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U.S. Securities Law and Federal Income Tax Considerations in Spin-Offs by Non-U.S. Companies

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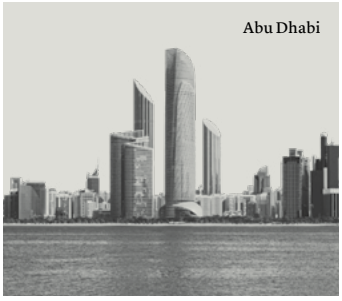

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Spin-offs have grown in popularity again in recent years as a means of creating and maximizing shareholder value, accelerating growth, and increasing management focus on a specific line of business. Recent years have witnessed completed or announced spin-offs in various sectors spanning healthcare, media, real estate, technology, energy, and even professional services. According to Refinitiv data, 145 spin-offs were announced in each of 2021 and 2022, the highest since 2015, with the majority of spin-offs in the past decade being announced by companies in the technology, industrials, financial and materials sectors.

Executing spin-off transactions can be very complex from an operational as well as legal perspective. Careful advance planning is therefore essential for the successful and timely execution of a spin-off. This article explores selected U.S. securities law and federal income tax considerations that should be considered early in the process by non-U.S. companies to ensure that the spin-off is completed as efficiently and seamlessly as possible.

A. Initial planning for a spin-off

The structure of the spin-off transaction, the lead time to the completion of the spin-off, and the associated costs and potential liabilities may be impacted by several initial considerations, including in respect of whether the spin-off must be registered under the U.S. Securities Act of 1933, as amended (the "**Securities Act**"), and the determination of the "foreign private issuer" or "domestic" status of the entity to be spun-off ("**SpinCo**"). Those considerations are discussed in the following sections.

I. The registration requirements under the Securities Act

Section 5 of the Securities Act requires the registration of any offer or sale of securities in the United States unless an exemption from registration is available. This overarching requirement is applicable, in principle, in the context of spin-offs if any SpinCo shares are distributed in the United States, even if both the parent company (the "**Parent**") and SpinCo are non-U.S. companies, and even if the Parent is not listed in the United States and no listing of SpinCo shares is sought in the United States.

In Staff Legal Bulletin No. 4 ("**SLB 4**") issued by the Division of Corporation Finance of the U.S. Securities and Exchange Commission (the "**SEC**") in 1997, the Staff set out five conditions, which, if satisfied, would allow the Parent to avoid Securities Act registration of the distribution of SpinCo shares to the Parent shareholders.[1] While SLB 4 applies on its face to the spin-off of "a subsidiary," the Staff has not objected to the application of SLB 4 to spin-offs taking the form of "indirect demergers" (*i.e.,* SpinCo is an orphan subsidiary that acquires the spun-off business from the Parent in exchange for the issuance of shares to Parent shareholders) when such structure is driven by tax reasons, which may be the case in certain jurisdictions, such as the United Kingdom, in some circumstances.[2]

The conditions set out in SLB 4 in order for a spin-off transaction to not require registration under the Securities Act are as follows:

1. ***No payment of consideration by the Parent shareholders for SpinCo shares.***

   Payment of consideration by the Parent shareholders for SpinCo shares means that the spin-off constitutes a "sale" of securities under the Securities Act, and therefore registration would be required, unless an exemption from registration is available.

2. ***Pro rata distribution of SpinCo shares to Parent shareholders***

   The distribution of SpinCo shares in the spin-off will be *pro rata* if the Parent shareholders have the same proportionate interest in the Parent and SpinCo both before and after the spin-off. A distribution may not be *pro rata* if, for example, the Parent has a

[1] The Staff noted in SLB 4 that it would no longer respond to requests for its views on the issues addressed in the bulletin, other than in relation to novel or unusual issues in a proposed spin-off. SLB 4 also references two specific instances, discussed below, when the Staff would entertain requests for its views.

In addition to the issues presented in this article, SLB 4 covers a number of other securities law issues that may need to be considered depending on the fact pattern of the transaction. For example, there could be additional considerations where the spin-off involves a shareholder vote on a plan or an agreement for the transfer of assets from the Parent to SpinCo.

[2] *See e.g., Hillsdown Holdings plc* (avail. Sept. 29, 1998). The no-action letters that reflected that position are specific to the facts covered in the relevant requests and may not be relied upon by other parties (though market participants often study these letters closely to see whether their circumstances closely match those under which the staff has previously taken a no-action position, and may decide they do not believe it is necessary to seek no-action relief in a similar situation). The need to seek the Staff's view on similar questions may depend on a variety of considerations, including how factually close the prior letters were to the situation being considered. It would be prudent, if it is considered necessary to seek to obtain a no-action letter in a particular situation, to budget one to two months or more, depending upon the complexity or novelty of the issues involved, to obtain the required letter.

dual-class voting structure, but the shares of SpinCo are distributed equally to the Parent shareholders, regardless of the difference in voting power of their shares, such that the collective voting power of the holders of each class of shares increases or decreases as a result of the distribution.[3]

On the other hand, the *pro rata* requirement would not be breached solely because SpinCo is not a wholly-owned subsidiary of the Parent, or because the Parent retained an interest in SpinCo after the distribution. In these cases, the distribution could still be *pro rata* provided that the number of SpinCo shares that each shareholder of the Parent receives will be equal to the distribution ratio multiplied by the number of Parent shares held by such shareholder.[4]

3. *Adequate Information Provided to Parent Shareholders*

SLB 4 requires the Parent to provide certain information to the Parent shareholders and to the trading markets to avoid the requirement to register the spin-off under the Securities Act. The extent of the information that the Parent needs to provide depends on whether each of the Parent and SpinCo is an ongoing reporting company under the Securities Exchange Act of 1934, as amended (the "**Exchange Act**"), both before and after the spin-off transaction.

