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Requirements for Spinoff Transactions

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Section 355 of the Internal Revenue Code permits a corporation to distribute to its shareholders the stock of one or more of its subsidiaries (generally referred to below as "controlled corporations") without the recognition of gain by either the distributing corporation or its shareholders, if there is a corporate business purpose for the distribution and other specific requirements of section 355 are met.

The IRS has published several rulings this year regarding the requirements of section 355, in an effort to facilitate the completion of spinoff transactions without advance IRS review through the time-consuming private letter ruling process. The two most recent rulings relate to the requirement, not set forth in the statute but established by case law and by regulations under section 355, that a transaction must be motivated, in whole or substantial part, by a corporate business purpose in order to come within section 355.

Two other rulings, published earlier this year and also briefly discussed below, relate to the statutory requirement that, in general, each of the distributing corporation and controlled corporation be engaged, immediately following the distribution, in a trade or business that had been actively conducted for the 5-year period preceding the distribution.

Background

Section 355 will not apply to a transaction that lacks a corporate business purpose. Section 1.355-2(b)(2) of the regulations states that "[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."

Thus, a transaction motivated solely by a purpose to reduce Federal taxes will not qualify under section 355. Similarly, a transaction motivated solely by personal planning considerations of shareholders will not qualify.

Frequently, however, the distinction between a shareholder and corporate business purpose is not clear-cut, for example, in situations typically involving closely-held businesses. The management of business operations and planning for corporate growth in such corporations may be impeded if the principal shareholders and managers have different objectives and management styles or simply dislike each other.

The regulations under section 355 briefly acknowledge the difficulty in distinguishing between corporate and shareholder purposes in some circumstances, stating that "a shareholder purpose for a transaction may be so nearly coextensive with a corporate business purpose as to preclude any distinction between them." In such a case, the corporate business purpose requirement will be met. The IRS recently elaborated on this issue in a helpful way by ruling that a transaction motivated in large part by personal circumstances may nevertheless qualify as a spinoff.

Rev. Rul. 2003-52

In Rev. Rul. 2003-52, a corporation (X) engaged in two farming businesses -- growing grain, and breeding and raising livestock -- was owned equally by four shareholders: Father, Mother, Son, and Daughter. Son was more interested in the livestock business and Daughter more interested in the grain business, and they disagreed on issues relating to the future direction of the two businesses. In addition, Son disliked Daughter's husband (and vice-versa) for reasons unrelated to the farm business, and Father and Mother believed that having Son and Daughter continue in business together would lead to family discord.

In order to permit each of Son and Daughter to focus on management and business strategy for the business that each was more interested in, to improve "family harmony," and to accomplish estate planning objectives for the senior generation, X transferred the livestock business to a newly formed subsidiary (Y) and distributed half the stock of Y to Son in exchange for his stock in X. The balance of the Y stock was distributed by X to Father and Mother in exchange for half of their X stock. Father and Mother also amended their wills to provide that, upon their death, Son would receive stock in Y only, with Daughter receiving their X stock.

The ruling discusses the corporate business purpose requirement described in the section 355 regulations, and focuses in particular on an example in those regulations involving a corporation with two businesses (jewelry and furniture) and two shareholders (A and B). In the example, A, who is more interested and proficient in the furniture business, and B, who is more interested and proficient in the jewelry business, believe that operations of the two businesses will be enhanced if the businesses are separated and each of A and B focuses on the business in which he is more interested.

Accordingly, A and B decide to split up the two businesses through a distribution of the jewelry business. The example concludes that the distribution has a valid corporate business purpose.

The fact pattern in Rev. Rul. 2003-52 presented a more difficult case than the example in the regulations, in that the shareholder purposes were more distinct and arguably more numerous. Specifically, the transaction is described as fulfilling two shareholder purposes (estate planning, and promotion of family harmony) and one corporate purpose with personal aspects (to allow Son and Daughter to each apply a consistent business strategy to the business in which he or she is most interested). Nevertheless, the ruling concludes that the spinoff was motivated in substantial part by a business strategy purpose intended to benefit each business, and that this motivation is sufficient to meet section 355's corporate business purpose requirement.

Rev. Rul. 2003-55

Another recent ruling, Rev. Rul. 2003-55, concerns a different issue relating to corporate business purpose under section 355, namely, whether the business purpose requirement is satisfied if the transaction is motivated by an objective that, because of a change in circumstances, cannot be achieved after the distribution.

