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

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Takeaways

- Tax law changes in the Build Back Better Act (BBBA) would limit the amount of value a company could extract in a spin-off by using a debt-for-debt exchange.
- Companies may be able to achieve most of the tax-free monetization currently available using alternative approaches, such as effecting a reverse spin-off, transferring high-basis assets to the Spinco or using a debt-for-equity exchange.
- Under the BBBA amendment, dividends to shareholders and stock buybacks do not appear to count toward the proposed cap on other forms of monetization.

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. Typically, they are 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 requirements, the transaction is not taxable to the Parent, Spinco or shareholders who receive Spinco stock.

Current spin-off rules sanction a variety of tax-free methods of extracting value from the spin-off business. For example, 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.

The Spinco's assumption of debt or other liabilities from the Parent is generally tax-free to the extent the liabilities assumed do 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" (a term of art that refers to certain longer-term debt instruments) and uses them to retire outstanding Parent debt. That is usually achieved through an intermediary such as an investment bank that buys the relevant Parent debt in the secondary market and exchanges it for the newly issued Spinco debt, which is 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 currently applies only to liability assumptions and boot payments (the BBBA spin-off amendment). If enacted, the changes 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 debt securities (and the value of certain debt-like "nonqualified preferred stock") 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.

If enacted, the proposed tax basis limitation will force many companies undertaking spin-offs to engage in complex transaction structuring to avoid paying higher taxes when the amount of debt that the Parent wishes to reallocate to the Spinco exceeds the tax basis of the spin-off business.

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 monetizable tax basis in multitiered structures. The proposed tax basis limitation increases the importance of maximizing the 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. Depending on the Parent group's tax attributes and legal entity structure, proper planning may allow the Parent to use the tax basis at lower-tier subsidiary entities to support tax-free leveraged distributions of cash to the Parent, monetizing value without exceeding the tax basis limitation.

Sales of "low-taxed" assets by subsidiaries. With careful structuring, the Parent may sell some 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 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. Non-U.S. subsidiaries of the Parent can also sell assets to the Spinco at reduced effective U.S. tax rates.

"Reverse" spin-offs. Another option is 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 the core business it wants to retain to a newly formed subsidiary (New Parent) and distributes the New Parent's stock to the Parent's shareholders, and the "old" Parent keeps the unwanted business, which can be leveraged in advance of the distribution to provide cash proceeds for the New Parent.

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, because the Parent is not the company being spun off. The Parent may also transfer cash to the New Parent before the reverse spin-off 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; the statutory cap does not apply to 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, regulations effectively cap the latter 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.

In other words, the amendment appears to allow a monetization of up to two times the Parent's tax basis in the spin-off business. 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.

For more details, see our December 17, 2021, client alert "Build Back Better Act Would Change Monetization Playbook for Tax-Free Spin-Offs."