CORPORATE SPLIT-OFF
Comparison of the U.S. and German models

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Abstract

In this paper I will show that not only marriages but also divorces do make sense in the corporate level, and that the form the divorce is carried out might strongly affect the outcome. Hence, I will clarify the meaning, mechanics, practical use, legal implications and effects of the split-off to give a complex picture of the transaction. I will base my research on the US jurisdiction, given that there the divestiture can be examined in its most sophisticated way and highest variety. Then I will provide for the recent developments in EC law illustrating them with one particular jurisdiction of the region, namely the German one, since there divestitures already became a popular way of restructuring.

1 P. L. Zweig: Why divorce is paying off on the street, Business Week, December 5, 1994
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**Introduction**

In the last decade the press has been often reporting of breaking up, selling units, spinning-off, or splitting of companies. All these referred to divestitures which are in basic terms the opposite of Mergers and Acquisitions. However, while Mergers and Acquisitions got an immense attention from the legal research community, divestitures and in particular their different types have been scarcely analyzed by legal specialists, despite the fact that they became common phenomena lately. That is exactly what motivated me to do a research on this topic.

Divestitures and their different types in their sophisticated forms originate in the United States. There they can be examined in their most developed form and highest variety. From there they were imported and implemented in the European and other jurisdictions though many times with significant differences.

Though divestitures have become widely applied and thus often mentioned in the press, its related terminology is often confused and not employed in the proper way. While writing this paper I often encountered difficulties to decide the mode the divestiture is executed after reading several articles of prominent business or law journals. At the first chapter of this paper I will clarify the terminology.
Divestiture is a way of corporate restructuring whereby a company sells, exchanges or otherwise disposes of a business unit, division, product line or subsidiary. The divestiture may be executed in several ways.

For the purposes of this paper I have chosen the divestiture by means of split-off, whereby the company distributes shares of a newly formed or existing subsidiary to one or more shareholders of the distributing company in exchange of the redemption of their shares in the distributing company. I opted for this type of transaction mainly because, though it was not frequently used in the past as opposed to other ways of divestiture, lately more and more split-off announcements has appeared in the business news without being significantly commented by legal researchers. I found several working papers, books and articles on corporate spin-offs (a widely used alternative to split-off) but hardly any that would have dealt primarily with split-offs and even these were dealing only with some narrow aspects of the transaction. Thus the main sources of my work are the related laws and their commentaries, working papers on the closely related spin-off, that often raise some issues on the split-off as well, articles of business journals mainly reporting the fact and reasons of a split-off announcement, and the SEC database that contains all the relevant material a company is obliged to prepare in relation to the transaction, including the split-off agreements, reports, information statements etc. that helped me to understand the process in a practical way. I will use these sources to understand and subtract the different elements and aspects of the transaction, while my aim will be to present the operation in its complexity.

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3 Fletcher Cyclopedia of the Law of Corporations FLETCHER-CYC § 6970.125 available at Westlaw
5 American Jurisprudence, Second Edition Database updated February available at Westlaw
6 Corporate Counsel's Guide to Spin-Offs; CCGSPIN § 1:10 available at WestLaw
7 The New York Times, Business Week
8 www.sec.org
From the recent events I find worth mentioning that Procter & Gamble announced to divest its coffee business most likely by means of split-off\(^9\), while AOL plans to split-off its web access unit from the web site and internet advertising business\(^{10}\) and Motorola’s Board of Directors has just accepted the plan of splitting-off the wireless handset division\(^{11}\).

Thus, in this paper I will show that not only marriages but also divorces do make sense in the corporate level\(^{12}\), and that the form the divorce is carried out might strongly affect the outcome. Hence, I will clarify the meaning, mechanics, practical use, legal implications and effects of the split-off to give a complex picture of the transaction. I will base my research on the US jurisdiction, given that there the divestiture can be examined in its most sophisticated way and highest variety. Then I will provide for the recent developments of EC law illustrating them with one particular jurisdiction of the region, namely the German one, since there divestitures already became a popular way of restructuring\(^{13}\).

\(^{9}\) Dan Sewel: “P&G has strong quarter, lifts outlook, will split off Folgers” available at http://www.usatoday.com/money/companies/earnings/2008-01-31-pg_N.htm


\(^{11}\) Sinead Carew: Motorola shares up as it mulls phone unit split-off, Reuters, February 1, 2008. available at: http://www.reuters.com/article/hotStocksNews/idUSN0154867320080201

\(^{12}\) P. L. Zweig: Why divorce is paying off on the street, Business Week, December 5, 1994

\(^{13}\) Dr. Tobias H. Eckerle (et al): Investment in Germany 2006 (report material prepared by KPMG), July 2006 available at: www.kpmg.de
1ST CHAPTER: DEFINING SPLIT-OFF AND ITS ALTERNATIVES

1.1. Incentives for divestitures

The exact reason of a divestiture is often unique and arises from the particular set of circumstances. Though we can state that in the vast majority of the cases the general aim of the unbundling, as of many other transactions, equals to the ultimate corporate goal, that is, to create shareholder value\textsuperscript{14}.

While this general objective is common to nearly all the transactions, the specific motives may differ a lot, though many times they are also correlated. Below I will present some of the frequent ones:

**Focusing on best competences:** It often occurs that a company being successful in one specific sector extends its business to other fields as well, however it turns out that because of the capital structure, approach, the composition of employees and other professionals, lack of knowledge or other circumstances the company is not able to pursue that activities with the same success as its core business. Thus it rather decides to focus on the main activity and divest the non core sectors. The following reason is strongly related to the present one.

**Correct negative synergies**\textsuperscript{15}: Several examples from the current business world shows that mergers many times do not generate the expected success or even result in failure. Thus often the company decides to separate again to correct the wrongful choice. The transaction is thus of remedial rather then proactive nature. This is what caused for example the restructuring of Mattel. In 1999 Mattel acquired Learning Co. a firm developing education software. In a few

\textsuperscript{14} Andreas Kemper, Florian Khuen: Corporate Restructuring Dynamics: A Case Study Analysis posted and available at http://www.systemdynamics.org/conferences/2004/SDS_2004/PAPERS/305KEMPE.pdf
months Mattel had to sell the acquired firm because the merger was a complete failure, mainly because Mattel, being a leading firm on the toys market did not have the experience to do business as a having a small market share on the software market.\textsuperscript{16}

**Underperforming business unit:** It may also happen that one of the businesses of the company is performing below the expectations in long term and this reflects heavily on the overall picture of the company. This is the current issue at AOL whose dial-up unit is said to be responsible for the huge (32\%) drop in the corporations annual return, and thus to meet the investors’ expectations the problematic unit is to be rather divested\textsuperscript{17}.

**Good business opportunity**

The reverse of the previous motive may also occur. It happens that the company sells its unit when its value is culminating, thus it represents a good business in the given circumstances.

