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How Tax Insurance Is Key to Unlocking Post-Spinoff Transactions

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In this article, Brody argues that tax insurance can unlock opportunities to expand post-spinoff change-of-control transaction activity.

The Daring Adventure

To the indomitable Helen Keller this quote is attributed: "Security is mostly a superstition. Life is either a daring adventure or nothing." Corporations that execute spinoff transactions often feel the same, as planning for and executing a spinoff feels like a daring adventure. If successful, a spinoff is a rare exception to a corporation being taxed on the disposition of a business. If any of the myriad requirements for a tax-free spinoff are not met, the corporation making the distribution (Parent) is taxed on the spread between the fair market value of the stock of the distributed company (SpinCo) and its tax basis in the SpinCo stock.[1]

Typically, this spread between FMV and basis is significant, thus prompting a willingness to engage in the daring adventure to execute a tax-free spinoff. When evaluating whether to move forward with a proposed spinoff transaction, or specific post-spinoff activity, there may be compelling reasons to execute the transaction, but there also may be a matter of law or fact that produces enough risk to allow inertia to win out over sound business strategy. As examined more fully below, tax insurance could be the gust of wind needed to break the inertia and set sail on an intentionally less daring adventure.

An area of both fact and law that often impedes spinoffs or post-spinoff activity is a series of rules that addresses post-spinoff transactions, and violation of these rules can cause a spinoff that was once treated as tax free to retroactively be taxable to Parent and possibly its shareholders.[2] One of the most onerous of these restrictions is intended to prevent distributions from qualifying as tax free if they are part of a plan to facilitate a change in control of Parent or SpinCo (for these purposes, a change of control is generally a 50-percent or greater change in stock ownership).

The rules contain a "rebuttable presumption" that a plan is presumed to exist if one or more persons acquire a 50 percent or greater interest in Parent or SpinCo within two years before or after the distribution.[3] Given this onerous restriction and rebuttable presumption, it is understandable that

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transactions resulting in a change of control would concern a parent corporation that has completed or is contemplating a spinoff within the period covered by the rebuttable presumption.

Despite the ominous tone of the rebuttable presumption, there are several exceptions and safe harbors that provide taxpayers with guidance in specific fact patterns.[4] The most relevant is colloquially referred to as the "super safe harbor," and it provides that a distribution and a later acquisition of stock of Parent or SpinCo can be part of a plan only if there is an:

> agreement, understanding, arrangement, or substantial negotiations regarding the acquisition or a similar acquisition at some time during the two-year period ending on the date of the distribution.[5]

To apply the safe harbors, it is therefore necessary to know detailed facts about conversations and considerations by and among Parent, SpinCo, and third parties.

The Lockdown

Fear of the rebuttable presumption or, worse, a post-spinoff transaction causing the spinoff to constitute an impermissible device, has resulted in a near lockdown on post-spinoff "change of control" transactions. Many transactions involving SpinCo equity following a spinoff are both permissible and common (for example, raising capital through equity issuances, incentive compensation, or using equity as acquisition currency). Also, it isn't uncommon for an investor to want to acquire a direct equity interest in SpinCo once it is separated from Parent. However, these transactions involving SpinCo stock are subject to the change of control restrictions, which if violated cause Parent to retroactively suffer a material tax liability.

Further, a determination of whether these SpinCo equity transactions can or should be aggregated and treated as part of a plan is a question of law and fact, further contributing to the near lockdown on post-spinoff change of control transactions. It is clear why Parent has a strong incentive to protect itself from a violation of the change of control restrictions, but Parent's shareholders (generally also shareholders of SpinCo immediately after the spinoff), have an incentive for both companies to grow and prosper independently. SpinCo, as a new stand-alone company, may need to engage in equity-based transactions to maintain or grow its business, creating a potential disconnect between Parent's legitimate concern over SpinCo's transactions that could violate the change of control restrictions, and SpinCo's need to conduct its business free of unnecessary limitations.

This dichotomy between Parent's concerns and SpinCo's need for transactional flexibility is reflected in the legal agreement between Parent and SpinCo governing the spinoff, typically named the tax matters agreement (TMA). Because Parent and its advisers typically draft the TMA with little or no input from SpinCo or its advisers, the TMA severely restricts transactions that could cause a change in control. The significant limitation on post-spinoff equity-based transaction activity is accomplished by requiring SpinCo to obtain an "unqualified opinion"[6] or a private letter ruling in advance of a transaction that could cause a change of control.[7]

However, as Parent and its advisers are likely already aware, the IRS characterizes the determination of whether a change of control and a distribution are part of a prohibited plan as a no-

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rule area in which a private letter ruling will not be granted.[8] Also, tax advisers are often unable to provide an unqualified opinion on changes of control because of the breadth of the "rebuttable presumption" and the subjective nature of the existence of a plan or an "agreement, understanding, arrangement or substantial negotiations." Although an unqualified opinion may be obtainable under fact patterns that fall squarely within one of the safe harbors, legal advisers are unwilling to provide unqualified opinions for many permissible transactions. To unlock those transactions without putting Parent at any increased economic risk, tax insurance is a compelling solution.

Post-Spinoff Transaction Example

Tax insurance is a bespoke solution designed to address the economic impact of a tax position being successfully challenged by a governmental tax authority, resulting in a material adverse tax consequence for the insured. Consider the following hypothetical tax insurance program designed to unlock post-spinoff change of control activity, which is similar to programs Aon has created.