If both the Parent and SpinCo are Exchange Act reporting companies, the requirement to provide adequate information will be limited to transaction-specific information in relation to the distribution ratio, treatment of fractional shares, and tax consequences. SpinCo will be considered a "reporting subsidiary" for the purpose of the adequate information requirement if it has been reporting for at least 90 days prior to the spin-off and is current in its Exchange Act reporting. The relaxation of the adequate information requirement in this case is based on the premise that sufficient disclosure around the business of SpinCo is available to the public given its reporting status (which would be the case if, for example, SpinCo is listed on a U.S. securities exchange, with the spin-off being intended to distribute the remaining interest held by the Parent, or if SpinCo has issued SEC-registered debt securities prior to the spin-off).

If the Parent is an Exchange Act reporting company but SpinCo is not, the Parent must provide to its shareholders an information statement that substantially complies with the requirements of Regulation 14A or Regulation 14C under the Exchange Act describing the spin-off and SpinCo. Such compliance broadly requires a description and rationale of the spin-off and certain disclosure in relation to both the Parent and SpinCo, including business description, risk factors, financial information, and a management discussion and analysis of financial performance. The information statement disclosure does not need to be contained in a standalone document and may be satisfied by the incorporation of information by reference from the Parent's Exchange Act reports.

If the Parent is a non-reporting company, the information statement must, in addition to the information requirements noted above, include the transfer limitations applicable to the spun-off shares that are designed to ensure that no public market develops in SpinCo's shares before its registration under the Exchange Act.[5] The Staff indicated in SLB 4 that they would continue to respond to no-action requests for spin-offs by non-reporting Parents.

SLB 4 generally requires that SpinCo register its shares under the Exchange Act. If, in the case of

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[3] *See Hyster-Yale Materials Handling, Inc* (avail. July 25, 2012) (SEC comment letter in respect of Registration Statement on Form S-1). Other scenarios that could raise issues under the *pro rata* requirement involve those where there will be an IPO or concurrent capital raise by SpinCo in connection with the spin-off.

[4] *See Care Capital Properties, Inc.*, response letter (avail. June 8, 2015).

[5] *Axion Inc.* (avail. Sept. 17, 1996). The transfer limitations requirement will be relevant in the less common cases where SpinCo's shares will not be listed on any securities exchange in connection with the spin-off.

a non-U.S. Parent and SpinCo, SpinCo shares are not intended to be registered under the Exchange Act (*e.g.,* in reliance on the exemption from the registration requirements under Rule 12g3-2(b) under the Exchange Act[6]), the determination as to whether the Parent has provided adequate information to its shareholders in relation to the spin-off will depend on the facts and circumstances. The Staff indicated in SLB 4 that they will continue to consider requests for no-action positions from non-U.S. companies that do not intend to register the spun-off shares under the Exchange Act.[7]

4. Valid Business Purpose for the Spin-off

One of the criteria of SLB 4 is that the spin-off must have a valid business purpose. A valid business purpose for the spin-off could include, for example, allowing the management of each business to focus solely on that business or enhancing access to financing by allowing the financial community to focus separately on each business. On the other hand, a spin-off is not viewed as having a valid business purpose if, for example, it is intended to create a market in SpinCo shares without providing adequate information to the Parent shareholders or to the trading markets. A *bona fide* spin-off will most likely satisfy this requirement.

5. Holding period for restricted securities

If SpinCo shares are "restricted securities" within the meaning of Rule 144 under the Securities Act (*e.g.,* if the Parent has acquired SpinCo's shares from SpinCo or an affiliate of SpinCo in a transaction or chain of transactions not involving any public offering), the Parent must hold the shares for at least two years prior to the spin-off.[8] If SpinCo's shares are restricted securities that have not been held for two years prior to the spin-off, SLB 4 will not be available for the spin-off. The two-year holding period requirement does not apply where the Parent formed SpinCo, rather than acquiring the business from a third party.

II. Advantages of structuring a spin-off in compliance with SLB 4

While a spin-off transaction can be completed pursuant to a Securities Act registration if it does not meet the requirements of SLB 4, structuring the spin-off transaction to meet the requirements of SLB 4 may be more advantageous to both the Parent and SpinCo compared to a spin-off registered under the Securities Act for several reasons, including the following[9]:

1. Securities Act registration fees would not apply to a spin-off structured under SLB 4. An Exchange Act registration on Form 10, for a domestic issuer, or Form 20-F, for a foreign private issuer, does not require payment of registration fees. For a spin-off

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[6] Rule 12g3-2(b) under the Exchange Act provides an exemption from registration to foreign private issuers that do not have listed or publicly offered securities in the United States, maintain a listing of their shares on a non-U.S. exchange, and publish on their website, in English, the information that they make public in their home country.

[7] While the Staff indicated its willingness to consider requests for no-action relief in these situations, the Parent and counsel may take the view that seeking a no-action relief is unnecessary where there is confidence that the fact pattern under consideration is consistent with similar transactions in the past where relief was sought and obtained or where it was not felt necessary to seek the Staff's views. The Staff has in the past verbally expressed its view that it is unlikely to have a concern about the structure where the level of U.S. shareholding or trading of the company being spun-off is below 30%.

