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Spinoffs: Always Popular

Once again, spinoffs are in the news. The IRS made a "soft announcement" in May that it is taking a hard look at spinoffs of subsidiaries (the "Spinco") that have a small qualifying trade or business and a large investment asset.

The announcement was "soft" because it was made orally at a Bar Association meeting that was covered by the tax press. The speaker was not a highly placed IRS official, but nevertheless, practitioners have taken the announcement seriously.

The speaker made clear that he was not talking about a Spinco with a small qualifying business and a large business that did not meet the statutory requirements because it happened to have existed less than five years. Rather, he precisely described cases where a Spinco operated a relatively small historic business and owned a quite large investment asset, such as a minority position in the stock of another corporation.

Why Is This Important?

This announcement caused ripples in the real world as well as the tax world because lots of investors hold stock in public companies that own large blocks of other public companies. Such stock holdings come about in a variety of ways. The holder may have been flush with cash at one time and made lots of investments in startups in the same industry, hoping one would hit gold (and it has). Or the holder may have obtained the investment in a prior merger with the original owner. In either event, the investment no longer fits the holder's business model.

More importantly, the holder's shareholders might like to "monetize" the stake in the other corporation, without the holder having to sell it and pay tax and distribute the net proceeds as a taxable dividend. So why not put the investment in a Spinco and spin it off tax free and, who knows, maybe the other corporation will acquire the Spinco … later.

If you think this does not sound like what tax-free spinoffs are supposed to be for, you would be right; but that is nothing new. Spinoffs have been the go-to corporate tax planning tool for C corporations since at least 1986.

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What Is the Issue?

There are two possible tax issues, but really only one matters. There could be a concern that the Spinco does not have a qualifying active trade or business. But it does, by definition. The parent corporation will make sure of that. It just might not be very large. That in itself should not be a problem because the IRS has long allowed small businesses to satisfy the requirement.

Rather, the problem is with what is called the "device" requirement. The Code says that Section 355 is not supposed to be used as a device to distribute earnings and profits to shareholders tax free. This concept dates back to when dividends were taxed at ordinary income rates and capital gains were highly preferred. Therefore, if a corporation could put investment assets into a Spinco and the shareholders could sell the Spinco essentially for the value of the investment assets, the shareholders effectively would receive the corporation's earnings and profits as a capital gain.

Is spinning off a large minority investment in another corporation evidence of a device? It could be. Reg. Section 1.355-2(d)(2)(iv)(B) describes a situation somewhat like this one. But the IRS is uncertain, which is the reason for the announcement made in May.

During the period while the IRS and Treasury are considering what to do about this type of situation, the IRS will decline to issue private letter rulings on the issue. That is not an unusual response: the IRS has taken the same approach recently to rulings on problematic issues involving REITs and publicly traded partnerships. In both cases, the issues have been resolved.

Expect to see some resolution from the IRS perhaps by the end of 2015. They could decide to do nothing and start ruling again; or they could issue a proposed regulation addressing the device issue in this context.

For additional information, call Jack Cummings at 919.862.2302.

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