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the transaction was used principally as a device must be made from all the facts and circumstances, including the presence of the device factors and nondevice factors specified in paragraph (d)(2) and (3) of this section.

(e) *Stock and securities distributed*—(1) *In general.* Section 355 applies to a distribution only if the distributing corporation distributes—

(i) All of the stock and securities of the controlled corporation that it owns, or

(ii) At least an amount of the stock of the controlled corporation that constitutes control as defined in section 368(c). In such a case, all, or any part, of the securities of the controlled corporation may be distributed, and paragraph (e)(2) of this section shall apply.

(2) *Additional rules.* Where a part of either the stock or the securities of the controlled corporation is retained under paragraph (e)(1)(ii) of this section, it must be established to the satisfaction of the Commissioner that the retention by the distributing corporation was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax. Ordinarily, the corporate business purpose or purposes for the distribution will require the distribution of all of the stock and securities of the controlled corporation. If the distribution of all of the stock and securities of a controlled corporation would be treated to any extent as a distribution of “other property” under section 356, this fact tends to establish that the retention of stock or securities is in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax.

(f) *Principal amount of securities*—(1) *Securities received.* Section 355 does not apply to a distribution if, with respect to any shareholder or security holder, the principal amount of securities received exceeds the principal amount of securities surrendered, or securities are received but no securities are surrendered. In such cases, see section 356.

(2) *Only stock received.* If only stock is received in a distribution to which section 355(a)(1)(A) applies, the principal amount of the securities surrendered, if any, and the par value or stated value of the stock surrendered, if any, are

not relevant to the application of that section.

(g) *Period of ownership*—(1) *Other property.* For purposes of section 355(a)(1)(A), stock of a controlled corporation acquired in a transaction in which gain or loss was recognized in whole or in part (other than a transaction described in § 1.355-3(b)(4)(iii)) within the five-year period ending on the date of the distribution shall not be treated as stock of the controlled corporation but shall be treated as “other property.” See section 356. However, for purposes of section 355(a)(1)(D), the stock so acquired is stock of the controlled corporation.

(2) *Example.* Paragraph (g)(1) of this section may be illustrated by the following example:

Example. Corporation X has held 85 of the 100 outstanding shares of the stock of corporation Y for more than five years on the date of the distribution. Six months before that date, X purchased ten more shares. If X distributes all of its 95 shares of the stock of Y, so much of section 356 as relates to section 355 may apply to the transaction and the ten newly acquired shares are treated as other property. On the other hand, if X retains ten of the shares of the stock of Y then the application of paragraph (e) of this section must take into account all of the stock of Y, including the ten shares newly acquired by X and the five shares owned by others. Similarly, if, by the use of any agency, X acquired any of the stock of Y within the five-year period ending on the date of the distribution in a transaction in which gain or loss was recognized in whole or in part (for example, where another subsidiary of X purchased stock of Y), then that stock is treated as other property. If X had held only 75 of the 100 outstanding shares of the stock of Y for more than five years on the date of the distribution and had purchased the remaining 25 shares six months before that date, then neither section 355 nor section 356 would apply to the distribution.

(h) *Active conduct of a trade or business.* Section 355 applies to a distribution only if the requirements of § 1.355-3 (relating to the active conduct of a trade or business) are satisfied.

[T.D. 8238, 54 FR 290, Jan. 5, 1989; 54 FR 5577, Feb. 3, 1989; 57 FR 28463, June 25, 1992]

§ 1.355-3 Active conduct of a trade or business.

(a) *General requirements*—(1) *Application of section 355.* Under section

355(b)(1), a distribution of stock, or stock and securities, of a controlled corporation qualifies under section 355 only if—

(i) The distributing and the controlled corporations are each engaged in the active conduct of a trade or business immediately after the distribution (section 355(b)(1)(A)), or

(ii) Immediately before the distribution, the distributing corporation had no assets other than stock or securities of the controlled corporations, and each of the controlled corporations is engaged in the active conduct of a trade or business immediately after the distribution (section 355(b)(1)(B)). A *de minimis* amount of assets held by the distributing corporation shall be disregarded for purposes of this paragraph (a)(1)(ii).

(2) *Examples.* Paragraph (a)(1) of this section may be illustrated by the following examples:

Example (1). Prior to the distribution, corporation X is engaged in the active conduct of a trade or business and owns all of the stock of corporation Y, which also is engaged in the active conduct of a trade or business. X distributes all of the stock of Y to X's shareholders, and each corporation continues the active conduct of its trade or business. The active business requirement of section 355(b)(1)(A) is satisfied.

