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Tax
WEBINAR SERIES

Spin-offs and M&A: A Deep Dive

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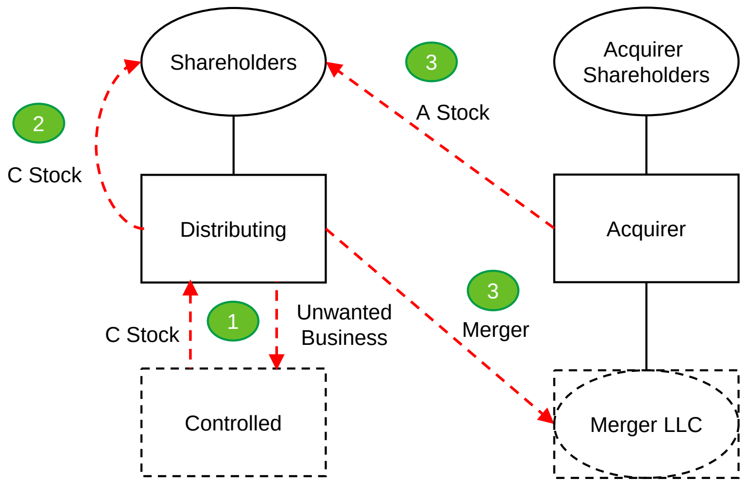
A. Basics

Morris Trust Basics

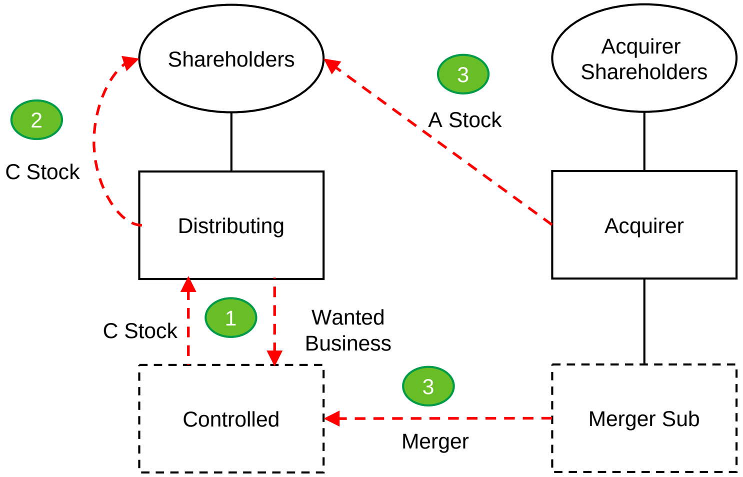
- Tax-free spin-offs are often undertaken to facilitate the acquisition of a business of either Distributing or Controlled by a third-party acquirer ("Acquirer").
- The most common form of this acquisition involves the post spin-off merger of either Distributing or Controlled with the Acquirer (the "Merger") whereby the relevant shareholders receive equity of the Acquirer as the merger consideration.
- These post spin-off Mergers are often referred to as a "Morris Trust" transaction (if Distributing is the Merger target) or "Reverse Morris Trust" transaction (if Controlled is the Merger target). See CIR v. Morris Trust, 367 F.2d 794 (4th Cir. 1966).
- As discussed in further detail below, the terms of the Merger must satisfy certain criteria, including as regards the type of consideration received in the Merger and the minimum percentage of Acquirer stock Distributing (or Controlled, as relevant) shareholders must own post-merger, to ensure that the Merger does not adversely impact the tax free treatment of the spin-off.

Morris Trust vs. Reverse Morris Trust



Morris Trust - Distributing is Acquired

- Distributing contributes Unwanted Business (i.e., the business that Acquirer does not want to acquire) to Controlled in exchange for Controlled stock.
- Distributing distributes the Controlled stock to its shareholders.
- Distributing merges with and into Merger LLC with Merger LLC surviving, and Distributing's shareholders receive more than 50%, by vote and value, of Acquirer stock.



Reverse Morris Trust - Controlled is Acquired

- Distributing contributes Wanted Business (i.e., the business that Acquirer does want to acquire) to Controlled in exchange for Controlled stock.
- Distributing distributes the Controlled stock to its shareholders.
- Merger Sub merges with and into Controlled with Controlled surviving, and Controlled's shareholders receive more than 50%, by vote and value, of Acquirer stock.

