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WHO PROCEEDS AND WHO SUCCEEDS: NEW ANTI-*MORRIS* TRUST PROPOSED REGULATIONS

By Lisa M. Zarlenga and Kevin Spencer

Lisa M. Zarlenga is a partner and Kevin Spencer is an associate with Steptoe & Johnson LLP, Washington.

This article explores recently proposed regulations that define "predecessor" and "successor" for purposes of section 355(e). The proposed regulations, although seemingly complex, appropriately tailor the definitions to the purposes behind section 355(e).

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I. Background

A. Introduction

Enacted as part of the Taxpayer Relief Act of 1997,[1] section 355(e)[2] was intended to force corporate taxpayers to recognize gain on disguised sales of businesses in connection with section 355 distributions.[3] Generally, section 355(e) requires a distributing corporation (Distributing) to recognize gain on the distribution of a controlled corporation (Controlled) when, as part of a plan, one or more persons directly or indirectly acquires 50 percent or more of the stock (by vote or value) of Distributing or Controlled.[4] Section 355(e)(4)(D) provides that for purposes of section 355(e), "any reference to a controlled corporation or a distributing corporation shall include a reference to any predecessor or successor of such corporation." However, the statute fails to define "predecessor" and "successor," and the legislative history provides no guidance.[5]

The terms "predecessor" and "successor" are not foreign to the code. Indeed, they are found in other sections of the code, typically defined with reference to section 381 or other carryover basis asset acquisitions.[6]

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[1]Pub. L. No. 105-34 (1997).

[2]Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended, or to the Treasury regulations thereunder.

[3]The purpose of section 355(e) is discussed further in section I.B. below.

[4]Section 355(e) imposes a corporate-level tax — it does not disqualify the distribution under section 355, so the recipient shareholders do not recognize gain. For a more detailed discussion of section 355(e), see Mark J. Silverman and Lisa M. Zarlenga, "A Comprehensive Guide to Section 355(e) of the Internal Revenue Code," *University of Southern California Law School's 55th Institute on Federal Taxation — Major Tax Planning for 2003* (2003); Mark J. Silverman, Andrew J. Weinstein, and Lisa M. Zarlenga, "The New Anti-*Morris Trust* and Intragroup Spin Provisions," 49 *Tax Executive* 455 (Nov.-Dec. 1997).

[5]The original bill introduced in the House by Bill Archer, chair of the Ways and Means Committee, and in the Senate by William Roth, chair of the Finance Committee, and Daniel Moynihan, Finance Committee ranking Democrat, provided that a prohibited acquisition could occur with respect to "the distributing corporation or any controlled corporation (or any successor)." The bill as passed by the House deleted the parenthetical reference to successor and added the provision that was ultimately enacted as section 355(e)(4)(D). H.R. 2014, 105th Cong. section 1012 (1997). However, there was no explanation for the change.

[6]Definitions of "predecessor" and "successor" elsewhere in the code is discussed further in section I.C. below.

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Despite that relatively common usage, commentators have highlighted the need for guidance.[7]

On November 22, 2004, the Treasury Department and the IRS responded to that call and issued proposed regulations providing long-awaited definitions of ''predecessor'' and ''successor'' (the proposed regulations).[8] This article explores the proposed regulations. As discussed herein, the proposed regulations adopt the same basic section 381 approach adopted elsewhere in the code. However, the approach has been modified somewhat to more closely follow the assets being spun off. Although at first blush the proposed regulations appear unnecessarily complex, the approach of the proposed regulations appropriately tailors the definitions of predecessor and successor in section 355(e) to the purposes of that provision. Before we discuss the proposed regulations, however, it is helpful to summarize the purposes of section 355(e) and the approach of other code provisions in defining predecessor and successor.

B. Purpose of Section 355(e)

Section 355(e) is referred to as the anti-*Morris Trust* provision because it was designed to shut down the type of transaction involved in *Commissioner v. Morris Trust*,[9] a transaction that involved the contribution of an unwanted business to a controlled corporation and a distribution of that corporation in a tax-free spinoff to facilitate the acquisition of the distributing corporation in a tax-free reorganization. The legislative history of section 355(e) points to the following ''abuse'' at which section 355(e) was aimed:

> The Committee believes that section 355 was intended to permit the tax-free division of existing business arrangements among existing shareholders. In cases in which it is intended that *new shareholders will acquire ownership* of a business in connection with a spin off, the transaction more closely *resembles a corporate level disposition* of the portion of the business that is acquired.[10]

By referring to ''new shareholders'' acquiring interests in connection with a spinoff, the legislative history of section 355(e) suggests that Congress wanted to ensure that historic shareholders of Distributing and Controlled maintained a significant ownership interest in the corporations.

The events leading up to the enactment of section 355(e) make clear that the provision was intended to prevent disguised sales of businesses without a corporate-level tax. A few highly publicized transactions, such as Viacom's sale of its cable company to TCI, GM's sale of Hughes to Raytheon, and Disney's sale of its newspaper properties to Knight-Ridder, contained features that caused the transaction to more closely resemble a sale, including a separation of debt and its proceeds so that the ''buyer'' ends up with the debt and the ''seller'' ends up with the proceeds, and a recapitalization of the target corporation to shift equity value to the acquirer.[11]

C. 'Predecessor' and 'Successor' in Other Contexts

Although the terms ''predecessor'' and ''successor'' are typically defined with reference to section 381 or other carryover basis asset acquisitions, the precise definition often differs depending on the purpose of the provision for which they are being defined. There are, however, several common formulations of definitions.

