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How Not To Do A Section 355 Spinoff

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Hard lesson to learn. Even though many spinoffs have succeeded without prior IRS blessing, the double tax treatment that results if the deal fails muster is a risk. South Tulsa Pathology Laboratory learned this lesson the hard way. The IRS did not like the tax-free spinoff that it attempted in 1993, nor did the tax court. IRC Section 355 provides an often-used formula for a company to separate its components through a stock merger or spinoff. Most tax professionals agree that companies should apply for an IRS ruling prior to doing a Section 355 deal, but South Tulsa did not. It created a corporation, transferred the assets of its lab operations to the new entity, then spun off the shares to its shareholders, who immediately sold to a third party at a previously negotiated price and for a substantial gain. The IRS and the court saw this as nothing more than a mechanism for distributing earnings. Adding insult to injury, South Tulsa had claimed that the stock was worth one-fifth of the value for which it was sold.

Section 355 benchmarks. The South Tulsa failure was a hard lesson for its shareholders about the Section 355 requirements. The deal seemed to comply with the law because the assets were exchanged entirely for stock and the stock in the sub was later distributed. However, the court found it flawed in two ways: The distribution was principally a device for distributing the company's earnings and had no real business purpose other than saving taxes. South Tulsa argued that the gain could not be treated as a dividend since its accumulated earnings amounted to slightly over $200,000. The court rejected this argument, pointing out that the deal itself had added over $5 million to earnings, since it was a taxable event. The IRS won the point, asserting that the shareholders were trying to distribute future earnings.

Device argument faulty. Most tax-qualifying deals include a device for distributing earnings. The rather nebulous device point is difficult for the IRS to prove in many cases, since all Section 355 arrangements avoid taxation. The key provision is that the deal's principal purpose cannot be to save taxes. South Tulsa failed because the stock was distributed to shareholders pro rata (as a dividend would be) and the distributed stock was sold immediately after the distribution. Adding to the IRS contention, the sale had been prearranged. The court saw this as no different from the stock being sold directly to the shareholders. As a result, South Tulsa paid tax on the asset values in excess of their book value, and the shareholders were taxed on a dividend equal to the value of the entity spun off.

Not compelling. Often a spinoff with a strong business purpose can offset the IRS's device argument. Practitioners disagree on whether spinners are better served by arguing for one major business purpose or for several. South Tulsa gave three: competitive pressures; a state law preventing doctors from owning stock in a lab; and the buyer requiring the physicians to sign noncompete agreements. Although these arguments had some merit, none proved a compelling reason why the new company stock had to be distributed. The IRS would likely have made that point had South Tulsa requested a private ruling ahead of time. In the end, the company's experience is a lesson in how not to plan a spinoff.

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