Part I

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

IRC § 355: Distribution of Stock and Securities of a Controlled Corporation
(Also §§ 301; 351; 361; 368)

Rev. Rul. 2017-09

ISSUES

(1) If a parent corporation (*P*) transfers property (including property constituting an active trade or business that is transferred for the purpose of meeting the requirements of § 355(b)(1)(A) of the Internal Revenue Code (Code)), to its subsidiary (*D*), and if, pursuant to the same overall plan, this transfer is followed by a distribution by *D* of the stock of its controlled subsidiary (*C*) to *P*, are the transactions treated for federal income tax purposes as an exchange under § 351, followed by a distribution under § 355?

(2) Is a transfer of money or other property by *C* to *D*, made in pursuance of a plan of reorganization under §§ 368(a)(1)(D) and 355, governed by § 301 or § 361?

FACTS

<u>Situation 1:</u>

P owns all the stock of *D*, which owns all the stock of *C*. The fair market value of the *C* stock is $100X. *P* has been engaged in Business A for more than 5 years, and *C* has been engaged in Business B for more than 5 years. Business A and Business B each constitutes the active conduct of a trade or business within the meaning of § 355(b). *D* is not engaged in the active conduct of a trade or business, directly or through any member of its separate affiliated group (within the meaning of § 355(b)(3)) other than *C*.

On Date 1, *P* transfers the property and activities constituting Business A, having a fair market value of $25X, to *D* in exchange for additional shares of *D* stock. On Date 2, pursuant to a dividend declaration, *D* transfers all the *C* stock to *P* for a valid corporate business purpose. *D* retains the Business A property and continues the active conduct of Business A after the distribution. The purpose of *P*'s transfer of the property and activities of Business A to *D* is to allow *D* to satisfy the active trade or business requirement of § 355(b)(1)(A).

Situation 2:

P owns all the stock of *D*, which owns all the stock of *C*. *D* has been engaged in Business A for more than 5 years. *C* has been engaged in Business B for more than 5 years. Business A and Business B each constitutes the active conduct of a trade or business within the meaning of § 355(b).

On Date 1, *C* transfers $15X of money and property having a fair market value of $10X to *D*, pursuant to a dividend declaration, and *D* retains the money and property. On Date 2, *D* transfers to *C* property having a basis of $20X and a fair market value of $100X, and *D* distributes all the *C* stock to *P* in a transaction qualifying as a reorganization under

§§ 368(a)(1)(D) and 355. *C* and *D* planned and executed the Date 1 transfer in pursuance of the plan of reorganization.

LAW

Section 301(c)(1) provides that a distribution that is a dividend (as defined in § 316), made by a corporation to a shareholder with respect to its stock, will be includible in the gross income of the shareholder. Section 301(c)(2) provides that the portion of the distribution which is not a dividend will be applied against and reduce the adjusted basis of the stock. Section 301(c)(3) provides that the portion of the distribution which is not a dividend, to the extent that it exceeds the adjusted basis of the stock, will be treated as gain from the sale or exchange of property.

Section 311(b) provides in part that, if a corporation distributes appreciated property to a shareholder in a distribution to which § 301 applies, gain (but no loss) will be recognized to the distributing corporation as if it had sold the property to the shareholder at its fair market value.

Section 316 generally defines a dividend as any distribution of property made by a corporation to its shareholders out of its earnings and profits accumulated after February 28, 1913, or out of its earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any other distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

Section 351(a) provides that no gain or loss will be recognized when property is transferred to a corporation by one or more persons solely in exchange for stock in such

corporation and immediately after the exchange such person or persons are in control (as defined in § 368(c)) of the corporation.

Section 355(a)(1) provides that, if certain requirements are met, a corporation may distribute stock and securities of a controlled corporation to its shareholders and security holders without recognition of gain or loss (nonrecognition treatment) or income to the recipient shareholders or security holders.

Section 355(a)(1)(A) provides that, for a distribution to qualify for nonrecognition treatment, the distributing corporation must distribute stock or securities of a corporation it controls (as defined in § 368(c)) immediately before the distribution.

Section 355(a)(1)(D) provides in part that a distribution may qualify for nonrecognition treatment if the distributing corporation distributes an amount of stock in the controlled corporation constituting control within the meaning of § 368(c).