Tax Issues Relating to Morris Trust Transactions

- There are a number of tax issues that must be considered in connection with a Morris Trust or Reverse Morris Trust transaction that could impact the tax-free treatment of the spin-off including:
  - Device
  - Continuity of Interest
  - Section 355(e) - This requirement is discussed in greater detail below

Device

- To qualify for tax-free treatment, a spin-off transaction may not be used as a device to distribute the earnings and profits of Distributing or Controlled.
- The determination of whether a transaction is principally used as a device is based on all facts and circumstances. In addition, the regulations provide certain device and non-device factors.
- These factors include:
  - A pro-rata distribution;
  - A subsequent sale or exchange of stock; or
  - The nature of the assets of Distributing and Controlled immediately after the distribution (discussed further on the next slide).

Device continued

- The nature of the assets of Distributing or Controlled immediately after the distribution is relevant to the monetization transactions discussed below. The regulations make clear that "cash or other liquid assets" are not assets used in a trade or business (i.e., are evidence of a device).
- Since either a Morris Trust or a Reverse Morris Trust transaction involves a disposition of either Distributing of Controlled after the distribution, there is potential for the disposition to be considered a device if it is not a tax-free reorganization.
- When analyzing a Morris Trust or Reverse Morris Trust transaction it is important to consider (i) the type of transaction and (ii) the proximity of the acquisition to the spin-off.
  - If the acquisition is a tax-free reorganization, there is ordinarily not evidence of a device because the shareholders have not monetized their stock of Distributing or Controlled.
  - The regulations provide that the proximity of the negotiations or taxable acquisition to the spin-off impact whether there is substantial evidence of a device.

Continuity of Interest

- Section 355 regulations also require "continuity of shareholder interest." For a spin-off transaction to satisfy this requirement, one or more of the pre-distribution direct or indirect historic shareholders must own an amount of stock "establishing continuity of interest."
- There is no clear answer regarding what ownership percentage is sufficient to "establish continuity of interest" but two examples in the regulations provide that (i) 50% is sufficient, while (ii) 20% is not.
- One PLR suggests that 40% would be sufficient, which aligns with an example in the acquisitive reorganization regulations (which regulations are not applicable to divisive reorganizations or Section 355 distributions).
- In a Morris Trust or Reverse Morris Trust transaction that satisfies Section 355(e) because Distributing (or Controlled, as relevant) shareholders own more than 50% by vote and value of Acquirer stock (discussed further below), continuity of interest would also generally be expected to be satisfied.

Section 355(e): Anti-Morris Trust Rule

- Section 355(e) provides that Distributing (but not its distributee shareholders) recognizes gain on a distribution if, pursuant to a plan or series of related transactions with the spin-off transaction, one or more person acquires 50% or more of the vote or value of Distributing or Controlled pursuant to a plan including the distribution.
- Most spin-off transactions will involve a tax matters agreement whereby Controlled agrees to indemnify Distributing if Controlled takes any action that triggers taxable gain to Distributing under Section 355(e). Further, Controlled is typically required to request Distributing's permission to enter into certain transactions, e.g., an acquisition, during the two-year period after the spin-off transaction.

B. Shrink to Fit Transactions

Shrink to Fit Transactions

- As noted, Distributing (or Controlled, as relevant) shareholders must own a greater than 50% interSection 355(e).
- As a result, in general**,** Distributing (or Controlled, as relevant) must be larger than Acquirer at the time of the Merger, which may require a “shrink to fit” (e.g., via a leveraged distributionest (by vote and value) in the Acquirer after a Merger to avoid corporate level gain under) to make the relative values work for tax purposes.
- Generally, these “shrink to fit” transactions don’t impact the tax treatment of the spin-off or the Merger. However, there may be non-tax commercial issues with such transactions, including (among others) the following:
  - Source of funds for a shrinking distribution (including cost of financing if the funds are borrowed); and
  - For publicly traded companies, protecting against significant changes in trading price (and therefore in value) between signing and closing.

