Correction of Publication

Accordingly, the publication of proposed rulemaking (REG–144859–04), which was the subject of FR Doc. E7–6764, is corrected as follows:

1. On page 18417, column 3, in the preamble, under the caption **DATES:**, first sentence of the paragraph, the language ''Written or electronic comments and requests for a public hearing must be received by July 11, 2007.'' is corrected to read ''Written or electronic comments must be received by July 10, 2007.''.

2. On page 18418, column 1, in the preamble, under the caption **FOR FURTHER INFORMATION CONTACT:**, lines six through eleven, the language ''attend the hearing, Richard Hurst at (202) 622–2949 (TDD Telephone) (not toll free numbers) and his e-mail address is *Richard.A.Hurst@irscounsel.treas.gov*, (202) 622–7180 (not toll-free numbers).'' is corrected to read ''attend the hearing, Richard Hurst at *Richard.A.Hurst@irscounsel.treas.gov*, (202) 622–7180 (not toll-free numbers).

3. On page 18420, column 2, in the preamble, under the paragraph heading ''Comments and Public Hearing'', the second paragraph of the column, first line, the language ''The rules of 26 CFR 606.601(a)(3)'' is corrected to read ''The rules of 26 CFR 601.601(a)(3)''.

§ 1.1367–2 [Corrected]

4. On page 18422, column 1, § 1.1367–2, first paragraph of the column, third line of the paragraph, the language ''1. The section heading is revised.'' is corrected to read ''1. The section heading and paragraph are revised.''.

5. On page 18422, column 1, § 1.1367–2, first paragraph of the column, lines four through seven are removed.

§ 1.1367–3 [Corrected]

6. On page 18422, column 1, § 1.1367–3, second paragraph of the column, the language of the paragraph heading ''§ 1.1367–3 Effective dates and transitional rules.'' is corrected to read ''§ 1.1367–3 Effective date.''.

LaNita Van Dyke,

Chief, Publications and Regulations Branch, Legal Processing Division, Associate Chief Counsel (Procedure and Administration).

[FR Doc. E7–8705 Filed 5–7–07; 8:45 am]

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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG–123365–03]

RIN 1545–BC94

Guidance Regarding the Active Trade or Business Requirement Under Section 355(b)

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations that provide guidance regarding the active trade or business requirement under section 355(b) of the Internal Revenue Code. These proposed regulations provide guidance on issues involving the active trade or business requirement under section 355(b), including guidance resulting from the enactment of section 355(b)(3). These proposed regulations will affect corporations and their shareholders.

DATES: Written or electronic comments and requests for a public hearing must be received by August 6, 2007.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–123365–03), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG–123365–03), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC, or sent electronically via the Federal eRulemaking Portal at *www.regulations.gov* (IRS REG–123365–03).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Russell P. Subin, (202) 622–7790; concerning submissions and the hearing, Kelly Banks, (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background and Explanation of Provisions

A. Background and Overview of the Key Aspects of the Proposed Regulations

1. Background

Section 355(a) of the Internal Revenue Code (Code) provides that, under certain circumstances, a corporation may distribute stock and securities of a corporation it controls to its shareholders and security holders without causing either the corporation or its shareholders and security holders to recognize income, gain or loss. Sections 355(a)(1)(C) and 355(b)(1) generally require that the distributing corporation (distributing) and controlled corporation (controlled) each be engaged, immediately after the distribution, in the active conduct of a trade or business. Section 355(b)(2)(A) provides that a corporation shall be treated as engaged in the active conduct of a trade or business if and only if it is engaged in the active conduct of a trade or business, or substantially all of its assets consist of stock and securities of a corporation controlled by it (immediately after the distribution) which is so engaged. For this purpose, control is defined under section 368(c). All references to control in this preamble are references to control as defined in section 368(c).

Section 202 of the Tax Increase Prevention and Reconciliation Act of 2005, Public Law 109–222 (120 Stat. 345, 348) (TIPRA) amended section 355(b) by adding section 355(b)(3). Section 355(b)(3)(A), as amended by Division A, Section 410 of the Tax Relief and Health Care Act of 2006, Public Law 109–432 (120 Stat. 2922, 2963), provides that in the case of any distribution made after May 17, 2006, a corporation shall be treated as meeting the requirement of section 355(b)(2)(A) if and only if such corporation is engaged in the active conduct of a trade or business. Section 355(b)(3)(B) provides that for purposes of section 355(b)(3)(A) (and, consequently, section 355(b)(2)(A)), all members of such corporation's separate affiliated group (SAG) shall be treated as one corporation (SAG rule). For purposes of the preceding sentence, a corporation's SAG is the affiliated group which would be determined under section 1504(a) if such corporation were the common parent and section 1504(b) did not apply.