SpinCo was distributed in a spinoff supported by a tax opinion of nationally recognized legal counsel that the distribution should qualify as tax-free. Parent had not previously explored a sale or other disposition of SpinCo and had no conversations with investment bankers regarding SpinCo for at least 12 months preceding the distribution. Similarly, for over 12 months after the distribution, neither SpinCo nor its shareholders had any conversations with investment bankers or prospective buyers.

However, 15 months after the distribution, SpinCo received a compelling indication of interest from a prospective buyer. The change of control transaction appeared to meet at least one of the safe harbors, but legal counsel concluded only that the transaction "should not" violate the change of control rules. Also, because of potential concerns over the application of the "device" rules (another no-rule area for private letter rulings), legal counsel was able to conclude only that the sale of SpinCo "should not" cause the initial spinoff to constitute an impermissible device.[9] Although the "should"-level opinion provides persuasive support, it isn't unqualified, and still leaves 20 to 30 percent risk of an adverse outcome.[10]

Because it could not obtain an unqualified opinion or private letter ruling, SpinCo explored tax insurance to cover a meaningful amount of the tax exposure Parent would suffer if the original spinoff were later determined to be taxable as a result of the post-spinoff transaction. Multiple underwriters provided the insurance coverage because the aggregate exposure was several hundred million dollars. Interestingly, while the tax insurance program can be paid for by either party, it isn't unusual for the cost of the insurance program addressing post-spinoff activity to be paid for by SpinCo, even though it would be written for the benefit of Parent.

The post-spinoff tax insurance program described above would protect Parent from material exposure if the original spinoff were successfully challenged by the IRS because of the acquisition of SpinCo. The policy would cover additional assessed tax, interest, penalties, and contest costs incurred by Parent (subject to industry standard limitations) for seven years. It also would include a gross-up mechanism, to the extent the insurance proceeds themselves were also considered taxable income.[11] With the combination of the tax insurance program and the "should"-level opinions of legal counsel, Parent permitted the acquisition of SpinCo to be completed.

The Key to Unlocking Value

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There is a need to greatly expand post-spinoff activity beyond the narrow set of transactions for which an unqualified opinion or private letter ruling can be obtained, and thus a growing tax insurance market has developed. Carriers have expressed a strong interest in exploring insurance programs to cover inherently subjective aspects of spinoffs, such as business purpose or device, and change of control transactions after the spinoff. Consistent with this interest on the part of carriers, we have seen increasing insurance limits (now up to or possibly exceeding $2 billion per issue), and historically low costs for such insurance programs.

After a tax-free spinoff, SpinCo corporations often need to raise additional capital, offer incentives to key employees, make acquisitions using equity currency, and possibly be acquired by an unrelated third party. The industry standard to limit change of control transactions to ones for which an unqualified opinion or private letter ruling can be obtained unnecessarily stifles legitimate business activity. Tax insurance is the key to unlocking those transactions.[12]

FOOTNOTES

[1] If certain of these rules are violated, Parent's shareholders are also taxed on the distribution.

[2] A post-spinoff transaction could jeopardize the entire tax-free nature of the spinoff if the initial spinoff was determined to be an impermissible "device" resulting from the post-spinoff transaction. Alternatively, if a change of control transaction is treated as part of a plan with the distribution, but did not constitute a "device," the spinoff would result in taxation to Parent but not its shareholders. The "device" rules are contained in section 355(a)(1)(B) and reg. section 1.355-2(d). The "change of control" restrictions are found in section 355(e) and reg. section 1.355-7.

[3] Section 355(e)(2)(B).

[4] *See* reg. section 1.355-7.

[5] Reg. section 1.355-7(b)(2).

[6] An unqualified opinion is typically defined as a "will" opinion of a tax adviser on which Parent may rely to the effect that a transaction will not affect the tax-free status of the distribution.

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[7] *See, e.g.*, TMA for Pfizer Inc.'s distribution of Zoetis Inc., section 6.01(c) (private letter ruling or unqualified tax opinion required before "change of control" transaction); TMA for Smith & Wesson's distribution of American Outdoor Brands Inc., section 3.02(f) (Aug. 21, 2020); and TMA for United Technologies' distribution of Otis Worldwide Corporation and Carrier Global Corporation, section 7.02(d) (Apr. 2, 2020).

[8] *See* Rev. Proc. 2017-52, 2017-41 IRB 283, section 2.03(2) (confirming no change in IRS no-rule policy on section 355(e)); and Rev. Proc. 2017-3, 2017-1 IRB 130, section 3.01(54). *See also* IRS, "Statement on Private Letter Ruling Pilot Program Extension" (Mar. 12, 2019) (extending section 355 private letter ruling pilot ruling practice indefinitely).

[9] In general, if a spinoff is determined to constitute an impermissible device to convert what would otherwise be a distribution treated as ordinary income into a transaction for which capital gain treatment applies, the spinoff is treated as taxable to the Parent company and its shareholders.

[10] *See* American Institute of CPAs, "Statements on Standards for Tax Services" (2010) (AICPA standards published on IRS website that indicates a "should"-level opinion denotes 70 to 80 percent probability of success if challenged by the IRS).

[11] Recent tax literature would suggest this is an issue of keen interest.

[12] Aon is not a law firm or an accounting firm and does not provide legal or tax advice. Commentary provided is based solely on Aon's experience as insurance practitioners. We recommend you consult with your legal counsel and tax and financial advisers to address your specific situation.

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END FOOTNOTES