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Structuring Spin-Offs: Reverse Morris Trusts, Section 355 Safe Harbors

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Structuring Spin-Offs: Reverse Morris Trusts, Section 355 Safe Harbors

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October 5, 2022

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I. Introduction

Background

- A spin-off involves the separation of a corporation’s businesses by creating one or more distinct corporations.

- Spin-offs have been popular because investors, boards and managers can maximize strategic flexibility value if the corporation is owned and managed separately, rather than as part of the same enterprise.

- Section 355 is a valuable planning tool for corporations because it is one of the few transactions that allows a corporation to move assets out of corporate solution in a tax-free manner.

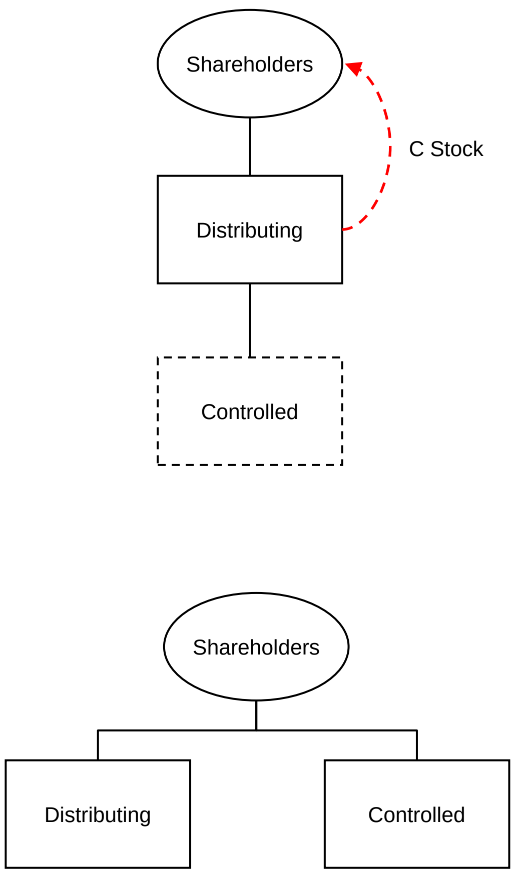
- Section 355 permits the separation of a parent corporation’s (“Distributing”) active businesses, with Distributing retaining one or more of its active businesses and distributing to its shareholders the stock of a subsidiary corporation (“Controlled”) that holds directly or indirectly, one or more of Distributing’s other active businesses.

Overview of Section 355 Transactions

- Three primary Section 355 transactions:
  - Spin-off: A pro rata distribution (i.e., a dividend) of Controlled stock to Distributing's shareholders.
  - Split-off: A non-pro rata distribution of Controlled stock to some, but not all, of Distributing’s shareholders in redemption of Distributing stock.
  - Split-up: A distribution of stock of two or more controlled corporation to Distributing’s shareholders, followed by a liquidation of Distributing (infrequent).
- For simplicity, we will generally refer to Section 355 transactions as spin-offs.
- Spin-offs can also involve an M&A component following the spin-off where either Distributing (through a Morris Trust transaction) or Controlled (through a Reverse Morris Trust transaction) merges with a third party corporation.