[8] The two-year holding period requirement included in SLB 4 was presumably intended to match the length of the holding period requirement of Rule 144 under the Securities Act when SLB 4 was issued. The holding period requirement has since been reduced in Rule 144 under the Securities to one year in respect of non-reporting companies and six months in respect of reporting companies. While the Staff has not, to our knowledge, expressed a view as to whether the holding period for SLB 4 purposes should be reduced accordingly, we believe it would be appropriate to apply the same holding period under SLB 4 as is currently required under Rule 144 under the Securities Act.

[9] If SpinCo's shares are to be registered under either the Securities Act or the Exchange Act, consideration needs to be given to the need to have its financial statements audited in accordance with the auditing standards of the Public Company Accounting Oversight Board (PCAOB). In addition to considering generally these auditing requirements, it should be confirmed at an early stage of the process that the auditors meet the PCAOB independence requirements and the independence requirements set out under Rule 2-01 of Regulation S-X.

registered under the Securities Act, the registration fees are required to be calculated, in accordance with Rule 457(f) under the Securities Act, by reference to the market value of SpinCo shares or, if there is no market for such shares, by reference to the book value of the assets of SpinCo.[10] The registration fees could therefore be significant depending on the market value of SpinCo's shares or the book value of its assets. For example, if the market value of SpinCo shares is $10 billion, the registration fees, based on the current rate applicable through September 2023, would be $1,102,000.

2. A spin-off registered under the Securities Act would be subject to a stricter disclosure liability framework.[11] In particular, Section 11 of the Securities Act, which creates potential liabilities in relation to the disclosure in the registration statement for the registrant (in respect of which the liability is strict), its directors and officers who are required to sign the registration statement and its independent accountants, applies to a Securities Act-registered spin-off but not to a spin-off that is registered only under the Exchange Act. If the spin-off is registered under the Exchange Act, the registrant will be subject to potential liabilities under Rule 10b-5 under the Exchange Act and certain other provisions of the Exchange Act.[12] Rule 10b-5 provides a cause of action for the SEC or private investors against the registrant and/or the directors and officers for written or oral material misstatements or omissions, such as in documents filed with the SEC, including the registration statement filed on Form 10, for domestic SpinCos, or Form 20-F, for SpinCos that qualify as foreign private issuers. Unlike Section 11, which provides for strict liability for the registrant, a cause of action under Rule 10b-5 requires proof of scienter, which is generally considered to include intentional deception or the making of a false representation with knowledge of its falsity or with reckless disregard of whether it is true or false.

3. If the spin-off does not comply with SLB 4 and is therefore considered an offer of securities that requires registration under the Securities Act, communications around the offer will be subject to restrictions to avoid "gun jumping" or violations of the publicity restrictions. On the other hand, if the spin-off complies with SLB 4, the distribution of the spun-off shares to the Parent shareholders will not constitute an "offer" for U.S. securities law purposes and therefore will not be subject to similar restrictions around publicity.

4. In addition, where a spin-off is structured in accordance with SLB 4 and SpinCo registers its shares under the Exchange Act, SpinCo will be subject to the Sarbanes-Oxley Act of 2002 (the "**Sarbanes-Oxley Act**") only when the registration statement on Form 10 or Form 20-F has become effective. Conversely, if SpinCo registers its shares under the Securities Act on Form S-1 or Form F-1, it will be subject to the Sarbanes-Oxley Act when the registration statement is publicly filed, which precedes the effectiveness of the registration statement. A delayed application of the Sarbanes-Oxley Act, which, among other things, prohibits the extension of loans to executives subject to certain exemptions, until the effectiveness of the registration statement may provide SpinCo more time to ensure compliance with the requirements of the Sarbanes-Oxley Act and flexibility if, for example, the plans to complete the spin-off are changed after the public filing of the registration statement and before its effectiveness.

5. If the spin-off is structured in accordance with SLB 4, SpinCo may be able to inherit the accelerated filer

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[10] *See* SEC, Division of Corporation Finance, Compliance and Disclosure Interpretations, Securities Act Sections, Question 240.03 (Jan. 26, 2009).

[11] Even unregistered spin-offs will, however, involve exposure to liability under U.S. securities laws and regulations where U.S. shareholders are participating or where U.S. jurisdictional means are otherwise being used in connection with a spin-off, such as in relation to any information documents being distributed to shareholders or the market in relation to the spin-off. A key potential source of U.S. liability in connection with all transactions will be Rule 10b-5 under the Exchange Act, discussed below.

[12] As noted above, Rule 10b-5 also applies to unregistered transactions.

and the "well-known seasoned issuer"[13] status of its Parent, which is not possible if the spin-off does not comply with SLB 4. SLB 4 allows a SpinCo to consider the reporting history of the Parent in terms of its eligibility to use the more abbreviated registration statement on Form S-3 for offerings of securities (and, by analogy in the case of foreign private issuers, Form F-3, where applicable) before a recent SEC registrant would otherwise be eligible to use these forms if (1) the spin-off meets the conditions of SLB 4; (2) the Parent is current in its Exchange Act reporting; and (3) SpinCo has "substantially the same assets, business, and operations as a segment or subsidiary about which the Parent has reported extensive segment data."[14] To meet this last requirement, the segment data reported must include at least: revenues; operating profit or loss; identifiable assets; expenses from depreciation, and amortization; capital expenditures; and any other information required by Statement of Financial Accounting Standards (FAS) No. 131 (*Disclosures about Segments of an Enterprise and Related Information*). Further, the Parent's Exchange Act reports must have discussed the business of SpinCo as a separate segment in the business and financial review sections.

