



Tax Reduction Letter

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Rev. Proc. 77-37

1. Purpose

.01. The purpose of this Revenue Procedure is to update Rev. Proc. 74-26, 1974-2 C.B. 478, which sets forth certain operating rules of the Internal Revenue Service pertaining to issuing ruling letters and in determining whether it should decline to issue ruling letters.

.02. This Revenue Procedure incorporates the amplifications and clarifications made to Rev. Proc. 74-26 by Rev. Proc. 75-24, 1975-1 C.B. 719, Rev. Proc. 76-22, 1976-1 C.B. 562, Rev. Proc. 76-26, 1976-2 C.B. 643, and Rev. Proc. 77-27, 1977-2 C.B. 537. Rev. Proc. 75-24 clarified the "substantially all" requirement of section 355(b)(2)(A) of the Code contained in Sec. 3.04; Rev. Proc. 76-22 amplified Sec. 3 by adding subsection.07 to quantify the "relatively small" test of section 1.351-1(a)(1)(ii) of the regulations; Rev. Proc. 76-26 superseded Rev. Proc. 75-11, 1975-1 C.B. 652, by expanding new subsection .06 of Sec. 3 to cover stock escrows and turn back arrangements; and Rev. Proc. 77-27, 1977-2 C.B. 537, added rules relating to certain ruling requests under section 341(b), which have been incorporated herein as Sec. 6.

.03. In addition, this Revenue Procedure changes the first sentence of Sec. 4 to make it clear that less than one percent common stock ownership referred to therein means the aggregate common stock ownership of all shareholders receiving convertible preferred stock in the reorganization.

2. Background

.01. When requested by taxpayers or their authorized representatives, the Reorganization Branch of the Corporation Tax Division issues ruling letters as to the tax consequences of corporate reorganizations, liquidations, stock dividends and redemptions; transfers to and distributions of stock or securities of controlled corporations; exchanges or distributions by corporations in obedience to orders of the Securities and Exchange Commission; and distributions by corporations pursuant to the Bank Holding Company Act. The Reorganization Branch also determines whether distributions, redemptions, exchanges or transfers referred to in sections 306(b)(4), 355(a)(1)(D)(ii), 367, 1492, and 1494 of the Internal Revenue Code of 1954 are in pursuance of a <Page 569> plan having as one of its principal purposes the avoidance of Federal income taxes and answers questions under section 1244 relating to small business stock. In addition, the Reorganization Branch issues ruling letters concerning transactions involving collapsible corporations under section 341 and special limitations on net operating loss carryovers under section 382.

.02. The Reorganization Branch has developed certain operating rules for determining whether a ruling will be issued in certain types of cases and the conclusions which will be expressed in such rulings.

.03. These operating rules are being published solely to provide assistance to taxpayers and their representatives in preparing ruling requests. These operating rules do not define, as a matter of law, the lower limits of "continuity of interest" or "substantially all of the properties"; nor do

they define any other terms used in the Internal Revenue Code, Income Tax Regulations and prior Revenue Procedures discussed below.

.04. A requested ruling involving a question covered in Sec. 3 of this Revenue Procedure will ordinarily be issued if the applicable operating rule or rules set forth in Sec. 3 of this Revenue Procedure are complied with and if all other pertinent provisions of the Internal Revenue Code, Income Tax Regulations, Revenue Procedures and Revenue Rulings are satisfied.

3. Operating Rules for Issuing Ruling Letters

.01. The "substantially all" requirement of sections 354(b)(1)(A), 368(a)(1)(C), 368(a)(2)(B)(i), 368(a)(2)(D), and 368(a)(2)(E)(i) of the Code is satisfied if there is a transfer (and in the case of a surviving corporation under section 368(a)(2)(E)(i), the retention) of assets representing at least 90 percent of the fair market value of the net assets and at least 70 percent of the fair market value of the gross assets held by the corporation immediately prior to the transfer. All payments to dissenters and all redemptions and distributions (except for regular, normal distributions) made by the corporation immediately preceding the transfer and which are part of the plan of reorganization will be considered as assets held by the corporation immediately prior to the transfer.

