Weil partners Devon Bodoh, Joe Pari, Greg Featherman, Amy Rubin and Paul Wessel presented on “Spin-offs and M&A – A Deep Dive,” Part II of a three-part series focused on spin-offs within Weil’s 2021 Tax Webinar Series.

Key Takeaways

I. Introduction

Mr. Bodoh introduced the focus of the panel, which was spin-off transactions in the mergers and acquisitions (“M&A”) context. The panel included a discussion of limitations under the U.S. tax rules on the ability to execute an M&A transaction without impacting the tax-free nature of the spin-off, and related matters such as employee benefits and executive compensation.

Mr. Pari described how the acquisition of the corporation making the spin-off distribution (“Distributing”) or the corporation being spun-off (“Controlled”) in connection with a spin-off (commonly referred to as a “Morris Trust” transaction when Distributing is acquired and a “Reverse Morris Trust” transaction when Controlled is acquired) allows a company to make itself an attractive acquisition target by separating assets the acquirer may not want. Mr. Pari noted that while these transactions came into play when ordinary income tax rates were significantly higher than capital gains tax rates (which is no longer the case), Morris Trust and Reverse Morris Trust transactions remain common.

There are a number of specific requirements to achieve tax-free treatment for a spin-off that are implicated by Morris Trust (or Reverse Morris Trust) transactions. These include continuity of interest, the device requirement and Section 355(e)[1] (discussed further below).

In particular, with respect to the device requirement, Mr. Pari noted that while post spin-off acquisitions of Distributing or Controlled are generally considered evidence that the spin-off is a “device” for the distribution of earnings and profits, the acquisition of Distributing or Controlled in a tax-free transaction is generally not considered evidence of device.

II. Shrink to Fit and Leveraged Spin-Off Considerations

Next, Mr. Pari described Section 355(e) which states that if one or more persons acquire 50% or more of Distributing or Controlled pursuant to the same plan as the spin-off (each such acquisition counting towards this 50% threshold, a “plan acquisition”), the distribution is taxable to Distributing. Mr. Bodoh and Mr. Pari then discussed the use of distributions immediately prior to a spin-off (referred to as “midnight dividends”) that are intended to shrink the value of the acquirer sufficiently such that the shareholders of Distributing (or Controlled, as applicable) hold more than 50% of the acquirer stock after the acquisition. Midnight dividends are usually undertaken at the last moment before the acquisition to ensure that the acquisition is certain to occur before the dividend is paid.

Mr. Pari subsequently discussed the use of leverage in Morris Trust and Reverse Morris Trust structures, including an overview of common methods used in connection with spin-offs (*see* the

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[1] All references to “Section” are to sections of the Internal Revenue Code of 1986, as amended.

following link for a presentation and discussion of such methods in Part I of the series: https://tax.weil.com/speaks/spin-offs-in-the-current-uncertain-environment/).

In addition to the general overview of leveraged distributions, Mr. Pari described other specific transaction structures that allow for a monetization in connection with a spin-off that are intended to not impact the ability of the spin-off to qualify for tax-free treatment.

III. Section 355(e) Safe Harbors

Next, Mr. Featherman discussed Section 355(e) including specifically how to analyze whether a specific acquisition of Distributing or Controlled stock is a plan acquisition. Mr. Featherman discussed various safe harbors provided for in the Treasury Regulations that, if satisfied with respect to a specific acquisition, cause the acquisition to not be treated as a plan acquisition. These include a "Super Safe Harbor" (which provides that a post-spin acquisition will not be a plan acquisition unless 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), and nine other safe harbors applicable to specific fact patterns.

Mr. Featherman also touched on the "facts and circumstances" test, which may be applicable with respect to an acquisition if none of the safe harbors are satisfied. The "facts and circumstances" test is applied by weighing a number of "plan" and "non-plan" factors.

Finally, Mr. Featherman discussed recent Treasury Regulations under Section 355(e), which provide that a partnership cannot be a "predecessor" or "successor" for purposes of applying the Section 355(e) rules. This is considered to be a taxpayer favorable decision to the extent that it allows the use of a partnership in a post spin-off combination of Distributing or Controlled with another business without implicating Section 355(e) (in a manner that would not have been available if a corporate entity had been used for the combination).

IV. Executive Compensation Considerations

Ms. Rubin provided an overview of three approaches for treating existing equity awards in the context of a spin-off transaction, which consisted of the Employment Approach, the Shareholder Approach and the Hybrid Approach. Ms. Rubin described the basic mechanics of each approach and provided insight into the basis for using each approach.

Next, Mr. Wessel described the basic provisions of the Internal Revenue Code and Treasury Regulations which govern the timing of compensation deductions including Section 83(h), which governs the deduction for transfers of property including restricted stock and stock options, and Section 404(a)(5), which governs the deduction for the issuance of RSUs and stock appreciation rights. Mr. Wessel also noted that under Treasury Regulation 1.83-6(d) a Subsidiary receives the deduction for property transferred thereto from its Parent. Ms. Rubin noted that if a Section 83(b) election has been made with respect to a restricted stock award prior to the spin-off, it is prudent to make a Section 83(b) election for restricted stock into which that award is converted in the spin-off.

Mr. Wessel then discussed Rev. Ruling 2002-1 that addresses Section 1032 as well as the deductibility of awards following a spin-off transaction. Ms. Rubin addressed the facts of that

ruling and other private letter rulings which provide guidance on which entity is entitled to a tax deduction for the vesting and exercise of equity awards post-spin. Mr. Wessel noted that because the IRS has indicated that the deduction analysis is based on the facts and circumstances of the transaction, the parties should consider agreeing to the allocation of the deductions and memorialize in a tax sharing agreement.

Finally, Ms. Rubin discussed the mechanics of adjusting incentive stock options and nonqualified stock options under Section 424 and Section 409A, respectively. She discussed the spread and ratio test which are required under Section 424, as well as the less strict requirements under Section 409A. Ms. Rubin ended the discussion by noting that in order to retain tax favorable treatment incentive stock options must be exercised within 3 months of the spin-off event if the holder is no longer employed by the issuing entity or a related entity.

Upcoming Panels

Wednesday, March 10, 2021 – Part III “Cross Border Spin-offs”

In Part III, the panel will discuss spin-offs in the context of cross-border transactions.