For example, some provisions define predecessor or successor as the transferor/distributor or transferee/distributee in a section 381 transaction or, more generally, in a nonrecognition transaction.[12] Section 381 generally provides rules for the carryover of specific corporate tax attributes in certain corporate asset acquisitions: a complete subsidiary liquidation under section 332; or a transfer in conjunction with a reorganization described in subparagraphs (A), (C), (D), (F), or (G) of section 368(a)(1) (a transaction to which section 381 applies is hereinafter referred to as a 381 transaction). Other provisions define predecessor or successor as the transferor or transferee of assets in a carryover basis or substituted basis transaction.[13] Other provisions combine the two and require either a 381 transaction or a carryover basis transaction to

[7]*See, e.g.,* New York State Bar Assoc. Tax Section ''Report on Section 355(e) 'Non-Plan' Issues,'' *Doc 2004-746, 2004 TNT 9-27* (Jan. 13, 2004); Dana L. Trier and Kathleen L. Ferrell, ''Section 1012 of the 1997 Act: The Application of Section 355(e) to Distributions in Connection With Acquisitions,'' 630 *PLI/Tax* 593 (2004); Thomas F. Wessel et al., ''Corporate Distributions Under Section 355,'' 629 *PLI/TAX* 9 (2004); Mark J. Silverman et al., ''The New Anti-*Morris Trust* and Intragroup Spin Provisions,'' 49 *The Tax Executive* 455 (1997).

[8]Prop. Treas. reg. section 1.355-8, 69 *Fed. Reg.* 67,873 (2005).

[9]367 F.2d 794 (4th Cir. 1966). Ironically, section 355(e) would not apply to the facts of the *Morris Trust* case, because the distributing corporation's shareholders in *Morris Trust* retained a 50-percent-or-greater interest in the distributing corporation following the acquisition.

[10]*See* H.R. Rep. No. 105-148, at 462 (1997) (emphasis added); S. Rep. No. 105-33, at 130-40 (1997) (emphasis added).

[11]Rather than targeting the disguised sale transactions that shift debt or equity value to the ''buyer,'' section 355(e), as enacted, broadly reaches all *Morris Trust* transactions in which there is a 50-percent-or-greater acquisition of Distributing or Controlled. Indeed, those shifts are permissible as long as the 50 percent acquisition threshold is not reached.

[12]*See* Treas. reg. section 1.367(e)-1(c)(3)(vi) (exception to gain recognition on disposition of stock received in a section 355 spinoff); Treas. reg. section 1.1275-6(g) (integration of qualifying debt instrument with a hedge); Treas. reg. sections 1.1502-79(c)(1), (d)(1), (e)(1) (apportioning tax attributes to separate return year of departing member); Treas. reg. section 1.1502-77A(e)(4) (agent for consolidated group); *see also* Treas. reg. section 1.597-3(d) (federal financial assistance transactions; definition of successor includes a 381 transaction or a bridge bank to which another bridge bank transfers deposit liabilities).

[13]*See* Treas. reg. section 1.337(d)-1(c) (transitional rule limiting losses on the disposition of subsidiary stock); Treas. reg. section 1.337(d)-7(b)(ii) (application of section 1374 to property of a C corporation that becomes property of a regulated investment company or real estate investment trust); Treas. reg. section 1.851-6(d) (rule permitting inclusion of securities in computation of asset value not applicable if securities held for 10 years); Treas. reg. section 1.1374-1(e) (section 1374 is not applicable to a corporation that has always been an S corporation); Treas. reg. section 1.1504-32(f) (stock basis adjustments for

(Footnote continued on next page.)

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constitute a predecessor or successor.[14] Other provisions require the transfer of a specified threshold level of assets (for example, substantially all or 50 percent) to give rise to a predecessor or successor.[15] Other provisions define predecessor or successor to include an entity in which the shareholders have a 50 percent continuity of interest.[16]

Although there are no set guidelines to determine which formulation is appropriate for a particular provision, certain logical relationships exist. When the provision focuses on an entity, such as the transfer of a subsidiary, a predecessor or successor might logically be defined by reference to a 381 or nonrecognition transaction, because that formulation follows the entity. When the provision focuses on attributes of particular assets, such as built-in gain or loss, a predecessor or successor might logically be defined by reference to carryover or substituted basis, because that formulation preserves the attributes. When the provision ensures compliance, such as the filing of information returns, or when it depends on the nature of the activities of the entity, such as a financial institution, a predecessor or successor might logically be defined by reference to the transfer of a significant portion of the entity's assets.

There are also provisions that deviate from those general approaches and adopt a unique definition of predecessor or successor more tailored to the purpose of the provision. For example, for purposes of defining qualifying dividends under section 243, the regulations treat a corporation as a predecessor of the distributing corporation if the distributing corporation succeeds to the earnings and profits of the predecessor.[17] Such a definition makes sense because dividends are paid out of earnings and profits.[18] Another example is the golden parachute provisions defining predecessor as an entity that, as a result of a merger, consolidation, purchase, or acquisition of property or stock, separation, or other similar transaction, transfers some or all of its employees to the corporation undergoing the change in control.[19] Such a definition also makes sense because the provision focuses on compensation. A third example is the rule providing that the common parent of a consolidated group acts as the agent for each member or successor for tax matters. For that purpose, a successor is an individual or entity that is primarily liable, under applicable law, for the tax liability of a member of the group. Such a definition makes sense because the common parent is acting as the agent for tax matters.

II. Who Proceeds: Definition of 'Predecessor'

Consistent with other definitions of predecessor and successor found elsewhere in the code and in the regulations, the measuring stick for the proposed regulations is whether there has been a 381 transaction. The proposed regulations then add a gloss to the definition of predecessor that limits the definition to transactions that implicate the purposes behind section 355(e). The proposed regulations provide separate definitions of predecessor for Distributing and Controlled, focusing largely on predecessors of Distributing because predecessors of Controlled do not raise the section 355(e) concerns. That a corporation is a predecessor does not automatically trigger section 355(e) — it also must be determined whether there has been a 50-percent-or-greater acquisition of the predecessor as part of the same plan as the distribution.[20] The proposed regulations provide for separate testing of Distributing and its predecessor in determining whether such an acquisition has occurred, and they provide special gain limitation rules depending on which entity is acquired.

A. Definition of Predecessor of Distributing

To determine if a corporation is a predecessor of Distributing, the proposed regulations provide two tests that focus on what happens to the assets transferred to Distributing. Specifically, the tests are designed to identify transactions in which there is a separation of the predecessor's assets. The preamble to the proposed regulations explains the reason:

> The definition of a predecessor of Distributing in these proposed regulations is intended to reflect the fact that section 355(e) generally denies tax-free treatment under sections 355(c)(1) and 361(c)(1) if

consolidated subsidiaries); Treas. reg. section 1.1502-33(h) (computation of earnings and profits for consolidated groups); Treas. reg. section 1.1502-76(b)(1)(ii)(C) (tax year of members of consolidated group).