**Strategic freedom**\textsuperscript{18}: The strategy of the company may be unsuitable for the type of business a specific unit pursues and that may be an incentive for the management of the unit to initiate a separation to be able to implement its own strategy that fit better with its business. This was the case of the divestiture of the Visteon Corporation from Ford Motor Company.

The strategic freedom also enables the separated unit to enter businesses that it would otherwise not be able to do. For example a back office ancillary to the streamline business, after separation also serve the competitors of the company and thus has the opportunity to expand.

\textsuperscript{16} Freda Turner: Mergers and acquisitions vary in degrees of success, Jacksonville Business Journal, August 31, 2001


Resolving conflicts: Divestiture may be a solution for disputes between corporate control groups, since they can go their separate ways. That is what I deducted from the split-off of EDS from GM. The GM Hourly Plan Special Trust controlled GM E class stocks, and because of the conflicts, it had been decided to split-off EDS and convert by way of an exchange offer all E class shares into EDS shares and then retire all class E shares\textsuperscript{19}.

Avoiding organizational costs: Coordination, compromise, inflexibility, transactional,\textsuperscript{20} and inefficiency costs are often oppressing a complex corporate structure. Thus an over diversified company, which has several units of distinct activities, market approaches and even structures, requires a high level of coordination. Such corporation is usually overloaded by bureaucracy which is detrimental to the flexibility and increases the administrative costs of the transaction. The manager of the unit will often have to take disadvantageous compromises taking into account the interests of the company to the detriment of the unit. And finally, the performance of the unit gets absorbed by the results of the huge company and thus often the unit managers are not that induced to reach a high level of efficiency as if they were separate players on the market.

Improving market transparency\textsuperscript{21} and unlocking hidden value\textsuperscript{22}: For future investors it is often burdensome to value a conglomerate comprising of a complex system of diverse activities. The particular units may inhere distinct risk factors and growth rates that require different

\textsuperscript{22} Timothy A. Thompson: Sell offs, spin offs, carve outs and tracting stock – Corporate restructuring; 2007, Presentation material available at: http://www.kellogg.northwestern.edu/faculty/thompsnt/htm/emp-corp-restruc/divest_2001.ppt
valuation methods and expectations. This was the reason for the split-off of InterContinental Hotels Groups Plc.’s from Six Continents. According to Jim Larson the company’s executive vice president after the happenings September 11, the market changed so much that it seemed to be better to separate the hotels from the restaurants and bars business, since the market could not value them in their complexity.  

Given that the investors will have a better overview and will be able to invest directly to the business they prefer, the unit may result to have better access to capital markets. This was one of the motives for Viacom’s CBS divestiture. As the company’s chief executive Mr. M. Redstone said, the transaction was hoped to attract investors that may choose upon their preferences between a high-growth business and a business that is not developing rapidly but represent great value.

**Poison Pill:** The divestiture might also constitute a defense strategy against hostile takeovers in two ways. First, the company may detach crown jewels, that is to say separating units or assets that represent the biggest attraction and second, the transaction may also amount to a tax poison pill. Certain types of divestitures are tax-free when fulfilling a set of requirements, among others the divesting parent or the divested subsidiary cannot be acquired within two

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25 G. Fabrikant: Viacom Considers a Plan to Split Into 2 Companies, the new York Times, March 17, 2005

years of the transaction. This latter defense tactic was used by the ITT Corporation against the Hilton Hotels Corporation’s hostile tender-offer.

Comply with legal requirements.

The divestiture might also be involuntary, where the given legislation imposes certain rules pursuant to which the separation becomes necessary. These rules are usually of anti-trust nature.

This was the case of the Spanish Telefónica S.A. that had to divest Antenna 3 because the Spanish legislation restricted the possibility for a telecommunication company to hold interest in a television station.

Similarly, PricewaterhouseCoopers split-off its consulting section to avoid that the state authorities questioned its independence as auditor. The issue was addressed by the other major accounting giants KPMG, Ernst &Young and Deloitte as well.

It may also occur that one of the business activities of the company is subject to government regulations and thus certain standards or inspections or other burdensome measures are imposed on the whole company. To avoid these the problematic unit is detached.

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29 Information Statement filed with the SEC on July 30, 2003 available at http://sec.edgar-online.com/2003/06/30/0001193125-03-014800/Section4.asp
31 CCGSPIN § 1:12 Westlaw
1.2. Definition and consequences of split-off

Split-off is defined in the Black’s Law Dictionary in the following way: “When a corporation set up and funds a new corporation and gives the shares of this new corporation to the old corporation’s stockholders in exchange for some of their shares in the old company, this new company is a ‘split-off’ and the process is a split-off” 32

In my opinion this definition is not covering all the transactions that are understood in the business world as split-offs. I explain my finding as follows:

From the structural point of view, on the analogy of the literature related to spin-offs 33, and on the basis of the relevant U.S legislation 34 a differentiation can be made between the reorganized split-off and the pure split-off.

In a reorganized split-off or in other words drop down split-off company A wishes to detach a unit and therefore incorporates a new company B. The newly created shares of B will be initially owned by A. Then A transfers, or as referred to above drops down, the assets of the unit, together with its employees and management to B. And then comes the second stage that makes the transaction a split-off as opposed to a simple creation of a subsidiary: Company A offers to its shareholders to distribute its B shares in exchange of the A shares. Thus, those shareholders of A that accept the offer will get shares of B but in turn will have to redeem their shares in A.

This is the transaction that the Black’s Law Dictionary describes.

However, it is more common that the company splits-off an already existing subsidiary. Often the company acquires a company but later on decides to de-merge it. This was the case for

32 Black’s Law Dictionary by Henry Campbell Black - 6th ed./ by the publisher’s editorial staff, contributing authors: Joseph R. Notan (et. al); West Group, 1990, p. 1401
34 Internal Revenue Code § 355.
example at DuPont acquiring Conoco in 1981 and then splitting it off in 1999. In this situation no new company is formed as referred to in the above quoted definition. The split-off consists solely of the second stage described in the previous paragraph. It seems to me thus that the definition does not cover this non-drop split-off.

My definition would sound as follows:

Split-off is a type of corporate divestiture where the parent company offers its shares of a subsidiary to its shareholders who, accepting the offer surrender their shares in the parent company.

To comment my definition I find it worth mentioning that the U.S. jurisdiction which is the starting point of my work, and in particular the Internal Revenue Act as the most relevant primary source of this paper, understands the split-off from its technical aspect as a distribution of shares of a controlled company\textsuperscript{35} followed by surrender of shares of the parent company, rather then an exchange of stock and securities\textsuperscript{36}. Nevertheless from the practical point of view I will use the word ‘exchange’ since it is widely referred to in the business world.

While before the split off the subsidiary was owned by the parent, as a result of the split-off the detached subsidiary will be in the hands of some of the former shareholders of the parent and the parent will be owned by the remaining shareholders that did not exchange their shares for the shares of the subsidiary. Thus the former subsidiary becomes a company independent from the parent. Though not usual, it may also occur that the parent retains some shares in the subsidiary.

