Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:NR:DAL:2OKLPOSTF-154194-01
EFMoates

date: November 2, 2001

to: John Parsons, LMSB Team Manager

attn: Cynthia A. Adkisson, Revenue Agent
Team 1242, Tulsa, LMSB, FSH

from: Associate Area Counsel

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subject: **Request for Advisory Opinion**

Taxpayer: [redacted]

Issue: Section 355 Spin-off

We are responding to your request for our advice on whether the two distributions from [redacted] ([redacted]) to [redacted] (hereinafter [redacted]) and by [redacted] to the individual shareholders are tax-free distributions pursuant to I.R.C. § 355(a). This memorandum should not be cited as precedent. You specifically asked if the distributions would qualify as a tax-free spin-off pursuant to section 355. As discussed below, the distributions meet all of the tests for tax-free treatment pursuant to section 355.

Although we informally coordinated this matter with the National Office, the advisory is subject to the review procedures of CCDM (35)3(19)4(4). The CCDM procedures require us to transmit a copy of the memorandum to the National Office. The National Office has ten days from receipt of our memorandum to respond. The National Office may extend the review period if necessary. We will keep you informed of any delays.

Facts

[redacted] is the common parent of an affiliated group of corporations filing a consolidated federal income tax return reporting on the accrual method of accounting for federal income

tax purposes with a fiscal year ending on June 30th. [redacted] has one class of stock, voting common stock, issued and outstanding. [redacted] owns [redacted] percent of the voting common stock of [redacted].

[redacted] is a holding company. The business conducted by members of the [redacted] are; (1) the oil and gas exploration and production business, and (2) the continuing care retirement community business.

[redacted] which incorporated on [redacted], is a subsidiary of [redacted]. [redacted] has one class of stock, voting common stock, issued and outstanding. [redacted] owns [redacted] percent of all of the issued and outstanding voting common stock of [redacted]. [redacted] has continuously conducted oil and gas exploration and production business since its inception.

[redacted] joined the [redacted] in [redacted] when [redacted] contributed certain bonds and all of its limited partnership interest in the partnerships to [redacted] for newly issued common stock of [redacted] representing an [redacted] percent ownership interest. Following such exchange, [redacted] was owned by [redacted] as the majority shareholder, [redacted] percent and [redacted] individuals and trusts as minority shareholders, collectively, [redacted] percent. Such ownership has remained constant and reflected the ownership of [redacted] until [redacted].

Prior to the steps of the transaction at issue, [redacted] was a subsidiary of [redacted]. Prior to [redacted], [redacted] was a holding company holding the stock of [redacted] domestic subsidiaries and a [redacted] percent limited partnership interest in each of the [redacted] limited partnerships. On [redacted], [redacted], one of [redacted] wholly-owned subsidiaries, was merged with and into [redacted], a single member LLC owned by [redacted], with [redacted]. Because [redacted] is a disregarded entity for federal income tax purposes (one member LLC), the merger of [redacted] into [redacted] caused [redacted] to become the sole owner of the [redacted] limited partnerships. Accordingly, at that time, the partnerships were deemed to terminate for federal income tax purposes pursuant to I.R.C. § 708(b) of the Code and [redacted] became the direct owner of all the properties formerly held by the partnerships.

[redacted] has only one class of stock, voting common stock, issued and outstanding. [redacted] owned [redacted] percent of all of the issued and outstanding voting common stock of [redacted] with the remaining [redacted] percent voting common stock interest held by

individuals and trusts unrelated to or to the shareholders.

As of , wholly owned domestic subsidiaries. of these subsidiaries were primarily holding companies. One of the holding companies owns domestic subsidiaries each owning continued care retirement community (CCRC) properties in a particular State. The other holding company subsidiary wholly owns domestic subsidiaries each engaged in the provision of home health care services in a particular State. and all of the entities directly and indirectly owned by form the .

The group consist of approximately corporations. also owns various partnership interests which are directly involved in the overall trade or business which is primarily (1) nursing and personal care facilities, (2) real estate operations and lessors of buildings and (3) other real estate. The group is engaged in the CCRC business in that it operates a group of residential communities serving the lifestyle needs of seniors and the elderly by combining the services for independent living, assisted living, home health care, Alzheimer's and dementia care as well as skilled nursing care facilities in campus settings. The group's CCRC facilities enter into long-term care contracts to provide various degrees of healthcare services, living care services, various amenities, transportation, planned activities, and food service of one to three meals per day. In addition, the group conducts market research of products and services for senior residential communities. This business has been conducted by various members of the group since .

