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Morris Trust Repeal Introduced

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On April 17, 1997, the chairmen of the tax writing committees of the United States Congress each introduced legislation (H.R. 1365 and S. 612) repealing the so-called *Morris Trust* doctrine previously applicable to tax-free corporate spin-offs. In its current form and subject to various transition rules, the legislation will apply to corporate distributions after April 16, 1997.

In addition, the pending legislation also eliminates, except as provided in regulations to be issued, tax-free spin-offs within consolidated groups.

Background

Internal Revenue Code section 355 specifies the conditions under which one corporation (the "distributing corporation") can distribute to its own stockholders the stock it holds in a controlled subsidiary (the "controlled corporation") without the recognition of gain or loss by the distributing corporation, its stockholders or the distributed corporation. Following repeal of the General Utilities doctrine in the Tax Reform Act of 1986, section 355 became the sole remaining provision allowing tax-free distributions by corporations.

A number of transactions have been structured where a distributing corporation first distributes the stock of a subsidiary to its stockholders in a tax-free spin-off and then itself is acquired in a tax-free merger or other reorganization. The case of *Commissioner v. Mary Archer W. Morris Trust*, 367 F.2d 794 (4th Cir. 1966) held that the subsequent acquisition of the distributing corporation did not invalidate the tax-free nature of the prior spin-off. Several Internal Revenue Service published and private rulings also approved so-called *Morris Trust* transactions.

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Internal Revenue Service Proposes Significant Changes in Shareholder Continuity of Interest, by Laura E. Watts, follows on page 6 of this bulletin.

Proposed Legislation

The bills introduced by Representative Archer (H.R. 1365) and jointly by Senators Roth and Moynihan (S. 612) would repeal the *Morris Trust* doctrine and provide that if pursuant to a plan or arrangement in place at the time of an otherwise tax-free spin-off, either the distributing or distributed corporation is acquired, then the other corporation recognizes gain as of the date of the spin-off. If the distributed corporation is acquired, the distributing corporation recognizes gain as if it had sold the stock of the distributed corporation for fair market value at the time of the distribution. If the distributing corporation is acquired, the distributed corporation recognizes gain as if it had sold its "net assets" for fair market value at that time. The proposed legislation would affect only the corporations participating in the spin-off; it would not change the tax treatment of the distributing corporation's stockholders.

A corporation would be considered to have been "acquired" if any person acquires a 50 percent or greater interest in the corporation. Unless it can be established to the contrary, all such acquisitions within the four year period beginning two years before and ending two years after the spin-off would be treated as giving rise to a proscribed plan or arrangement in existence at the time of the spin-off.

The proposed legislation would also eliminate, except to the extent to be provided in regulations, tax-free spin-offs from one member of an affiliated group filing consolidated returns to another member.

As introduced, this new legislation would be effective for distributions occurring after April 16, 1997 but would not apply to any distribution (i) made pursuant to a written agreement which was (subject to customary conditions) binding on April 16, 1997 and at all times thereafter, (ii) described in a ruling request submitted to the Internal Revenue Service on or before April 16, 1997 or (iii) described on or before April 16, 1997 in a public announcement or in a filing with the Securities and Exchange Commission required solely by reason of the

distribution, as long as the written agreement, ruling request, or public announcement or filing identifies the acquirer of the distributing corporation or any controlled corporation, whichever is applicable.

Legislative Material

- Text of H.R. 1365 and S. 612.
- April 17, 1997 Joint Introductory Statement of Senators Roth and Moynihan.
- April 18, 1997 Joint Statement Providing Clarification of Recently Introduced Section 355 Legislation (H.R. 1365 and S. 612).

Text of H.R. 1365 and S. 612

SECTION 1. APPLICATION OF SECTION 355 TO DISTRIBUTIONS FOLLOWED BY ACQUISITIONS AND TO INTRAGROUP TRANSACTIONS.

(a) DISTRIBUTIONS FOLLOWED BY ACQUISITIONS– Section 355 of the Internal Revenue Code of 1986 (relating to distribution of stock and securities of a controlled corporation) is amended by adding at the end the following new subsection:

"(e) RECOGNITION OF GAIN WHERE CERTAIN DISTRIBUTIONS OF STOCK OR SECURITIES ARE FOLLOWED BY ACQUISITION–

"(1) GENERAL RULE– If there is a distribution to which this subsection applies, the following rules shall apply:

"(A) ACQUISITION OF CONTROLLED CORPORATION– If there is an acquisition described in paragraph (2)(A)(ii) with respect to any controlled corporation (or any successor thereof), any stock or securities in the controlled corporation shall not be treated as qualified property for purposes of subsection (c)(2) of this section or section 361(c)(2).

