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New Spin-off Rules

On July 14 and 15, 2016, the Treasury and the IRS issued new guidance on the requirements for tax-free corporate "spin-off" transactions. The guidance includes proposed regulations which would make it more difficult to successfully execute a tax-free spin-off transaction, when the distributing company and/or the distributed company holds significant nonbusiness assets.

Last fall, the IRS announced that it was studying issues that arise in spin-off transactions where either the distributing company ("Distributing") or the distributed company ("Controlled") holds significant investment assets, in the wake of purported discussions between Yahoo and its shareholders to split most of Yahoo's business assets from its stock in Alibaba. The IRS was concerned that these types of spin-offs could provide shareholders with a mechanism for separating investment assets from operating businesses, thereby enabling the potential monetization of the investment assets through a sale of stock without triggering corporate-level tax.

The proposed regulations are the result of the IRS's review of this topic. The proposed regulations provide more specific rules for evaluating whether a spin-off is tax-free where either or both of Distributing and Controlled own significant "nonbusiness assets" immediately after the spin-off or if the ratio of business assets to "nonbusiness assets" of Distributing and Controlled differ substantially. For this purpose, the IRS defines "nonbusiness assets" as almost any assets that are not used in an active business. For example, real estate held for investment or cash or securities in excess of what is necessary for working capital would be nonbusiness assets.

Under the proposed rules, the greater the amount of nonbusiness assets Distributing or Controlled owns (relative to the amount of such company's business assets), the stronger the evidence that the potential spin-off is being used as a "device" to facilitate certain types of tax avoidance and, as a result, is ineligible for tax-free treatment. In addition, the bigger the difference between the percentage of Distributing's total assets that consists of nonbusiness assets, versus the percentage of Controlled's total assets that consist of nonbusiness assets, the stronger the evidence that the transaction is being used as a device for tax avoidance and should not be a tax-free transaction. The proposed regulations generally would be effective for spin-offs that occur after the date final regulations are published.

We do not believe that these rules (if finalized) will adversely impact tax-free spin-offs by REITs of either TRSs or subsidiary REITs. (As discussed in our December 23, 2015 Client Briefing (available here), these two transactions remain eligible to be structured as tax-free spin-offs even after Congress restricted most REIT spin-offs late last year). This view is based on the fact that many REITs actively manage their real properties. As a result, in their hands, real properties should qualify as business assets and therefore should continue to be eligible to be part of a tax-free spin-off transaction. REITs contemplating a potential spin-off would essentially need to ensure that their real estate holdings are treated as business assets.

In separate guidance issued a day after the proposed rules described above, the IRS provided safe harbors for transactions where Controlled is recapitalized immediately before the spin-off in order to give Distributing 80% voting control over Controlled. Such voting control is required for a tax-free spin-off, under the spin-off statute. The new rules can be useful in a case where Distributing completes an IPO for more than 20% of Controlled's stock, and Distributing then recapitalizes its shares of Controlled into "high-vote" stock, in order to meet the 80% voting control requirement for a tax-free spin-off. The new rules also would apply where minority shareholders own nonvoting stock – such as nonvoting preferred stock – of Controlled, and

Controlled is recapitalized before the spin-off to give Distributing 80% ownership of all classes of nonvoting stock, as is required under the tax law in order for the spin-off to be a tax-free transaction.

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