[14]*See* Treas. reg. section 1.338-8(j)(6) (asset and stock consistency rules); Treas. reg. section 1.382-2(a)(1)(ii) (defining loss corporation); Treas. reg. section 1.1502-1(f)(4) (general definitions for consolidated return regulations); *see also* Treas. reg. section 1.1502-13(j)(2) (defining successor as a transferee in a 381 transaction, a transfer of substantially all of the assets of the transferor, a carryover basis transaction (but only with respect to those assets transferred), or an intercompany transaction (but only with respect to those assets being accounted for as an intercompany transaction)); Treas. reg. section 1.1502-35T (same).

[15]Section 41(f)(3)(A) (credit for increasing research activities); Treas. reg. section 1.585-2(e)(4) (addition to reserve for losses on loans); Treas. reg. section 1.6043-4T(e) (information returns for acquisitions of control or changes in capital structure); Treas. reg. section 1.6050P-2(g) (information returns reporting cancellation of debt by certain lending institutions).

[16]*See* Treas. reg. section 1.953-7(c)(1)(ii) (election to treat income as effectively connected); *see also* Treas. reg. section 1.856-8(c)(2) (termination or revocation of REIT election; containing a continuity of interest and continuity of asset requirement); Treas. reg. section 1.1362-5(b) (termination or revocation of S corporation election; containing a continuity of interest and continuity of asset requirement).

[17]Treas. reg. section 1.243-4(a)(4).

[18]*See* section 316(a).

[19]Treas. reg. sections 1.280G-1, A-21(b).

[20]For purposes of this article, it is assumed that any acquisition is part of the same plan as the distribution.

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there is a division of a corporation's assets to which section 355(a) applies that is coupled with planned acquisitions of stock representing in the aggregate a 50-percent or greater interest in Distributing or Controlled.[21]

Under the first test, a corporation is a predecessor of Distributing if, before the distribution, it transfers property to Distributing in a 381 transaction (referred to by the proposed regulations as the combining transfer), but only if Distributing transfers some, but not all, of the property to Controlled (or a predecessor of Controlled) (referred to by the proposed regulations as the separating transfer), and Controlled's basis in the transferred assets is the same as Distributing's basis in the assets before the transfer.[22]

Example 1 — Predecessor of Distributing Test One: Shareholder X owns 100 percent of P corporation and shareholder Y owns 100 percent of D corporation. P merges into D in an ''A'' reorganization. D then contributes in a ''D'' reorganization one of the former P assets to its wholly owned subsidiary, C, for additional C stock and then distributes C to its shareholders pro rata.

Because P transferred property to D in a 381 transaction and D transferred some, but not all of the former P property to C, there has been a separation of P's assets. Therefore, P is considered a predecessor to D.[23]

Under the second test, a corporation is a predecessor of Distributing if it transfers property to Distributing, including stock of Controlled, in a 381 transaction (that is, the combining transfer), and thereafter, Distributing does not transfer all of that property (other than the Controlled stock) to Controlled (that is, the separating transfer).[24]

Example 2 — Predecessor of Distributing Test Two: Shareholder X owns 100 percent of P corporation and shareholder Y owns 100 percent of D corporation. P owns 35 percent of C corporation, and D owns the remaining 65 percent of C. P merges into D in an ''A'' reorganization. As a result of the merger, D owns 100 percent of C. D then distributes C to its shareholders pro rata.

Because P transferred property to D, including stock of C, in a 381 transaction, and D did not transfer all of that property to C, there has been a separation of P's assets (that is, the C stock from P's other assets). Therefore P is considered a predecessor to D.[25]

By limiting the definition of predecessor to combining transfers that occur before the distribution, the proposed regulations avoid a technical glitch that could lead to some anomalous results.

Example 3 — ''Predecessor'' After Combining Transfer: D owns all the stock of a controlled corporation, C. D distributes its C stock to its shareholders. As part of a plan, P, a small corporation, merges into D in an ''A'' reorganization, with the shareholders of P receiving two percent of the stock of D.

Only 2 percent of D's stock was acquired by P shareholders in the merger; section 355(e) therefore should not apply. However, if the term ''predecessor'' were defined to include corporations merging into Distributing after the distribution, the predecessor rule could operate to trigger section 355(e) in this example because D's shareholders acquired a 50-percent-or-greater interest in P, a predecessor to D.

B. Acquisition of Distributing or a Predecessor

The proposed regulations provide that the determination of whether one or more persons has acquired a 50-percent-or-greater interest is made separately for Distributing and any predecessor of Distributing.[26] Accordingly, there may be situations in which there is an acquisition of a 50-percent-or-greater interest in a predecessor of Distributing when there is no similar acquisition of a 50-percent-or-greater interest in Distributing, and vice versa.

Because a predecessor of Distributing may no longer exist after it combines with Distributing, the proposed regulations deem some acquisitions to be acquisitions of the predecessor's stock.[27] First, the proposed regulations provide that historic shareholders of Distributing immediately before the combining transfer are treated as acquiring stock of the predecessor of Distributing in the combining transfer.[28] Thus, the combining transfer itself can constitute a 50-percent-or-greater acquisition of the predecessor of Distributing.

Example 4 — Acquisition of Predecessor in Combining Transfer: Shareholder X owns 100 percent of P corporation and shareholder Y owns 100 percent of D corporation. P merges into D in an ''A'' reorganization. Immediately after the merger, X and Y own 10 percent and 90 percent, respectively, of the stock of D. D then contributes in a ''D'' reorganization one of the former P assets to its wholly owned subsidiary, C, for additional C stock and then distributes C to its shareholders pro rata.

P is a predecessor of D under test one discussed above. Y, D's historic shareholder, is treated as acquiring 90 percent of the stock of P in the combining transfer (that is, the ''A'' reorganization).[29] Thus, there has been a 50-percent-or-greater acquisition of a predecessor of D.

