

Tax

WEBINAR SERIES

Cross Border Spin-Offs

Devon Bodoh
Joseph Pari
Greg Featherman
Jenny Doak

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Weil, Gotshal & Manges LLP

March 10, 2021

Agenda

- I. Morris Trust Transactions
 - A. Interaction of Section 355(e) and Section 367(a)
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- II. Allocation of Earnings & Profits
- III. Section 7874 Issues
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 - B. Spinversions: U.S. Distributing & CFC Spinco
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- IV. Inbound Investor Spin-Offs
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I.	Morris Trust Transactions					

Morris Trust Transactions

Interaction of Section 355(e) and Section 367(a)

- Generally, Section 367(a)(1) turns off non-recognition for certain transfers of property by U.S. persons to a foreign corporation (referred to as an “outbound transfer”) that would otherwise qualify for non-recognition treatment.
 - The underlying policy is to ensure that income economically realized within the U.S. does not escape taxation in the U.S, e.g., via tax-deferred transfer of appreciated assets by a U.S. person to a foreign corporation that would sell such assets (See H.R. Rep. No. 72-708, at 20 (1932)).
- Treas. Reg. Section 1.367(a)-3 specifically addresses the treatment under Section 367(a) of the outbound transfer of stock or securities that are otherwise described in Sections 351, 354, 356, or 361.
 - Certain transactions that are not in form outbound stock transfers but have the effect of one, e.g., a Forward Triangular Reorganization where U.S. Target is acquired by a U.S. Acquirer but U.S. Target shareholder received Foreign Parent stock, are treated as outbound stock transfers under the indirect stock transfer rules of Treas. Reg. Section 1.367(a)-3(d).
- Under these regulations, the outbound transfer of stock or securities of a U.S. corporation are generally taxable unless an exception (described on the following slide) applies.
 - An outbound stock transfer may also implicate the anti-inversion rules in Section 7874 (which are discussed in greater detail below).

Morris Trust Transactions

Interaction of Section 355(e) and Section 367(a) continued

- Under Treas. Reg. Section 1.367(a)-3(c), the outbound transfer of U.S. corporation stock is not taxable under Section 367(a) if all of the following conditions are met:
 - 50% or less (by vote and value) of the stock of the foreign acquirer is received in the exchange by U.S. transferors.
 - 50% or less (by vote or value) of the stock of the foreign acquirer is owned after the transfer by U.S. persons that are either officers, directors or 5% shareholders of the U.S. corporation.
 - Either (a) the U.S. transferor is not a 5% shareholder of the foreign acquirer immediately after the exchange, or (b) the U.S. transferor enters into a 5-year gain recognition agreement with respect to the transferred U.S. corporation.
 - An active trade or business test is satisfied. Specifically, the active trade or business test is satisfied if the foreign acquirer has an active trade or business that satisfies a substantiality test, which requires the fair market value of the foreign acquirer to be at least equal to the fair market value of the U.S. corporation (the “Substantiality Test”).
 - The transferred U.S. corporation complies with certain reporting requirements.

Morris Trust Transactions

Interaction of Section 355(e) and Section 367(a) continued

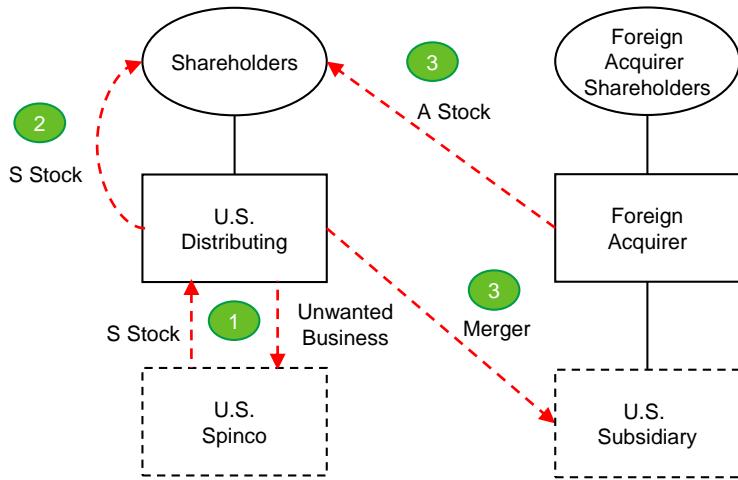
- What if the acquisition of the U.S. corporation by a foreign acquirer occurs with respect to the post spin-off acquisition of Distributing (referred to as a “Morris Trust Transaction”) or Spinco (referred to as a “Reverse Morris Trust Transaction”)?
- Under Section 355(e), if one or more persons acquire 50% or more (by vote or value) of either Distributing or Spinco pursuant to a plan or series of related transactions with a spin-off, the spin-off becomes taxable to Distributing (but not Distributing’s shareholders).
- This rule may be at odds with the exception to Section 367(a) described on the previous slide, which imposes a shareholder-level tax if certain legacy U.S. shareholders of Distributing receive more than 50% of the foreign acquirer’s stock.

