Part I

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

26 CFR 1.355-7: Recognition of Gain on Certain Distributions of Stock or Securities in Connection with an Acquisition.

Rev. Rul. 2005-65

ISSUE

Under the facts described below, is a distribution of a controlled corporation by a distributing corporation part of a plan pursuant to which one or more persons acquire stock in the distributing corporation under § 355(e) of the Internal Revenue Code and § 1.355-7 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. 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, and in light of the unavailability of nontaxable alternatives, Distributing decides and publicly announces that it intends to distribute all the stock of Controlled pro rata to Distributing's shareholders. It is expected that both businesses will benefit in a real and substantial way from the distribution. This business purpose is a corporate business purpose (within the meaning of § 1.355-2(b)). The distribution is substantially motivated by this business purpose, and not by a business purpose to facilitate an acquisition.

After the announcement but before the distribution, X, a widely held corporation that is engaged in the pharmaceuticals business, and Distributing begin discussions regarding an acquisition. There were no discussions between Distributing or Controlled and X or its shareholders regarding an acquisition or a distribution before the announcement. In addition, Distributing would have been able to continue the successful operation of its pharmaceuticals business without combining with X. During its negotiations with Distributing, X indicates that it favors the distribution. X merges into Distributing before the distribution but nothing in the merger agreement requires the distribution.

As a result of the merger, X's former shareholders receive 55 percent of Distributing's stock. In addition, X's chairman of the board and chief executive officer become the chairman of the board and chief executive officer, respectively, of Distributing. Six months after the merger, Distributing distributes the stock of Controlled pro rata in a distribution to which § 355 applies and to which § 355(d) does not apply. At the time of the distribution, the distribution continues to be substantially motivated by the business purpose of eliminating the competition for capital between the pharmaceuticals and cosmetics businesses.

LAW

Section 355(c) generally provides that no gain or loss is recognized to the distributing corporation on a distribution of stock in a controlled corporation to which § 355 (or so much of § 356 as relates to § 355) applies and which is not in pursuance of a plan of reorganization. Section 355(e) generally denies nonrecognition treatment under § 355(c) if the distribution is part of a plan (or series of related transactions) (a plan) pursuant to which one or more persons acquire directly or indirectly stock representing a 50-percent or greater interest in the distributing corporation or any controlled corporation.

Section 1.355-7(b)(1) provides that whether a distribution and an acquisition are part of a plan is determined based on all the facts and circumstances, including those set forth in § 1.355-7(b)(3) (plan factors) and (4) (non-plan factors). The weight to be given each of the facts and circumstances depends on the particular case. The determination does not depend on the relative number of plan factors compared to the number of non-plan factors that are present.

Section 1.355-7(b)(3)(iii) provides that, in the case of an acquisition (other than involving a public offering) before a distribution, if at some time during the two-year period ending on the date of the acquisition there were discussions by Distributing or Controlled with the acquirer regarding a distribution, such discussions tend to show that the distribution and the acquisition are part of a plan. The weight to be accorded this fact depends on the nature, extent, and timing of the discussions. In addition, the fact that the acquirer intends to cause a distribution and, immediately after the acquisition, can meaningfully participate in the decision regarding whether to make a distribution, tends to show that the distribution and the acquisition are part of a plan.

Section 1.355-7(b)(4)(iii) provides that, in the case of an acquisition (other than involving a public offering) before a distribution, the absence of discussions by Distributing or Controlled with the acquirer regarding a distribution during the two-year period ending on the date of the earlier to occur of the acquisition or the first public announcement regarding the distribution tends to show that the distribution and the acquisition are not part of a plan. However, this factor does not apply to an acquisition where the acquirer intends to cause a distribution and, immediately after the acquisition, can meaningfully participate in the decision regarding whether to make a distribution.

Section 1.355-7(b)(4)(v) provides that the fact that the distribution was motivated in whole or substantial part by a corporate business purpose (within the meaning of § 1.355-2(b)) other than a business purpose to facilitate the acquisition or a similar acquisition tends to show that the distribution and the acquisition are not part of a plan.

