TAX 101:

HOW TO STRUCTURE A CORPORATE DIVISION

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Tags
Corporate Reorganization
Corporate Tax
Spin-off
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Type D Reorganization
Yahoo! Inc.

INTRODUCTION

A corporate division is a transaction that allows (i) a corporation (a "Distributing Corporation") to (ii) separate multiple businesses into separate corporations by (iii) transferring one or more active trades or businesses to an existing or newly-created controlled subsidiary corporation (a "Controlled Corporation") followed by (iv) a distribution of the stock of the Controlled Corporation to its shareholders. A corporate division can also involve the division of an already existing Controlled Corporation that conducts an active trade or business. In Europe, these divisive transactions are often known as "demergers."

In the absence of Internal Revenue Code ("Code") §355, a corporate division would be considered a taxable event for both the Distributing Corporation and its shareholders. The Distributing Corporation would recognize any gain (but not loss) on the distribution of the Controlled Corporation's stock. If a shareholder of the Distributing Corporation receives a *pro rata* distribution of the Controlled Corporation's stock, it will be taxed on the distribution: first as a dividend to the extent of both the Distributing Corporation's and the Controlled Corporation's earnings and profits, then as a recovery of the shareholder's basis, and finally, as capital gain to the extent that the value received exceeds the shareholder's basis.

However, if Code §355 applies, the Distributing Corporation does not recognize gain when it distributes the stock or securities of the Controlled Corporation. In addition, the Distributing Corporation's shareholders and security holders can receive stock or securities of the Controlled Corporation without recognizing gain. Finally, if the Distributing Corporation also distributes other property (known as "boot" in the context of reorganizations) in connection with the exchange, both the Distributing Corporation and its shareholders may recognize gain, but not loss, to the extent of the value of the boot.

FORMS OF CORPORATE DIVISIONS

A tax-free corporate division may take the form of a spin-off, spilt-off, or a spilt-up. It may also be a divisive Type D reorganization.

Spin-off

A spin-off involves the distribution of stock of the Controlled Corporation, on a *pro rata* basis, to the Distributing Corporation's shareholders. After the spin-off, the shareholders of the Distributing Corporation own stock of both the Distributing Corporation and the Controlled Corporation and the Distributing Corporation no longer has control of the stock or assets of the Controlled Corporation.

Example 1:

Corporation A owns and operates grocery stores and an online shopping website. The online shopping website is operated by Corporation B, a wholly-owned subsidiary of Corporation A. Corporation A transfers the stock of Corporation B *pro rata* to its shareholders in a corporate division that meets the requirements of a §355 spin-off.

Spilt-off

A split-off involves the shareholders of the Distributing Corporation exchanging part or all of their Distributing Corporation shares for Controlled Corporation shares. In a split-off, some shareholders of the Distributing Corporation may elect to participate in the split-off and others may not. Thus, after the split-off is completed, one shareholder group may own the Distributing Corporation, while another shareholder group may own the Controlled Corporation. Therefore, split-offs are a way to separate businesses among groups of shareholders. As in a spin-off, the Distributing Corporation no longer controls the Controlled Corporation after the split-off is completed.

Example 2:

Assuming the facts are the same as in the Example 1 above, Corporation A transfers the stock of Corporation B to some or all of its shareholders ("Shareholder Group 1") in exchange for part or all of the shareholders' Corporation B stock. The balance of the shareholders ("Shareholder Group 2") do not participate in the transaction. After the split-off is completed, Corporation A is owned by Shareholder Group 1 and Corporation B is owned by Shareholder Group 2.

Spilt-up

A split-up involves the Distributing Corporation distributing the stock and securities of at least two Controlled Corporations to its shareholders, after which it is liquidated. A split-up may involve either a *pro rata* distribution or a disproportionate distribution of the stock of the Controlled Corporations to the Distributing Corporation's shareholders. When the split-up is completed, the Distributing Corporation no longer exists.

Example 3:

Corporation A operates two businesses: a grocery store business through Corporation B and an online shopping website through Corporation C. Corporation A distributes the Corporation B and Corporation C stock to its shareholders and then is liquidated.