Morris Trust Transactions

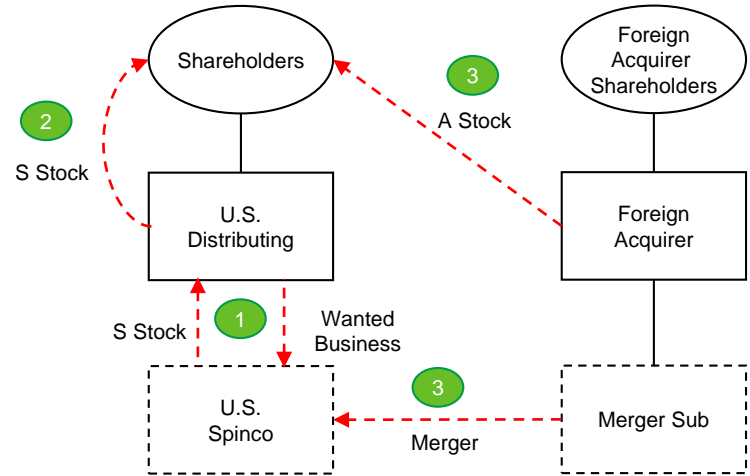
Interaction of Section 355(e) and Section 367(a) continued



Morris Trust - Distributing is Acquired



Reverse Morris Trust - Spinco is Acquired



Structured as a Forward Triangular to avoid application of Section 367(a) to the Distributing assets. This would be treated as an outbound stock transfer under the indirect stock transfer rules.

U.S. Distributing (or Spinco) is larger than Foreign Acquirer

- Section 367(a) applies (i.e., Substantiality Test failed)
- Section 355(e) does not apply

Shareholder-level gain recognition

Foreign Acquirer is equal to or larger than U.S. Distributing (or Spinco)

- Section 367(a) does not apply (i.e., Substantiality Test met)*
- Section 355(e) applies

Corporate-level gain recognition

* Assuming all other requirements to the exception are also met

Morris Trust Transactions

Interaction of Section 355(e) and Section 367(a) continued

- The “overlap rule” in Section 355(e)(3)(A)(iv) may allow a transaction to avoid the application of both Sections 355(e) and 367(a) in certain situations where certain of the foreign acquirer’s historic shareholders also own Distributing (or Spinco, as relevant) stock prior to the acquisition.
- Note that, unlike Section 355(e), which provides flexibility to undertake sizing transactions (e.g., shrink to fit) to fix the relative sizes of the parties to a Morris Trust transaction to avoid the “50% or more” threshold, the Treasury Regulations under Section 367(a) include specific anti-abuse rules that seek to prevent this. See, e.g., Treas. Reg. Section 1.367(a)-3(c)(3)(iii)(C) (value of the U.S. target increased by the amount of the NOCD (defined below) for purposes of applying the Substantiality Test).

Morris Trust Transactions

Section 367(a) & Device Test

- Under Section 355(a)(1)(B), a spin-off cannot be used principally as a device for the distribution of the earnings and profits (“E&P”) of Distributing or Spinco.
 - Determination is based on all facts and circumstances, and the regulations identify a series of “device factors” and “non-device factors.”
 - The device factors include a “subsequent sale or exchange” of the stock of the Distributing or Spinco, but reorganizations in which no or only an insubstantial amount of gain or loss is recognized are expressly carved out.
- If Section 367(a) applies to cause a post-spin acquisition of U.S. Spinco to be taxable, does this render the carve-out for nonrecognition transactions inapplicable with respect to the spin-off, thereby causing the acquisition to be a “subsequent sale or exchange” evidencing a device?

Morris Trust Transactions

Section 367(a) & Device Test continued

- U.S. Distributing's shareholders have a continued investment in the business.
 - The device test is designed to deter a “bail-out” of E&P that is not subject to tax as a dividend.
 - A spin-off that facilitates a stock-for-stock exchange in a reorganization does not seem to facilitate such a bail-out; E&P remain in corporate solution and the shareholders' investment in the business continues in modified form.
- In at least two PLRs, the IRS held that a distribution qualified under Section 355 despite gain recognition under Section 367(a) where the taxpayer made the following representation:
 - “Taking into account the exchange of [U.S. spinco stock] for [foreign acquirer stock] in the exchange (including the resulting Section 367(a) gain recognition), the distribution is not being used principally as a device for the distribution of earnings and profits of any of Distributing, [foreign acquirer], or Controlled.”
 - See PLR 201232014 and PLR 201817001.

Morris Trust Transactions

Section 367(a) & Active Trade or Business Test

- Under Section 355(b), each of Distributing and Spinco must be engaged in the active conduct of a trade or business immediately after the spin-off, and each such trade or business must have been conducted for the 5-year period preceding the spin-off (the “ATB Test”).
- To satisfy the ATB Test, with certain exceptions, the active trade or business must not have been acquired in a transaction in which gain or loss was recognized, in whole or in part, during the 5-year period preceding the spin-off.
- Similar rules apply to the acquisition of control of any corporation that was conducting the trade or business during the 5-year period preceding the spin-off.

Morris Trust Transactions

Section 367(a) & Active Trade or Business Test continued

- To the extent that Section 367(a) requires gain recognition upon the acquisition of an active trade or business (or the acquisition of an entity that conducts an active trade or business) during the 5-year period prior to the spin-off, it does not appear that such trade or business can be relied upon for purposes of satisfying Section 355(b).
- However, with respect to the taxable inbound acquisition under Section 367(a), some of the policy concerns meant to be addressed by the limitation on acquisitions of a trade or business may not be relevant.
- For example, the acquisition of a trade or business preceding a spin-off may present a tax benefit to the extent that it (i) represents a bail out of earnings via use of cash to buy a business or (ii) presents the ability to allocate purchased basis between Distributing and Spinco, but an inbound investor may be indifferent to such benefits.