\textsuperscript{35} IRC § 355.
\textsuperscript{36} IRC § 354.
The following table illustrates the above described change in the ownership structure:

<table>
<thead>
<tr>
<th>Before split-off</th>
<th>After split-off</th>
</tr>
</thead>
<tbody>
<tr>
<td>Co. A</td>
<td>Co. A</td>
</tr>
<tr>
<td>1. Shareholder</td>
<td>1. Shareholder</td>
</tr>
<tr>
<td>2. Shareholder</td>
<td>2. Shareholder</td>
</tr>
<tr>
<td>Co. B</td>
<td>(→) Co. B</td>
</tr>
</tbody>
</table>

After the exchange has been accomplished, the parent company remains with a large number of its own shares received from the shareholders switching to the subsidiary. Holding own shares is restricted in most jurisdiction both in time and in quantity, thus the company will routinely retire these shares. The company may then for instance increase the nominal value of the shares of the remaining shareholders compensating them for the loss of the subsidiary.

From some relevant transactions of the last few years I find worth mentioning

- the split-off of Chipotle Mexican Grill from McDonald’s Corporation in 2006,
- Viacom Inc.’s split-off of Blockbuster Inc. in 2004,
- General Motors Corporation’s detachment of EDS,
- Conoco’s separation from E.I. du Pont de Nemours and Co (DuPont) and also
- the British InterContinental Hotels Group Plc’s split-off from the British hotel and pub operator Six Continents in 2001 or finally
• AT&T’s split off of Liberty Media Corporation in 2001.

1.3. Alternatives to split-off

Beside split-off there are several other types of divestiture. To give a complex overview of the analyzed transaction I found it important to present the other types of divestitures as well and then scrutinize the choices that lead to the employment of one or the other form.

1.3.1. Spin off

I start with the description of the alternative that is the most closely related one to my subject topic, namely the spin-off which is also the most widely used divestiture mode after sell-off. Spin-off as defined in the Black’s Law Dictionary is “[a] form of corporate divestiture that results in a subsidiary or division of a corporation becoming an independent company. Spin-off occurs where part of assets of a corporation is transferred to a new corporation and stock of transferee is distributed to shareholders of transferor without surrender by them of stock in transferor”\(^{37}\)

I would comment on this definition in the same way as I did in the case of the split-off. Namely I would suggest that the definition does not cover the pure spin-offs, where not a unit but an already existing subsidiary is to be detached.

The main difference between the spin-off and a split-off is that while in the case of spin off the shares of the subsidiary are distributed among all the shareholders of the parent on a pro rata basis without requiring them to give up their shares, in a split-off shares of subsidiary will

\(^{37}\)Black’s Law Dictionary, p. 1400
be distributed only to those shareholders of the parent that accepting the exchange offer are willing to surrender their shares.

As a result the shareholders of the parent company will have shares both in the parent and in the detached subsidiary, while the parent will not own shares in the subsidiary after the transaction. This means that the indirect ownership of the shareholders in the subsidiary changes to a direct interest. The following table illustrates the changes:

Some examples for spin-offs from the last years are include:

- Pepsico Inc. spin off its restaurant business in 1997
- Viacom’s separation of CBS in
- Tico International Ltd’s spin-off in 2007
- Altria Group Inc. spun-off first Kraft Foods Inc. in March 2007 and than recently Philip Morris International Inc. in March 2008
- Telefonica S.A. divested Antenna 3.
1.3.2. Split-up

Split-off, spin-off and split-up are often cited together, mainly because these are the three divestiture transactions that are tax-free under US law. Thus after the spin-off I find it logical to present split-up next.

Departing once again from the Black’s Law Dictionary “[w]hen a corporation divides into two or more separate new corporations, gives its shareholders the shares of these new corporations, and goes out of business, this process is termed a ‘split-up’”\textsuperscript{38}.

The major distinction of this type of transaction from the other types of divestiture is that as a result the parent company is liquidated and ceases to exist. Typically the parent will form two or more new subsidiaries and transfer there the assets of the units to be separated. It may also happen though that the parent drops down its assets to already existing subsidiaries.

Accordingly, the shareholders will have interest in both companies that are created as a result of the split-up and will not have to opt for one of these corporations as opposed to a split off, moreover will not be able to retain the stock of the parent company as opposed to spin-off.

An example for the spin of might be the division of AT&T into the new AT&T, Lucent Technologies and NCR in 1996.

\textsuperscript{38} Black’s Law Dictionary, p. 1401
1.3.3. Sell-off

Sell-off is the sale of a business unit or a subsidiary for cash or other assets\(^{39}\). Sell-off might be executed either by a private sale bargaining directly with a third party or via a public sale offering the shares of the newly created or existing subsidiary on the stock exchange.

Sell-off is the most known and most frequent form of divestiture thus probably that is the reason why some authors\(^{40}\) refer to ‘sell-off’ and ‘divestiture’ as interchangeable synonyms. For the purposes of this paper I will remain with the clear separation of the two terms.

Among some sell-offs I would mention:

- Pfizer sold-off the Adams confectionery products business to Cadbury Schweppes in 2003
- Mitsubishi and Sanyo recently announced its plan to sell its unprofitable mobile phone business.

1.3.4. Equity carve-out

Carve-out occurs where the company sells the minority (usually maximum 20 percent)\(^{41}\) of the shares of a newly created or existing subsidiary by a so called initial public offering (IPO). The company offers to the public the shares that were previously privately held by the company or has just been registered. This transaction is often referred to as ‘partial spin-

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\(^{40}\) “Divestiture” is used for “sell off” by Timothy A. Thompson in: Sell offs, spin offs, carve outs and tracting stock – Corporate restructuring; 2007, Presentation material available at: http://www.kellogg.northwestern.edu/faculty/thompsnt/htm/emp-corp-restruc/divest_2001.ppt

\(^{41}\) www.investopedia.com
The specific feature of this type of divestiture is that the parent company retains its control over the subsidiary.

Equity carve-outs are often employed before the company starts another type of divestiture. In particular split-offs are routinely preceded by carve-outs. The most relevant reason is that an IPO of the subsidiary’s shares to be divested helps to establish the value of the company on the stock market and further to set a proper exchange ratio.

Among divestitures preceded by a carve out I could mention:

- Conoco’s carve-out from E.I. du Pont de Nemours and Co (DuPont)
- Viacom Inc.’s carve-out of Blockbuster Inc.
- AT&T went public with Lucent Technologies
- Deutsche Telekom AG carved out T-online International AG.

Other carve-outs were employed by:

- Siemens carving-out Infineon
- Or by General Motors Corporation when it carved-out 18 percent of Delphi Automotive

**1.3.5. Management buyout (MBO) and Leveraged buyout (LBO)**

Other two related methods I would like to briefly mention and cite a definition without, however, dealing with them any further is management buyout and leveraged buyout.

