

Section 355 reverse Morris trust. The acquisition by an unrelated corporation of all the assets of a newly formed controlled corporation following distribution of the controlled corporation's stock under section 355 will satisfy the "substantially all" requirement of section 368(a)(1)(C) even though the acquired assets represent only half of the assets held by the distributing corporation before it formed the controlled corporation.

Rev. Rul. 2003-79

ISSUE

Whether the acquisition by an unrelated corporation of all the assets of a newly formed controlled corporation following the distribution of the stock of the controlled corporation by a distributing corporation will satisfy the requirement of § 368(a)(1)(C) of the Internal Revenue Code that substantially all of the properties of the acquired corporation be acquired where the assets of the controlled corporation represent less than substantially all of the assets that the distributing corporation held before it formed the controlled corporation.

FACTS

D, a domestic corporation, directly conducts Business X and Business Y. D's assets are equally divided between the two businesses. A, a domestic corporation unrelated to D, conducts Business X and wishes to acquire D's Business X, but not D's Business Y.

To accomplish the acquisition, D and A agree to undertake the following steps in the following order: (i) D will transfer its Business X assets to C, a newly formed domestic corporation, in exchange for 100 percent of the stock of C, (ii) D will distribute the C stock to D's shareholders, (iii) A will acquire all the assets of C in exchange solely for voting stock of A, and (iv) C will liquidate. Apart from the question of whether the acquisition of C's assets by A will satisfy the requirement of § 368(a)(1)(C) that the acquiring corporation acquire substantially all of the properties of the acquired corporation, steps (i) and (ii) together meet all the requirements of § 368(a)(1)(D), step (ii) meets all the requirements of § 355(a), and steps (iii) and (iv) together meet all the requirements of § 368(a)(1)(C).

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 distributees to recognize gain or loss.

Section 368(a)(1)(C) defines a reorganization to include the acquisition by one corporation, in exchange solely for all or a part of its voting stock, of substantially all of the properties of another corporation.

Section 368(a)(1)(D) defines a reorganization to include a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor, or one or more of its shareholders (including persons who were shareholders immediately before the transfer), or any combination thereof, is in control of the corporation to which the assets are transferred; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction that qualifies under § 354, 355, or 356.

In *Helvering v. Elkhorn Coal Co.*, 95 F.2d 732 (4th Cir. 1937), *cert. denied*, 305 U.S. 605, *reh'g denied*, 305 U.S. 670 (1938), Elkhorn Coal, in anticipation of being acquired by Mill Creek, transferred part of its operating assets to a newly formed subsidiary and distributed the subsidiary's stock to Elkhorn Coal's shareholders. The court concluded that the distribution of subsidiary stock prevented the subsequent acquisition from qualifying under a predecessor of § 368(a)(1)(C) because, as a result of the distribution, Mill Creek did not acquire substantially all of Elkhorn Coal's historical assets.

In *Commissioner v. Mary Archer W. Morris Trust*, 367 F.2d 794 (4th Cir. 1966), *aff'g* 42 T.C. 779 (1964), the taxpayer, in anticipation of a merger with a national bank, contributed its insurance business to a new subsidiary and distributed the subsidiary's stock to its shareholders. The divestiture was necessary to comply with national banking laws. The court held that the distribution satisfied the requirements for nonrecognition under § 355(a) and, therefore, that the contribution qualified as a reorganization under § 368(a)(1)(D).

In Rev. Rul. 68-603, 1968-2 C.B. 148, the Internal Revenue Service announced that it would follow the decision in *Mary*

Archer W. Morris Trust to the extent it held that (1) the active business requirements of § 355(b)(1)(A) were satisfied even though the distributing corporation, immediately after the spin-off, merged into the unrelated acquiring corporation, (2) the control immediately after requirement of § 368(a)(1)(D) implies no limitation upon a reorganization of the transferor corporation (the distributing corporation) after the distribution of the stock of the controlled corporation, and (3) there was a business purpose for the spin-off and the merger.

Rev. Rul. 98–27, 1998–1 C.B. 1159, states that the Service will not apply any formulation of the step transaction doctrine to determine whether the distributed corporation was a controlled corporation immediately before a distribution under § 355(a) solely because of any post-distribution acquisition or restructuring of the distributed corporation, whether pre-arranged or not. The holding of Rev. Rul. 98–27 is based on § 1012(a) and § 1012(c) of the Taxpayer Relief Act of 1997 (the “1997 Act”), Pub. L. No. 105–34, 111 Stat. 788, 916–17. Section 1012(c) amended the control requirements of §§ 368(a)(1)(D) and 351 to provide that, generally for transactions seeking qualification after August 5, 1997, under either provision and § 355, the shareholders of the distributing corporation must own stock possessing more than 50 percent of the voting power and more than 50 percent of the total value of the controlled corporation's stock immediately after the distribution. See §§ 368(a)(2)(H) and 351(c). Section 1012(a) amended § 355 by adding subsection (e), which provides rules for the recognition of gain on certain distributions of stock or securities of a controlled corporation in connection with acquisitions of stock representing a 50 percent or greater interest in the distributing corporation or any controlled corporation.

