IRS Offers Limited Safe Harbors for Recapitalizations Before Spin-Offs

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On July 15, 2016, the Internal Revenue Service (IRS) released a new revenue procedure, Rev. Proc. 2016-40, providing safe harbors for transactions in which a corporation (Distributing) obtains the requisite control of a subsidiary (Controlled) in order to qualify a subsequent distribution of Controlled's stock as tax-free under Section 355 of the Internal Revenue Code. These transactions involve the adoption of a capital structure for Controlled with two classes of voting stock, one having higher voting power than the other. For recent coverage of new Treasury Department regulations governing Section 355, see July 20, 2016, client alert "Proposed Treasury Regulations Raise New Hurdles for Tax-Free Spin-Offs."

If certain requirements are met, Section 355 allows Distributing to distribute stock of a corporation it "controls" (*i.e.*, Controlled) without either Distributing or its shareholders recognizing gain or loss on the distribution. Control for this purpose generally means ownership of stock representing at least 80 percent of the total combined voting power and at least 80 percent of each class of nonvoting stock. If Distributing's stake in Controlled is below the 80 percent threshold, it generally may obtain control of Controlled in a tax-free recapitalization prior to the distribution in which it exchanges its Controlled shares for shares having enhanced voting rights. Additionally, Controlled may recapitalize into high- and low-vote classes of stock when Distributing already controls Controlled but wishes to effectuate a substantial carve-out initial public offering (IPO) of Controlled preceding the distribution. This can be done by having Controlled issue low-vote shares to investors in the IPO before Distributing's distribution of the high-vote class to Distributing's shareholders.

The two-class capital structure resulting from such recapitalizations may produce less efficient trading or otherwise be less than optimal for a publicly traded entity. Accordingly, Controlled may wish to "unwind" that capital structure after the distribution by recapitalizing into a single class of stock. Under various income tax principles, such an unwind may jeopardize the qualification of the distribution under Section 355 if the initial recapitalization into control is considered transitory or otherwise lacking in substance (or, in the case of a recapitalization of a Controlled already controlled by Distributing, if Distributing is treated as losing control prior to the distribution). Under pre-existing published and informal IRS guidance, various standards had been developed governing the impact of such an unwind on a distribution's qualification under Section 355. In 2013, the IRS announced that it was studying recapitalizations preceding Section 355 distributions and would not issue private letter rulings during the pendency of the study.

Revenue Procedure 2016-40

Recognizing inherent factual difficulties in applying the relevant income tax principles, the IRS announced in Rev. Proc. 2016-40 that it would not challenge Controlled's status as a corporation controlled by Distributing in an otherwise qualifying Section 355 distribution as a result of an unwind if the unwind is described in either of two safe harbors.

As a threshold matter, Rev. Proc. 2016-40 applies to a transaction in which (i) Distributing owns stock of Controlled not constituting control, (ii) Controlled issues shares of one or more classes of stock to Distributing or other shareholders and, following such issuance, Distributing owns stock constituting control of Controlled (the Issuance), and (iii) Distributing distributes Controlled stock in a transaction that otherwise qualifies under Section 355.

The unwind of a recapitalization into control is defined as any post-distribution action by Controlled that "actually or in effect substantially restores" shareholders to (i) the relative direct or indirect interest in Controlled or any successor, had the Issuance not occurred, or (ii) the relative voting rights and value of Controlled's classes of stock prior to the Issuance.

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The first safe harbor (the Two-Year Safe Harbor) will apply if no action is taken by Controlled's board of directors, management or any controlling shareholders in the two years following the distribution that, if implemented, would unwind the recapitalization into control. The actions potentially taken include "the adoption of any plan or policy."

