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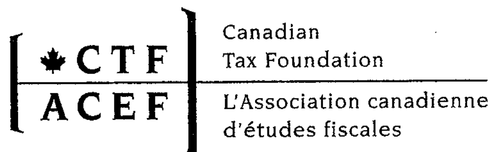

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Public Company Non-Butterfly Spinouts

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Abstract

This paper reviews the various methods by which a public corporation can effect a pro rata distribution of property to its shareholders, other than on a divisive reorganization known as a "butterfly." The reasons why a butterfly transaction might not be possible or appropriate are discussed. The alternative forms of spinout transaction are then reviewed in detail, and various related issues that may arise on the spinout (for example, treatment of employee stock options) are discussed. The advantages and disadvantages of the different alternatives (including butterfly transactions) are reviewed.

Keywords Dividends; public companies; spinoffs; butterfly transactions; paid up capital; share exchanges.

Introduction

For any number of reasons, a corporation may decide that some of its assets should be distributed to its shareholders in one form or another. Different segments of its business may become incompatible with the corporation's core business activities, occupying too much management attention or having different financing needs. Separating such business segments allows management to focus on its core operations. In addition, such separation of assets may enhance the ability of the various business segments to obtain financing. Capital markets may not fully value all of the corporation's business activities, putting a premium on "pure plays" that can be valued (using earnings multiples or other

criteria relevant to the particular business) in a simple way that is easily comparable with others in that industry. If the valuation that the market puts on the existing entity with the combined businesses is less than the total of its businesses valued separately, putting different businesses into separate entities can "unlock" value for shareholders. Where different businesses attract different kinds of investors (for example, growth versus yield), separating the businesses into distinct entities can also maximize shareholder value. Moreover, there may be business opportunities open to an entity competing in only one industry that would not be available to a conglomerate with a greater number of competitors, customers, and suppliers to consider. For all these reasons, the sum of the parts is sometimes greater than the whole.

A public corporation wishing to distribute some of its assets pro rata to its shareholders (herein, "a spinout") has a variety of options to choose from, each with different consequences under the Income Tax Act.[1] While transactions utilizing the paragraph 88(1)(d) bump to effect a general distribution of property to shareholders of the distributing corporation are effectively precluded by the rules in subparagraph 88(1)(c)(vi),[2] often a traditional "butterfly" divisive reorganization will be possible. However, in many cases, a butterfly transaction may not be possible or may be suboptimal compared to other possible transactions. This paper discusses

- some of the reasons why a butterfly transaction may not always be the most suitable alternative for effecting a spinout;
- the tax issues arising from a spinout effected as a dividend in kind;
- the tax issues arising from a spinout based on utilizing the paid-up capital of the distributing corporation, including the various forms such a transaction might take and the differences between them; and
- certain related tax issues that arise in the course of effecting any spinout.