C. Leverage Considerations

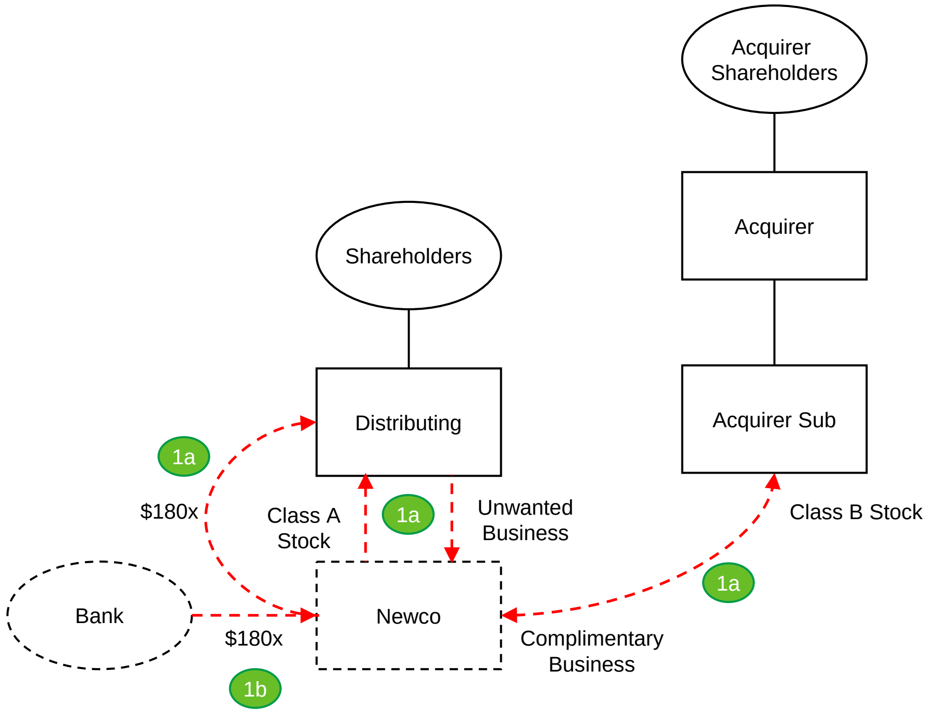
Monetization and Leverage, Generally

- As noted above, there are significant limitations on the ability of the Acquirer to pay cash consideration to the Distributing (or Controlled) shareholders without negatively impacting the tax-free treatment of the spin-off.
- There may nonetheless be methods for a spin-off transaction to result in a monetization of the assets being spun-off in a tax efficient manner via a leveraged spin-off.
- As discussed on the following slides, the structure for a monetization via a leveraged spin-off may depend on whether Distributing or Controlled is being acquired in the Merger.

Monetization and Leverage Acquisition of Controlled

- In a Reverse Morris Trust (i.e., a post spin-off acquisition of Controlled), a leveraged spin-off may result in monetization via a debt issuance by Controlled and a related cash distribution to, or reduction in debt by, Distributing.
- These leveraged spin-off structures (which were discussed in greater detail in the previous presentation) include:
  - Assumption of Distributing debt by Controlled
  - Payment of cash (funded by borrowing) by Controlled to Distributing (followed by a payment of the cash to Distributing creditors or shareholders)
  - Issuance of new Controlled debt to Distributing, which is used to repay Distributing debt
- The amount of debt in some (but not all) of these structures may be limited by the tax basis in the assets contributed to Controlled. In addition, in the context of a Reverse Morris Trust, the amount of debt may be further limited to the extent it could reduce the value of Controlled below 50% of the value of the combined entity.
- However, as demonstrated on the following slides, there may be ways to obtain a significant monetization notwithstanding the tax basis or Reverse Morris Trust limitations.

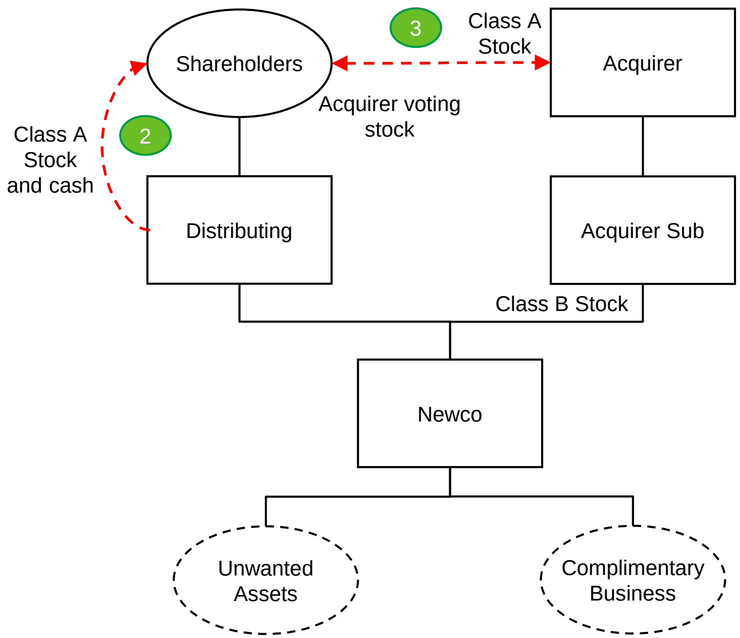
Monetization and Leverage - "Enhanced Leverage Pre-Acquisition Integration" § 361(b) Transaction