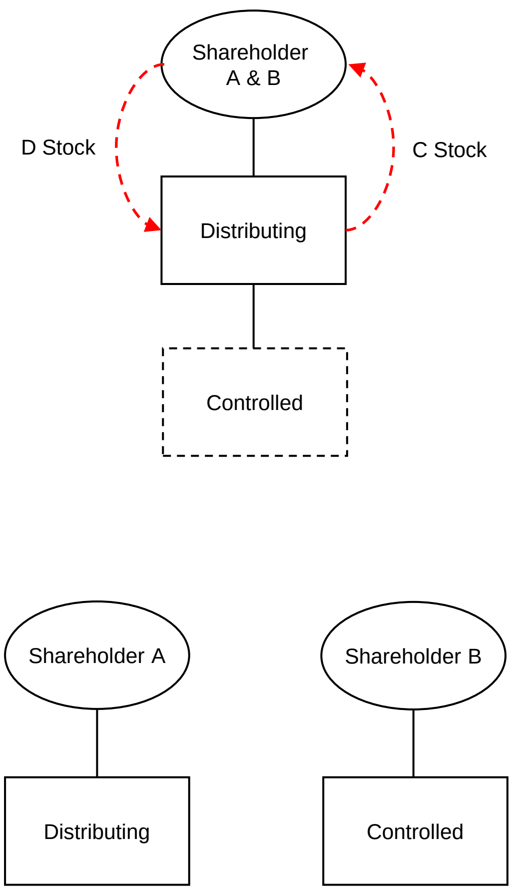
Basic Section 355 Structures

Spin-off



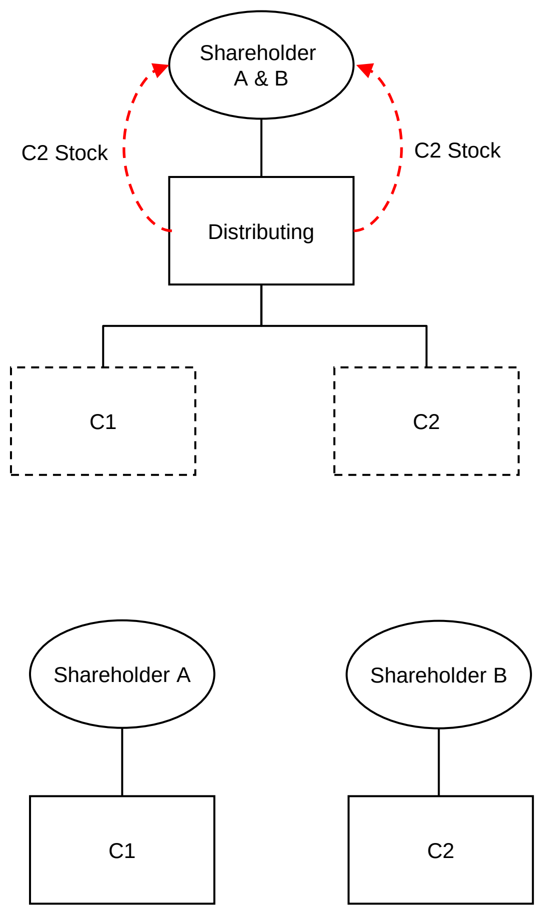
A corporate dividend

Split-off



A corporate redemption

Split-up



A corporate liquidation

Tax Treatment under Section 355

- If the spin-off qualifies under Section 355, it would be tax-free to both Distributing and its shareholders.
- If the spin-off does not qualify under Section 355, then it would be a taxable distribution of stock by Distributing to its shareholders.
  - Potential for taxable gain at the Distributing level.
  - Potential for taxable dividend to Distributing's shareholders.
  - No step-up in inside basis of Controlled's assets, but Section 336(e) regulations can mitigate the potential negative consequences.

II. Spin-off Basics

Overview of Basic Spin-off Requirements

- Distribution of Control (Section 355(a)(1)(A))
- Corporate Business Purpose (Treas. Reg. Section 1.355-2(b))
- Active Trade or Business (Section 355(b))
- Device (Section 355(a)(1)(B))
- Disqualified Distributions (Section 355(d))
- Anti-Morris Trust Rules (Sections 355(e) and (f))
- Cash-Rich Split-offs (Section 355(g))
- Continuity of Interest (Treas. Reg. Section 1.355-2(c))

Distribution of Control Requirement

- Distributing must distribute Section 368(c) “control” of Controlled.
  - 80% of the voting power and 80% of each class of non-voting stock.
    - Stock possessing high vote/low vote structure is possible.
  - To extent Distributing retains stock or securities of Controlled after the spin-off, Distributing generally must demonstrate a valid business purpose for the retention and dispose of the stock or securities within a limited period of time (generally no more than 5 years).

Corporate Business Purpose

- A corporate business purposes is a real and substantial non-federal tax purpose germane to the business of Distributing or Controlled that cannot be achieved through any other nontaxable transaction that is not impractical or unduly expensive.
- Increasing shareholder value is sufficient if it serves a corporate purpose; not if there is no corporate purpose (Rev. Rul. 2004-23).
- Appendix A of Rev. Proc. 96-30 contained what the taxpayer needed to demonstrate (at least historically) corporate business purpose in the IRS letter ruling context.