II.	Allocation of Earnings & Profits					

Spin-Offs Involving CFCs

Overview

- Treas. Reg. Section 1.367(b)-5 provides a set of rules addressing the tax consequences of spin-offs involving controlled foreign corporations (“CFCs”).
 - These rules are intended to preserve the “Section 1248 Amount” with respect to the CFC stock which, generally speaking, is the amount of income a 10% U.S. shareholder of the CFC (a “U.S. Shareholder”) would include in income under Section 1248 if they had sold their CFC stock prior to the spin-off.
 - Section 1248 is a provision that requires certain U.S. Shareholders to recharacterize a portion of any gain from the disposition of CFC stock as a dividend to the extent of the E&P attributable to their stock.
- In a scenario where Distributing is a CFC, a distributee shareholder that is a U.S. Shareholder may be required to make adjustments to its tax basis in Distributing stock or include an amount in income to preserve its Section 1248 Amount with respect to Distributing. Similar rules may also apply with respect to Spinco if Spinco is also a CFC.

Spin-Offs Involving CFCs

Overview continued

- The rules in Treas. Reg. Section 1.367(b)-5 are necessary because, in the absence of rules affirmatively preserving the Section 1248 Amount, taxpayers could use the spin-off rules to reduce or eliminate their Section 1248 Amount.
 - Specifically, since every spin-off requires the allocation of certain tax attributes (including Distributing's E&P and the distributee shareholder's tax basis in Distributing stock) between Distributing and Spinco, spin-offs could provide an opportunity to shift attributes in a manner that affects the Section 1248 Amount, post spin-off.
- Note that after the enactment of Section 245A and Section 965 in the Tax Cuts and Jobs Act of 2017, Section 1248 and Treas. Reg. Section 1.367(b)-5 may be less relevant to U.S. Shareholders that are corporate entities in many circumstances.

Spin-Offs Involving CFCs

Pre- and Post- Distribution Amount

- To determine whether a spin-off has preserved a U.S. shareholders Section 1248 Amount, the distributee shareholder must compare its “pre-distribution” and “post-distribution” Section 1248 Amount attributable to Distributing (and, where relevant, Spinco).
 - If the U.S. Shareholder’s Section 1248 Amount with respect to Distributing (or Spinco, where relevant) decreased after the spin-off, the distributee shareholder reduces its basis in its shares of that entity.
 - If the reduction exceeds the shareholder’s basis in the relevant shares, the shareholder recognizes a deemed dividend to the extent of the excess.
 - If the shareholder reduced basis or recognized a deemed dividend, the shareholder increases its basis in the other corporation by that amount, except to the extent such increase would either be above fair market value or reduce its post-distribution Section 1248 Amount with respect to that corporation.
- As a threshold matter, to determine whether a reduction in Section 1248 Amount has occurred, it is necessary to determine the tax basis and E&P for both Distributing and Spinco.

Spin-Offs Involving CFCs

Allocation of Tax Basis

- Under Section 358(b)(2) and Treas. Reg. Section 1.358-2(a), the distributee shareholder allocates its basis in Distributing's shares between the shares of Distributing and Spinco in proportion to their respective fair market values.
- Any boot (*i.e.*, cash or other property) is treated as received in exchange for each share surrendered based on the fair market value of such shares, unless the terms of the exchange specify that the boot is received in exchange for a particular share and such terms are "economically reasonable".

Spin-Offs Involving CFCs

Allocation of E&P

- Generally, the allocation of E&P between Distributing and Spinco differs based on whether a spin-off involves a reorganization within the meaning of Section 368(a)(1)(D) (a “D Spin-off”) or not (“Non-D Spin-off”). See Treas. Reg. Section 1.312-10(a) and (b).
- D Spin-Off: In a D Spin-Off, Distributing contributes assets to Spinco (which is either newly formed (“NewCo”) or an existing subsidiary (“OldCo”) prior to the spin-off.
 - Spinco is a NewCo: The pre-spin E&P of Distributing is allocated between Distributing and Spinco based on the relative fair market values of the assets transferred to Spinco and the assets retained by Distributing.
 - Spinco is an OldCo: The Regulations don’t specifically address this fact pattern.
 - Note that Treas. Reg. Section 1.312-10 states that “[i]n a proper case, allocation shall be made between the distributing corporation and the controlled corporation in proportion to the net basis of the assets transferred and of the assets retained or by such other method as may be appropriate under the facts and circumstances of the case.”
 - Query what the “proper case” is.