Facts

- Step 1(a): Distributing and Acquirer Sub form Newco
  - Distributing contributes Unwanted Business worth $200x (with a $10x tax basis) to Newco in exchange for $20X of Class A stock and $180x cash (see Step 1b).
    - The Class A stock possesses at least 80% of the vote of Newco, but less than 80% of the value of Newco.
  - Acquirer Sub contributes Complimentary Business worth $100x to Newco in exchange for $100x of Class B stock.
    - The Class B stock possesses less than 20% of the vote in Newco, but more than 20% of the value in Newco.
    - The amount of assets contributed by Acquirer Sub (plus the Unwanted Business) needs to be sufficient to support the $180x of borrowing in Step 2.
- Step 1(b): Simultaneously with Step 1(a), Newco borrows $180x from Bank, which is distributed in accordance with Step 1(a).

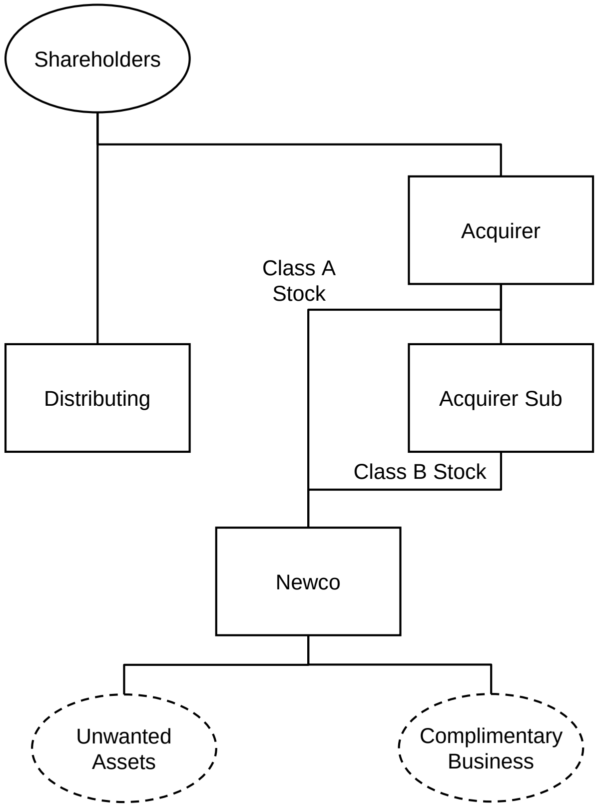
Monetization and Leverage - "Enhanced Leverage Pre-Acquisition Integration" § 361(b) Transaction



Facts

- Step 2: Distributing distributes Class A stock in Newco and cash to its shareholders.
  - Distributing may use up to $10x of the cash (i.e., an amount of cash equal to tax basis in assets) to repay debt.
- Step 3: Acquirer or Acquirer Sub acquires the Class A Newco stock from Distributing shareholders in exchange for Acquirer stock in a tax-free reorganization or Section 351 transaction.

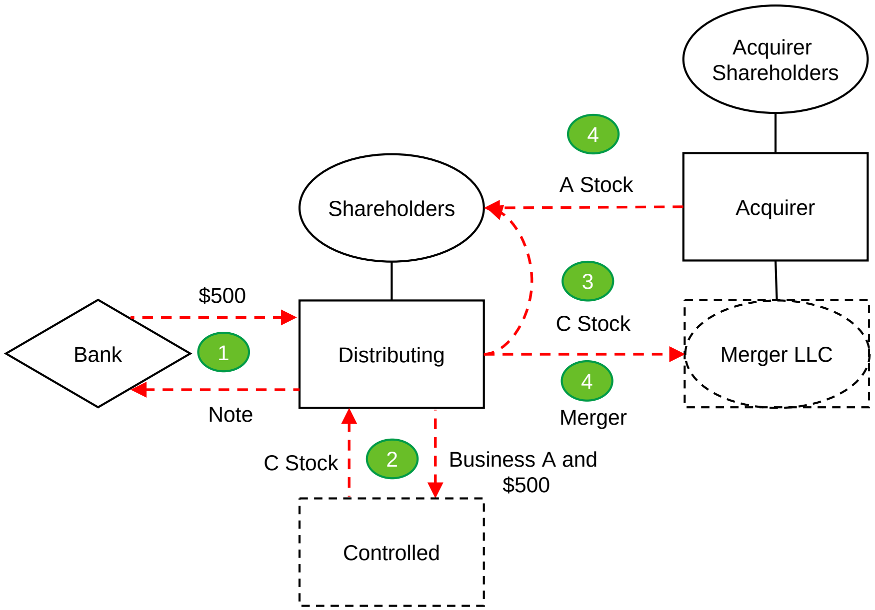
Monetization and Leverage - "Enhanced Leverage Pre-Acquisition Integration" § 361(b) Transaction Final Structure