Example (2). The facts are the same as in *Example (1)*, except that X transfers all of its assets other than the stock of Y to a new corporation in exchange for all of the stock of the new corporation and then distributes the stock of both controlled corporations to X's shareholders. The active business requirement of section 355(b)(1)(B) is satisfied.

(b) *Active conduct of a trade or business defined—(1) In general.* Section 355(b)(2) provides rules for determining whether a corporation is treated as engaged in the active conduct of a trade or business for purposes of section 355(b)(1). Under section 355(b)(2)(A), a corporation is treated as engaged in the active conduct of a trade or business if it is itself engaged in the active conduct of a trade or business or if substantially all of its assets consist of the stock, or stock and securities, of a corporation or corporations controlled by it (immediately after the distribution) each of which is engaged in the active conduct of a trade or business.

(2) *Active conduct of a trade or business immediately after distribution—(i) In general.* For purposes of section 355(b), a corporation shall be treated as engaged in the “active conduct of a trade or business” immediately after the distribution if the assets and activities of the corporation satisfy the requirements and limitations described in paragraph (b)(2)(ii), (iii), and (iv) of this section.

(ii) *Trade or business.* A corporation shall be treated as engaged in a trade or business immediately after the distribution if a specific group of activities are being carried on by the corporation for the purpose of earning income or profit, and the activities included in such group include every operation that forms a part of, or a step in, the process of earning income or profit. Such group of activities ordinarily must include the collection of income and the payment of expenses.

(iii) *Active conduct.* For purposes of section 355(b), the determination whether a trade or business is actively conducted will be made from all of the facts and circumstances. Generally, the corporation is required itself to perform active and substantial management and operational functions. Generally, activities performed by the corporation itself do not include activities performed by persons outside the corporation, including independent contractors. A corporation may satisfy the requirements of this subdivision (iii) through the activities that it performs itself, even though some of its activities are performed by others. Separations of real property all or substantially all of which is occupied prior to the distribution by the distributing or the controlled corporation (or by any corporation controlled directly or indirectly by either of those corporations) will be carefully scrutinized with respect to the requirements of section 355(b) and this § 1.355-3.

(iv) *Limitations.* The active conduct of a trade or business does not include—

(A) The holding for investment purposes of stock, securities, land, or other property, or

(B) The ownership and operation (including leasing) of real or personal property used in a trade or business, unless the owner performs significant

services with respect to the operation and management of the property.

(3) *Active conduct for five-year period preceding distribution.* Under section 355(b)(2)(B), a trade or business that is relied upon to meet the requirements of section 355(b) must have been actively conducted throughout the five-year period ending on the date of the distribution. For purposes of this subparagraph (3)—

(i) Activities which constitute a trade or business under the tests described in paragraph (b)(2) of this section shall be treated as meeting the requirement of the preceding sentence if such activities were actively conducted throughout the 5-year period ending on the date of distribution, and

(ii) The fact that a trade or business underwent change during the five-year period preceding the distribution (for example, by the addition of new or the dropping of old products, changes in production capacity, and the like) shall be disregarded, provided that the changes are not of such a character as to constitute the acquisition of a new or different business. In particular, if a corporation engaged in the active conduct of one trade or business during that five-year period purchased, created, or otherwise acquired another trade or business in the same line of business, then the acquisition of that other business is ordinarily treated as an expansion of the original business, all of which is treated as having been actively conducted during that five-year period, unless that purchase, creation, or other acquisition effects a change of such a character as to constitute the acquisition of a new or different business.

(4) *Special rules for acquisition of a trade or business (Prior to the Revenue Act of 1987 and Technical and Miscellaneous Revenue Act of 1988)*—(i) *In general.* Under section 355(b)(2)(C), a trade or business relied upon to meet the requirements of section 355(b) must not have been acquired by the distributing corporation, the controlled corporation, or another member of the affiliated group during the five-year period ending on the date of the distribution unless it was acquired in a transaction in which no gain or loss was recognized. Similarly, under section

355(b)(2)(D), the trade or business must not have been indirectly acquired by any of those corporations (or a predecessor in interest of any of those corporations) during that five-year period in a transaction in which gain or loss was recognized in whole or in part and which consisted of the acquisition of control of the corporation directly engaged in the trade or business, or the indirect acquisition of control of that corporation through the direct or indirect acquisition of control of one or more other corporations. A trade or business acquired, directly or indirectly, within the five-year period ending on the date of the distribution in a transaction in which the basis of the assets acquired was not determined in whole or in part by reference to the transferor's basis does not qualify under section 355(b)(2), even though no gain or loss was recognized by the transferor.