Spin-Offs Involving CFCs

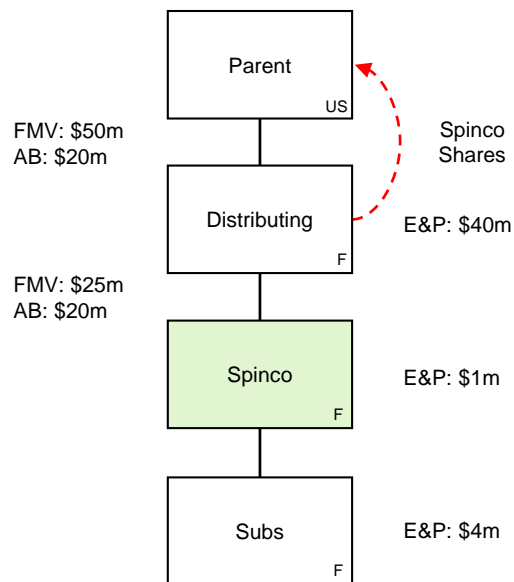
Allocation of E&P continued

- Non-D Spin-Off: No assets contributed pre-Spin by Distributing to Spinco.
 - The pre-spin E&P of Distributing is reduced by the lesser of (a) the amount that would have been allocated to Spinco if it were transferred to a newly created corporation in a D Spin-Off and (b) Spinco's "net worth" (*i.e.*, the sum of the bases of all of its assets plus cash, minus all liabilities).
 - Further, if Spinco's post-spin E&P is less than the decrease of Distributing's pre-spin E&P, Spinco's E&P is increased to equal the amount of the decrease.
- Proposed Treas. Reg. Section 1.367(b)-8
 - In a D Spin-Off, E&P always allocated based on net basis of assets.
 - In a non-D Spin-Off, Distributing's E&P decreased by the amount of its E&P that would have been reduced if it had transferred the stock of Spinco to a Newco in a D Spin-Off but Spinco's E&P is not increased or replaced.

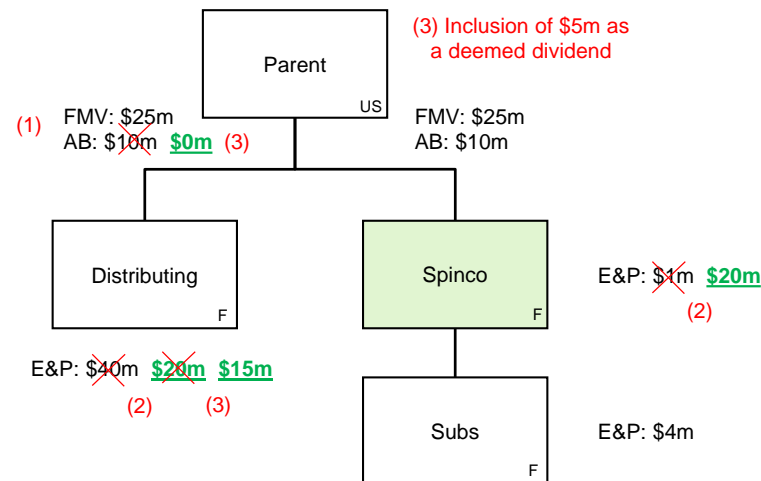
Example: Pro Rata Non-D Spin-off

Both Distributing and Spinco are CFCs

1 Pro Rata Non-D Spin-off



2 Resulting structure



Tax Consequences

- First, under Section 358(b)(2) and Treas. Reg. Section 1.358-2(a), Parent allocates its basis in Distributing's shares between the shares of Distributing and Spinco in proportion to their respective fair market values. Here, because the fair market value of each of Distributing and Spinco is \$25m, after the spin-off, Parent allocates its \$20m basis in Distributing \$10m to Distributing and \$10m to Spinco.
- Second, under Section 312(h) and Treas. Reg. Section 1.312-10, Distributing's E&P of \$40m is reduced by the lesser of the amount that would have been allocated based on fair market values (here, \$20m) and Spinco's net worth (\$25m). Thus, Distributing's E&P is reduced by \$20m to \$20m. In addition, Spinco's E&P is increased up to the amount of the reduction in Distributing E&P (here, up to \$20m).
- Third, under Treas. Reg. Section 1.367(b)-5, Parent's pre-spin Section 1248 Amount in Distributing (here, \$30m) is compared to Parent's post-spin Section 1248 Amount in Distributing after the spin-off (here, \$15m), and, therefore, Parent's basis in Distributing is adjusted downward by the difference of \$15m. Because Parent's basis in Distributing after the spin-off is only \$10m, it is adjusted to \$0 and \$5m is included in Parent's income as a dividend, further reducing Distributing's E&P by \$5m to \$15m. Finally, because Spinco's pre-distribution Section 1248 Amount is \$5m and its post-distribution Section 1248 Amount is \$15m, no adjustments need to be made.

Spin-Offs Involving CFCs

Device Test

- As discussed above, a spin-off cannot be used principally as a device for the distribution of the E&P of Distributing or Spinco.
- Treas. Reg. Section 1.355-2(d)(3)(iv) states that a distribution to U.S. shareholders that, if Section 355 did not apply, would be entitled to a dividend received deduction under Section 243(a)(2) or (3), 243(c) or 245(b), is evidence of non-device.
- Although Section 245A(a) is not listed, it should be treated the same as Sections 243(a) and 245(b) under the device “facts and circumstances” test because the same policy rationale applies—i.e., it would be absurd to conclude that a taxpayer has a purpose to avoid income that is effectively tax-exempt.
- The same logic would appear to also apply to spin-offs that would be treated as distributions of previously taxed earnings and profits (“PTEP”) that would also be non-taxable.

III.	Section 7874 Issues					

Overview of Section 7874

- Section 7874 provides potentially detrimental U.S. tax consequences to a U.S. corporation that undergoes a transaction whereby substantially all of its assets are acquired by a foreign corporation (“Foreign Acquirer”) and greater than a threshold percentage of Foreign Acquirer stock (the “Ownership Percentage”) is received by the U.S. corporation’s shareholders by reason of holding U.S. corporation stock (subject to some exceptions).
 - If the Ownership Percentage is 80% or more, the Foreign Acquirer is treated as a U.S. corporation for U.S. tax purposes.
 - If the Ownership Percentage is at least 60% but less than 80%, the Foreign Acquirer is not treated as a U.S. corporation but there may be various adverse tax consequences, e.g., the loss of certain tax attributes.
- Section 7874 and the regulations thereunder include many complex rules that govern the determination of the Ownership Percentage, including (among others):
 - Anti-abuse rules that result in an increase in the amount of Foreign Acquirer stock deemed received “by reason of” (or decrease of Foreign Acquirer stock not deemed received “by reason of”) in certain scenarios (including the “non-ordinary course distribution” or “NOCD” rule), and
 - Rules that ignore Foreign Acquirer stock otherwise received “by reason of” in certain scenarios where the policy concerns of Section 7874 are not implicated (including the “expanded affiliated group” or “EAG” rule).
- Some of these rules are discussed further below.