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42 Robert Stow England: Take part of me - How companies are unlocking value by carving out pieces of their business; CFO Magazine, March 1999
43 Robert Stow England: Take part of me - How companies are unlocking value by carving out pieces of their business; CFO Magazine, March 1999
Management buyout occurs "[w]hen the managers and/or executives of a company purchase controlling interest in a company from existing shareholders. In most cases, the management will buy out all the outstanding shareholders and then take the company private because it feels it has the expertise to grow the business better if it controls the ownership. Quite often, management will team up with a venture capitalist to acquire the business because it's a complicated process that requires significant capital".44

Leveraged buyout is on the other hand in the wording of the Black’s Law Dictionary a "[m]ethod of purchasing outstanding stock of publicly held corporation by management or outside investors, with financing consisting primarily of fund borrowed from investment bankers or brokers. The initial and subsequent long term capital used for buyout is usually secured by the target company’s assets with repayment generated from the company’s retained or future earnings, sales of certain assets, and the like".45

1.4. The choice between different types of divestiture

As mentioned above the reasons of unbundling may strongly depend on the particular set of circumstances and so it is with the choice of the method of the separation. However, examining the consequences of each form of divestiture in the light of the incentives or targets the company wishes to achieve a general conclusion can be drawn concerning when one method is preferable.

45 Black’s Law Dictionary, p. 960
Powers\textsuperscript{46} indicates several factors that affect the choice of the method. I partially agree with his categorization, thus I will present here the three relevant ones from my point of view. Moreover, I will supplement these with other factors peculiar to the split-off that I deducted partially from the published reasoning of some recent transactions.

Thus, first I will present the factors referred to by Powers:

**Financial need**: Since carve-out and sell-off are generating cash, these methods will be used by companies that need financial instruments for investing or retiring debt or simply to enforce the remaining business. Carve out will be employed where the company wants to retain control over the subsidiary, however carve out implies also that the new investors, though in minority, may cause difficulties to the parent\textsuperscript{47} since their targets might differ from the interests of the parent. Dispersed public investors are usually looking for high cash returns while the parent company may have other incentives.

**Focus**: Where the company wishes to concentrate on its core business, it will probably use either split-off or spin-off, sell-off since these all result in the complete separation of the entity in question. Spin-off and sell-off is easier\textsuperscript{48} to accomplish since it does not involve any exchange tender offer. In deciding between spin-off and sell-off, the company will have to consider the tax burden the sell-off implies together with the next factor, the prospective price.


\textsuperscript{47}Robert Stow England: Take part of me - How companies are unlocking value by carving out pieces of their business; CFO Magazine, March 1999

\textsuperscript{48}John Cumming and Tina Y. Mallie: Accounting for Divestitures; A Comparison of Sell-Offs, Spin-Offs, Split-Offs, and Split-Ups, Issues in Accounting Education Vol. 14, No. 1, February 1999
Prospective price: According to Powers where the price of the unit or subsidiary under which it could be sold on the market is lower than the value the management attaches to it or the business simply cannot be properly appreciated because the market is too small and market conditions are bad then a sell-off is less probable to be applied. However, where the unit is either loss giving or break-even and does not represents high value for the company or is performing well, and is therefore highly valued by the market, then the sell-off is rather considerable then another type of divestiture.

There are certain peculiar factors that play important role in opting for a split-off.

Conflict: Split off is often employed to resolve disputes between different groups of shareholders whereby the shareholders can opt by means of accepting or refusing the exchange tender offer in which business they want to retain their investments. That was the case at General Motors when it divested EDS.

Minority buyout: This form of divestiture is also used as a method to buyout large minority by the majority in a tax-free way. The company drops down a large amount of liquid assets to the subsidiary and offers the shares to the minority. This constitutes the so called cash-rich split-off.

"Dilution of earnings": A company that is held too widely might face the problem that the interests of the shareholders will be too dispersed and thus the earnings too diluted. Accordingly, it might be interested to retire some of the shares. That was the main reason

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49 Corporate Counsel's Guide to Spin-Offs; CCGSPIN § 1:10 available at WestLaw
50 Saba Ashraf and Jack Cummings: Large minority shareholder buyout method in jeopardy; International Tax Review, April, 2005
51 P. L. Zweig: Why divorce is paying off on the street, Business Week December 5, 1994
Viacom opted for a split-off instead of spin-off when detaching Blockbuster\(^{52}\). And the same induced the split-off of Lehman Brothers\(^{53}\).

\(^{52}\) G. Fabrikant A. Ross Sorkin: Viacom May Spin Off Blockbuster to Shareholders; New York Times, February 10, 2004

\(^{53}\) P. L. Zweig: Why divorce is paying off on the street, Business Week December 5, 1994
2\textsuperscript{nd} CHAPTER: LEGAL BACKGROUND TO SPLIT-OFF

In this chapter I will discuss the legal framework of the split-off transaction. I will take United States as a basis, given that it is regarded as the most developed one as far as the regulation of the split-off transaction is concerned.

First I will examine the process of the transaction and the legislative acts and other common law principles that have to be taken into account. Then I will illustrate the previously discussed process through a case study, taking as example the recent split-off of Viacom. I will turn to the most discussed issue on split-offs, namely the tax implications. Finally, I will compare the US model with the German model focusing on the same aspects as I highlighted at the description of the US structure.

2.1. Split-off in the United States

2.1.1. Process of the transaction

As mentioned above the split-off transaction has two forms. In the first form, there is already an existing subsidiary to be split off, and the transaction consists of the distribution of shares by way of exchange. In the second, more complex form, however, the company wants to split-off an integrated unit. In this latter case, under US law the split-off will consist of two separate transactions: First, the company will form a subsidiary and will drop down the business and assets to be split-off. This phase has to be made according to the state corporate laws and corporate bylaws. Moreover, where the subsidiary is to be publicly traded, the requirements for listing at the relevant stock exchange are needed to be satisfied. Given that from the standpoint of my thesis topic the emphasis should be on the second stage, I will concentrate solely on the process of that phase.
Examining the course of the actions we can divide the process to a decision, separation and post-separation phase. I will describe this below examining especially what legal rules govern these different phases.

**Decision phase**

The corporate governance system the company is situated plays the main role in this phase. The following are the worth mentioning prongs of this stage:

**Initiative**: Concerning the initiative, the literature\(^5^4\) differentiates between a top-down structure, where the Board of Directors are recognizing the necessity of the divestiture mainly because of the underperformance of the unit, and on the other hand its reverse alternative, where it is the division manager who comes up with the idea to separate from the streamline business. In any case it is usually either the management or the directors who starts the process, especially in widely held corporations; however it may also happen that it is the shareholders, as in the case of the 1997 PepsiCo divestiture where investors wanted to divest the restaurant business even before top-management started to think about it.\(^5^5\)

**Decision of Board of Directors**: When the idea has been born, the Board of Directors usually convenes several times to evaluate the possible modes and effects of the transaction involving internal advisors, committees and the managers concerned. The Board typically asks for a so called fairness opinion to rely on it in its final decision.