Thus, the separate affiliated group of distributing (DSAG) is the affiliated group that consists of distributing as the common parent and all corporations affiliated with distributing through stock ownership described in section 1504(a)(1)(B) (regardless of whether the corporations are includible corporations under section 1504(b)). The separate affiliated group of controlled (CSAG) is determined in a similar manner (with controlled as the common parent). Accordingly, unlike prior law, a corporation is not treated as engaged in the active conduct of a trade or business solely as a result of substantially all of its assets consisting of stock, or stock and securities, of one or more

corporations that are merely controlled by it (immediately after the distribution) each of which is engaged in the active conduct of a trade or business.

Section 355(b)(2)(B) requires that the trade or business have been actively conducted throughout the five-year period ending on the date of the distribution (pre-distribution period). Section 355(b)(2)(C) provides that the trade or business must not have been acquired in a transaction in which gain or loss was recognized, in whole or in part, within the pre-distribution period. Section 355(b)(2)(D), as amended in 1987 and 1988, provides that control of a corporation which (at the time of acquisition of control) was conducting the trade or business must not have been directly or indirectly acquired by any distributee corporation or by distributing during the pre-distribution period in a transaction in which gain or loss was recognized, in whole or in part. See Public Law 100–203 (101 Stat. 1330, 1330–411 (1987)) and Public Law 100–647 (102 Stat. 3342, 3605 (1988)). For purposes of section 355(b)(2)(D), all distributee corporations which are members of the same affiliated group (as defined in section 1504(a) without regard to section 1504(b)) shall be treated as one distributee corporation. The requirements under section 355(b) are collectively referred to in this preamble as either the active trade or business requirement or the requirements of section 355(b).

Accordingly, the requirements of section 355(b) are generally satisfied if distributing and controlled each have engaged in the active conduct of a trade or business throughout the pre-distribution period, are so engaged immediately after the distribution, and there have been no acquisitions of control of distributing or controlled during such period.

The active trade or business requirement is one of several requirements that must be satisfied in order for a distribution to qualify under section 355. For example, section 355(a)(1)(B) states that a transaction must not be used principally as a device for distributing the earnings and profits of distributing, controlled, or both. In addition, § 1.355–2(b)(1) provides that section 355 will apply to a transaction only if it is carried out for one or more corporate business purposes.

The active trade or business requirement, in tandem with the device prohibition and business purpose requirement, limits a corporation's ability to convert dividend income into capital gain through the use of a section 355 distribution. See S. Rep. No. 83–1622, at 50–51 (1954) and *Coady* v. *Commissioner,* 33 TC 771, 777 (1960), *acq.,* 1965–2 CB 4, *aff'd,* 289 F.2d 490 (6th Cir. 1961). In *Coady,* the Tax Court stated that one purpose of section 355(b) is ''to prevent the tax-free separation of *active* and *inactive* assets into *active* and *inactive* corporate entities.'' The court also stated that a tax-free separation under section 355 ''will involve the separation only of those assets attributable to the carrying on of an active trade or business * * *.'' *Coady*, 33 TC at 777.

The IRS and Treasury Department are aware of a number of issues that have arisen regarding the active trade or business requirement, including issues arising as a result of the enactment of section 355(b)(3). The following sections describe the active trade or business requirement and the significant issues that are addressed in these proposed regulations. No inference should be drawn from these proposed regulations regarding the definition of trade or business or active trade or business under any other provision of the Code or Treasury regulations, even if such provision specifically references section 355. Comments are requested as to whether or the extent to which these proposed regulations should apply to other provisions that specifically reference section 355.

2. Overview of the Key Aspects of the Proposed Regulations

Principally, these proposed regulations provide guidance regarding the application of section 355(b)(3), the application of the acquisition rules in section 355(b)(2)(C) and (D) and the impact thereon of section 355(b)(3), and the determination of whether a corporation is engaged in a trade or business through the attribution of trade or business assets and activities from a partnership.

As discussed in section A.1. of this preamble, section 355(b)(3) treats all SAG members as one corporation. Accordingly, as discussed in detail in section B. of this preamble, these proposed regulations provide that subsidiary SAG members (SAG members that are not the common parent of such SAG) are treated like divisions of distributing or controlled, as the case may be. These proposed regulations also clarify that controlled may be a DSAG member during the pre-distribution period. Most significantly, these provisions treat a stock acquisition that results in a corporation becoming a subsidiary SAG member as an asset acquisition. As a result, the applicability of section 355(b)(2)(D) is substantially reduced. Further, as discussed in section E. of this preamble, this treatment alters the analysis regarding whether an existing business may be expanded as a result of a stock acquisition.

Notwithstanding that these proposed regulations provide that certain stock acquisitions may be treated as asset acquisitions under section 355(b)(3), purchases of stock of controlled during the pre-distribution period may be subject to section 355(a)(3)(B). See section F. of this preamble.

