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## Spin-Off Revenue Procedure Removes a No-Rule Area and Provides Safe Harbors for Unwinding High Vote/Low Vote Stock Structures

On July 15th, the IRS released Rev. Proc. 2016-40 (the “Rev. Proc.”) removing a recent “no-rule” area with respect to transactions undertaken in anticipation of a spin-off involving high vote/low vote stock classes for the spun-off corporation, and providing safe harbors with respect to subsequent adjustments to the stock structures. The Rev. Proc. is a positive development for taxpayers because the safe harbors provide certainty while the removal of the no-rule area gives taxpayers the opportunity to seek further guidance from the IRS through the private letter ruling process.

### Background

One of the requirements for a tax-free spin-off under Section 355 is that the distributing corporation (“D”) distributes stock of the controlled corporation (“C”) representing “control” of C (the “Distribution of Control Requirement”). For purposes of the Distribution of Control Requirement, control means at least 80% of the voting power of all classes of stock entitled to vote, and at least 80% of each class of non-voting stock.

If D did not have control of C, a recapitalization of C could be undertaken to create two classes of voting stock, high vote and low vote, where D could receive the high vote stock and obtain the requisite 80% control. In Rev. Rul. 69-407, the IRS permitted this type of recapitalization where D owned 70% of C’s single class of stock prior to the recapitalization and ruled that the spin-off of C by D qualified under Section 355 because the recapitalization resulted in a “permanent realignment of voting control” with respect to C. In contrast, in Rev. Rul. 63-260, the IRS ruled that a spin-off did not qualify under Section 355 where D owned 70% of C’s stock, D’s shareholder owned the remaining 30% of C’s stock and, prior to the spin-off, D’s shareholder contributed 10% of the C stock to D because such transfer was transitory in that the contributed C stock was returned to D’s shareholder in the spin-off.

In addition, C may undertake an IPO prior to a spin-off. In the IPO, C could issue low vote stock to public shareholders such that more than 20% (but less than 50%) of the value but less than 20% of the voting power of the C stock is issued to investors in the IPO. As a result, D would maintain 80% control of C and could subsequently distribute its C stock in a spin-off that satisfies the Distribution of Control Requirement.

The issue that arises with respect to these recapitalizations (or other transactions) is whether the high vote/low vote structures can be unwound without violating the Distribution of Control Requirement. In particular, if these voting structures are unwound after the spin-off then the IRS could challenge these dual class voting structures as transitory and thus assert that D failed the Distribution of Control Requirement. In 1997, Section 355(e) was enacted, which requires D to recognize gain if C undergoes a change of control as part of a plan that includes the spin-off. The legislative history to Section 355(e) generally provides that post-spin restructurings of C generally

should not be taken into account in determining whether the Distribution of Control Requirement was satisfied. Based in part on this legislative history, the IRS issued Rev. Rul. 98-27 providing that transactions with respect to C stock following a spin-off will not be taken into account under the step transaction doctrine in determining whether the Distribution of Control Requirement was satisfied in the spin-off. Consistent with this view, the IRS had privately ruled that certain unwinds were permissible. For example, the Service privately ruled that a spin-off satisfied the Distribution of Control Requirement where there was no binding commitment to unwind the voting structure and the structure could not be unwound without the C board independently determining after the spin-off to hold a shareholder vote but an unwind was nevertheless expected (see, e.g., PLR 201123030). The particular circumstances that the IRS ruled were permissible varied somewhat over time.

More recently, in Rev. Proc. 2013-3, the IRS announced a new no-rule area with respect to these voting structures by providing that private letter rulings will not be issued if, in anticipation of a spin-off, (i) D acquires putative control of C in any transaction (including a recapitalization) in which stock or securities were exchanged for stock having a greater voting power than the stock or securities relinquished in the exchange, or (ii) C issues stock to another person having different voting power per share than the stock held by D.

The no-rule announcement created uncertainty as to the circumstances under which the IRS would take the position that the Distribution of Control Requirement was not satisfied when the voting structure was unwound following the spin-off. In this regard, notwithstanding the Section 355(e) legislative history and Rev. Rul. 98-27, the IRS could assert that the Distribution of Control Requirement was never satisfied in the first place because the changes to the stock of C in recapitalization were transitory and should be disregarded.

### **The Rev. Proc.**

The Rev. Proc. provides that Treasury and the IRS recognize the difficulty of determining whether an acquisition of control of C by D in anticipation of a spin-off will be respected and, to resolve the uncertainty, set forth safe harbors in which the IRS will not assert that an acquisition of control should be disregarded. In addition, the Rev. Proc. removes the dual class stock structure as a no-rule area, meaning that the IRS will consider issuing private letter rulings with respect to recapitalizations and other transactions that result in D acquiring control of C in anticipation of a spin-off. The Rev. Proc. does not contain safe harbors relating to C issuing low vote stock in a pre-spin IPO, but the removal of the no-rule status for this area should be read to permit taxpayers to submit private letter ruling requests with respect to pre-spin IPOs.

The Rev. Proc. applies to transactions pursuant to which (i) D owns less than 80% control of C stock, (ii) C issues stock to D or other C shareholders, thereby creating the high vote/low vote structure and providing D with the requisite 80% control, (iii) D distributes the C stock in a spin-off that otherwise satisfies the requirements of Section 355, and (iv) following the spin-off, C engages in a transaction that, actually or in effect, substantially restores C's shareholders to the relative interests and/or voting rights and value that were present prior to the high vote/low vote structure.

The first safe harbor applies if no action (including the adoption of a plan or policy) is taken at any time during the 24-month period following the spin-off by C's board of directors, C's management or C's controlling shareholders

(for a public company, a 5% shareholder who actively participates in the management of the corporation) that would, actually or effectively, result in an unwind of the high vote/low vote structure.

The second safe harbor applies if C acquires or is acquired by a third party in a transaction that results in an unwind of the high vote/low vote structure regardless of whether the transaction occurs during the 24-month period following the spin-off, provided that (i) there was no agreement, understanding, arrangement or substantial negotiations or discussions concerning the transaction or a similar transaction at any time during the 24-month period ending on the date of the spin-off and (ii) no more than 20% (by vote or value) of the stock of the third party acquiror is owned by the same persons that own more than 20% of the C stock (taking into account constructive ownership rules).

Finally, the Rev. Proc. notes that the failure to satisfy a safe harbor has no effect on the determination of whether the Distribution of Control Requirement is satisfied, which will be determined under general US federal income tax principles.

## Effective Date

The Rev. Proc. is effective with respect to spin-offs that occur on or after August 1, 2016 but taxpayers may apply the Rev. Proc. to spin-offs that occurred prior to August 1st.

The Rev. Proc. is a welcome addition from the IRS to the spin-off area. By removing the no-rule area, taxpayers have the opportunity to seek guidance from the IRS with respect to the Distribution of Control Requirement. In addition, the safe harbors provide greater certainty to taxpayers with respect to unwinding of high vote/low vote structures following a spin-off.

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This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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