**Fairness opinion**: The fairness opinion is an analysis of an independent outside expert – many times an investment bank- that shows that the split-off “meets a threshold level of fairness

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from a financial perspective.” Acting in accordance with the fairness opinion, the Board can more easily demonstrate that it has followed the business judgment principle and its fulfillment of duty of care can be hardly questioned.

The fairness opinion also serves as a solution where there is a disagreement concerning for example the valuation of business assets, the exchange ratio or other important question that would give rise to subsequent disputes.

Fairness opinions are usually accepted when made in consistence with the established best practices or widely recognized guidelines such as the Guidelines of the Investment Banking Authority.

Such fairness opinion has been asked for in the divestiture of EDS from General Motors. The opinion concluded that the transaction is “in the best interests and fair to, General Motors and to each class of the common stockholders.”

Approval by shareholders: Under the US state corporate laws shareholders’ approval is not required to accomplish the split-off transaction, unless the bylaws of the company so provide. Only when the substantial part of the parent company’s assets is transferred to the daughter, a shareholders’ ratification is necessary. The abovementioned principle is however subject to the Securities and Exchange Commission 14a-8 regulation and its so called Shareholders’ Proposal Rule. Thus when the Company is publicly traded, under certain circumstances the shareholders have a right to propose.

58 AMJUR CORPORATNS § 2285 available at Westlaw
Separation phase:

Filing with the Securities and Exchange Commission: Where the company is publicly traded, than in this phase the management has to follow mainly the filing requirements of the federal Securities Act of 1933, the Securities Exchange Act of 1934 and securities regulations together with the rules set by the Securities and Exchange Commission (SEC). The parent and the subsidiary have to file several documents during the process of the transaction. First of all the parent company has to provide information about the transaction including the risk factors to the shareholders and to the market fulfilling the disclosure requirement by filing a prospectus.\(^{59}\) Besides filing with the SEC the company typically provides information directly to the shareholders. Then the subsidiary will hand in a Registration Statement\(^{60}\) for the registration of the securities in order to list them on the stock exchange and thus ensure a secondary market.\(^{61}\) The exchange offer also has to be filed by the parent company with the SEC as a Tender Offer Statement\(^{62}\). After the transaction has been accomplished, the parent company provides a report, which contains the financial statements of the operation\(^{63}\).

Multiple Agreements: Given its complexity, the transaction is typically not governed by a single agreement rather by a number of documents. Usually there is a master document dealing with the main responsibilities of the parties and there are several ancillary documents. These are dealing with key issues such as the assets and liabilities transferred for example to define responsibilities of obligations, tax and employees and transition services the ratio, intellectual property\(^{64}\).

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\(^{59}\) SEC Rule 11-01 regulation s-x  
\(^{60}\) Form S-4 under the Securities Act of 1933  
\(^{61}\) Roger Rudisuli: Value Creation of Spin-offs and Carve-outs, May 2005, Zurich  
\(^{62}\) Under Section 14(d)(1) or 13(e)(1) of the Securities Exchange Act of 1934  
\(^{63}\) Form 8-K Current report Pursuant to Section 13 OR 15(d) of the Securities Exchange Act of 1934.  
\(^{64}\) Agreement between Altria Inc and its divested subsidiary Kraft Food Inc.
Exchange offer: The core of the entire transaction is the exchange offer. The parent company has to determine certain key issues in the offer. First of all it has to set the exchange ratio. The exchange ratio shows how many shares of the subsidiary the shareholder will receive in exchange for its shares in the parent company. For setting the ratio a prior valuation of the shares has to be done, for that purpose outside experts are often involved. The valuation can be based on several factors such as the current market price of the share, the market value of the assets representing the shares etc. Where the shares of the subsidiary are not traded publicly or where it would be otherwise burdensome to establish their market value, the mother company often employs a carve-out by an initial public offering to have a guideline in the appreciation of the shares.

Besides the ratio the offer must include the day the offer becomes effective and its expiration date, these two straddle the exchange period.

Typically the exchange will be accomplished through an exchange agent, who is identified in the offer, together with the technical mechanism of exchange and transfer of the shares, the details of which I am not covering in this thesis.

The separation phase is accomplished by the transfer of the shares.

Post-separation phase:

After the separation both parent and subsidiary become independent legal entities. They may however still cooperate for a certain period of time according to the concluded agreements. For example the parent company may undertake to provide the necessary infrastructure for the operation of the business of the split-off unit, such as administrative, accounting or other ancillary services.
There are also certain risk factors inherent in the transaction that comes to the surface after the separation.

First of all, although as mentioned above the company routinely asks for a private letter ruling from the Internal Revenue Service to have a security that the transaction will be tax free. However, the private ruling of the authority is not a final obligatory ruling, it is rather an opinion of the Service, that under the given circumstances the company described, the transaction will be tax-free. The circumstances may however change or the authority may find out additional elements that it did not take into account at the first assumption. Thus it may happen that the tax-neutral status will be revoked, which will have huge negative financial effects both on the shareholders and the parent company.

Moreover, the overall performance of the companies may also turn out to be worse. And the value of the shares may undergo significant negative changes. Given that the shareholders usually have no word in the process, both the parent and the subsidiary will be responsible for the result of the transaction. Thus especially where the shareholders suffer loss as an effect of the transaction, they may try to make the Board of directors responsible for the loss by reason of its decision lacking the duty of care, and litigate for indemnification as happened in the case of Viacom mentioned below.

It is also worth mentioning, what happens with the parent shares that are exchanged for the subsidiary shares. Those shares will be owned by the mother at least for a while. Most corporate laws limit the number of own shares a company can hold and also the time period of it. Thus what usually happens is that the company retires its own shares. Increasing the nominal value of the rest of the shares that remained in the property of shareholders, or it reduces the capital.

65 CCGSPIN § 1:28 available at Westlaw
2.1.2. Case-study: Split-off of Blockbuster Inc. from Viacom Inc.

Writing this subchapter I relied on the filings of Viacom Inc. and Blockbuster Inc. with the Securities and Exchange Commission\textsuperscript{66}.

- The divestiture process of Viacom Inc. started already at the end of 1998 when the Board of Directors of Viacom Inc. determined that the divestiture of Blockbuster Inc. is necessary. The Board decided to effectuate first an equity carve out and than progress with a split-off of Blockbuster. The first step of the divestiture was completed in August 1999 when by an Initial Public Offering approximately 18% of the Blockbuster shares where carved out.

- The second step was however delayed. In fall 2003 the Board of Directors authorized the Viacom management to investigate, and evaluate the possible separation structures and their legal, tax, financial and other implications. The management thus first tried to attract potential buyers, but after long negotiations did not manage to agree on an appropriate price.

- In November 2003 a special committee of independent directors was formed from the part of the Blockbuster Board to follow the divestiture transaction and to report and advice the Board promptly about the recent developments.

- In February 2004 Viacom, Blockbuster, the special committee and the financial and legal advisors hold a meeting to discuss the terms under which the separation could be effected.

