Build Back Better Act Would Change Monetization Playbook for Tax-Free Spin-Offs

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If enacted in its present form, the Build Back Better Act (BBBA) would amend the U.S. tax code's rules for tax-free spin-off and split-off transactions (spin-offs), imposing significant restrictions on a parent company's ability to reallocate debt to the spin-off company without incurring a tax liability. Navigating these restrictions, or mitigating their impact, will require careful planning and transaction structuring, particularly in spin-offs involving highly appreciated assets.

Background on Spin-Offs and Traditional Methods of Debt Reallocation

A spin-off generally involves the separation of a historic business line of a parent company (Parent) into an independent, separately traded entity. Spin-offs are typically structured as "divisive" reorganizations in which the Parent contributes the spin-off business to a newly formed subsidiary (Spinco) and then distributes the Spinco's stock to the Parent's shareholders. If the spin-off satisfies certain tax-free qualification requirements, the transaction is not taxable to the Parent, Spinco or shareholders who receive Spinco stock.

The Parent may receive cash proceeds or reallocate some of its existing debt to the Spinco as a way of partially "monetizing" the Parent's interest in the spin-off business and establishing appropriate capital structures for the two companies going forward. Within prescribed limits, the spin-off rules sanction a variety of tax-free methods of extracting value from the spin-off business.

The Spinco's assumption of debt or other liabilities from the Parent is generally tax-free to the extent the amount of liabilities assumed does not exceed the tax basis of the assets that the Parent transfers. Similarly, the Parent's receipt of cash or other property (referred to as "boot") from the Spinco is generally tax-free to the extent (1) the value of the boot does not exceed the tax basis of the transferred assets less the amount of liabilities assumed, and (2) the Parent "purges" the boot through payments to its shareholders (*e.g.*, as dividends or stock repurchases) or to its creditors (*e.g.*, via repayment of outstanding Parent debt).

The current law provides flexibility to reallocate additional debt to the Spinco — in excess of the tax basis of the transferred assets — through a "debt-for-debt exchange," by which the Parent receives newly issued Spinco debt "securities"[1] and uses them to retire outstanding Parent debt. Debt-for-debt exchanges are frequently structured as "intermediated" exchanges in which investment banks or other financial intermediaries buy the relevant Parent debt in the secondary markets and exchange it for Spinco debt securities (which are usually sold promptly to investors). This is one of the most well-trod and generally efficient paths to "monetize above basis" in a spin-off.

Proposed BBBA Amendments to Spin-Off Rules

The BBBA would amend the spin-off rules in an effort to create parity among these different methods of debt reallocation by subjecting debt-for-debt exchanges to the same overall tax basis limitation that had previously applied only to liability assumptions and boot payments (the BBBA spin-off amendment). If enacted, the BBBA spin-off amendment would apply a single, aggregate tax basis limitation to (1) the amount of liabilities assumed by the Spinco, (2) the amount of cash (and the value of non-cash boot) paid by the Spinco and transferred to the Parent's creditors, and (3) the principal amount of

[1] "Security" is a tax law term of art that refers to a debt instrument representing a meaningful, longer-term investment in the issuer.

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debt securities (and the value of certain debt-like "nonqualified preferred stock"[2]) issued by the Spinco and transferred to the Parent's creditors. As a result, the Parent would generally be taxed on any built-in gain in the spin-off business to the extent the aggregate amount of these items exceeds the Parent's tax basis in the assets that it transfers to the Spinco.

The BBBA spin-off amendment generally applies to spin-offs occurring after the date of enactment. A transition rule provides "grandfathering" relief for transactions that are (1) consummated pursuant to a written agreement that was binding as of the enactment date and at all times thereafter, (2) described in a ruling request submitted to the Internal Revenue Service (IRS) on or before that date, or (3) described on or before that date in a public announcement or filing with the Securities and Exchange Commission.

General Observations

If enacted, the proposed tax basis limitation will force many companies undertaking spin-offs to engage in complex transaction structuring — or simply pay more tax — when the amount of debt that the Parent wishes to reallocate to the Spinco exceeds the tax basis of the spin-off business. As a general matter, the BBBA spin-off amendment will put more pressure on the structure of the overall transaction and its individual steps, including the "external" spin-off itself and any internal restructuring transactions effectuated as part of the separation.

For non-grandfathered transactions, there will be more of a premium on structuring techniques that maximize the amount of tax basis available to support the desired allocation of leverage and cash proceeds between the Parent and Spinco. Companies constrained by the tax basis limitation may even consider reversing the overall direction of the spin-off, leaving the spin-off business (and debt) with the Parent and spinning off the Parent's other businesses and assets into a separate entity. Stronger incentives will exist to use Spinco stock as an alternative currency to retire Parent debt, even though such "debt-for-equity exchanges" often entail greater friction costs than debt-for-debt exchanges and may not produce an optimal capital structure.

Moreover, while it is unclear how the BBBA spin-off amendment might impact the IRS's private letter ruling program, a proliferation of novel and complex structures could strain the program and test the IRS's willingness to issue rulings in some cases.

Revisiting the Monetization Playbook

While the BBBA spin-off amendment, if enacted, would introduce new structuring challenges for companies and their advisers, several key techniques may address the proposed tax basis limitation and achieve tax-efficient monetization in a spin-off. Each technique should be evaluated in the early planning stages of the transaction to determine which best suits the Parent's particular facts and business objectives.

