

stock described in section 351(g)(2)(C)(i)(II).

[T.D. 8238, 54 FR 289, Jan. 5, 1989, as amended by T.D. 8752, 63 FR 410, Jan. 6, 1998; T.D. 8882, 65 FR 31078, May 16, 2000; T.D. 8904, 65 FR 58651, Oct. 2, 2000]

§ 1.355-2 Limitations.

(a) *Property distributed.* Section 355 applies to a distribution only if the property distributed consists solely of stock, or stock and securities, of a controlled corporation. If additional property (including an excess principal amount of securities received over securities surrendered) is received, see section 356.

(b) *Independent business purpose*—(1) *Independent business purpose requirement.* Section 355 applies to a transaction only if it is carried out for one or more corporate business purposes. A transaction is carried out for a corporate business purpose if it is motivated, in whole or substantial part, by one or more corporate business purposes. The potential for the avoidance of Federal taxes by the distributing or controlled corporations (or a corporation controlled by either) is relevant in determining the extent to which an existing corporate business purpose motivated the distribution. The principal reason for this business purpose requirement is to provide nonrecognition treatment only to distributions that are incident to readjustments of corporate structures required by business exigencies and that effect only readjustments of continuing interests in property under modified corporate forms. This business purpose requirement is independent of the other requirements under section 355.

(2) *Corporate business purpose.* A corporate business purpose is a real and substantial non Federal tax purpose germane to the business of the distributing corporation, the controlled corporation, or the affiliated group (as defined in § 1.355-3(b)(4)(iv)) to which the distributing corporation belongs. A purpose of reducing non Federal taxes is not a corporate business purpose if (i) the transaction will effect a reduction in both Federal and non Federal taxes because of similarities between Federal tax law and the tax law of the other jurisdiction and (ii) the reduction

of Federal taxes is greater than or substantially coextensive with the reduction of non Federal taxes. See *Examples (7) and (8)* of paragraph (b)(5) of this section. A shareholder purpose (for example, the personal planning purposes of a shareholder) is not a corporate business purpose. Depending upon the facts of a particular case, however, a shareholder purpose for a transaction may be so nearly coextensive with a corporate business purpose as to preclude any distinction between them. In such a case, the transaction is carried out for one or more corporate business purposes. See *Example (2)* of paragraph (b)(5) of this section.

(3) *Business purpose for distribution.* The distribution must be carried out for one or more corporate business purposes. See *Example (3)* of paragraph (b)(5) of this section. If a corporate business purpose can be achieved through a nontaxable transaction that does not involve the distribution of stock of a controlled corporation and which is neither impractical nor unduly expensive, then, for purposes of paragraph (b)(1) of this section, the separation is not carried out for that corporate business purpose. See *Examples (3) and (4)* of paragraph (b)(5) of this section. For rules with respect to the requirement of a business purpose for a transfer of assets to a controlled corporation in connection with a reorganization described in section 368(a)(1)(D), see § 1.368-1(b).

(4) *Business purpose as evidence of non-device.* The corporate business purpose or purposes for a transaction are evidence that the transaction was not used principally as a device for the distribution of earnings and profits within the meaning of section 355(a)(1)(B). See paragraph (d)(3)(ii) of this section.

(5) *Examples.* The provisions of this paragraph (b) may be illustrated by the following examples:

Example (1). Corporation X is engaged in the production, transportation, and refining of petroleum products. In 1985, X acquires all of the properties of corporation Z, which is also engaged in the production, transportation, and refining of petroleum products. In 1991, as a result of antitrust litigation, X is ordered to divest itself of all of the properties acquired from Z. X transfers those

properties to new corporation Y and distributes the stock of Y pro rata to X's shareholders. In view of the divestiture order, the distribution is carried out for a corporate business purpose. See paragraph (b)(1) of this section.

Example (2). Corporation X is engaged in two businesses: The manufacture and sale of furniture and the sale of jewelry. The businesses are of equal value. The outstanding stock of X is owned equally by unrelated individuals A and B. A is more interested in the furniture business, while B is more interested in the jewelry business. A and B decide to split up the businesses and go their separate ways. A and B anticipate that the operations of each business will be enhanced by the separation because each shareholder will be able to devote his undivided attention to the business in which he is more interested and more proficient. Accordingly, X transfers the jewelry business to new corporation Y and distributes the stock of Y to B in exchange for all of B's stock in X. The distribution is carried out for a corporate business purpose, notwithstanding that it is also carried out in part for shareholder purposes. See paragraph (b)(2) of this section.