Second, if stock of Distributing is acquired after the combining transfer, that stock is treated as stock of the predecessor of Distributing. Thus, an acquisition of Distributing stock after the combining transfer is treated as not only an acquisition of Distributing stock but also of stock of the predecessor of Distributing.[30] Assume in Example 4, above, that X and Y end up owning 55 percent

[21]Preamble to prop. Treas. reg. section 1.355-8, 69 *Fed. Reg.* at 67,874.
[22]Prop. Treas. reg. section 1.355-8(b)(1)(i).
[23]*See* prop. Treas. reg. section 1.355-8(g), Ex. 1.
[24]Prop. Treas. reg. section 1.355-8(b)(1)(ii).
[25]*See* prop. Treas. reg. section 1.355-8(g), Ex. 2.
[26]Prop. Treas. reg. section 1.355-8(d)(4).
[27]Preamble to prop. Treas. reg. section 1.355-8, 69 *Fed. Reg.* at 67,874.
[28]Prop. Treas. reg. section 1.355-8(d)(1)(i).
[29]*See* prop. Treas. reg. section 1.355-8(g), Ex. 1.
[30]Prop. Treas. reg. section 1.355-8(d)(1)(ii).

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and 45 percent, respectively, of the stock of D. As part of the same plan, Y contributes property to D in exchange for additional stock representing 5 percent of the vote and value of D. Presumably Y is also treated as acquiring 5 percent of the stock of P, resulting in a 50-percent-or-greater acquisition of D and of P. The proposed regulations do not appear to take into account the relative values of P and D in computing the percentage of P stock deemed acquired by reason of acquiring the D stock.

C. Special Gain Limitation Rules

Generally, if there is a 50-percent-or-greater acquisition of Distributing or Controlled, section 355(e) requires Distributing to recognize the gain inherent in its Controlled stock on the date of the distribution. That amount serves as the overall limitation on Distributing's gain recognition under the proposed regulations.[31] In some instances, the proposed regulations temper gain recognition to avoid unfair results, focusing on the gain inherent in the separated assets at the time of the distribution.

The preamble describes the potential unfairness. If there is a 50-percent-or-greater acquisition of a predecessor of Distributing but not of Distributing and the gain inherent in the predecessor's assets contributed to Controlled is small relative to the gain inherent in the Controlled stock on the date of the distribution, it seems inappropriate to require Distributing to recognize the full amount of the gain inherent in the Controlled stock. Similarly, if there is a 50-percent-or-greater acquisition of Distributing but not of the predecessor of Distributing, and the gain inherent in the Controlled stock is largely attributable to the predecessor's assets contributed to Controlled, it seems inappropriate to require Distributing to recognize the full amount of the gain inherent in the Controlled stock.[32] Accordingly, the proposed regulations provide special rules limiting the amount of gain to be recognized by Distributing when there is a 50-percent-or-greater acquisition of either Distributing or the predecessor of Distributing, but not both. If there is a 50-percent-or-greater acquisition of both Distributing and the predecessor, then the entire gain inherent in the Controlled stock is recognized. The gain limitation rules focus on which assets are being separated and are therefore consistent with the purpose of section 355(e) to deny tax-free treatment under section 355 when a division of a corporation's assets is coupled with a planned 50-percent-or-greater acquisition of Distributing or Controlled.

1. Acquisitions of predecessor of distributing. If there is a 50-percent-or-greater acquisition of a predecessor of Distributing, Distributing's gain is limited to the gain that the predecessor of Distributing would have otherwise recognized if, immediately before the distribution, the predecessor contributed the property that was transferred to Controlled in the separating transfer and any stock of Controlled transferred to Distributing in the combining transfer to a newly formed, wholly owned corporation in a section 351 transaction, and sold the subsidiary's stock to a third party for cash equal to its fair market value.[33]

> *Example 5 — Gain Limitation on Acquisition of Predecessor*: Shareholder X owns 100 percent of P corporation and shareholder Y owns 100 percent of D corporation. P merges into D in an "A" reorganization. Immediately after the merger, X and Y own 10 percent and 90 percent, respectively, of the stock of D. D then contributes in a "D" reorganization one of the former P assets to its wholly owned subsidiary, C, for additional C stock and then distributes C to its shareholders pro rata. Immediately before the distribution, the asset contributed to C has a basis of $50 and a fair market value of $110, and the stock of C held by D has a basis of $100 and a fair market value of $200.

Under the rules discussed above, P is a predecessor of D and Y is deemed to have acquired 90 percent of P in the combining transfer. Without regard to the gain limitation rule of prop. Treas. reg. section 1.355-8(e)(2), D would be required to recognize $100 gain. Under the gain limitation rule, however, D's gain is limited to $60, which is the amount of gain P would have recognized if, immediately before the distribution, it had transferred the asset contributed to C to a newly formed, wholly owned corporation in a section 351 exchange and then sold that stock to a third party for cash equal to its fair market value.[34]

The proposed regulations provide a substituted asset rule that provides that if Distributing or Controlled transfers property of the predecessor of Distributing in a transaction in which gain or loss is not recognized in whole, the property received in exchange is treated as that property.[35]

2. Acquisitions of distributing. If there is a 50-percent-or-greater acquisition of Distributing, and the acquisition(s) occur in the combining transfer, the amount of gain recognized by Distributing is limited to the excess, if any, of the amount described in section 355(c)(2) or 361(c)(1), as applicable (which is essentially Distributing's built-in gain in its Controlled stock), less the amount of gain that Distributing would have recognized if there had been a 50-percent-or-greater acquisition of a predecessor of Distributing but not Distributing (which is the amount calculated on the deemed section 351 transaction and stock sale under prop. Treas. reg. section 1.355-8(e)(2)).[36]

When Controlled is newly formed, that calculation will result in a gain limitation equal to the gain inherent in any assets contributed by Distributing to Controlled.

> *Example 6 — Gain Limitation on Acquisition of Distributing*: Shareholder X owns 100 percent of the stock of P and shareholder Y owns 100 percent of D. P merges into D in an "A" reorganization. In the merger, X receives 60 percent of the D stock and Y

[31] *See* prop. Treas. reg. section 1.355-8(e)(4).
[32] Preamble to prop. Treas. reg. section 1.355-8, 69 *Fed. Reg.* at 67,875.
[33] Prop. Treas. reg. section 1.355-8(e)(2)(i).
[34] *See* prop. Treas. reg. section 1.355-8(g), Ex. 1.
[35] Prop. Treas. reg. sections 1.355-8(e)(2)(ii)(A), (C).
[36] Prop. Treas. reg. section 1.355-8(e)(3).