D, a public corporation, conducts two businesses (A and B) directly and a third business through "C," a subsidiary. C needs additional capital, and an investment banker advises D that this may be accomplished most efficiently by separating C from D, with C then making a public offering of its stock.

In reliance on the investment banker's advice, the stock of C is distributed by D to its shareholders, and C then prepares to issue additional stock in a public offering. Market conditions deteriorate unexpectedly, however, before the offering can be effected, and C and its advisors conclude that the offering should be postponed.

One year after the distribution, and at a time when market conditions continue to preclude a stock offering, C raises funds for its capital needs through a sale of debentures.

The ruling observes that the regulations do not require that the corporate business purpose motivating a spinoff be achieved; they merely require that, at the time of the distribution, the purpose exist and motivate the transaction in whole or in substantial part.

Thus, the IRS concluded, an unanticipated change in circumstances that prevents achievement of the ultimate purpose of the distribution should not preclude the satisfaction of the business purpose requirement at the time of the distribution. Therefore, the distribution by D in this case met the business purpose requirement.

The conclusion in the ruling that the business purpose requirement was satisfied seems obvious in light of the fundamental principle, almost universally applicable in federal tax contexts, that the tax treatment of a transaction is to be determined by reference to the facts and circumstances at the time of the transaction. The issuance of the ruling may suggest, however, that IRS auditors have argued (or, at a minimum, that practitioners are concerned that auditors would argue) that a transaction did not qualify under section 355 because a business purpose cited for the transaction was not ultimately attained.

While the ruling is helpful as far as it goes, in real life facts tend to be more complex and ambiguous, and contemporaneous and subsequent events may prompt the IRS to assert that the purported business purpose never, in fact, existed and that section 355 does not apply.

For example, what if D had reason to believe at the time of the distribution that market conditions might be about to decline, so that there was some doubt that a stock offering could actually be made at a reasonable valuation? Or what if C was spun off, but thereafter never got so far as to undertake significant preparation for a public offering, in light of declining market conditions? Or what if market conditions did not preclude a public stock offering by C, but simply made it less attractive than the debt alternative?

The specificity with which facts are set out in the ruling suggests that the IRS may sometimes cite failure to accomplish an alleged purpose for a spinoff, together with other circumstances, as evidence that such purpose was never truly a substantial motivating factor for the spinoff transaction. Thus, from a planning perspective, it remains prudent for taxpayers and their advisers to consider, in determining whether it is likely that the qualification of a transaction under section 355 will be challenged, the probability that a stated business purpose may not be achieved.

Five-Year Business Requirement

Two rulings earlier this year regarding the “active trade or business” requirement under section 355 are also noteworthy.

Section 355(b) requires that, in general, each of the distributing corporation and the controlled corporation be engaged, immediately after the distribution, in a trade or business actively conducted throughout the 5-year period ending on the date of the distribution (a “qualifying business”).

A common issue in this regard is whether a business, itself less than five years old, which is related to a qualifying business of the taxpayer can share the "5-year" history of the qualifying business for purposes of section 355, so that the newer business may be incorporated and then spun off on a nontaxable basis.

In Rev. Rul. 2003-18, the IRS concluded that the acquisition, by an auto dealer selling automobiles under one brand (X), of a franchise and related assets pertaining to a second automobile brand (Y), constituted an expansion of the dealer's existing business, because the two products were similar, the associated business activities were the same, and the Y brand business involved the use of experience and know-how already developed in selling the X brand automobiles. Therefore, brand Y was viewed as a qualifying business for purposes of a spinoff of the brand X assets that was effected only two years after the Y acquisition.

Rev. Rul. 2003-38 involved a corporation in the retail shoe store business for more than 5 years that launched a web site to sell shoes over the Internet. Two years after the launch of the web site, the site assets were transferred to a newly formed subsidiary that was then spun off. The IRS concluded that the web site business should be viewed as an expansion of the pre-existing retail store shoe business for section 355 purposes because of the similarities and relationships between the two businesses, notwithstanding that the web site involved know-how not associated with retail store operations, such as differing marketing strategies, distribution chains, and technological issues.

All of the rulings described above appear to be consistent with widely held views among tax practitioners as to the appropriate analysis with respect to the issues addressed in the rulings. Although they do not appear to contain any major surprises, the rulings should be welcomed as appearing to evidence an IRS objective of allaying some concerns relating to the qualification of relatively common spinoff transactions under section 355, and in that way reducing the tax burden of continuing to conduct business in corporate form.