Example (3). Corporation X is engaged in the manufacture and sale of toys and the manufacture and sale of candy. The shareholders of X wish to protect the candy business from the risks and vicissitudes of the toy business. Accordingly, X transfers the toy business to new corporation Y and distributes the stock of Y to X's shareholders. Under applicable law, the purpose of protecting the candy business from the risks and vicissitudes of the toy business is achieved as soon as X transfers the toy business to Y. Therefore, the distribution is not carried out for a corporate business purpose. See paragraph (b)(3) of this section.

Example (4). Corporation X is engaged in a regulated business in State T. X owns all of the stock of corporation Y, a profitable corporation that is not engaged in a regulated business. Commission C sets the rates that X may charge its customers, based on its total income. C has recently adopted rules according to which the total income of a corporation includes the income of a business if, and only if, the business is operated, directly or indirectly, by the corporation. Total income, for this purpose, includes the income of a wholly owned subsidiary corporation but does not include the income of a parent or "brother/sister" corporation. Under C's new rule, X's total income includes the income of Y, with the result that X has suffered a reduction of the rates that it may charge its customers. It would not be impractical or unduly expensive to create in a nontaxable transaction (such as a transaction qualifying under section 351) a holding company to hold the stock of X and Y. X distributes the stock of Y to X's shareholders. The distribution is

not carried out for the purpose of increasing the rates that X may charge its customers because that purpose could be achieved through a nontaxable transaction, the creation of a holding company, that does not involve the distribution of stock of a controlled corporation and which is neither impractical nor unduly expensive. See paragraph (b)(3) of this section.

Example (5). The facts are the same as in *Example (4)*, except that C has recently adopted rules according to which the total income of a corporation includes not only the income included in *Example (3)*, but also the income of any member of the affiliated group to which the corporation belongs. In order to avoid a reduction in the rates that it may charge its customers, X distributes the stock of Y to X's shareholders. The distribution is carried out for a corporate business purpose. See paragraph (b)(3) of this section.

Example (6). (i) Corporation X owns all of the one class of stock of corporation Y. X distributes the stock of Y pro rata to its five shareholders, all of whom are individuals, for the sole purpose of enabling X and/or Y to elect to become an S corporation. The distribution does not meet the corporate business purpose requirement. See paragraph (b)(1) and (2) of this section.

(ii) The facts are the same as in *Example (6)(i)*, except that the business of Y is operated as a division of X. X transfers this division to new corporation Y and distributes the stock of Y pro rata to its shareholders, all of whom are individuals, for the sole purpose of enabling X and/or Y to elect to become an S corporation. The distribution does not meet the corporate business purpose requirement. See paragraph (b)(1) and (2) of this section.

Example (7). The facts are the same as in *Example (6)(i)*, except that the distribution is made to enable X to elect to become an S corporation both for Federal tax purposes and for purposes of the income tax imposed by State M. State M has tax law provisions similar to subchapter S of the Internal Revenue Code of 1986. An election to be an S corporation for Federal tax purposes will effect a substantial reduction in Federal taxes that is greater than the reduction of State M taxes pursuant to an election to be an S corporation for State M purposes. The purpose of reducing State M taxes is not a corporate business purpose. The distribution does not meet the corporate business purpose requirements. See paragraph (b)(1) and (2) of this section.

Example (8). The facts are the same as *Example (7)*, except that the distribution also is made to enable A, a key employee of Y, to acquire stock of Y without investing in X. A is considered to be critical to the success of Y and he has indicated that he will seriously consider leaving the company if he is not

given the opportunity to purchase a significant amount of stock of Y. As a matter of state law, Y could not issue stock to the employee while it was a subsidiary of X. As in *Example (7)*, the purpose of reducing State M taxes is not a corporate business purpose. In order to determine whether the issuance of stock to the key employee, in fact, motivated the distribution of the Y stock, the potential avoidance of Federal taxes is a relevant factor to take into account. If the facts and circumstances establish that the distribution was substantially motivated by the need to issue stock to the employee, the distribution will meet the corporate business purpose requirement.

