

CONGLOMERATE SPIN-OFFS: WHETHER U.S. TAX LAW INHIBITS DECONGLOMERATION

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Abstract

In this Note, I examine whether the complex nature of the U.S. spin-off rules and the burdens associated with successfully navigating such rules discourage conglomerates from breaking up into smaller companies through tax-free spin-offs. First, I argue that there are numerous disadvantages of conglomeration, which generally tend to outweigh any economic benefits derived from the conglomerate form. Next, I describe the statutory and nonstatutory requirements of tax-free spin-offs, evaluating particularly how each requirement may impact a conglomerate wishing to spin off one or more of its business units. Because conglomerates are usually multinational corporations, I also briefly consider the tax consequences of spinning off a foreign company. In the following section, I discuss the issuance of private letter rulings in connection with conglomerate spin-offs and assess whether the I.R.S.'s recent policy changes have accelerated spin-off activity or, to the contrary, whether they have produced a chilling effect on conglomerate spin-offs. Finally, I examine a recent example of a successful conglomerate spin-off—Liberty's spin-off of TripAdvisor—before analyzing an example of a failed conglomerate spin-off—Yahoo's attempt to spin off Alibaba. I conclude that, although tax-free spin-offs are occasionally unsuccessful, such failures are rare.

Even if the tax rules are byzantine and the monetary stakes are exceptionally high, conglomerates wishing to spin off business units typically manage to satisfy the requirements. Therefore, although U.S. tax law does not completely hinder deconglomeration, spin-offs are nevertheless costly. Fulfilling the spin-off requirements leads to economic inefficiencies because it entails expensive pre-spin-off restructuring and delays, as well as high transaction and friction costs.

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INTRODUCTION

Following chief executive Lawrence Culp’s announcement in 2021 that General Electric (“GE”) would split up into three smaller companies,¹ GE’s stock price briefly surged, and investors and economists wondered why it had taken the company so long to take the necessary steps toward deconglomeration.² Allowing conglomerates to divest their business divisions is essential to improving corporate focus and specialization, increasing shareholder value, enhancing long-term corporate wellbeing, and enabling businesses to evolve as operational and economic circumstances change. Moreover, ease and simplicity in conglomerate divestment are crucial for a well-functioning economy.

Nevertheless, the tax consequences of deconglomeration can be so costly that conglomerate managers may prefer to avoid divestment altogether. Outright sales of business assets or corporate stock are almost always taxable events. Thus, conglomerates often turn to the spin-off rules under section 355 of the Internal Revenue Code (“I.R.C.” or “the Code”) to divest their business units tax-free. Satisfying the byzantine statutory and nonstatutory requirements for tax-free spin-offs,³ however, is not for the faint of heart. And failing to qualify as a tax-free spin-off can have disastrous results. The tax consequences of such a failure are draconian and—particularly in the case of conglomerates—can lead to tax liability in the billions of dollars. Therefore, the stakes are incredibly high.

In this Note, I examine whether the complexity and severity of the spin-off rules in the United States discourage conglomerates like GE from breaking up into smaller companies through tax-free spin-offs. In Part I, I discuss some of the benefits of conglomeration but then argue that the disadvantages associated with conglomeration tend to outweigh the benefits. In Part II, I review the statutory and common law requirements of spin-offs, focusing on how each requirement may impact a conglomerate wishing to spin off a business unit. I also briefly examine the difficulties that arise when a U.S. conglomerate wishes to spin off a foreign subsidiary and the issuance of private letter rulings in connection with conglomerate spin-offs—particularly, whether certain recent policy changes by the Internal Revenue Service (“I.R.S.” or “the Service”) have accelerated spin-off activity or, conversely, whether they have produced a chilling effect on conglomerate spin-offs. In Part III, I analyze a recent example of a successful conglomerate spin-off, Liberty’s spin-off of TripAdvisor. Finally, in Part IV, I

¹ Steve Lohr & Michael J. de la Merced, *G.E. Breaks Up With Its Storied Past*, N.Y. TIMES (Nov. 9, 2021), <https://www.nytimes.com/2021/11/09/business/general-electric-break-up.html> [https://perma.cc/3M4G-3BQE].

² See Alicia Doniger, *GE never made sense, says Yale corporate leadership expert*, CNBC (Nov. 11, 2021), <https://www.cnbc.com/2021/11/11/ge-never-made-sense-says-yale-corporate-leadership-expert.html> [https://perma.cc/Y8GF-TUH6] (describing GE’s decision to split into three firms as long overdue).

³ N.Y. STATE BAR ASS’N TAX SECTION, REPORT NO. 1342, REPORT ON NOTICE 2015-59 AND REVENUE PROCEDURE 2015-43 RELATING TO SUBSTANTIAL INVESTMENT ASSETS, DE MINIMIS ACTIVE TRADES OR BUSINESSES AND C-TO-RIC SPIN-OFFS (2016), at 27 [hereinafter REPORT NO. 1342].

examine an example of a failed conglomerate spin-off, Yahoo's attempt to spin off Alibaba.

I conclude that, although tax-free spin-offs are occasionally unsuccessful, such failures are rare. Even if the tax rules are byzantine and the stakes are exceptionally high, conglomerates wishing to spin off business units usually manage to satisfy the requirements. Therefore, although U.S. tax law does not completely hinder deconglomeration, spin-offs are costly. To satisfy the rules, companies must usually restructure in preparation for a spin-off. Pre-spin-off restructuring is expensive because of the delays and friction costs that companies must endure. Such costs often include consultations with outside legal and accounting experts followed by lengthy and expensive internal restructuring to comply with their advice. Thus, the tax rules related to spin-offs lead to inefficiencies and economic distortions as conglomerates undergo complex restructurings in an attempt to satisfy their myriad requirements.

I. THE PROBLEMS WITH CONGLOMERATION

Conglomerates are companies—usually corporations—comprised of multiple businesses. A conglomerate develops when a parent company begins to acquire a controlling stake in various smaller subsidiary companies.⁴ Conglomeration can occur quickly as a result of a rapid succession of merger-and-acquisition activity, or slowly through steady acquisitions over the span of many decades. Although each subsidiary's managers typically report to the senior management of the parent, each conglomerate subsidiary tends to conduct its business operations more or less independently of the parent, usually with separate boards of directors.⁵ The aggregation of multiple subsidiaries frequently renders conglomerates large and multinational.

After World War II, the United States experienced a boom in merger-and-acquisition activity that led to the rapid creation of numerous conglomerates. Many companies justified their shift toward conglomeration as a means of growth and value enhancement. Proponents of conglomeration cited four main arguments in favor of such expansion.

First, managers of conglomerates believed in the virtue of diversification at the firm level. This was also known as the “portfolio” effect of conglomeration.⁶ Conglomerate managers claimed to have superior abilities vis-à-vis investors when it came to monitoring and allocating resources to promising new projects. By participating in different, often unrelated markets that offered uncorrelated revenue streams, conglomerates could dispel the risks of cyclical downturns in a single business. Thus, a well-performing subsidiary's gains could offset the losses of a subsidiary that was performing poorly.

⁴ James Chen, *Conglomerate*, INVESTOPEDIA (Dec. 23, 2021), <https://www.investopedia.com/terms/c/conglomerate.asp> [<https://perma.cc/LMT8-YNB5>].

⁵ *Id.*

⁶ See Gary T. Haight, *The Portfolio Merger: Finding the Company that Can Stabilize Your Earnings*, 16 MERGERS & ACQUISITIONS 33-34 (1981) (describing the “portfolio” effect as an “acquisition benefit”).

Second, conglomerates provided access to internal capital markets and internal labor markets. If external capital markets offered unfavorable rates, a conglomerate could rely on the size and breadth of its portfolio of subsidiaries to allocate capital through private internal borrowing and lending contracts at more favorable rates or on more favorable terms than could be obtained through banks or stock and bond markets.⁷ Moreover, as an internal labor market, top conglomerate managers believed that their expertise in choosing and replacing divisional managers exceeded the expertise of a stand-alone firm's board of directors.⁸

Third, horizontal and vertical integration could help conglomerates take advantage of a wealth transfer from consumers to conglomerate firms. The acquisition of a greater share of market power allowed conglomerates to raise their prices at the expense of consumers. Moreover, vertical integration could result in a reduction of costs through the exploitation of economies of scope—through which the average total cost of production decreases because costs are spread over a variety of products—and economies of scale—through which the increased output of goods or services yields a further cost advantage.

Finally, the size and interconnectedness of conglomerates could provide them with *de facto* immunity from takeovers, as well as a greater likelihood of obtaining governmental emergency assistance to avoid receivership or bankruptcy in the event of a major financial crisis. As a conglomerate grew larger, its number of potential acquirers tended to diminish because it became increasingly more expensive to take over. Conglomeration shrinks the pool of acquirers because only very large companies likely would find themselves in a position to bid to acquire a gargantuan conglomerate. And, as the Financial Crisis of 2007-2009 showed, the larger and more interconnected the systemically important conglomerate—like AIG or Citigroup—the more concerned the regulatory authorities became in offering emergency support to prevent its downfall. Failure of a systematically important financial conglomerate could unleash havoc on both the domestic and global economies.⁹

In recent decades, however, there has been growing consensus among economists and academics that the conglomerate form was operationally inefficient and ultimately costly for shareholders. The disastrous merger of America Online and Time Warner in 2000 is a not-so-distant cautionary tale of the risks of conglomeration.¹⁰ There is strong evidence that many conglomerate acquisitions

⁷ See RONALD J. GILSON ET AL., *THE LAW AND FINANCE OF CORPORATE ACQUISITIONS* 319 (3d. ed. forthcoming 2022) [hereinafter GILSON ET AL.]; MALCOLM S. SALTER & WOLF A. WEINHOLD, *DIVERSIFICATION THROUGH ACQUISITION* 65-78 (1979).

⁸ GILSON ET AL., *supra* note 7, at 332 (identifying internal labor markets as a “claimed advantage of the conglomerate firm”).

⁹ See Sang Yop Kang, *Re-envisioning the Controlling Shareholder Regime: Why Controlling Shareholders and Minority Shareholders Often Embrace*, 16 U. PA. J. BUS. L. 843, 878-80 (2014) (noting that conglomerates in countries like South Korea are popular and successful, that development of a well-known name or brand is useful in export-oriented companies, and that government subsidies and preferential treatment come at expense of general taxpayers).