"(B) ACQUISITION OF DISTRIBUTING CORPORATION– If there is an acquisition described in paragraph (2)(A)(ii) with respect to the distributing corporation (or any successor thereof), the controlled corporation shall recognize gain in an amount equal to the amount of net gain which would be recognized if all the assets of the distributing corporation (immediately after the distribution) were sold (at such time) for fair market value. Any gain recognized under the preceding sentence shall be treated as long-term capital gain and shall be taken into account for the taxable year which includes the day after the date of such distribution.

"(2) DISTRIBUTIONS TO WHICH SUBSECTION APPLIES–

"(A) IN GENERAL– This subsection shall apply to any distribution–

"(i) to which this section (or so much of section 356 as relates to this section) applies, and

"(ii) which is part of a plan (or series of related transactions) pursuant to which a person acquires stock representing a 50-percent or greater interest in the distributing corporation or any controlled corporation (or any successor of either).

"(B) PLAN PRESUMED TO EXIST IN CERTAIN CASES– If a person acquires stock representing a 50-percent or greater interest in the distributing corporation or any controlled corporation (or any successor of either) during the 4-year period beginning on the date which is 2 years before the date of the distribution, such acquisition shall be treated as pursuant to a plan described in subparagraph (A)(ii) unless it is established that the distribution and the acquisition are not pursuant to a plan or series of related transactions.

"(C) CERTAIN ACQUISITIONS NOT TAKEN INTO ACCOUNT– If–

"(i) a person acquires stock in any controlled corporation by reason of holding stock in the distributing corporation, and

"(ii) such person did not acquire the stock in the distributing corporation pursuant to a plan described in subparagraph (A)(ii),

the acquisition described in clause (i) shall not be taken into account for purposes of subparagraph (A)(ii) or (B).

"(D) COORDINATION WITH SUBSECTION (d)– This subsection shall not apply to any distribution to which subsection (d) applies.

"(3) Definition and Special Rules– For purposes of this subsection–

"(A) 50-Percent or Greater Interest– The term '50-percent or greater interest' has the meaning given such term by subsection (d)(4).

"(B) Distributions in Title 11 or Similar Case– Paragraph (1) shall not apply to any distribution made in a title 11 or similar case (as defined in section 368(a)(3)).

"(C) Aggregation and Attribution Rules–

"(i) Aggregation– The rules of paragraph (7) of subsection (d) shall apply.

"(ii) Attribution– Section 318(a)(2) shall apply in determining whether a person holds stock or securities in any corporation. Except as provided in regulations, section 318(a)(2)(C) shall be applied without regard to the phrase '50 percent or more in value' for purposes of the preceding sentence.

"(D) Statute of Limitations– If there is an acquisition to which paragraph (1) (A) or (B) applies–

"(i) the statutory period for the assessment of any deficiency attributable to any part of the gain recognized under this subsection by reason of such acquisition shall not expire before the expiration of 3 years from the date the Secretary is notified by the taxpayer (in such manner as the Secretary may by regulations prescribe) that such acquisition occurred, and

"(ii) such deficiency may be assessed before the expiration of such 3-year period notwithstanding the provisions of any other law or rule of law which would otherwise prevent such assessment.

"(4) Regulations– The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this subsection, including regulations–

"(A) providing for the application of this subsection where there is more than 1 controlled corporation,

"(B) treating 2 or more distributions as 1 distribution where necessary to prevent the avoidance of such purposes, and

"(C) providing for the application of rules similar to the rules of subsection (d)(6) where appropriate for purposes of paragraph (2)(B)."

(b) Section 355 not to Apply to Certain Intragroup Transactions– Section 355 of the Internal Revenue Code of 1986, as amended by subsection (a), is amended by adding at the end the following new subsection:

"(f) Section not to Apply to Certain Intragroup Transactions– Except as provided in regulations, this section shall not apply to the distribution of stock from 1 member of an affiliated group filing a consolidated return to another member of such group, and the Secretary shall provide proper adjustments for the treatment of such distribution, including (if necessary) adjustments to–

"(1) the adjusted basis of any stock which–

"(A) is in a corporation which is a member of such group, and

"(B) is held by another member of such group, and

"(2) the earnings and profits of any member of such group."

