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# Stock Value Increases

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In Revenue Ruling 2004-23, the IRS held that a corporate division intended to increase the combined value of the stock of the resulting two corporations over the value of the stock of the distributing corporation before the transaction was a sufficient business purpose to justify tax-free treatment when all the other requirements of tax law are met.

A corporate division may take various forms. For example, a “spinoff” is a transaction in which a parent corporation distributes the stock of a subsidiary to the parent’s shareholders with respect to their stock in the parent corporation. A “splitup” occurs when stock of a subsidiary is distributed to one set of shareholders in exchange for their stock in the parent and, as a result of the transaction, those shareholders own no stock in the parent and all of the stock of the former subsidiary.

In order for a corporate division to be free of tax to the parent corporation and its shareholders, it must meet the requirements expressly set out under Section 355 of the Internal Revenue Code of 1986, as amended, and the regulations thereunder. Among them is the requirement that the parent and the spun off entity must each be engaged directly or indirectly in an active business that has been in existence for at least five years and was not acquired during that period in a transaction in which gain or loss was recognized. The parent corporation must own at least 80% (“control”) of the stock of the subsidiary before its separation, and control must not have been acquired within the prior five years in a transaction in which gain or loss was recognized. All of the stock of the subsidiary must be distributed or, if all is not distributed, no less than control must be distributed (and the retention of any stock by the parent may have to be explained). Moreover, the division must not be used as a device for the distribution of the earnings of the parent.

In addition to these statutory requirements, there is superimposed a requirement that the transaction be carried out for a significant corporate business purpose. A shareholder purpose is not generally regarded as a satisfactory corporate business purpose.

In the ruling situation, the parent, indirectly conducting two businesses, was advised by an investment banker that, on a separation of the businesses, the shares of the resulting two corporations would trade at a higher price than those of the parent prior to the corporate division. The IRS recognized that there would be a significant corporate business purpose in reducing dilution of its shares in a situation in which the parent had used equity-based compensation as incentives for its employees when to use cash would be too expensive. The IRS also found a significant business purpose in a situation in which the parent had made acquisitions using its stock to expand its businesses and had a strategic plan to continue that practice and, thus, higher prices for the stock would preserve capital. The fact that the division would create shareholder benefits would not invalidate the corporate business purpose.