Section 355(b)(1)(A) provides that the distributing corporation and the controlled corporation each must be engaged in the active conduct of a trade or business immediately after the distribution.

Section 361(a) provides that no gain or loss will be recognized to a corporation a party to a reorganization upon exchange of property in pursuance of a plan of reorganization solely for stock or securities in another corporation a party to the reorganization.

Section 361(b) provides that, if § 361(a) would apply to an exchange of assets by a reorganizing corporation but for the fact that the property received in exchange consists not only of stock or securities of the acquiring corporation permitted by § 361(a) to be received without the recognition of gain, but also of other property or money, then (A) if the corporation

receiving that other property or money distributes it in pursuance of the plan of reorganization, no gain to the corporation will be recognized from the exchange, but (B) if the corporation receiving that other property or money does not distribute it in pursuance of the plan of reorganization, any gain that the corporation realizes on the exchange of its property will be recognized up to the sum of the money and the fair market value of the other property received that is not distributed.

Section 361(c)(2)(A) provides that, if the acquiring corporation distributes property other than qualified property (defined in § 361(c)(2)(B)), and the fair market value of such property exceeds its adjusted basis, then gain will be recognized as if such property were sold to the distributee at its fair market value.

Section 368(a)(1)(D) includes within the definition of "reorganization" a transfer by a corporation of part of its assets to another corporation if immediately after the transfer the transferor is in control of the corporation to which the assets are transferred and the transferor distributes the stock in a transaction that qualifies under § 354, § 355, or § 356.

Section 368(c) defines "control" as ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.

Section 1001(a) provides that the gain from the sale or other disposition of property will be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss will be the excess of the adjusted basis provided in such section for determining loss over the amount realized. Section 1001(c) provides that except as otherwise provided in subtitle A of the Code, the entire amount of the

gain or loss, determined under § 1001, on the sale or exchange of property will be recognized.

Section 1032(a) provides that no gain or loss will be recognized to a corporation on the receipt of money or other property in exchange for stock (including treasury stock) of such corporation.

Section 1.1002-1(c) provides, in part, with respect to §§ 351 and 361, that the underlying assumption of these exceptions to the recognition of gain or loss under § 1001 is that the new property is substantially a continuation of the old investment still unliquidated; and in the case of reorganizations, that the new enterprise, the new corporate structure, and the new property are substantially continuations of the old still unliquidated.

In Rev. Rul. 74-79, 1974-1 C.B. 81, the Internal Revenue Service (Service) ruled that § 355(b)(1)(A)'s requirement that the distributing corporation be engaged in an active trade or business was satisfied where the distributing corporation was an inactive holding company, and a subsidiary of the distributing corporation engaged in a § 332 liquidation for the purpose of transferring its active trade or business to the distributing corporation.

In Rev. Rul. 2003-51, 2003-1 C.B. 938, a person (transferor) transferred assets to a corporation (first corporation) in exchange for an amount of stock in the first corporation constituting control (first transfer). Pursuant to a binding agreement entered into by the transferor with a third party prior to the first transfer, (i) the transferor transferred the stock of the first corporation (second transfer) to another corporation (second corporation); (ii) the third party transferred money to the second corporation (third transfer); and (iii) the second corporation transferred the money transferred to it by the third party to its wholly-owned

subsidiary, the first corporation. Immediately after these transactions, the transferor and the third party were in control of the second corporation, and the second corporation was in control of the first corporation. The Service ruled that the first transfer satisfied the control requirement of § 351(a) notwithstanding the second transfer. The Service concluded that the second transfer, a nontaxable disposition of the stock received in the first transfer, was not inconsistent with the purposes of § 351 because the transaction lacked the characteristics of a sale and the transferor retained beneficial ownership in the assets transferred to the first corporation.

In Estates of Bell v. Comm'r, T.C.M. 1971-285, the Tax Court explained that sales of assets between a taxpayer's wholly-owned corporations followed by liquidating distributions "literally comply with the provisions of the Code dealing with complete liquidations, sections 331, 332, and 337, but *in substance* accomplish a reorganization coupled with the distribution of a dividend." (Emphasis added.) The court went on to state that, because § 356 is "the exclusive measure of dividend income provided by Congress where money is distributed to shareholders as an incident of a reorganization," § 301 and § 1.301-1(l) were not applicable to the acquisitive reorganization under § 368(a)(1)(D).

