TAX INCREASE PREVENTION AND RECONCILIATION ACT OF 2005; TAX-FREE SPIN-OFF DEVELOPMENTS

Recently, the President signed into law the Tax Increase Prevention and Reconciliation Act of 2005 (the "Act"). The Act contains two significant amendments to Section 355 of the Internal Revenue Code of 1986, as amended (the "Code"). If the requirements of Code Section 355 are met, a corporation (the "distributing corporation") may distribute to one or more of its shareholders stock of a subsidiary (the "controlled corporation") without incurring corporate-level or shareholder-level tax. These transactions are commonly referred to as spin-offs or split-offs.

Among the requirements that must be met for Section 355 to apply is a requirement that both the distributing corporation and the controlled corporation be engaged in an active trade or business that has been actively conducted for at least five years prior to the spin-off and that has not been acquired in a taxable transaction during that period (the "ATB test"). One amendment is designed to limit taxpayers' ability to engage in so-called cash-rich split-off transactions. The other simplifies the application of the ATB test.

I. Limitation on Cash-Rich Split-Offs

The Act adds new Code Section 355(g), which is targeted at so-called cash-rich split-offs. The government views these transactions as tantamount to a tax-free cash sale of a shareholder's interest in the distributing corporation. Interestingly, the new law confirms that such transactions are tax-free as long as they are carried out within the confines of new Code Section 355(g), in addition to satisfying the general Section 355 requirements.

In a cash-rich split-off, the distributing corporation capitalizes the controlled corporation with a large amount of cash and a relatively minor active business (in order to satisfy the ATB test). All of the stock of the controlled corporation is then distributed to a shareholder of the distributing corporation in complete redemption of that shareholder's interest in the distributing corporation. Code Section 355(g) does not apply to pro-rata spin-offs.

The technique was employed by Janus with respect to the disposal of its investment in DST Systems in December 2003 (89.6% cash). It was also used by KeySpan with respect to its investment in The Houston Exploration Company (86.6% cash), and Henkel with respect to its investment in The Clorox Company (73% cash).

Code Section 355(g) denies tax-free treatment if (i) either the distributing corporation or the controlled corporation is a "disqualified investment corporation" immediately after the distribution and (ii) any person that did not hold, directly or indirectly, 50 percent or more of the voting power or value of the stock of such distributing corporation or controlled corporation immediately before the distribution does hold, directly or indirectly, 50 percent or more of the voting power or value of the stock of such disqualified investment corporation immediately after such distribution (including any series of related transactions).

Generally, a disqualified investment corporation is any distributing corporation or controlled corporation if the fair market value of the investment assets of the corporation is two-thirds or more of the fair market value of all assets of the corporation. However, for the first year after the date of enactment, this test uses a more generous 75 percent threshold, instead of two-thirds.

For this purpose, "investment assets" generally includes (i) cash, (ii) stock or securities in a corporation, (iii) interests in a partnership, (iv) debt instruments or other evidences of indebtedness, (v) options, forwards, futures, notional principal contracts or other derivatives, (vi) foreign currency and (vii) any similar asset. Excepted from the definition of "investment assets" are certain assets held for use in the active conduct of a lending, financing, banking or insurance business, securities held by dealers and certain partnership interests used to satisfy the ATB test under applicable guidelines. In addition, investment assets issued by a corporation with respect to which the distributing or controlled corporation owns directly or indirectly at least 20 percent of the voting power or value are also generally excluded from the definition of "investment assets."

This provision generally applies to distributions after May 17, 2006, with certain exceptions.

II. Simplification of the Active Trade or Business Test

Under prior law, a corporation met the ATB test only if, among other things, (i) the corporation was directly engaged in the active conduct of a trade or business or (ii) the corporation was not directly engaged in an active business but substantially all of its assets consisted of stock or securities of one or more corporations that it controls that were engaged in the active conduct of a trade or business.

The Act modifies this rule so that it is now applied on an "affiliated group" basis for both the distributing and controlled corporations, thus eliminating the need to determine whether the ATB test is met "directly" or "indirectly." This will simplify or eliminate the need for corporate internal restructurings that were often necessary prior to effecting a tax-free spin-off. For instance, under the new law it is no longer necessary to determine whether substantially all the assets of a parent holding company are stock or securities of one or more other corporations.

For the distributing corporation, the relevant affiliated group consists of the distributing corporation as the common parent and one or more chains of corporations connected through stock ownership representing at least 80 percent of the total voting power and 80 percent of the total value of the stock of each corporation, immediately after the distribution. The relevant affiliated group for a controlled corporation is determined in a similar manner with the controlled corporation being treated as the common parent. This provision, which is a modified version of a bill originally introduced by Senator Breaux (D-La.) in 1998, applies to distributions occurring after May 17, 2006, and on or before December 31, 2010, with certain elective exceptions.

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