As discussed in detail in section C. and section D. of this preamble, these proposed regulations interpret section 355(b)(2)(C) and (D) to mean that a corporation generally cannot use its assets to acquire a trade or business to be relied on to facilitate a distribution under section 355. Accordingly, these proposed regulations generally prohibit acquisitions made in exchange for distributing's assets even if no gain or loss is recognized in connection with the acquisition. Further, these proposed regulations provide certain exceptions to the literal application of section 355(b)(2)(C) and (D) for acquisitions in which gain or loss is recognized where the purposes of that section are not violated. However, these proposed regulations do not disregard the recognition of gain or loss in transactions between affiliates unless the affiliates are members of the same SAG. See section G. of this preamble.

Section I. of this preamble explains how these proposed regulations clarify a corporation's ability to be attributed the trade or business assets and activities of a partnership. Most significantly, these partnership provisions yield results similar to the rules regarding the satisfaction of the continuity of business enterprise requirement, and thus allow a partner to be attributed the partnership's trade or business assets and activities where the partner owns a significant interest in the partnership.

B. TIPRA

Congress enacted section 355(b)(3) because it was concerned that, prior to a distribution under section 355, corporate groups conducting business in separate corporate entities often had to undergo elaborate restructurings to place active businesses in the proper entities to satisfy the active trade or business requirement. See, for example, H.R. Rep. No. 109–304, at 53, 54 (2005). By treating a SAG as one corporation, Congress believed that it would greatly reduce the need for such restructurings. However, the introduction of the affiliation-based SAG rule into the active trade or business requirement

significantly impacts the application of section 355(b)(2) in certain situations.

Accordingly, consistent with congressional intent, these proposed regulations provide several rules interpreting section 355(b)(3) in a manner that diminishes the need for pre-distribution restructurings while fully integrating the various provisions in section 355(b). These rules are intended to more closely reflect the way corporate groups structure their businesses while, at the same time, ensuring that the purposes underlying section 355(b)(2)(C) and (D) are not circumvented.

Specifically, to accomplish these objectives the IRS and Treasury Department believe that it is appropriate to apply the SAG rule by disregarding the separate existence of all subsidiary SAG members for purposes of determining whether distributing and controlled satisfy the requirements of section 355(b).

1. SAG Rule Applicable During the Pre-Distribution Period

The IRS and Treasury Department believe that it is appropriate to apply the SAG rule for purposes of determining whether the trade or business was actively conducted throughout the pre-distribution period and whether the requirements of section 355(b)(2)(C) or (D) have been violated.

The SAG rule applies for purposes of determining whether distributing and controlled are engaged in the active conduct of a trade or business immediately after the distribution. Specifically, the legislative history to section 355(b)(3) describes the corporations included in the DSAG and CSAG by reference to post-distribution affiliation. See H.R. Rep. No. 109–455, at 88 (2006) (Conf. Rep.); H.R. Rep. No. 109–304, at 54 (2005). However, there is nothing in the statute or legislative history that precludes the SAG rule from applying throughout the pre-distribution period.

The IRS and Treasury Department believe that applying the SAG rule throughout the pre-distribution period is consistent with the single-entity approach. If the SAG rule is not applied during the pre-distribution period, there may be unintended consequences. For example, assume that an active trade or business is segmented among the SAG members in a manner that precludes any one member from individually being treated as engaged in an active trade or business. Under the SAG rule the segments are aggregated and may be treated as a single active trade or business immediately after the distribution. However, if the SAG rule is not applied throughout the pre-distribution period, there would be no five-year active trade or business because no one member would be engaged in that trade or business. The IRS and Treasury Department do not believe there is any policy reason to apply the SAG rule in such a disparate manner. Accordingly, these proposed regulations apply the SAG rule throughout the pre-distribution period. This approach is consistent with Congressional intent to view SAGs as an aggregate for purposes of the active trade or business requirement.

Because the SAG rule treats all SAG members as one corporation, the separate existence of subsidiary SAG members are disregarded and all assets (and activities) owned (and performed) by SAG members are treated as owned (and performed) by distributing or controlled, as the case may be, for purposes of determining whether distributing or controlled is engaged in a five-year active trade or businesses. Therefore, where one DSAG or CSAG member satisfies the active trade or business requirement, distributing or controlled, as the case may be, satisfies the active trade or business requirement.

