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The Honorable Paul Sarbanes
United States Senate
Washington, D.C. 20510

Dear Senator Sarbanes:

This letter is in response to your May 10, 2001 inquiry on behalf of your constituent, [redacted]. [redacted] questioned the tax consequences of a stock distribution she and her husband received from [redacted].

The [redacted] bought the [redacted] stock in 1992, when the company owned a [redacted] interest in [redacted]. In 1997, the [redacted] stock was split 2 for 1. According to [redacted], this split resulted in reallocation of a portion of the original basis to the new shares. In May of 2000, [redacted] distributed all but [redacted] of the [redacted] stock to its shareholders. [redacted] told the [redacted] the [redacted] stock they received is considered a dividend for U.S. citizens in the amount of the value of the [redacted] stock on the date of the distribution. [redacted] also said Canadian citizens would face different tax consequences. [redacted] citizens' stock basis would be spread between the [redacted] stock and the [redacted] stock. [redacted] believes U.S. citizens are being discriminated against because their tax consequences differ from that of [redacted] citizens. She would like an explanation of why the spin-off of [redacted] stock is treated differently than the stock split of [redacted] stock.

The distribution of property, including cash, from a corporation to its shareholders is taxable in the amount of cash or fair market value of other property the shareholder received as a dividend in an amount no greater than the corporation's earnings and profits [Section 301(c)(1) of the Internal Revenue Code (the Code)]. The term property includes a corporation's stock if it is not the stock of the corporation making the distribution. In this case, [redacted] stock would not be property. Thus, the [redacted] stock would be property and the distribution of it is a dividend to the [redacted] shareholders, assuming [redacted] has sufficient earnings and profits. If [redacted] has insufficient earnings and profits, the amount by which the distribution exceeds the earnings and profits accumulated as of the end of the taxable year in which the distribution is made is applied against the adjusted basis of the [redacted] stock. Any excess is treated as gain from the sale or exchange of property. The fact that [redacted] is a [redacted] company does not change the treatment of the distribution as a dividend to its United States shareholders.

The most significant exception to this rule is in section 355, which governs tax-free spin-offs. If a transaction qualifies as a tax-free spin-off, there is no immediate tax payable by the shareholders. They would spread the basis in the shares they previously held between those shares and the shares of the distributed company received in the spin-off. There are many complicated requirements, which must be satisfied to qualify under section 355. The most important requirement for the [redacted] is the corporation making the distribution must distribute at least 80% of its subsidiary's stock. Because [redacted] owned only [redacted] of [redacted]'s stock before the distribution, the distribution cannot qualify as a tax-free spin-off under section 355. No other provision in the Code or the Income Tax Regulations exempts the [redacted] from tax on the receipt of the [redacted] shares as a dividend.

The tax consequences of the distribution of the [redacted] stock are different from those of the stock split by [redacted] before the distribution of [redacted] stock. The tax consequences of a stock split are governed by section 305, which generally says stock of a corporation issued to its shareholders is not included in the shareholders' gross income. The basis of the old shares is spread between those shares and the new shares.

I hope this information is helpful. If you have any questions, please call me or Paula Hu-Pitzer (Identification Number 50-03517) at (202) 622-7550.

Sincerely,

Debra Carlisle,
Chief, Branch 5, CC:CORP