Foreign Distributing/Foreign Spinco

Foreign-Parented Group Exception

- Assume that Foreign Distributing contributes USCo to Foreign Spinco for 100% of its stock which it spins off to the public.
- For a moment in time (after the contribution and before the spin-off), a specific rule with respect to the Ownership Percentage (the “EAG Rule”) applies with respect to the Foreign Spinco stock held by Foreign Distributing that would cause the Ownership Percentage to be zero.
 - Under the EAG Rule, Section 7874(c)(2)(A) excludes from both the numerator and the denominator of the Ownership Percentage stock of a Foreign Acquirer that is held by members of an “expanded affiliated group” (“EAG”), which is generally defined as a chain of corporations connected through a 50% ownership with a common parent corporation.
 - Further, a special rule in Treas. Reg. Section 1.7874-1(c)(2) allows stock held by a member of an EAG to be included in the denominator (but not the numerator) of the Ownership Percentage if the acquisition qualifies as an “internal group restructuring”.
- However, Foreign Distributing and Foreign Spinco cease to be in the same EAG as a result of the spin-off.
- Treas. Reg. Section 1.7874-6 provides that transferred stock of a Foreign Acquirer (e.g., Foreign Spinco stock that is transferred by Foreign Distributing pursuant to a spin-off) is not treated as held by an EAG member for purposes of the above rules unless an exception (discussed on the next slide) applies.

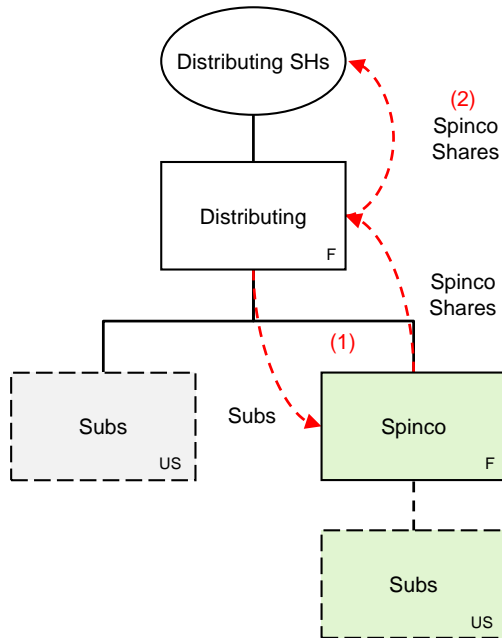
Foreign Distributing/Foreign Spinco

Foreign-Parented Group Exception continued

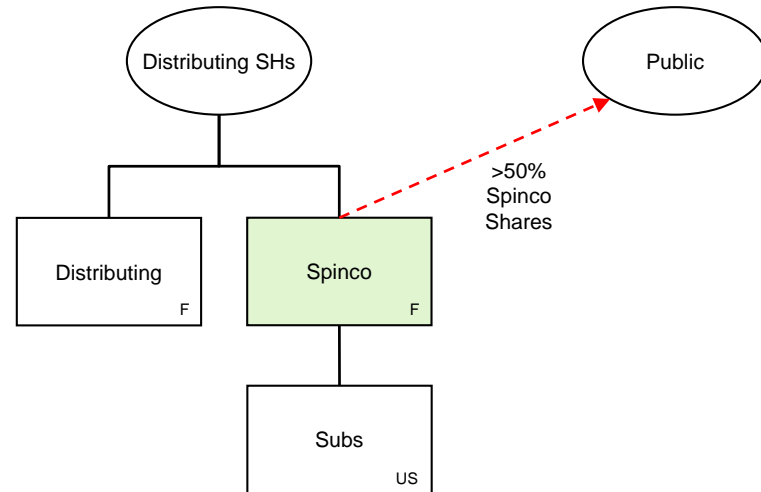
- The “foreign-parented group” exception (“FPG”) applies if (i) before the acquisition, the transferring corporation (i.e., Foreign Distributing) and the domestic entity are members of the same foreign-parented group, and (ii) after the acquisition, the transferring corporation (a) is a member of the EAG or (b) would be a member of the EAG absent the subsequent transfer of any stock of the foreign acquiring corporation (i.e., Foreign Spinco) by a member of the foreign-parented group in a transaction related to the acquisition.
- In this case, the FPG applies notwithstanding that Foreign Distributing and Foreign Spinco cease to be in the same EAG solely as a result of the spin-off.
- However, Treas. Reg. Section 1.7874-6(e) further provides that all transactions that are related to the acquisition are taken into account in applying this rule.
 - In other words, certain post-spin transactions (e.g., an IPO of Foreign Distributing or Foreign Spinco) may result in “breaking” the EAG for purposes of applying the FPG exception.