(ii) *Example.* Paragraph (b)(4)(i) of this section may be illustrated by the following example:

Example. In 1985, corporation X, which operates a business and has cash and other liquid assets, purchases all of the stock of corporation Y, which is engaged in the active conduct of a trade or business. Later in the same year, X merges into Y in a “downstream” statutory merger. In 1986, Y transfers the business assets formerly owned by X to a new subsidiary, corporation Z, and then distributes the stock of Z to Y's shareholders. Section 355 does not apply to the distribution of the stock of Z because the trade or business of Y was indirectly acquired by X, a predecessor in interest of Y, during the five-year period preceding the distribution.

(iii) *Gain or loss recognized in certain transactions.* The requirements of section 355(b)(2)(C) and (D) are intended to prevent the direct or indirect acquisition of a trade or business by a corporation in anticipation of a distribution by the corporation of that trade of business in a distribution to which section 355 would otherwise apply. A direct or indirect acquisition of a trade or business by one member of an affiliated group from another member of the group is not the type of transaction to which section 355(b)(2)(C) and (D) is intended to apply. Therefore, in applying

section 355(b)(2)(C) or (D), such an acquisition, even though taxable, shall be disregarded.

(iv) *Affiliated group.* For purposes of this subparagraph (4), the term *affiliated group* means an affiliated group as defined in section 1504(a) (without regard to section 1504(b)), except that the term *stock* includes nonvoting stock described in section 1504(a)(4).

(5) *Special rules for acquisition of a trade or business (After the Revenue Act of 1987 and Technical and Miscellaneous Revenue Act of 1988).* [Reserved]

(c) *Examples.* The following examples illustrate section 355(b)(2)(A) and (B) and paragraph (b)(1), (2), and (3) of this section. However, a transaction that satisfies these active business requirements will qualify under section 355 only if it satisfies the other requirements of section 355 (a) and (b).

Example (1). Corporation X is engaged in the manufacture and sale of soap and detergents and also owns investment securities. X transfers the investment securities to new subsidiary Y and distributes the stocks of Y to X's shareholders. Y does not satisfy the requirements of section 355(b) because the holding of investment securities does not constitute the active conduct of a trade or business. See paragraph (b)(2)(iv)(A) of this section.

Example (2). Corporation X owns, manages, and derives rental income from an office building and also owns vacant land. X transfers the land to new subsidiary Y and distributes the stock of Y to X's shareholders. Y will subdivide the land, install streets and utilities, and sell the developed lots to various homebuilders. Y does not satisfy the requirements of section 355(b) because no significant development activities were conducted with respect to the land during the five-year period ending on the date of the distribution. See paragraph (b)(3) of this section.

Example (3). Corporation X owns land on which it conducts a ranching business. Oil has been discovered in the area, and it is apparent that oil may be found under the land on which the ranching business is conducted. X has engaged in no significant activities in connection with its mineral rights. X transfers its mineral rights to new subsidiary Y and distributes the stock of Y to X's shareholders. Y will actively pursue the development of the oil producing potential of the property. Y does not satisfy the requirements of section 355(b) because X engaged in no significant exploitation activities with respect to the mineral rights during the five-year period ending on the date of the dis-

tribution. See paragraph (b)(3) of this section.

Example (4). For more than five years, corporation X has conducted a single business of constructing sewage disposal plants and other facilities. X transfers one-half of its assets to new subsidiary Y. These assets include a contract for the construction of a sewage disposal plant in State M, construction equipment, cash, and other tangible assets. X retains a contract for the construction of a sewage disposal plant in State N, construction equipment, cash, and other intangible assets. X then distributes the stock of Y to one of X's shareholders in exchange for all of his stock of X. X and Y both satisfy the requirements of section 355(b). See paragraph (b)(3)(i) of this section.

Example (5). For the past six years, corporation X has owned and operated two factories devoted to the production of edible pork skins. The entire output of one factory is sold to one customer, C, while the output of the second factory is sold to C and a number of other customers. To eliminate errors in packaging, X opens a new factory. Thereafter, orders from C are processed and packaged at the two original factories, while the new factory handles only orders from other customers. Eight months after opening the new factory, X transfers it and related business assets to new subsidiary Y and distributes the stock of Y to X's shareholders. X and Y both satisfy the requirements of section 355(b). See paragraph (b)(3)(i) and (ii) of this section.

Example (6). Corporation X has owned and operated a men's retail clothing store in the downtown area of the City of G for nine years and has owned and operated another men's retail clothing store in a suburban area of G for seven years. X transfers the store building, fixtures, inventory, and other assets related to the operations of the suburban store to new subsidiary Y. X also transfers to Y the delivery trucks and delivery personnel that formerly served both stores. Henceforth, X will contract with a local public delivery service to make its deliveries. X retains the warehouses that formerly served both stores. Henceforth, Y will lease warehouse space from an unrelated public warehouse company. X then distributes the stock of Y to X's shareholders. X and Y both satisfy the requirements of section 355(b). See paragraph (b)(3)(i) of this section.