- Finally in mid-June the Board of Directors of Blockbuster approved the terms of the separation agreements ("Agreements Between Viacom and Blockbuster and Other

\textsuperscript{66} All the SEC filings available at www.sec.gov. or www.sec.edgar-online.com
Related Party Transactions—Relationships Between Viacom and Blockbuster”) and the revised bylaws of the corporation.

- The next day on June 17, 2004 the Board of Directors of Viacom (respectively its committee to which the Board delegated its power) approved the separation by way of split-off and the conclusion of the separation agreements. Viacom Inc.’s management was not under the duty to require shareholders’ approval since neither the US legislation nor the By-laws of the corporation impose that obligation. With this action the decision phase came to its end and the separation phase started.

- The next day Blockbuster and Viacom executed the separation agreements. They entered into a Split-off Agreement which defined the basic responsibilities of the parties (in the wording of the agreement: the assignment and assumption of obligation, cooperation in order to consummate the split-off transaction in particular obligation to make all the necessary filings get authorizations and approvals of any authority, assignments and transfers while the agreement also addressed the issue of expenses of the transaction, indemnification of third parties for claims that arose because of the transaction, covenants, transfer of information). Then a separate but ancillary ‘Release and Indemnification Agreement’, ‘Transition Services Agreement’, ‘Registration Rights Agreement’ and a ‘Tax Matters Agreement’ was concluded.

- On June 18, 2004 Blockbuster filed a Form S-4 Registration Statement with the SEC which contained the history of the split-off transaction, the context, the separation agreements the way of calculating the exchange ratio, the preliminary planned further events such as the planned commencement of the public offering, and other relevant

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67 Viacom Inc.’s amended and restated By-laws available at http://www.sec.gov/Archives/edgar/data/813828/000094787104001510/ex3-1_053104.txt
terms, conditions and information concerning the separation over more than 150 pages.

- On September 8, 2004 Viacom Inc. filed a SCHEDULE TO, Tender Offer Statement under Section 14(d)(1) or 13(e)(1) of the Securities Exchange Act of 1934 with the SEC. This contained the exact conditions of the exchange offer including the exchange ratio and the date of expiration of the exchange offer which was set to October 5, 2004. The Statement also named The Bank of New York as Exchange Agent. This was the day the exchange offer became effective.

- On October 5, 2004, at 0:00 the exchange offer expired.

- On September 30, 2004, Viacom obtained a ruling from Internal Revenue Service which stated that the split-off transaction would qualify as tax free.

- On October 13, 2004, Viacom announced the final results of the exchange and filed a Form 8-K Current Report containing a pro forma financial statement of operations.

- The Blockbuster shares were credited on the accounts of the shareholders by October 20, 2004.

The split-off was thus consummated and as a result 27,961,165 Viacom shares were exchanged for 72 million class A Blockbuster shares 72 million class B Blockbuster shares.

### 2.1.3. Tax Implications

Under the Internal Revenue Code the split-off transaction together with the above discussed spin-off and split-up is in general non-taxable for both the shareholders and the corporations involved.
The tax neutrality of the transaction is set forth in the IRC through a system of cross references:

Under section 355 the distribution of shares in a transactions qualifying as reorganization under section 368 is tax free. Section 368 contains definitions of the terms used in the preceding sections of the code. The section defines several types of reorganization from which the split-off transaction together with spin-off and split-up qualifies as the so-called “D Reorganization”, where “D” stands for subsection D of section 368 (a)(1), which sets as follows:

“(D) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor, or one or more of its shareholders (including persons who were shareholders immediately before the transfer), or any combination thereof, is in control of the corporation to which the assets are transferred”.

Section D then refers back to the further list of requirements to be met in order to qualify as non taxable D reorganization. These additional conditions were introduced to avoid the use of the tax-neutral divestiture as a way of circumventing the rules applying to taxable transactions. These requirements are the following:

**Requirements for tax-free status**

**Control:** The corporation whose shares are to be distributed to the shareholders of the distributing corporation must be under the control of the Distributing Corporation immediately before the distribution takes place.  

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69 IRC Section 368(a)(1)(D)  
70 Fletcher Cyclopedia of the Law of Corporations FLETCHER-CYC § 6970.126 available at Westlaw  
71 IRC Section 355(a)(1)(A)
voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation”72.

**Active Conduct of a Trade or Business:** Both the parent and the subsidiary are "engaged immediately after the distribution in the active conduct of a trade or business"73. The rule has been introduced to avoid tax circumventing situations where the parent decides to separate a non active unit from the active business and dissolves the former in a tax-free liquidation distributing the assets among shareholders. For example when the parent drops investment assets to the new subsidiary and then distributes it to the shareholders because this would be a way of circumventing the taxable distribution.

No matter how the original business is separated; whether vertical separation or horizontal or along certain other interest, each new activity must constitute a standalone business in the sense that it has to be separated in a way that both the mother company and the subsidiary are pursuing genuine active business and then a tax free liquidation. Though the IRC permits one exception, namely, where the parent company is a holding company, its activity may consist of holding subsidiaries shares that are though engaged in an active business.

**Five-year Business History Requirement**74: The trade or business in which the parent and subsidiary are engaged immediately after the separation as discussed above "must have been actively conducted throughout the 5- year period ending on the date of the distribution" that is to say that the business to be separated must have had been acquired prior to the five year period preceding the split-off transaction. However, this rule does not apply to tax-free acquisitions of business such as the acquisitions by a controlled company.75

72 IRC 368 (c)
73 IRC § 355(b)(1)(A)
74 Fletcher Cyclopedia of the Law of Corporations FLETCHER-CYC § 6970.126 available at Westlaw
75 Fletcher Cyclopedia of the Law of Corporations FLETCHER-CYC § 6970.130 available at Westlaw
Obviously, there might have occurred certain changes in the business in the preceding five years which are not subject to the referred IRC requirement. Thus an assessment is necessary how fundamental the change is as far as the overall business is concerned to establish whether the 5-year business history requirement is met. For example, the company may acquire new units or expand its activities or purchase new lines without qualifying as acquisition of a new business.  

**Distribution of all the stock:** The parent shall distribute to its shareholders all the stocks that it owns in the subsidiary. Nevertheless, the transaction qualifies as tax-free when not all the shares have been distributed, but at least shares constituting control within the meaning of 368 (a) cited above, and the parent is able to establish that the retention of shares was not accomplished for tax-avoidance purposes.

**Not a device for distributing profits:** "The transaction was not used principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both" To determine whether such preclusive factor is present the overall context of the transaction need to be examined. Nevertheless the regulation ancillary to the IRC give some guidelines by providing what factors indicate that the transaction is a device for distributing profits and further what factors indicate the opposite. Thus for example when after the transaction the majority of the shares are sold, or when the shares are distributed pro rata, transfer to the subsidiary assets that are unrelated to its activity it is probable that the transaction will fail the device test. On the other hand when the distributing corporation is widely held—meaning that no shareholder own more than 5% of the shares— and listed on the stock exchange indicates that the split-off was not used to circumvent the rules for taxable transactions.

