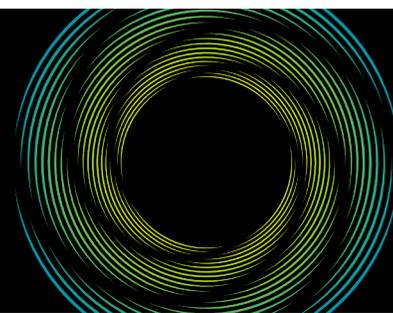


M&A Tax Talk

Distressed market series



Can a business be brought out of corporate solution tax-free?

A Reverse Morris Trust (RMT) transaction may be the only answer

The tax lobster trap: C corporations?

In the world of taxation for business entities, a single level of taxation is ideal. Unlike “flow-through” entities, a C corporation generally results in two levels of taxation (an entity-level tax and a tax at the stakeholder level when proceeds are distributed). These distinct levels of taxation apply to both operating income and gain from the disposition or distribution of assets held by the C corporation. Accordingly, C corporations have been compared to lobster traps: easy to enter and painful to get out of.

Busting the tax lobster trap: Dispose corporate assets tax-free with an RMT

A C corporation’s stakeholders may decide that it’s in the company’s best interest to divest of a business line for a variety of business reasons (for example, the “conglomerate discount,” the business line no longer aligning with the company’s overall strategy, or competition for management attention and capital). As noted above, this divestiture will generally be subject to two levels of taxation.

The primary way a C corporation can distribute a business line to its stakeholders on a tax-free basis is through a spin-off. A Reverse Morris Trust (RMT) transaction builds upon the tax-free spin-off and allows the relevant stakeholders to transfer the unwanted business line to a corporate acquirer in return for stock from the acquirer that is distributed to the corporation’s shareholders. As a result, the distributing company can monetize its interest in the distributed business on a tax-free basis by having the distributed business: (i) engage in a leveraged distribution or (ii) issue debt securities in the spin-off leg of the RMT. An RMT transaction can be beneficial to

both the stakeholders of the disposing C-corporation (by avoiding double-level taxation), as well as the corporate acquirer. To bust the corporate lobster trap, an RMT transaction may be the only answer.

The anatomy of an RMT

The RMT transaction consists of two distinct components: a tax-free spin-off and a prearranged merger of the spun-off company with an unrelated third party in a tax-free reorganization (see “How an RMT works” for more detail).

For each component of the RMT to be treated as tax-free, the RMT must comply with numerous technical requirements of both spin-offs under IRC section 355 and tax-free reorganizations under IRC section 368. Following the execution of an RMT transaction, the relevant stakeholders will continue to hold: (i) more than 50 percent of the acquirer and (ii) 100 percent of the C corporation from which the disposed business line was spun off.

One significant hurdle to executing an RMT is IRC section 355(e), which requires that the shareholders of the distributing corporation retain more than 50 percent of the spun-off entity’s stock (by vote and value), including indirectly after the anticipated merger with a third party, and any other transactions that are considered “part of the plan” (see “How an RMT works” for more detail). If this 50 percent threshold is not met, the spin-off will be taxable to the distributing corporation (although not necessarily to its shareholders).

If the acquiring corporation is already larger than the business to be spun off, all is not lost, however. If the distributing corporation and the acquirer have overlapping shareholders (such as index

funds if the parties are in the same industry), all of the shares held by these shareholders after the transaction may count as “good” for these purposes. In addition, the acquirer could consider a preclosing leveraged distribution to slim itself down below the 50 percent threshold.

How an RMT works

An RMT transaction is typically executed in the following steps:

- A distributing corporation (Distributing) operates a business (Business A), which it intends to spin-off from its existing operations (Business B). A corporate acquirer (Acquirer) wishes to acquire Business A from Distributing in a transaction which is nontaxable to both Distributing and its shareholders.
- Distributing contributes Business A to a newly formed corporation (SpinCo) in exchange for the stock of SpinCo (and typically debt proceeds or SpinCo’s securities) and distributes SpinCo to its shareholders.
- SpinCo merges with, and into, Acquirer with SpinCo’s shareholders (Distributing’s existing shareholders), receiving stock of Acquirer in exchange for their stock of SpinCo.

Following the RMT, Acquirer owns and will continue to operate Business A. However, for the transaction to be nontaxable to all parties, Distributing’s historic shareholders must hold both (i) the stock of Distributing, and (ii) more than 50 percent of the stock of Acquirer. Distributing will continue to separately operate Business B.

Challenges and shortfalls of RMTs

While RMT transactions allow a corporate divestiture to be completed in a tax-free manner, these transactions are, by their very nature, complicated to execute. Given that an RMT transaction is composed of two steps (a tax-free spin-off under section 355 and a tax-free reorganization under section 368), there are distinct tax rules to be satisfied. In addition, the implementing agreements often contain restrictions on post-closing activities that could jeopardize the tax-free treatment (for example, under the tax separation agreement, the parties to an RMT typically are limited in their ability to complete other corporate transactions for a period of time).

Consideration should also be given to the potential complexities, tax leakage, or other costs that could arise in separating the wanted and unwanted businesses. Additional complexities may arise when the acquiring corporation is foreign, as such transactions are often taxable to certain shareholders of the spun-off entity and must be structured to avoid the anti-inversion rules.

From both a commercial and tax perspective, the implementation of leverage is another significant consideration when structuring an RMT transaction. The parties to the RMT, together with their investment bankers, must ensure the proper capital structure of both the distributing company and the combined company post-RMT merger, which may be very different from their current capital structure.

These changes in debt levels may have tax consequences, as the amount of cash the distributing corporation receives generally cannot exceed the tax basis in the net assets of the spun-off business and must be transferred to creditors or shareholders as part of the plan to ensure tax-free treatment. Tax advisers, investment bankers, and legal counsel should all be included in discussions related to the implementation of leverage to ensure the desired capital structure is implemented in a tax-efficient manner.

Given the complexities, detailed tax analyses, and documentation required to execute an RMT, it is crucial that the company's external advisers (including lawyers, accountants, and bankers) have experience implementing similar transactions and are closely aligned with each other and the company's internal functions (tax, legal, treasury, accounting, HR, etc.) at every step of the process.

Wild-caught, tax-free lobster: The case for an RMT

An RMT transaction is a powerful tool in the M&A space, as it allows a distributing corporation to receive the tax benefits of a spin-off and the managerial and operational benefits of combining a business line with an existing company in a manner that is accretive to its shareholders. Although the requirements to avoid corporate and shareholder-level taxation are numerous and complex, requiring quantitative calculations and qualitative balancing of factors, an RMT is a tax planning consideration to bust the corporate lobster trap—pulling a business out of its existing corporate solution and releasing it, tax-free.

Want to learn more?

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