Separations of Energy Companies *Powerful Trends*

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In the first half of 2011, reorganizations of companies—whether mergers or demergers, are making a comeback. It appears that the combination of increased economic activity and the cyclical nature of corporate reorganization activity (remember the flurry of new tracking stocks in the 80s and 90s?) are making spin-offs and related events seemingly more popular. These events will likely add to inevitable questions this tax season from shareholders. Dedicated corporate actions professionals, although very busy, should be prepared to answer them.

Recent corporate reorganization trends in U.S. stocks may allow investors to further tailor portfolios to better meet investment risk profiles. In the case of energy, is the investor enamored with tales of adventure and, like Harrison Ford, eager to play the explorer, investing in companies scouring untamed regions of the world for new sources of oil and gas? Or, does the investor love traversing the U.S. through its extensive transportation systems of railroad, truck and pipeline bringing energy to every corner of the country? Due to past and future energy company reorganizations, investors can pick and choose among these business enterprises rather than having to buy a one-size-fits-all energy investment.

Splitting companies with successful businesses, whether energy or other companies, can be exciting to investors who see that they "unlock value" as some analysts say, by allowing the separated companies to focus on their respective businesses. Witness one of the most successful spin-offs, the distribution by McDonalds of Chipotle, a stock that has substantially increased in value since its public listing. Highlights of recent and pending activity amongst energy organizations include:

- Marathon Oil recently spun off Marathon Petroleum, its refinery business, which (according to its website) is the 5th largest U.S. refinery. That spin-off resulted in a large gain in Marathon value;
- Coming in the future is another nontaxable spin-off announced May 24, 2011 by El Paso [NYSE: EP], a natural gas company comprising two businesses, a pipeline company and an exploration and development company;
- Then there's The Williams Companies [NYSE: WMB], announcing February 16, 2011 that it is planning an IPO of a 20% portion of a newly created public company consisting of its exploration and production business, followed by an anticipated 2012 spin-off of the remainder of the new company, leaving Williams with midstream infrastructure and natural gas pipeline assets;
- Sunoco, Inc. is planning a separation of its fuels business and its coke manufacturing business (SunCoke Energy) into two separate companies, detailed in a July 2011 SEC filing; and,
- The most recent energy company to announce a separation of its business is ConocoPhillips.

Event Details: Marathon Oil

Marathon effected its spin-off on June 30, 2011, unfortunately second quarter end being another busy time for corporate actions processing. Shareholders received one-half share of Marathon Petroleum Corp. common for each share of Marathon Oil stock held.

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Split-offs: Liberty Media Corp.

Contrast the **spin-off**, in which the shareholder retains the shares of the distributing company, with the **split-off**, which is effected by an exchange of shares of the distributing company for shares of the distributed company.

The most recent **split-off** example is the pending reorganization of Liberty Media Corp., through which the shareholders of Liberty Media have approved an exchange of Liberty Media tracking stocks for stocks of a newly independent Liberty Starz company. The basis treatment is fairly simple in **split-offs**, as the basis of the shares held becomes the basis of the shares received in the exchange. Note that it was not always that simple with **split-offs**; prior to regulatory changes in 2006, the allocation of basis between any distributing company stock not exchanged and any distributed company stock received was based on their relative fair market values. This created problems because there was not one universal basis allocation as in a **spin-off** distribution, because each shareholder could choose to exchange a different percentage of stock for the new company stock.

Non-U.S. Spin-offs: Prophecy Coal Corp.,Pacific Coat Nickel Corp.

Demerger is the term for a separation in many non-U.S. jurisdictions. At one time demerging had the meaning of sinking into or immersing, now as a legal concept it has practically the opposite meaning, that is, the separation of a large company into two or more smaller organizations. This current meaning is probably the result of a back-formation from the word merger.

An example of a recent demerger/distribution is the distribution by Prophecy Coal Corp. of Pacific Coast Nickel Corp. This demerger did not qualify as a nontaxable distribution because, among other reasons, the distributing company retained approximately 44.48% of the distributed company's stock, which causes the distribution to fail one of the tests of Code Sec. 355.

Pursuant to IRS Code Sec. 358 and regulations there under, the basis of the Marathon Oil shares held is allocated between those shares and the new Marathon Petroleum shares received in proportion to their relative fair market values. Or, as the company put it in its spin-off information statement, in proportion to their fair market values effective with the spin-off. According to Capital Changes' calculations at the time of distribution, this came out to 60.6137% of basis to the holder's Marathon Oil stock and 39.3863% of basis to the Marathon Petroleum stock.

Marathon Oil followed later with a basis allocation of 59.65% and 40.35% based on ex-date prices.