¹⁰ Tim Arango, *How the AOL-Time Warner Merger Went So Wrong*, N.Y. TIMES (Jan. 10, 2010), <https://www.nytimes.com/2010/01/11/business/media/11merger.html> [<https://perma.cc/2S6K-UTRK>] (“The trail of despair in subsequent years included countless job

decreased firm value but nevertheless occurred because of agency costs—particularly poor managerial incentives.¹¹

First, diversification at the portfolio level has been shown to offer better returns than diversification at the firm level, which some scholars have dubbed “diworseification.”¹² Whereas outside investors in public companies examine stock prices that reflect other investors’ beliefs about value, the market often has trouble evaluating a conglomerate’s many business units separately.¹³ Conglomerate managers tend to err in evaluating a single business unit’s prospects.¹⁴ Rather than actually acquiring multiple subsidiaries, companies can instead acquire merely a stake in multiple subsidiaries.¹⁵ Diversification at the portfolio level affords companies the benefits of diversification without the onerous burden of managing and operating multiple unrelated business units.

Second, there is no evidence that conglomerate managers are better than investors at allocating capital efficiently or better than the board of directors of stand-alone firms at choosing and replacing divisional managers. Although access to internal capital markets may be beneficial, it is unclear whether such access contributes enough value to justify the transaction costs of a takeover. After all, an acquirer usually pays a premium for the shares of a target—particularly in a competitive bidding environment—due to the winner’s curse.¹⁶ Conglomerate managers certainly have access to different information than do outside investors,

losses, the decimation of retirement accounts, investigations by the Securities and Exchange Commission and the Justice Department, and countless executive upheavals. Today, the combined values of the companies, which have been separated, is about one-seventh of their worth on the day of the merger. To call the transaction the worst in history, as it is now taught in business schools, does not begin to tell the story of how some of the brightest minds in technology and media collaborated to produce a deal now regarded by many as a colossal mistake.”)

¹¹ GILSON ET AL., *supra* note 7, at 312.

¹² LOUIS LOWENSTEIN, *SENSE AND NONSENSE IN CORPORATE FINANCE* 161-66 (1991); *see also* Haim Levy & Marshall Sarnat, *Diversification, Portfolio Analysis and the Uneasy Case for Conglomerate Mergers*, 25 J. FIN. 795, 796 (1970) (“[A] conglomerate merger *per se* does not necessarily create opportunities for risk diversification over and beyond what was possible to individual (and institutional) investors prior to the merger.”).

¹³ GILSON ET AL., *supra* note 7, at 330-31.

¹⁴ *See id.*

¹⁵ *See* R. Hal Mason & Maurice Goudzwaard, *Performance of Conglomerate Firms: A Portfolio Approach*, 31 J. FIN. 39, 45 (1976) (“We had expected the sample of conglomerate firms to either significantly outperform or at least perform as well as a set of randomly selected portfolios—simply because operating control should confer certain advantages to a diversified portfolio of assets. We find quite the opposite from the data at hand. The statistical tests indicate that the portfolios outperformed the conglomerates in terms of both rates of return on assets and accumulated stockholder wealth over the 1962 to 1967 period.”); GILSON ET AL., *supra* note 7, at 339 (“Mason & Goudzwaard is representative of a large number of studies that reach the consistent conclusion that firm-level diversification reduces firm value.”); *id.* at 342 (“The *best* one can say is that there is no evidence of the value added that is needed to justify the acquirer paying a premium for the target. If anything, the evidence suggests that conglomerates turn 2 + 2 into a little bit less than 4, on average.”).

¹⁶ In M&A, the winner’s curse is the tendency for the winning acquirer to overpay for a target company in an auction-like scenario because of the competitive bidding dynamic that encourages the pool of potential acquirers to drive up target’s purchase price in excess of its intrinsic value. *See* GILSON ET AL., *supra* note 7, at 330.

but different does not necessarily mean better.¹⁷ Moreover, private companies offer outside investors detailed financial information prior to investment.¹⁸ With respect to the internal labor market argument, such intensive oversight is expensive, sophisticated private executive search firms are skilled in locating top managers, and the skills of a manager in one division of a conglomerate may not be transferable to a separate business unit.¹⁹ Thus, it is unclear whether the conglomerate's internal labor market works any better than an external market. And even if it does, it remains to be seen whether the comparative transaction costs offer the conglomerate a significant advantage that outweighs the transaction costs of an expensive acquisition.²⁰

Third, the benefits of horizontal and vertical integration may be short-lived, and the increased attention of antitrust regulatory authorities, the risk of hefty fines for engaging in antitrust violations in multiple jurisdictions, and bids from regulators to reduce market share by being broken up or reorganized may outweigh any such benefits. Scholars during the wave of conglomeration in the 1960s and 1970s sounded the alarm that the ubiquitous amassing of such large concentrations of wealth and the combination of such a wide array of diverse business units were quickly creating cumbersome, bureaucratic institutions that threatened the economy and even democracy.²¹

Fourth, companies can achieve immunity from takeovers without growing into corporate titans. Through a shareholder rights agreement or "poison pill," a board of directors without shareholder approval can force a hostile acquirer to become friendly. Put differently, the threat of deploying a poison pill enables the board to compel a hostile acquirer to stop and negotiate. With respect to being too big to fail, increased size often comes at the cost of increased regulatory oversight, and such supervision can impose additional costs on the conglomerate.

Moreover, the empire-building hypothesis posits that conglomeration may result from corporate managers' desire to seek growth in firm size not to maximize share price but instead "to justify better compensation and perquisites, to increase prestige, to expand opportunities for promotion, and . . . to protect themselves from the discipline of the market."²² Often, the larger the firm, the higher the salary and social standing of its managers. Furthermore, the hubris hypothesis suggests that managers convince themselves that they are making good acquisitions even when they are not. And the winner's curse hypothesis helps to explain why managers tend to overpay for acquisitions. Conglomerate managers have an incentive to continue

¹⁷ See *id.* at 330-31.

¹⁸ See *id.*

¹⁹ See *id.* at 331.

²⁰ See *id.*

²¹ Dougherty Jr. warns that private concentrations of economic power may breed antidemocratic forces that could threaten the fundamental institutions and traditions of the United States. See Alfred F. Dougherty Jr., *Concentration, Conglomeration, and Economic Democracy: A Concurrent Divestiture Proposal*, 11 ANTITRUST L. & ECON. REV. 29, 30-32 (1979) ("Conglomerate mergers realize few, if any, efficiencies in specific product markets, probably confer no benefits on the economy as a whole, and may well impose substantial long-term social and political costs.").

²² George W. Dent, *Unprofitable Mergers: Toward a Market-Based Legal Response*, 80 NW. U. L. REV. 777, 781 (1986).

to grow the firm through value-neutral or value-destroying acquisitions. Such misguided acquisitions are one way in which cash-rich conglomerates waste excess cash.²³ Additionally, studies have found that conglomerates spend less on research and development than their industry peers.²⁴

Conglomerate managers may succeed in stabilizing a firm and its income stream, but such stabilization may offer no benefit to shareholders. It is estimated that one-third of all entities acquired between 1950 and 1977 were later sold off.²⁵ Conglomerates have been found to have low Tobin's Q ratios—a comparison of the market value and replacement value of a company's physical assets—which suggests high levels of managerial inefficiency in deriving value from corporate assets.²⁶ Economists believe that focus, fit, and specialization in a particular market are vital for value enhancement, whereas conglomerate diversification across multiple unrelated industries tends to drain operational efficiency and shareholder value.²⁷

For all of these reasons, conglomeration is generally viewed as an undesirable, inefficient business structure. Whatever benefits conglomerate managers touted during the wave of conglomeration that ensued after World War II can be achieved through more efficient means. A tax-free spin-off is the best way for a conglomerate to downsize.

II. CONGLOMERATE SPIN-OFFS

Spin-offs are a kind of corporate division. A spin-off is a distribution of one of the businesses of a distributing corporation ("Distributing" or "Parent") pro rata to its shareholders, who do not surrender any of their stock. Put differently, in a spin-off, the Parent separates from one of its subsidiaries by distributing all of that subsidiary's stock to the Parent's shareholders. The result is that after the transaction, the Parent and the spun-off subsidiary ("SpinCo") become independent entities, although the Parent's shareholders continue to own stock in both the Parent and the SpinCo.

A key aspect in executing a spin-off is to ensure that the spin-off is structured as "tax-free" under section 355 for both the Parent and the Parent's shareholders.²⁸ At the corporate level, the advantage of the spin-off is the permanent tax benefit of truly tax-free treatment, which can save conglomerates billions of dollars. Non-taxation at the entity level is the primary gift that the I.R.S.

²³ See GILSON ET AL., *supra* note 7, at 383.

²⁴ See *id.* at 343.

²⁵ *Id.* at 341.

²⁶ See *id.*

²⁷ See *id.* at 331 ("[O]utside investors can specialize. One investor, or analyst, or bank loan officer, can focus on auto parts suppliers, another on specialty chemicals, another on computers. In contrast, the conglomerate manager probably oversees only one firm in any one industry, and must divide his attention among a number of disparate businesses. Once again, the conglomerate manager lacks information available to the outside investor; in this case, the background knowledge that comes from specialization.").

²⁸ Unless I specify otherwise, references to sections of statutory provisions refer to the I.R.C.

provides in allowing corporations to split up under section 355, and this corporate-level non-taxation is the primary motivation for tax-free spin-offs. Parent's shareholders receive only the benefit of deferral of gain recognition.

Section 355 is intended to provide tax-free treatment to transactions in which each company continues with a robust business following the separation.²⁹ Through tax-free spin-offs, Congress wished to provide a means of enabling corporations to divide ongoing operating business units in such a way that the different continuing businesses could persist, albeit in a modified corporate structure.³⁰ Section 355 promotes economic efficiency and the well-being of capital markets by allowing large, unwieldy conglomerates to break themselves up into smaller business units for bona fide corporate purposes.³¹ Because Congress believes that a mere readjustment of business interests within a corporation should not be impeded by gain recognition at either the corporate or the shareholder level, section 355 allows each company to avoid such gain recognition and to operate distinct business units following the separation but with a certain degree of shareholder continuity.³²

The transaction at issue in *Gregory v. Helvering* embodied a perceived abuse of the tax-free spin-off rules in which the taxpayer separated and distributed principally passive non-business assets.³³ Here, the taxpayer attempted to use the spin-off rules to avoid paying corporate-level taxes on appreciated shares.³⁴ The case reached the Supreme Court, which found that the dividend distribution was sham-like, lacked any real business purpose, and constituted a tax-avoidance device.³⁵ *Gregory v. Helvering* is a paradigmatic example of a taxpayer's near perfect adherence to formal statutory requirements—the letter of the law—that

²⁹ See REPORT NO. 1342, *supra* note 3.