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76 Fletcher Cyclopedia of the Law of Corporations FLETCHER-CYC § 6970.130 available at Westlaw
77 IRC § 355(a)(1)(D)(i)
78 IRC 355 (a)(1)(B)
Besides the above requirements of the IRC, the Common law also developed certain rules that are to be considered. These are as follows:

**Business Purpose:** This factor is strongly connected to the non-device requirement. The transaction must be effectuated for a valid business purpose. The managers have to indicate why the split-off is needed from the standpoint of the business itself. The split-off must be in the interest of the company as opposed for example to the interests of the shareholders. Nevertheless the dispute of the shareholders may constitute a valid basis for a split-off. The purpose cannot comprise of tax avoidance neither

**Continuity of Interest:** The shareholders must retain their investment in the business in essential part. Thus the pre-transaction investment must correspond to the post-transaction investment in its substance, though its form may change. This rule also serves to hinder liquidations from the reach of section 355.

**Continuity of Business Enterprise:** According to this principle the business of the reorganized company has to be continued. This means that the significant part of the business has to carry or at least the substantial part of the assets has to be used for a new business. The company may close up certain business units, but in an overall assessment the business must go on. Thus if all the above mentioned requirements are met neither the shareholders nor the parent will have to recognize gain or loss from the transaction. Recently an issue related to the continuity of business enterprise has been raised. Namely in 2006 a proposal has been raised by the U.S. government in order to eliminate the cash-rich split-offs. The idea is that at least 50% of the value of the corporate assets in the new companies has to satisfy the continuity

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79 Fletcher Cyclopedia of the Law of Corporations FLETCHER-CYC § 6970. available at Westlaw
principle. The proposal has not been adopted yet. Though it would hinder the use of the cash-rich split-off as a method of minority buyout discussed above\textsuperscript{81}.

**Consequences of not qualifying for the tax-free status**

In cases when the transaction does not qualify as tax free under section 355, the transaction will not be treated examined in its integrity but it will be treated as a set of different transactions thus it will be recognized as a redemption of shares at first stage and then as a taxable distribution under section 301 or where the circumstances are such, it will qualify for sale or exchange of shares under 302 (a).\textsuperscript{82}

As far as the distributing parent company is concerned, if the transaction does not qualify as tax-free, it will have to recognize gain under IRC 311(b) „*to the extent that the fair market value of the stock of the distributed subsidiary exceeds the distributing corporation’s adjusted basis in the stock*”\textsuperscript{83}.

Given the complexity of the tax-free requirements the managers of the company often ask for a private letter ruling from the Internal Revenue Service to clarify whether the transaction will qualify for the tax-neutrality. This was the case in the split-off process of Viacom Inc. as well.

If the Internal Revenue Service rules that the transaction under the given circumstances will not qualify as tax neutral, than where the conditions cannot be changed to meet the criteria for the tax-free status, the split-off transaction is usually revoked given the large tax burden, and another way of divestiture is applied.

\textsuperscript{81} Saba Ashraf and Jack Cummings: Large minority shareholder buyout method in jeopardy; International Tax Review, April, 2005

\textsuperscript{82} Fletcher Cyclopedia of the Law of Corporations FLETCHER-CYC § 6970.137 available at Westlaw

\textsuperscript{83} Fletcher Cyclopedia of the Law of Corporations FLETCHER-CYC § 6970.138 available at Westlaw
Tax treatment of boot:

In certain occasions in exchange for their securities in the parent company the shareholders receive in addition to their shares of the subsidiary also cash or other property. All that property received in addition to the shares is called boot. The boot is taxable under IRC, but still can be treated in two different ways: either as a capital gain or as a dividend.

First, when the value of the boot and shares received equal to the value of the shares exchanged, the boot is treated as a capital gain, since it is reducing the shareholder’s economic investment in the business.

Second, to the extent the boot together with the received share exceeds the value of the exchanged share; the boot is treated as dividend, and is taxed as such.  

2.2. Differences in the German model

In this subchapter I will compare the above discussed US model with the model of an EU legislation. For this purposes I have opted for presenting the German model mainly given its developed market but rather because of the fact that the divestiture transactions has became popular in this Member State.  

I will focus solely on the major differences I encountered between the two structures from the aspect of the process and taxation.

2.2.1. Steps of the process

To analyze the process of the split-off it is worth to derive from the German Reorganization Act of 1995 (Umwandlungsgesetz or UmwG.). Examining the process as regulated in the

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84 Lewis R. Steinberg: Selected Issues in the Taxation of Section 355 Transactions, Tax Lawyer, Fall, 1997 available at westlaw under 51 Tax Law. 7.
85 Dr. Tobias H. Eckerle (et al): Investment in Germany 2006 (report material prepared by KPMG), July 2006 available at: www.kpmg.de
UmwG, I will primarily rely on the work of Roger Rüdisüli\textsuperscript{86} unless I specifically refer to other sources.

The UmwG provides for three types of divisive reorganizations. The common feature of these three forms is that a transfer of assets and liabilities is accomplished in exchange for stocks of the company acquiring those assets.\textsuperscript{87}

The first form is the ‘Aufspaltung’ that equals to a split-up. The company transfers all assets to the ‘acquiring’ companies and ceases to exist.\textsuperscript{88} The stocks of the acquiring company will be distributed among the shareholders of the liquidated company.

The second variation is the ‘Ausgliederung’ where only part of the assets is transferred to a new or existing company. However, in this case the shares of the acquiring company will be received by the transferring company itself and not by its shareholders.\textsuperscript{89}

The third type called the ‘Abspaltung’ governed by 123 (2) UmwG also consists of a partial transfer as the ‘Ausgliederung’, however, the shares of the acquiring company will be received by the shareholders of the transferring company. This transaction is covering both the spin-off and a split-off.

The UmwG further distinguishes between a symmetric and asymmetric distribution of shares.

The first means that the stocks of the acquiring company are distributed among the

\textsuperscript{87} Dr. Tobias H. Eckerle (et al): Investment in Germany 2006 (report material prepared by KPMG), July 2006 available at: www.kpmg.de
\textsuperscript{88} Dr. Tobias H. Eckerle (et al): Investment in Germany 2006 (report material prepared by KPMG), July 2006 available at: www.kpmg.de
\textsuperscript{89} Dr. Tobias H. Eckerle (et al): Investment in Germany 2006 (report material prepared by KPMG), July 2006 available at: www.kpmg.de
shareholders on a pro rata basis considering their participation in the transferring company, which would be the spin-off transaction. The second, on the other hand means that the shares are not distributed on a pro rata basis, which equals according to Rudisuli to split-off.

This categorization is in my opinion the best that can be achieved in the given circumstances even though the specific feature of the split-off, namely the surrender of the shares is definitely missing. The asymmetric ‘Abspaltung’ is in my understanding covering the split-off transaction, but is more wide then that. It is also embracing non pro rata distributions where the surrender is not required.