Active Trade or Business

- Each of Distributing and Controlled must have continuously conducted an active business for the 5-year predistribution period that was not acquired in a taxable transaction during such period.
- Size of active trade or business (ATB):
  - Prior to 2003, for advance ruling purposes, the IRS required that assets of the ATB make up at least 5% of the total assets of the newly separated entity or that based on facts/circumstances, the ATB not be de minimis. This was abandoned in 2003 (Rev. Proc. 2003-48).
  - 2016 Proposed Regulations reinstitute a 5% requirement.
  - In 2017, the IRS reinstituted a 5% requirement for advance ruling purposes (Rev. Proc. 2017-3, Section 4.01(30).

- Expansion Doctrine– permits active businesses acquired in a taxable transaction provided certain requirements are met.

Device

- The spin-off cannot be used principally as a device for the distribution of the E&P of Distributing, Controlled or both.
- Determination is based on all of the facts and circumstances.
- Device factors: (i) pro rata distribution; (ii) subsequent sale/exchange of stock; and (iii) nature and use of assets.
- Nondevice factors: (i) a corporate business purpose; (ii) publicly traded and widely held Distributing; and (iii) distribution to domestic corporate shareholders entitled to a DRD.
- “Ordinarily” not a device: (i) absence of current or accumulated E&P for either Distributing or Controlled (treating the spin as if it were taxable); and (ii) in absence of Section 355, the distribution would have been a redemption to which Section 302(a) applied to all distributee shareholders (i.e., exchange treatment rather than dividend treatment).
- Proposed Regulations issued in July 2016 modify the nature and use device factor and the corporate business purpose non-device factor. They also add a per se device test.

Disqualified Distributions

- Distributing will recognize gain on the distribution if, immediately after the distribution, a person holds 50% or more (by vote or value) of Distributing or Controlled and acquired its Distributing stock in a taxable transaction within the past 5 years.
- In general and subject to exceptions, a purchase is any acquisition if (a) the basis of the acquired property is not determined (i) by reference to the transferor’s basis or (ii) under Section 1014 and (b) the property is not acquired in an exchange to which Section 351, 354, 355, or 356 applies.

Cash-Rich Split-offs

- Section 355(g) provides that Section 355 does not apply to so-called “cash-rich split-offs.”
- Section 355(g) generally applies if any person holds, immediately after the transaction, 50% or more of any “disqualified investment corporation,” but only if such person did not hold such an interest in such corporation before the transaction. Section 318 generally applies for purposes of determining ownership.
- A disqualified investment corporation is generally any distributing or controlled corporation if 2/3 or more of the fair market value of its assets constitute investment assets. For this purpose, investment assets include, (i) cash, (ii) stock or securities in a corporation or interest in a partnership unless, in either such case, certain minimum ownership thresholds are satisfied, (iii) debt instruments, (iv) options, forward or futures contracts, notional principal contracts, or derivatives, (v) foreign currency, or (vi) any similar asset. There are certain exceptions for financial trades or businesses and securities that are mark-to-market.

Continuity of Interest

- Section 355 requires that one or more persons who, directly or indirectly were owners of the enterprise prior to the distribution own, in the aggregate, an amount of stock establishing a continuity of interest in Distributing and each Controlled.