ANALYSIS

Situation 1: The federal income tax consequences to *P* and *D* in Situation 1 will depend on whether the Date 1 and Date 2 transfers are treated as separate transactions. Because they are undertaken pursuant to the same overall plan, a question arises as to whether the two transactions are part of a single reciprocal transfer of property—an exchange.

If the Date 1 and Date 2 transfers are respected as separate transactions for federal income tax purposes, *P* would be treated as transferring property to *D* on Date 1 for *D* stock in an exchange to which § 351 applies, and *D* would be treated as distributing all the stock of *C* to *P* on Date 2 in a distribution to which § 355 applies (assuming the requirements under those Code sections are otherwise satisfied).

If the Date 1 and Date 2 transfers are integrated into a single exchange for federal income tax purposes, *P* would be treated as transferring its Business A property to *D* in exchange for a portion of the *C* stock in an exchange to which § 1001 applies. In such an exchange, gain or loss would be recognized to *P* on the transfer of its property to *D*; gain or loss would be recognized to *D*, under § 1001(a), upon its transfer of 25 percent of the *C* stock to *P* in exchange for the property transferred to it. In addition, § 355 would not apply to any part of the distribution of *C* stock because *D* would not have distributed stock constituting § 368(c) control of *C*. Gain would be recognized to *D*, under § 311(b), upon the distribution of the remaining 75 percent of the *C* stock with respect to *P*'s stock in *D* to which § 301 would apply.

The determination of whether steps of a transaction should be integrated requires review of the scope and intent underlying each of the implicated provisions of the Code. The tax treatment of a transaction generally follows the taxpayer's chosen form unless: (1) there is a compelling alternative policy; (2) the effect of all or part of the steps of the transaction is to avoid a particular result intended by otherwise-applicable Code provisions; or (3) the effect of all or part of the steps of the transaction is inconsistent with the underlying intent of the applicable Code provisions. See H.B. Zachry Co. v. Comm'r, 49 T.C. 73 (1967); Makover v.

Comm'r, T.C. Memo 1967-53; Rev. Rul. 78-330, 1978-2 C.B. 147. Sections 351, 355, and 368 generally allow continued ownership of property in modified corporate form without recognition of gain. See American Compress & Warehouse Co. v. Bender, 70 F.2d 655 (5th Cir. 1934), cert. denied, 293 U.S. 607 (1934); § 1.1002-1(c); Rev. Rul. 2003-51.

Section 355(b)(2)(C) and (D) permit the direct and indirect acquisition of an active trade or business by a corporation within the 5-year period ending on the date of a distribution in transactions in which no gain or loss was recognized. The intent of § 355(b)(2)(C) and (D) is to prevent the acquisition of a trade or business by the distributing corporation or the controlled corporation from an outside party in a taxable transaction within the 5-year pre-distribution period. See Rev. Rul. 78-442, 1978-2 C.B. 143 (holding that § 357(c) gain arising from a § 351 transfer of an active trade or business does not violate § 355(b)(2)(C)). These provisions ensure that transfers of assets in transactions eligible for nonrecognition treatment (nonrecognition transactions) throughout the 5-year period will not adversely impact an otherwise qualifying § 355 distribution. This principle is illustrated in Rev. Rul. 74-79, in which an active trade or business was transferred to a distributing corporation in a § 332 liquidation to satisfy the requirements of § 355(b).

The transfer of property permitted to be received by *D* in a nonrecognition transaction has independent significance when undertaken in contemplation of a distribution by *D* of stock and securities described in § 355(a)(1)(A). The transfer thus is respected as a separate transaction, regardless of whether the purpose of the transfer is to qualify the distribution under § 355(b). See, e.g., Rev. Rul. 78-330; § 1.355-6(d)(3)(v)(B), Example 1; and Athanasios v. Comm'r, T.C. Memo 1995-72. Back-to-back nonrecognition transfers are

generally respected when consistent with the underlying intent of the applicable Code provisions and there is no compelling alternative policy. See, e.g., Rev. Rul. 2015-9, 2015-21 I.R.B. 972, and Rev. Rul. 2015-10, 2015-21 I.R.B. 973.