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receives 40 percent. In a ''D'' reorganization, D contributes some of the former P assets and one D asset to a newly formed corporation, C. After the contribution, D distributes the C stock pro rata to its shareholders. Immediately before the distribution, the former P assets had a $1 basis and a fair market value of $30, and the former D asset had a $3 basis and a $10 fair market value. Furthermore, D's basis in the C stock was $4 and had a value of $40.

P is a predecessor of D under test one discussed above. Because X acquired 60 percent of the D stock, there has been a 50-percent-or-greater acquisition of D, but not of P. Without regard to the gain limitation rule of prop. Treas. reg. section 1.355-8(e)(3), D would be required to recognize $36 gain, the fair market value of its C's stock less its basis ($40 less $4). Under the gain limitation rule, however, D's gain is limited to $7, or the built-in gain in the C stock ($36) less D's gain if there had been a 50-percent-or-greater acquisition of P's stock ($30 less $1, or $29).[37] That is the same amount of built-in gain that D had in the asset it transferred to C ($10 less $3).

When Controlled is a preexisting entity, however, Distributing's gain will include any gain inherent in the Controlled stock as well as any gain inherent in assets transferred to Controlled. Assume in Example 6 that C was a preexisting corporation and that D's C stock had a basis of $10 and a value of $25. Immediately before the distribution and after the contribution of P's and D's assets, the C stock has a basis of $14 and a value of $65. Under the gain limitation rule, D's gain is limited to $22, or the built-in gain in the C stock ($51) less D's gain if there had been a 50-percent-or-greater acquisition of P's stock ($29). Stated differently, D's gain is limited to the built-in gain in the C stock before the contributions ($15) and D's built-in gain in assets contributed by D to C ($7).

Note that the gain limitation rule applies only if the 50-percent-or-greater acquisition of Distributing occurs in the combining transfer. That limitation is probably not necessary in light of the fact that acquisitions of Distributing after the combining transfer are also treated as acquisitions of the predecessor of Distributing.[38] Therefore, post-combining-transfer acquisitions would likely result in a 50-percent-or-greater acquisition of both Distributing and a predecessor of Distributing and trigger the entire gain inherent in the Controlled stock. To illustrate, assume in Example 6, above, that X and Y ended up owning 40 percent and 60 percent, respectively, of D after the combining transfer, and D issued 20 percent of its stock in an initial public offering. The 20 percent of stock acquired in the IPO is treated as an acquisition of both D and P. Therefore, there has been a 50-percent-or-greater acquisition of both D and P, and the entire gain inherent in the C stock would be recognized.

What if Distributing and the predecessor are of equal size so that the combining transfer results in a 50 percent acquisition of each company? It would appear that Distributing's entire built-in gain in its Controlled stock is recognized. That places a significant amount of pressure on the valuation of Distributing and the predecessor, because the gain will be limited if more than 50 percent of either corporation is acquired.

3. Measuring the gain limitation.

a. Timing. Even though the relevant predecessor assets must be acquired in the combining transfer, the proposed regulations measure gain for purposes of the gain limitation rules ''immediately before the distribution'' with reference to the basis of the property in the hands of Controlled.[39] The one exception is for stock of Controlled owned by the predecessor, the basis and fair market value of which are determined immediately before the combining transfer.[40] As a result, any postmerger appreciation (or depreciation) in the predecessor's assets (other than Controlled stock) will increase (or decrease) the gain limitation. Similarly, any basis adjustments to the property will affect the gain limitation. For example, if Distributing recognizes gain on the divisive ''D'' reorganization by reason of receiving boot, the resulting increase in the basis of the asset in Controlled's hands will reduce the amount of the gain limitation.[41] Further, any assets purchased after the combining transaction are treated as Distributing's assets and do not affect the predecessor's gain limitation. Treasury and the IRS viewed those timing rules as reasonable because, in the combining transfer, the predecessor will likely cease to exist but the division of the predecessor's assets does not occur until the distribution.[42]

b. Netting gains and losses on multiple assets. The mechanism for computing the gain limitation regardingthe predecessor's assets, that is, the deemed section 351 exchange followed by a stock sale, necessarily aggregates the bases and fair market values of the assets being transferred in the separating transfer. As a result, built-in losses in contributed assets may offset built-in gains.[43] That is illustrated by an example in the proposed regulations.

Example 7 — Netting of Gains and Losses: Shareholder X owns 100 percent of P corporation and shareholder Y owns 100 percent of D corporation. P owns 35 percent of C corporation, with a basis of $40 and a fair market value of $35. D owns the remaining 65 percent of C with a basis of $10 and a fair market value of $65. P merges into D in an ''A'' reorganization, and after the merger, X and Y own 10 and 90 percent of D respectively, and D owns 100 percent of the stock of C with a basis of $50 and a fair

[37]*See* prop. Treas. reg. section 1.355-8(g), Ex. 4.

[38]*See* prop. Treas. reg. section 1.355-8(d)(1)(ii).

[39]Prop. Treas. reg. sections 1.355-8(e)(2)(i), (e)(2)(ii)(B).

[40]Prop. Treas. reg. section 1.355-8(e)(2)(ii)(D).

[41]Section 362(b); *see also* prop. Treas. reg. section 1.355-8(g), Ex. 1.

[42]Preamble to prop. Treas. reg. section 1.355-8, 69 *Fed. Reg.* at 67,876. Measuring the gain inherent in the stock of Controlled transferred by the predecessor in the combining transfer does not appear inconsistent with that reasoning, because the division of the predecessor's Controlled stock effectively occurs at the time of the combining transfer.

[43]That result makes sense, because contributing built-in loss assets to Controlled would likewise reduce the amount of the section 355(e) gain.