U.S. Federal Income Tax Consequences for an "Enhanced Leverage Pre-Acquisition Integration" § 361(b) Transaction

- Assuming the spin-off in step 2 qualifies under Sections 361 and 355, the receipt of cash and distribution should not give rise to gain (notwithstanding that cash distributed is in excess of basis).
- Additionally, since Distributing never owns 80% of the vote and value of Newco, Distributing and Newco are never consolidated (and therefore the cash distribution in excess of basis should not give rise to an ELA that could be triggered in the spin-off).
- The subsequent acquisition of the Class A stock would result in taxation to Distributing under Section 355(e), but the gain recognized should be limited to $20x. Note that this step should be structured as a tax-free transaction to avoid any device issues.

Monetization and Leverage Reverse Spin and Acquisition of Distributing



Facts

- Distributing borrows $500 from a Bank.
- Distributing transfers Business A (FMV of $1,000, basis of $400) and $500 cash to Controlled in exchange for Controlled stock.
- Distributing distributes the Controlled stock to its shareholders.
- Distributing merges with and into Merger LLC (a disregarded entity) with Acquirer surviving, and Distributing's shareholders receive more than 50%, by vote and value, of Acquirer stock.

Considerations

- The borrowed proceeds are not limited to Distributing's basis in the assets transferred to Controlled.
- It is necessary to analyze the device test, particularly given the amount of cash on Distributing's balance sheet.

V. Section 355(e)

Anti-Morris Trust Rules

- If one or more persons acquire 50% or more (by vote or value) of either Distributing or Controlled stock pursuant to a “plan or series of related transactions” with the spin-off, the distribution is generally taxable to Distributing (but not Distributing's shareholders).
- Acquisitions that occur within 2 years of the distribution are presumed to be part of a “plan or series of related transactions.”
  - Presumption is rebuttable.
  - Regulations provide a number of safe harbors and a facts and circumstances test.
- Each acquisition of Distributing or Controlled stock is tested separately to determine if it is pursuant to “plan or series of related transactions” with the distribution and all such “plan” acquisitions are aggregated.

A. Super Safe Harbor

Super Safe Harbor

- The Section 355(e) regulations contain a “super safe harbor” for post-distribution acquisitions not involving a public offering.
- The regulations provide that a post-distribution acquisition can only be part of a plan if there was an agreement, understanding, arrangement, or substantial negotiations regarding the acquisition or a similar acquisition at some time during the two-year period ending on the date of the distribution.
- Substantial negotiations in the case of an acquisition (other than involving a public offering) generally require discussions of significant economic terms, e.g., the exchange ratio in a reorganization, by one or more officers, directors, or controlling shareholders of Distributing or Controlled, or another person or persons with the implicit or explicit permission of one or more officers, directors, or controlling shareholders of Distributing or Controlled, with the acquirer or a person or persons with the implicit or explicit permission of the acquirer.

B. Other Safe Harbors

Safe Harbors

- In addition to the “super safe harbor” the Section 355(e) regulations contain nine additional safe harbors relating to specific fact patterns.
- These safe harbor provisions provide different standards that, if satisfied, mean the acquisition and distribution are not part of a plan. Some focus on post-distribution acquisitions, while others relate to pre-distribution acquisitions.

Post-Acquisition Safe Harbors

- Safe Harbor I applies if the (i) acquisition occurs more than six months after the distribution and the distribution was motivated in whole or substantial part by a corporate business purpose other than to facilitate an acquisition of the acquired corporation; and (ii) there was no agreement, understanding, arrangement, or substantial negotiations concerning the acquisition or a similar acquisition during the period beginning one year before and ending six months after the distribution.
- Safe Harbor II applies if the (i) acquisition occurs more than six months after the distribution and the distribution was not motivated by a business purpose to facilitate the acquisition or similar acquisition; and (ii) there was no agreement, understanding, arrangement, or substantial negotiations concerning the acquisition or a similar acquisition during the period beginning one year before and ending six months after the distribution; and (iii) no more than 25% of the stock of the acquired corporation was either acquired or subject of an agreement, understanding, or substantial negotiations during the same period as (ii).
- Safe Harbor III applies if the acquisition occurs after a distribution in which there was no agreement, understanding or arrangement concerning the acquisition at the time of the distribution or within one year after the distribution.

