Client Update
Treasury and IRS Provide New Spin-off Guidance

NEW YORK
Michael Bolotin
mbolotin@debevoise.com

Gary M. Friedman
gmfriedman@debevoise.com

Peter A. Furci
pafurci@debevoise.com

Vadim Mahmoudov
vmahmoudov@debevoise.com

Peter F.G. Schuur
pfgschuur@debevoise.com

The Treasury Department and IRS have issued significant new guidance addressing tax-free spin-offs:

- New Proposed Regulations provide rules for determining when the ownership by parent or spinco of substantial nonbusiness assets—such as cash or cash equivalents that exceed the reasonable working capital requirements of the business and that are not required for business exigencies or regulatory purposes—can disqualify a tax-free spin-off.
- The new Proposed Regulations include a five-percent test to determine if a five-year active trade or business conducted by parent or spinco is too small to support a tax-free spin-off. This rule builds on notices released by the IRS in September of 2015, under which the IRS stated that it would not rule on a spin-off transaction if the five-year trade or business assets of either parent or spinco represented less than five percent of the corporation's value.
- The IRS also issued a new Revenue Procedure that provides safe harbors for permissible post-spin recapitalizations of high-vote/low-vote share structures of spincos.
- The Proposed Regulations will be effective for transactions occurring after the publication date of the final regulations. There will be grandfathering exceptions for transactions that occur pursuant to a binding agreement entered into, or for which a public announcement was made, before the publication date. The Revenue Procedure will be effective for transactions that occur on or after August 1, 2016, or earlier if the taxpayer so chooses.

YAHOO AND ALIBABA

The Proposed Regulations were likely influenced by transactions like Yahoo! Inc.'s proposed spin-off of its minority interest in Alibaba Group in 2015. Yahoo planned to distribute its valuable publicly traded interest in Alibaba to its shareholders by way of a spin-off. In the proposed spin-off, the active trade or business of the spinco that would hold the Alibaba shares would have made up a small percentage of the spinco's total fair market value. The IRS declined to issue either a favorable or adverse letter ruling on the proposed transaction.

NONBUSINESS ASSETS CAN DISQUALIFY SPIN-OFF

To qualify for tax-free treatment, a spin-off transaction must not be used principally as a "device" for the tax-free distribution of earnings and profits of parent or spinco that would otherwise be taxable. The Proposed Regulations introduce the concept of business assets and nonbusiness assets, and treat the presence of excessive nonbusiness assets, or a disproportionate ratio of nonbusiness assets between parent and spinco, as evidence of device that can disqualify a spin-off. Business assets are gross assets used in one or more businesses (determined without regard to the five-year requirement) and include reasonable amounts of cash/cash equivalents held for working capital and assets required (by binding commitment or legal requirement) to be held for exigencies or regulatory purposes related to a business. Nonbusiness assets are gross assets other than business assets, including real estate not related to a business. While partnership interests and corporate stock are generally treated as nonbusiness assets, the Proposed Regulations permit a look-through for certain affiliated partnerships or corporations in a manner that is consistent with present law.

Facts and Circumstances Test. Under the Proposed Regulations, the ownership of nonbusiness assets is evidence of device unless both (i) less than 20% of each of parent and spinco's total assets are nonbusiness assets and (ii) the difference in the percentage of nonbusiness assets owned by each of parent and spinco is less than 10 percentage points or, if the distribution is not pro rata, the difference equalizes the value of the stock and securities distributed and the value of the stock and securities exchanged in the transaction.

- Under existing law, a corporate business purpose can generally outweigh the evidence of device. However, under the Proposed Regulations, a purpose that relates to the separation of nonbusiness assets from one or more businesses or business assets cannot outweigh evidence of device, unless the business purpose involves an exigency requiring an investment or other use of the nonbusiness assets in one or more businesses.
- The examples in the Proposed Regulations show that even a spin-off with a very strong business purpose can be disqualified by the presence of cash or other nonbusiness assets in excess of reasonable working capital needs and a percentage of nonbusiness assets of parent and spinco that is materially different, unless there is a business exigency requiring the use of the cash or nonbusiness assets (*i.e.*, parent maintains a disproportionate amount of cash

to facilitate a purchase of property that must be made within six months, as opposed to a purchase that might be made within two years).

Per Se Test. The Proposed Regulations add a per se device test under which a distribution will be considered a per se device, and therefore a taxable transaction, if (i) 66 2/3% or more of either parent or spinco's total assets are nonbusiness assets and (ii) the difference in the percentage of nonbusiness assets of the parent and spinco falls into one of three bands. The bands are intended to capture transactions where there is a significant difference between the percentage of nonbusiness assets held by parent and spinco and apply if: (A) at least 66 2/3% but less than 80% of one corporation's total assets are nonbusiness assets and less than 30% of the other corporation's total assets are nonbusiness assets, (B) at least 80% but less than 90% of one corporation's total assets are nonbusiness assets and less than 40% of the other corporation's total assets are nonbusiness assets or (C) at least 90% of one corporation's total assets are nonbusiness assets and less than 50% of the other corporation's total assets are nonbusiness assets. The Proposed Regulations provide two exceptions to the per se rule for internal spin-offs within a corporate group and certain other transactions that would not ordinarily be considered a device.

FIVE-PERCENT ACTIVE TRADE OR BUSINESS REQUIREMENT

In contrast with some past IRS ruling practices, pursuant to which the active business requirement could be satisfied regardless of the absolute or relative size of an active business, the Proposed Regulations provide a five-percent minimum percentage of five-year-active business assets for both parent and spinco. A corporation's five-year-active business assets are its gross assets used in one or more five-year active businesses and, similar to business assets discussed above, include reasonable amounts of cash/cash equivalents held for working capital and assets required to be held for exigencies or regulatory purposes related to a business. This percentage is determined by dividing the fair market value of the corporation's five-year-active business assets by the fair market value of its total assets and takes into account assets held by affiliates. Unlike the device test, this requirement will apply to internal spin-offs within a corporate group, requiring that care be taken to ensure that, when internal spin-offs are required in connection with a larger transaction, each spin-off satisfies this requirement.

POST SPIN-OFF CHANGE IN VOTING STRUCTURE

Revenue Procedure 2016-40 outlines safe harbors under which the IRS will not challenge a tax-free spin-off transaction for failing to meet the 80% control test. These safe harbors cover cases where, in preparation for the spin-off, spinco issues new stock to parent and/or its other shareholders in order to meet the 80%

control test, and after the spin-off, spinco engages in a transaction that restores shareholders to the same level of control or relative interest in the company they would have held if the issuance had not occurred. Because the safe harbor scenarios were already thought to comply with the substance requirements of the spin-off rules, the Revenue Procedure offers little additional clarity.

The IRS will not challenge the substance of the spin-off if no action is taken related to unwinding shareholder control, including the adoption of a plan or policy, during the 24 months following the spin-off. Nor will it challenge the substance of the spin-off if the unwinding occurs because of a transaction with an unrelated third party anytime after the spin-off, as long as that transaction was not contemplated during the 24 months prior to the spin-off.

It is not yet clear how the IRS would treat post-spin recapitalizations or changes in voting power that occur outside of these safe harbors, such as recapitalizations soon after a spin-off where the different classes of voting stock issued to fulfill the control requirement have been determined to create confusion in the market, or structures where shareholders can lose special voting rights by selling their shares to third parties.

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Please do not hesitate to contact us with any questions.