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market value of $100. In a ''D'' reorganization, D contributes one former P asset to C in exchange for additional C shares. After the contribution, D distributes all of the C stock to X and Y pro rata. Immediately before the distribution, the former P asset contributed to C by D has a $40 basis and a $100 fair market value, and the C stock held by D has a $90 basis and a fair market value of $200.

P is a predecessor of D under both of the tests described in the proposed regulations. Because Y acquired 90 percent of the P stock, there has been a 50-percent-or-greater acquisition of P. Without regard to the gain limitation rule of prop. Treas. reg. section 1.355-8(e)(2), D would be required to recognize $110 gain ($200 value of C before the distribution less $90 basis). Under the gain limitation rule, however, D's gain is limited to the gain P would have recognized if, immediately before the distribution, it had transferred in a section 351 transaction the former P property that was transferred by D to C ($100 value less $40 basis, or $60) and the C stock acquired from P ($35 value less $40 basis, or ($5)) to a newly formed corporation, and then sold the stock of the newly formed section 351 corporation to a third party for cash. The built-in loss in P's C stock offsets the built-in gain in P's asset, and D's recognition of gain is limited to $55 ($60 plus ($5)).[44]

D. Multiple and Successive Predecessors

The proposed regulations provide that more than one corporation may be a predecessor of Distributing or Controlled.[45] However, the proposed regulations do not provide for successive predecessors. In other words, a corporation that transfers property to a predecessor of Distributing is not also a predecessor of Distributing.[46] The preamble to the proposed regulations states that although Treasury and the IRS recognize that those transfers can be part of a plan, they wisely realized that such a successive rule would ''add substantial complexity.''[47] Given that the proposed regulations track acquisitions of predecessors separately, it would be enormously complex to track acquisitions with respect to separate pools of assets within a single entity. Further, because predecessors are defined with reference to 381 transactions, any built-in gain or loss in the assets of the predecessor to the predecessor would carry over to the predecessor, thus preserving any gain to be recognized on a subsequent separating transfer, as illustrated by the following examples.

Example 8 — Multiple Predecessors: Shareholder A owns 100 percent of X corporation which owns businesses M and N. Business M has a value of $20 and basis of $5. Shareholder B owns 100 percent of Y corporation, which owns businesses M and O. Y's business M has a value of $30 and a basis of $20. Shareholder E owns D corporation. X and Y each merge into D in an ''A'' reorganization. D, a much larger entity, owns businesses M, N, and O. In the merger, A receives 10 percent of D stock, B receives 14 percent of D stock and E's ownership in D shrinks to 76 percent. D then creates a wholly owned subsidiary, C, contributes the M business to C in a ''D'' reorganization, and distributes C to its shareholders pro rata. Immediately before the distribution, D's C stock has a basis of $55 and a fair market value of $150.

Both X and Y are predecessors of D under test one discussed above. Because 90 percent and 86 percent, respectively, of the X and Y stock were acquired, there has been a 50-percent-or-greater acquisition of each corporation. Without regard to the gain limitation rule of prop. Treas. reg. section 1.355-8(e)(2), D would be required to recognize $95 gain (value of C stock, $150, less D's basis, $55). The proposed regulations provide that the gain limitation rule is applied separately to each predecessor.[48] Under the gain limitation rule, D's gain is limited to the gain that each of X and Y would have recognized if, immediately before the distribution, they had transferred in separate section 351 transactions their M businesses to a newly formed corporation and then sold the stock of the newly formed section 351 corporation to a third party for cash. Thus, D's gain will be limited to $25, $15 of which relates to X's business M and $10 of which relates to Y's business M.

Example 9 — Successive Predecessors: Assume the same facts as Example 8, above, except that X merges into Y, and then Y (with X's assets) merges into D in successive ''A'' reorganizations.

Y, but not X, is a predecessor of D under test one. That does not, however, alter the amount of gain D must recognize. When X merged into Y, the basis and value of its business M ($20 value, $5 basis) carried over to Y and was combined with Y's business M ($30 value, $20 basis). Thus, when the combined business M of X and Y, with an aggregate value of $50 and basis of $25, are transferred to C, the gain limitation remains at $25.[49]

E. Definition of Predecessor of Controlled

The proposed regulations contain a definition of a predecessor of Controlled, but only for limited purposes. The preamble to the proposed regulations explains that generally Controlled will not be able to transfer property it receives in a 381 transaction to Distributing tax-free[50] (except when Controlled is itself a distributing corporation in a section 355 transaction). Thus, the concern that was present regarding Distributing's ability to separate its or a predecessor's property tax-free is generally not present with Controlled. Accordingly, Treasury and the

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[44]Prop. Treas. reg. section 1.355-8(g), Ex. 2.

[45]Prop. Treas. reg. section 1.355-8(b)(4)(iii).

[46]Prop. Treas. reg. section 1.355-8(b)(3).

[47]Preamble to prop. Treas. reg. section 1.355-8, 69 *Fed. Reg.* at 67,874.

[48]Prop. Treas. reg. section 1.355-8(e)(1).

[49]It is possible that X and Y's business M has a greater value when combined than when conducted separately, so that the value of X and Y as a single entity is greater than the value of each entity separately. That could increase the percentage interest received by the shareholders of X and Y in the combining transaction.

[50]*See* section 311(b).

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IRS determined that the policy underlying the definition of a predecessor of Distributing does not appear to necessitate a definition of a predecessor of Controlled. Nonetheless, such a definition is necessary for limited purposes under the proposed regulations. Specifically, the definition of a predecessor of Controlled applies only for purposes of determining whether a corporation is a predecessor of Distributing, calculating the gain limitation when a predecessor of Distributing is acquired and applying a special affiliated group rule.[51] An acquisition of a predecessor of Controlled therefore cannot trigger section 355(e) gain. For example, if P merges into Controlled and Distributing contributes additional assets to Controlled and spins it off, there has been no separation of P's assets to implicate section 355(e). Similarly, if P merges into Controlled and Controlled distributes certain P assets to Distributing before the spinoff, that distribution is taxable and does not implicate section 355(e).

> *Example 10 — Predecessor of Controlled*: Shareholder X owns 100 percent of P and P owns assets, including 100 percent of the stock of R corporation. Shareholder Y owns 100 percent of D corporation, which owns 100 percent of C. P merges into D in an ''A'' reorganization. D then causes R to merge into C in a ''D'' reorganization.

