

WHAT IS A CORPORATE BUSINESS PURPOSE FOR A TAX-FREE CORPORATE DIVISION?

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Since 2003, the Internal Revenue Service (“I.R.S.”) has stated that it will not issue rulings on certain specific technical requirements for a tax-free corporate division under Internal Revenue Code (“Code”) §355 – also known as a “spin-off” – including whether the transaction has a corporate business purpose requirement. Further, in 2013, the I.R.S. stated that it would stop issuing rulings on spin-off transactions altogether, except for transactions with one or more “significant issue.” According to the I.R.S., a significant issue is an issue of law, the resolution of which is not essentially free from doubt, and that is germane to determining the tax consequences of the transaction.

More recently, in Revenue Procedure 2015-43¹ and Revenue Procedure 2016-3,² the I.R.S. stated the “no-ruling” areas of spin-offs. Further, in Notice 2015-59,³ the I.R.S. discussed specific tax-free spin-off issues that it is studying and for which it is seeking public comments.

The limitations to the I.R.S.’s ruling policy for tax-free spin-offs has placed even more significance on the formal opinion of tax counsel.

CORPORATE BUSINESS PURPOSE DEFINED

A tax-free spin-off must be motivated, in whole or substantial part, by one or more “corporate business purposes.”⁴ A corporate business purpose is described in the Treasury Regulations as a real and substantial purpose germane to the business of the corporation.⁵ The corporate business purpose may be germane to the business of the distributing corporation, the controlled corporation, or the affiliated group.⁶ As discussed in more detail below, a corporate business purpose is not a shareholder’s business purpose.

The corporate business purpose requirement is intended to limit tax-free treatment to transactions in which the distributions are incident to readjustments of corporate structures required for business reasons and that result only in readjustments of continuing interests in property under modified corporate forms.⁷

A classic example of a corporate business purpose is the separation of two lines of

¹ Rev. Proc. 2015-43, 2015-40 I.R.B. 467, 9/14/2015.

² Rev. Proc. 2016-3, 2016-1 IRB 126, 12/31/2015.

³ Notice 2015-59, 2015-40 IRB 459, 9/14/2015.

⁴ Treas. Reg. §1.355-2(b)(1).

⁵ Treas. Reg. §1.355-2(b)(2).

⁶ *Id.*

⁷ Treas. Reg. §1.355-2(b)(1).

businesses held by one corporation. Suppose that Corporation X is owned by two shareholders, A and B, and operates two businesses of equal value: One business is the design, manufacture, and sale of jewelry (the “Jewelry Business”), and the other business involves the ownership and active management of residential rental property (the “Real Estate Business”). The shareholders are siblings who inherited equal ownership of the corporation from their parents. Shareholder A is passionate about the Jewelry Business. She studied jewelry design and has built a reputation as an admired and sought-after jewelry designer. Shareholder B has no interest or expertise in the Jewelry Business. She prefers working with people in the Real Estate Business. She has a good track record of identifying undervalued residential buildings in up-and-coming neighborhoods, renovating them and then renting the units as luxury apartments. A and B decide to split up the businesses of the Corporation X because it is anticipated that the value of each business will be enhanced by the separation, since each shareholder will be able to devote undivided attention to the business in which she is more interested and more proficient. Further, since the siblings do not generally get along well, the separation of the businesses will help promote family harmony. Accordingly, Corporation X transfers the Jewelry Business to new Corporation Y and distributes the Corporation Y stock to A in exchange for all of A’s stock in Corporation X. The spin-off has a corporate business purpose: namely, the separation of the business lines in order to improve the operations of each of the businesses.

Other examples of a corporate business purpose are (i) compliance with laws, including regulatory laws, such as a state-chartered bank required to divest itself of a subsidiary in the insurance business before it can merge with a Federally-chartered bank;⁸ (ii) improving the financial position of a company, such as a spin-off in which the distribution is intended to increase the amount of commercial credit that the distributing and controlled corporation can each attract;⁹ (iii) improving the public or market perception of business, such as a corporation’s spin off of a baby food business from its pesticide business to attract customers who have concerns about the pesticide business.¹⁰



A DISTRIBUTION MUST HAVE A BUSINESS PURPOSE

The distribution of the stock of the controlled corporation required in a spin-off must have a corporate business purpose as well.¹¹ That is, there must be a business purpose for the transaction to take the form of a distribution. Thus, in the above example, if the corporate business purpose for separating the business lines was, instead, to protect the Jewelry Business from the liability claims of the Real Estate Business, then the distribution of the Corporation Y stock to A would not have a business purpose. This is because the protection of the Jewelry Business is achieved as soon as Corporation X transfers the Jewelry Business to Corporation Y. The distribution of the Corporation Y stock is not necessary to carry out the business purpose.

⁸ *Commr. v. Morris*, 367 F.2d 794 (4th Cir. 1966).

⁹ Rev. Rul. 77-22, 1977-1 CB 91.

¹⁰ Rev. Rul. 2003-110, 2003-2 CB 1083.

¹¹ Treas. Reg. §1.355-2(b)(3).

SHAREHOLDER'S BUSINESS PURPOSE V. CORPORATE BUSINESS PURPOSE

A shareholder's business purpose is not a corporate business purpose. However, as illustrated in the example above, if the shareholder's business purpose is closely aligned with the corporate business purpose, the spin-off will be considered to have a corporate business purpose.

In another example, the I.R.S. ruled that a separation that was intended to increase the value of the stock of the distributing and controlled corporations was a corporate business purpose even though the shareholders' business purpose was certainly apparent in wanting to increase the value of their shares.¹²

"If the shareholder's business purpose is closely aligned with the corporate business purpose, the spin-off will be considered to have a corporate business purpose."

¹²

Rev. Rul. 2004-23, 2004-1 CB 585.