

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

26 CFR 1.355-2: Business purpose.

Section 355 management ruling. Where two different businesses operate within the same corporate group, and senior management wishes to focus on only one, the separation of the businesses to enable the management of each to concentrate on its own business satisfies the business purpose requirement of section 1.355-2(b) of the regulations.

ISSUE

Whether, in the situation described below, the distribution of the stock of a controlled corporation by a distributing corporation to enable the management of each corporation to concentrate on its own business satisfies the business purpose requirement of § 1.355-2(b) of the Income Tax Regulations.

FACTS

Distributing is a publicly traded corporation that conducts a software technology business. Controlled, a wholly owned subsidiary of Distributing, conducts a paper products business. One shareholder, who does not actively participate in the management or operations of Distributing or Controlled, owns eight percent of the outstanding Distributing stock.

The software business develops and markets software for various applications. It is a high-growth business that depends for its success on innovation and acquisitions of related businesses. It is the business around which Distributing originally developed and remains the core operation. The paper products business manufactures and distributes paper products. It was acquired five years ago to support the software business and is significantly smaller than the software business. The paper products business grows at a slow to moderate rate largely through increased efficiencies in productivity.

Distributing's senior management devotes more of its time to the software business because it believes that business presents better opportunities for growth. Indeed, it would like to concentrate solely on the software business but is prevented from doing so by the need to service the paper products business. The management of the paper products business, on the other hand, believes that the disproportionate attention paid the software business deprives the paper products business of the management resources needed for its full development.

To enable Distributing's senior management to concentrate on the software business and the management of the paper products business to concentrate on its own operation, Distributing distributes the

Controlled stock to Distributing's shareholders, *pro rata*. Because Distributing's senior management would have continued responsibility for the paper products business as long as Distributing owns a controlling interest in the stock of the corporation operating the paper products business, there is no other nontaxable transaction that would permit Distributing's senior management to concentrate on the software business and permit the paper products business to have a senior management that adequately serves that business. Distributing's directors and senior management expect that each business will benefit in a real and substantial way from the separation.

Following the distribution, no officer will serve both Distributing and Controlled. However, two of Distributing's eight directors will also serve on Controlled's six-person board. Director A will help with administrative aspects of the transition. His term will expire after two years, and he cannot seek reelection. Director B is recognized as an expert in corporate finance. His presence on the Controlled board is intended to reassure the financial markets by providing a sense of continuity. His term will expire after six years, at which time he may seek reelection. Both directors are officers of Distributing, but neither will be an officer or employee of Controlled.

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

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 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).

ANALYSIS

The distribution of Controlled stock by Distributing to Distributing's shareholders will enable Distributing's senior management to concentrate its efforts on the software business, which it believes presents better opportunities for growth, and allow the management of the paper products business to secure for that business the management resources needed for its full development. There is no other nontaxable transaction that would permit Distributing's senior management to concentrate on the software business and permit the paper products business to have a senior management that adequately serves that business, and it is expected that the separation of the two businesses will enhance the success of each business in a real and substantial way.

Although the continuing relationship between Distributing and Controlled evidenced by the two common directors appears inconsistent with the assertion that the software business and the paper products business require independent management teams, this relationship does not conflict with the business purpose for the separation. Director A will serve for only a short period and will further that purpose by aiding in the creation of two independently administered operations. Director B will assist the separation by calming market concerns that might

otherwise adversely affect one or both businesses. Further, the two directors together constitute only a minority of each board.

Hence, the distribution of Controlled stock by Distributing to Distributing's shareholders is motivated in whole or substantial part by a real and substantial non-federal tax purpose germane to the businesses of Distributing and Controlled and satisfies the corporate business purpose requirement of § 1.355-2(b).

HOLDING

In the situation described above, the distribution of the stock of a controlled corporation by a distributing corporation to enable the management of each corporation to concentrate on its own business satisfies the business purpose requirement of § 1.355-2(b).

DRAFTING INFORMATION

The principal author of this revenue ruling is Richard M. Heinecke of the Office of Associate Chief Counsel (Corporate). For further information regarding this revenue ruling, contact Mr. Heinecke at (202) 622-7930 (not a toll-free call).