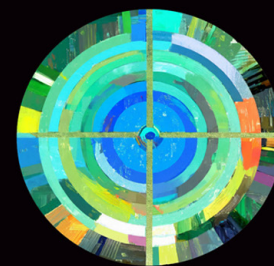


## M&A Tax Talk

### Monetization techniques in spin-offs



The tax-free spin-off rules in Section 355 provide a tax-efficient pathway for a corporation to dispose of a business without corporate or shareholder-level tax. Subject to numerous complex requirements, the spin-off rules permit a distributing corporation (referred to as “Distributing”) to distribute the stock and securities of a controlled corporation (referred to as “Controlled”) to some or all of its shareholders and security holders on a tax-free basis to Distributing and its shareholders.

The spin-off rules also provide flexibility to partially monetize Distributing’s interest in Controlled in order to adjust the capital structures of both Distributing and Controlled on a tax-efficient basis. There are multiple methods to accomplish this, each with its own considerations and nuances under the tax rules.

Generally, prior to distributing Controlled stock, if Controlled is not already a separate, tax-regarded entity, Distributing will transfer the assets and liabilities of the business it desires to dispose to Controlled in a so-called “divisive D reorganization.” If Distributing receives cash (typically out of the proceeds from Controlled borrowing) or property other than stock or “securities” (discussed below) of Controlled (referred to as “boot”) in connection with the divisive D reorganization, Distributing generally will not recognize gain so long as it “purges” the boot by distributing it to its shareholders or using it to repurchase Distributing shares. Distributing may also purge the boot by using it to repay a portion of its historic debt so long as the amount of boot received does not exceed the tax basis in the assets

contributed to Controlled less the liabilities assumed by Controlled in connection with the divisive D reorganization. If Distributing retains the boot it received, it would recognize gain on receipt of the boot. If Controlled does not have sufficient tax basis in its assets to accomplish its debt allocation goals solely through a boot dividend, the spin-off rules allow for Distributing to satisfy its historic liabilities with Controlled debt in a “debt-for-debt exchange.” This involves Controlled issuing its own debt securities to Distributing, which Distributing uses to repay its own indebtedness, thus, accomplishing the goals of leveraging up Controlled while de-levering Distributing. To meet the requirements of a tax-free debt-for-debt exchange, the Controlled debt must constitute a “security.” Although there is no statutory or regulatory definition of a “security,” a debt instrument with a weighted average life to maturity of seven years or greater is generally considered to qualify.

The proposed Build Back Better Act would hinder the flexibility of debt-for-debt exchanges by imposing a basis limitation on securities, similar to the basis limitation on boot. Under current law, however, debt-for-debt exchanges are not limited in the same way as boot dividends by Controlled.

Another approach to de-lever Distributing is a stock-for-debt exchange, in which Distributing exchanges Controlled stock with creditors in satisfaction of a portion of the historic Distributing liabilities. The amount of Controlled stock that can be exchanged in a stock-for-debt exchange is generally limited to 20% and requires that Distributing obtain a private letter ruling from the IRS establishing that the

retention of Controlled stock to be used in the stock-for-debt exchange is not in pursuance of a plan having federal tax avoidance as one of its principal purposes.

Because the holders of Distributing’s debt are often diverse or unknown, it is common for debt-for-debt or stock-for-debt exchanges to be intermediated by an investment bank. In such structures, the investment bank acquires historic Distributing indebtedness in the market and exchanges it with Distributing for the Controlled stock or securities, which the investment bank then sells. As such structures present complexities that are not fully answered in the Internal Revenue Code, it is common to seek a private letter ruling to provide certainty on the resulting tax consequences.

In Rev. Proc. 2018-53, the IRS set forth standards for taxpayers who seek private letter rulings on boot dividends, debt-for-debt exchanges, or stock-for-debt exchanges in the context of a tax-free spin-off. In order to obtain a ruling, the revenue procedure requires that the taxpayer make certain representations of fact, one of which being that the Distributing debt which will be satisfied in connection with the spin-off is “historic.” Rev. Proc. 2018-53 defines historic debt as debt that will be assumed or satisfied in the transaction that was incurred by Distributing (a) before the request for any relevant ruling is submitted and (b) no later than 60 days before the earliest of the (i) the date of the first public announcement of the divisive D reorganization, (ii) the date of the entry by Distributing into a binding agreement to engage in the divisive D reorganization, or (iii) the date of approval of

the divisive D reorganization. If Distributing incurs new debt to satisfy its historic debt, the new debt will be treated as historic debt for these purposes. This exception appears intended to put distributing corporations on the same level, irrespective of when their debt matures, so long as they do not increase the amount of their overall leverage. However, it also provides some potential opportunities to reduce the frictional costs of implementing a debt-for-debt or stock-for-debt exchange.

In that regard, the IRS has blessed a novel structure that further eases some of the practical difficulties of a debt-for-debt or stock-for-debt exchange by flipping the traditional order of the steps. In PLR 202218002, Distributing incurred new debt from a financial institution, satisfied such new debt with boot, retained Controlled stock and/or Controlled securities, and later used the proceeds of such new debt to repay historic Distributing liabilities. The ability to effectuate the exchange using Distributing debt that is newly issued directly to the party engaging in the exchange is a more efficient proposition as it eliminates the premium that is typically incurred by the investment bank when acquiring existing Distributing debt on the open market, as well as other transaction costs. By changing the order of the steps, the structure allows all distributing corporations to achieve this benefit, regardless of whether they have debt maturing shortly before or after the spin-off. While it is not strictly required, taxpayers should strongly consider seeking a ruling for a transaction that aims to utilize this structure.

The development of new transaction structures creates flexibility and alleviates inefficiencies, while still achieving tax-efficient outcomes. These are valuable tools to have when considering options for monetization in a tax-free spin-off.



## Want to learn more?

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