(c) *Continuity of interest requirement—*

(1) *Requirement.* Section 355 applies to a separation that effects only a readjustment of continuing interests in the property of the distributing and controlled corporations. In this regard section 355 requires that one or more persons who, directly or indirectly, were the owners of the enterprise prior to the distribution or exchange own, in the aggregate, an amount of stock establishing a continuity of interest in each of the modified corporate forms in which the enterprise is conducted after the separation. This continuity of interest requirement is independent of the other requirements under section 355.

(2) *Examples.*

Example (1). For more than five years, corporation X has been engaged directly in one business, and indirectly in a different business through its wholly owned subsidiary, S. The businesses are equal in value. At all times, the outstanding stock of X has been owned equally by unrelated individuals A and B. For valid business reasons, A and B cause X to distribute all of the stock of S to B in exchange for all of B's stock in X. After the transaction, A owns all the stock of X and B owns all the stock of S. The continuity of interest requirement is met because one or more persons who were the owners of X prior to the distribution (A and B) own, in the aggregate, an amount of stock establishing a continuity of interest in each of X and S after the distribution.

Example (2). Assume the same facts as in *Example (1)*, except that pursuant to a plan to acquire a stock interest in X without acquiring, directly or indirectly, an interest in S, C purchased one-half of the X stock owned by A and immediately thereafter X distributed all of the S stock to B in exchange for all of B's stock in X. After the transactions, A owns 50 percent of X and B owns 100 percent of S. The distribution by X of all of the stock

of S to B in exchange for all of B's stock in X will satisfy the continuity of interest requirement for section 355 because one or more persons who were the owners of X prior to the distribution (A and B) own, in the aggregate, an amount of stock establishing a continuity of interest in each of X and S after the distribution.

Example (3). Assume the same facts as in *Examples (1) and (2)*, except that C purchased all of the X stock owned by A. After the transactions, neither A nor B own any of the stock of X, and B owns all the stock of S. The continuity of interest requirement is not met because the owners of X prior to the distribution (A and B) do not, in the aggregate, own an amount of stock establishing a continuity of interest in each of X and S after the distribution, *i.e.*, although A and B collectively have retained 50 percent of their equity interest in the former combined enterprise, they have failed to continue to own the minimum stock interest in the distributing corporation, X, that would be required in order to meet the continuity of interest requirement.

Example (4). Assume the same facts as in *Examples (1) and (2)*, except that C purchased 80 percent of the X stock owned by A. After the transactions, A owns 20 percent of the stock of X, B owns no X stock, and B owns 100 percent of the S stock. The continuity of interest requirement is not met because the owners of X prior to the distribution (A and B) do not, in the aggregate, have a continuity of interest in each of X and S after the distribution, *i.e.*, although A and B collectively have retained 60 percent of their equity interest in the former combined enterprise, the 20 percent interest of A in X is less than the minimum equity interest in the distributing corporation, X, that would be required in order to meet the continuity of interest requirement.

(d) *Device for distribution of earnings and profits—(1) In general.* Section 355 does not apply to a transaction used principally as a device for the distribution of the earnings and profits of the distributing corporation, the controlled corporation, or both (a "device"). Section 355 recognizes that a tax-free distribution of the stock of a controlled corporation presents a potential for tax avoidance by facilitating the avoidance of the dividend provisions of the Code through the subsequent sale or exchange of stock of one corporation and the retention of the stock of another corporation. A device can include a transaction that effects a recovery of basis. In this paragraph (d), "exchange" includes transactions, such as redemptions, treated

as exchanges under the Code. Generally, the determination of whether a transaction was used principally as a device will be made from all of the facts and circumstances, including, but not limited to, the presence of the device factors specified in paragraph (d)(2) of this section (“evidence of device”), and the presence of the non-device factors specified in paragraph (d)(3) of this section (“evidence of non-device”). However, if a transaction is specified in paragraph (d)(5) of this section, then it is ordinarily considered not to have been used principally as a device.