The Staff has also provided guidance allowing a SpinCo to rely, if these conditions are met, on the Parent's pre-spin-off reporting history for purposes of evaluating whether SpinCo is a "well-known seasoned issuer" as defined in Rule 405 under the Securities Act and is eligible to file an automatically effective registration statement on Form S-3ASR or Form F-3ASR for offerings of securities following the spin-off. However, if SpinCo avails itself of that accommodation, it would need to accelerate its compliance with the Sarbanes-Oxley Act requirements to include, in the first annual report it files following the spin-off, a management report on the registrant's internal control over financial reporting and an auditor's attestation report on the registrant's internal control over financial reporting, to the extent its Parent is required to do so, which the registrant would otherwise be exempt from including in its first annual report due to phase-in periods applicable to initial registrants. As such, a SpinCo that meets the requirements to be able to rely on the reporting history of its Parent should consider carefully whether the benefits of availing itself of the accommodation outweigh the burden of accelerated compliance with these provisions of the Sarbanes-Oxley Act.

III. Determining SpinCo's "foreign private issuer" status

If SpinCo is a U.S.-incorporated entity, it will be considered a "domestic issuer", with no need for further analysis of its shareholder base or business, and irrespective of the status of the Parent.

Similarly, if SpinCo is incorporated outside the United States, and no more than 50% of its outstanding voting securities are directly or indirectly held of record by residents of the United States, it will be considered a "foreign private issuer" with no need for further analysis of its business, and irrespective of the status of the Parent. In applying the shareholders test, SpinCo must "look through" the record ownership of brokers, dealers, banks, or other nominees that hold securities for the account of their customers, and determine the residency of those customers. If the Parent is a public company with dispersed shareholding, SpinCo may treat it as one shareholder, with its jurisdiction of incorporation being its residence for the purpose of the shareholder test.[15] As such, if, prior to the spin-off, SpinCo is majority-owned by a non-U.S. Parent with such a dispersed public shareholding, it will be

[13] "Well-known seasoned issuers" or "WKSIs", defined according to certain criteria set out in the rules, are a category of issuers created by the 2005 Securities Offering Reforms and represent the most widely followed issuers with the most significant amount of capital raised and traded in the United States. WKSIs benefit from certain flexibilities in relation to communications and registration, including the use of automatically effective shelf registration statements.

[14] Item 9 to SLB 4.

[15] Sandra Folsom Kinsey, *Foreign Private Issuers*, The Review of Securities & Commodities Regulation, Apr. 25, 2001, 79-88.

considered a foreign private issuer when conducting the spin-off, and hence can register the spin-off on Form F-1 or Form 20-F, as applicable. However, as the foreign private issuer test needs to be run annually, SpinCo may fail the shareholder test following the spin-off if the distribution of its shares to the Parent's shareholder results in more than 50% of its voting securities being directly or indirectly held of record by residents of the United States.

If SpinCo is foreign-incorporated with more than 50% of its voting securities expected to be directly or indirectly held of record by residents of the United States following the spin-off, its status would then hinge on whether the majority of its executive officers or directors are United States citizens or residents, more than 50% of its assets are located in the United States or its business is otherwise administered principally in the United States. If qualifying as a foreign private issuer is a key consideration for a SpinCo with a majority of the voting securities expected to be held by U.S. residents after the spin-off, and assuming no more than 50% of its assets are located in, and its business is not principally administered from, the United States, it would be important to ensure that less than a majority of its executive officers or directors (with the test being run for the executive officers separately from the directors) are citizens or residents of the United States.

While in most cases SpinCo will have the same issuer status as the Parent, SpinCo may have a different status in certain circumstances. For example, if SpinCo is a U.S. subsidiary of a foreign private issuer Parent, it will be a domestic company. Similarly, if SpinCo holds the U.S. assets of a foreign private issuer Parent with global operations, it will likely be considered a domestic company if the majority of its voting securities are held by U.S. shareholders.

If SpinCo fails to satisfy the definition of a foreign private issuer, it will be subject to additional U.S. disclosure and governance rules compared to a foreign private issuer, including a requirement to prepare accounts and quarterly results in accordance with U.S. GAAP (which could be particularly burdensome if SpinCo is also required, by virtue of the non-U.S.-listing of its securities or otherwise, to prepare accounts in accordance with IFRS or another accounting standard), compliance with quarterly Sarbanes-Oxley testing and certification requirements in connection with 10-Q filings, compliance with the U.S. proxy rules in connection with the procedures and required documentation for soliciting shareholder votes, insider reporting and the short-swing profit rules under Section 16 of the Exchange Act, and extensive and individualized disclosure of compensation policies.

IV. Availability of confidential submission policies

Parents contemplating a spin-off may prefer to have their first public filing of the relevant registration statement follow the SEC review process and reflect substantially all SEC comments on the draft document, such as in circumstances where SpinCo will be dual-listed and is simultaneously undergoing other regulatory review processes in relation to the listing documents that will be prepared in connection with the spin-off. To the extent the spin-off is registered under the Securities Act or the Exchange Act, SpinCo may take advantage of the SEC's confidential review process for draft registration statements if it qualifies for such accommodation under the SEC's 2012 policy for non-public submissions from foreign private issuers (the "**FPI Policy**"), pursuant to the accommodation under Section 6(e) of the Securities Act for emerging growth companies, or under the SEC's 2017 policy extending the procedures for submitting draft registration statements to all issuers (the "**2017 Policy**").