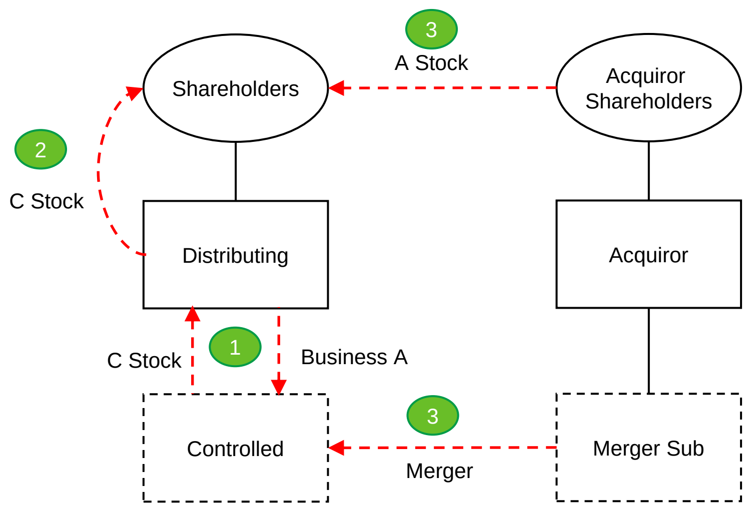
Reverse Morris Trust

- A spin-off can also be used with a concurrent M&A transaction, subject to limitations.
- To be tax-free, the Reverse Morris Trust transaction generally requires, among other things, that Controlled’s (i.e., Distributing’s) shareholders own a majority of the stock of the combined entity.
  - This ensures the spin-off transaction will not flunk 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 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 acquisitions are aggregated.

Reverse Morris Trust



Facts

- Distributing transfers Business A 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 Acquiror stock.

Considerations

- Controlled's shareholders must own more than 50% of Acquiror stock as a result of the merger.
- A leveraged distribution is frequently used in conjunction with a Reverse Morris Trust transaction.

Anti-Morris Trust Rules
Safe Harbors

- Super Safe Harbor
  - Acquisition after a distribution with no agreement, understanding, arrangement or substantial negotiations concerning the acquisition or a similar acquisition (collectively, an “Agreement) during the 2-year period prior to the distribution
- Safe Harbor I
  - Acquisition more than six months after the distribution with no Agreement during the period that begins one year before the distribution and ends six months thereafter. Cannot have a business purpose to facilitate an acquisition.
- Safe Harbor II
  - Acquisition more than six months after the distribution with no Agreement during the period that begins one year before the distribution and ends six months thereafter. Can have a business purpose to facilitate an acquisition but not the specific acquisition being tested
  - No more than 25 percent of the stock of the acquired corporation acquired or the subject of an Agreement during the period that begins one year before the distribution and ends six months thereafter
- Safe Harbor III
  - Acquisition after the distribution and no Agreement within one year after the distribution
- Safe Harbor IV
  - Acquisition before the date of the first disclosure event regarding the distribution (but not to exceed 20% of the acquired corporation)

Anti-Morris Trust Rules

Safe Harbors

- Safe Harbor V
  - Acquisition after the date of a public announcement regarding the distribution and no discussions by Distributing or Controlled with the acquirer regarding a distribution on or before the date of the first public announcement (but not to exceed 20% of the acquired corporation).
- Safe Harbor VI
  - 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/public announcement
- Safe Harbor VII
  - Public trading
- Safe Harbor VIII
  - Acquisitions by a person in connection with such person's performance of services as an employee, director, or independent contractor
- Safe Harbor IX
  - Acquisitions by certain retirement plans

Tax Opinion v. Private Letter Ruling

- Tax Opinion v. Private Letter Ruling timeline
- Value in the market?
- Rev. Proc. 2022-10 - Expedited Private Letter Ruling Pilot Program

Inflation Reduction Act Issues
Corporation Alternative Minimum Tax (“CAMT”)

- Imposes a 15% minimum tax on adjusted financial statement income (“AFSI”) starting in 2023 for corporations with average annual AFSI over a three-year period in excess of $1 billion
  - Isolated transactions that generate significant financial statement income may cause a taxpayer to become subject to the CAMT

- Absent additional guidance from Treasury and the IRS, certain transactions that qualify for tax-free treatment under Section 355 and/or related provisions can generate significant financial statement income that appears to be captured under the CAMT rules
  - Split-offs (but not spin-offs)
  - Debt-for-equity exchanges (the use of Controlled stock to satisfy Distributing debt)
  - Certain post-spin-off combination transactions of Distributing or Controlled

Inflation Reduction Act Issues
Excise Tax on Stock Repurchases

- Imposes a 1% excise tax on the fair market value of stock repurchased by domestic corporations with stock traded on an established securities market

- A "repurchase" is defined as a redemption for tax purposes
  - This generally includes any acquisition by a corporation of its stock from a shareholder in exchange for property, except for its stock or rights to acquire its stock
  - Limited exceptions are provided