(2) *Device factors*—(i) *In general.* The presence of any of the device factors specified in this subparagraph (2) is evidence of device. The strength of this evidence depends on the facts and circumstances.

(ii) *Pro rata distribution.* A distribution that is pro rata or substantially pro rata among the shareholders of the distributing corporation presents the greatest potential for the avoidance of the dividend provisions of the Code and, in contrast to other types of distributions, is more likely to be used principally as a device. Accordingly, the fact that a distribution is pro rata or substantially pro rata is evidence of device.

(iii) *Subsequent sale or exchange of stock*—(A) *In general.* A sale or exchange of stock of the distributing or the controlled corporation after the distribution (a “subsequent sale or exchange”) is evidence of device. Generally, the greater the percentage of the stock sold or exchanged after the distribution, the stronger the evidence of device. In addition, the shorter the period of time between the distribution and the sale or exchange, the stronger the evidence of device.

(B) *Sale or exchange negotiated or agreed upon before the distribution.* A subsequent sale or exchange pursuant to an arrangement negotiated or agreed upon before the distribution is substantial evidence of device.

(C) *Sale or exchange not negotiated or agreed upon before the distribution.* A subsequent sale or exchange not pursuant to an arrangement negotiated or agreed upon before the distribution is evidence of device.

(D) *Negotiated or agreed upon before the distribution.* For purposes of this subparagraph (2), a sale or exchange is always pursuant to an arrangement negotiated or agreed upon before the distribution if enforceable rights to buy or sell existed before the distribution. If a sale or exchange was discussed by the buyer and the seller before the distribution and was reasonably to be anticipated by both parties, then the sale or exchange will ordinarily be considered to be pursuant to an arrangement negotiated or agreed upon before the distribution.

(E) *Exchange in pursuance of a plan of reorganization.* For purposes of this subparagraph (2), if stock is exchanged for stock in pursuance of a plan of reorganization, and either no gain or loss or only an insubstantial amount of gain is recognized on the exchange, then the exchange is not treated as a subsequent sale or exchange, but the stock received in the exchange is treated as the stock surrendered in the exchange. For this purpose, gain treated as a dividend pursuant to sections 356(a)(2) and 316 shall be disregarded.

(iv) *Nature and use of assets*—(A) *In general.* The determination of whether a transaction was used principally as a device will take into account the nature, kind, amount, and use of the assets of the distributing and the controlled corporations (and corporations controlled by them) immediately after the transaction.

(B) *Assets not used in a trade or business meeting the requirement of section 355(b).* The existence of assets that are not used in a trade or business that satisfies the requirements of section 355(b) is evidence of device. For this purpose, assets that are not used in a trade or business that satisfies the requirements of section 355(b) include, but are not limited to, cash and other liquid assets that are not related to the reasonable needs of a business satisfying such section. The strength of the evidence of device depends on all the facts and circumstances, including, but not limited to, the ratio for each corporation of the value of assets not used in a trade or business that satisfies the requirements of section 355(b) to the value of its business that satisfies such requirements. A difference in the ratio

described in the preceding sentence for the distributing and controlled corporation is ordinarily not evidence of device if the distribution is not pro rata among the shareholders of the distributing corporation and such difference is attributable to a need to equalize the value of the stock distributed and the value of the stock or securities exchanged by the distributees.

(C) *Related function.* There is evidence of device if a business of either the distributing or controlled corporation (or a corporation controlled by it) is (1) a “secondary business” that continues as a secondary business for a significant period after the separation, and (2) can be sold without adversely affecting the business of the other corporation (or a corporation controlled by it). A secondary business is a business of either the distributing or controlled corporation, if its principal function is to serve the business of the other corporation (or a corporation controlled by it). A secondary business can include a business transferred to a newly-created subsidiary or a business which serves a business transferred to a newly-created subsidiary. The activities of the secondary business may consist of providing property or performing services. Thus, in *Example (11)* of §1.355-3(c), evidence of device would be presented if the principal function of the coal mine (satisfying the requirements of the steel business) continued after the separation and the coal mine could be sold without adversely affecting the steel business. Similarly, in *Example (10)* of §1.355-3(c), evidence of device would be presented if the principal function of the sales operation after the separation is to sell the output from the manufacturing operation and the sales operation could be sold without adversely affecting the manufacturing operation.

