February 14, 2002

The "Device" Test for Spinoffs Under Section 355

By: Elliot Pisem and David E. Kahen

Section 355 of the Internal Revenue Code permits a corporation under certain circumstances to engage in a divisive, or "spinoff," transaction without the imposition of tax at either the corporate level (to reflect the unrealized appreciation in the assets or stock being distributed) or the shareholder level (to reflect receipt of what could otherwise be an ordinary taxable dividend).

Much of the recent discussion of nontaxable spinoffs under section 355 by practitioners and the Internal Revenue Service has focused on the interpretation of two relatively recent additions to section 355—subsections 355(d) and 355(e). These new provisions are intended to deny a portion of the benefit of section 355 to certain types of spinoffs, by requiring the recognition of gain at the corporate, though not at the shareholder, level.

The new provisions have not, however, supplanted other longstanding requirements under section 355, including the requirement set forth in section 355(a)(1)(B) that a spinoff not be used principally as a device for the distribution of earnings and profits ("E&P"). A major purpose of the device test is to prevent section 355 from being used to avoid the dividend provisions of the Code through transactions involving a distribution of stock followed by a sale of the stock of either the distributing or the controlled corporation (the stock of which was distributed in the spinoff). If a spinoff is used as a "device," the transaction is taxable both to the distributing corporation and to its shareholders.

The current regulations under section 355 regarding the device test were issued in 1989, but there exists little subsequent authority interpreting or applying the device test as set forth in those regulations. In the recent Tax Court decision of *South Tulsa Pathology Laboratory, Inc. v. Commissioner* (118 T.C. No. 5, Jan. 28, 2002), the device test was addressed and evidence of the existence of a device was held to preclude treatment of a spinoff as nontaxable under section 355.

Facts in South Tulsa

The petitioner, South Tulsa Pathology Laboratory, Inc. ("South Tulsa") was an Oklahoma professional corporation incorporated in 1968. South Tulsa was owned by seven physicians and provided two types of pathology services. "Anatomic" pathology services were performed by the physician shareholders and other physicians, while clinical pathology services were provided by non-physician employees of the petitioner.

South Tulsa received over the years several offers, that had been rejected, to purchase its clinical business. In 1993, however, the petitioner's shareholders concluded that the growth of large national clinical laboratories and the implementation of managed health care would ultimately preclude their continuation of the clinical pathology business, and decided to sell that business while retaining the anatomic pathology business.

After being approached in August 1993 by two bidders, South Tulsa decided to sell the clinical business to National Health Laboratories, Inc. ("NHL").

To effectuate the sale, South Tulsa and NHL agreed upon a plan whereby the clinical business would be transferred to a newly formed corporation, the new corporation would be spun off from South Tulsa, and the stock of the new corporation would then be sold to NHL. Consistent with this plan, Clinpath, Inc. ("Clinpath") was formed on October 5, 1993.

On October 29, South Tulsa and its shareholders entered into a reorganization agreement whereby the clinical laboratory assets would be transferred to Clinpath in exchange for its stock and the petitioner would distribute that stock to the shareholders of South Tulsa in proportion to their ownership of stock in South Tulsa. The clinical laboratory assets were transferred to Clinpath in exchange for its stock on the same day.

On October 30, the stock of Clinpath was distributed by South Tulsa to its shareholders. Immediately following the distribution, and pursuant to an acquisition agreement dated October 30, the Clinpath shares were sold to NHL for $5,530,000.

Separately, each of the shareholders of South Tulsa granted to NHL a 5-year covenant not to compete in the clinical business, in exchange for consideration of $10,000 per shareholder.

As of the beginning of the taxable year in which the spinoff occurred, South Tulsa had accumulated earnings and profits of at least $236,347.

Issues

The petitioner's position was that the transfer of property to Clinpath and the stock distribution was a nontaxable transaction under Code section 355 and that no gain was required to be recognized by reason of these transactions.

The Commissioner argued that the spinoff failed to qualify as a nontaxable distribution under section 355 because the distribution of the Clinpath stock was a device principally for the distribution of earnings and profits. The Commissioner also argued that two other requirements of section 355 were not met, in that the spinoff lacked an appropriate corporate business purpose and the prearranged sale of Clinpath stock deprived the transaction of the requisite continuity of proprietary interest.

If any of the above arguments prevailed, section 355 would not apply and South Tulsa would be required to recognize gain equal to the excess of the value of the Clinpath shares over South Tulsa's basis in those shares. (The shareholders of South Tulsa were not before the court, so there was no occasion to consider the effect of the Commissioner's contentions on their tax treatment.)