Pre-Acquisition and Public Offering Safe Harbors

- Safe Harbor IV provides that a pre-distribution acquisition will not be considered part of a plan if it occurs before the first “disclosure event”, which is defined as ***any*** (emphasis added) communication by an officer, director, controlling shareholder, or employee of Distributing or Controlled (or any corporation related to them) regarding even the possibility of a distribution.
- The Non-Public Offering and Public Offering Safe Harbors.
  - Safe Harbor V provides that a pro-rata distribution to Distributing shareholders and an acquisition (other than a public offering) of Distributing stock will not be considered part of a plan if (i) the acquisition occurs after the date of the public announcement of the distribution and (ii) there were no discussions by Distributing or Controlled with the acquirer regarding the distribution on or before the date of the public announcement.
  - Safe Harbor VI provides that a distribution and an acquisition involving a public offering occurring before the distribution will not be considered part of a plan if the acquisition occurs before the date of the first disclosure event regarding the distribution in the case of stock that is not listed on an established market immediately after the acquisition or before the date of the first public announcement in the case of stock listed on an established market immediately after the acquisition.

Post-Acquisition Safe Harbors

- Safe Harbor VII generally provides that an acquisition (other than involving a public offering) of Distributing or Controlled that is listed on a domestic public market is not part of a plan if, immediately before or immediately after none of the transferor, the transferee, or a coordinating group is (i) the acquired corporation, (ii) a corporation controlled by the acquired corporation or a member of the controlled group of which the acquired corporation is a member (within the meaning of Section 1563), (iii) a controlling shareholder or a ten percent shareholder of the acquired corporation.
- Safe Harbor VIII applies if, in a transaction to which Section 83 or 421(a) or (b) applies, stock of Distributing or Controlled is acquired someone in connection with the performance of services for Distributing, Controlled, a related person (defined in Section 355(d)(7)(A)), a corporation that acquires the assets of which are acquired by Distributing, Controlled, or a related person, or a corporation that acquires the assets of Distributing or Controlled.
- Safe Harbor IX applies if the stock of Distributing or Controlled is acquired by a retirement plan of Distribution or Controlled. Note that this exception does not apply to the extent that the stock of Distributing or Controlled acquired during the four year period beginning two years before the distribution exceeds (in the aggregate) more than ten percent of the total combined voting power.

Facts and Circumstances Test

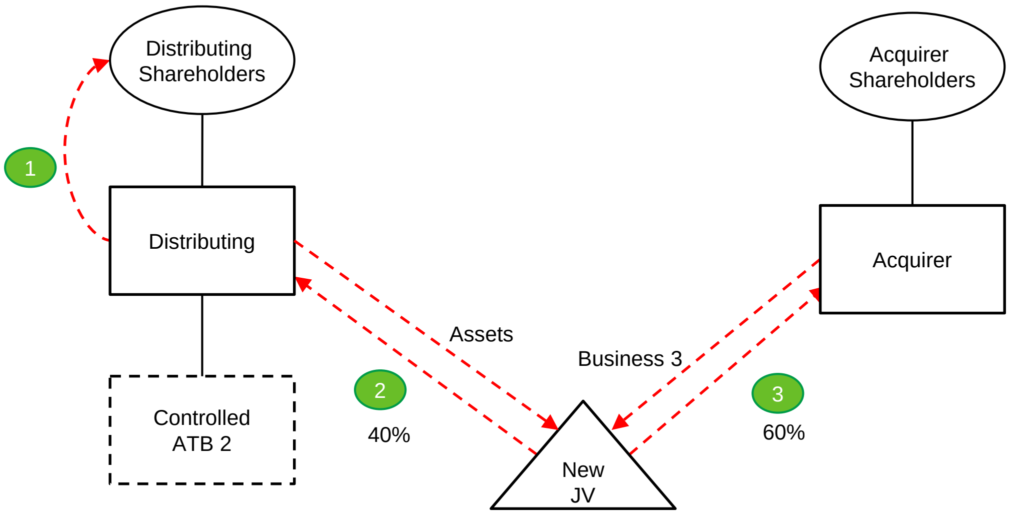
- Acquisitions that are not covered by any of the safe harbors discussed above or others in the regulations may still be able to avoid being designated as part of a plan under the facts and circumstances test.
- The regulations contain a non-exclusive list of factors that are “plan” and “non-plan” factors which must be analyzed for the specific facts and circumstances.
- Plan factors include:
  - A post-distribution acquisition or public offering and distribution tend to be part of a plan if there was an agreement, understanding, arrangement, or substantial negotiations regarding the acquisition or public offering.
  - A pre-distribution acquisition or public offering and distribution tend to be part of a plan if there was discussion regarding a distribution (i.e., could have been a different distribution than the one effected).
- Non-Plan factors include:
  - A post-distribution acquisition or public offering that occurs outside the two year period after the acquisition or due to unexpected events.
  - A pre-distribution acquisition of public offering that does not occur within the two year period ending on the earlier of the acquisition or first public announcement regarding the distribution or due to unexpected events.
  - The distribution would have occurred in the absence of the acquisition.

