# Office of Chief Counsel Internal Revenue Service

# memorandum

CC:LM:NR:DAL:20KLPOSTF-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

subject:

Request for Advisory Opinion

Taxpayer:

Issue:

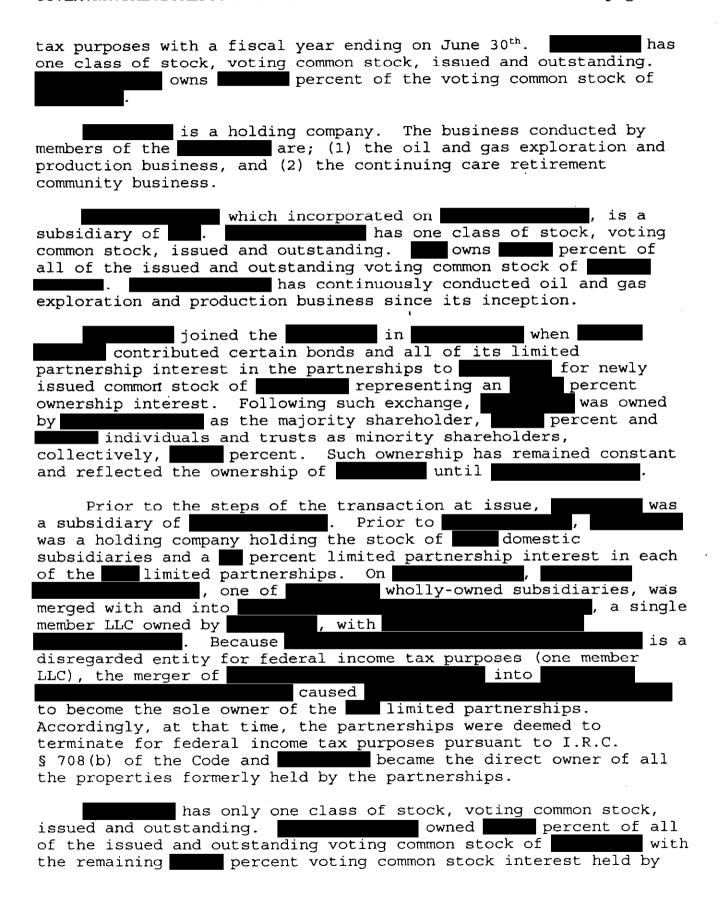
Section 355 Spin-off

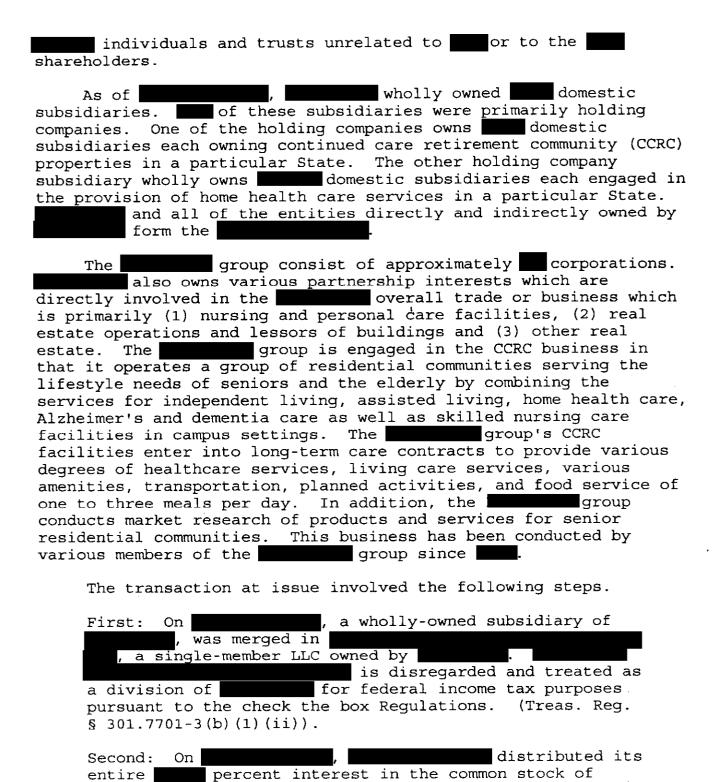
We are responding to your request for our advice on whether the two distributions from (hereinafter and by to the individual shareholders are tax-free distributions pursuant to I.R.C. § 355(a). This memorandum should not be cited as precedent. You specifically asked if the distributions would qualify 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.

### <u>Facts</u>

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





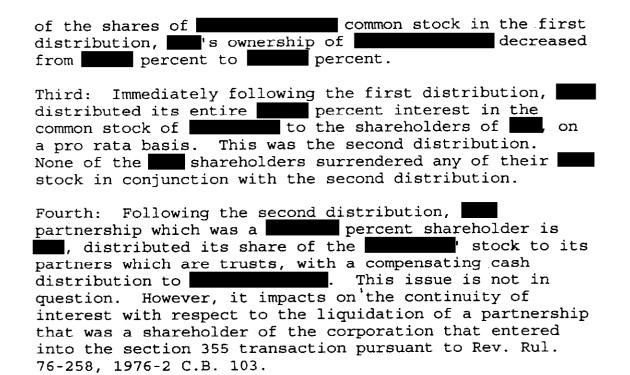
to , in exchange for

was the first distribution. As a result of the surrender

shares of its

surrendering

common stock.



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 <u>all</u> 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 approximately 84 percent of

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 distributed percent of the stock to and nothing to the other shareholders (primarily ). The second distribution was a pro rata distribution from 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.

was originally

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.

incorporated in Subsequently,
and were
incorporated in and , respectively. As a result,
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 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, has been in the oil and gas
exploration business for more than five years. Since,
acquired <u>in a non-taxable transaction</u> (section
351) and since certainentities as well as
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 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.

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 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 into bankruptcy. For this reason alone the separation of from the 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 essentially remained the same. No sales or exchanges of 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.

MARK A. O'LEARY (Group 2) Associate Area Counsel

EDITH F. MOATES

Senior Attorney