Consistent with the foregoing, these proposed regulations provide that the SAG rule also applies for purposes of determining whether there has been an impermissible acquisition, as discussed in section C. of this preamble, of a trade or business during the pre-distribution period under section 355(b)(2)(C) or (D). Because the SAG rule disregards the separate existence of subsidiary SAG members, these proposed regulations generally treat stock acquisitions that result in a corporation becoming a subsidiary SAG member as a direct acquisition of any assets (or activities) owned (or performed) by the acquired corporation. Further, these proposed regulations generally disregard transfers of assets (or activities) that are owned (or performed) by the SAG immediately before and immediately after the transfer. Such transfers cannot result in an acquisition. Under the SAG rule, such transfers have the effect of a transfer between divisions of a single corporation.

2. The DSAG May Include CSAG Members Throughout the Pre-Distribution Period

The IRS and Treasury Department believe that it is appropriate to include the CSAG members in the DSAG during the pre-distribution period if the applicable affiliation requirements are satisfied. The IRS and Treasury Department believe this approach is consistent with the purposes of section 355(b)(3) and the SAG rule's general single-entity approach, and provides flexibility for the division of SAG members between distributing and controlled.

For example, assume that during the pre-distribution period, segments or portions of the business to be conducted by controlled are held by distributing (or other subsidiaries that are not directly or indirectly owned by controlled) and that distributing intends to transfer those portions of the business to controlled immediately prior to the distribution. If the DSAG does not include the CSAG members throughout the pre-distribution period, it is possible that neither SAG would be engaged in the active conduct of that trade or business throughout the pre-distribution period, because neither SAG would have all the appropriate segments of that business to satisfy the active trade or business requirement. The IRS and Treasury Department believe that such a result is inconsistent with the purposes of section 355(b)(3). Accordingly, by including the CSAG members in the DSAG throughout the pre-distribution period if the ownership requirements are satisfied, these proposed regulations give appropriate credit to five-year active trades or businesses regardless of how the assets and activities may be owned (and performed) by the SAG members throughout the pre-distribution period.

3. Acquisitions of Stock in Subsidiary SAG Members

Section 355(b)(3) treats SAG members as one corporation for purposes of satisfying the requirements of section 355(b). As a result, the SAG rule alters the application of section 355(b)(2)(C) and (D) with respect to the acquisition of stock of a corporation that is or becomes a subsidiary SAG member. Further, because section 355(b)(3) supplanted the holding company rule in section 355(b)(2)(A), section 355(b)(2)(D) is now only applicable to certain acquisitions of stock of distributing and certain acquisitions of stock of controlled.

The SAG rule alters the application of section 355(b)(2)(C) and (D) with respect to the acquisition of stock of a corporation that is or becomes a subsidiary SAG member. Section 355(b)(3) treats SAG members as one corporation for purposes of satisfying section 355(b). Consequently, a transaction that results in a corporation—including controlled—becoming a subsidiary SAG member is treated as a direct acquisition of all the assets (and activities) owned (and performed) by the acquired corporation

at the time of the acquisition. Thus, such an acquisition is tested under section 355(b)(2)(C) rather than section 355(b)(2)(D). Nevertheless, as discussed in sections B.4 and C.3.a.ii. of this preamble, section 355(b)(2)(D) has continuing limited application.

In addition, an acquisition that results in a corporation becoming a subsidiary SAG member in a transaction in which gain or loss is recognized might satisfy the requirements of section 355(b)(2)(C) as an expansion of one of the acquiring SAG's existing businesses, as discussed in section E. of this preamble. Finally, because the SAG rule treats subsidiary SAG members like divisions, the acquisition of additional stock of a current subsidiary SAG member has no effect for purposes of applying section 355(b)(2)(C).

4. Acquisitions of Control of Controlled Where It Is Not a DSAG Member

While section 355(b)(2)(D) is not applicable to acquisitions of stock of subsidiary SAG members, the requirements of section 355(b)(2)(D) must be satisfied where the DSAG acquires control of controlled where controlled is not and does not become a DSAG member prior to the distribution. This rule applies where distributing acquires stock constituting control of controlled but not stock meeting the requirements of section 1504(a)(2).

C. Acquisitions of a Trade or Business

Section 355(b)(2)(C) and (D) generally provide that a trade or business acquired, directly or indirectly, during the pre-distribution period will not satisfy the active trade or business requirement unless it was acquired in a transaction in which no gain or loss was recognized. The IRS and Treasury Department believe that these provisions have been and should continue to be interpreted and applied in a manner consistent with the overall purposes of section 355. For example, in certain situations, transactions in which gain or loss is recognized have been found not to violate the purposes of section 355(b)(2)(C) and (D). See, for example, *C.I.R.* v. *Gordon*, 382 F.2d 499 (2d Cir.1967), *rev'd on other grounds*, 391 U.S. 83 (1968) (discussed in section C.2. of this preamble). Additionally, while the enactment of section 355(b)(3) substantially revised how distributing and controlled may satisfy the active trade or business requirement, TIPRA did not contain conforming amendments to section 355(b)(2)(C) and (D). As such, the IRS and Treasury Department also believe that a purpose-based interpretation of section 355(b)(2) is essential to harmonize these provisions. Accordingly, these proposed regulations interpret and apply section 355(b)(2)(C) and (D), and section 355(b)(3), in a manner consistent with their purpose, even if not always consistent with the literal language of the statute.