- Absent additional guidance from Treasury and the IRS, it appears a split-off transaction under Section 355 may be subject to the excise tax because the distribution of the Controlled stock is in redemption of Distributing stock
  - A split-off preceded by reorganization under Section 368 may qualify for an exception to the excise tax

III. Paradigm Cases

Permitted Business Purposes

- Revenue Procedure 96-30 sets forth certain specific permitted business purposes:
  - To provide an equity interest to a key employee
  - To facilitate a stock offering
  - To facilitate a borrowing
  - To achieve cost savings
  - To allow two disparate business units to be specifically focused on their respective businesses (“fit and focus”)
  - To address concerns of suppliers or customers that a related business competes with their own
  - To facilitate an acquisition of Distributing
  - To facilitate an acquisition by Distributing or Controlled
  - To protect one business from the risks of another business

Reasons for Pursing a Spin-off

- Fit and Focus
  - A spin-off can allow each company to focus on its “core” business.
- Appropriate Capital Structure
  - A spin-off can enable each business to purse a capital structure that aligns with its business and strategy.
- Separate Investment Identity
  - A spin-off can create distinct investment opportunities for each business that are more attractive to investors that are focused on a specific sector or growth strategy.
- Key Employees
  - A spin-off can increase the effectiveness of equity-based compensation programs in a manner that cannot be accomplished under the current capital structure.
- Access to Capital
  - A spin-off can enable at least one of the businesses to raise capital (either debt or equity) on more favorable terms.

Fit and Focus

- Due to a lack of synergy between the businesses, a spin-off will enable each corporation to focus on its own strategic and operational growth.
- The spin-off will enhance the success of the businesses by enabling the businesses to resolve management, systemic or other problems that arise as a result of (or are exacerbated by) operating different businesses within an affiliated group.
- When the business purpose is "fit and focus," special attention will be given to any continuing relationship between Distributing and Controlled to ensure that the two are indeed being separated through the spin-off.
  - Examples of "continuing relationships" include:
    - Common directors, officers or key employees
    - Provision of goods and services
      - Transitional services agreements (accounting, treasury, IT, etc.) should be transitional
      - Licensing and inter-corporate sales should be arm's length
      - Short term loans between the businesses should be carefully considered
    - Commonly-owned property

IV. Leveraged Spin-offs

Establishing the Capital Structure

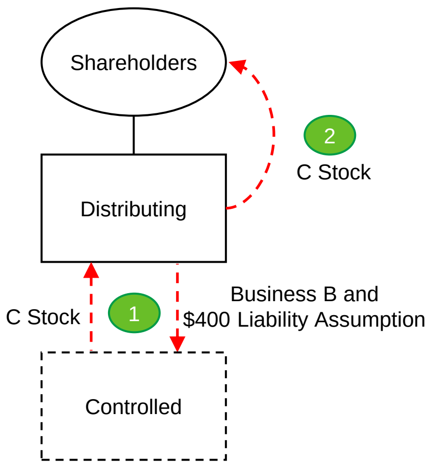
- Leveraged spin-offs are beneficial for corporations because they enable Distributing and Controlled to achieve a desired capital structure post-spin.

- Note, shifting debt in a leveraged spinoff may yield an economically equivalent result, but the tax consequences to Distributing vary considerably based on the form of the transaction. The optimal debt allocation strategy is often influenced by tax considerations and the terms of the existing debt.

- The following slides illustrate 4 types of strategies to consider:
  - debt for debt exchange;
  - debt for equity exchange;
  - internal spin-off; and
  - reverse spin-off.

