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A Simple Spinoff

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This recent letter ruling is one of the few "significant issue" rulings issued by Chief Counsel (Corporate) after it stopped ruling generally on most nonrecognition transactions in Subchapter C. It should be simple, as spinoffs go, because it is all domestic and involves a pro rata spinoff to public shareholders, where the possibility of "device" is almost nonexistent. And yet, getting to "yes" required a lot of tax engineering.

Facts

D2 is the parent of a consolidated group that will spin off C to the public shareholders. D2's direct subsidiary, D1, will organize C in a Section 368(a)(1)(D)/355 reorganization and distribute the C stock to D2. The businesses and assets that D1 will contribute to C will have flowed up to D1 in a series of subsidiary liquidations and upstream mergers. The taxpayer represents that three of the upstream mergers are Section 368(a)(1)(A) reorganizations, two upstream mergers are Section 332 liquidations and one upstream check the box liquidation is also subject to Section 332. The taxpayer states that after the spins, certain assets of the three liquidated subsidiaries may be transferred (by D1 and/or C) to new subsidiaries of D1 or C; the taxpayer represented that the value of assets transferred would not exceed X% per corporation liquidated.

Treatment of Mergers and Liquidations

The taxpayer presumably decided it could treat three statutory mergers as A reorganizations because assets or businesses of the merging corporations would remain in D1 sufficient to comprise a continuity of business enterprise. As a result, Reg. 1.368-2(k) could apply, which allows the taxpayer to ignore the effect of the contribution of assets by D1 to C, for purposes of satisfying the reorganization requirement.

On the other hand, as to the two mergers that the taxpayer treats as Section 332 liquidations, presumably a continuity of business enterprise will not be left in D1, meaning that the mergers cannot be A reorganizations and the cited regulation cannot apply. Assets or businesses satisfying the continuity of business enterprise (COBE) requirement could be transferred to C if D1 retained C, but because D1 will spin off C, the spun-off business cannot qualify D1 for the COBE requirement because the business must be in the qualified group headed by D1. Reg. 1.368-1(d)(4).

Nevertheless, those mergers, and the check the box liquidation of the remaining subsidiary, can satisfy the requirement for a complete liquidation for purposes of Section 332, despite the fact that assets are reincorporated into C. The theory (held within Chief Counsel (Corporate)) is that C stands in the same relationship to the shareholders as does D1, and so, in effect, there has been no reincorporation by D1 of the lower tier sub's assets. Of course here, C gets closer than D1 to the public shareholders through the spin by D2, but evidently that does not disturb the fiction.

How Would You Know This?

The foregoing analysis requires a working knowledge of the following rules:

1. Reg. 1.368-2(k) says you can ignore most nonrecognition dispositions of target assets by the acquiring corporation after a reorganization, so long as the reorganization otherwise qualifies as a reorganization, including satisfying the COBE requirement without regard to that regulation subsection.
2. Reg. 1.368-1(d)(4) requires the qualifying continuity of business to stay in the qualified group headed by the acquiring corporation.
3. Section 332 applies to upstream mergers, but does not mean that the upstream merger is not also a reorganization, which can qualify for Reg. 1.368-2(k).
4. Section 332 requires a "complete liquidation," which has been interpreted to preclude reincorporation of the liquidating corporation's assets before or after the liquidation.
5. Reincorporation does not include de minimis amounts, which Chief Counsel (Corporate) believes means less than 30 percent of gross value.
6. Reincorporation of any amount into a C that is spun off does not preclude complete liquidation.

Rule 1 is clear, so long as you focus on the brief reference to continuity of business in the regulation.

Similarly, Rule 2 is clear, so long as you realize that a spun-off C is no longer in D's qualified group.

Rule 3 is not obvious, but is the premise on which Reg. 1.368-2(k) is based.

Rule 4 is fairly clear, based on case law and a regulation.

Rule 5 is not knowable without closely following letter rulings and what Chief Counsel officials say at CLE programs.

Rule 6 is not knowable without closely following letter rulings and what Chief Counsel officials say at CLE programs.

Conclusion

Most of the rules above are taxpayer friendly, and yet they are fairly hard to find or confusing or counterintuitive. They just go to show that a simple spinoff is usually not a simple thing.

For additional information, call Jack Cummings at 919.862.2302.

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