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Split-offs and Device

A current combination of two media companies illustrates a sometimes overlooked way to have a spinoff and sell one of the two companies.

Normally, the only sure way to flunk the inscrutable device prohibition in the Section 355 rules is for the shareholders to dispose of the stock of one of the two corporations at least in part for cash. However, the regulation states that "ordinarily" a Section 355 distribution will not be treated as a device to distribute earnings if the distribution would have produced gain if it had been taxable.

One way to produce gain or perhaps a recovery of basis is for the distributing corporation to have no earnings and profits; and that is another "out" from device. Another way is for the distribution to be a split-off.

Evidently, when the Treasury wrote this regulation, it had in mind a non pro rata split-off, as when a sub is split off to a disgruntled shareholder. But the gain result can also be obtained if the split-off is pro rata and the shareholders who receive the split-co stock suffer a decline in stock ownership some other way.

How might that be? How about a *Morris Trust* transaction? That describes the media companies' combination. Company X will split off Y and then X will merge with Z, a much larger company. If you compare the X shareholders' interest in X before and after the combined transactions, it will decline. That should be true of each of the public X shareholders as long as there is no cross-ownership.

Where does the cash come in? Z will pay some boot in the merger to the X shareholders. So if things work out right, X shareholders can wind up with Y stock and Z stock and cash and will be taxable only on the boot in the merger; the split will not be a device.

For more information, please contact Jack Cummings at 919.862.2302.

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