Foreign-Parented Group Exception Example

1 D Spin-off



2 Related IPO

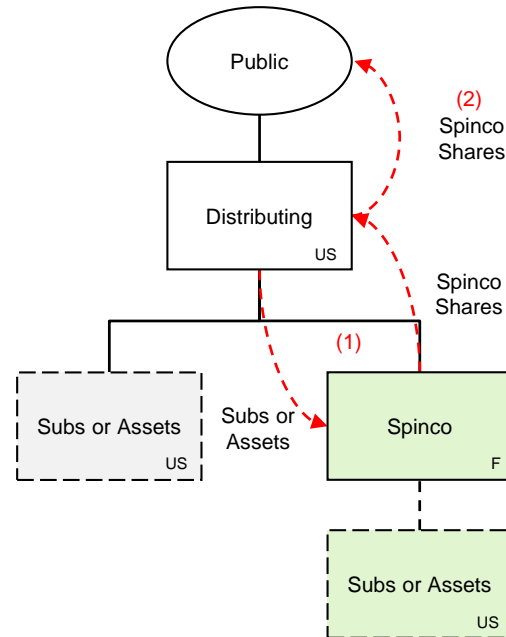


Tax Consequences

- If Spinco issues more than 50% of its equity in a related IPO (or acquisition), because the rules take into account all related transactions when applying the FPG exception, Spinco ceases to be in the same EAG and thus the FPG exception does not apply. Accordingly, assuming Distributing transferred solely U.S. Subs to Spinco, the Ownership Fraction is 100% and Section 7874 applies.

Spinversions

U.S. Distributing & CFC Spinco



- Assume instead that U.S. Distributing (i) contributes either substantially all of its assets or stock of a U.S. subsidiary to Foreign Spinco and (ii) distributes 100% of the Foreign Spinco stock to the public.
- Similar to the transaction in the prior slides, the stock received by U.S. Distributing in exchange for the assets satisfies the EAG test for a moment in time (prior to the contribution but before the spin-off).

Spinversions

U.S. Distributing & CFC Spinco continued

- In addition to the FPG exception (which is not available here because Distributing is a U.S. corporation), the regulations also include a U.S.-parented group (“USPG”) exception, which applies if (i) before the acquisition, the transferring corporation (*i.e.*, U.S. Distributing) is a member of a U.S.-parented group, and (ii) after the acquisition, each of the transferring corporation, any person that holds transferred stock, and the foreign acquiring corporation are members of a U.S.-parented group the common parent of which (x) before the acquisition, was a member of the U.S.-parented group, or (y) is a corporation that was formed in a transaction related to the acquisition, provided that, immediately after the corporation was formed, the corporation was a member of the U.S.-parented group.
- Similar to the FPG exception, all transactions that are related to the acquisition must be taken into account.
- In comparison to the FPG exception, the “would be a member” language is missing, and thus the USPG exception does not apply in a “spinversion” because after the spin-off, the transferred stock is held by the public and not U.S. Distributing.

Non-Ordinary Course Distributions

Overview

- Under the non-ordinary course distribution (“NOCD”) rules, certain adjustments may be made that increase the amount of Foreign Acquirer stock treated as received by the shareholders of the U.S. corporation stock by reason of holding such stock for purposes of determining the Ownership Percentage.
- Under Treas. Reg. Section 1.7874-10, the amount of the increase is equal to the amount of NOCDs during the 36-month period ending on the acquisition date.
- NOCDs are defined as the excess of all distributions made by the inverted U.S. corporation during each of the look-back years over the 36-month period before the acquisition over 110% of the average of such distributions during the 36-month period immediately preceding each such look-back year.
- For example, if a spin-off happens January 1, 2021, for a calendar year taxpayer, look-back years would be 2018, 2019 and 2020. Distributions made during 2020 must be compared to 110% of the average of distributions made during the 36-month immediately before the 2020 tax year (same with 2018 and 2019).

Non-Ordinary Course Distributions

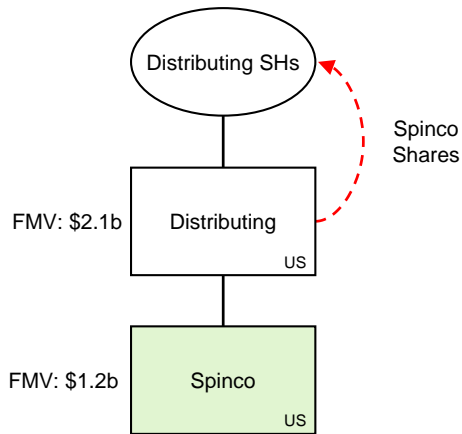
Application to Spin-Off Transactions

- A spin-off is a distribution that must be considered under the NOCD rules. One issue arises as to which entity the spin-off should be treated as an NOCD with respect to (as the direction of a spin-off could be reversed to circumvent the rules).
- Under Treas. Reg. Section 1.7874-10(g), if a U.S. corporation distributes Spinco in a Section 355 transaction, and immediately before the distribution, the fair market value of Spinco represents more than 50% of the fair market value of the stock of Distributing, Spinco is deemed to distribute Distributing's stock for purposes of applying the NOCD rules.