(3) *Nondevice factors*—(i) *In general.* The presence of any of the nondevice factors specified in this subparagraph (3) is evidence of nondevice. The strength of this evidence depends on all of the facts and circumstances.

(ii) *Corporate business purpose.* The corporate business purpose for the transaction is evidence of nondevice. The stronger the evidence of device (such as the presence of the device factors specified in paragraph (d)(2) of this

section), the stronger the corporate business purpose required to prevent the determination that the transaction was used principally as a device. Evidence of device presented by the transfer or retention of assets not used in a trade or business that satisfies the requirements of section 355(b) can be outweighed by the existence of a corporate business purpose for those transfers or retentions. The assessment of the strength of a corporate business purpose will be based on all of the facts and circumstances, including, but not limited to, the following factors:

(A) The importance of achieving the purpose to the success of the business;

(B) The extent to which the transaction is prompted by a person not having a proprietary interest in either corporation, or by other outside factors beyond the control of the distributing corporation; and

(C) The immediacy of the conditions prompting the transaction.

(iii) *Distributing corporation publicly traded and widely held.* The fact that the distributing corporation is publicly traded and has no shareholder who is directly or indirectly the beneficial owner of more than five percent of any class of stock is evidence of nondevice.

(iv) *Distribution to domestic corporate shareholders.* The fact that the stock of the controlled corporation is distributed to one or more domestic corporations that, if section 355 did not apply, would be entitled to a deduction under section 243(a)(1) available to corporations meeting the stock ownership requirements of section 243(c), or a deduction under section 243(a)(2) or (3) or 245(b) is evidence of nondevice.

(4) *Examples.* The provisions of paragraph (d)(1) through (3) of this section may be illustrated by the following examples:

Example (1). Individual A owns all of the stock of corporation X, which is engaged in the warehousing business. X owns all of the stock of corporation Y, which is engaged in the transportation business. X employs individual B, who is extremely knowledgeable of the warehousing business in general and the operations of X in particular. B has informed A that he will seriously consider leaving the company if he is not given the opportunity to purchase a significant amount of stock of X. Because of his knowledge and experience, the loss of B would seriously damage the

business of X. B cannot afford to purchase any significant amount of stock of X as long as X owns Y. Accordingly, X distributes the stock of Y to A and A subsequently sells a portion of his X stock to B. However, X could have issued additional shares to B sufficient to give B an equivalent ownership interest in X. There is no other evidence of device or evidence of nondevice. In light of the fact that X could have issued additional shares to B, the sale of X stock by A is substantial evidence of device. The transaction is considered to have been used principally as a device. See paragraph (d)(1), (2)(ii), (iii)(A), (B) and (D), and (3)(i) and (ii) of this section.

Example (2). Corporation X owns and operates a fast food restaurant in State M and owns all of the stock of corporation Y, which owns and operates a fast food restaurant in State N. X and Y operate their businesses under franchises granted by D and E, respectively. X owns cash and marketable securities that exceed the reasonable needs of its business but whose value is small relative to the value of its business. E has recently changed its franchise policy and will no longer grant or renew franchises to subsidiaries (or other members of the same affiliated group) of corporations operating businesses under franchises granted by its competitors. Thus, Y will lose its franchise if it remains a subsidiary of X. The franchise is about to expire. Accordingly, X distributes the stock of Y pro rata among X's shareholders. X retains its business and transfers cash and marketable securities to Y in an amount proportional to the value of Y's business. There is no other evidence of device or evidence of nondevice. The transfer by X to Y and the retention by X of cash and marketable securities is relatively weak evidence of device because after the transfer X and Y hold cash and marketable securities in amounts proportional to the values of their businesses. The fact that the distribution is pro rata is evidence of device. A strong corporate business purpose is relatively strong evidence of nondevice. Accordingly, the transaction is considered not to have been used principally as a device. See paragraph (d)(1), (2)(ii), (iv)(A), and (B) and (3)(i) and (ii)(A), (B) and (C) of this section.

