

26 CFR 601.105: Examination of returns and claims for refund, credit or abatement;
determination of tax liability
(Also: Part I §§ 355, 1.355-1

Rev. Proc. 2016-40

SECTION 1. PURPOSE

This revenue procedure provides fact patterns (safe harbors) in which the Internal Revenue Service (IRS) will not assert that a distributing corporation, D, lacks control of another corporation, C, within the meaning of § 355(a)(1)(A) of the Internal Revenue Code (Code), even though D and C engage in a transaction described in sections 3 and 4 of this revenue procedure.

SECTION 2. BACKGROUND

.01 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 by the shareholders or security holders.

.02 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 (the controlled corporation) it controls immediately before the distribution. For this purpose, “control” is defined by cross-reference to § 368(c) 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 each other class of stock of the corporation.

.03 In Rev. Rul. 56-117, 1956-1 C.B. 180, corporation M owned all of the voting common stock and 12 percent of the non-voting preferred stock of corporation N. Disputes arose among the M shareholders, and it was decided that M would distribute its N stock to one group of M shareholders (the departing shareholders) in exchange for all their M stock. To qualify N as a controlled corporation for purposes of § 355(a)(1)(A), N issued shares of voting common stock to the preferred shareholders other than M, in exchange for all their non-voting preferred shares in a recapitalization within the meaning of § 368(a)(1)(E). After the recapitalization, M owned 93 percent of the outstanding N voting common stock and all of the outstanding N nonvoting preferred stock. M then distributed all of its common and preferred N stock to the departing shareholders in exchange for all their M stock. After the distribution, the departing shareholders controlled N, and N’s business was carried on under their management. The ruling holds that, under § 355(a)(1), no gain or loss was recognized to the departing shareholders upon their receipt of N stock.

.04 In Rev. Rul. 63-260, 1963-2 C.B. 147, A owned all the stock of corporation X, which owned 70 shares of the stock of corporation Y. A also owned the remaining 30 shares of Y stock. A contributed 10 shares of his Y stock to X, and, immediately

thereafter, X distributed all of its 80 shares of Y stock to A. The ruling holds that the distribution did not qualify under § 355, because X, the distributing corporation, did not have control of Y immediately before the distribution except in a transitory and illusory sense.

.05 In Rev. Rul. 69-407, 1969-2 C.B. 50, corporation X owned 70 percent, and A and B owned the remaining 30 percent, of the single outstanding class of stock of corporation Y. In exchange for the surrender of all the Y stock, Y issued Class A voting stock to A and B and Class B voting stock to X. The Class A stock issued to A and B represented 20 percent, and the Class B stock issued to X represented 80 percent, of the total combined voting power of all classes of Y voting stock. The exchange qualified as a recapitalization under § 368(a)(1)(E). Following the recapitalization, X distributed all of the Class B stock to its shareholders. The ruling holds that, immediately prior to the distribution, X had control of Y, and that, under § 355, no gain or loss was recognized to X's shareholders on the distribution to them of the Y stock. The transaction was distinguished from the transaction described in Rev. Rul. 63-260, because the recapitalization resulted in a permanent realignment of voting control.

.06 Rev. Rul. 98-27, 1998-1 C.B. 1159, states that the IRS will not apply Commissioner v. Court Holding Co., 324 U.S. 331 (1945) (or 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 prearranged or not. The ruling also states that, otherwise, in applying the step transaction doctrine, all facts and circumstances will be considered (citing Rev. Rul. 63-

260, 1963-2 C.B. 147), and an independent shareholder vote is only one relevant factor.

.07 Rev. Rul. 98-27 is based, in part, on § 1012(c) of the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788, 916-17, which added § 355(e) to the Code. Under § 355(e), gain is recognized to the distributing corporation on a distribution of stock or securities of a controlled corporation in connection with a planned acquisition of stock representing a 50-percent or greater interest, by vote or value, in the distributing corporation or the controlled corporation. The Conference Report accompanying the legislation states in part:

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 [T]he 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.

.08 As illustrated in Rev. Rul. 56-117 and Rev. Rul. 69-407, the control requirement of § 355(a)(1)(A) may be satisfied by an acquisition of control that occurs immediately before a distribution for the purpose of qualifying the distribution under § 355. However, as illustrated in Rev. Rul. 63-260, an acquisition of control by the distributing corporation is not respected for purposes of § 355(a)(1)(A) if it is transitory or illusory. The acquisition of control must have substance under general federal tax principles.

.09 Although the § 355(e) legislative history states, and Rev. Rul. 98-27 provides, that post-distribution events are not to be taken into account in determining whether a distributing corporation has control of the distributed corporation, this interpretation of § 355 applies only after it has been determined that, at the time of the distribution, the

distributing corporation otherwise had control of the distributed corporation in substance. Thus, the § 355(e) legislative history and Rev. Rul. 98-27 do not prevent the step transaction doctrine from applying to determine if, taking into account all facts and circumstances (including post-distribution events), a pre-distribution acquisition of control has substance such that a distributing corporation has control of a corporation within the meaning of § 355(a)(1)(A) immediately prior to a distribution of the stock of that corporation.

