and generally the decision to engage in a spin-off can be made by the distributing firm’s directors without a vote of the shareholders. The directors will have to be certain, however, that there are no restrictions on the spin-off in any of the corporation’s contracts, including the certificate of designation or charter provisions dealing with preferred stock. For example, in *HB Korenvaes Investments, LP v. Marriott Corp.*, Marriott, a publicly held firm, was planning to spin-off a subsidiary, International, which would have a large part of the net worth of Marriott. The preferred stock of Marriott was to stay in place at the Marriott level. The preferred holders claimed, inter alia, (1) violation of fiduciary duty, and (2) violation of the preferred designation. In holding for Marriott, the court found that (1) Marriott’s board did not owe a duty of loyalty to the preferred shareholders, and (2) the rights of the preferred shareholders are to be determined by the certificate of designation, which did not prohibit the spin-off or require the approval of the preferred shareholders.

The decision to engage in a spin-off will generally be evaluated under the business judgment rule, unless the spin-off is a defensive measure, in which case the enhanced business judgment rule of *Unocal* would apply. [See chapter 5.] Also, as a distribution, a spin-off must satisfy the dividend provisions of the applicable state corporate law. Directors are personally liable for paying illegal dividends, and the limitation on liability statutes, such as section 102(b)(7) of the Delaware General Corporation Law, does not free directors of liability for paying illegal dividends. As indicated in the discussion of this issue in chapter 14, dealing with LBOs, under Delaware law a board can create revaluation surplus provided the firm’s assets are appreciated, thereby generating capacity to pay dividends.

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§ 15:3.2 The Corporate Agreements

The distribution will usually be made pursuant to a distribution and separation agreement between the distributing corporation and the controlled corporation, which will set out the terms and conditions of the spin-off. For example, section V of Appendix 15A, Morgan Stanley’s Spin-Off of Discover, explains:

The distribution will be accomplished pursuant to the terms and conditions of the separation and distribution agreement, pursuant to which Morgan Stanley will distribute to its stockholders of record all of the outstanding shares of our common stock.

You will not be required to make any payment for the shares of Discover common stock you receive, nor will you be required to surrender or exchange your shares of Morgan Stanley common stock or take any other action in order to receive Discover common stock. The distribution will not affect the number of outstanding Morgan Stanley shares or any rights of Morgan Stanley stockholders, although it will affect the market value of the outstanding Morgan Stanley common stock.

Section XIV.B of Appendix 15A, describes the separation and distribution agreement in detail, including the following:

The separation and distribution agreement will provide, among other things, for the principal corporate transactions required to effect the distribution of our common stock to the holders of record of Morgan Stanley common stock and certain other agreements governing our relationship with Morgan Stanley after the distribution. Set forth below are certain provisions expected to be included in the separation and distribution agreement. In addition to the separation and distribution agreement, the parties also expect to enter into certain ancillary agreements, including those described below.

It is common for the distributing corporation to provide the controlled corporation with certain services for a transitional period after the spin-off, pursuant to what is commonly referred to as a transitional services agreement. This was addressed in section XIV.D of Appendix 15A:

Transition Services Agreement

We will enter into a transition services agreement with Morgan Stanley pursuant to which Morgan Stanley and Discover will provide each other with a variety of services for a period of time, generally expected not to exceed 18 months, following the distribution. Services to be provided by Morgan Stanley and
Discover, directly or indirectly through their respective subsidiaries or subcontractors, will include services in the areas of human resources, information technology, accounting, office space leasing, corporate services and treasury. It is expected that compensation for transition services that are not marketed to third parties will be determined using an internal cost allocation methodology based on fully loaded cost (e.g., including an allocation of corporate overhead) or, in certain cases, on arm’s-length terms.

For an example of a transitional services agreement, see Appendix 2Q, Sample Transitional Services Agreement Relating to the Purchase of a Division. These agreements are discussed further in chapter 2, drafting acquisition agreements.

§ 15:3.3 Impact of Indenture in Split-Off—Liberty Media

Bank of New York Mellon v. Liberty Media\textsuperscript{30} illustrates the potential impact of debentures and other corporate contracts on the ability of a parent corporation to effectuate a spin-off or split-off.

Liberty Media was planning to transfer to its shareholders stock of a subsidiary containing certain assets in a split-off transaction (the Capital Split-off). Whereas in a spin-off a parent corporation distributes the stock of a subsidiary to all of the parent’s shareholders in accordance with their proportionate interests, in a split-off the parent distributes stock of the subsidiary to some of the parent’s shareholders in exchange for all or a portion of their stock in the parent.

The Capital Split-off was the fourth major distribution by Liberty of its assets in spin-off or split-off transactions since March 2004, and New York Mellon, the Trustee under an indenture for bondholders of Liberty, made the following claim:

[W]hen aggregated with the previous three transactions, the Capital Split-off would violate a successor obligor provision in an indenture . . . pursuant to which Liberty agreed not to transfer substantially all of its assets unless the successor entity assumed Liberty’s obligations under the Indenture (“Successor Obligor Provision”).\textsuperscript{31}

The court explained that if the Capital Split-off were considered in isolation and not aggregated with the prior distribution, “the Capital Split-off would not constitute a transfer of substantially all of Liberty’s assets or violate the Successor Obligor Provision.”\textsuperscript{32}

\textsuperscript{31} Id. at 227.
\textsuperscript{32} Id.
Applying New York law, the Delaware Supreme Court affirmed the Court of Chancery decision that the “substantially all” provision was not violated in the split-off, because “the Capital Split-off ‘is not sufficiently connected to the [prior spinoffs and split-off] to warrant aggregating the four transactions.”