Divisive Type D Reorganization

A transfer of assets to a new or existing Controlled Corporation, followed by a distribution of the Controlled Corporation stock and securities, may qualify as a divisive Type D reorganization, but only if the distribution also meets the requirements of Code §355. The distribution of the Controlled Corporation stock and securities can take the form of a spin-off, split-off, or split-up.

A divisive Type D reorganization must meet the requirements of Code §368(a)(1)(D). Specifically, the Distributing Corporation must transfer assets to one or more corporations; the Distributing Corporation and/or its shareholders must be in control of the corporation immediately after the transfer, and the Distributing Corporation must distribute stock or securities of the corporation pursuant to a plan of reorganization that satisfies the requirements of Code §355.

Thus, a divisive Type D reorganization is a reorganization that meets the requirements of a corporate division under Code §355. But, as demonstrated above, a corporate division can exist in the absence of a divisive Type D reorganization. That is, when there are no asset transfers and the stock distributed is stock of an already existing Controlled Corporation (as in Examples 1, 2, and 3 above).

Example 4:

Corporation A operates both a grocery store business and an online shopping website. It forms a new subsidiary, Corporation B, and transfers the assets and liabilities related to the online shopping website business to Corporation B in exchange for all of its stock pursuant to a plan of reorganization under Code §368(a)(1)(D). Then, Corporation A spins off Corporation B to its shareholders by distributing all of the Corporation B stock *pro rata* pursuant to Code §355.

"A transfer of assets to a new or existing Controlled Corporation, followed by a distribution of the Controlled Corporation stock and securities, may qualify as a divisive Type D reorganization, but only if the distribution also meets the requirements of Code §355."

REQUIREMENTS OF A TAX-FREE CORPORATE DIVISION

A corporate division must meet the following statutory and non-statutory requirements to qualify for tax-free treatment under Code §355.

Control

The Distributing Corporation must control, immediately before the distribution, the subsidiary whose stock or securities are being distributed to shareholders. For this purpose, control means that the Distributing Corporation owns stock representing (i) at least 80% of the total combined voting power of all classes of stock entitled to vote and (ii) at least 80% of the total number of shares of all other classes of stock of the corporation. The latter typically consists of nonvoting preferred shares.

Distribution

Section 355 requires a distribution of the Controlled Corporation's stock by the Distributing Corporation to a shareholder with respect to its stock, or to a security holder in exchange for its securities. The distribution of the Controlled Corporation's stock or securities will be tax-free if the Distributing Corporation distributes all or substantially all (*i.e.*, an amount constituting 80% control, as defined above) of the stock and securities that it owns in the Controlled Corporation. However, boot received by the shareholders or security holders will be taxable.

Active Trade or Business

In order to meet the active trade or business requirement, the Distributing Corporation and the Controlled Corporation must be engaged in an active trade or business immediately after the distribution. Alternatively, this requirement can also be met if

immediately before the distribution, the Distributing Corporation has no assets other than stock or securities of two or more Controlled Corporations and each Controlled Corporation is engaged in an active trade or business immediately after the distribution.

The active trades or businesses must have been conducted by the Distributing and/or Controlled Corporations for five years before the distribution and the business(es) must not have been acquired in a taxable transaction during that period.

"In order to meet the active trade or business requirement, the Distributing Corporation and the Controlled Corporation must be engaged in an active trade or business immediately after the distribution."

This requirement is meant to prevent the avoidance of dividend treatment by disallowing the tax-free division of an existing corporation into an active business entity and an inactive business entity. For example, the division of a corporation into one corporation that owns an operating company and another corporation that only holds stock and securities. An example is Yahoo!, which has its own website operation and owns a significant portion of shares in the e-commerce company Alibaba, but not enough to be in control of Alibaba. A proposed spin-off of Alibaba shares to Yahoo! shareholders appears to have morphed into a spin-off of the historic Yahoo! business while retaining the Alibaba shares. Presumably, the possible tax exposure arising from failing the two active-business requirements is significantly less in the revised plan and might even result in a loss if certain investors are to be believed.