Example (7). For the past nine years, corporation X has owned and operated a department store in the downtown area of the City of G. Three years ago, X acquired a parcel of land in a suburban area of G and constructed a new department store on it. X transfers the suburban store and related business assets to new subsidiary Y and distributes the stock of Y to X's shareholders. After the distribution, each store has its own manager and is operated independently of the other store. X and

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Y both satisfy the requirements of section 355(b). See paragraph (b)(3)(i) and (ii) of this section.

Example (8). For the past six years, corporation X has owned and operated hardware stores in several states. Two years ago, X purchased all of the assets of a hardware store in State M, where X had not previously conducted business. X transfers the State M store and related business assets to new subsidiary Y and distributes the stock of Y to X's shareholders. After the distribution, the State M store has its own manager and is operated independently of the other stores. X and Y both satisfy the requirements of section 355(b). See paragraph (b)(3)(i) and (ii) of this section.

Example (9). For the past eight years, corporation X has engaged in the manufacture and sale of household products. Throughout this period, X has maintained a research department for use in connection with its manufacturing activities. The research department has 30 employees actively engaged in the development of new products. X transfers the research department to new subsidiary Y and distributes the stock of Y to X's shareholders. After the distribution, Y continues its research operations on a contractual basis with several corporations, including X. X and Y both satisfy the requirements of section 355(b). See paragraph (b)(3)(i) of this section. The result in this example is the same if, after the distribution, Y continues its research operations but furnishes its services only to X. See paragraph (b)(3)(i) of this section. However, see § 1.355-2 (d)(2)(iv)(C) (related function device factor) for possible evidence of device.

Example (10). For the past six years, corporation X has processed and sold meat products. X derives income from no other source. X separates the sales function from the processing function by transferring the business assets related to the sales function and cash for working capital to new subsidiary Y. X then distributes the stock of Y to X's shareholders. After the distribution, Y purchases for resale the meat products processed by X. X and Y both satisfy the requirements of section 355(b). See paragraph (b)(3)(i) of this section. However, see § 1.355-2(d)(2)(iv)(C) (related function device factor) for possible evidence of device.

Example (11). For the past eight years, corporation X has been engaged in the manufacture and sale of steel and steel products. X owns all of the stock of corporation Y, which, for the past six years, has owned and operated a coal mine for the sole purpose of supplying X's coal requirements in the manufacture of steel. X distributes the stock of Y to X's shareholders. X and Y both satisfy the requirements of section 355 (b). See paragraph (b)(3)(i) of this section. However, see § 1.355-2 (d)(2)(iv)(C) (related function device factor) for possible evidence of device.

Example (12). For the past seven years, corporation X, a bank, has owned an eleven-story office building, the ground floor of which X has occupied in the conduct of its banking business. The remaining ten floors are rented to various tenants. Throughout this seven-year period, the building has been managed and maintained by employees of the bank. X transfers the building to new subsidiary Y and distributes the stock of Y to X's shareholders. Henceforth, Y will manage the building, negotiate leases, seek new tenants, and repair and maintain the building. X and Y both satisfy the requirements of section 355 (b). See paragraph (b)(3) of this section.

Example (13). For the past nine years, corporation X, a bank, has owned a two-story building, the ground floor and one half of the second floor of which X has occupied in the conduct of its banking business. The other half of the second floor has been rented as storage space to a neighboring retail merchant. X transfers the building to new subsidiary Y and distributes the stock of Y to X's shareholders. After the distribution, X leases from Y the space in the building that it formerly occupied. Under the lease, X will repair and maintain its portion of the building and pay property taxes and insurance. Y does not satisfy the requirements of section 355 (b) because it is not engaged in the active conduct of a trade or business immediately after the distribution. See paragraph (b)(2)(iv)(A) of this section. This example does not address the question of whether the activities of X with respect to the building prior to the separation would constitute the active conduct of a trade or business.

[T.D. 8238, 54 FR 294, Jan. 5, 1989]

§ 1.355-4 Non pro rata distributions, etc.

Section 355 provides for nonrecognition of gain or loss with respect to a distribution whether or not (a) the distribution is pro rata with respect to all of the shareholders of the distributing corporation, (b) the distribution is pursuant to a plan of reorganization within the meaning of section 368 (a) (1)(D), or (c) the shareholder surrenders stock in the distributing corporation. Under section 355, the stock of a controlled corporation may consist of common stock or preferred stock. (See, however, section 306 and the regulations thereunder.) Section 355 does not apply, however, if the substance of a transaction is merely an exchange between shareholders or security holders of stock or securities in one corporation