³⁰ See *id.*

³¹ See *id.*

³² See *id.*

³³ *Gregory v. Helvering*, 293 U.S. 465 (1935).

³⁴ Evelyn Gregory was the sole shareholder of United Mortgage Corporation (“UMC”) and was entitled to receive dividends from UMC. UMC, in turn, owned 1,000 outstanding shares of Monitor Securities Corporation (“MSC”). Gregory wished to dispose of her interest in MSC, but if UMC sold the MSC shares and distributed the proceeds to Gregory as a dividend, both UMC and Gregory would be taxed at the high rates applicable to dividend income at that time. Thus, Gregory performed a corporate reorganization to avoid such tax treatment. In the reorganization, Gregory had UMC transfer the MSC shares to a newly formed SpinCo. The SpinCo then issued its shares to Gregory. After four days, Gregory had the SpinCo liquidate and distribute the MSC stock to herself. Gregory then sold the MSC stock to a third party for cash. Gregory argued that the receipt of the SpinCo stock was not a recognition event because the shares were received as part of a reorganization. Gregory recognized the capital gain on the receipt of the MSC stock and took a stepped-up fair market value basis in the MSC stock after the liquidation. Thus, she recognized no gain or loss on the subsequent sale of the MSC stock. The Commissioner argued that the SpinCo should be ignored because of its sham-like, transitory nature and lack of any substantive business purpose. The government viewed the transaction as if UMC had sold the MSC shares for cash and distributed the proceeds to Gregory in a cash dividend. The Supreme Court agreed with Commissioner, finding that the transaction lacked any business purpose and was merely a “device which put on the form of a corporate reorganization as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganize a business . . . but to transfer a parcel of corporate shares to the petitioner.” *Id.*

³⁵ *Id.*

nevertheless violated the spirit of the law. The case has served as an important lens through which the government and taxpayers have interpreted the spin-off rules for almost a century.

To qualify for tax-free treatment under section 355, the transaction must satisfy two common law requirements: corporate business purpose and continuity of interest. Moreover, three major statutory requirements must also be met: distribution of sufficient control, the active conduct of a trade or business, and non-device. In addition, Congress in recent decades has enacted additional statutory provisions in response to perceived abuses of section 355, including section 355(d) and section 355(e). Finally, section 367 contains provisions that turn off nonrecognition for a U.S. corporation that spins off a foreign business with appreciated assets.

1. Statutory Requirements

A. Distribution of Control

Spin-off transactions must result in distribution of control. The Parent must distribute either all of its stock in the SpinCo or a sufficient amount so as to place the Parent shareholders in control of the SpinCo.³⁶ “Control” is defined as ownership of stock that entails possession of at least both 80% of the total combined voting power of all classes of stock entitled to vote, as well as 80% of the total number of shares of each other class of stock of the corporation.³⁷ This provision is important because if the Parent does not maintain sufficient control over SpinCo, the spin-off begins to resemble the sale of a business unit, and sales are generally taxable transactions.³⁸

The control requirement does not seem particularly problematic for conglomerates to satisfy and overcome because it is a mechanical test. Conglomerates are often sitting on business units and holdings that they have accumulated over decades. Although satisfying the control requirement may necessitate some pre-spin-off internal corporate restructuring, as long as conglomerates navigate this mechanical rule carefully, it should not stand in the way of deconglomeration through a spin-off.

B. Active Conduct of a Trade or Business

The active trade or business provision requires that Parent and SpinCo be “engaged in the active conduct of a trade or business immediately after the

³⁶ See Kotran et al., *Spin-offs: Overview*, Practical Law Practice Note Overview 2-503-1986.

³⁷ *Id.*

³⁸ Moreover, any SpinCo stock that Parent acquired in a taxable transaction during the five years before the spin-off is deemed “hot stock” and does not qualify for tax-free treatment. See *Spin-Offs: Tax Overview*, *supra* note 36. Here, the government wishes to prevent Parent from using excess cash to buy shares of SpinCo and then distribute those shares to stockholders as an in-kind but tax-free dividend. *Id.*

distribution”³⁹ and that the trade or business has been “actively conducted throughout the five-year period ending on the date of the distribution.”⁴⁰ Activities qualify as trade or business activities if they are for the purpose of earning income or profits.⁴¹ Such activities include every operation that forms part of earning income, and the activities must generally include the receipt of income and payment of expenses.⁴² By contrast, the “holding for investment purposes of stock, securities, land, or other property, or [t]he ownership and operating (including leasing) of real or personal property used in a trade or business, unless the owner performs significant services with respect to the operation and management of the property,” does not constitute active conduct of a trade or business.⁴³

Proposed regulations from 2016 (“the 2016 Proposed Regulations”) imposed a threshold for the size of the active trade or business, which must be at least 5% of the total assets for each of Parent and SpinCo.⁴⁴ The 2016 Proposed Regulations, however, today serve only as guidance because they were never finalized and therefore expired after three years.⁴⁵ But in revenue procedures over the past few decades, including Revenue Procedure 2021-3, the I.R.S. has expressed discomfort with spin-off transactions where the fair market value of the trade or business on which the distributing corporation relies to satisfy the active trade or business requirement is less than 5% of the fair market value of the total gross assets of the corporation.⁴⁶

The active conduct of a trade or business provision helps to ensure that the spin-off is not used as a vehicle to disguise a dividend distribution or subsidiary sale. Much like the device requirement discussed below, its purpose is to prevent the use of a spin-off as a mechanism for distributing excess cash as a dividend to parent shareholders. A low percentage of business assets may be evidence of an abusive transaction in which the spin-off is being used as a device to distribute earnings and profits.

Unlike the corporate business purpose requirement, the active trade or business requirement can be a difficult hurdle to overcome, particularly in light of the 2016 Proposed Regulations and Revenue Procedure 2021-3. Although expired proposed regulations are technically not authoritative—and although revenue procedures are low-level guidance—both can still have an impact on tax practitioners’ advice and, therefore, on corporate behavior. A conglomerate wishing to spin off a subsidiary combining nonqualifying holdings for investment purposes will need to ensure that the size of the active trade or business that it spins off together with the holdings exceeds 5% of SpinCo. Thus, this rule may preclude conglomerates from offloading large holdings of appreciated stock because the larger the stake in passive holdings, the larger the active trade or business must be

³⁹ Treas. Reg. § 1.355-3(a)(i).

⁴⁰ Treas. Reg. § 1.355-3(b)(iv)(3).

⁴¹ See Treas. Reg. § 1.355-3(b)(2).

⁴² See *id.*

⁴³ Treas. Reg. § 1.355-3(b)(2)(iv).

⁴⁴ See Prop. Treas. Reg. § 1.355-9, 81 Fed. Reg. 46004 (July 15, 2016).

⁴⁵ The I.R.S. may not challenge a transaction solely based on guidance issued in proposed regulations.

⁴⁶ See *e.g.*, Rev. Proc. 2021-3, 2021-1 I.R.B. 140; Rev. Proc. 2003-48, 2003-2 C.B. 86.

that accompanies the stake in the spin-off. However, through an internal corporate restructuring in anticipation of a spin-off, a conglomerate can likely customize the SpinCo to ensure that the transaction satisfies the 5% requirement. As I discuss in Parts III and IV, because conglomerates are by definition large and consist of numerous business units, finding an active business unit to spin off together with large passive shares is usually not overly cumbersome or prohibitive.

C. Nondevice

Tax-free treatment under section 355 is not afforded to any “transaction used principally as a device for the distribution of the earnings and profits of the distributing corporation, the controlled corporation, or both.”⁴⁷ Factors that constitute evidence of device include: a pro rata distribution among the shareholders of the distributing corporation,⁴⁸ a subsequent sale or exchange of stock (“the greater the percentage of the stock sold or exchanged after the distribution, the stronger the evidence of device . . . the shorter the period of time between the distribution and the sale or exchange, the stronger the evidence of device”),⁴⁹ and the nature, kind, amount, and use of the assets (for example, a high ratio of cash and other liquid assets not related to the reasonable needs of the business weighs in favor of device).⁵⁰ On the other hand, factors weighing against a finding of device include a strong corporate business purpose,⁵¹ the extent to which the Parent is a widely held, publicly traded company (where a corporation is publicly traded and has no shareholder that is “the beneficial owner of more than five percent of any class of stock is evidence of nondevice”),⁵² and the “fact that the stock of the controlled corporation is distributed to one or more domestic corporations that, if section 355 did not apply, would be entitled to a [dividends-received] deduction under section 243 . . . is evidence of nondevice.”⁵³ Moreover, if the corporation has no earnings and profits to bail out in the first place or if redemption treatment would apply to the transaction, a spin-off is ordinarily not deemed to be a device.

The primary policy reason for the nondevice requirement stems from the government’s awareness that, as in *Gregory*, “a tax-free distribution of the stock of a controlled corporation presents a potential for tax avoidance by facilitating the avoidance of the dividend provisions of the Code through the subsequent sale or exchange of stock of one corporation and the retention of the stock of another corporation.”⁵⁴ The government wishes to disallow the conversion of earnings and profits of what would otherwise be ordinary dividend income into capital gain through the device or vehicle of a tax-free spin-off. Although dividend income may

⁴⁷ Treas. Reg. § 1.355-2(d)(1).

⁴⁸ Treas. Reg. § 1.355-2(d)(2)(ii).

⁴⁹ Treas. Reg. § 1.355-2(d)(2)(iii).

⁵⁰ Treas. Reg. § 1.355-2(d)(2)(iv).

⁵¹ Treas. Reg. § 1.355-2(d)(3)(ii).

⁵² Treas. Reg. § 1.355-2(d)(3)(iii).

⁵³ Treas. Reg. § 1.355-2(d)(3)(iv).

