

the manufacture and sale of consumer products. *C* corporation, engaged in the production and distribution of prepared food products, has been a wholly owned subsidiary of *D* since *D* purchased the *C* stock eight years ago. Both *D* and *C* have actively conducted their respective businesses for more than five years.

For a valid business purpose, *D* adopted a plan whereby it distributed, on a pro rata basis to its shareholders, all of the *C* stock. No stock of *D* was surrendered.

Soon after the distribution, *Y*, an unrelated corporation, and *C* commenced negotiations leading to an agreement and plan of reorganization pursuant to which *C* was to be merged with and into *Y*. Pursuant to the agreement, the *C* stock would be converted into *Y* stock representing 25 percent of the outstanding stock of *Y*. Under applicable state law, the merger could not be consummated without the approval of the shareholders of *C*, and the agreement and plan of reorganization provided that such approval was a condition precedent to the merger. At the time of the distribution of the *C* stock to the *D* shareholders, there had been no negotiations or agreements relating to the transaction involving *C* and *Y*, although an acquisition of *C* was a possibility recognized by the management of *D* and *C* at such time.

The plan of reorganization was submitted to the *C* shareholders after it was approved by the directors of *C* in accordance with applicable state law. As a legal and practical matter, the *C* shareholders were free to vote their *C* stock for or against the merger. The *C* shareholders approved the merger at a meeting of the shareholders that had been specifically called for such purpose. *C* then merged with and into *Y* and the *C* stock was converted into *Y* stock in accordance with the plan. The merger satisfies all of the requirements of a reorganization under §368(a)-(1)(A).

## LAW AND ANALYSIS

Section 355(a) of the Internal Revenue Code provides, in part, that where (1) a corporation distributes to its shareholders, with respect to its stock, either (a) all of the stock of a corporation which it controls imme-

diately before the distribution, or (b) subject to compliance with certain conditions not relevant to the facts of this ruling, an amount of stock constituting control of such a corporation, (2) the active-trade-or-business requirements of § 355(b) are met, and (3) the transaction is not used principally as a device to distribute earnings and profits, no gain or loss will be recognized to (and no amount will be includible in the income of) such shareholders on the receipt of such stock.

Section 355(c) provides, in effect, that no gain or loss shall be recognized to a corporation on a distribution, to which § 355 applies, of stock in the controlled corporation and that § 311 shall not apply to any such distribution.

*Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945), holds that a sale of property by the shareholders of a corporation after receipt of the property as a liquidating distribution was taxable to the corporation when the corporation had in fact conducted all the negotiations and the terms of the sale had been agreed upon prior to the distribution of the property. However, *United States v. Cumberland Public Service Co.*, 338 U.S. 451 (1950), holds that a sale of assets by the shareholders after a distribution of the assets by the corporation pursuant to a liquidation was not taxable to the corporation. This latter decision was based on the finding of fact by the trial court to the effect that the corporation had rejected an offer to sell the property and the negotiations had been carried on by the shareholders after receipt of the property in liquidation.

In *Court Holding*, the Supreme Court recognized that “[t]he incidence of taxation depends upon the substance of a transaction . . . [T]he transaction must be viewed as a whole, and each step, from the commencement of negotiations to the consummation of the sale, is relevant. A sale by one person cannot be transformed for tax purposes into a sale by another by using the latter as a conduit through which to pass title.” 324 U.S. 331, 334.

If the *C* stock had, in form, been exchanged by the *D* shareholders for *Y* stock under circumstances in which *D* had, in substance, made the exchange of the *C* stock, *D* would be treated as having distributed an amount of stock in *Y* that did not constitute control of *Y*.

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

26 CFR 1.355-2: Limitations.

The revenue ruling holds that the form of the transaction, consisting of the distribution by a parent corporation of the stock of a subsidiary to its shareholders followed by a merger of the former subsidiary into an unrelated corporation, reflects its substance, determined on the basis of all of the relevant facts and circumstances, and is respected for federal income tax purposes. See Rev. Rul. 96-30, on this page.

### Spin-off of subsidiary, followed by its merger with unrelated corporation.

The form of the transaction, consisting of the distribution by a parent corporation of the stock of a subsidiary to its shareholders followed by a merger of the former subsidiary into an unrelated corporation, reflected its substance, determined on the basis of all of the relevant facts and circumstances, and was respected for federal income tax purposes.

Rev. Rul. 96-30

## ISSUE

If, under the facts below, a corporation distributes the stock of its wholly owned subsidiary to its shareholders and soon thereafter, the assets of the former subsidiary are acquired in a merger, is the form of the transaction respected for Federal income tax purposes?

## FACTS

*D* corporation, whose stock is widely held and actively traded, is engaged in

As a result, one of the requirements of § 355 would not have been met. The determination of the substance of the transaction, *i.e.*, which party (*D* or the shareholders of *D*) had, in substance, disposed of the *C* stock for Federal income tax purposes is based on all of the relevant facts and circumstances.

In this case, the form of the transaction will be respected for Federal income tax purposes. At the time of the distribution of the *C* stock by *D*, there had been no negotiations regarding the acquisition of *C* by *Y*, and the only action taken by *D* with respect to the transaction was that the directors of *D* had authorized the distribution of the *C* stock to the shareholders of *D*. The *C* shareholders voted on the merger with *Y* after the distribution and were free to vote their stock for or against the merger. Based on all of the facts and circumstances, the substance of the transaction is a distribution of the *C* stock by *D* with respect to its stock followed by the exchange of the *C* stock by its shareholders for *Y* stock pursuant to the merger.

## HOLDING

The form of the transaction, consisting of the distribution by *D* of the *C* stock to the *D* shareholders followed by the exchange of the *C* stock by the *D* shareholders for *Y* stock pursuant to the merger of *C* into *Y*, reflects its substance and will be respected for Federal income tax purposes.

## EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 75-406 is modified.

## APPLICATION OF SECTION 7805(b)

The Service will consider the application of § 7805(b) on a case-by-case basis.

## FURTHER INFORMATION

For further information regarding this revenue ruling contact Filiz A. Serbes of the Office of Assistant Chief Counsel (Corporate) at (202) 622-7750 (not a toll-free call).