1. Purpose of Section 355(b)(2)(C) and (D)

Section 355 ''contemplates that a tax-free separation shall involve only the separation of assets attributable to the carrying on of an active business.'' S. Rep. No. 83–1622, at 50 (1954). The active trade or business requirement is intended to ensure that only these types of separations qualify under section 355. Further, it operates as an additional safeguard to the device prohibition (a prohibition against disguised dividends) in section 355(a)(1)(B).

As discussed in section A. of this preamble, the active trade or business requirement is designed to limit the potential for the conversion of dividend income into capital gain through a section 355 distribution. Specifically, section 355(b)(2)(C) and (D) is intended to prevent dividend avoidance otherwise available through the purchase of a new business in order to facilitate a tax-free distribution under section 355. See *Gordon,* 382 F.2d at 506–507 (stating that ''[t]o safeguard against this possibility, subsections (b)(2)(C) and (D) prohibit acquisition of a trade or business, or of a corporation, in a transaction in which gain or loss was recognized.''). Thus, the statute prohibits acquisitions of a trade or business in which gain or loss is recognized. Nevertheless, the recognition of gain or loss, in and of itself, does not violate the purposes of section 355. Rather, recognition of gain or loss is generally indicative of the type of consideration used in the transaction. Typically, a transaction in which gain or loss is recognized consists of an acquisition in exchange for assets. On the other hand, a transaction in which no gain or loss is recognized typically consists of an acquisition in exchange for the corporation's equity.

Accordingly, the IRS and Treasury Department believe that the common purpose of section 355(b)(2)(C) and (D) is to prevent distributing from using assets—instead of its stock or stock of a corporation in control of distributing—to acquire a new trade or business in anticipation of distributing that trade or business (or facilitating the distribution of another trade or business) to its shareholders in a tax-free distribution. A distribution of a corporation holding assets that would have been used to effect a purchase generally would be treated as a dividend and section 355 was not intended to allow a tax-free separation of such assets. Acquiring a new trade or business using these assets and distributing it (or an existing trade or business) would effectively accomplish such a separation, and should not qualify under section 355.

Complementing the principle that the common purpose of section 355(b)(2)(C) and (D) is to prevent distributing from using it assets—instead of its stock, or stock of a corporation in control of distributing—to acquire a new trade or business is the notion that section 355 is intended to apply to separations of active trades or businesses with which the participants have a historic relationship. Section 355, like the reorganization provisions, involves the maintenance by the shareholders of a continuing interest in their business or businesses in modified corporate forms. For section 355 to apply to a divisive transaction, it is essential that distributing and its shareholders have a historic relationship with the active trades or businesses in the two resulting corporations. See, for example, § 1.355–1(b) (''[section 355] applies only to the separation of existing businesses that have been in active operation for at least five years * * * and which, in general, have been owned, directly or indirectly, for at least five years by the distributing corporation''). These requirements ensure that the historic owners of the acquired trade or business are participants in the divisive transaction and minimize the potential for transactions that violate the common purpose of section 355(b)(2)(C) and (D).

Where distributing issues its own equity (or uses the equity of a corporation in control of distributing) to acquire an active trade or business in a transaction in which no gain or loss is recognized, distributing is not acquiring the trade or business in exchange for its assets and the historic owners of the trade or business will be participants in the divisive transaction. In such cases, the common purpose of section 355(b)(2)(C) and (D) is carried out.

Finally, an additional purpose of section 355(b)(2)(D) is to prevent a distributee corporation from acquiring control of distributing in anticipation of a distribution to which section 355 would otherwise apply, enabling the disposition of controlled without the proper recognition of corporate level gain. See H.R. Rep. No. 100–391, at 1080, 1082–1083 (1987).

2. Current Law and the § 1.355–3(b)(4) Regulations

Under current law, several authorities depart from the literal language of section 355(b)(2)(C) and (D) in order to carry out the common purpose underlying section 355(b)(2)(C) and (D). For example, in *Gordon*, gain was recognized when distributing transferred a trade or business to controlled. The Second Circuit concluded that, even though gain was recognized, section 355(b)(2)(C) was not violated because new assets were not brought within the combined corporate shells of distributing and controlled. Therefore, the common purpose of section 355(b)(2)(C) and (D) was not violated. Furthermore, Rev. Rul. 69–461 (1969–2 CB 52) held that a first-tier subsidiary's taxable distribution of stock of a second-tier subsidiary to its parent did not violate section 355(b)(2)(D). The ruling stated that section 355(b)(2)(D) is intended to prevent the acquisition of control of a corporation from a party not within the direct or indirect control of distributing. In addition, Rev. Rul. 78–442 (1978–2 CB 143) held that gain under section 357(c) on the transfer from distributing to controlled does not violate section 355(b)(2)(C). Rev. Rul. 78–442 stated that section 355(b)(2)(C) is intended to prevent the acquisition of a trade or business by distributing or controlled from an outside party in a taxable transaction within five years of a distribution.

