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Internal Revenue Service (I.R.S.)

Revenue Ruling

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26 CFR 1.355-2: Limitations

A pro rata spin-off may qualify for nonrecognition of gain or loss even though less than half of the controlled corporation's total assets are utilized in the active conduct of a business as defined in section 355(b) of the Code.

Advice has been requested regarding the application of the provisions of section 355 of the Internal Revenue Code of 1954 to the distribution of stock of a controlled corporation under the circumstances described below.

Prior to May 20, 1969, X corporation, the stock of which was widely held and publicly traded, was engaged in various business enterprises which may be summarized as follows:

- (a) tin container manufacture and distribution, which was actively conducted for the preceding five-year period (the assets of this business represented more than half of the value of X's assets);
- (b) newspaper publication, operated as a wholly-owned subsidiary, Y, which was acquired within the preceding five-year period in a transaction in which gain was recognized; and
- (c) glass container manufacture and distribution, which was actively conducted for more than five years.

For valid business purposes, X transferred all of the assets used in connection with the operation of its glass container business to Y in exchange for additional stock of Y and the assumption by Y of certain liabilities of the transferred business. The total adjusted basis of the assets transferred to Y exceeded the liabilities assumed by Y. Due to fact that the newspaper business did not meet the active business requirements of section 355(b) of the Code, the only active business of Y under section 355(b) of the Code was the glass container business the assets of which represented a substantial portion of the value of Y's total assets but less than half of such value. On May 20, 1969, for valid business purposes, all of the stock of Y was distributed pro rata to the shareholders of X. It had been represented that at the time of the distribution the shareholders of X had no plan to dispose of the stock of X or Y, nor was there any plan to liquidate X or Y or have X or Y dispose of its assets.

Section 355(a) of the Code and the Income Tax Regulations thereunder provide that if for valid business purposes (1) a corporation distributes to its shareholders, with respect to its stock, solely the stock of a corporation that it controlled immediately before the distribution, (2) the transaction is not used principally as a device for the distribution of earnings and profits, and (3) the requirements of section 355(b) are satisfied, no gain or loss will be recognized by the shareholders on the receipt of such stock.

Section 355(b) of the Code requires that both the distributing corporation and the controlled corporation be engaged immediately after the distribution in the active conduct of a trade or business that has been actively conducted throughout the five-year period ending on the date of distribution and that was not acquired within the five-year period in a transaction in which gain or loss was recognized in whole or in part.

Section 355(b) of the Code and the regulations thereunder require only that the distributing and controlled corporations must each be engaged in the active conduct of a trade or business. There is no requirement in section 355(b) that a specific percentage of the corporation's assets be devoted to the active conduct of a trade or business. In the instant case, therefore, it is not controlling for purposes of the active business requirement that the active business assets of the controlled corporation, Y, represent less than half of the value of the controlled corporation immediately after the distribution. Accordingly, X and Y were each engaged in the active conduct of a trade or business immediately after the distribution within the meaning of section 355(b) of the Code.

The percentage of Y's assets that are devoted to the active conduct of a trade or business is a relevant factor to be considered along with all the other facts and circumstances in determining whether the transaction is used principally as a device to distribute earnings and profits. See Section 1.355-2(b)(3) of the regulations. The fact that more than half of the value of Y's total assets consists of a trade or business acquired within the five-year period ending on the date of the distribution in a transaction in which gain or loss was recognized, is evidence that the transaction was principally a device for the distribution of earnings and profits.

The facts and circumstances of the transaction in the instant case, however, as well as the nature, kind, and amount of the assets involved, indicate that the pro rata distribution by X of all the stock of Y is not a device. The fact that the stock of X is widely held and publicly traded, that investment assets were not involved, and that the transaction was compelled by valid business purposes are indicative of the absence of a device. Moreover, the assets included in Y represent operating businesses, and not assets that could be used to facilitate the distribution of the earnings and profits of X or Y or both.

Therefore, in the instant case, no gain or loss is recognized to (and no amount is includible in the income of) the shareholders of X on the receipt of the Y stock pursuant to section 355 of the Code.