⁵⁴ Treas. Reg. § 1.355-2(d).

be taxed at the same rates as the long-term capital gain that shareholders would realize if they sold their controlled stock immediately after a section 355 distribution, there are still reasons why taxpayers may prefer capital gains over dividend income.⁵⁵

The fact that conglomerates tend to be widely held and publicly traded corporations helps to constitute evidence of nondevice for conglomerate spin-offs. Publicly traded conglomerates with no significant shareholder will probably be less motivated to bail out earnings and profits for the benefit of their shareholders.⁵⁶ Moreover, large public companies have more straightforward means of returning excess cash to shareholders.⁵⁷ For example, they can engage in share tenders rather than facing the uncertainty and complex requirements of section 355.⁵⁸

2. Additional Statutory Anti-Abuse Provisions

A. Section 355(d): “Disqualified Distributions”

Section 355(d) may require that a Parent recognize gain on certain distributions of stock or securities in a controlled subsidiary.⁵⁹ This section considers whether a distribution is “disqualified” from corporate-level nonrecognition treatment because it is more akin to a disguised sale rather than a mere change in corporate form. Stock in the distributing corporation of one of its controlled subsidiaries is considered “disqualified stock” if it was acquired by purchase within the five-year period ending on the date of the distribution.⁶⁰ If so, the distribution will trigger gain to the distributing corporation as if the stock were sold to the distributee shareholders at its fair market value. Section 355(d) does not, however, alter the nonrecognition treatment available to the shareholder distributees.⁶¹

Section 355(d) can be a particularly burdensome hurdle for a multinational conglomerate to overcome because the conglomerate may have engaged in stock

⁵⁵ See REPORT NO. 1342, *supra* note 3, at 24-25 (“[W]hen a taxpayer receives stock of a controlled corporation in a spin-off, it allocates a portion of its basis in its stock of Distributing to the Controlled stock received in the distribution. As a result, gain realized in a subsequent disposition of either Distributing or Controlled will generally be less than the amount of dividend income the taxpayer would have had to include in gross income if the distribution had been taxed as a dividend . . . The Treasury recognized this potential for tax avoidance and, as part of the 1989 Regulations, broadened the definition of Device to include “a transaction that effects a recovery of basis. . . . Second, in the case of individual taxpayers, capital gains are preferred to dividend income because the former may be offset by capital losses. Thus, the Device concern could be relevant even where a shareholder has little or no basis in the shareholder’s shares. Third, foreign shareholders generally prefer capital gain over dividend income, because capital gain is not subject to withholding, while dividends are subject to 30 percent withholding, subject to reduction under treaties.”).

⁵⁶ See *id.* at 27.

⁵⁷ See *id.*

⁵⁸ See *id.*

⁵⁹ § 355(d)(2)(A).

⁶⁰ § 355(d)(3).

⁶¹ DOUGLAS A. KAHN & JEFFREY H. KAHN, *PRINCIPLES OF CORPORATE TAXATION* 243 (2d ed. 2019).

acquisitions within five years of a planned spin-off that would cause it to hold disqualified stock and therefore to engage in a “disqualified distribution.”⁶² If a distribution is disqualified, “no stock or securities of any of the controlled corporations will be treated as ‘qualified property,’ and any unrealized appreciation in such stock or securities will be taxed to the distributing corporation in the same manner as with other appreciated property.”⁶³ Section 355(d) is often particularly onerous for multinational conglomerates that have structured their foreign lines of business in unique ways to comply with the laws or differing economic realities of foreign jurisdictions. Thus, section 355(d) can force them to engage in circuitous and costly internal tax planning to separate out their intertwined foreign companies and lines of business in preparation for a tax-free spin-off.

B. Section 355(e): Anti-*Morris Trust* Provision

A spin-off transaction will not be tax-free if the distribution is “part of a plan (or series of related transactions) pursuant to which 1 or more persons acquire directly or indirectly stock representing a 50[%] or greater interest in the distributing corporation or any controlled corporation.”⁶⁴ Moreover, “[i]f 1 or more persons acquire directly or indirectly stock representing a 50[%] or greater interest in the distributing corporation or any controlled corporation during the 4-year period beginning on the date which is 2 years before the date of the distribution, such acquisition shall be” presumed to be pursuant to a plan unless the taxpayer can offer evidence to the contrary.⁶⁵

Taxpayers engaged in so-called *Morris Trust* transactions⁶⁶ when they tried to circumvent the repeal of *General Utilities* by using spin-offs to dispose of unwanted businesses in preparation for a tax-free acquisition by another

⁶² § 355(d)(2).

⁶³ § 355(d); KAHN, *supra* note 60, at 243.

⁶⁴ § 355(e)(2).

⁶⁵ *Id.* § 355(e)(2)(B).

⁶⁶ See Herbert N. Beller, *Section 355 Revisited: Time for a Major Overhaul?*, 72 TAX LAW. 131, 149-50 (2018) (“Long before the enactment of section 355(e), in *Commissioner v. Morris Trust*, prior to merging into a national bank, a state banking corporation spun-off an unwanted insurance department that the acquiring bank could not legally operate under federal law. The post-spin statutory merger separately qualified as a type ‘A’ reorganization (under section 368(a)(1)(A)), and, despite its planned occurrence immediately after the spin-off, the disappearance of Distributing pursuant to the merger, and the transfer of its active business assets to the acquiring corporation, the separate section 355 qualification of the spin-off was not disturbed. Consistent with the *Morris Trust* decision, similarly structured transactions subsequently flourished with the Service’s blessing. Section 355(e) is often referred to as the ‘anti-*Morris Trust* provision.’ That label stems from certain high profile *Morris Trust* transactions during the mid-1990s that involved substantial pre-spin borrowing by Distributing or Controlled and an ultimate separation of the borrowing proceeds from the debt obligation (which was effectively assumed by the corporation acquiring Distributing or Controlled as partial consideration for the acquisition). It was the leveraging features of these transactions that initially caused ‘disguised sale’ concerns at Treasury. But as ultimately enacted, section 355(e) applies as well to nonleveraged *Morris Trust* transactions where the 50% change in ownership threshold is breached and a proscribed ‘plan’ exists. For that and other reasons, the provision has been criticized by bar groups and other commentators as much broader than necessary to address the perceived abusive situations.”).

corporation.⁶⁷ Congress enacted section 355(e) in 1997 to stymie such transactions.⁶⁸ But there are a number of safe harbors that allow conglomerate corporations to evade this requirement through careful tax planning.⁶⁹ Because conglomerates tend to engage in frequent mergers and acquisitions, careful navigation of section 355(e) is of particular importance for conglomerates to succeed in spinning off a business unit tax-free.

3. Nonstatutory Requirements

A. Corporate Business Purpose

Conglomerates have many valid reasons for engaging in spin-off transactions that the I.R.S. will respect. The section 355 regulations provide that the corporate business purpose requirement is independent of the statutory requirements.⁷⁰ The spin-off must have a “real and substantial non Federal tax purpose germane to the business of the distributing corporation, the controlled corporation, or the affiliated group.”⁷¹ Valid corporate business purposes include: resolution of shareholder disputes; enabling management to focus on core businesses while allocating to non-core divisions separate resources and managerial attention to increase operating efficiencies and realize greater shareholder value; maximizing shareholder value in business units that are particularly successful and have high growth potential that the market may be undervaluing because of their

⁶⁷ See Azebu et al., *A New Role for the Device Test?*, 150 TAX NOTES 1427, 1430, 1432 (Mar. 21, 2016) (“In *General Utilities*, the Supreme Court held that corporations could distribute appreciated property to their shareholders tax free. . . . The Tax Reform Act of 1986 added section 311(b), effectively repealing the *General Utilities* doctrine. Regarding the decision to repeal *General Utilities*, the House committee report states: ‘The *General Utilities* rule tends to undermine the corporate income tax. Under normally applicable tax principles, nonrecognition of gain is available only if the transferee takes a carryover basis in the transferred property, thus assuring that a tax will eventually be collected on the appreciation. Where the *General Utilities* rule applies, assets generally are permitted to leave corporate solution and to take a stepped-up basis in the hands of the transferee without the imposition of a corporate-level tax. Thus, the effect of the rule is to grant a permanent exemption from the corporate income tax.’ Under section 311(b), if a corporation distributes appreciated property to its shareholders, the corporation must recognize gain as if that property were sold at its FMV. Thus, following the repeal of *General Utilities*, the code generally imposes two levels of tax . . . on distributions of appreciated property, including stock, outside corporate solution. To further combat the inevitable efforts of taxpayers to mitigate this double taxation, Congress enacted section 337(d), which provided broad authority to Treasury to issue regulations necessary to enforce the principles of *General Utilities* repeal. Section 337(d) states that Treasury ‘shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of *General Utilities* repeal, including ‘regulations to ensure that such purposes may not be circumvented through the use of any provision of law or regulations . . . or through the use of a regulated investment company, real estate investment trust, or tax-exempt entity,’ and ‘regulations providing for appropriate coordination of the provisions of this section with the provisions of this title relating to taxation of foreign corporations and their shareholders.’”).

⁶⁸ *Id.*

⁶⁹ See *Spin-Offs: Tax Overview*, *supra* note 36 (describing ten types of safe harbors under section 355(e)).

⁷⁰ § 1.355-2(b)(1).

⁷¹ § 1.355-2(b)(2).

affiliation with slow-growth or declining business units; allowing the adjustment of executive and employee compensation packages in more narrow business units; separating a subsidiary in preparation for a sale to a third party; disposing of businesses that no longer fit within the business plan and that may be illiquid or lack a fair current market valuation; permitting SpinCo to raise capital by seeking financing separately; defending from a takeover by spinning off a valuable subsidiary, thus rendering the Parent less attractive as a hostile takeover target; complying with antitrust or other regulatory decrees by changing the structure and regulatory regimes to which the Parent and SpinCo are subject; removing conflicts among different lines of business; providing employees with an equity interest; facilitating a stock offering, borrowing or an acquisition of either the Parent or SpinCo; generating significant cost savings; enhancing fit and focus; solving competitive concerns; and risk reduction by shielding one business from the risks of another.⁷²

The business purpose must be a proper, corporate-level—as opposed to a purely shareholder-level—motivation. Moreover, the reduction of non-federal tax may be a valid corporate business purpose only if the transaction does not result in a reduction of federal and non-federal taxes because of similarities in their respective laws or the reduction of federal tax exceeds the reduction of non-federal tax.⁷³ In addition, a business purpose fails if the same objectives can be met through a non-taxable transaction that does not require the distribution of stock. For example, if creating a subsidiary rather than spinning off a business unit is a convenient alternative mechanism that is “neither impractical nor unduly expensive,” the transaction will fail the business purpose requirement.⁷⁴

Thus, the government requires that businesses wishing to take advantage of tax-free treatment articulate a business reason for the spin-off. Out of concern that taxpayers like Gregory will exploit the spin-off rules to avoid paying corporate-level taxes, the government requires that companies state that the spin-off be motivated by one or more corporate business purposes. However, it would seem that even noncreative taxpayers and lawyers could fairly easily devise pretexts for a spin-off that in fact has the primary purpose of tax avoidance. One benefit of this requirement for the government, however, is that if a corporation states a qualifying business purpose—for example, in a press release or private letter ruling request—and then later changes course and fails to engage in the stated activity, the I.R.S. may be able to challenge the transaction as motivated by tax avoidance rather than by a bona fide corporate business purpose.