The transaction at issue involved the following steps.

First: On , a wholly-owned subsidiary of , was merged in , a single-member LLC owned by . is disregarded and treated as a division of for federal income tax purposes pursuant to the check the box Regulations. (Treas. Reg. § 301.7701-3(b)(1)(ii)).

Second: On , distributed its entire percent interest in the common stock of to , in exchange for surrendering shares of its common stock. This was the first distribution. As a result of the surrender

of the shares of [redacted] common stock in the first distribution, [redacted]'s ownership of [redacted] decreased from [redacted] percent to [redacted] percent.

Third: Immediately following the first distribution, [redacted] distributed its entire [redacted] percent interest in the common stock of [redacted] to the shareholders of [redacted], on a pro rata basis. This was the second distribution. None of the [redacted] shareholders surrendered any of their [redacted] stock in conjunction with the second distribution.

Fourth: Following the second distribution, [redacted] partnership which was a [redacted] percent shareholder is [redacted], distributed its share of the [redacted]' stock to its partners which are trusts, with a compensating cash distribution to [redacted]. This issue is not in question. However, it impacts on the continuity of interest with respect to the liquidation of a partnership that was a shareholder of the corporation that entered into the section 355 transaction pursuant to Rev. Rul. 76-258, 1976-2 C.B. 103.

While the above referenced facts are lengthy, they represent the minimum facts necessary to establish that the requirements are met for a tax-free spin-off pursuant to I.R.C. § 355.

Law and Analysis

A corporation generally is required to recognize gain on the distribution of property including stock of a subsidiary as if such property had been sold for its fair market value. Likewise, the shareholder generally must treat the receipt of property as a taxable event as well. However, I.R.C. § 355 provides an exception to this general rule for certain spin-off type distributions of stock of a controlled corporation, provided that various requirements are met.

Section 355 permits a corporation to distribute stock or securities of a controlled corporation to its shareholders without the recognition of gain or loss provided that all of the requirements are met. Each of the requirements of section 355 and a brief discussion of the fact relating to those requirements is set out below:

1. The property distributed must consist solely of stock or securities of a corporation that was "controlled" by the distributing corporation immediately before the distribution. (I.R.C. § 355(a)(1)(A)).

For this purpose control is defined by I.R.C. § 368(c) as requiring the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of each class of outstanding nonvoting stock. (Rev. Rul. 59-259, 1959-2 C.B. 115). This requirement is satisfied as [redacted] owns approximately 84 percent of [redacted].

2. The transaction including the distributions must not have been used principally as a device to distribute the earnings and profits of the distributing corporation or of the controlled corporation, or both. I.R.C. § 355(a)(1)(B).

The requirements for section 355 are designed to prevent a corporation from using a corporation division to convert what should be dividend income into capital gain. On the other hand, the rules are designed to permit tax-free corporate divisions where they are carried out for legitimate business reasons and is not an attempt to convert dividend income into capital gain. Thus, to qualify for section 355 treatment, distributions must not have been used principally as a device for the distribution of earnings and profits (E & P).

Whether distributions are devices to distribute E & P depends on all of the facts and circumstances surrounding the distribution. A pro rata distribution is more likely to be a device to distribute E & P than a non pro rata distribution. In this case, the first distribution was a non pro rata distribution. In the first distribution [redacted] distributed [redacted] percent of the stock to [redacted] and nothing to the other shareholders (primarily [redacted]). The second distribution was a pro rata distribution from [redacted] to its shareholders. In this case there is no evidence that the distributions were used as device to distribute the E & P of either the distributing corporation or the controlled corporation.

Other factors that are considered in determining if a corporate division is a device to distribute E & P are set forth in the regulations. When the facts and circumstances of this case are applied to the factors set forth in the regulations, the majority of the factors weigh in favor of the spin-off not being a device to distribute E & P.

3. Immediately following the distribution, the distributing corporation and the controlled corporation must both be engaged in the active conduct of a trade or business.

Pursuant to I.R.C. § 355(a)(1)(C) and (b) immediately after the distributions, both the distributing corporation and the controlled corporation must be engaged in the active conduct of a trade or business. If the distributing corporation is a holding company, as is the case here, each of the controlled corporations must be engaged in the active conduct of a trade or business. This requirement generally requires that a holding company is engaged in a trade or business itself if "substantially all" of its assets consist of stock or securities of a corporation controlled by it immediately after the distribution.