Similarly, § 1.355–3(b)(4) (generally applicable to distributions on or before December 15, 1987, but applied in various situations by the IRS administratively to distributions occurring after that date) provides an exception from the literal language of section 355(b)(2)(C) and (D) for the direct or indirect acquisition of a trade or business by one member of an affiliated group from another member of the group, stating that an acquisition from another member of the affiliated group ''is not the type of transaction to which section 355(b)(2)(C) and (D) is intended to apply.'' See § 1.355–3(b)(4)(iii).

Section 1.355–3(b)(4) also departs from the literal language of section 355(b) in providing that a trade or business acquired, directly or indirectly, within the pre-distribution period 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. See § 1.355–3(b)(4)(i). The reason for this departure is that in some circumstances a transaction in which no gain or loss is recognized may nevertheless constitute a prohibited acquisition of a trade or business in exchange for assets.

3. The Proposed Regulations

Consistent with current law (and § 1.355–3(b)(4)), these proposed regulations generally prohibit acquisitions in which gain or loss was recognized but apply section 355(b)(2)(C) and (D) in a manner consistent with their purposes. Accordingly, these proposed regulations provide for certain exceptions for acquisitions in which gain or loss is recognized, and prohibit certain transactions in which no gain or loss is recognized.

a. Certain Transactions in Which Recognized Gain or Loss Is Disregarded

Under these proposed regulations, certain acquisitions are excepted from the general rule under section 355(b)(2)(C) and (D) that a trade or business, or control of a corporation engaged in a trade or business, cannot satisfy the active trade or business requirement if it was acquired during the pre-distribution period in a transaction in which gain or loss was recognized. These transactions are so excepted because they do not violate the purposes of section 355(b)(2)(C) and (D).

i. Certain Acquisitions by the DSAG or CSAG

These proposed regulations provide a number of exceptions to the application of section 355(b)(2)(C) and (D) not contained in the current regulations (or § 1.355–3(b)(4)). One of these exceptions disregards any gain or loss recognized in connection with an acquisition by the CSAG from the DSAG of a trade or business, an interest in a partnership engaged in a trade or business, or stock of a corporation engaged in a trade or business. This exception is appropriate because it is not a use of distributing's assets to acquire the trade or business

Another exception disregards gain or loss recognized in an acquisition solely as a result of the payment of cash to shareholders for fractional shares where the cash paid represents a mere rounding off of the fractional shares in the exchange and is not separately bargained for consideration. The IRS and Treasury Department believe that this is not the type of transaction to which section 355(b)(2)(C) or (D) is intended to apply. Although such a transaction involves a small use of assets, these proposed regulations except such acquisitions because the small amount of assets are not separately bargained for and are used merely to simplify the exchange. Other authorities reach similar conclusions in the context of reorganizations. See Rev. Rul. 66–365 (1966–2 CB 116), amplified by Rev. Rul. 81–81 (1981–1 CB 122) (concluding that cash in lieu of fractional shares does not violate the solely for voting stock requirement of section 368(a)(1)(B) and (C) because it was merely a mathematical rounding off for simplicity, and the transaction ''was for all practical purposes ''solely in exchange for voting stock'').

In addition, as discussed in section G. of this preamble, these proposed regulations provide a limited exception for taxable acquisitions from affiliates that are members of the same SAG. Specifically, acquisitions between SAG members (where the assets (or activities) are owned (or performed) by the SAG immediately before and immediately after the transfer) are disregarded whether they are taxable or not.

Like the current regulations, these proposed regulations provide that acquisitions that expand a pre-existing business are generally exempted from the nonrecognition requirement. See § 1.355–3(b)(3)(ii). While these transactions may involve the use of the DSAG's or CSAG's assets, they are not acquisitions of a new or different trade or business. Because the DSAG or CSAG, as the case may be, is already in the business, such transactions are not considered acquisitions of a trade or business under section 355(b)(2)(C) and (D).