P's transfer on Date 1 is the type of transaction to which § 351 is intended to apply. Analysis of the transaction as a whole does not indicate that *P's* transfer should be properly treated other than in accordance with its form. Each step provides for continued ownership in modified corporate form. Additionally, the steps do not resemble a sale, and none of the interests are liquidated or otherwise redeemed. On these facts, nonrecognition treatment under §§ 351 and 355 is not inconsistent with the congressional intent of these Code provisions. The effect of the steps in Situation 1 is consistent with the policies underlying §§ 351 and 355. Accordingly, the Date 1 and Date 2 transfers described in Situation 1 will be respected as separate transactions for federal income tax purposes. Therefore, § 351 applies to *P's* transfer on Date 1 and § 355 applies to *D*'s transfer on Date 2.

The federal income tax consequences would be the same (qualification under § 355) if, instead of acquiring an active trade or business in a § 351 transfer from *P* to *D*, *D* acquired an active trade or business from a subsidiary of *P* in a cross-chain reorganization under § 368(a)(1). See Rev. Rul. 74-79.

Situation 2: If the distribution by *C* of money and other property on Date 1 is treated as separate from the distribution of *C* stock, § 301 would apply to *D*'s receipt of the money and other property from *C*, and no gain would be recognized to *D* upon the transfer of property to *C*.

If the Date 1 distribution is treated as made in pursuance of the plan of reorganization under §§ 368(a)(1)(D) and 355 that includes the Date 2 distribution of *C* stock, the money and other property distributed by *C* to *D* would constitute boot to *D*, and, under § 361(b)(1)(B), gain would be recognized to *D* on its transfer of property to *C* to the extent of the amount of the money and the fair market value of the property. Section 361(b) requires gain recognition to *D* if boot is distributed to *D* and not further distributed by *D* to its shareholders or creditors in pursuance of the plan of reorganization unless the facts establish that the distribution is in substance a separate transaction. Cf., Rev. Rul. 71-364, 1971-2 C.B. 182 (finding that a distribution of money declared and paid following a reorganization exchange is treated as boot in the reorganization).

As noted above, in Estates of Bell v. Comm'r, the Tax Court explained that the boot rules are "the exclusive measure of dividend income provided by Congress where cash is distributed to shareholders as an incident of a reorganization." See also American Manufacturing. Co. v. Comm'r, 55 T.C. 204 (1970). Section 361 broadly looks to whether transfers of money or other property occur "in pursuance of the plan of reorganization" or "in connection with the reorganization."

In Situation 2, the distribution is made in pursuance of the plan of reorganization. A distribution of money and other property in pursuance of the plan of reorganization will be treated as boot subject to recognition of gain, consistent with the congressional intent underlying § 361.

Therefore, the federal income tax treatment of the transaction will follow its substance, and the distribution of money and property by *C* to *D* will constitute a distribution of boot under § 361(b).

HOLDINGS

(1) In Situation 1, the transfer by *P* to its subsidiary, *D*, of property (including a transfer of property constituting an active trade or business for the purpose of meeting the requirements of § 355(b)(1)(A)), immediately followed by the distribution by *D* to *P* of the stock of its controlled subsidiary, *C*, is treated as an exchange to which § 351 applies, followed by a distribution of *C* stock to which § 355 applies.

(2) In Situation 2, § 361, and not § 301, applies to the transfer of money or other property by *C* to *D* made in pursuance of the plan of reorganization under §§ 368(a)(1)(D) and 355.

EFFECT ON OTHER DOCUMENTS

Rev. Proc. 2017-3, 2017-1 I.R.B. 130, is modified by deleting section 5.02 (with respect to steps in North-South transactions). However, the Service may decline to issue a letter ruling addressing the integration of steps when appropriate in the interest of sound tax administration or on other grounds when warranted by the facts or circumstances of a particular case. There are also areas in which the Service will not issue letter rulings or determination letters because the issues are inherently factual, in the interest of sound tax administration, and other reasons. See Rev. Proc. 2017-1, 2017-1 I.R.B. 1, section 6.02; Rev. Proc. 2017-3, sections 2.01 and 3.01(51).

DRAFTING INFORMATION

The principal author of this revenue ruling is Susan E. Massey of the Office of Associate Chief Counsel (Corporate). For further information regarding this revenue ruling, contact Susan E. Massey at (202) 317-5024 (not a toll-free call).