Part I

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

26 CFR 1.355-2: Business Purpose

Rev. Rul. 2003-75

ISSUE

Whether, in the situation described below**,** the distribution of the stock of a controlled corporation to resolve a capital allocation problem between the distributing and controlled corporations 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 pharmaceuticals business. Controlled, a wholly owned subsidiary of Distributing, conducts a cosmetics business. One shareholder, who does not actively participate in the management or operations of Distributing or Controlled, owns six percent of the outstanding Distributing stock.

The pharmaceuticals business develops, manufactures, and markets specialty drugs. It is a high-margin business that emphasizes rapid growth through innovation. The cosmetics business develops, manufactures, and markets cosmetics. It is a low-margin business that grows at a moderate rate by increasing its productivity and market share. Both businesses require substantial capital for reinvestment and research and development.

Distributing does all of the borrowing for both Distributing and Controlled and makes all decisions regarding the allocation of capital spending between the pharmaceuticals and cosmetics businesses. Because Distributing's capital spending in recent years for both the pharmaceuticals and cosmetics businesses has outpaced internally generated cash flow from the businesses, it has had to limit total expenditures to maintain its credit ratings. Although the decisions reached by Distributing's senior management regarding the allocation of capital spending usually favor the pharmaceuticals business due to its higher rate of growth and profit margin, the competition for capital prevents both businesses from consistently pursuing development strategies that the management of each business believes are appropriate.

To eliminate this competition for capital, Distributing distributes the Controlled stock to Distributing's shareholders, pro rata. Because the total capital available to the two businesses would continue to be limited as long as the two businesses remained within the same corporate group, there is no other nontaxable transaction that would solve the competition problem. It is expected that both businesses will benefit from the separation, and that the cosmetics business will benefit in a real and substantial way as a result of increased control over its capital spending and direct access to the capital markets.

To facilitate the separation, Distributing and Controlled will enter into transitional agreements that relate to information technology, benefits administration, and accounting and tax matters. Other than the tax matters agreement, each agreement will terminate after two years absent extraordinary circumstances, in which case the affected agreement may be extended on arm's-length terms for a limited period. Following the separation, there will be no cross-guarantee or cross-collateralization of debt between Distributing and Controlled, and an arm's-length loan from Distributing to Controlled for working capital will have a term of two years.

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

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 operation of the pharmaceuticals business and the cosmetics business within the same corporate group causes capital allocation problems that prevent each business from pursuing the development strategies most appropriate to its operation. The separation of the two businesses is the only nontaxable transaction that will resolve these problems. It is expected that both businesses will benefit from the separation, and that the separation will enhance the success of the cosmetics business in a real and substantial way.

The limited continuing relationship between Distributing and Controlled evidenced by the various administrative agreements and the loan for working capital is not incompatible with the extent of separation contemplated by § 355. The administrative agreements, except for the tax matters agreement, and the loan are transitional and short-term, and all are designed to facilitate, rather than impede, the separation of the pharmaceuticals business from the cosmetics business.

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 business of 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 to resolve a capital allocation problem between the distributing and controlled corporations 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 Richard M. Heinecke on (202) 622-7930 (not a toll-free call).