Foreign private issuers may prefer to rely on the FPI Policy, which, unlike the 2017 Policy or the accommodation available under Section 6(e) of the Securities Act, does not require the public filing of the registration statement 15 calendar days prior to the requested effective date of the registration statement. However, SpinCos that are foreign private issuers and seek to rely on the FPI Policy must satisfy one of the other conditions stipulated therein, *i.e.,* SpinCo must be concurrently listing its securities on a non-U.S.

securities exchange, be privatized by a foreign government, or can demonstrate that the public filing of an initial registration statement would conflict with the law of an applicable foreign jurisdiction.

The accommodation available to emerging growth companies pursuant to Section 6(e) of the Securities Act would only be applicable if the spin-off is registered under the Securities Act, and not structured pursuant to, and to take advantage of, SLB 4.

The 2017 Policy is broader in scope than the accommodation available to emerging growth companies under Section 6(e) of the Securities Act because it applies to initial Securities Act registration statements as well as the initial registration of securities under Section 12(b) of the Exchange Act. As such, an SLB 4-compliant spin-off may benefit from the 2017 Policy if SpinCo's securities are registered under Section 12(b) of the Exchange Act for listing on a U.S. national securities exchange. It should be noted, however, that voluntary registration under Section 12(g) of the Exchange Act is not covered by the 2017 Policy. As such, if SpinCo registers its shares under Section 12(g) of the Exchange Act to meet the adequate information requirement under SLB 4 without listing its shares on a U.S. national securities exchange, it will not be eligible to submit a draft registration statement for confidential review under the 2017 Policy.

V. Special considerations for ADR issuers

Parents that have their shares listed or traded in the United States in the form of American depositary receipts ("**ADRs**") may prefer to structure the spin-off such that SpinCo establishes its own ADR program to facilitate a comparable form of trading by the recipients of the SpinCo shares. ADRs are trading certificates evidencing the American depositary shares ("**ADSs**") that represent underlying shares of a non-U.S. issuer and facilitate the holding and trading of its shares in the United States. ADSs are typically issued by a financial institution with a U.S. depositary business, which holds the underlying non-U.S. shares directly or through a custodian. Each ADR evidences one or more ADSs, with each ADS representing a number or a fraction of underlying shares.

An ADR facility may be "sponsored" by the issuer (*i.e.,* issued by a depositary pursuant to an agreement with the issuer) or "unsponsored" (*i.e.,* issued by a depositary for outstanding non-U.S. shares deposited by shareholders with the depositary without an agreement with the issuer).

If the Parent maintains a sponsored ADR program, the deposit agreement entered into between the Parent and the depositary will set out the process and requirements for distributing the shares of SpinCo to the holders of the Parent ADRs. While it is technically possible for the depositary of the SpinCo ADR program to be different from the depositary of the Parent ADR program, having the same entity acting as a depositary under both programs can, as a practical matter, facilitate the process of distributing SpinCo's shares to the holders of the Parent ADRs in the form of SpinCo ADRs.

It may also be possible, under certain circumstances, for the depositary of the Parent ADR program that, in its capacity as a legal holder of certain of the Parent shares, will receive its pro rata distribution of SpinCo shares, to set up an unsponsored ADR program for SpinCo instead of SpinCo setting up a sponsored ADR program. In practice, pursuing this structure will require coordination between the Parent and the depositary.

In either the sponsored or unsponsored program scenario, the ADRs themselves will need to be registered with the SEC under the Securities Act on a separate registration statement, Form F-6. It will also be necessary in each case to ensure that the registration requirements of the Securities Act and Exchange Act are satisfied in relation to the underlying shares being spun-off – utilization of ADRs may only be possible where the shares are registered with the SEC, say in connection with a U.S. listing, or where there is no U.S. listing, the transaction is exempt under SLB 4 and SpinCo avails itself going forward of the exemption from ongoing Exchange Act

reporting requirements referenced above under Rule 12g3-2(b) thereunder.[16]

VI. Alternative transaction structures seeking to take advantage of exemptions from the registration requirements

The spin-off structuring scenarios described above – one in which the spin-off satisfies the exemption from the Securities Act registration requirements contained in SLB 4 but SpinCo nevertheless registers its shares under the Exchange Act because it is seeking a U.S. listing, and one in which the spin-off satisfies SLB 4 but then utilizes the exemption from ongoing Exchange Act reporting pursuant to Rule 12g3-2b under the Exchange Act because SpinCo will not be listed in the United States – are the most common but not the only possible structuring scenarios. Other approaches that are sometimes considered to address the registration requirements may include, for example, where commercially practicable and legal under applicable home country law, seeking to exclude U.S. shareholders from the spin-off and otherwise seeking to avoid the use of U.S. jurisdictional means in conjunction with the spin-off to argue that the U.S. requirements simply do not apply to the offshore spin-off. Another structure that is sometimes considered, again subject to commercial and home country law feasibility considerations, is limiting U.S. participants in the spin-off to institutional investors (*e.g.,* "qualified institutional buyers" within the meaning of Rule 144A under the Securities Act) that may enable Parent to satisfy a private placement exemption from the Securities Act registration requirements in relation to the distribution of shares in the United States (noting that privately placed shares would be subject to transfer restrictions). In those and other scenarios, consideration is sometimes given to how shareholders, such as U.S. shareholders, who may not receive shares in the spin-off may instead receive a cash payment in lieu of their share entitlement. Any such cash option would need to be analyzed carefully from the standpoint of its effect on the analysis of the applicable SEC registration requirements. For example, it would probably be acceptable for an ADR depositary that receives SpinCo shares in a spin-off as the beneficial holder of shares underlying ADRs to sell them into the market and remit the cash proceeds from such sales to any Parent shareholders to which it does not feel it can in turn distribute the shares, either because the registration status of the transfer is unclear or where the shareholder fails to satisfy certain contractual or technical requirements (*e.g.,* providing the depositary with appropriate local broker or securities account information). Other scenarios, such as where there is a desire to present Parent shareholders with an option to receive cash in a spin-off in lieu of SpinCo shares, may be harder to structure in a manner compatible with the registration requirements.