The second safe harbor (the Unanticipated Acquisition Safe Harbor and, together with the Two-Year Safe Harbor, the Safe Harbors) applies to transactions Controlled enters into with a counterparty (such as an acquisition or merger not otherwise violating Section 355(e)) that meets the following conditions: First, the parties participating in the unwind transaction have not entered into any "agreement, understanding, arrangement, or substantial negotiation" or "discussions" in the two years prior to the distribution, using the definitions of such terms in the Treasury regulations governing Section 355(e); and second, no more than 20 percent, by vote or value, of the interest in the counterparty is owned by the same persons that own more than 20 percent of Controlled, after applying certain attribution rules (the 20 Percent Relatedness Threshold). The Unanticipated Acquisition Safe Harbor applies regardless of whether the unwind occurs within two years of the distribution.

Unwind transactions not described in the Safe Harbors do not prevent a distribution from qualifying under Section 355 and are analyzed under "general federal tax principles without regard to the provisions of" the revenue procedure. Rev. Proc. 2016-40 also removes the issue of recapitalizations into control and carve-out IPOs followed by unwinds from the current "no-rule" list described above, signaling new potential for obtaining private letter rulings for transactions falling outside of the Safe Harbors.

The revenue procedure generally applies to distributions occurring on or after August 1, 2016, but taxpayers may apply it to distributions occurring before that date.

Potential Impacts of the Revenue Procedure

The Safe Harbors should provide some measure of certainty enabling distributions preceded by recapitalizations into control to proceed. In a variety of situations, however, the Safe Harbors may prove no less difficult to apply than the general tax principles they were intended to supplant. The most significant impact of the revenue procedure may be its interpretation of prior IRS guidance on the application of general tax principles to post-distribution unwinds of high-vote/low-vote structures. Below are a few highlights:

Application of the Two-Year Safe Harbor

Although purporting to obviate an analysis under general tax principles, the Two-Year Safe Harbor expressly excludes unwinds where management of Controlled has adopted a "plan or policy" to effect an unwind within two years following a distribution. A potential unwind well beyond two years of a distribution may still raise difficult factual questions of whether Controlled management had adopted a plan within the prohibited two-year period. It is unclear whether management's mere contemplation of an unwind in the two-year period would prevent application of this Safe Harbor. In public remarks at a New York State Bar Association conference on July 17, 2016, the IRS associate chief counsel (corporate) said that it was not intended that such "thought crimes" would preclude application of the Two-Year Safe Harbor. Nevertheless, corporations with a dual class structure will have to exercise caution against formulating anything that might seem like a plan.

Limited Applicability of the Unanticipated Acquisition Safe Harbor

The Unanticipated Acquisition Safe Harbor may be unavailable for many public companies. A counterparty in the same or related industry as Controlled (a likely candidate for a transaction described in the Safe Harbor) may have investors in common with Controlled and would not satisfy the 20 Percent Relatedness Threshold. Because there is no minimum size or influence requirement for a shareholding to be taken into account, any two large capitalization corporations included in one or more indices (*e.g.*, the Standard & Poor's 500 index) are likely to have a 20 percent overlap. Moreover, a public company would face further difficulty proving that the 20 Percent Relatedness Threshold was satisfied, as the identity of smaller noninstitutional shareholders holding through brokers is protected by investor privacy laws. Speaking at the July 17 conference, the IRS associate chief counsel (corporate) acknowledged that this aspect of the Safe Harbor was problematic and asked for suggestions as to how it should be revised.

Safe Harbors Inapplicable to Recapitalizations to Retain Control

The Safe Harbors, by their terms, apply only when Distributing acquires control of Controlled in a recapitalization preceding a Section 355 distribution and do not apply to an unwind of a high-vote/low-vote structure if Distributing already controlled Controlled prior to the issuance of low-vote stock (*e.g.*, in a carve-out IPO). Accordingly, unwinds of such structures continue to require analysis under general tax principles.

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The Safe Harbors are a welcome development that should provide some measure of certainty for transactions involving recapitalizations into control. Nevertheless, they still present a number of significant questions concerning their application.

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If you have any questions regarding the matters discussed in this memorandum, please contact the following attorneys or call your regular Skadden contact.

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