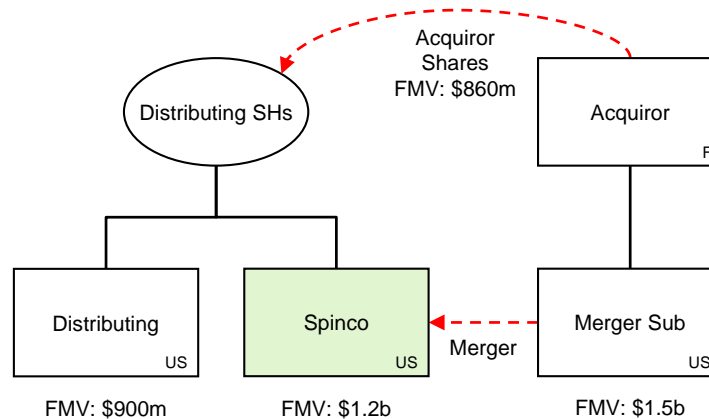
Non-Ordinary Course Distributions Example



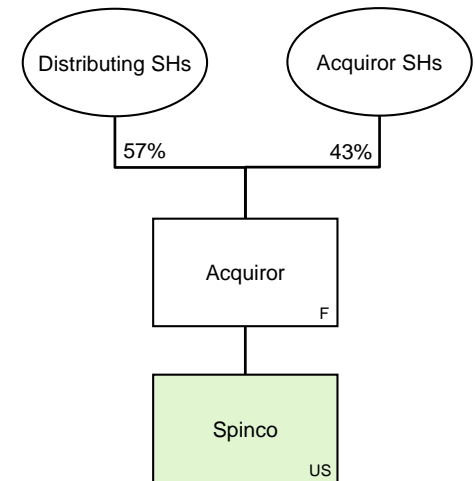
1 Spin-off



2 Merger



3 Final Structure



Anticipated U.S. Tax Consequences

- Assume the Merger occurs within 36 months of the Spin-Off (and that Spinco has not otherwise made any distributions during the relevant look-back period). Since Spinco's fair market value is higher than Distributing's fair market value, Treas. Reg. Section 1.7874-10(g) reverses the order of the Spin-Off and effectively adds back \$900m to Spinco's value for purposes of determining the Ownership Percentage on a subsequent acquisition.
- Therefore, after the application of Treas. Reg. Section 1.7874-10(g), the Ownership Fraction is $\$2.1b / \$2.96b = 71\%$, and Section 7874 applies to the Merger.
- For comparison, absent Treas. Reg. Section 1.7874-10(g), the Ownership Fraction would have been $\$1.2b / \$2.06b = 58\%$, and Section 7874 would not have applied to the Merger.
- Note that the result would be the same if Distributing SHs received a mix of Acquiror's stock and cash (see T.D. 9761, I.R.B. 2016-20, preamble to the Section 7874 regulations).

IV.	Inbound Investor Spin-Offs					

Inbound Investor Spin-Offs

Section 355(d)

- Section 355(d) generally causes gain recognition to Distributing in the case of a “disqualified distribution”, which is any Section 355 distribution where, immediately after such distribution, any person holds “disqualified stock” in either Distributing or Spinco that constitutes a 50% or greater interest (by vote or value) in such a corporation.
- “Disqualified stock” means any stock in Distributing or Spinco acquired by “purchase” after October 9, 1990, and during the 5-year period ending on the date of the distribution, or any stock in Spinco received in a distribution on Distributing stock or securities that were acquired by “purchase” after October 9, 1990, and during the 5-year period ending on the date of the distribution.
- The rationale behind Section 355(d) (broadly speaking) is to prevent a distributee shareholder from allocating its high, purchased tax basis in Distributing stock to Spinco post spin-off in order “to dispose of [Spinco] in a transaction that resembles a sale ... without incurring corporate-level tax.” (See H.R. Rep. No. 101-881, at 340-341 (1990)).

Inbound Investor Spin-Offs

Section 355(d) continued

- There are a number of detailed exceptions to the definition of “purchase” in Treasury Regulations with respect to Section 355(d) pursuant to Treas. Reg. Section 1.355-6.
- One specific exception, the affiliated group exception (“AGE”) in Treas. Reg. Section 1.355-6(d)(3)(v), provides that an acquisition of stock in exchange for cash, marketable security or debt of the transferor in a Section 351 exchange is not a “purchase” if:
 - (i) the transferor and the transferee are members of the same affiliated group before the Section 351 exchange;
 - (ii) the cash, marketable security or debt of the transferor have not been acquired by the transferor from a nonmember in a related transaction in which section 362(a) or (b) applies to determine the basis of the acquired assets; and
 - (iii) the transferor, the transferee and Spinco do not cease to be members of such affiliated group in any transaction pursuant to a plan that includes the Section 351 exchange.

Inbound Investor Spin-Offs

Section 355(d) continued

- For purposes of the AGE, “affiliated group” is defined by reference to Section 1504(a). Notably, foreign corporations cannot be members of an affiliated group for purposes of the AGE because the regulations do not carve out Section 1504(b)(3), which generally excludes foreign corporations from corporations includible in an affiliated group. Therefore, a foreign parent funding a U.S. group may cause a Section 355(d) issue in situations where U.S.-parented groups could rely on the AGE.
- The exclusion of foreign corporations is generally believed to have been deliberate, but there is not an obvious policy rationale for the different treatment.
 - See *Attorneys Seek Guidance for Spinoff Transactions*, 2009 TNT 135-10 (July 16, 2009) (recommending amendment to Treas. Reg. Section 1.355-6(d)(3)(v) to expand the exception to the definition of “purchase” for transfers between affiliated group members to remove an impediment to intragroup spinoffs involving foreign affiliates).