In general, any alternative scenarios beyond the primary ones discussed earlier in this paper would need to be analyzed carefully to ensure that they do not run afoul of the applicable registration requirements, and factors such as the level of U.S. shareholding or trading in the relevant securities might affect the Staff's views of the acceptability of any of these structures.

[16] *Supra* n 5.

B. U.S. federal income tax considerations

I. Qualification for tax-free treatment under Sections 355 and 368(a)(1)(D)

From a U.S. federal income tax perspective, the central question in the spin-off context typically is whether the distribution by the Parent to its shareholders of stock in SpinCo (which must be a corporation for U.S. federal income tax purposes) will be tax-free to the shareholders and to the Parent.[17]

The requirements that such a distribution must satisfy in order for the distribution to qualify for tax-free treatment are set forth in Section 368(a)(1)(D) and/or Section 355 of the Internal Revenue Code (the "**Code**")[18] and are expanded on in the Treasury regulations under Section 355 and in decades' worth of caselaw and Internal Revenue Service ("**IRS**") guidance. Unfortunately, these very technical requirements are rife with potential foot-faults and therefore merit close attention throughout the spin-off process. The following discussion is intended only as a high-level summary of these requirements, as a full treatment is outside the scope of this article. There are eight main requirements:

1. **Corporate Business Purpose**. The spin-off must be motivated by a valid *corporate* business purpose (that cannot be a shareholder purpose). If the business purpose for the spin-off can be achieved in a tax-free manner without the spin-off in a way that is neither "impractical nor unduly expensive", then the spin-off does not have an acceptable business purpose. Business purposes often cited as satisfying this requirement include resolving shareholder differences; complying with antitrust, regulatory or other legal decrees; increasing a company's access to credit; allowing management teams to focus on separate businesses; retaining employees; facilitating an acquisition or stock offering; producing significant cost savings; protecting one or more businesses from the risks of another business; and resolving customers' or suppliers' objections to associating with a competing business.

2. **Device**. The transaction cannot be used as a device for the distribution of the Parent's earnings and profits. This is a facts and circumstances analysis. The regulations under Section 355 set forth various factors that support, or militate against, a conclusion that a distribution is such a device.

3. **Control Test**. The Parent must have "control"[19] of SpinCo immediately before the distribution of SpinCo's stock. In addition, the Parent generally must distribute all of the SpinCo stock that it owns, and in all cases must distribute at least an amount of stock constituting "control" of SpinCo. If Parent retains any of its SpinCo stock, Parent generally must dispose of it within a relatively short period of time (generally no

[17] The Inflation Reduction Act of 2022 introduced a 15% minimum tax on the "applicable financial statement income" ("AFSI") of certain large corporations (the corporate alternative minimum tax, or "CAMT"). Pursuant to IRS guidance on which taxpayers may rely until proposed regulations are issued by the U.S. Department of Treasury, any accounting gain or loss resulting from the application of the accounting standards (*e.g.*, GAAP) used to prepare the "applicable financial statement" of a party to a transaction that qualifies for tax-free treatment under Section 368(a)(1)(D) and/or Section 355 will not be taken into account for the purposes of calculating the party's AFSI. Notice 2023-7; 2023-3 IRB 390. The Inflation Reduction Act of 2022 also introduced a 1% excise tax on share repurchases made by certain publicly traded corporations (the "share repurchase tax"). Pursuant to additional IRS guidance on which taxpayers may similarly rely, share repurchases that are part of a spin-off qualifying under Section 355 generally are not subject to the share repurchase tax (although there are some nuances for split-offs). Notice 2023-2; 2023-3 IRB 374.

[18] From a technical perspective, Section 355 applies to spin-offs of existing subsidiaries where the business to be spun off is already contained in a subsidiary of the Parent. Both Section 368(a)(1)(D) and Section 355 apply where the Parent first needs to drop down assets into a new subsidiary in connection with the spin-off. While there are some technical differences between the two categories of spin-offs, they do not affect this high-level summary.

[19] For this purpose, "control" means the ownership of stock possessing (i) at least 80% of the total combined voting power of all classes of stock entitled to vote; and (ii) at least 80% of the total number of shares of all other classes of stock of the corporation.

more than 5 years following the spin-off))[20] and must establish to the IRS's satisfaction that its retention of SpinCo stock was not in pursuance of a plan having as one of its principal purposes the avoidance of U.S. federal income tax. The IRS has recognized certain business purposes that may justify Parent's retention of SpinCo stock, including where the retained SpinCo stock facilitates the appropriate capital structure of Parent (*e.g.,* by deleveraging), where it is used as collateral for financing necessary for Parent's remaining business and where it is subsequently disposed of pursuant to an employee stock plan.