Because R transferred property to C in a 381 transaction before the distribution, R is a predecessor of C for purposes of determining whether P is a predecessor of D. Because P transferred property to D, including stock of R, a predecessor of C, in a 381 transaction and D did not transfer all of the property acquired from P to C, P is a predecessor of D.[52]

III. Who Succeeds — Definition of 'Successor'

A. Successor Rules in General

The preamble to the proposed regulations explains that the definition of a successor corporation intends to identify those corporations that are a continuation of Distributing or Controlled for section 355(e) purposes. Thus, the proposed regulations define a successor as a corporation to which Distributing or Controlled transfers property in a 381 transaction after the distribution of Controlled.[53] The proposed regulations thus create a sort of timeline — 381 transactions before the distribution can result in predecessors, while 381 transactions after the distribution can result in successors.

The proposed regulations also provide deemed acquisition rules for successors similar to those provided for predecessors. Each person that owned stock in a successor of Distributing or Controlled before the successor transaction is deemed to acquire stock in Distributing or Controlled in the successor transaction.[54] Likewise, successor stock acquired after the successor transaction is counted as Distributing or Controlled stock.[55]

Similar to the definition of predecessor, more than one corporation may be a successor of Distributing or Controlled.[56] However, unlike the definition of predecessor, the proposed regulations trace to successors of successors. For example, if Distributing transfers property to X corporation in a 381 transaction and X corporation transfers property to Y corporation in a 381 transaction, each of X and Y may be successors of Distributing.[57] However, the successor status of the last corporation to which property was transferred (in our example Y corporation) is dependent on whether the first corporation (in our example X corporation) to which property was transferred qualifies as a successor.[58] Successive entities in the case of successors does not present the same administrative concerns as it would with predecessors — because an acquisition of a successor of Distributing or Controlled after the successor transaction is treated as an acquisition of Distributing or Controlled,[59] there is no need to separately trace the ownership changes of Distributing or Controlled and each successor as required for predecessors.[60]

> *Example 11 — Successor of Controlled*: Shareholder X owns 100 percent of D and R corporations. D owns 100 percent of C corporation. D distributes its C stock to X, and immediately thereafter, C merges into R in a ''D'' reorganization. Z purchases 60 percent of the vote and value of R from X for cash.

R is a successor of C because after the distribution, C transfers property to R in a 381 transaction. Thus, Z acquired an interest in a successor of C. R's stock is treated as stock of C, and therefore Z is treated as acquiring a 60 percent interest in C.[61]

B. Scope of Successor Rules

Prop. Treas. reg. section 1.355-8(a) restates the rule in section 355(e)(4)(D) that references to Distributing or Controlled include references to any predecessor or successor of that corporation, but presumably the definitions in the proposed regulations apply for purposes of all of section 355(e). Section 355(e) contains two other references to ''successor'' corporations. Section 355(e)(3)(A)(iii) excludes from section 355(e) acquisitions of stock in any

[51]Prop. Treas. reg. section 1.355-8(b)(2). The special affiliated group rule clarifies the application of the affiliated group exception to section 355(e) in the context of predecessors and successors. Section 355(e)(2)(C) provides that section 355(e) will not apply if, immediately after the planned distribution and acquisition, the distributing and all controlled corporations are members of a single affiliated group (as defined in section 1504 without regard to subsection (b) thereof). The proposed regulations provide that for purposes of applying that exception, a predecessor of Distributing or Controlled will be treated as continuing in existence following the combining transfer, and Distributing or Controlled will be treated as continuing in existence following a transfer of property to a successor. Prop. Treas. reg. section 1.355-8(f).

[52]Prop. Treas. reg. section 1.355-8(g), Ex. 3.

[53]Prop. Treas. reg. section 1.355-8(c)(1).

[54]Prop. Treas. reg. sections 1.355-8(d)(2)(i), (d)(3)(i).

[55]Prop. Treas. reg. sections 1.355-8(d)(2)(ii), (d)(3)(ii).

[56]Prop. Treas. reg. section 1.355-8(c)(2).

[57]*Id.*

[58]*Id.*

[59]Prop. Treas. reg. sections 1.355-8(d)(2)(ii), (d)(3)(ii).

[60]*See* prop. Treas. reg. section 1.355-8(d)(4).

[61]*See* prop. Treas. reg. section 1.355-8(g), Ex. 5.

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successor corporation of Distributing or Controlled by reason of holding stock or securities of Distributing or Controlled (the successor exception). Section 355(e)(3)(B) treats the acquisition of assets by a successor of Distributing or Controlled in an ''A,'' ''C,'' or ''D'' reorganization as an acquisition of stock of Distributing or Controlled (the asset rule).

> *Example 12 — Scope of Successor Rule*: D owns 100 percent of C corporation. D distributes its C stock to its shareholders. Immediately thereafter, D merges into S in an ''A'' reorganization. D's shareholders receive 60 percent of the S stock.

S is a successor to D under the proposed regulations, because after the distribution, D transfers property to S in a 381 transaction. Assuming that the successor definition applies for purposes of all of section 355(e), then S is also a successor for purposes of the successor exception and the asset rule. As a result, under the asset rule, S's shareholders are treated as acquiring 40 percent of D's stock, and under the successor exception the acquisition by D's shareholders of the S stock is ignored. Thus, there has been only a 40 percent acquisition of D and section 355(e) does not apply. If that were not the case, you could end up with the bizarre result that D's shareholders are treated as acquiring 60 percent of S, a successor of D, and section 355(e) would always apply to a merger into a successor because there will always be a 50-percent-or-greater acquisition of either Distributing/Controlled or the successor.