.02. The "continuity of interest" requirement of section 1.368-1(b) of the Income Tax Regulations is satisfied if there is continuing interest through stock ownership in the acquiring or transferee corporation (or a corporation in "control" thereof within the meaning of section 368(c) of the Code) on the part of the former shareholders of the acquired or transferor corporation which is equal in value, as of the effective date of the reorganization, to at least 50 percent of the value of all of the formerly outstanding stock of the acquired or transferor corporation as of the same date. It is not necessary that each shareholder of the acquired or transferor corporation receive in the exchange stock of the acquiring or transferee corporation, or a corporation in "control" thereof, which is equal in value to at least 50 percent of the value of his former stock interest in the acquired or transferor corporation, so long as one or more of the shareholders of the acquired or transferor corporation have a continuing interest through stock ownership in the acquiring or transferee corporation (or a corporation in "control" thereof) which is, in the aggregate, equal in value to at least 50 percent of the value of all of the formerly outstanding stock of the acquired or transferor corporation. Sales, redemptions, and other dispositions of stock occurring prior or subsequent to the exchange which are part of the plan of reorganization will be considered in determining whether there is a 50 percent continuing interest through stock ownership as of the effective date of the reorganization.

.03. In reorganizations under sections 368(a)(1)(A), 368(a)(1)(B), and 368(a)(1)(C) of the Code where the requisite stock or property has been acquired, it is not necessary that all of the stock of the acquiring corporation or a corporation in "control" thereof, which is to be issued in exchange therefor, be issued immediately provided (1) that all of the stock will be issued within five years from the date of the transfer of assets in the case of reorganizations under sections 368(a)(1)(A) and 368(a)(1)(C), or within five years from the date of the initial distribution in the case of reorganization under section 368(a)(1)(B). (2) there is a valid business reason for not issuing all of the stock immediately, such as the difficulty in determining the value of one or both of the corporations involved in the reorganization; (3) the maximum number of shares which may be issued in the exchange is stated; (4) at least fifty percent of the maximum number of shares of each class of stock which may be issued is issued in the initial distribution; (5) the agreement evidencing the right to receive stock in the future prohibits assignment (except by operation of law) or, in the alternative, if the agreement does not prohibit assignments, the right must not be

evidenced by negotiable certificates of any kind and must not be readily marketable; and (6) such right can give rise to the receipt of only additional stock of the acquiring corporation or a corporation in "control" thereof, as the case may be. Stock issued as compensation, royalties or any other consideration other than in exchange for stock or assets will not be considered to have been received in the exchange. Until the final distribution of the total number of shares of stock to be issued in the exchange is made, the interim basis of the stock of the acquiring corporation received in the exchange by the shareholders of the acquired corporation (not including that portion of each share representing interest) will be determined, pursuant to section 358(a), as though the maximum number of shares to be issued (not including that portion of each share representing interest) had been received by the shareholders.<Page 570>

.04. The "substantially all of its assets" requirement of section 355(b)(2)(A) of the Code is satisfied if at least 90 percent of the fair market value of the gross assets of the corporation (assets undiminished by liabilities) consists of stock and securities of controlled corporations which are engaged in the active conduct of a trade or business as defined in section 355(b)(2).

.05. In determining stock ownership to be attributed to a trust or from a trust under the rules of sections 318(a)(2)(B)(i) and 313(a)(3)(B)(i) of the Code in those cases where a surviving spouse is entitled to all the income for life from the trust and also holds a power of appointment over the corpus of the trust, and in default of the exercise of the power the property held by the trust is to pass to the children of the surviving spouse, attribution will be computed as if the surviving spouse has exercised the power in favor of his or her children, so that they will be considered beneficiaries in the absence of evidence that the power has been differently exercised.

.06. In reorganizations under sections 368(a)(1)(A), 368(a)(1)(B), and 368(a)(1)(C) of the Code where the requisite stock or property has been acquired, a portion of the stock of the acquiring corporation, or a corporation in "control" thereof, that is issued in the exchange may be placed in escrow by the exchanging shareholders, or may otherwise be made subject to a condition pursuant to the agreement or plan of reorganization, for possible return to the acquiring corporation under specified conditions provided (1) there is a valid business reason for establishing the arrangement; (2) the stock subject to such arrangement appears as issued and outstanding on the balance sheet of the acquiring corporation and such stock is, in fact, legally outstanding under applicable state law; (3) all dividends paid on such stock will be distributed currently to the exchanging shareholders; (4) all voting rights of such stock (if any) are exercisable by or on behalf of the shareholders or their authorized agent; (5) no shares of such stock are subject to restrictions requiring their return to the issuing corporation because of death, failure to continue employment or similar restrictions; (6) all such stock is released from the arrangement within 5 years from the date of consummation of the reorganization (except where there is a bona fide dispute as to whom the stock should be released to); and (7) at least 50 percent of the number of shares of each class of stock issued initially to the shareholders (exclusive of shares of stock to be issued at a later date as described in.03 above) is not subject to the arrangement.