C. Section 355(e) and Partnerships

Section 355(e) Predecessors and Successors

- Section 355(e)(4)(D) provides that, for purposes of section 355(e), “any reference to [Controlled] or [Distributing] shall include a reference to any predecessor or successor of such corporation.”
- On December 16, 2019, final Section 355(e) regulations (TD 9888) were issued that address issues concerning predecessors and successors of Distributing and Controlled.
- Among other things, the preamble confirms that a partnership cannot be a successor for purposes of Section 355(e).

Successors and Partnerships



Facts

- Distributing spins off Controlled,
- As part of a plan involving the spin, D transfers 100% of its assets to New JV in exchange for 40% of New JV, and
- Unrelated X transfers Business 3 to New JV in exchange for 60% of New JV.

Considerations

- Does Section 355(e) apply?
- Note that Section 355(e) would apply if either Acquirer acquired Distributing or Distributing acquired Acquirer because Distributing shareholders would own only 40% of the stock of the combined company.

VI. Executive Compensation Issues in Spin-offs

A. Treatment of Equity Awards in Spin-Offs

Treatment of Equity Awards in Spin-Offs

- Employment Approach
  - Employees remaining with Distributing hold only Distributing equity awards after the spin-off
  - Employees staying with Controlled hold only Controlled equity awards after the spin-off
  - Aligns executives' interests with the interests of their post-spin employer's shareholders
  - Reduces the administrative burdens associated with non-employees participating in equity plans post-spin
- Shareholder Approach
  - Employees are treated in the same manner as shareholders generally, with each of an employee's equity awards being converted into a Distributing equity award and a Controlled equity award
  - Following the spin-off, employees hold equity awards covering shares of both entities regardless of which entity is continuing the employees' employment
  - Requires Distributing and Controlled to share information about terminations of service and forfeitures
- Hybrid Approach
  - Distributing and Controlled implement a combination approach, with some equity awards held in an employee's employer and other equity awards converted into both a Distributing equity award and/or a Controlled equity award
  - Distributing may treat awards differently based on the type of award, when an award was granted, vested status of award, grant date of award and/or holder of award

B. Tax Deduction for Equity Awards Post-Spin

Tax Deductions for Equity Awards Post-Spin

- Section 83(h) and Section 404(a)(5) generally provide that the *service recipient* is entitled to a compensation deduction when the service provider includes the compensation in income
- *Transfer of Property – Restricted Stock / Stock Options*
  - Section 83(h) "the deduction shall be allowed for the taxable year of such person in which or with which ends the taxable year in which such amount is included in the gross income of the person who performed such services"
    - If a Section 83(b) election has been made for a restricted stock award prior to spin-off, consider having employees make a new "protective" election in respect of the go-forward appreciation
  - Treas. Reg. 1.83-6(a)(1) provides that a transfer of property in connection with the performance of services is deductible under Section 162 *by the person for whom the services were performed*
  - Treas. Reg. 1.83-6(d)(1) provides that if such transfer of property is made by Parent to an employee of Subsidiary in respect of services performed by the employee, the transfer will represent a capital contribution from Parent to Subsidiary and the transfer will be deductible by the Subsidiary
- *Deferred Compensation – Restricted Stock "RSUs" / Stock Appreciation Rights "SARs"*
  - Section 404(a)(5) "if contributions are paid by an employer . . . under a plan deferring the receipt of such compensation . . . they shall be deductible under this section . . . in the taxable year in which an amount attributable to the contribution is includible in the gross income of employees participating in the plan"
  - Treas. Reg. 1.404(a)-12 "a deduction is allowable . . . only in the taxable year *of the employer* in which or with which ends the taxable year of an employee in which an amount attributable to such contribution is includible in his gross income as compensation"