Nevertheless, most of the corporate business purposes that satisfy this requirement are rather vague. For example, the I.R.S. would have a difficult time challenging a conglomerate that stated a desire to enhance “fit and focus” as a pretext for spinning off a subsidiary for tax avoidance purposes. The I.R.S. will likely only challenge a company’s stated business purpose if it is unreasonable or frivolous, if it is a pure shareholder purpose, if it can be accomplished in a convenient alternative mechanism, or if it reduces federal tax by more than it

⁷² *Spin-Offs: Tax Overview*, *supra* note 36; Rev. Proc. 96-30, 1996-1 C.B. 696.

⁷³ § 1.355-2(b)(2).

⁷⁴ § 1.355-2(b)(3).

reduces non-federal tax. Thus, the common law corporate business purpose requirement seems fairly easy to overcome and difficult to challenge in practice. Business purpose is a highly factual analysis that depends on whether a disinterested party would find the business purpose reasonable. Because it is generally easy to navigate, this requirement likely does little to discourage deconglomeration.

B. Continuity of Interest

The other common law requirement is continuity of interest, which encompasses both continuity of business enterprise and continuity of proprietary interest. Continuity of business enterprise requires that the “businesses existing prior to the separation” be continued.⁷⁵ The exact length of time required for continuing the businesses is nowhere explicitly stated, but in practice, distributing and controlled should each continue to operate at least one of their substantial historic businesses.⁷⁶ Continuity of proprietary interest is understood as requiring that “a substantial portion of the consideration received by parties to a reorganization consist of an ongoing equity interest in the surviving enterprise.”⁷⁷ In the case of spin-offs, the current regulations require that “one or more persons who, directly or indirectly, were the owners of the enterprise prior to the distribution or exchange own, in the aggregate, an amount of stock establishing a continuity of interest in each of the modified corporate forms in which the enterprise is conducted after the separation.”⁷⁸

The rationale behind the continuity of interest requirements is again to help to ensure that the spin-off resembles a mere change in form as opposed to a sale.⁷⁹ As long as a conglomerate wishing to engage in a spin-off makes sure that the conglomerate and SpinCo continue to operate at least one substantial historic business and at least one of the shareholders who historically owned an interest in the conglomerate before the division owns an amount of stock that establishes a continuity of interest in each of the modified corporate forms following the transaction, this requirement should be met without great difficulty.⁸⁰

4. Two Additional Considerations

A. Section 367: International Spin-offs

Conglomerates today are almost by definition international entities. A U.S. multinational may have strong corporate business reasons to pursue a spin-off a controlled foreign corporation (“CFC”). Certain tax provisions in the Code and

⁷⁵ Treas. Reg. § 1.355-1(b).

⁷⁶ KAHN, *supra* note 61, at 224.

⁷⁷ *Id.* at 225.

⁷⁸ Treas. Reg. § 1.355-2(c)(1).

⁷⁹ Treas. Reg. § 1.355-1(c).

⁸⁰ If at least one shareholder of distributing owns at least 50% of the equity in each of the corporations after the transaction, the continuity of proprietary interest requirement will be met. Rev. Proc. 77-37, 1977-2 C.B. 568; Treas. Reg. § 1.368-1(e)(8), Ex. (1).

regulations, however, make spinning off an entirely or predominantly foreign business with appreciated assets by a U.S. conglomerate highly disadvantageous by requiring gain recognition.

Much as section 367(a) overrides nonrecognition in what would otherwise be a tax-free transaction under section 351—and much as Treasury regulation section 1.367(b)-3 overrides nonrecognition for an inbound liquidation that would otherwise be tax-free under sections 332 and 337—so too section 367(e)(1) and Treasury regulation section 1.367(b)-5 turn off nonrecognition for individual distributees in what would otherwise be a tax-free spin-off of a CFC.

Section 367(e)(1) states that “[i]n the case of any distribution described in section 355 . . . by a domestic corporation to a person who is not a United States person, to the extent provided in regulations, gain shall be recognized under principles similar to the principles of this section.”⁸¹ Moreover, Treasury regulation section 1.367(b)-5(b)(1)(ii) adds that “[i]f the distributee is an individual, then, solely for purposes of determining the gain recognized by the distributing corporation, the controlled corporation shall not be considered to be a corporation, and the distributing corporation shall recognize any gain (but not loss) realized on the distribution.”⁸² Because these provisions override nonrecognition only for individual distributees, they may not seem too onerous at first glance. In practice, however, U.S. multinational conglomerates tend to have many—and sometimes even a majority of—foreign and individual shareholders.⁸³ Therefore, attempting to spin off a CFC with appreciated assets is often prohibitively expensive. Restructuring a transaction to circumvent section 367(e)(1) and Treasury regulation section 1.367(b)-5 requires navigating the complex anti-inversion provisions and related regulations under section 7874, which include numerous traps for the unwary.⁸⁴ Therefore, the spin-off rules in the international arena can be viewed as punishing multinational conglomerates wishing to downsize. In light of various changes in the 2017 Tax Cuts and Jobs Act including the section 245A 100% “exemptive deduction” for most dividends received from 10%-owned foreign corporations, the government may need to reconsider whether some of the inbound provisions under section 367(b) still make sense today.

⁸¹ § 367(e)(1).

⁸² § 1.367(b)-5(b)(1)(ii).

⁸³ U.S. individuals and foreigners often constitute more than half of a multinational conglomerate’s shareholder base. In addition, mutual funds and tax-exempts typically own large blocks of the stock of multinational conglomerates. Whether mutual funds and tax-exempts are treated as corporations or individuals for the purposes of these provisions is unclear. See Devon Bodoh et al., *Cross Border Spin-Offs, Tax Webinar Series*, WEIL, GOTSHAL & MANGES LLP (Mar. 10, 2021), <https://www.weil.com/~media/mailings/2021/q1/210310cross-border-spinoffs.pdf> [<https://perma.cc/V5BQ-QECJ>].

⁸⁴ See § 7874; Bodoh et al., *supra* note 81 (“Section 7874 provides potentially detrimental U.S. tax consequences to a U.S. corporation that undergoes a transaction whereby all of its assets are acquired by a foreign corporation . . . and greater than a threshold percentage of Foreign Acquirer stock . . . is received by the U.S. corporation’s shareholders by reason of holding U.S. corporation stock.”).

B. Private Letter Rulings

Before a conglomerate performs a high-stakes, tax-free spin-off—particularly one in which some aspect of the transaction might be considered abusive, novel, or uncertain—it may seek a private letter ruling from the I.R.S. The decision to request a private letter ruling depends on many factors, including cost, speed, certainty, and risk.⁸⁵ The process is costly and slow, and there are risks associated with having a request denied.⁸⁶ It may be “better not to ask than to ask and be denied.”⁸⁷ Regardless of whether the company requests a private letter ruling, it will undoubtedly request that its tax counsel approve the transaction. Typically, corporations require “will-level”—or at a minimum “should-level”—opinions from a reputable law firm and one of the big-four accounting firms.⁸⁸

The I.R.S. has changed its policies over the past couple of decades with respect to the private letter ruling procedures for spin-offs. In 2003, the I.R.S. announced that it would stop issuing rulings on whether a spin-off constitutes a device, whether the stated corporate business purpose for a spin-off is legitimate, and whether a spin-off and a related acquisition constitute a plan under section 355(e).⁸⁹ These new “no-rule” areas made spin-offs slightly riskier and more uncertain.

In 2005, the I.R.S. announced that it would attempt to expedite the private letter ruling process by issuing its decisions within ten weeks of receiving a request.⁹⁰ And in 2009, the I.R.S. allowed taxpayers to request rulings on the discrete aspects of a spin-off within an integrated transaction without ruling on the larger transaction.⁹¹ These were taxpayer-friendly policy changes because the former policy change hastened the issuance of so-called “comfort rulings,” and the

⁸⁵ Robert W. Wood, *Tax Opinion or Private Letter Ruling? A 12-Point Comparison*, 149 TAX NOTES 835, 835 (Nov. 9, 2015).

⁸⁶ *Id.*

⁸⁷ *Id.*

⁸⁸ Tax practitioners offer different levels of opinion to express their varying levels of comfort with a given transaction. See Robert P. Rothman, *Tax Opinion Practice*, 64 TAX LAW. 301 (Winter 2011) (explaining and quantifying tax lawyers’ varying comfort levels). “Will” opinions represent the highest level of comfort, with a roughly 90% chance that a particular consequence will ensue. *Id.* at 312, 327. “Should” represents a reasonably high level of confidence, around 70-90% likelihood, that the position will be sustained. *Id.* at 313, 327. “More likely than not” reflects a comfort level roughly between 50-70%. *Id.* at 314, 327. “Substantial authority” means “the weight of authorities in support of the position is substantial in relation to the weight of authorities supporting contrary treatment.” *Id.* at 319. This type of opinion reflects a 35-40% comfort level. *Id.* at 327. “[A] position has a ‘realistic possibility of success’ if a reasonable and well-informed analysis by a person knowledgeable in the tax law would lead such person to conclude that the position has approximately a one-in-three, or greater, likelihood of being sustained.” *Id.* at 321. “Reasonable basis” is higher than “merely arguable” or “merely . . . colorable.” *Id.* at 322. Finally, “not frivolous” is the lowest level at which there is still “some modicum of comfort as to a position,” where prior regulations defined “frivolous” as “patently improper.” *Id.* at 324.

⁸⁹ Rev. Proc. 2003-48, *supra* note 46.

⁹⁰ Rev. Proc. 2005-68, 2005-2 C.B. 694. See J. William Dantzler Jr., *Spin-offs: Still Remarkably Tax Friendly*, 129 TAX NOTES 683 (Nov. 8, 2010) (observing that I.R.S. still takes fourteen to seventeen weeks on average, but its ten-week goal is viewed positively by taxpayers).

⁹¹ See Rev. Proc. 2009-25, 2009-1 C.B. 1088 (explaining circumstances under which I.R.S. may issue letter rulings).

latter policy change allowed taxpayers to avoid disclosing extensive details about the overall context of the spin-off if they so desired.