[redacted] was originally incorporated in [redacted]. Subsequently, [redacted] and [redacted] were incorporated in [redacted] and [redacted], respectively. As a result, [redacted] entities have been engaged in at least one active trade or business for five years or more. Furthermore, no taxable asset or stock acquisitions of a trade or business have occurred. While it is probable that [redacted] has made taxable stock and/or asset acquisitions within five years prior to the distribution date, these were likely additions to an already existing trade or business.

Clearly, [redacted] has been in the oil and gas exploration business for more than five years. Since, [redacted] acquired [redacted] in a non-taxable transaction (section 351) and since certain [redacted] entities as well as [redacted] have been engaged in an active trade or business for five years or more, this requirement is satisfied.

4. The distributing corporation must distribute either all of its stock and securities in the controlled corporation, or it must distribute at least sufficient stock to constitute control under I.R.C. § 368(c). If any stock or securities are retained by the distributing corporation, it must be established that they were not retained as part of a tax-avoidance plan. (I.R.C. § 355(a)(1)(D)).

In this case no stock or securities were retained by the distributing corporation.

5. The distributions must have a substantial corporate business purpose to the corporation. (Treas. Reg. § 1.355-2(b)).

Treas. Reg. 1.355-2(b)(1) sets forth the independent business purpose requirement. The regulation clarifies that section 355 applies to a transaction only if it is carried out for one or more corporate business purposes. A transaction is carried out for a corporate business purpose if it is motivated, in whole or substantial part, by one or more corporate business purposes. The primary reason for this business purpose requirement is to provide nonrecognition treatment only to distributions that are incident to realignments of corporate structures required by business exigencies and that effect only realignments of continuing interests in property under modified corporate forms. It should be noted that this business purpose requirement is independent of the other requirements pursuant to section 355.

In this case, the taxpayer sets forth problems in the regulation of the CCRC business. In addition to Federal regulations, all of the States have numerous regulations on CCRC businesses. The intensive regulation poses a series of problems in operation of the CCRC business as a controlled corporation.

Part of the business purpose for the spin-off was to enable to secure assisted living licenses in New York, which restricts issuance of licenses to corporation whose shareholders are individuals. Since owned and owned , no license could be secured in the New York.

(See 10 NYCRR 86-1.1 for the regulations governing New York assisted living centers.) Generally, the person controlling an entity delivering CCRC services is deemed to be the applicant and subject to direct regulation. New York state law regulations do not allow a corporation to obtain an assisted living license unless shareholders of the corporation are individuals. After the spin-off the shareholder of were individuals who would qualify for CCRC licensing in New York.

Some States require extensive disclosures of the control persons who are providing CCRC services. In the case of corporate entities, the disclosure requirements include public filing of audited or unaudited financial statements. maintains its books on the tax method, not generally accepted accounting practices method. The two methods would be inconsistent and it would be very costly to have audited financial statements prepared as well as having all of 's oil and gas reserves valued annually. Thus, a second business purpose of the spin-off was to allow for the disclosure of the financial statements of without the necessity of valuing oil and gas interests held by .

The third business purposes of the spin-off was simply risk reduction. The threat of excessive damage awards due to litigation in CCRC provider business was a major concern and a bonafide purpose of the spin-off. Prior to the spin-off, the consolidated financial position of [redacted] could have been discovered and presented to a jury for the purpose of determining an award for damages in a trial for negligence in one of the care facilities. An excessive judgement could force [redacted] into bankruptcy. For this reason alone the separation of [redacted] from the [redacted] appears to have a valid the business purpose nature of the spin-off.

6. One or more persons who were owners of the enterprise prior to the distribution must own (in the aggregate) an amount of stock establishing a continuity of interest in each of the surviving corporate forms in which the activities are conducted after the separation.

This requirement is referred to as the continuity of interest requirement. There must be a continuity of interest on the part of those persons who, directly or indirectly, owned the corporation prior to its division. (Treas. Reg. § 1.355-29c). In this case the ownership of [redacted] essentially remained the same. No sales or exchanges of [redacted] stock has occurred. As a result, the continuity of interest requirement has been met.

Conclusion

In this instance it appears that both the first distribution and the second distribution meet all of the requirements of section 355. Thus, the spin-off qualifies for tax free treatment pursuant to I.R.C. § 355(a).

Disclosure Statement

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse affect on privileges, such as the attorney client privilege. If disclosure becomes necessary please contact this office for our views.

Please contact Edith Moates at (405) 297-4810 if you have any questions.

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