§ 15:4 Federal Securities Issues Relating to Spin-Offs

A distribution by a real operating corporation of the stock of a real operating subsidiary in a spin-off does not involve a sale of the subsidiary’s stock and, therefore, does not have to be registered under the ’33 Act. This may not be the case in spin-offs by certain shell companies, but the transactions discussed here are spin-offs undertaken for legitimate business reasons by legitimate corporations. For these transactions, the SEC’s Division of Corporation Finance has ruled that the subsidiary does not have to register its shares that are spun off when:

- the parent shareholders do not provide consideration for the spun-off shares;
- the spin-off is pro rata to the parent shareholders;
- the parent provides adequate information about the spin-off and the subsidiary to its shareholders and to the trading markets;
- the parent has a valid business purpose for the spin-off; and
- if the parent spins-off “restricted securities,” it has held those securities for at least two years.

Each of these conditions is likely to be met in any legitimate spin-off. Also, even though such a spin-off does not have to be registered, the SEC has made it clear that the shareholders of the distributing corporation must be provided with adequate information on the subsidiary that is spun off. In a straight spin-off, information will be provided in an information statement prepared under section 14(c) of the ’34 Act, which was the case in Morgan Stanley’s spin-off of Discover. Section IX of Appendix 15A, Morgan Stanley’s Spin-Off of Discover, explains the purpose of the information statement:

This information statement is being furnished solely to provide information to Morgan Stanley stockholders who will receive shares of Discover common stock in connection with the

33. Id. at 243.
34. SEC Staff Legal Bulletin No. 4 (Sept. 16, 1997).
35. Id.
distribution. It is not provided as an inducement or encouragement to buy or sell any of our securities.

After completion of the spin-off of a subsidiary to public shareholders, the subsidiary will become subject to the '34 Act reporting requirements. In this regard, the newly public subsidiary will be required to file a Form 10 registration statement under section 12 of the '34 Act. (See Appendix 15B, Discover’s Form 10 Registration Statement Filed Pursuant to section 12 of the '34 Act.)

In a combined spin-off followed by a tax-free merger, the information requirement will be satisfied in the acquirer’s S-4 registration statement, which will include a proxy statement for the target’s shareholders, who will have the right to vote on at least the merger part of the transaction. (See Appendix 15C, AT&T–Comcast Spin-Off and Merger.)

§ 15:5 Is the Spin-Off a Fraudulent Conveyance?—Campbell Soup

A spin-off is a unilateral distribution, and consequently, the distributing parent does not receive reasonably equivalent value in exchange for the shares of the subsidiary distributed in the transaction. Thus, the first condition for a fraudulent conveyance under section 548 of the Bankruptcy Act (see the discussion of this issue in chapter 14 dealing with LBOs) is satisfied in a spin-off. Consequently, it is important that the second condition for a fraudulent conveyance not be present, that is, the distributing parent must not (1) be insolvent, (2) be unable to pay its debts, or (3) operate on an unreasonable small capital.

As illustrated in VFB LLC v. Campbell Soup Co., the fraudulent conveyance issue can also apply to the subsidiary that is distributed, where prior to the spin-off the subsidiary incurs debt and pays the proceeds to the parent in a leveraged spin-off. If after the spin-off the subsidiary goes bankrupt, the creditors of the subsidiary are likely to sue the parent alleging that the transfer of the cash to the parent was a fraudulent conveyance. If the transfer of the debt proceeds is considered to have been made without the receipt by the subsidiary of a reasonably equivalent value, then the transaction will be a fraudulent conveyance if after the spin-off the subsidiary (1) is insolvent, (2) is unable to pay its debts, or (3) operates on an unreasonable small capital. The Campbell Soup case found that the leveraged spin-off there was not a fraudulent conveyance because, inter alia, after the

36. VFB LLC v. Campbell Soup Co., No. 02-137 KAJ, 2005 U.S. Dist. LEXIS 19999 [D. Del. Sept. 13, 2005] [holding that the spin-off was not a fraudulent conveyance], aff’d, VFB LLC v. Campbell Soup Co., 482 F.3d 624 [3d Cir. 2007].
spin-off the subsidiary was not insolvent as indicated by the public trading value of the subsidiary’s stock.

§ 15:6 Business Reasons for Spin-Offs and Related Transactions

A good basic guide to some of the business considerations for spin-offs is provided in The Art of Spinning Off. This article points out the following business uses of spin-offs:

- **Greater Operational Focus on Core Business.** This involves the facilitation of “operational improvements by allowing each management team to focus on its own core business.”

- **Improving the Parent’s Position for Sale or IPO.** This involves the removal of underachieving businesses to allow management of the parent to concentrate on the parent’s business in preparation for sale or an IPO.

- **Facilitation of Follow-On Exit or Bolt-On Acquisitions.** On the exit side, this involves potential partial exits or partial IPOs, which can increase the “transparency of businesses with unique investment identities, unlocking sum-of-the-parts value.” With regard to bolt-on acquisitions, the equity of the newly spun off subsidiary may be used to effectuate bolt-on acquisitions.

- **Reduce the Impact of Litigation Overhang.** This involves the use of a spin-off to remove a business with litigation overhang, such as potential liability related to environmental matters, from the parent’s core business, thus improving the parent’s “valuation and capital markets attractiveness.”

Obviously, this type of litigation overhang motivated transaction would present fraudulent conveyance issues, which are discussed in section 15:5.

The article also points out that a business issue that will arise in virtually all spin-offs involves the “Control of Disaggregation.” This issue is particularly challenging when the business that is being spun off has been historically operated as a division and the separation of liabilities and assets is not clear. Using a spin-off that is completely under the control of the parent can “obviate the need for a bilateral negotiation of the separation issues.”


38. Id. at 13–14.

39. Id. at 14.