Nevertheless I do agree with Rudisuli that split-off belongs to the category of ‘Abspaltung’ and thus I will proceed with the examination of that instrument.

Since in the ‘Abspaltung’ the shares might be allocated directly to the shareholders skipping the part when the transferring company is holding shares in the acquiring company, the reorganization can be executed in a more simplified manner than in the US concerning the number of stages of the transaction.

The process of the transaction resembles to the US model however also has some differences. Thus the process starts with the preparation of the split-off plan and the draft split-off agreement.

The decision phase is characterized by the German peculiarities as the two tier system and co-determination. Moreover, as opposed to the US model under the German legislation, the shareholders have to approve the transaction by a ¾ qualified majority [UmwG 125(1), 13(1) and 65(1)] as Rudisuli argues. For that purpose a mandatory split-off report is prepared which explains the exact reasons and prognosticated consequences of the transaction to provide the
shareholders with information that can serve as a basis for their decision. The report must be supplemented by the statement of an external auditor\textsuperscript{90}. This resembles to the US fairness opinion, however, unlike the latter, it is required by the law.

The resolution of the shareholders must be certified by a public notary which is again an important German difference, given the distinctive importance of the institution of the notary public in that jurisdiction.

Getting the approval, the split-off will continue with the separation phase. The split-off has to be registered with the Commercial register as referred to by Rudisuli, under section 16, 17, 19 and 21 of UmwG.

After the separation the two companies will be jointly liable for the liabilities transferred, for a five year period following the split-off.

\subsection*{2.2.2. Tax Implications}

As mentioned above the split-off transaction is in general tax neutral under US legislation. The same approach is followed by the German Reorganization Tax Act according to the transaction fulfilling certain requirements is also tax-exempt.

Moreover, as a recent development of the EU law, the split-off transaction has been added to the list of the tax neutral cross-border restructurings.

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\textsuperscript{90} Dr. Tobias H. Eckerle (et al): Investment in Germany 2006 (report material prepared by KPMG), July 2006 available at: www.kpmg.de
I will first discuss the German legislation and then turn to the Council Directive 2005/19/EC that amended 90/434/EEC on the taxation of cross-border restructurings.

**German Reorganization Tax Act**

The German Reorganization Tax Act (Umwandlungssteuergesetz – UmwStG) is dealing with the ‘Abspaltung’. As under IRC § 355. the transaction is tax neutral when meeting certain requirements very similar to those provided for by the US legislation.

Thus as Rudisuli\(^91\) points out under the UmwStG the transferring company would have to be the exclusive owner of the divested business for at least three years. This slightly differs under the IRC where an ownership amounting to 80% suffices though the period is five years. Analogically to the US system the transaction may not be used as device for a tax free sale. This is presumed where within five years following the transaction more then 20% of the shares are sold.

Where the transaction does not qualify for the tax-free status, then it is treated as a distribution in kind and a contribution of assets to the acquiring corporation.\(^92\)

**EC Tax Mergers Directive**

The EC Tax Mergers Directive 90/434/EEC provides companies that accomplish cross-border reorganization with the deferral of taxes on capital gains arising from such transactions.

In 2005 the Directive has been amended by directive 2005/19/EC extending the list of the types of reorganizations to which the tax deferral apply. Thus, besides cross-border mergers,

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92 Dr. Tobias H. Eckerle (et al): Investment in Germany 2006 (report material prepared by KPMG), July 2006 available at: www.kpmg.de
divisions, transfer of assets and exchanges of shares according to the new Article 2(b)(a) the „split-off“ or in other words the „partial“ division is also qualifying for the tax facility.\textsuperscript{93}

The referred article defines split-off as follows:

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‘partial division’ shall mean an operation whereby a company transfers, without being dissolved, one or more branches of activity, to one or more existing or new companies, leaving at least one branch of activity in the transferring company, in exchange for the pro-rata issue to its shareholders of securities representing the capital of the companies receiving the assets and liabilities, and, if applicable, a cash payment not exceeding 10% of the nominal value or, in the absence of a nominal value, of the accounting par value of those securities.’\textsuperscript{94}
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As we can see the defined transaction, though referred to as „split-off“ does not exactly cover the US concept of the „split-off“. The above defined transaction seems to equal rather to the closely related „spin-off“ transaction.

However, in my view the emphasis should be rather added to the element that the partial division is a transaction that do not result in the liquidation of the parent company as opposed to divisions where the parent is dissolved. That is what I deducted examining some preparatory acts to the directive.\textsuperscript{95}

As a consequence I would conclude that the tax deferral should be viewed as applicable to the cross-border split-offs taking into consideration especially the objective of the directive, that

\textsuperscript{94} Directive 90/434/EEC Article 2(b)(a)
is “taxation of the income, profits and capital gains from business reorganizations should be deferred”\textsuperscript{96}

\textsuperscript{96} Directive 2005/19/EC (2) Recital
Conclusion

Not only investing but also divesting might be a right decision to achieve economic growth. Several reasons may motivate a corporate unbundling but a lot depends on its exact form, given that the types differ in their mechanisms, effects and legal implication. Comparing the different ways of divestiture while setting their advantages and drawbacks, this paper shows that in a certain set of circumstances it is the split-off transaction with which the best results can be achieved.

I based my research on the developed US model, and I found out that when exported to other jurisdictions, it was not implemented with its original settings, and thus I encountered differences related the terminology, mechanism, and legal implications of the unbundling operations. The most salient divergence was that the EC legislators refer to the same “split-off” term as used in US, with a somewhat resembling but still distinct meaning.

While examining the legal background of the transaction I found that it is governed by corporate law, securities law and several other fields of law but the emphasis is on the tax law implications. The main principle I could deduce from the tax-related literature and legislation I have revised is that the mere change in the structure of the company should not be the basis of taxation\(^\text{97}\) and that is the rule that has been recently adopted by the European Council, when it extended the tax deferral eligibility to split-off transactions by amending in 2004 the mergers tax directive.

As I have shown in the last chapter split offs and other types of divestitures do have an effect on the stock prices. And since there are some common features in these effects certain speculation tactics have developed in relation to the divestiture transactions among the players of the stock exchange.

In this work I focused on the most discussed issues on split-off and obviously I could not cover everything. A future research on split-off could focus on the economic and legislative background of divestitures in the CEE region, to fill the gap I have encountered both in the literature and the legislation, which can be though explained by the decreased use of this type of divestiture in the region.
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www.investopedia.com

Used acts of legislation:

Internal Revenue Code of 1986 (US)

Securities and Exchange Act of 1934 (US)

Securities Act of 1933 (US)

German Transformation Act 1995 (Umwandlungsgesetz)

German Transformation Tax Act (“Umwandlungssteuergesetz” – UmwStG)

Council Directive 90/434/EEC of 23 July 1990 on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States as amended