

Part I

Section 355.-- Distribution of Stock and Securities of a Controlled Corporation

26 CFR 1.355-2: Business Purpose

Rev. Rul. 2003-110

ISSUE

In determining whether a distribution of the stock of a controlled corporation satisfies the business purpose requirement of § 1.355-2(b) of the Income Tax Regulations that the distribution be motivated, in whole or substantial part, by one or more corporate business purposes, does the fact that § 355 of the Internal Revenue Code permits a distributing corporation to distribute the stock of a controlled corporation without recognition of gain present a potential for the avoidance of Federal taxes under § 1.355-2(b)?

FACTS

Distributing is a publicly traded corporation that conducts a pesticides business. Controlled, a wholly owned subsidiary of Distributing, conducts a baby foods business. The pesticides business formulates, manufactures, and markets pesticides for agricultural use. The baby foods business processes and markets baby foods.

A significant number of potential customers of the baby foods business refuse to buy from Controlled because of its affiliation with Distributing and its pesticides business. Distributing's management consultant has advised Distributing that separating Controlled from Distributing would relieve the baby foods business of the adverse market perception caused by its association with the pesticides business.

To solve the market perception problem, Distributing distributes the Controlled stock to Distributing's shareholders, pro rata. There is no other nontaxable solution to the problem. Sale of the Controlled stock by Distributing would have resulted in recognition of gain. Distributing's directors expect that the baby foods business will benefit in a real and substantial way from the improved market perception produced by the separation.

Apart from the issue of whether the business purpose requirement of § 1.355-2(b) is satisfied, the distribution of the Controlled stock meets all the requirements of § 355.

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 distributing corporation or the distributees to recognize gain or loss or include any amount in income.

To qualify as a distribution described in § 355, a distribution must, in addition to satisfying the statutory requirements of § 355, satisfy certain requirements in the regulations, including the business purpose requirement. Section 1.355-2(b)(1)

provides that a distribution must be motivated, in whole or substantial part, by one or more corporate business purposes. 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 to which the distributing corporation belongs. Section 1.355-2(b)(2). The potential for the avoidance of Federal taxes by the distributing or controlled corporation (or a corporation controlled by either) is relevant in determining the extent to which an existing corporate business purpose motivated the distribution. Section 1.355-2(b)(1). 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).

Section 355(c) provides that no gain or loss will be recognized by a corporation on any distribution to which § 355 (or so much of § 356 as relates to § 355) applies. See also § 361(c) (to the same effect if the distribution is pursuant to a plan of reorganization). Absent § 355, such a distribution would be subject to § 311(b), which provides that, if the fair market value of the distributed property exceeds its adjusted basis, then gain will be recognized by the distributing corporation as if the property had been sold to the distributee at its fair market value. Section 355(c)(3).

ANALYSIS

To satisfy the business purpose requirement, a distribution must be motivated, in whole or substantial part, by one or more corporate business purposes. Section 1.355-2(b)(1). The market perception business purpose motivates Distributing's directors to approve the distribution, there is no other nontaxable transaction that would solve the market perception problem, and it is expected that the baby foods business will benefit in a real and substantial way from the improved market perception produced by the separation.

Except as provided in § 355(d) and (e), the application of § 355(c) or § 361(c) to distributions that qualify under § 355 is part of the statutory scheme of § 355 and implicit in all such distributions. Accordingly, the fact that § 355 permits a distributing corporation to distribute the stock of a controlled corporation without the recognition of gain does not present a potential for the avoidance of Federal taxes under § 1.355-2(b).

This is further implied by § 1.355-2(b)(3), which provides that the business purpose requirement is not satisfied if the purpose can be achieved through a nontaxable alternative transaction. That is, the distributing corporation is entitled to reject a taxable disposition in favor of a tax-free distribution.

Therefore, although the distribution of Controlled stock results in the nonrecognition of gain that otherwise would be recognized under § 311(b) if § 355(c) did not apply, the distribution is motivated in whole by a real and substantial non-Federal tax purpose germane to the business of Distributing. Hence, the business purpose requirement of § 1.355-2(b) is satisfied.

HOLDING

In determining whether a distribution of the stock of a controlled corporation satisfies the business purpose requirement of § 1.355-2(b) that the distribution be motivated, in whole or substantial part, by one or more corporate business purposes, the fact that § 355 permits a distributing corporation to distribute the stock of a controlled corporation without recognition of gain does not present a potential for the avoidance of Federal taxes under § 1.355-2(b).

DRAFTING INFORMATION

The principal author of this revenue ruling is Wayne T. Murray of the Office of Associate Chief Counsel (Corporate). For further information regarding this revenue ruling contact Mr. Murray at (202) 622-7700 (not a toll-free call).