(c) Effective Date–

(1) In General– The amendments made by this section shall apply to distributions after April 16, 1997.

(2) Transition Rule for Distributions Followed by Acquisitions– The amendments made by subsection (a) shall not apply to any distribution after April 16, 1997, if such distribution is–

(A) made pursuant to a written agreement which was (subject to customary conditions) binding on such date and at all times thereafter,

(B) described in a ruling request submitted to the Internal Revenue Service on or before such date, or

(C) described on or before such date in a public announcement or in a filing with the Securities and Exchange Commission required solely by reason of the distribution.

This paragraph shall not apply to any written agreement, ruling request, or public announcement or filing unless it identifies the acquirer of the distributing corporation or any controlled corporation, whichever is applicable.

April 17, 1997 Joint Introductory Statement of Senators Roth and Moynihan

Background

Several recent news reports describe corporate acquisition transactions in which one corporation distributes the stock of one (or more) of its subsidiaries to its shareholders (in a so-called "spin-off") and, pursuant to a pre-arranged plan, either the distributed subsidiary or the old parent corporation is acquired by another, unrelated corporation. Often, the corporation that is to be acquired borrows or assumes a large amount of debt incurred prior to the spin-off, while the proceeds of such indebtedness are retained by the other corporation.

For Federal income tax purposes, the initial distribution generally is tax-free pursuant to section 355 of the Internal Revenue Code and the subsequent acquisition is tax-free pursuant to one of the various reorganization provisions described in section 368. Such positions are consistent with the holding in the case of *Commissioner v. Mary Archer W. Morris Trust*, 367 F.2d 794 (4th Cir. 1966) and published IRS rulings.

Congress did not intend that section 355 apply to insulate these transactions from tax. Section 355 was intended to permit tax-free restructurings of several businesses among existing shareholders, with limitations to prevent the bail-out of corporate earnings and profits to the shareholders as capital gains. The recent transactions that raise concerns have very little to do with individual shareholder tax planning. Rather, they are pre-arranged structures designed to avoid corporate level gain recognition. In essence, these transactions resemble sales.

Today's introduced legislation is intended to treat transactions occurring after April 16, 1997, the general effective date of the bill, as sales at the corporate level.

A technical explanation of the legislation is provided below. This legislation affects complex transactions and additional or alternative legislative changes also may be appropriate. For example, it may be appropriate to amend or repeal present law section 355(d), and to treat certain asset acquisitions as stock acquisitions. Written comments on the issues raised by this bill are welcome.

Description of Proposal

Acquisitions of distributing or controlled corporations pursuant to plan

The proposal would adopt additional restrictions under section 355. Under the proposal, if pursuant to a plan or arrangement in existence on the date of distribution, either the controlled or distributing corporation is acquired, gain would be recognized by the other corporation as of the date of the distribution.

Whether a corporation is acquired would be determined under rules similar to those of present-law section 355(d), except that acquisitions would not be restricted to "purchase" transactions. Thus, an acquisition would occur if a person (or persons acting in concert) acquired more than 50 percent of the vote or value of the stock of the controlled or distributing corporation pursuant to a plan or arrangement. For example, assume a corporation ("P") distributes the stock of its wholly-owned subsidiary ("S") to its shareholders. If, pursuant to a plan or arrangement, either P or S is acquired, the proposal would apply to require gain recognition by the corporation not acquired. It is anticipated that certain asset acquisitions would be treated as stock acquisitions.

Acquisitions occurring within the four-year period beginning two years before the date of distribution would be presumed to have occurred pursuant to a plan or arrangement. Taxpayers could avoid gain recognition by showing that an acquisition occurring during this four-year period was unrelated to the distribution.

In the case of an acquisition of the controlled corporation, the amount of gain recognized by the distributing corporation would be the amount of gain that the distributing corporation would have recognized had the stock of the controlled corporation been sold for fair market value on the date of distribution. In the case of an acquisition of the distributing corporation, the amount of gain recognized by the controlled corporation would be the amount of net gain that the distributing corporation would have recognized had it sold its assets for fair market value immediately after the distribution. This gain would be treated as long-term capital gain. No adjustment to the basis of the stock or assets of either corporation would be allowed by reason of the recognition of the gain.