Efficiently maximizing available tax basis in multitiered structures. The proposed tax basis limitation increases the importance of efficiently maximizing available tax basis to support monetization. In most spin-offs by large public companies, the "external" spin-off of the Spinco is preceded by a series of internal restructuring transactions to package and separate the spin-off business from the Parent's other businesses and assets. Depending on the Parent group's tax attributes and legal entity structure, certain opportunities may provide access to incremental tax basis at lower "tiers" of entities within the group.

As one example, assume that the Parent has a disproportionately high tax basis in the stock of a first-tier subsidiary that owns a second-tier subsidiary with low-basis spin-off business assets. The Parent may "hive off" some of its basis in the stock of the first-tier subsidiary through an internal spin-off (or split-off) in which a portion of that basis is allocated to the stock of the distributed subsidiary, which can support a leveraged distribution of cash to the Parent, either by the distributed subsidiary or by the Spinco after the distributed subsidiary is contributed to it. Many variations of this scenario can and often do arise.

Sales of "low-taxed" assets by subsidiaries. With careful structuring, the Parent may sell particular spin-off business assets into the Spinco structure in a manner that permits tax-efficient cash extraction from the Spinco. For example, if a subsidiary of the Parent holds recently acquired spin-off business assets that have little built-in gain, the subsidiary may be able to sell those assets (or an entity formed to hold them) to the Spinco at minimal tax cost, as long as the sale is respected as a separate exchange and not integrated with the Parent's contribution of the rest of the spin-off business to the Spinco. Similarly, assets held by a non-U.S. subsidiary of the Parent can generally be sold at reduced effective U.S. tax rates under the GILTI regime.

[2] Nonqualified preferred stock is generally any "preferred stock" (as defined under the U.S. tax code) that (1) has one or more specified put, call or mandatory redemption features exercisable within 20 years after the issue date, or (2) provides for dividends at a floating rate tied to interest rates, commodity prices or similar indices. Although Spinco nonqualified preferred stock is listed as one of the items subject to the tax basis limitation, the proposed statutory text contains a general exception for any stock of the Spinco that is issued to the Parent in the transaction. If taken at face value, this exception would seem to remove Spinco nonqualified preferred stock from the scope of the tax basis limitation, a result that is likely unintended.

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"Reverse" spin-offs. Another powerful tool is the ability to reverse the "direction" of a spin-off, which can allow for largely unrestricted, tax-free extraction of value from the "unwanted" business. Instead of spinning that business off, the Parent transfers its core business to a newly formed subsidiary (New Parent), distributes the New Parent's stock to the Parent's shareholders and keeps the unwanted business, which can be leveraged to provide cash proceeds for the New Parent. If necessary for non-tax reasons, the Parent can undertake a preliminary reorganization to place the existing Parent legal entity with the New Parent and create a new entity that will be treated as the "old" Parent for tax purposes.

A reverse spin-off allows the unwanted business to be allocated an amount of debt, either historic or newly incurred, in excess of the Parent's tax basis in that business. The Parent may also transfer cash to the New Parent without any tax basis limitations or "purging" requirements. This structure can be used in preparatory internal spin-offs to similar effect.

Debt-for-equity exchanges. Although debt-for-debt exchanges are subject to the proposed tax basis limitation, the BBBA spin-off amendment does not change the treatment of debt-for-equity exchanges in which the Parent uses Spinco common stock (or "qualified" preferred stock) as the medium of exchange to retire Parent debt in connection with a spin-off. Like debt-for-debt exchanges, debt-for-equity exchanges are often structured as intermediated exchanges. They can be used to effectuate an initial public offering by the Spinco before the spin-off or to dispose of a retained equity stake in the Spinco after the spin-off.

The spin-off rules require the Parent to distribute "control" of the Spinco (generally, an amount of Spinco stock representing at least 80% of the Spinco's voting power and at least 80% of each of its nonvoting classes of stock) to the Parent's shareholders. This normally means that the Parent can dispose of up to 20% of the Spinco stock in a debt-for-equity exchange, assuming that the Spinco has just one class of voting stock. If a dual-class voting structure is palatable as a business matter, the Parent may be able to monetize an even larger portion of the Spinco's equity value (up to 49.9%) by capitalizing it with "high-vote" and "low-vote" classes of stock, distributing the high-vote shares (representing at least 80% of Spinco's voting power and more than 50% of its equity value) to the Parent's shareholders and using the low-vote shares to retire Parent debt.

Cash payments to the Parent's shareholders. By its terms, the proposed tax basis limitation only takes into account boot that is "purged" through payments to the Parent's creditors; it does not take into account boot that is paid to the Parent's shareholders in the form of dividends or stock repurchases. For companies that file consolidated U.S. tax returns, the consolidated return regulations effectively cap the amount of boot that can be purged to shareholders at the Parent's pre-spin-off tax basis in the stock of the Spinco, but those rules apply separately from the BBBA spin-off amendment's statutory debt reallocation limitations.

Although it is unclear if this is the intent, the BBBA spin-off amendment appears to permit the Parent to (1) extract cash proceeds from the Spinco up to its tax basis in the Spinco stock and use that amount to fund dividends or stock repurchases, and (2) receive Spinco debt securities in a principal amount up to the tax basis of the spin-off business and use them to retire the Parent debt. After the spin-off, the Parent would presumably be free to use its other cash resources (*e.g.*, amounts that it would otherwise have used to pay dividends or repurchase stock) for further deleveraging.