Example (3). Corporation X is engaged in a regulated business in State M and owns all of the stock of corporation Y, which is not engaged in a regulated business in State M. State M has recently amended its laws to provide that affiliated corporations operating in M may not conduct both regulated and unregulated businesses. X transfers cash not related to the reasonable needs of the business of X or Y to Y and then distributes the stock of Y pro rata among X's shareholders. As a result of the transfer of cash, the ratio of the value of its assets not used in a trade or business that satisfies the requirements of section 355(b) to the value of

its business is substantially greater for Y than for X. There is no other evidence of device or evidence of nondevice. The transfer of cash by X to Y is relatively strong evidence of device because after the transfer Y holds disproportionately many assets that are not used in a trade or business that satisfies the requirements of section 355(b). The fact that the distribution is pro rata is evidence of device. The strong business purpose is relatively strong evidence of nondevice, but it does not pertain to the transfer. Accordingly, the transaction is considered to have been used principally as a device. See paragraph (d)(1), (2)(ii), (iv)(A) and (B), and (3) and (i) and (ii) of this section.

Example (4). The facts are the same as in *Example (3)*, except that, instead of transferring cash to Y, X purchases operating assets unrelated to the business of Y and transfers them to Y prior to the distribution. There is no other evidence of device or evidence of nondevice. The transaction is considered to have been used principally as a device. See paragraph (d)(1), (2)(ii), (iv)(A) and (B), and (3)(i) and (ii) of this section.

(5) *Transactions ordinarily not considered as a device—(i) In general.* This subparagraph (5) specifies three distributions that ordinarily do not present the potential for tax avoidance described in paragraph (d)(1) of this section. Accordingly, such distributions are ordinarily considered not to have been used principally as a device, notwithstanding the presence of any of the device factors described in paragraph (d)(2) of this section. A transaction described in paragraph (d)(5)(iii) or (iv) of this section is not protected by this subparagraph (5) from a determination that it was used principally as a device if it involves the distribution of the stock of more than one controlled corporation and facilitates the avoidance of the dividend provisions of the Code through the subsequent sale or exchange of stock of one corporation and the retention of the stock of another corporation.

(ii) *Absence of earnings and profits.* A distribution is ordinarily considered not to have been used principally as a device if—

(A) The distributing and controlled corporations have no accumulated earnings and profits at the beginning of their respective taxable years,

(B) The distributing and controlled corporations have no current earnings and profits as of the date of the distribution, and

(C) No distribution of property by the distributing corporation immediately before the separation would require recognition of gain resulting in current earnings and profits for the taxable year of the distribution.

(iii) *Section 303(a) transactions.* A distribution is ordinarily considered not to have been used principally as a device if, in the absence of section 355, with respect to each shareholder distributee, the distribution would be a redemption to which section 303(a) applied.

(iv) *Section 302(a) transactions.* A distribution is ordinarily considered not to have been used principally as a device if, in the absence of section 355, with respect to each shareholder distributee, the distribution would be a redemption to which section 302(a) applied. For purposes of the preceding sentence, section 302(c)(2)(A)(ii) and (iii) shall not apply.

(v) *Examples.* The provisions of this subparagraph (5) may be illustrated by the following examples:

Example (1). The facts are the same as in *Example (3)* of paragraph (d)(4) of this section, except that X and Y had no accumulated earnings and profits at the beginning of its taxable year, X and Y have no current earnings and profits as of the date of the distribution, and no distribution of property by X immediately before the separation would require recognition of gain that would result in earnings and profits for the taxable year of the distribution. The transaction is considered not to have been used principally as a device. See paragraph (d)(5)(i) and (ii) of this section.

Example (2). Corporation X is engaged in three businesses: a hotel business, a restaurant business, and a rental real estate business. Individuals A, B, and C own all of the stock of X. X transfers the restaurant business to new corporation Y and transfers the rental real estate business to new corporation Z. X then distributes the stock of Y and Z pro rata between B and C in exchange for all of their stock in X. In the absence of section 355, the distribution would be a redemption to which section 302(a) applied. Since this distribution involves the stock of more than one controlled corporation and facilitates the avoidance of the dividend provisions of the Code through the subsequent sale or exchange of stock in one corporation and the retention of the stock of another corporation, it is not protected by paragraph (d)(5)(i) and (iv) of this section from a determination that it was used principally as a device. Thus, the determination of whether

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.