C. Transfers to Partnerships or Corporations

The preamble states:

> The IRS and Treasury Department are concerned that certain transfers of assets to a partnership or a corporation by Distributing or Controlled may facilitate an acquisition of an interest in Distributing's or Controlled's assets that is functionally equivalent to an acquisition of Distributing or Controlled. The IRS and Treasury Department are also concerned that certain acquisitions by persons unrelated to Distributing or Controlled of an interest in a corporation or partnership in which Distributing or Controlled directly or indirectly owns an interest may also be an acquisition that is functionally equivalent to an acquisition of Distributing or Controlled. If such transfers and acquisitions are part of a plan that includes the distribution, they could be used to circumvent the purposes of section 355(e). Accordingly, the IRS and Treasury Department are studying how section 355(e) might apply to such transfers and acquisitions. Comments are requested in this regard.[62]

Treasury and the IRS appropriately decided not to treat a partnership or corporation to which Distributing or Controlled transfers assets as a successor. Such a rule would have added substantial complexity because it would have required measuring the ownership changes of Distributing or Controlled as well as each entity to which it transferred assets. By limiting the definition of successor to require a 381 transaction, the prior entity no longer exists and there is only one entity to monitor.

The transfer of assets to a partnership or corporation might also be addressed by Treasury and the IRS under regulatory authority granted under section 355(e). There are two possible sources of regulatory authority in section 355(e). The first is to expand the asset rule discussed above. Section 355(e)(3)(B) provides:

> (B) Asset Acquisitions. — Except as provided in regulations, for purposes of this subsection, if the assets of the distributing corporation or any controlled corporation are *acquired by a successor corporation* in a transaction described in subparagraph (A), (C), or (D) of section 368(a)(1) *or any other transaction specified in regulations by the Secretary*, the shareholders (immediately before the acquisition) of the corporation acquiring such assets shall be treated as acquiring stock in the corporation from which the assets were acquired. (Emphasis added.)

The specific regulatory authority granted by section 355(e)(3)(B) requires the transaction that may be specified in regulations involve the acquisition of assets by a ''successor corporation.'' However, neither a corporation receiving assets in a section 351 transaction nor a partnership receiving assets in a section 721 transaction qualifies as a successor corporation under the proposed regulations. Absent expanding the definition of successor in the regulations or adopting a different definition of successor for this purpose, that specific grant of regulatory authority would not appear to permit such a rule.

The second is to rely on the general grant of regulatory authority under section 355(e)(5), which provides that ''[t]he Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this subsection.'' However, as discussed below, the authors believe that transfers of assets to corporations or partnership are beyond the intended reach of section 355(e) and therefore would not be necessary to carry out the purposes of section 355(e).

The focus of section 355(e) is on changes in the stock ownership of Distributing or Controlled. As discussed above, the disguised sale transactions at which section 355(e) was aimed involved the transfer of ownership of Distributing or Controlled in a manner that shifted value from the ''buyer'' to the ''seller.'' The asset rule expands section 355(e) to some asset reorganizations that have the same effect as a transfer of stock ownership of Distributing or Controlled. Certainly, Distributing or Controlled could sell assets, including stock of a subsidiary or an interest in a partnership, even as part of the same plan, without violating section 355(e). Section 355 contains other rules to police inappropriate transfers of assets, that is, active trade or business, continuity of business enterprise,[63] and even business purpose.

[62]Preamble to prop. Treas. reg. section 1.355-8, 69 *Fed. Reg.* at 67,876.

[63]It is arguable that there is no continuity of business enterprise requirement separate from the active trade or business test. *See* Wayne T. Murray, ''The Active Trade or Business

(Footnote continued on next page.)

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Transfers of Distributing or Controlled assets in a section 351 or 721 transaction (or acquisitions of an interest in a preexisting corporation or partnership owned by Distributing or Controlled) does not appear to implicate the purposes of section 355(e) — the historic owners of Distributing and Controlled do not change, nor is there a shift in value from the third-party investor to Distributing or Controlled. Further, the transfer of assets in section 351 or 721 transactions is very different economically from the disguised sales targeted by section 355(e) in that Distributing or Controlled and the third party maintain a continued relationship as joint venturers, unlike the disguised sale transactions targeted by section 355(e).

The asset policing rules of section 355 adequately address those transfers of assets. Assume the extreme case in which Controlled contributes all of its assets to a partnership in exchange for less than 50 percent of the partnership interests. Controlled must satisfy the rather stringent requirements of Rev. Rul. 92-17,[64] that is, that its officers perform active and substantial management functions for the partnership, to satisfy the active trade or business requirement. If Controlled were to contribute all of its assets to a corporation in exchange for less than 50 percent of the corporation's stock, the active trade or business requirement would not be satisfied, because the active trade or business requirement mandates that Controlled either conduct the active trade or business directly or through 80 percent controlled subsidiaries.[65] Thus, section 355 would not apply.

Requirement of Section 355 (With Emphasis on Internal Revenue Service Private Letter Ruling Positions),'' 10 *Tax Strategies for Corporate Acquisitions, Disposition, Spin-Offs, Joint Ventures, Financings, Reorganizations, and Restructurings* 567 (2002).

[64]1992-1 C.B. 142, *amplified by* Rev. Rul. 2002-49, 2002-32 IRB 288, *Doc 2002-16962, 2002 TNT 140-17*.

[65]Section 355(b)(2)(A).

IV. Concluding Thoughts

Treasury and the IRS should be commended for proposing a set of well-thought-out regulations that attempt to tailor the definitions of predecessor and successor to the purposes behind section 355(e). The proposed regulations deviate from the general approaches of predecessor definitions elsewhere in the code and adopt a unique definition of predecessor that is designed to identify transactions in which there is a separation of the predecessor's assets. That is consistent with the purpose of section 355(e) to deny tax-free treatment under section 355 when a division of a corporation's assets is coupled with a planned 50-percent-or-greater acquisition of Distributing or Controlled. Because the same concern is not present with Controlled, because Controlled generally will not be able to separate property of a predecessor tax-free, the proposed regulations reasonably do not adopt the concept of a predecessor of Controlled, except for limited purposes.

The taxpayer-friendly gain limitation rules soften the effect of section 355(e) when the gain inherent in the separated assets of the acquired entity is small in relation to the overall gain inherent in the Controlled stock.

The proposed regulations take the more traditional approach regarding the definition of successor, defining it with reference to 381 transactions. The definition is intended to identify those corporations that are a continuation of Distributing or Controlled for section 355(e) purposes. That approach is consistent with other provisions that focus on transfers of entities and define successor with reference to 381 or nonrecognition transactions.

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