The Conference Report accompanying the 1997 Act states, in part, that:

The . . . bill does not change the present-law requirement under section 355 that the distributing corporation must distribute 80 percent of the voting power and 80 percent of each other class of stock of the controlled corporation. It is expected that this requirement will be applied by the Internal Revenue

Service taking account of the provisions of the proposal regarding plans that permit certain types of planned restructuring of the distributing corporation following the distribution, and to treat similar restructurings of the controlled corporation in a similar manner. Thus, the 80-percent control requirement is expected to be administered in a manner that would prevent the tax-free spin-off of a less-than-80-percent controlled subsidiary, but would not generally impose additional restrictions on post-distribution restructurings of the controlled corporation if such restrictions would not apply to the distributing corporation.

H.R. Rep. No. 105–220, at 529–30 (1997); 1997–4 C.B. 1457, at 1999–2000.

Section 6010(c)(2) of the Internal Revenue Service Restructuring and Reform Act of 1998 (the “1998 Act”), P.L. 105–206, 1998–3 C.B. 145, amended § 1012(c) of the 1997 Act to provide that, in the case of a § 368(a)(1)(D) or § 351 transaction that is followed by a § 355 transaction, solely for purposes of determining the tax treatment of any transfer of property by the distributing corporation to the controlled corporation, the fact that the shareholders of the distributing corporation dispose of part or all of the controlled corporation's stock after the § 355 distribution shall not be taken into account in determining whether the control requirement of either § 368(a)(1)(D) or § 351 has been satisfied.

The Senate Report accompanying the 1998 Act contains three examples in which distributing corporation D transfers appreciated business X to newly created subsidiary C in exchange for at least 85 percent of the C stock and then distributes its C stock to the D shareholders. As part of the same plan, C then merges into unrelated acquiring corporation A. Each example concludes that if the distribution satisfies the requirements of § 355, the control immediately after requirement will be satisfied solely for purposes of determining the tax treatment of the transfer of business X by D to C. See S. Rep. No. 105–174, at 173–176 (1998); 1998–3 C.B. 537, at 709–712.

ANALYSIS

Section 1012 of the 1997 Act, as amended by § 6010(c) of the 1998 Act, evidences the intention of Congress that a corporation formed in connection with a distribution that qualifies for nonrecognition under § 355 will be respected as a separate corporation for purposes of determining (i) whether the corporation was a controlled corporation immediately before the distribution and (ii) whether a pre-distribution transfer of property to the controlled corporation satisfies the requirements of § 368(a)(1)(D) or § 351, even if a post-distribution restructuring causes the controlled corporation to cease to exist. See Rev. Rul. 98–44, 1998–2 C.B. 315; Rev. Rul. 98–27, *supra*; S. Rep. No. 105–174, *supra*. Therefore, the controlled corporation should also be considered independently from the distributing corporation in determining whether an acquisition of the controlled corporation will qualify as a reorganization under § 368. Accordingly, in determining under § 368(a)(1)(C) whether an acquiring corporation has acquired substantially all of the properties of a newly formed controlled corporation, reference should be made solely to the properties held by the controlled corporation immediately following the distributing corporation's transfer of properties to the controlled corporation, rather than to the properties held by the distributing corporation immediately before its formation of the controlled corporation.

Hence, the acquisition by A of all the properties held by C immediately after the distribution will satisfy the requirement of § 368(a)(1)(C) that A acquire substantially all the properties of C. This result obtains even though an acquisition by A of the same properties from D would have failed this requirement if D had retained Business X, contributed Business Y to C, and distributed the stock of C. See *Helvering v. Elkhorn Coal Co.*, *supra*.

HOLDING

The acquisition by an unrelated corporation of all the assets of a newly formed controlled corporation following the distribution of the stock of the controlled corporation by a distributing corporation will satisfy the requirement of

§ 368(a)(1)(C) that substantially all of the properties of the acquired corporation be acquired where the assets of the controlled corporation represent less than substantially all of the assets that the distributing corporation held before it formed the controlled corporation.

corporation following distribution of the controlled corporation's stock under section 355 will satisfy the "substantially all" requirement of section 368(a)(1)(C) even though the acquired assets represent only half of the assets held by the distributing corporation before it formed the controlled corporation. See Rev. Rul. 2003-79, page 80.

DRAFTING INFORMATION

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Section 368.—Definitions Relating to Corporate Reorganizations

26 CFR 1.368-2: Definition of terms.

Whether the acquisition by an unrelated corporation of all the assets of a newly formed controlled