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Spin-Offs Become Easier and Easier

Recent government releases show that the section 355 spin-off continues to be a favored corporate transaction, despite Congress' efforts to restrict it in recent years.

Recap Into Control . . . and Back Out of Control

LTR 200837027 concludes that a split-off will qualify for section 355 treatment, even though the distributing corporation did not have control of the controlled corporation until it recapped into control, and an unwinding of that recap is planned, but not hard wired. This is significant because the distribution of a controlling amount of stock appears to be a transitory condition; nevertheless, the corporation and its shareholders can enjoy the benefits of a tax-free distribution.

Facts. Distributing owned D2, which owned D1, which owned part of the stock of Controlled; the public owned the rest. Controlled was not part of Distributing's consolidated group, because section 1504(a)(2) requires ownership of 80 percent of vote and value, and as we will see in the next paragraph, D1 did not own 80 percent of the vote of Controlled.

For all of the usual reasons (fit and focus, customer complaints, capital raising, etc.), Distributing believed it had a business purpose to split-off Controlled. Actually, Distributing proposed to give its shareholders the option to swap some of their shares for Controlled shares, but it appears that the real goal of the transaction was to raise cash for Distributing, which proposed to issue the unsubscribed Controlled stock to a variety of new and old creditors of Distributing.

The problem was that D1 did not control Controlled under section 368(c), as required by section 355(a)(1)(A). Therefore, D proposed to recapitalize Controlled to give D1 a new class of high vote common Class B stock of Controlled and leave the public with a reclassified low vote common Class A stock of Controlled.

Thus, after the split-off, the former shareholders of Distributing and some creditors will own high vote common class B of Controlled and the original public minority shareholders of Controlled will own low vote common class A or Controlled along with the residual hot shares retained by D1. It is easy to see how that situation might make the Class A holders grumpy; after all, they were the original roughly 30 percent owners of Controlled who have been demoted for control purposes to less than 20 percent (it has to be less than 20 percent because D1 will retain some of that low vote stock and Distributing still has to distribute 80 percent of the vote).

The ruling then states:

Controlled presently expects that, following the consummation of the Split-Off and the Debt Exchange and in connection with the consideration of resolutions to be submitted to the Controlled shareholders at the next regularly scheduled

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annual shareholders' meeting of Controlled or at a special shareholders' meeting of Controlled, the Controlled Board will consider a proposal to convert the Controlled Class B Common Stock to Controlled Class A Common Stock on a share-for-share-basis (a "conversion"), subject to the receipt of Controlled shareholder approval. There will be no binding commitment by the Controlled Board to, and there can be no assurance that the Controlled Board will, consider the issue or resolve to present the proposal to the Controlled shareholders at that meeting or any subsequent meeting. Moreover, there can be no assurance that, if presented, the Controlled shareholders will approve a conversion. If such proposal is approved by the Controlled Board and presented to the Controlled shareholders, a vote by a majority of each of the Controlled Class A Common Stock and the Controlled Class B Common Stock represented in person or by proxy at the shareholder meeting, voting separately, will be required for the proposal to be approved. [Emphasis added.]

The ruling concludes that Distributing distributed section 368(c) control of Controlled, so that section 355 applies.

No binding commitment. This phrase was critical to obtaining the ruling. Evidently the Chief Counsel decided to apply the binding commitment standard to determine whether Distributing held control of Controlled at the time of distribution of its stock. That is the most stringent of the possible tests for applying the step transaction doctrine.

Hot Stock Rule Relaxed

Reg. section 1.355-2T(g) substantially relaxes the rule of section 355(a)(3)(B) (the "hot stock" rule) for acquisitions of stock of a controlled corporation that either (1) is a member of the separate affiliated group (SAG) of the distributing corporation (DSAG) immediately before and after the acquisition, or (2) is a member of the DSAG at any time after the acquisition, but before the section 355 distribution of the stock of controlled; in addition, (3) the regulations reinstate the exception for acquisitions of controlled corporation stock from another member of the affiliated group, as specially defined.

The first exception makes final one aspect of the 2007 proposed SAG regulations, built on the 2006 enactment of section 355(b)(3), as later augmented by the 2007 enactment of section 355(b)(3)(C) and (D). It treats a SAG as one corporation for active trade or business purposes, thus allowing an intra-SAG transfer to be treated as a "nothing." The second exception implements a key concept of the proposed regulations, as later augmented by the 2007 enactment of section 355(b)(3)(C) and (D), treating as an asset acquisition the entry of a corporation into the SAG in a recognition transaction. The third exception formally reestablishes a former regulation ignoring intra-affiliate transfers.

Left subject to the hot stock rule are acquisitions of stock of a corporation that is distributed as a controlled corporation under section 355 but that never enters the DSAG. This can occur because the section 368(c) definition of control that defines a controlled corporation permits the ownership of less value of stock than the 80 percent of vote and value definition required for SAG membership. When the hot stock rule applies, the hot stock is treated as boot in the otherwise non-taxable section 355 distribution.

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