Event Details: El Paso

The El Paso spin-off is expected to be completed by the end of 2011. As exciting as this may be to investors, the corporate actions professional may have a different take. For those that process corporate actions to adjust customer accounts, the prospect of another large December corporate action may seem a challenge—one that they are more than equipped by experience to handle, but also made more challenging by the cost basis reporting law and the changes it brings to the 2011 year-end accounting and tax reporting season. Adding to the usual press of work at that time is the specter of a flood of issuer statements required by the cost basis law. Issuers having received penalty relief from the IRS until January 2012, have not had to publish statements of the effect of their organizational actions as required by the law and IRS Reg. 1.6045B-1.

Event Details: The Williams Companies

Williams is spinning off its exploration and production business. First, it intends an initial public offering of up to 20% of its interest in the third quarter of 2011. Second, the remaining interest is expected to be distributed in a nontaxable distribution in 2012. Why 20% in the initial public offering? One of the requirements of a nontaxable distribution under IRS Code Sec. 355 is that the distributing corporation distributes stock of a controlled corporation. The distributing corporation must either distribute all of its stock in the controlled corporation or distribute enough stock to constitute control. Control is defined by Sec. 368(c). For the distributed corporation to qualify as a controlled corporation, the distributing corporation must own at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock of the distributed corporation.

Event Details: Sunoco

Sunoco plans to separate SunCoke Energy Inc. in two steps. First there will be an initial public offering of about 19% of SunCoke. Second, the company will distribute the remaining shares to Sunoco shareholders in a spin-off distribution that is intended to be a nontaxable distribution under IRS Code Secs. 368(a)(1)(D) and 355. If all goes to plan, 80% or more of SunCoke will be owned by Sunoco and be distributed to Sunoco shareholders in satisfaction of one of the requirements of a nontaxable spin-off. Sunoco has obtained an IRS private letter ruling regarding the spin-off.

Event Details: ConocoPhillips

Following the El Paso and Williams company announcements comes ConocoPhillips, the multinational oil and gas producer. ConocoPhillips announced it would split into two stand-alone companies, making a nontaxable distribution of its oil refining and marketing business to its shareholders who would then own that business and the remainder of ConocoPhillips consisting of its worldwide exploration and production operations. This spin-off will create the world's biggest refining company. Prices of ConocoPhillips stock jumped on that announcement.

Corporate Separations: History

For some historical background on the legal developments of corporate separation treatment, take a look at the following extracts from a U.S. appellate court:

- A **spin-off** occurs where a part of the assets of a corporation is transferred to a new corporation and the stock of the transferee is distributed to the shareholders of the transferor without the surrender by them of stock in the transferor…Congress apparently first permitted the tax-free treatment of **spin-off** transactions in section 203(c) of the Revenue Act of 1924…Because of the general terms of that and subsequent enactments, Congress soon recognized that wide-spread tax avoidance might result.
- Congress reacted to this possibility by eliminating the provision which characterized the **spin-off** as a non-taxable reorganization. See the Revenue Act of 1934…48 Stat. 680, 704 (1934). From then until 1951, without regard to whether a particular transaction served a legitimate business need, the gain realized by a shareholder as a result of a **spin-off** was subject to tax as an ordinary dividend.
- In 1951, Congress reconsidered its position, having come to the view that business reasons could exist which would justify allowing tax-free status to the division of a single corporation into two or more corporations each owned directly by the shareholders. Therefore, in that year, Congress reinstated non-recognition treatment to those **spin-offs** which met carefully specified conditions….In the Internal Revenue Code of 1954, Congress sought to create a single set of limitations that would govern all forms of transactions having the potential of either a bona fide business transaction or a tax avoidance scheme…[S]uch transactions, including not only **spin-offs**, but also so-called **split-offs** and **split-ups**, are to be tested under the provisions of section 355…A **split-off** involves the same kind of transaction as a **spin-off** except that the shareholders surrender part of their stock in the parent corporation in exchange for stock in the subsidiary.

Comm'r v. Baan, 382 F2d 485 (9th Cir. 1967) [citations omitted]

Corporate Separations: Tax Terms

Often corporate actions processers refer generically to any distribution by a company of stock or securities of another company (or even of the distributing company) as a **spin-off**. The more precise meaning of a **spin-off** is contained in the following description which includes descriptions of other methods of separating the businesses of a corporation.

Prior to enactment of the Internal Revenue Code of 1954, corporate divisions had, in tax jargon, been traditionally classified into three different types, the **'split-up'** the **'split-off,'** and the **'spin-off.'**

- In a **split-up**, the original corporation would transfer all of its assets to two new corporations and then distribute their stock to its shareholders in complete liquidation.
- A **split-off** involved a transfer of part of the original corporation's assets to a new corporation, followed by a distribution of the new corporation's stock in exchange for part of the stock of the original corporation.
- A **spin-off** differed from a split-off only in that no stock of the transferor was surrendered by its stockholders upon their receipt of the transferee's stock.

W. E. Gabriel Fabrication Co. v. Comm'r, 42 T.C. 545 (1964)

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