Nevertheless, in 2013, the I.R.S. changed course. The Service altered its former policy of ruling on an entire spin-off transaction to a new policy of ruling on only one or more significant issues presented by the transaction.⁹² In 2017, however, the I.R.S. reversed course, once again allowing taxpayers to obtain a private letter ruling on the entire spin-off transaction rather than on only one or more significant issues.⁹³

Although one might expect the 2013 policy change to have chilled the frequency of spin-off transactions, it seems that companies that were already considering spin-offs instead rushed to submit private letter ruling requests before the change went into effect.⁹⁴ Moreover, many companies continued to undertake “plain vanilla” spin-offs that did not present high levels of uncertainty and that were based solely on the opinions of their tax advisers—a practice that only expanded after the 2013 policy change.⁹⁵ When the I.R.S. reverted to its previous practice in 2017, many tax lawyers had already grown comfortable advising on spin-offs without the I.R.S.’s blessing, and taxpayers became accustomed to relying solely on the advice of law firm and accounting firm opinions. As it turned out, costly, time-consuming comfort rulings were not as vital as taxpayers may have previously believed.⁹⁶ An additional benefit of phasing out private letter rulings was that companies could avoid describing all related transactions that pertained to the spin-off.⁹⁷ Therefore, conglomerates’ decreased reliance on private letter rulings and increased reliance on opinion letters by tax counsel has likely made spin-offs less burdensome and more feasible in recent years.

III. LIBERTY’S SPIN-OFF OF TRIPADVISOR

In August 2014, Liberty Interactive Corporation (“Liberty”), an American media conglomerate that operated a broad range of digital commerce businesses including QVC and Expedia, announced its completion of a tax-free spin-off of TripAdvisor, Inc. (“TripAdvisor”).⁹⁸ Liberty bundled its 22% stake in TripAdvisor with an online retail subsidiary called BuySeasons, creating a new publicly traded

⁹² Rev. Proc. 2013-32, 2013-28 I.R.B. 55; Rev. Proc. 2013-28, 2013-27 I.R.B. 28. See Amy Elliott, *IRS Expands No-Rule Policy to Spin-offs to Save Money*, 14 TAX NOTES 23, 23-24 (July 1, 2013) (summarizing I.R.S.’s new policy).

⁹³ Rev. Proc. 2017-52, 2017-41 I.R.B. 283.

⁹⁴ See Elliott, *supra* note 92 (noting that when I.R.S. previously cut back on corporate letter ruling program, taxpayers rushed to submit rulings before no-rule policy went into effect).

⁹⁵ Jasper A. Howard, *Considerations in Seeking Private Letter Rulings for Spin-offs*, TAX NOTES 1365, 1366 (May 27, 2019).

⁹⁶ See *id.* (predicting taxpayers will continue solely to use tax opinions due to ease of execution).

⁹⁷ *Id.*

⁹⁸ Press Release, Liberty Interactive Corporation, Liberty Interactive Corporation Announces Completion of Liberty TripAdvisor Holdings Spin-Off (Aug. 27, 2014), <https://www.sec.gov/Archives/edgar/data/1355096/000155837014000156/lint-20140827ex991479fde.htm> [<https://perma.cc/8WFZ-YEQS>].

company called Liberty TripAdvisor Holdings.⁹⁹ The media conglomerate needed to package the large stake in TripAdvisor with BuySeasons to satisfy the 80% control requirement in section 355. Liberty could have taken the 22% stake in TripAdvisor and formed a new company to meet the control requirement, but this transaction would not have met the active trade or business requirement. Thus, Liberty created the NewCo Liberty TripAdvisor Holdings and distributed into it the online retail subsidiary and a 22% stake in TripAdvisor. The transaction qualified as a tax-free reorganization under sections 355 and 368(a)(1)(D).

Liberty's board of directors was specifically forbidden from waiving a condition precedent that the conglomerate receive a will-level opinion from its tax counsel, and Liberty's law firm, Baker Botts LLP, provided the will-level opinion, deeming the transaction proper.¹⁰⁰ Although the spin-off transaction contained some potentially abusive ingredients on which the I.R.S. refused to rule, the government ultimately blessed the transaction in a private letter ruling in 2014.¹⁰¹

To satisfy the nonstatutory corporate business purpose requirement, Liberty offered a description of the transaction's benefits in its request for a private letter ruling.¹⁰² The media conglomerate explained that Liberty and TripAdvisor would achieve higher stock prices as a result of the spin-off, rendering TripAdvisor a "significantly more attractive acquisition" target.¹⁰³ This would enable both the Parent and SpinCo to "more efficiently . . . compensate their officers and employees."¹⁰⁴ The I.R.S. has acknowledged that increasing the stock price can constitute a compelling business purpose for a spinoff as long as the possible share price increase is not a "pure" shareholder concern. That is, the company must also draw a link between an increase in the share price and some benefit at the corporate level, such as helping to improve cash flow so that management may purchase a necessary business asset. Here, what would otherwise be a pure shareholder purpose, a higher stock price, satisfied the corporate business purpose requirement because the boost in share value would supposedly help to attract corporate buyers. In accordance with its no-rule policy on the legitimacy of a transaction's business purpose,¹⁰⁵ the I.R.S. expressed no opinion as to whether the spin-off met the corporate business purpose requirement. The transaction satisfied the active trade or business requirement because, before the transaction, Liberty and BuySeasons

⁹⁹ Vinu Goel & Michael J. de la Merced, *I.R.S. Look at Spin-offs May Affect Yahoo Plan*, N.Y. TIMES (May 19, 2015), <https://www.nytimes.com/2015/05/20/technology/irs-look-at-spin-offs-may-affect-yahoo-plan.html> [<https://perma.cc/B9G5-UEMS>].

¹⁰⁰ See Liberty TripAdvisor Holdings, Inc., Registration Statement (Form S-1) (May 5, 2014), https://sec.report/Document/0001047469-14-004609/#ca71601_the_spin-off [<https://perma.cc/X6UV-3RBZ>]; Amy S. Elliott, *Yahoo May Waive Receipt of Favorable Ruling Spin-off Condition*, TAX ANALYSTS (July 21, 2015), <http://www.taxhistory.org/www/features.nsf/Articles/5C5BF388237946AD85257E89005CAECD?OpenDocument> [<https://perma.cc/Z4Q7-EEXP>].

¹⁰¹ See I.R.S. Priv. Ltr. Rul. 2014-35-005 (Aug. 29, 2014) (discussing rationale behind I.R.S.'s ruling).

¹⁰² See *id.*

¹⁰³ *Id.* at 5.

¹⁰⁴ *Id.* at 6.

¹⁰⁵ Rev. Proc. 2003-48, *supra* note 46.

presented “gross receipts and operating expenses representing the active conduct of a trade or business for . . . five years.”¹⁰⁶

In its request for a private letter ruling, Liberty represented, among other things, that the spin-off was “not being used principally as a device for the distribution of the earnings and profits” of BuySeasons or SpinCo, and that “the spin-off [was] not part of a plan or series of related transactions (within the meaning of § 1.355-7) pursuant to which one or more persons [would] acquire . . . stock representing a 50[%] or greater interest (within the meaning of § 355(d)(4)) in Distributing or Controlled.”¹⁰⁷ As it did with respect to the business purpose requirement, the I.R.S. cautioned that it expressed no opinion regarding these issues either.¹⁰⁸

The I.R.S. flagged two potentially concerning aspects of Liberty’s spin-off: (1) whether the transaction satisfied the nondevice requirement, and (2) whether the transaction constituted a plan or series of related transactions in violation of the anti-*Morris Trust* provision under section 355(e).¹⁰⁹ The I.R.S. flagged the nondevice requirement because the SpinCo would consist primarily of a large, appreciated 22% stake in TripAdvisor—a passive investment—combined with a very small active trade or business, the online retailer BuySeasons. The inclusion of BuySeasons could therefore be seen as pretextual. The spin-off’s overall purpose was likely to enable a tax-free distribution of the TripAdvisor shares. Founded in 1999, BuySeasons grew to 550 employees by 2011, but it reduced its operations to around 350 employees by 2014.¹¹⁰ Thus, BuySeasons’s size paled in comparison to Liberty’s stake in TripAdvisor. Moreover, the spin-off was in anticipation of an acquisition: Rubie’s Costume Co. acquired BuySeasons in 2017.¹¹¹

Although the I.R.S. may have expressed some reservations about the transaction, it nevertheless approved Liberty’s spin-off of Liberty TripAdvisor Holdings, and the tax-free transaction was executed unchallenged. But the I.R.S. was growing increasingly concerned about potentially abusive spin-offs. The I.R.S. reached its breaking point when Yahoo announced its plans to perform a tax-free spin-off of its massive, appreciated stake in Alibaba, combined with the comparatively tiny Yahoo Small Business.

IV. YAHOO’S FAILED SPIN-OFF OF ALIBABA

By 2016, Yahoo! Inc. (“Yahoo”) had grown into an internet conglomerate. Yahoo was founded in 1994 as a directory of websites.¹¹² In the following years, it created a search engine and began to offer email, shopping, and news supported by

¹⁰⁶ I.R.S. Priv. Ltr. Rul. 2014-35-005, *supra* note 101, at 5.

¹⁰⁷ *Id.* at 9, 11.

¹⁰⁸ *Id.* at 13.

¹⁰⁹ *Id.*

¹¹⁰ Melanie Lawder, *BuySeasons acquired by Rubie’s Costume Co.*, MILWAUKEE BUS. J. (July 5, 2017), <https://www.bizjournals.com/milwaukee/news/2017/07/05/buyseasons-acquired-by-rubies-costume-company.html> [<https://perma.cc/MN7H-PKDM>].

¹¹¹ *See id.* (discussing Rubie’s Costume Co.’s acquisition of BuySeasons).