4. **Active Trade or Business**. Immediately after the distribution, the Parent and SpinCo must both be actively conducting a trade or business that has been actively conducted throughout the five-year period preceding the distribution, and that was not acquired directly or indirectly in such period in a "taxable" transaction.

5. **Continuity of Interest**. The Parent's historic shareholders, as a whole, must maintain a continued interest (generally, 50% ownership) in both the Parent and SpinCo.

6. **Continuity of Business Enterprise**. The Parent and SpinCo must continue to operate the businesses post-spin-off.

7. **Permissible Entities**. There are limitations on the ability of certain "investment corporations" and REITs to participate in a spin-off transaction.

8. **Anti-avoidance rules**. The rules contain countermeasures against transactions that the IRS believes constitute disguised sales in substance, and thus do not merit fully tax-free treatment, despite the transactions otherwise satisfying the requirements for tax-free treatment discussed above. If a distribution is subject to one of these disguised sale rules, the Parent will recognize gain on SpinCo stock distributed in the distribution (but the Parent's shareholders continue to be eligible for tax-free treatment with respect to their receipt of shares of SpinCo). The first disguised sale rule applies if, immediately after the distribution, any shareholder holds at least a 50% interest (by vote or value) in the Parent or SpinCo that is attributable to stock that the shareholder purchased during the five-year period preceding the distribution (or, in the case of stock in SpinCo, that the shareholder received in the spin-off in respect of Parent stock). The second disguised sale rule, under the so-called Morris Trust rules, applies if the distribution is part of a plan (or a series of related transactions) pursuant to which one or more shareholders directly or indirectly acquire stock representing at least a 50% interest (by vote or value) in the Parent or SpinCo.

   Additional rules apply to (i) distributions of stock of a SpinCo that has been acquired in the five years preceding the spin-off in a taxable transaction, as well as to (ii) the assumption of the Parent debt by SpinCo (or equivalent transactions).

II. IRS rulings and Section 355

The IRS's stance on the rulings that taxpayers can request in connection with a spin-off has evolved substantially over the years. Currently, taxpayers can request a "transactional" letter ruling that addresses the general U.S. federal income tax consequences of a transaction that is intended to qualify under section 355. The required information, representations and other materials a request for such a letter ruling must contain are set forth in IRS Revenue Procedure 2017-52. However, there are certain aspects of the application of Section 355 that the IRS sees as inherently factual and on which it will not rule on unless, in the taxpayer's particular case, that aspect presents a "significant" legal issue that is not already clearly and adequately addressed by existing law and IRS guidance. These so-called "no rule" aspects are the business purpose requirement, the device prohibition, and the existence

[20] *See* Rev. Proc. 96-30, 1996-1 C.B. 696, Appendix B, Section 1.01.

of a plan under the Morris Trust rules, all discussed in the preceding section. If a part of a transaction falls under a no-rule area, the IRS may still issue a letter ruling on other parts of the transaction.

The IRS is under no obligation to issue a ruling within a set period of time (although a recent pilot program establishes a "fast-track processing" that allows certain spin-offs to qualify for a 12-week processing time)[21] or to rule at all. In addition, the IRS may decline to issue a ruling in the interest of sound tax administration, and ordinarily declines to rule on issues that are under examination or consideration or in litigation.[22]

A Parent that is considering a spin-off should decide whether to seek a ruling or instead to rely on an opinion from its advisor(s) early in the spin-off preparation process. This choice is often made based on the amount of potential tax at stake, the timeline of the transaction and the complexity of the proposed transaction from a tax perspective.

[21] *See generally* Rev. Proc. 2022-10; 2022-10 IRB 10.

[22] *See* Section 6.01, Rev. Proc. 2022-1; 2022-1 IRB 1.

C. Special considerations when the Parent retains an interest in SpinCo

The Parent may decide to retain an interest in SpinCo following the spin-off, for example, for future monetization or as a strategic interest. In most cases, the Parent-retained interest would not exceed 20% of the share capital and voting rights of SpinCo due to the U.S. federal income tax considerations noted above.[23] From a U.S. securities law perspective, retaining an interest in SpinCo by the Parent requires consideration as to the future disposal of that interest by the Parent, as well as beneficial ownership reporting requirements, among other possible considerations.

I. Disposal of the retained interest by the Parent

The complexities associated with post-spin-off sales by the Parent of the retained interest in SpinCo depend on whether the Parent will be considered an "affiliate," within the meaning of Rule 405 under the Securities Act, of SpinCo at the time of such sales. A shareholder of a company holding at least 10% of the outstanding voting securities is generally considered to be an affiliate of such a company, subject to a different conclusion based on an analysis of the factual circumstances. Offers and sales of an issuer's securities by an affiliate of the issuer may not be made in the United States unless: (i) prior to their offer and sale, the securities have been registered with the SEC under the Securities Act or (ii) the affiliate's offers and sales of the securities are made pursuant to an exemption from these registration requirements, such as pursuant to Rule 144 under the Securities Act.[24] The Parent may also be able to conduct the offer and sale of the retained shares in offshore transactions pursuant to Regulation S under the Securities Act. In all cases, the Parent will need to ensure that it does not trade in SpinCo's securities while in possession of material non-public information regarding SpinCo.

