Section 355.—Distributions of Stock and Securities of a Controlled Corporation

26 CFR 1.355–2: Limitations.

Section 355; stock distribution. This ruling examines whether a distribution that is expected to increase aggregate stock value satisfies the business purpose requirement of section 355 of the Code when the increased value is expected to serve both a corporate business purpose and a shareholder purpose.

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ISSUE

Whether a distribution that is expected to cause the aggregate value of the stock of a distributing corporation and the stock of a controlled corporation to exceed the pre-distribution value of the distributing corporation's stock satisfies the corporate business purpose requirement of § 355 of the Internal Revenue Code and § 1.355–2(b) of the Income Tax Regulations when the increased value is expected to serve a corporate business purpose of either the distributing corporation or the controlled corporation (or both), even if it benefits the shareholders of the distributing corporation.

FACTS

D is a corporation that indirectly conducts Business 1 and Business 2 through its subsidiaries. Some subsidiaries engage only in Business 1 and others only in Business 2. D's common stock is widely held and publicly traded.

The two businesses attract different investors, some of which are averse to investing in D because of the presence of the other business. Therefore, D believes, and D's investment banker has advised D, that if each business were conducted in a separate and independent corporation, the stock of the two corporations likely would trade publicly for a higher price, in the aggregate, than the stock of D if it continued to represent an interest in both businesses. The expected increase in the aggregate trading price of the stock of D and C over the pre-distribution trading price of D would not, however, derive in any significant respect from any Federal tax advantage made available to either D or C by the transaction.

With the intent and expectation of increasing the aggregate trading price of the common stock representing Business 1 and Business 2, D transfers the subsidiaries that engage in Business 2 to a newly formed corporation, C, in exchange for all of the C stock and distributes the C stock to its common shareholders, *pro rata*. D's remaining subsidiaries will continue to conduct Business 1.

Increasing the aggregate trading price of the D and C common stock over the trading price of the pre-distribution D common stock is expected to confer a benefit to existing shareholders. In deciding whether to undertake the distribution, D's directors consider this expected benefit to the shareholders, as well as the expected benefits to the corporation described below. However, D's directors do not effect the distribution to facilitate any particular shareholder's disposition of the stock of either D or C.

Apart from the issue of whether the business purpose requirement of § 1.355–2(b) is satisfied, the distribution meets the requirements of §§ 368(a)(1)(D) and 355.

Situation 1. D uses equity-based incentives as a significant part of its program to compensate a significant number of employees of both Business 1 and Business 2. D's directors wish to enhance the value of employee compensation and have considered either granting additional equity-based incentives or making cash payments in lieu of additional equity incentives. However, granting additional equity-based incentives would unacceptably dilute D's existing shareholders' interests, and making cash payments would be unduly expensive. Therefore, D undertakes the separation of Business 2 from Business 1 with the expectation that its stock value will increase and such increase will enhance the value of its equity-based compensation, providing D with a real and substantial benefit.

Situation 2. As part of its overall strategic planning, D has expanded both Business 1 and Business 2 through acquisitions of assets and the stock of other corporations. In some of these acquisitions, D has used its stock, either in whole or in part, as consideration. D's directors expect to continue expanding Business 1 as appropriate acquisition opportunities are identified in the future. D expects to offer its common stock as consideration, either in whole or in part, in connection with future acquisitions. Therefore D undertakes the separation of Business 2 from Business 1 with the expectation that its stock value will increase and such increase may permit D to effect such acquisitions in a manner that preserves capital with significantly less dilution of the existing shareholders' interests, providing D with a real and substantial benefit.

LAW

Section 355 provides that if certain requirements are met, a corporation may distribute stock and securities in a controlled corporation to its shareholders and security holders without causing the distributees to recognize gain or loss.

In addition to the statutory requirements, the regulations provide that § 355 will apply to a transaction only if it is carried out for one or more corporate business purposes. Section 1.355–2(b)(1). 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. *Id.* A corporate business purpose is a real and substantial non-Federal tax purpose germane to the business of the distributing corporation, the controlled corporation, or the affiliated group (as defined in § 1.355–3(b)(4)(iv)) to which the distributing corporation belongs. Section 1.355–2(b)(2). The principal reason for the business purpose requirement is to provide nonrecognition treatment only to distributions that are incident to readjustments of corporate structures required by business exigencies and that effect only readjustments of continuing interests in property under modified corporate forms. Section 1.355–2(b)(1). If a corporate business purpose can be achieved through a nontaxable transaction that does not involve the distribution of stock of a controlled corporation and that is neither impractical nor unduly expensive, then the separation is not carried out for that corporate business purpose. Section 1.355–2(b)(3).

A shareholder purpose (for example, the personal planning purposes of a shareholder) is not a corporate business purpose. Section 1.355–2(b)(2). Depending upon the facts of a particular case, however, a shareholder purpose for a transaction may be so nearly coextensive with a corporate business purpose as to preclude any distinction between them. *Id.* In such a case, the transaction is carried out for one or more corporate business purposes. *Id.* A transaction motivated in substantial part by a corporate business purpose does not fail the business purpose requirement merely because it is motivated in part by non-Federal tax shareholder purposes. *See* § 1.355–2(b)(5), Example (2).

ANALYSIS

Situation 1. Because D believes that the increased value of its stock expected to result from the separation will enhance the value of its employee compensation, providing a real and substantial benefit to D, the distribution is motivated by a real and substantial non-Federal tax purpose germane to the business of D. Section 1.355–2(b)(1) and (2). Further, because this purpose cannot be achieved through another nontaxable transaction that is neither impractical nor unduly expensive, the distribution is carried out for a corporate business purpose. Section 1.355–2(b)(2) and (3). Although the increase in stock value is expected to benefit the shareholders by increasing the amount they would realize on a sale of their shares, this shareholder purpose is so nearly coextensive with the corporate business purpose as to preclude any distinction between them. Section 1.355–2(b)(2). Therefore, the distribution is treated as carried out for a corporate business purpose. *Id.*

Situation 2. Because D expects that the increased value of its stock expected to result from the separation may permit D to effect future acquisitions in a manner that preserves capital with significantly less dilution of the existing shareholders' interests, providing D with a real and substantial benefit, the distribution is motivated by a real and substantial non-Federal tax purpose germane to the business of D. Section 1.355–2(b)(1) and (2). Further, because this purpose cannot be achieved through another nontaxable transaction that is neither impractical nor unduly expensive, the distribution is carried out for a corporate business purpose. Section 1.355–2(b)(2) and (3). Although the increase in stock value is expected to benefit the shareholders by increasing the amount they would realize on a sale of their shares, this shareholder purpose is so nearly coextensive with the corporate business purpose as to preclude any distinction between them. Section 1.355–2(b)(2). Therefore, the distribution is treated as carried out for a corporate business purpose. *Id.*

HOLDING

A distribution that is expected to cause the aggregate value of the stock of a distributing corporation and the stock of a controlled corporation to exceed the pre-distribution value of the distributing corporation's stock satisfies the corporate business purpose requirement of § 355 and § 1.355–2(b) when the increased value is expected to serve a corporate business purpose of either the distributing corporation or the controlled corporation (or both), even if it benefits the shareholders of the distributing corporation.

DRAFTING INFORMATION

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