¹¹² Goel & de la Merced, *supra* note 99.

ad revenue.¹¹³ Although its market capitalization soared to \$125 billion during the dot-com bubble, Yahoo lost its competitive edge to Google and Facebook in the early 2000s.¹¹⁴ As a result, Yahoo attempted to recast itself as a content company, but this was at a time when users were transitioning from web portals to apps and social networks.¹¹⁵ In 2005, Yahoo bought 40% of Alibaba Holding Ltd. (“Alibaba”), a major Chinese e-commerce group, for \$1 billion in cash plus the transfer of Yahoo’s Chinese internet operations to Alibaba.¹¹⁶ Around 2013, Yahoo began an acquisition frenzy, acquiring dozens of companies, including Tumblr.¹¹⁷ When Alibaba went public in 2014, Yahoo still owned a 15% stake in the firm.¹¹⁸ Yahoo also owned a 35.5% stake in Yahoo Japan.¹¹⁹ After Alibaba’s IPO, activist shareholder pressure mounted for Yahoo to design a plan to distribute the appreciated shares of Alibaba to Yahoo’s shareholders. Rather than disposing of the shares outright, which would have triggered a large corporate-level tax and would have required that Yahoo’s shareholders pay some \$10 billion in capital gains taxes,¹²⁰ Yahoo hoped to craft a tax-free spin-off of its Alibaba stake that would enable Yahoo to avoid over \$16 billion in tax liability.¹²¹

Following the I.R.S.’s approval of Liberty’s spin-off of TripAdvisor, Yahoo decided to pursue a similar spin-off strategy.¹²² Yahoo wished to extract its 15% interest in Alibaba to enable markets to value Yahoo’s core internet business independently of its Alibaba holdings. If the initial spin-off was successful, Yahoo contemplated a subsequent, similar tax-free spin-off of its 35.5% stake in Yahoo Japan. Therefore, Yahoo had valid business reasons for spinning off the Alibaba shares and thus would have little trouble satisfying the corporate business purpose requirement. Like Liberty, Yahoo believed that the separation of Yahoo’s core internet business from the massively appreciated shares of Alibaba would enable markets to value Yahoo’s core operations independently and that Yahoo would trade at a higher price as a result of the spin-off. Nevertheless, Yahoo could not spin off Alibaba alone because it lacked sufficient ownership to satisfy the distribution of control requirement. Therefore, Yahoo had to include another business within SpinCo to satisfy the control test, as well as the active trade or business requirement. According to estimates by analysts at the time, if Yahoo’s disposition of Alibaba were taxed, Yahoo’s stock was expected to have a fair market value of \$40 per share.¹²³ On the other hand, a tax-free spin-off would place the Yahoo shares closer to \$55 per share.¹²⁴ Moreover, like Liberty, Yahoo was

¹¹³ *Id.*

¹¹⁴ *Id.*

¹¹⁵ *Id.*

¹¹⁶ *Id.*

¹¹⁷ *Id.*

¹¹⁸ *Id.*

¹¹⁹ *Id.*

¹²⁰ See Young Ran (Christine) Kim & Geeyoung Min, *Insulation by Separation: When Dual-Class Stock Met Corporate Spin-Offs*, 10 U.C. IRVINE L. REV. 1, 16-17 (2019).

¹²¹ See Joshua D. Blank, *The Timing of Tax Transparency*, 90 S. CAL. L. REV. 449, 485-86 (2017).

¹²² *Id.* at 490.

¹²³ See Goel & de la Merced, *supra* note 99.

¹²⁴ *Id.*

also interested in facilitating an acquisition of the small business unit it would spin off together with the shares.¹²⁵

Yahoo's tax counsel, Skadden, developed the following plan. First, Yahoo would create a SpinCo called Aabaco to which it would convey all of its 384 million Alibaba shares, which were valued at \$40 billion.¹²⁶ Together with the large stake in Alibaba, Yahoo would tack on a legacy ancillary small business, Yahoo Small Business, to fulfill the control and active trade or business requirements.¹²⁷ Yahoo Small Business was an operating unit that, although profitable, never fit in well with the rest of Yahoo's portfolio of businesses.¹²⁸ Because Yahoo had operated the small legacy business for more than five years, Yahoo's counsel expected it to satisfy the active trade or business requirement. Yahoo felt confident in its strategy because the I.R.S. had approved Liberty's 2014 spin-off. Moreover, despite statements in revenue procedures that the active trade or business should represent at least 5% of the total assets of the distributing corporation and the distributed corporation to satisfy section 355, Revenue Ruling 73-44 has expressed that the size of the active business was immaterial.¹²⁹ In other words, the small business did not need to represent any particular percentage of the value of the business's total assets.

Yahoo Small Business, however, was estimated to constitute less than 0.2% of the total value of the SpinCo.¹³⁰ Whether the spin-off would be seen as a transaction used principally as a device for distributing earnings and profits was, therefore, another potential problem. On the one hand, Yahoo was widely held, and the spin-off could be justified by a strong corporate business purpose. These factors weighed in favor of nondevice. On the other hand, the SpinCo would hold an exceedingly high ratio of inactive or passive assets—the Alibaba holdings—compared to its total assets. This weighed rather strongly in favor of device.

Yahoo's endgame was for Alibaba eventually to acquire the SpinCo in exchange for some amount of its own stock, thus placing Yahoo's Alibaba shares into the hands of Yahoo's shareholders without any immediate tax consequences. If Yahoo had distributed its Alibaba stock directly to Yahoo's shareholders, this transaction would have produced a taxable gain at Yahoo's entity level under section 311(b), as well as taxable dividend income for the shareholders who received the distributions. Under Treasury Regulation section 1.355-7(b)(2), to achieve tax-free status, the spin-off and business combination must not be part of a plan or of a series of related transactions that together constitute a plan.¹³¹ A plan is defined as "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."¹³² Yahoo had no such agreement and

¹²⁵ *Id.*

¹²⁶ *Id.*

¹²⁷ *Id.*

¹²⁸ *Id.*

¹²⁹ *See* Rev. Rul. 73-44, 1973-1 CB 182.

¹³⁰ *See* Amy S. Elliott, *Size Does Matter: Wellen Explains New Hot Dog Stand Regs*, 152 TAX NOTES 480, 480 (July 25, 2016).

¹³¹ Treas. Reg. § 1.355-7(b)(2).

¹³² *Id.*

had not engaged in any substantial negotiations with potential acquirers, so the business combination could presumably take place shortly after the completion of the spin-off. Nevertheless, the parties planned to delay any merger for more than a year to avail themselves of a one-year safe harbor in the regulation.¹³³

When Yahoo announced the proposed spin-off transaction on January 27, 2015, the media criticized the plan as undeserving of the tax-free benefit.¹³⁴ And when the I.R.S. refused to issue a private letter ruling blessing the transaction, Yahoo's stock price fell by over 10%.¹³⁵ Skadden, nevertheless, issued a will-level legal opinion affirming its confidence that the deal would be tax-free at both the entity and shareholder levels.¹³⁶

In response to Yahoo's proposed spin-off—as well as other potentially abusive distributions involving RICs and REITs—the I.R.S. issued Notice 2015–59 (“the Notice”) and a request for comments relating to sections 337(d) and 355.¹³⁷ With respect to section 355, the government noted three transactional characteristics of concern. First, “ownership by the distributing corporation or the controlled corporation of investment assets, within the meaning of § 355(g)(2)(B), with modifications (Investment Assets), having substantial value in relation to (a) the value of all of such corporation's assets and (b) the value of the assets of the active trade(s) or business(es) on which the distributing corporation or the controlled corporation relies to satisfy the requirements of § 355(b) (a Qualifying Business or Qualifying Business Assets)”; second, “a significant difference between the distributing corporation's ratio of Investment Assets to assets other than Investment Assets and such ratio of the controlled corporation”; and third, ownership by the distributing corporation or the controlled corporation of a small amount of Qualifying Business Assets in relation to all of its assets.”¹³⁸ The I.R.S. in the Notice added transactions displaying these qualities to its list of “no-rule areas.”¹³⁹ The Notice explained that certain taxpayers in their requests for private letter rulings had been taking positions that their proposed transaction structures satisfied the requirements of section 355 despite exhibiting one or more of these concerning characteristics.¹⁴⁰ The Notice stated that such transactions had some or all of the following infirmities: 1) presenting evidence of device for the distribution of earnings and profits; 2) lacking an adequate business purpose or a Qualifying Business; 3) violating other section 355 requirements; 4) circumventing the purposes of certain provisions intended to repeal *General Utilities & Operating Co. v. Helvering*; and 5) the distributing corporation or the controlled corporation owning a small amount of Qualifying Business Assets compared to its other assets (non-Qualifying Business Assets).¹⁴¹

¹³³ See Treas. Reg. § 1.355-7(d).

¹³⁴ See Kim & Min, *supra* note 120, at 16-17.

¹³⁵ See Blank, *supra* note 121, at 485-86.

¹³⁶ See Elliott, *supra* note 100, at 374-75.

¹³⁷ Howard, *supra* note 95, at 1366.

¹³⁸ I.R.S. Notice 2015-59, 2015-2 C.B. 459.

¹³⁹ *Id.*

¹⁴⁰ See *id.*

¹⁴¹ See *id.*

Yahoo's proposed Alibaba spin-off involved the small active trade or business issue—what some refer to as a “candy store” or “hot dog stand”—and resembled a device because the SpinCo was exceedingly investment-heavy.¹⁴²

Despite its general language, it seemed clear that the I.R.S.'s notice was written partly in response to Yahoo's proposed spin-off. Because of the Notice, Yahoo abandoned its original structure and pursued a different structure: a reverse spin-off.¹⁴³ The reverse spin-off was an alternative means of achieving a similar result in which Yahoo would spin off its core assets, including its stake in Yahoo Japan: “Yahoo's assets and liabilities other than the Alibaba stake would be transferred to a newly formed company, the stock of which would be distributed pro rata to Yahoo shareholders resulting in two separate publicly-traded companies.”¹⁴⁴ The reverse spin-off would reduce the potential tax liability but would not address many of the concerns that the I.R.S. raised in the Notice.¹⁴⁵ According to tax practitioners who were involved in the transaction, although the reverse spin-off was controversial and included certain elements of risk, Skadden and Simpson Thacher—which was also involved in the tax planning—both expressed confidence that the reverse spin-off would work. The reverse-spinoff, however, contained many of the same infirmities as the original spin-off structure, and ultimately, Yahoo determined that the likelihood was too high that the I.R.S.

¹⁴² See Amy S. Elliott, *Hot Dog Stand Guidance Will Expand on Factor in Device Regs.*, 151 TAX NOTES 1458, 1458-59 (June 13, 2016). The policy behind the 2006 enactment of section 355(g), which prohibits “cash-rich” split-offs, is similar to the rationale underlying the regulatory response to Yahoo's proposed spin-off of Alibaba. Section 355(g) limits the amount of investment assets (that is, cash, corporate securities, debt instruments, options, forward or futures contracts, notional principal contracts, derivatives, foreign currencies, or assets of a like nature) that either Parent or SpinCo may own immediately after a distribution. See § 355(g). Section 355 does not apply to “any distribution which is part of a transaction if (A) either the distributing corporation or controlled corporation is, immediately after the transaction, a disqualified investment corporation, and (B) any person holds, immediately after the transaction, a 50-percent or greater interest in any disqualified investment corporation, but only if such person did not hold such an interest in such corporation immediately before the transaction.” § 355(g)(1). A disqualified investment corporation is any corporation in which the fair market value of its investment assets is equal to or greater than two-thirds of the fair market value of all of its assets. § 355(g)(2)(A). Before the enactment of section 355(g) prohibiting “cash-rich” split-offs, a shareholder of Parent could exchange its stock in the Parent for stock of a controlled subsidiary holding a substantial amount of cash or other liquid assets in proportion to its other assets in a transaction intended to qualify for nonrecognition treatment under section 355. See REPORT NO. 1342, *supra* note 3, at 26. Congress enacted section 355(g) to disallow transactions that resemble cash redemptions of the stock in Distributing that is held by a large shareholder. See *id.* The government was concerned about transactions intended to cash out large shareholders on a tax-free basis by having Distributing contribute the sale consideration to a controlled corporation and splitting it off under section 355 to the shareholder in exchange for the shareholder's Distributing shares. See *id.*

¹⁴³ See Kim & Min, *supra* note 120, at 16-17.