Corporate Business Purpose

A corporate division must be carried out for one or more corporate business purposes in order to receive tax-free treatment under Code §355. This is because tax-free treatment is meant to apply only to distributions that are part of restructurings of corporate operations that are required for business purposes. Further, the business purpose must be the business purpose of the corporation, and not that of the shareholders.

Device Restriction

A §355 corporate division must not be a "device" for the distribution of earnings and profits of the Distributing Corporation or the Controlled Corporation. The purpose of this requirement is to prevent the use of a tax-free distribution under Code §355 as a means for the Distributing Corporation's shareholders to convert the corporation's earnings into capital gain. To illustrate, if shareholders sell the stock in the Distributing or Controlled Corporations after the tax-free distribution, the transaction is not significantly different than a sale of the Controlled Corporation by the Distributing Corporation followed by a dividend of the sales proceeds to shareholders. This would be a taxable event for the Distributing Corporation and its shareholders.

An analysis of whether a corporate division is a device for the distribution of earnings is based on all of the facts and circumstances and weighs the presence of device and non-device factors. Factors indicating a device include

- a *pro rata* distribution resembling a dividend,
- a post-distribution sale by the shareholders, and
- the distribution of a disproportionately large amount of assets not used in a trade or business.

Factors considered to be evidence that the division was not a device include

- a strong corporate business purpose,
- a publicly traded Distributing Corporation, and
- the availability of the dividends received deduction to a corporate shareholder.

Continuity of Business Enterprise ("C.O.B.E.")

Under the C.O.B.E. requirement, the Distributing Corporation and the Controlled Corporation must continue their historic businesses or use a significant portion of their historic business assets after the distribution.

Continuity of Interest ("C.O.I.")

The C.O.I. requirement is met if there is continuity of ownership among one or more persons who were the owners of the enterprise before the distribution or exchange. That is, one or more pre-distribution shareholders must own a significant amount of the shares of the Distributing and Controlled Corporations after the distribution. The requirement applies to both the Distributing Corporation and the Controlled Corporation.

Not a Disqualified Investment Corporation

The Distributing Corporation and the Controlled Corporation must not be a "disqualified investment corporation." A corporation is a disqualified investment corporation if, immediately after the distribution, the fair market value of its investment assets is two-thirds or more of the fair market value of its gross assets.

Not a Disqualified Distribution

A corporate-level tax will be imposed on the Distributing Corporation if the distribution is a "disqualified distribution." A distribution is disqualified if, immediately after the distribution, any person holds stock purchased within the five-year period before the distribution (*i.e.*, disqualified stock), which constitutes 50% or more of the interest in the Distributing Corporation or the Controlled Corporation. It also includes a distribution of the Controlled Corporation's stock if the persons who acquired the Distributing Corporation's stock or securities during the five-year period later own a 50% or greater interest in the Controlled Corporation immediately after the distribution.

Distribution Made in Connection with a 50% or Greater Acquisition

A distribution under Code §355 must not be part of a plan to acquire stock of the Distributing or Controlled Corporations. The Distributing Corporation will recognize gain (not loss) as if it had sold the stock of the Controlled Corporation for fair market value, if the distribution is found to be a part of a plan in which one or more persons acquire a 50% or greater interest in the Distributing or Controlled Corporations

CONCLUSION

Tax-free corporate divisions conducted for valid business purposes are allowed under U.S. tax law. However, a corporate division contains similarities to a simple distribution to shareholders of appreciated property where the property takes the form of shares of a subsidiary. Whereas the division is tax-free, the distribution is taxable at two levels – the Distributing Corporation recognizes gain taxed at ordinary income rates and the shareholders report dividend income. The litmus test in distinguishing one tax result from the other is the package of hurdles that must be met in order to obtain tax-free treatment. Guessing wrong as to one of the hurdles can give rise to significant tax exposure. This is the conundrum that is currently faced by Yahoo! regarding its shares in Alibaba.[1]

[1] As of the date of this publication, Yahoo! has indicated that it will spin-off all shares other than those held in Alibaba.