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IRS Proposes Election to Increase Subsidiary's Basis in Assets Upon a Taxable Sale or Spin-off, Reducing the Cost and Risk of "Morris Trust" Transactions

On August 22nd, the IRS proposed long-awaited regulations under Internal Revenue Code Section 336(e), enacted in 1986. When finalized, the new regulations will permit a corporation that disposes of stock of a subsidiary in a taxable transaction to elect to increase the subsidiary's basis in its assets to fair market value. The election will be available in the case of a taxable spin-off or split-off of a corporate subsidiary and other circumstances where a current law Section 338 election is not available. The new regulations will mitigate the over-taxation that arises under current law if a corporation spins or splits off a subsidiary and, intentionally or unintentionally, the spin-off or split-off is taxable to the distributing corporation. The regulations will reduce the tax cost and risk of so-called "Morris Trust" transactions.

In a typical "Morris Trust" transaction, pursuant to an overall plan, an acquiror acquires a target corporation for acquiror stock after the target distributes to its shareholders the target businesses that the acquiror does not want. Code Section 355(e) imposes tax on the target corporation on such a spin-off that is part of a "plan" with an acquisition, unless the target's historic shareholders own more than 50 percent of the combined company. Current law does not generally permit a tax basis step-up in the assets of the spun-off corporation, however, making the corporate-level tax imposed by Section 355(e) particularly onerous. Indeed, the prospect of that tax often prevents transactions from occurring or distorts them. In order to avoid the tax, parties either seek to avoid having the spin-off and the acquisition be treated as part of a plan by refraining from negotiating prior to the spin-off or observing certain temporal safe harbors, or they adjust the economics of the acquisition such that the target's shareholders retain more than 50 percent of the combined company.

The new election will provide another alternative to address the tax imposed by Section 355(e). If a spin-off and acquisition are part of a plan and the target's historic shareholders own 50 percent or less of the combined company, then Section 355(e) will tax the target on the spin-off as under current law. If the election is made, however, the spun-off corporation would have a fair market value tax basis in its assets, including goodwill. Such tax basis would generally be able to be depreciated or amortized creating tax deductions over time. If the spun-off corporation is otherwise profitable, those tax deductions would reduce the spun-off corporation's taxes. The amount of the saved taxes could be paid over to the target corporation thus mitigating the target's tax on the spin-off.

A condition of making the new election is that the spin-off or split-off be taxable to the distributing corporation. Most spin-offs and split-offs are intended to be tax-free. The parties to a spin-off or split-off that is intended to be tax-free should consider making the new election protectively to provide for a basis step-up if the transaction turns out to be taxable (for example, as a result of a subsequent acquisition of the distributing or spun-off corporation). If the parties do make the election, the tax sharing agreement should define which party will be entitled to the resulting tax benefits, as well as the control of any contest relating to taxability.

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The new election is proposed to be effective for transactions completed on or after the date the regulations are finalized. It will be available if a domestic corporation makes a taxable disposition of stock representing at least 80 percent of the vote and value of another domestic corporation during a 12-month period. While current law Section 338 requires a single corporate purchaser to purchase stock representing at least 80 percent of the vote and value of the target corporation, the new Section 336(e) election will not require a corporate purchaser nor a single purchaser of 80 percent of the target nor even will it require a purchase.

In addition to its relevance to spin-offs and split-offs, the new election will be useful in the case of certain taxable sales of subsidiaries not eligible for Section 338. The new election incorporates the same prohibitions on sales to related persons and sales in partially tax-free transactions as apply under Section 338. Those prohibitions pose potential obstacles when a seller retains shares or when the buyer and seller are related (for example, through a partnership, even a partnership unconnected to the contemplated transaction). It may be easier to overcome certain of these obstacles in the case of the new election because a corporate purchaser is not required. For example, the new election can be made if a non-corporate acquiror buys at least 80 percent of the target and the seller corporation retains up to 20 percent of the target subsidiary. Under current law, a Section 338 election requires complicated mechanics to achieve a similar result. The IRS ought to reconsider the prohibitions in any event.

The new election is made unilaterally by the seller on its tax return. Buyers of target subsidiaries should include relevant protections in the purchase agreement, because an election in the case of a sale could lead to a step-down in asset basis if there are losses inherent in the target's assets.

Unlike a Section 338 election, the new election is not available in the case of a foreign target nor in the case of a target that is an S corporation. Further, the new election is not available if the transaction is eligible for a Section 338 election.

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