As resales made pursuant to Rule 144 under the Securities Act by an "affiliate" Parent include restrictions on the manner and volume of the sales as further illustrated below, and exempt sales in a private placement limit the universe of potential buyers, Parents that may be considered "affiliates" of SpinCo following the spin-off typically enter into registration rights agreements with SpinCo to allow for the registration of resales under the Securities Act of SpinCo's securities retained by the Parent (for example, upon demand by the Parent or by "piggybacking" on registered offerings by SpinCo or other selling shareholders).

To the extent the Parent is not, and was not for a period of at least 90 days immediately before the sale, an affiliate of SpinCo, it can freely sell its shares in the United States, so long as the other conditions of Rule 144 under the Securities Act are satisfied. To the extent the Parent is at the time of the sale, or was at any point during the 90 days immediately before the sale, an affiliate of SpinCo, any of SpinCo's securities held by the Parent will be considered "control securities"[25] for the purpose of Rule 144 under the Securities Act. Resales of control securities need to comply with certain volume restrictions limiting the amount of shares that can be

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[23] In addition, as noted in Section B(I) above, any such retention would also need to be shown not to have as one of its principal purposes the avoidance of U.S. federal income tax.

[24] Rule 144 under the Securities Act allows for public resale of "restricted" and "control" securities subject to certain conditions.

[25] This is separate from the "restricted securities" concept, which refers to securities acquired in a transaction not involving any public offering, and which are subject to transfer restrictions irrespective of whether or not they are held by an affiliate of the issuer.

sold in any three-month period to the greater of (i) 1% of the outstanding securities; and (ii) the average weekly trading volume on a U.S. national securities exchange during the four calendar weeks preceding the filing of a Form 144 notice, and manner restrictions limiting resales to only those made in (1) unsolicited brokers' transactions, (2) transactions directly with a market maker, or (3) riskless principal transactions (*i.e.,* the matching of a buyer and seller, without the intermediary taking a proprietary interest in the securities where the offsetting trades are executed at the same price). Marketed sales of shares of SpinCo in the United States by an affiliate Parent would not be possible without registration.

An affiliate Parent may also offer and sell the shares offshore in reliance on Rule 903 of Regulation S under the Securities Act, although the conditions for such a sale would depend on whether there is a "substantial U.S. market interest" in the shares of SpinCo within the meaning of Regulation S.

II. Reporting of beneficial ownership in SpinCo

If the shares of SpinCo are registered pursuant to Section 12 of the Exchange Act (*i.e.,* whether for listing on a U.S. national securities exchange under Section 12(b) or voluntarily under Section 12(g)), the Parent will be required to report its beneficial ownership in the shares of SpinCo under Schedule 13D or a short-form Schedule 13G, to the extent its beneficial ownership exceeds 5% of the registered class of the shares of SpinCo.

The requirement to report the beneficial ownership pursuant to Schedule 13D or Schedule 13G will depend on the structure of the spin-off, the level of beneficial ownership retained by the Parent, and the Parent's strategic plans in relation to the retained interest.

If the Parent simply retains an interest in SpinCo and distributes the remaining interest to its shareholders without acquiring any shares in SpinCo following the effectiveness of the Exchange Act registration statement, it would be entitled, in reliance on Rule 13d-1(d), to report its beneficial ownership in SpinCo pursuant to Schedule 13G, in lieu of Schedule 13D, within 45 days after the end of the calendar year in which the Exchange Act registration becomes effective.[26] However, if the structure of the spin-off requires the Parent to "acquire" its retained interest in the spun-off business following its transfer to an orphan subsidiary (as would be the case in indirect demergers structured in certain jurisdictions, such as the United Kingdom, for tax efficiency reasons) and the acquisition is made following the effectiveness of the Exchange Act registration statement, Rule 13d-1(d) will not be available to the Parent and it will need to report its beneficial ownership in the shares of SpinCo under Schedule 13D, unless it can avail itself of another exemption under Rule 13d-1 to report the beneficial ownership under Schedule 13G instead (*e.g.,* if the Parent meets the qualified institutional investor exemption under Rule 13d-1(b) or the passive investor exemption under Rule 13d-1(c)).

[26] *See also* SEC, Division of Corporation Finance, Compliance and Disclosure Interpretations, Exchange Act Sections 13(d) and 13(g) and Regulation 13D-G Beneficial Ownership Reporting, Question 103.01 (Sept. 14, 2009).

D. Special listing considerations

Listing the shares of SpinCo on a U.S. national securities exchange would work the same way as in a conventional IPO to the extent that the spin-off is registered under the Securities Act. If the spin-off is registered only under the Exchange Act in reliance on SLB 4, that would result in some different processes in completing the listing compared to a traditional IPO scenario. For example, as SpinCo would register its shares on Form 10 or Form 20-F, it would not need to file a separate Form 8-A to register the shares under the Exchange Act as would be required in a typical IPO. In addition, where the securities exchange normally requires certain confirmations from the financial advisors of the listed company regarding its compliance with the listing requirements (*e.g.,* as to the minimum share price, number of shareholders, and market capitalization), it may require those confirmations from the financial advisors of the Parent in a spin-off context.[27]

In addition, if the Parent's shares are themselves listed on a U.S. national securities exchange and it retains at least a 50% beneficial interest in SpinCo, SpinCo would be, in reliance on Rule 10A-3(c)(2), exempt from the listing standards relating to audit committees included in Rule 10A-3 under the Exchange Act.

[27] *See* NYSE LISTED COMPANY MANUAL § 102.01B.

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