.10 The Treasury Department and the IRS recognize that determining whether an acquisition of control has substance for federal tax purposes can be difficult and fact-intensive. The Treasury Department and the IRS are concerned that, in some cases, taxpayers may not be able to determine whether such an acquisition has substance with sufficient certainty to proceed with transactions that otherwise satisfy the requirements of § 355. To resolve this uncertainty, the Treasury Department and the IRS are describing transactions in which the IRS will not assert that an acquisition of control lacks substance.

SECTION 3. TRANSACTIONS TO WHICH THIS REVENUE PROCEDURE APPLIES

This revenue procedure applies to transactions in which--

- (1) D owns C stock not constituting control of C;
- (2) C issues shares of one or more classes of stock to D and/or to other shareholders of C (the issuance), as a result of which D owns C stock possessing at least 80 percent of the total combined voting power of all classes of C stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of C;

(3) D distributes its C stock in a transaction that otherwise qualifies under § 355 (the distribution); and

(4) C subsequently engages in a transaction that, actually or in effect, substantially restores (a) C's shareholders to the relative interests, direct or indirect, they would have held in C (or a successor to C) had the issuance not occurred; and/or (b) the relative voting rights and value of the C classes of stock that were present prior to the issuance (an unwind).

SECTION 4. SAFE HARBORS

The IRS will not assert that a transaction described in section 3 of this revenue procedure lacks substance, and that therefore D lacked control of C immediately before the distribution, within the meaning of § 355(a)(1)(A) of the Code, if the transaction is also described in one of the following safe harbors:

.01 No Action Taken Within 24 Months. No action is taken (including the adoption of any plan or policy), at any time prior to 24 months after the distribution, by C's board of directors, C's management, or any of C's controlling shareholders (as defined in § 1.355-7(h)(3)) that would (if implemented) actually or effectively result in an unwind.

.02 Unanticipated Third Party Transaction. C engages in a transaction with one or more persons (for example, a merger of C with another corporation) that results in an unwind, regardless of whether the transaction takes place more or less than 24 months after the distribution, provided that--

(1) There is no agreement, understanding, arrangement, or substantial negotiations (within the meaning of § 1.355-7(h)(1)) or discussions (within the meaning of § 1.355-7(h)(6)) concerning the transaction or a similar transaction (applying the

principles of § 1.355-7(h)(12) and (13), relating to similar acquisitions), at any time during the 24-month period ending on the date of the distribution; and

(2) No more than 20 percent of the interest in the other party, in vote or value, is owned by the same persons that own more than 20 percent in vote or value of the stock of C. For purposes of the preceding sentence, ownership is determined by application of the constructive ownership rules of § 318(a) as modified by § 304(c)(3), except that for purposes of applying § 318(a)(3)(A) and (B), the principles of § 304(c)(3)(B)(ii) (without regard to § 304(c)(3)(B)(ii)(I)) apply. In the case of a corporation the stock of which is listed on an established market (within the meaning of § 1.355-7(h)(7)), the persons referred to in the first sentence of this section 4.02(2) are limited to controlling shareholders (within the meaning of § 1.355-7(h)(3)(i), taking into account § 1.355-7(h)(8) but without regard to whether stock of a corporation is transferred) and ten-percent shareholders (within the meaning of § 1.355-7(h)(14) but without regard to the second sentence thereof or whether stock of a corporation is transferred).

SECTION 5. SCOPE AND EFFECT OF REVENUE PROCEDURE

.01 Exclusivity. The safe harbors provided in section 4 of this revenue procedure apply solely to determine whether an acquisition of control has substance for purposes of § 355(a)(1)(A). Further, they apply only to transactions described in section 3 of this revenue procedure. No inference should be drawn from this revenue procedure regarding the application of any federal tax principles outside the scope of this revenue procedure.

.02 Effect of Safe Harbor Not Applying. If a transaction is not described in one of the safe harbors in section 4 of this revenue procedure, this revenue procedure has no

effect on the determination of the federal tax treatment of the transaction. Rather, in such cases, the determination of whether an acquisition of control has substance and is therefore respected for purposes of § 355(a)(1)(A), and the proper treatment of all related transactions entered into by or between the parties, will be made under general federal tax principles without regard to the provisions of this revenue procedure.

SECTION 6. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 2016-3, 2016-1 I.R.B. 129, is modified by deleting section 5.01(4) (providing that the acquisition of putative control of a corporation, in certain circumstances, is an area under study in which a ruling letter will not be issued). However, the IRS may decline to issue a letter ruling addressing an acquisition of control when appropriate in the interest of sound tax administration or on other grounds when warranted by the facts or circumstances of a particular case. See Rev. Proc. 2016-1, 2016-1 I.R.B. 1, § 6.02; Rev. Proc. 2016-3, 2016-1 I.R.B. 129, §§ 2.01 and 3.01(50).

SECTION 7. DRAFTING INFORMATION

The principal authors of this revenue ruling are Frances Kelly and Theresa Abell of the Office of Associate Chief Counsel (Corporate). For further information regarding this revenue ruling, contact Ms. Kelly at (202) 317-6975 or Ms. Abell at (202) 317-7700 (neither a toll-free call).

SECTION 8. EFFECTIVE DATE

This revenue procedure is effective with respect to distributions that occur on or after August 8, 2016. However, taxpayers may apply this revenue procedure with respect to a distribution that occurs before August 8, 2016.