ii. Certain Acquisitions by a Distributee Corporation

Consistent with the principles of Rev. Rul. 74–5 (1974–1 CB 82), obsoleted by Rev. Rul. 89–37 (1989–1 CB 107), these proposed regulations disregard the recognition of gain or loss in applying section 355(b)(2)(D) to certain acquisitions of the stock of distributing by a distributee corporation. Prior to the 1987 and 1988 amendments noted in section A.1 of this preamble, section 355(b)(2)(D) was not violated in a case where distributing distributed the stock of controlled even though a purchaser acquired distributing's stock during the pre-distribution period in a transaction in which gain or loss was recognized. See Rev. Rul. 74–5 (reasoning that the purpose of section 355(b)(2)(D) was to prevent distributing, rather than the shareholder of distributing, from accumulating excess funds to purchase the stock of a corporation engaged in an active trade or business). However, Rev. Rul. 74–5 held that the purchaser could not then further distribute the stock of controlled until five years after such

purchase, reasoning that the purchaser, the distributing corporation in the second distribution, indirectly acquired the stock of controlled through another corporation, the distributing corporation in the first distribution.

The 1987 and 1988 amendments to section 355(b)(2)(D) prohibited such transactions because of a concern that such acquisitions were similar to transactions that permitted a corporation to dispose of an appreciated subsidiary without the proper recognition of gain contrary to the repeal of the *General Utilities* doctrine. For example, assume P, a corporation, acquired the stock of D in a transaction in which gain or loss was recognized and D immediately distributed the stock of C to P in a section 355 transaction. P would allocate its basis in the newly acquired D stock between the D stock and the C stock received in the distribution. P could then potentially sell the C stock without the appropriate recognition of gain. See H.R. Rep. No. 100–391, at 1080, 1082–1083 (1987).

However, there are transactions that violate the literal requirements of section 355(b)(2)(D) but do not violate the purpose of the 1987 and 1988 amendments. For example, assume that for more than five years, T, a corporation, owned all of the stock of D, which in turn owned all the stock of C. Throughout this period, D and C have each engaged in the active conduct of a trade or business. In year 6, P acquires the stock of T in a transaction in which gain or loss is recognized, and holds the T stock with a cost basis determined under section 1012. In year 7, P liquidates T in a transaction to which section 332 applies and in which no gain or loss is recognized, thereby eliminating its cost basis in the T stock. Thereafter, P holds the D stock with a basis equal to T's basis in the D stock. In year 8, D distributes the C stock to P. Under these facts, P cannot dispose of the D or C stock without recognizing the same amount of gain or loss that T would have recognized.

Similarly, assume the same facts as the previous example, except that in year 6 P acquires all of T's assets, including the D stock, in exchange for P stock and cash in a reorganization described in section 368(a)(1)(A). Because all of the cash is distributed to the T shareholders, T does not recognize any gain, and P's basis in the D stock is equal to T's basis in the D stock. See section 362(b). In year 7, D distributes the C stock to P. Under these facts, P cannot dispose of the D or C stock without recognizing the same amount of gain or loss that T would have recognized.

The IRS and Treasury Department believe that the distributee corporation language in section 355(b)(2)(D)(i) is intended only to prevent transactions that are contrary to the repeal of the *General Utilities* doctrine. In both of the examples just described, neither the D stock nor C stock can be disposed of in a manner that is contrary to the repeal of the *General Utilities* doctrine. Accordingly, these proposed regulations provide that section 355(b)(2)(D) is not violated where there is a direct or indirect acquisition by a distributee corporation of control of distributing in one or more transactions in which gain or loss is recognized where the basis of the acquired distributing stock in the hands of the distributee corporation is determined in whole by reference to the transferor's basis. However, consistent with the principles of Rev. Rul. 74–5, this rule is only applicable with respect to a distribution by the acquired distributing, and does not apply for purposes of any subsequent distribution by any distributee corporation.

b. Certain Nonrecognition Transactions Treated as Recognition Transactions

Because the IRS and Treasury Department believe that acquisitions made in exchange for assets violate the common purpose of section 355(b)(2)(C) and (D) even if no gain or loss is recognized, these proposed regulations provide that such transactions are treated as transactions in which gain or loss is recognized.

i. Acquisitions in Exchange for Assets

As discussed in section C.1 of this preamble, the common purpose underlying section 355(b)(2)(C) and (D) is that distributing generally should not be able to use its assets to acquire a new trade or business in anticipation of distributing that trade or business (or facilitating the distribution of another trade or business) to its shareholders in a tax-free transaction. Similarly, and also discussed in section C.1. of this preamble, section 355(b), by permitting the use of distributing stock to acquire a trade or business, ensures a historic relationship between the distributing shareholders and the trades or businesses relied upon to satisfy the active trade or business requirement.

The following examples illustrate distributing's use of its assets to acquire a new trade or business.

