

Part I

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

26 CFR 1.355-2(b): Independent Business Purpose.

Rev. Rul. 2003-52

ISSUE

Whether, in the situation described below, the distribution of the stock of a controlled corporation satisfies the business purpose requirement of § 1.355-2(b) of the Income Tax Regulations.

FACTS

Corporation X is a domestic corporation that has been engaged in the farming business for more than five years. The stock of X is owned 25 percent each by Father, age 68, Mother, age 67, Son, and Daughter. Although Father and Mother participate in some major management decisions, most of the management and all of the operational activities are performed by Son, Daughter, and several farmhands. The farm operation consists of breeding and raising livestock and growing grain.

Son and Daughter disagree over the appropriate future direction of X's farming business. Son wishes to expand the livestock business, but Daughter is opposed

because this would require substantial ² borrowing by X. Daughter would prefer to sell the livestock business and concentrate on the grain business. Despite the disagreement, the two siblings have cooperated on the operation of the farm in its historical manner without disruption. Nevertheless, it has prevented each sibling from developing, as he or she sees fit, the business in which he or she is most interested.

Having transferred most of the responsibility for running the farm to the children, Father and Mother remain neutral on the disagreement between their children. However, because of the disagreement, Father and Mother would prefer to bequeath separate interests in the farm business to their children.

For reasons unrelated to X's farm business, Son and Daughter's husband dislike each other. Although this has not impaired the farm's operation to date, Father and Mother believe that requiring Son and Daughter to run a single business together is likely to cause family discord over the long run.

To enable Son and Daughter each to devote his or her undivided attention to, and apply a consistent business strategy to, the farming business in which he or she is most interested, to further the estate planning goals of Father and Mother, and to promote family harmony, X transfers the livestock business to newly formed, wholly owned domestic corporation Y and distributes 50 percent of the Y stock to Son in exchange for all of his stock in X. X distributes the remaining Y stock equally to Father and Mother in exchange for half of their X stock. Going forward, Daughter will manage and operate X and have no stock interest in Y, and Son will manage and operate Y and have no stock interest in X. Father and Mother will also amend their wills to provide that Son and Daughter will inherit stock only in Y and X, respectively. After the distribution,

Father and Mother will still each own 25 percent of the outstanding stock of X and Y and will continue to participate in some major management decisions related to the business of each corporation.

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 §§ 368(a)(1)(D) and 355 of the Internal Revenue Code.

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). A shareholder purpose (for example, the personal planning purposes of a shareholder) is not a corporate business purpose. Id. 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. Preamble to the § 355 regulations, T.D. 8238, 1989-1 C.B. 92, 94.

In Example (2) of § 1.355-2(b)(5), Corporation X is engaged in two businesses: the manufacture and sale of furniture and the sale of jewelry. The businesses are of equal value. The outstanding stock of X is owned equally by unrelated individuals A and B. A is more interested in the furniture business, while B is more interested in the jewelry business. A and B decide to split up the businesses and go their separate ways. A and B expect that the operations of each business will be enhanced by the separation because each shareholder will be able to devote his undivided attention to the business in which he is more interested and more proficient. Accordingly, X transfers the jewelry business to new corporation Y and distributes the stock of Y to B in exchange for all of B's stock in X. The example concludes that the distribution is carried out for a corporate business purpose, notwithstanding that it is also carried out in part for shareholder purposes.

ANALYSIS

The disagreement of Son and Daughter over the farm's future direction has prevented each sibling from developing, as he or she sees fit, the business in which he or she is most interested. The distribution will eliminate this disagreement and allow each sibling to devote his or her undivided attention to, and apply a consistent business

strategy to, the farming business in which he or she is most interested, with the expectation that each business will benefit. Therefore, although the distribution is intended, in part, to further the personal estate planning of Father and Mother and to promote family harmony, it is motivated in substantial part by a real and substantial non-Federal tax purpose that is germane to the business of X. Hence, the business purpose requirement of § 1.355-2(b) is satisfied.

HOLDING

In the situation described above, the distribution of the stock of a controlled corporation satisfies the business purpose requirement of § 1.355-2(b).

DRAFTING INFORMATION

The principal author of this revenue ruling is Richard H. Cox of the Office of Associate Chief Counsel (Corporate). For further information regarding this revenue ruling, contact Mr. Cox on (202) 622-7790 (not a toll-free call).