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Client Alert

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Threading the Needle in “Tax-Free” Spinoffs

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With the rise in inflation and downturn in economies, spin-offs have become an increasingly popular method of unlocking shareholder value in a down market. Often, the ability to obtain tax-free treatment in the U.S. for the company and its shareholders increases the attractiveness of the spinoff. But the transaction is not always tax-free, at least not for those located outside the U.S.

The tax treatment for shareholders outside the U.S. can be vastly different than the tax-free treatment under U.S. rules. Countries have varying requirements to obtain tax-free treatment, which may directly conflict with U.S. requirements and often makes tax-free treatment unlikely. When local criteria are not met, the distribution of spin-co shares is taxable for shareholders. In other instances, the company can “thread the needle” to meet the requirements in multiple countries. Obtaining tax-free treatment in all shareholder locations is extremely unlikely given the differing requirements.

With this variance across jurisdictions, non-U.S. employees holding equity awards or otherwise holding shares under the employer’s equity programs can be significantly affected by the tax consequences of a spin-off.

IMPLICATIONS BY AWARD TYPE

The first aspect that must be carefully considered applies to outstanding equity awards. This generally includes stock options, restricted stock units (RSUs) or a mix of such awards. These equity awards will be adjusted to reflect the value of the company post-spin. Companies generally take one of two approaches to adjusting equity awards – either: (a) a basket approach, where employees hold equity awards from both companies post-spin; or (b) a concentration approach, where employees only retain equity awards from their post-spin employer. Under both approaches, the tax treatment of the adjusted awards needs to be analyzed to determine how employees will be impacted.

The second aspect that must be analyzed relates to “long” shares held by employees in an employer’s plan. This review is similar to the general shareholder analysis and the taxability of the shares held by shareholders, which may or may not be taxable upon distribution. However, the tax result may differ when the shares are held in a trust or in another manner where the employee does not yet have full ownership of the shares. In some countries, where the share distribution is tax free to shareholders, the share distribution may be treated as a taxable distribution when the shares are still held by the employer plan.

Tax-qualified equity awards also require analysis. In many countries, the tax-advantaged treatment may be lost. For example, in the UK, Share Incentive Plans (SIPs) and Company Share Option Plans (CSOPs) (which are fairly similar to U.S. incentive stock options (ISOs)) are common equity awards. However, the impact of a spin-off on the two awards differs. When an employee holds shares in a SIP for five years, the employee may sell the shares without paying income tax or national insurance contributions. However, when a spin-off transaction does not meet the UK “demerger’” rules for a tax-free spin-off, the SIP participants will be subject to taxation on the value of the distributed spin-co shares. Had the five-year requirement been met prior to spin-off, the employee could have sold the shares tax-free. Post spin-off, a portion of the employee’s shareholding becomes a taxable distribution, meaning that in many cases, it may be advantageous for the employee to sell these shares prior to the spin-off to avoid adverse tax treatment.

For CSOP options, the implication is slightly different. If the employee exercises CSOP options three or more years after grant, the employee doesn’t pay any income tax at exercise for the difference between the exercise price and the current fair market value of the shares. Any adjustment of the CSOP awards results in the loss of tax-qualified treatment. When awards and exercise prices are adjusted to reflect the value of spin-co leaving the company, CSOP awards are converted into non-qualified stock options. This subjects the employee to income taxation when the options are exercised. In these cases, employees who have already met the three-year requirement may prefer to exercise the awards prior to the spin-off.

MITIGATING IMPACTS FOR EMPLOYEES

Employees do not generally understand the ramifications of the spin-off until it is too late to take any action to mitigate the tax impact, which can bear negatively on employee morale. For U.S. multinationals, the U.S. Securities Exchange Commission (SEC) disclosure related to the spin-off is necessarily U.S. centric. While tax treatment applicable to the distribution must be included in this disclosure, in most cases, this discussion is limited to U.S. taxpayers. Treatment outside the U.S. is usually contained in a single sentence disclaiming the applicability of the U.S. analysis to anyone subject to tax outside the U.S., alongside a statement indicating the employee should consult a personal tax advisor for additional details.

In most cases, particularly if the communication occurs immediately prior to the spin-off, there is insufficient time or information for employees to understand that the spin-off may negatively affect them.

More notably, the magnitude of the tax bill surprises many employees. For example, consider a spinoff where one share is distributed for every two shares held, the pre-spin value of the company share is $50, and the employee’s shareholding is worth $100. Immediately after the spin-off, the employee will hold two company shares worth a total of $70 and a spin-co share worth $30. While the total value of the company and spin-co shares remains at $100, this does not consider the tax implications. If the $30 spin-co share is taxable at a 40% tax rate, this results in a $12 tax bill for the employee. An employee who held shares with a value of $100 before the spin-off, now has a net value of $88 -- a loss of 12%. The greater the value of spin-co relative to that of the company, the greater the amount the employee will lose due to applicable taxes.

In most cases, the tax basis in the shares will increase for the value of the spin-co shares subject to tax at distribution. When the shares are ultimately sold, the result is a lower taxable gain for the employee. However, this future "benefit" is often a small consolation to an employee, especially when they had no intention of selling the shares.

Compounding this issue is that employees usually have limited information about the tax consequences. Employees have repeatedly seen the message that the transaction is tax-free to the Company and its shareholders with little information to the contrary. While it's unrealistic to think that these messages will caveat tax treatment outside the U.S., the frequent "tax-free to the company and its shareholders" messages confuse and potentially mislead employees outside the U.S. into believing they will not be taxed on the spin-off.

Spin-offs can be extremely beneficial to companies and shareholders in a downturn market. Companies should carefully analyze the tax treatment to employees and their equity awards as early as possible in the planning process. With some flexibility in structuring the equity award adjustments, many of the adverse tax results can be avoided. Where adverse taxation cannot be avoided, early communication—specifically to those outside the U.S.—can provide employees with valuable information that will assist them in taking action to avoid unwanted tax results. In most cases, the earlier the planning and communication takes place, the better.

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