¹⁴⁴ *Yahoo Provides Update on Planned Spin Off of Remaining Stake in Alibaba Group*, Ex. 99.1, <https://www.sec.gov/Archives/edgar/data/1011006/000119312515398244/d93711dex991.htm> [<https://perma.cc/QEY9-B266>].

¹⁴⁵ See Alan S. Kaden & Michael J. Alter, *2015 in Review: Tax Regulators Attempt to Strike Back*, LAW360 (Jan. 4, 2016).

might end up challenging the transaction's tax-free status—placing billions in tax liability at stake.¹⁴⁶ Thus, Yahoo abandoned the reverse spin-off as well.

As I mentioned above, the government issued the 2016 Proposed Regulations, likely in response to Yahoo's high-profile proposed spin-off,¹⁴⁷ to offer guidance concerning certain statutory requirements under section 355.¹⁴⁸ Although not authoritative, the 2016 Proposed Regulations announced potentially significant policy changes with respect to the device test and the minimum size for an active business. The I.R.S. introduced a device test with two prongs that, if met, would render a distribution a "per se device." A spin-off would now be deemed a per se device if 1) Distributing or Controlled has a Nonbusiness Asset Percentage of 66^{2/3}% or more of the total assets and 2) the Nonbusiness Assets percentage of Distributing or Controlled is a) 66^{2/3}% or more but less than 80% of the total assets, and the Nonbusiness Assets percentage of the other corporation is less than 30% of the total assets, b) 80% or more but less than 90% of the total assets, and the Nonbusiness Assets percentage of the other corporation is less than 40% of the total assets, or c) 90% or more of the total assets, and the Nonbusiness Assets percentage of the other corporation is less than 50% of the total assets.¹⁴⁹ As discussed in Part II above, the active trade or business requirement previously could be satisfied regardless of the size of the historic active trade or business assets in comparison to the nonbusiness assets held by Distributing and Controlled.¹⁵⁰ Under the 2016 Proposed Regulations, however, a spin-off would be deemed a per se device if the proportion of nonbusiness assets to total assets met this new bright-line, two-prong test. Similarly, the proposed regulations stated that for the requirements of sections 355(a)(1)(C) and 355(b) to be satisfied, the five-year-active-business asset percentage of each of Controlled and Distributing must be at least 5% of their total assets.¹⁵¹

Although Yahoo's preferred transactional structure, a tax-free spin-off, and alternative structure, a tax-free reverse spin-off, were both unsuccessful because of the I.R.S.'s resistance through its tightening of the tax rules in the 2016 Proposed Regulations, Yahoo did not give up and resign itself to retaining its conglomerate form. In 2017, the company pursued a different strategy and sold its core internet business to Verizon Communications for \$4.48 billion in a taxable transaction.¹⁵² Yahoo's stockholders retained shares in a new company called Altaba, which then

¹⁴⁶ See Kim & Min, *supra* note 120, at 17.

¹⁴⁷ See Brett Wells, *Reform of Section 355*, 68 AM. U. L. Rev. 447, 491-93 (2018).

¹⁴⁸ See Prop. Treas. Reg. § 1.355-9, *supra* note 44.

¹⁴⁹ *Id.* See also Laurence M. Bambino et al., *Treasury and IRS Issue New Spin-Off Proposed Treasury Regulation on Device and Active Trade or Business Requirements*, SHERMAN & STERLING LLP (July 15, 2016), <https://www.shearman.com/media/files/newsinsights/publications/2016/07/treasury-and-irs-issue-new-spinoff-proposed-treasury-regulations-on-device-and-active-trade-or-business-requirements-tax-071516.pdf> [<https://perma.cc/J2Z2-9S9E>].

¹⁵⁰ See Rev. Rul. 73-44, 1973-1 C.B. 182. See also Wells, *supra* note 147, at 491-93.

¹⁵¹ See Prop. Treas. Reg. § 1.355-9, *supra* note 44.

¹⁵² See Vinu Goel, *Verizon Completes \$4.48 Billion Purchase of Yahoo, Ending an Era*, N.Y. TIMES (June 13, 2017), <https://www.nytimes.com/2017/06/13/technology/yahoo-verizon-marissa-mayer.html/> [<https://perma.cc/GX7Y-PGQB>].

owned a \$52 billion stake in Alibaba and a \$9 billion stake in Yahoo Japan.¹⁵³ In 2021, private equity firm Apollo Global Management bought Verizon’s media business consisting of Yahoo and AOL in a deal worth \$5 billion.¹⁵⁴ Apollo has expressed that it hopes to capture value by increasing focus on the individual media brands that have been “lost inside a large corporate empire.”¹⁵⁵

Proposed regulations offer only non-binding guidance to taxpayers. The I.R.S. never finalized the 2016 Proposed Regulations that dissuaded Yahoo from pursuing a spin-off or reverse spin-off. Thus, they expired in 2019, three years after their issuance. Does this mean that a conglomerate wishing to pursue a strategy like Liberty’s spin-off of TripAdvisor or Yahoo’s attempted spin-off of Alibaba could succeed today? Possibly, but probably not. Although the 2016 Proposed Regulations have expired, the I.R.S. has reiterated in various revenue procedures over the decades—and as recently as 2021—its stance that the active trade or business should represent at least 5% of the total assets of the distributing corporation and the distributed corporation to satisfy section 355.¹⁵⁶ Where so much is at stake and the risks of failure are so great, conglomerates should ensure that they fulfill the requirements under section 355, and it would be wise to follow the I.R.S.’s guidance, even if it has expired. Many areas of tax law—like the taxation of certain financial instruments—lack any binding precedent. In such cases, practitioners must rely on whatever guidance is available. Therefore, practitioners should do their best to follow the I.R.S.’s guidance related to spin-offs—even when such guidance has expired or is technically nonbinding.

CONCLUSION

Scholars and investors view deconglomeration as value-enhancing and beneficial to the real economy. Fortunately for conglomerates, U.S. tax law does not make tax-free spin-offs impossible. Although the spin-off rules are complex, burdensome, and byzantine, conglomerates in particular have ample resources to hire skilled teams of tax lawyers and accountants with extensive experience in navigating the spin-off rules to avoid the harsh consequences of failing to qualify under section 355. Expert tax and accounting advice can all but ensure tax-free treatment provided that each of the statutory and common law requirements for tax-free spin-offs is satisfied and as long as the transaction does not overtly violate less authoritative guidance that appears in proposed—albeit expired—regulations and revenue procedures. Tax law practitioners sometimes even refer to the spin-off rules as “taxpayer-friendly” because corporations are usually able to satisfy the requirements and take advantage of tax-free treatment under section 355.¹⁵⁷ One

¹⁵³ *See id.*

¹⁵⁴ *See* Edmund Lee & Lauren Hirsch, *Yahoo and AOL, Early Internet Pioneers, Are Sold to Private Equity Firm*, N.Y. TIMES (May 3, 2021), <https://www.nytimes.com/2021/05/03/business/verizon-aol-yahoo-sale.html> [https://perma.cc/H2LC-DYQU].

¹⁵⁵ *See id.*

¹⁵⁶ *See, e.g.*, Rev. Proc. 2021-3, 2021-1 I.R.B. 140.

¹⁵⁷ *See* Dantzer Jr., *supra* note 90.

important exception is the gain recognition requirement for U.S. conglomerates wishing to spin off a foreign business with appreciated assets. Thus, the cross-border spin-off rules do in fact inhibit deconglomeration efforts by U.S. multinationals.

The failure of Yahoo's spin-off constitutes an extremely rare, high-profile example of a conglomerate failing in its efforts to achieve a tax-free spin-off. Rather than allowing Yahoo to pursue the spin-off and then later challenging the transaction and assessing a \$16 billion deficiency, the I.R.S. sent Yahoo and its tax counsel clear signals that the plan seemed abusive and that the transaction likely would not qualify for tax-free treatment if Yahoo executed either the spin-off or reverse spin-off. Such warnings persuaded Yahoo to reevaluate its plan and to pursue alternative, less tax-favorable strategies. Here, instead of acting like a hostile adversary looking to seize on billions in potentially unpaid taxes, the I.R.S. comported itself more like a business-friendly partner or consultant that guided Yahoo to pursue an approved deconglomeration strategy that would avoid devastatingly draconian results.

If a spin-off transaction does not qualify for tax-free treatment, conglomerates can seek to break themselves into smaller business units using other routes: taxable stock sales, taxable asset sales, exchanges, closures, bankruptcies, or restructurings.¹⁵⁸ But such alternatives are never as beneficial as a spin-off because they all give rise to immediate corporate-level tax liability, whereas section 355 provides the unparalleled gift of no imposition of tax at the entity level. As a flurry of conglomerates including GE, Johnson & Johnson, Merck, and Toshiba either contemplate or begin downsizing,¹⁵⁹ tax-free spin-offs remain a critical tool for conglomerates—a vital tax-planning strategy that enables deconglomeration and thus benefits conglomerates, their shareholders, and the overall economy.

¹⁵⁸ See Michael Mankins et al., *How the Best Divest*, HARV. BUS. REV. (Oct. 2008), <https://hbr.org/2008/10/how-the-best-divest/> [<https://perma.cc/N8L2-H3ZZ>].

¹⁵⁹ See Kevin Dowd, *Death to Conglomerates: GE, J&J And Toshiba All Reveal Plans To Break Themselves Up*, FORBES (Nov. 14, 2021), <https://www.forbes.com/sites/kevindowd/2021/11/14/death-to-conglomerates-ge-jj-and-toshiba-all-reveal-plans-to-break-themselves-up/?sh=6c677a584d70/> [<https://perma.cc/2LRQ-SDAP>].