Tax Deductions for Equity Awards Post-Spin

- *Revenue Ruling 2002-1*:
  - Distributing (Parent) spun off Controlled (Subsidiary) in a tax-free spin-off under Section 355(c)
  - Employees of Distributing and Controlled each received restricted stock and stock options in Distributing – and Controlled – in connection with the spin-off (the "Shareholder Method")
  - Distributing and Controlled were each entitled to a tax deduction with respect to vested restricted stock awards or exercise of stock options held by their employees for the amount includible in the employees' income in the year in which the employees recognized the income
  - Neither Distributing nor Controlled recognize gain or loss in connection with the vesting of restricted stock or the exercise of stock options under Section 1032
- *Private Letter Rulings*
  - In contrast, several private letter rulings prior to Revenue Ruling 2002-1 had concluded that the deductions are allowed to the entity that *issues its shares* in satisfaction of the options upon exercise
  - In Private Letter Ruling 200031028, the IRS indicated that the allocation of the Section 83(h) deduction following the spin-off is a question of fact and each corporation should apportion the deduction
- *Tax Sharing Agreement*
  - Distributing and Controlled may wish to agree on the allocation of the deductions associated with the equity awards in a tax-sharing or similar agreement

C. Stock Options – Section 424 (ISO) and Section 409A (NQSO) Considerations

Stock Options – Section 424 (ISO) and Section 409A (NQSO) Considerations

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- *Adjustment or conversion of Stock Options*:
  - Each individual award is typically adjusted in a manner that maintains its intrinsic value;
  - ISOs are adjusted in accordance with Code Section 424; and
  - Non-qualified stock options are adjusted in accordance with Section 409A
- *Incentive Stock Options "ISOs"*: Under Code Section 424, to maintain the favorable tax treatment, adjustments to ISOs:
  - the adjustment to the number of shares subject to an ISO and the per share exercise price must comply with:
    - *the spread test*: the excess of the aggregate FMV of the shares subject to the adjusted option over the aggregate exercise price (the spread value) must not be greater than the spread value of the corresponding stock option immediately before adjustment; and
    - *the ratio test*: on a per share basis, the ratio of the exercise price to the FMV of each adjusted stock option cannot be less than the ratio of the exercise price to the FMV of the corresponding stock option immediately before adjustment
  - Distributing ISOs held by Controlled employees will be eligible for tax-favorable ISO treatment only if the holder exercises the ISO within 3 months of the spin-off event if no longer related

Stock Options – Section 424 (ISO) and Section 409A (NQSO) Considerations

- *Non-qualified Stock Options "NQSOs"*: If the requirements of Section 409A or Section 424 are satisfied, the adjustment of non-qualified stock options is not a new grant for option holders
- Section 409A's requirements are less strict than Section 424 but requires that the spread test be met but does not require that the ratio test be met or that the employee's employer or one of its related entities grant the award

D. Section 280G Considerations

Section 280G Considerations

- Section 280G prohibits a corporation from deducting certain “parachute payments” in connection with a Change in Control event
- Section 4999 imposes a 20% excise tax on the individual receiving the parachute payments
- In the context of a Morris Trust or Reverse Morris Trust transaction, a “Change in Control” under Section 280G may be triggered upon the post-spin Merger, typically with respect to the entity whose shareholders control less than 50% of the combined entity
  - A Section 280G analysis should be performed and Section 280G planning should be considered
- Section 280G would typically not be implicated in a spin-off-only transaction because no “Change in Control” will occur

E. Specified Employee Analysis

Section 409A Specified Employee Analysis

- Under Section 409A an employer that has publicly traded stock may not pay any deferred compensation to a "specified employee" until 6 months after the specified employee incurs a separation from service
- Following a spin-off transaction, Distributing's specified employees that continue employment with either Distributing or Controlled remain specified employees of their employer until the next specified employee effective date
- Specified employee identification and effective dates that were in effect before the spin-off continue for both Distributing and Controlled until changed
- To ensure that Controlled meets Section 409A's requirements with respect to specified employees, Controlled should:
  - Create and maintain a list of specified employees;
  - Be aware of Distributing's specified employee identification and effective dates that will initially apply to Controlled; and
  - Ensure Controlled's relevant executive compensation arrangements include language requiring the six-month delay for relevant payments to specified employees