.07. When a person transfers property to a corporation in exchange for stock or securities of such corporation and the primary purpose of the transfer is to qualify under section 351 of the Code the exchanges of property by other persons transferring property, the property transferred will not be considered to be of relatively small value, within the meaning of section 1.351-1(a)(1)(ii) of the regulations, if the fair market value of the property transferred is equal to, or in excess of, 10 percent of the fair market value of the stock and securities already owned (or to be received for services) by such person.

4. Rulings with Respect to Convertible Stock

A ruling will usually be issued to the effect that preferred stock that is convertible into common stock which is received in a reorganization by exchanging shareholders, who will receive no common stock as a result of the reorganization and who in the aggregate will own after the reorganization less than one percent of the common stock of the corporation issuing the convertible preferred stock, will not be " section 306 stock," within the meaning of section 306(c) of the Code, provided the convertible preferred stock will be widely held or it is represented that there will not be any conversion of the convertible preferred stock pursuant to a concerted plan which will result in both preferred and common stock being held by an exchanging shareholder. In all other cases, opinion will be reserved as to what part, if any, of the convertible preferred stock will constitute " section 306 stock," unless the conditions of Section 5 of this Revenue Procedure would apply if the convertible preferred stock is assumed to be " section 306 stock."

5. Rulings Under

Section 306(b)(4) of the Code

.01. A ruling will usually be issued under section 306(b)(4) of the Code to the effect that a distribution of " section 306 stock" (other than a distribution under section 305, or, in the case of any recapitalization under section 368(a)(1)(E), a distribution which has the effect of a pro rata stock dividend, that is, a distribution under section 305) and the disposition or redemption of the " section 306 stock" is not pursuant to a plan of tax avoidance if the stock of the issuing corporation is widely held and

(a) the " section 306 stock" is not by its terms redeemable for at least five years from the date of issuance; and

(b) it is represented that there will be no redemption of the " section 306 stock," by tender or otherwise, within the five-year period.

.02. A ruling will usually be issued under section 306(b)(4) of the Code to the effect that a distribution of " section 306 stock" (other than a distribution under section 305, or, in the case of any recapitalization under section 368(a)(1)(E), a distribution which has the effect of a pro rata stock dividend, that is, a distribution under section 305) and the disposition of the " section 306 stock," other than by redemption and other than in anticipation of a redemption, is not pursuant to a plan of tax avoidance if the stock of the issuing corporation is widely held and

1(a) the " section 306 stock" is by its terms redeemable within five years from the date of issuance, or<Page 571>

(b) the " section 306 stock" is not redeemable within five years from the date of issuance but the issuing corporation will not represent that there will be no redemption (as a result of a change in the terms of the stock, an invitation for tenders or otherwise) within five years from the date of issuance.

6. Rulings Under

Section 341(b) of the Code.

All of the facts and circumstances will be considered in a request for a ruling that a corporation has not been "formed or availed of" with a view to the action described in section 341(b) of the Code, and therefore, is not a "collapsible corporation" as defined in section 341(b), when the enterprise (1) has been in existence for at least 20 years, (2) has had substantially the same owners during that period, and (3) has conducted substantially the same trade or business during that period.

7. Effect on Other Documents

Rev. Proc. 74-26, Rev. Proc. 75-24, Rev. Proc. 76-22, and Rev. Proc. 76-26 are superseded. Rev. Proc. 77-27 is superseded in part insofar as it amplifies Rev. Proc. 74-26.

8. Inquiries

Inquiries in regard to this Revenue Procedure should refer to its number and should be addressed to the Assistant Commissioner (Technical), Attention: T:C:R, Internal Revenue Service, Washington, D.C. 20224.