A. Debt for Debt Exchanges

Leveraged Spin-offs: Liability Assumption



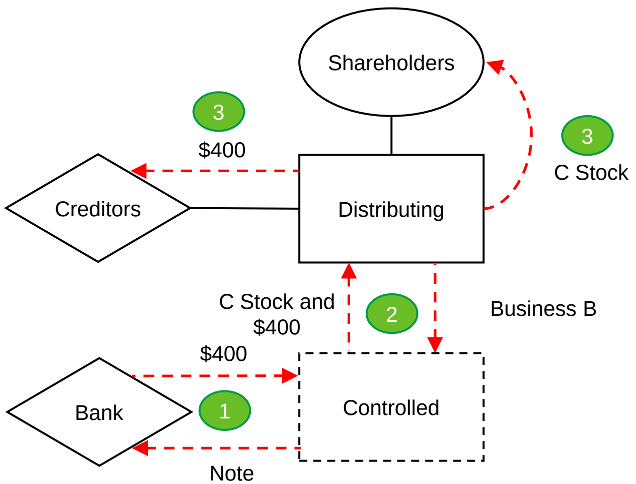
Facts

- Distributing transfers Business B (FMV of $1,000, basis of $400) to Controlled, and Controlled assumes $400 of Distributing's debt, in exchange for Controlled stock.
- Distributing distributes the Controlled stock to its shareholders.

Considerations

- Allows for nontaxable assumption of liabilities, subject to limitations.
- Note, however, that the amount of debt assumed by Controlled cannot exceed Distributing's basis in the assets transferred to Controlled.
- If Distributing has a low tax basis, tax-free monetization of debt assumption is likely limited.

Leveraged Distributions: Cash Distribution to Creditors



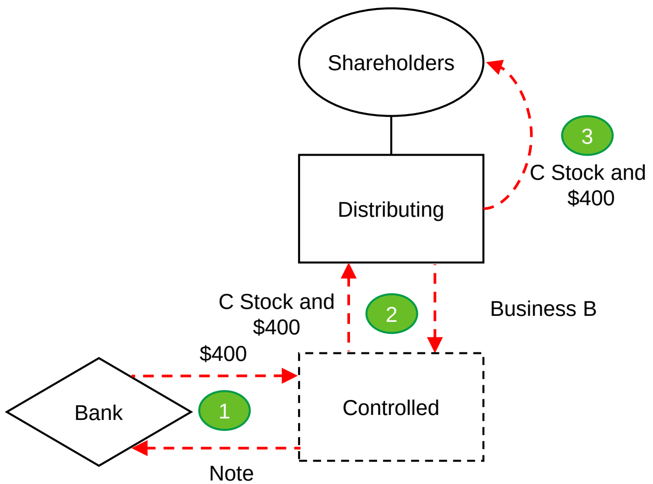
Facts

- Controlled borrows $400 from a Bank.
- Distributing transfers Business B (FMV of $1,000, basis of $400) to Controlled in exchange for Controlled stock and $400 cash.
- Distributing distributes the Controlled stock to its shareholders, and transfers $400 cash to repay its creditors.

Considerations

- Distributing may receive cash tax-free as long as it distributes the cash to its creditors in repayment of debt (subject to basis limitation).
- Note, however, that the amount of cash received by Distributing from Controlled that is paid to the creditors cannot exceed Distributing's basis in the assets transferred to Controlled.
  - If Distributing has a low tax basis, tax-free monetization of cash received by Distributing from Controlled is likely limited.
- Controlled can also generate cash by issuing low-vote stock to the public in an IPO prior to the spin-off.

Leveraged Distributions: Cash Distribution to Shareholders



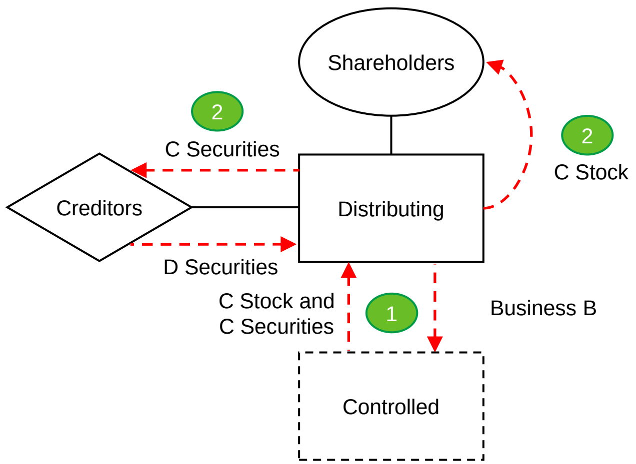
Facts

- Controlled borrows $400 from a Bank.
- Distributing transfers Business B (FMV of $1,000, basis of $400) to Controlled in exchange for Controlled stock and $400 cash.
- Distributing distributes the Controlled stock and $400 cash to its shareholders.