Section 1.355-7(b)(4)(vi) provides that the fact that the distribution would have occurred at approximately the same time and in similar form regardless of the acquisition or a similar acquisition tends to show that the distribution and the acquisition are not part of a plan.

Section 1.355-7(h)(6) provides that discussions with the acquirer generally include discussions with persons with the implicit permission of the acquirer.

Section 1.355-7(h)(9) provides that a corporation is treated as having the implicit permission of its shareholders when it engages in discussions.

ANALYSIS

Whether the X shareholders' acquisition of Distributing stock and Distributing's distribution of Controlled are part of a plan depends on all the facts and circumstances, including those described in § 1.355-7(b). The fact that Distributing discussed the distribution with X during the two-year period ending on the date of the acquisition tends to show that the distribution and the acquisition are part of a plan. See § 1.355-7(b)(3)(iii). In addition, X's shareholders may constitute acquirers who intend to cause a distribution and who, immediately after the acquisition, can meaningfully participate (through X's chairman of the board and chief executive officer who become D's chairman of the board and chief executive officer) in the decision regarding whether to distribute Controlled. See id. However, the fact that Distributing publicly announced the distribution before discussions with X regarding both an acquisition and a distribution began suggests that the plan factor in § 1.355-7(b)(3)(iii) should be accorded less weight than it would have been accorded had there been such discussions before the public announcement.

With respect to those factors that tend to show that the distribution and the acquisition are not part of a plan, the absence of discussions by Distributing or Controlled with X or its shareholders during the two-year period ending on the date of the public announcement regarding the distribution would tend to show that the distribution and the acquisition are not part of a plan only if X's shareholders are not acquirers who intend to cause a distribution and who, immediately after the acquisition, can meaningfully participate in the decision regarding whether to distribute Controlled. See § 1.355-7(b)(4)(iii). Because X's chairman of the board and chief executive officer become the chairman and chief executive officer, respectively, of Distributing, X's shareholders may have the ability to meaningfully participate in the decision whether to distribute Controlled. Therefore, the absence of discussions by Distributing or Controlled with X or its shareholders during the two-year period ending on the date of the public announcement regarding the distribution may not tend to show that the distribution and the acquisition are not part of a plan.

Nonetheless, the fact that the distribution was substantially motivated by a corporate business purpose (within the meaning of § 1.355-2(b)) other than a business purpose to facilitate the acquisition or a similar acquisition, and the fact that the distribution would have occurred at approximately the same time and in similar form regardless of the acquisition or a similar acquisition, tend to show that the distribution and the acquisition are not part of a plan. See § 1.355-7(b)(4)(v), (vi). The fact that the public announcement of the distribution preceded discussions by Distributing or Controlled with X or its shareholders, and the fact that Distributing's business would have continued to operate successfully even if the merger had not occurred, evidence that the distribution originally was not substantially motivated by a business purpose to facilitate the acquisition or a similar acquisition. Moreover, after the merger, Distributing continued to be substantially motivated by the same corporate business purpose (within the meaning of § 1.355-2(b)) other than a business purpose to facilitate the acquisition or a similar acquisition (§ 1.355-7(b)(4)(v)). In addition, the fact that Distributing decided to distribute Controlled and announced that decision before it began discussions with X regarding the combination suggests that the distribution would have occurred at approximately the same time and in similar form regardless of Distributing's combination with X and the corresponding acquisition of Distributing stock by the X shareholders.

Considering all the facts and circumstances, particularly the fact that the distribution was motivated by a corporate business purpose (within the meaning of § 1.355-2(b)) other than a business purpose to facilitate the acquisition or a similar acquisition, and the fact that the distribution would have occurred at approximately the same time and in similar form regardless of the acquisition or a similar acquisition, the acquisition and distribution are not part of a plan under § 355(e) and § 1.355-7(b).

HOLDING

Under the facts described above, the acquisition and the distribution are not part of a plan under § 355(e) and § 1.355-7(b).

DRAFTING INFORMATION

The principal author of this revenue ruling is Ross Poulsen of the Office of Associate Chief Counsel (Corporate). For further information regarding this revenue ruling, contact Mr. Poulsen at (202) 622-7770 (not a toll-free call).