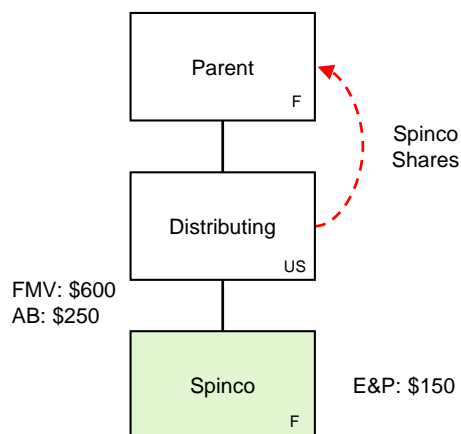
Inbound Investor Spin-Offs

Section 367(e)

- An inbound investor spin-off is a distribution by U.S. Distributing of a U.S. or foreign Spinco to a foreign distributee shareholder. These transactions are governed by Section 367(e).
- If Spinco is a U.S. corporation, regardless of whether a distributee shareholder is foreign, Section 367 does not apply.
 - Treas. Reg. Section 1.367(e)-1(c) carves out distributions by a U.S. Distributing corporation of a U.S. Spinco from the gain recognition rules of Section 367(e)(1).
 - The policy behind this is that there is no need to protect U.S. corporate tax base since U.S. Spinco's earnings will continue to be subject to U.S. corporate-level tax in the hands of a foreign shareholder.
- If Spinco is a foreign corporation, Section 367(e)(1) may apply to require U.S. Distributing to recognize gain on the distribution.
 - Under Treas. Reg. Section 1.367(e)-1(b)(1), U.S. Distributing recognizes gain (but not loss) on a distribution of a foreign Spinco to a person who is not a "qualified U.S. person" (i.e., who is not a U.S. tax resident individual or a U.S. corporation).
 - The amount of gain recognized by U.S. Distributing equals its built-in gain in the Spinco shares distributed to persons that are not qualified U.S. persons.
 - It appears that any gain recognized under Treas. Reg. Section 1.367(e)-1 should be treated as a gain from the sale or exchange of Spinco shares, thereby qualifying for a deemed dividend treatment under Section 1248(a) or (f). As such, Section 245A dividend received deduction may be available.

Inbound Investor Spin-Offs

Application of Section 367(e) (Example)



Facts

- Parent, a foreign corporation, wholly-owns Distributing, a U.S. corporation, which wholly-owns Spinco, a CFC.
- Distributing's basis in Spinco's stock is \$250, while their fair market value is \$600.
- Spinco has E&P of \$150.
- Distributing distributes 100% of Spinco shares to Parent in a distribution to which Section 355 applies.

Tax Consequences

- Distributing is required to recognize \$350 of gain on the distribution of Spinco shares under Treas. Reg. Section 1.367(e)-1 because Parent is not a qualified U.S. person.
- The amount of the gain is recharacterized as a deemed dividend under Section 1248(a) or (f) to the extent of Spinco's E&P of \$150.
- Distributing may be allowed a 100% dividend received deduction under Section 245A.

Inbound Investor Spin-Offs

Device Test

- As discussed above, a spin-off cannot be used principally as a device for the distribution of the E&P of Distributing or Spinco.
- In the inbound investor context, an inbound investor is subject to withholding tax at a statutory rate of 30% on U.S. source dividends. However, this rate may be reduced or eliminated under an income tax treaty between the U.S. and the relevant foreign country.
- Query the extent to which a reduced (or zero) rate of withholding tax under an applicable income tax treaty is evidence of non-device.

Summary of Cross Border Spin-Off Rules

U.S. Distributing, U.S. Spinco & Foreign Distributee

- Generally, none

U.S. Distributing & Foreign Spinco

- If distributee is a foreign person, Section 367(e) may trigger gain recognition for Distributing
- If distributee is a U.S. individual, Section 367(b) may trigger gain recognition for Distributing
- If Spinco is a CFC, Section 1248(f) may trigger a deemed dividend for Distributing

Foreign Distributing & U.S. Spinco

- If Distributing is a CFC, Section 367(b) may reduce basis in distributee's shares in Distributing or trigger a deemed dividend

Foreign Distributing & Foreign Spinco

- If Distributing is a CFC, Section 367(b) may reduce basis in distributee's shares in Distributing (or, if Spinco is a CFC, in Spinco) or trigger a deemed dividend

U.S. Distributing or Spinco & Foreign Post-Spin Acquirer of either

- Section 367(a) may trigger gain recognition for distributee and impact device and active trade or business analyses of the pre-acquisition spin-off
- Section 7874 may apply to treat foreign acquirer as U.S. or surrogate foreign corporation

V.	A View from Europe					

Non-U.S. Acquirer

- European jurisdictions
 - U.K., Netherlands, Ireland, Luxembourg
- Offshore
 - Bermuda, Cayman Islands, Jersey

U.K. Resident Acquirer: Considerations

- No tax on receipt of dividends from subsidiaries
- No withholding tax on outbound dividends
- No tax on disposal of trading subsidiaries
- CFC rules generally bite only if profits are diverted from the U.K.
- 19% corporation tax rate (25% from 2023)
- Stamp taxes if U.K.-incorporated (cf. U.S. listing / non-U.S. listing)
- Double tax treaty network
 - Dividends from U.S. subsidiaries can often be paid without withholding tax
- U.K.-incorporated or non-U.K.-incorporated?
 - Managing residence
- Impact of Brexit?

Demergers & Spin-Offs from U.K. PLC

- Generally structured as tax neutral for U.K. shareholders (some rare examples of taxable demerger)
- Disposal at company level / degrouping charges
- Stamp taxes
- Various structures:
 - Statutory demerger
 - Cancellation / reduction in capital / buyback
 - Liquidation
- Potential tensions with business combinations