Considerations

- Distributing may receive cash tax-free as long as it distributes the cash to the shareholders.
- Controlled can also generate cash by issuing low-vote stock to the public in an IPO prior to the spin-off.
- Note, however, that while the amount of cash received by Distributing that is distributed to the shareholders is not specifically limited to Distributing’s basis in the assets transferred to Controlled, Distributing’s receipt of cash in excess of Distributing’s basis in the assets transferred to Controlled may result in the creation of an “excess loss account” (an “ELA”). The ELA may be triggered on the distribution of Controlled, resulting in income to Distributing.

Debt Exchange



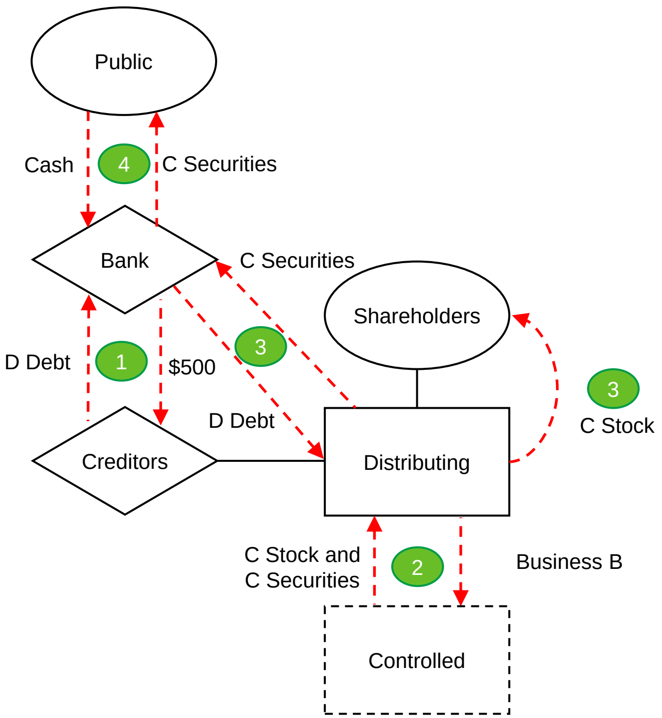
Facts

- Distributing transfers Business B (FMV of $1,000, basis of $400) to Controlled in exchange for Controlled stock and $500 of Controlled securities (e.g., debt with a 7-10 year term).
- Distributing distributes the Controlled stock to its shareholders, and transfers the Controlled securities to Distributing's creditors in exchange for Distributing securities.

Considerations

- The amount of debt exchanged is not limited to Distributing's basis in the assets transferred to Controlled.
- Distributing can reduce its debt by an amount that exceeds its basis in the assets transferred to Controlled without triggering tax.

Facilitated Exchange



Facts

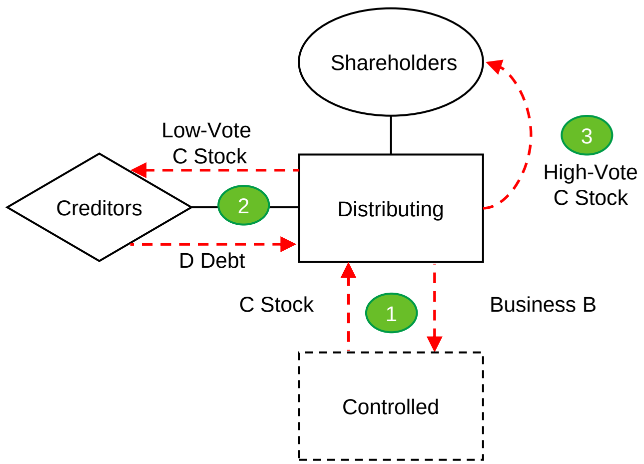
- Bank purchases $500 of Distributing’s debt from Distributing's creditors.
- Distributing transfers Business B (FMV of $1,000, basis of $400) to Controlled in exchange for Controlled stock and $500 of Controlled securities.
- Distributing distributes the Controlled stock to its shareholders and transfers the Controlled securities to Bank in satisfaction of Distributing's debt purchased by Bank.
- Bank sells the Controlled securities to the public.