Analysis

The Tax Court opinion follows a method of analysis contemplated by the regulations under section 355. The opinion first considers whether certain factors listed in the regulations as indicative of a "device" were present, and then addresses whether the device factors present were outweighed by nondevice factors (also listed in the regulations).

Device factors. The two apparently relevant device factors were (i) whether the distribution was pro rata among shareholders and (ii) whether there was a sale of the stock of the distributing or the controlled corporation after the distribution, with a sale being stronger evidence of device to the extent that (a) a greater percentage of stock is sold, (b) the sale is proximate in time to the distribution and (c) the sale is negotiated or agreed upon prior to the distribution.

In *South Tulsa*, the distribution was made pro rata to the shareholders and 100% of the stock of Clinpath was sold immediately after the distribution, pursuant to terms negotiated before the distribution. Accordingly, the court readily concluded that there was substantial evidence of device.

Nondevice factors. The petitioner argued, however, that there was evidence of nondevice, in the form of a strong business purpose, that outweighed any evidence of device. Specifically, South Tulsa alleged three corporate business purposes for the distribution: (1) changing economic circumstances indicating that the clinical business could not be continued by a smaller operator such as the petitioner; (2) completion of the transaction as a sale of the stock of South Tulsa was precluded by provisions of state law that prohibited NHL from owning an interest in a professional corporation; and (3) the sale of the business was effected by the shareholders rather than by South Tulsa to ensure that the noncompetition covenants granted to NHL by the shareholders would be enforceable.

The Commissioner did not question the petitioner's assertion that the changing economic environment might have ultimately forced South Tulsa to terminate its clinical business. The court noted, however, that the sale could have been effected as a sale of assets (which, the opinion observes, was the form of acquisition generally preferred by NHL), or through a sale by South Tulsa of the stock of Clinpath, rather than through a distribution followed by a sale by the shareholders. Thus, the court concluded, the changing economic environment did not itself constitute a valid corporate business purpose for the distribution of stock.

The court went on to conclude that it saw no reason why Oklahoma's rules limiting the stock ownership of professional corporations would preclude a sale by South Tulsa of the clinical assets directly or through a sale of the stock of a subsidiary; and that the petitioner failed to demonstrate that the enforceability of the noncompetition covenants would have been jeopardized under state law if the sale were completed at the corporate level rather than by the shareholders. Thus, the court stated that there was no corporate business purpose sufficient to constitute evidence of nondevice.

Absence of E&P. Even where there is evidence of device, the regulations provide that certain distributions do not present a potential for tax avoidance by facilitating the avoidance of the dividend provisions of the Code, and therefore are ordinarily not considered to be used principally as a device. In particular, a distribution is ordinarily not a device where neither the distributing nor the controlled corporation have current or accumulated earnings and profits.

South Tulsa contended that it came within this exception, and specifically that the amount of E&P shown on the books of South Tulsa was not "meaningful" and was insufficient to support a conclusion that the transaction as a whole was implemented as a "bailout" of corporate earnings.

The Commissioner successfully contended, however, that the presence of any E&P prevented South Tulsa from relying on the provision in the regulations regarding the (in)applicability of the device test to corporations with no earnings and profits.

The court also noted that South Tulsa failed to establish that it did not have current E&P (that is, E&P attributable to the current taxable year) as of the date of the distribution; and that, if section 355 did not apply, a gain upon the distribution would have been recognized and thereby increase South Tulsa's E&P. Under the section 355 regulations, such *potential* earnings, although they would exist only if section 355 were inapplicable, can be taken into account in determining whether section 355 does or does not apply in the first instance, by means of the presumption against device characterization for corporations lacking E&P.

Taking into account the substantial evidence of device and the lack of substantial evidence of nondevice, the court concluded that the distribution failed to comply with the requirements of section 355(a)(1). Given this conclusion, the court did not address the other arguments raised by the Commissioner.

Observations

Under section 355(e) as enacted in 1997, a similar distribution today followed by a prearranged sale o f the distributed stock to an unrelated party would clearly result in the recognition of gain at the corporate level with respect to the distribution if the value of the stock distributed exceeded its basis, regardless of how the "device" issue was analyzed.

Section 355(e) does not, however, prevent a distribution of stock followed by a sale from qualifying as a nontaxable distribution at the shareholder level, if the other requirements of section 355 are met. Therefore, the "device" analysis will remain important in situations where, for example, taxpayers may be prepared to do without nonrecognition treatment at the corporate level and seek to rely upon section 355 to avoid or minimize shareholder tax liabilities.

Also, of course, there will be other situations to which section 355(e) may not apply where the other provisions of section 355, including the nondevice requirement, will continue to require evaluation to determine if a spinoff transaction followed, sooner or later, by a sale or exchange qualifies under section 355.