The proposal would not apply to a distribution pursuant to a title 11 or similar case.

The Treasury Department would be authorized to prescribe regulations as necessary to carry out the purposes of the proposal, including regulations to provide for the application of the proposal in the case of multiple distributions.

Treatment of distributions within affiliated groups

Except as provided in Treasury regulations, section 355 would not apply to a distribution of stock of one member of an affiliated group of corporations filing a consolidated return to another member. In the case of a distribution of stock within an affiliated group, the Secretary of the Treasury would be instructed to provide appropriate rules for the treatment of the distribution, including rules governing adjustments to the adjusted basis of the stock and the earnings and profits of the members of the group.

Effective Date

The proposal would be effective for distributions after April 16, 1997, unless the distribution is: (1) made pursuant to a written agreement with an acquirer which was (subject to customary conditions) binding on or before such date and at all times thereafter; (2) described in a ruling request that identifies the acquirer and is submitted to the IRS on or before such date; (3) described in a Securities and Exchange Commission ("SEC") filing made on or before such date, to the extent such filing was required to be made on account of the distribution and identifies the acquirer; or (4) described in a public announcement that identifies the acquirer on or before such date. The exceptions for written agreements, IRS ruling requests, SEC filings, and public announcements would not apply to distributions of stock within a consolidated group of corporations.

April 18, 1997 Joint Statement Providing Clarification of Recently Introduced Section 355 Legislation (H.R. 1365 and S. 612)

Congressman Bill Archer, Chairman
Senator William V. Roth, Vice Chairman
Senator Daniel Patrick Moynihan

Yesterday we introduced legislation (H.R. 1365 and S. 612) that would amend section 355 to change the treatment of a distribution of stock of a subsidiary by a parent corporation, where either the parent corporation or the subsidiary is acquired pursuant to a prearranged plan that includes the distribution (*i.e.,* the so-called "Morris Trust" transactions). The bills also provide that section 355 would not apply to distributions within a consolidated group of corporations.

The bills generally would be effective for distributions occurring after April 16, 1997, with transitional exceptions for distributions made pursuant to, or described in, certain binding written agreements, ruling requests filed with the IRS, SEC filings made on account of the distribution, and public announcements. It is intended that the bills would not apply to an intragroup distribution of stock that is an integral part of a transaction that is made pursuant to, or is described in, a binding written agreement, IRS ruling request, SEC filing made on account of the transaction, or a public announcement on or before April 16, 1997. We recognize drafting changes to the bills may be required to achieve this intended result.

We also invite further comment as to the proper applicability of section 355 with respect to intragroup distributions.

Internal Revenue Service Proposes Significant Changes in Shareholder Continuity of Interest

Laura E. Watts

On December 23, 1996, the Treasury Department published a notice of proposed rulemaking in an attempt to clarify a previously murky rule of corporate tax law, the continuity of shareholder interest requirement, which has been the subject of debate among tax practitioners for many years.

Overview

A tax-free reorganization involves at least the corporation whose stock or assets are being acquired ("Target") and the corporation providing the consideration, including its own stock, to acquire those stock or assets ("Acquiring"). Section 368 of the Internal Revenue Code (the "Code") contains seven basic structures for corporate reorganizations which are eligible for tax-free treatment. Each structure has its own requirements. Some of the requirements are identified in the statute and some are described in the Income Tax Regulations (the "Regulations"). One requirement that is common to all but one[1] of the reorganization structures is the continuity of shareholder interest requirement contained in section 1.368-1(b) of the Regulations.

The proposed regulations establish that the continuity of shareholder interest requirement concerns the consideration furnished by the Acquiring corporation to the Target shareholders in a reorganization. Under the proposed regulations, post-reorganization sales of Acquiring stock, subject to certain exceptions, do not violate the continuity of shareholder interest requirement. However, the proposed regulations do not address the consequences of pre-reorganization sales of Target stock on the continuity of shareholder interest requirement, otherwise known as the historic shareholder requirement.