Considerations

- The amount of debt exchanged is not limited to Distributing's basis in the assets transferred to Controlled.

B. Debt for Equity Exchanges

Debt for Equity Exchange



Facts

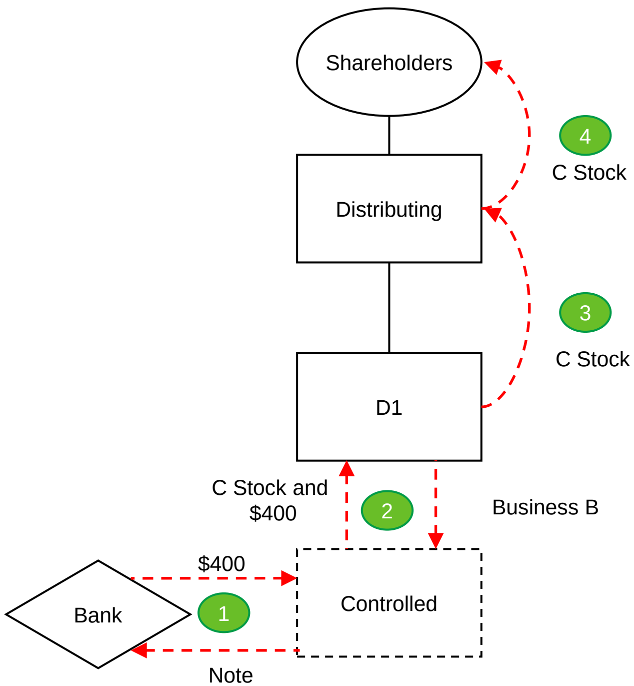
- Distributing transfers Business B to Controlled in exchange for two classes of Controlled stock:
  - “High-Vote” stock possessing at least 80% of the total voting power and 50% of the value, and
  - “Low-Vote” stock possessing at most 20% of the voting power and 50% of the value.
- Distributing transfers the Low-Vote Controlled stock to Distributing’s creditors in satisfaction of its existing debt.
- Distributing distributes the High-Vote Controlled stock to its shareholders.
- Note: Distributing may retain a portion of the Low-Vote Controlled stock and sell such stock at a later date, subject to limitations.

Considerations

- A subsequent sale of the remaining Controlled stock will be taxable to Distributing.

C. Internal Spin-offs

Internal Spin-off



Facts

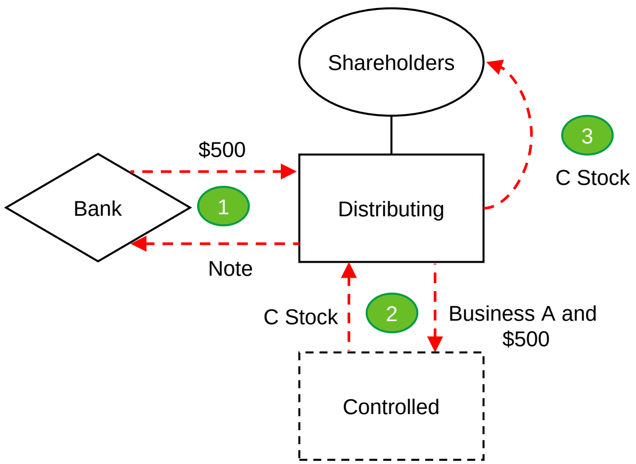
- Distributing, D1 and Controlled file a consolidated return.
- Controlled borrows $400 from a Bank.
- D1 transfers Business B (FMV of $1,000, basis of $400) to Controlled in exchange for Controlled stock and $400 cash.
- D1 distributes the Controlled stock to Distributing.
- Distributing distributes the Controlled stock to its shareholders.

Considerations

- No ELA triggered on the distribution of Controlled.
  - If D1 receives cash in excess of D1’s basis in the assets transferred to Controlled, an ELA may be triggered on the distribution of Controlled, resulting in income to D1.

D. Reverse Spin-offs

Reverse Spin-off



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.

Considerations

- The borrowed proceeds are not limited to Distributing’s basis in the assets transferred to Controlled.
- Alternatively, a Reverse Spin-off may be effected through an internal spin-off.