The Existing Rule

The rule contained in the existing regulations states that

> "[r]equisite to a reorganization under the Code are (except as provided in section 368(a)(1)(D) of the Code) a continuity of interest on the part of those person who, directly or indirectly, were the owners of the enterprise prior to the reorganization ..."[2]

The current rule does not explain what is meant by "a continuity of interest." The concept is drawn from case law and was adopted by the Treasury Department in section 1.368-1(b) of the Regulations. For some time, it has been unclear whether "a continuity of interest" referred merely to consideration furnished by Acquiring or encompassed further requirements that the Target shareholders should, at least at the time of the reorganization, intend to maintain a continuing interest in Acquiring through ownership of Acquiring stock. Or, as stated in *Revenue Procedure 86-42*, 1986-2 C.B. 722, the Target shareholders must have no plan or intention to sell

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1 A recapitalization, otherwise known as section 368(a)(1)(E) reorganization, does not require that there be continuity of shareholder interest.

2 The parenthetical concerning 368(a)(1)(D) reorganizations continues to remain a mystery. Some commentators attribute this cryptic reference to divisive D reorganizations. This view is supported by the subsequent promulgation of regulations under section 355 of the Code which contain a separate continuity of shareholder interest requirement for section 355 distributions. Some portion of these distributions will be divisive D reorganizations. Similarly, the reference to "directly or indirectly" is unclear since the attribution rules of section 318 do not apply to reorganizations contained in 368 other than acquisitive D reorganizations by virtue of 368(a)(2)(H) of the Code.

the Acquiring stock received in the reorganization. Commentators have referred to this concept as "post-reorganization continuity."

The Proposed Rule

Under the proposed continuity of interest regulations (1) the Acquiring corporation must furnish consideration representing a proprietary interest in the affairs of the Acquiring corporation and (2) such consideration must represent a substantial part of the value of the stock or properties transferred in the transaction. A transaction that satisfies these two prongs is deemed to be sufficiently distinguishable from a sale to warrant nonrecognition of gain or loss in transactions that otherwise qualify for the corporate reorganization provisions of section 368 of the Code and the Regulations.

The proposed rule limits the continuity of shareholder interest requirement to the consideration furnished by Acquiring to the Target shareholders. Thus, it rejects the concept of post-reorganization continuity. The first example in the proposed regulations also demonstrates that the continuity requirement is solely a "consideration received" requirement.

> A owns all of the stock of T. T merges into P. In the merger, A receives stock of P having a fair market value of $50x and cash of $50x. Immediately after the merger and pursuant to a pre-existing binding contract negotiated by A, A sells all of the stock of P received by A in the merger to B, a party not related to P. The transaction satisfies the continuity of shareholder interest requirement because A received stock of P representing a substantial part of the value of the total consideration transferred in the acquisition.

Thus, a Target shareholder may sell Acquiring stock acquired in a reorganization to a person unrelated to Acquiring, even pursuant to a pre-existing, binding contractual agreement, and still receive tax-free treatment.[3] Moreover, implicit in the above described example is the position that even if the step transaction doctrine is applied, the requirement that Acquiring furnish Acquiring stock in the reorganization will still be met since the sales proceeds are from a person that is unrelated to Acquiring.

The proposed regulations make it clear that the Target shareholders may not sell the Acquiring stock received in the transaction back to Acquiring or a party related to Acquiring as part of the overall transaction.[4] The preamble to the regulations notes that, in this context, the transaction may be recast, presumably under the step transaction doctrine, to treat the acquiring corporation as furnishing cash in the reorganization and depending upon the amount of stock sold, the transaction may not satisfy the continuity of interest requirement.

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[3] The Service has noted in the preamble to the proposed continuity of shareholder interest regulations that it must change its ruling policy contained in *Revenue Procedure 86-42*, 1986-2 C.B. 722 which, for purposes of obtaining a letter ruling, requires certain Target shareholders to represent that they have no plan or intention to sell the Acquiring stock received in the transaction which represents more than 50 percent of the value of the formerly outstanding Target stock.

[4] Example 4 in the proposed continuity of shareholder interest regulations demonstrates that an unrelated party, such as an investment banker, who acts as an agent for Acquiring by purchasing the Acquiring stock issued in the reorganization and shortly thereafter selling such Acquiring stock back to Acquiring will be ignored or viewed as a conduit and Acquiring will be regarded as using cash rather than Acquiring stock in the transaction. Presumably, if the investment banker was not acting on behalf of Acquiring and, rather than selling the Acquiring stock back to Acquiring or a related party, sold such stock to the public or an unrelated person, the continuity of shareholder interest requirement would be satisfied.