First, assume that D, a corporation that does not directly conduct a five-year active trade or business, owns all of the stock of C, a corporation with a five-year active trade or business. D wishes to spin-off C to its shareholders, but to do so D must satisfy the active trade or business requirement. Accordingly, D contributes assets to an unrelated partnership that is engaged in a five-year active trade or business in a transaction to which section 721 applies in exchange for an interest in the partnership that otherwise satisfies the requirements for D to be attributed the trade or business assets and activities of the partnership, as discussed in section I. of this preamble. Two years after the transfer, when D's only active trade or business is the business conducted by the partnership, D distributes the C stock pro rata to the D shareholders.

Alternatively, assume that D, a corporation with a five-year active trade or business, transfers assets to unrelated T, a corporation with a five-year active trade or business, in a transaction to which section 351 applies in exchange for an amount of T stock constituting control. Two years after the transfer, when T's only active trade or business is the business T conducted before D's transfer, D distributes the T stock pro rata to the D shareholders.

Similarly, assume that D, a corporation with a five-year active trade or business, owns all of the stock of C, a corporation that does not have a five-year active trade or business but has other assets. To cause C to satisfy the active trade or business requirement, D arranges for C to acquire a five-year active trade or business from T, an unrelated corporation, in a reorganization described in section 368(a)(1)(A). In the reorganization, the shareholders of T receive solely common stock of C representing 20 percent or less of the voting power of all classes of C stock. Two years after the reorganization, D distributes the C stock pro rata to the D shareholders.

In each of these examples, D has directly or indirectly acquired a trade or business in exchange for assets. See and compare Situation 2 of Rev. Rul. 2002–49 (2002–2 CB 288) (corporation's use of appreciated securities to acquire a trade or business of a partnership in a transaction to which section 721 applies is treated as an acquisition in which gain or loss was recognized); section 4.01(29) of Rev. Proc. 2007–3 (2007–1 IRB 108) (the IRS will not ordinarily rule where distributing acquires control of controlled by transferring inactive assets in a transaction meeting the requirements of section 351(a) or section 368(a)(1)(D) and in which no gain or loss is recognized). While these transactions satisfy the literal requirements of section 355(b)(2)(C) or (D), the underlying common purpose of those provisions has been violated. In each case, distributing has acquired in exchange for distributing's assets, either

directly or indirectly through the issuance of controlled stock the trade or business to be relied on by distributing or controlled.

Furthermore, in each of these examples, the historic owners have supplied a trade or business for distributing or controlled, but they are not participants in the divisive transaction. Not being shareholders of D, the position of the historic owners of the acquired business is not altered by the distribution of the controlled stock. Accordingly, neither distributing nor the distributing shareholders have a historic relationship with the separated businesses, and the distribution of the controlled stock is not the type of transaction to which section 355 was intended to apply.

By contrast, had D issued its own stock in the reorganization in the last example, the substance of the transaction would be different. D would not have indirectly acquired a trade or business in exchange for assets but rather for its own equity. Because D would not be purchasing a business for its shareholders, the distribution is not a substitute for a taxable distribution of the consideration that would have been used in the purchase. Furthermore, where D stock is used as the consideration the former T shareholders would have joined D's shareholder base, and become participants in the divisive reorganization.

These proposed regulations prohibit the acquisition of a trade or business directly or indirectly in exchange for assets in order to ensure that the common purpose of section 355(b)(2)(C) and (D) are satisfied. Such an acquisition also would include a swap of an interest in an existing five-year active trade or business for an interest in a new active trade or business. This type of an acquisition could occur through the formation of a joint venture structure.

For example, assume D and X form a partnership joint venture in which D contributes a five-year active trade or business (ATBD) and X contributes a different five-year active trade or business (ATBX). D and X each receive a 50-percent interest in the partnership. D's interest is sufficient to satisfy the requirements for D to be attributed the partnership's trade or business assets and activities (as discussed in section I. of this preamble). Prior to a potential section 355 distribution by D, and within five years of the contribution, the partnership sells ATBD.

D cannot rely on ATBX until five years after the acquisition of its interest in the partnership because, in effect, at the time of the contributions D exchanged a 50-percent undivided interest in ATBD for a 50-percent undivided interest in ATBX. Therefore, D acquired its interest in ATBX in exchange for its assets. While this was a transaction in which no gain or loss was recognized, the exchange of assets violates the common purpose of section 355(b)(2)(C) and (D). Further, the historic owner of ATBX would not participate in any distribution of controlled stock by D. Accordingly, such a distribution would not be the type of transaction to which section 355 was intended to apply.

Similarly, a corporation can effectively swap its assets through the issuance of stock of a subsidiary (including controlled). Accordingly, these proposed regulations provide a specific rule to address tax-free acquisitions involving the issuance of subsidiary stock. These proposed regulations provide that if a SAG directly or indirectly owns stock of a subsidiary (including a subsidiary SAG member) and the subsidiary directly or indirectly acquires a trade or business, an interest in a partnership engaged in a trade or business, or stock of a corporation engaged in a trade or business from a person other than such SAG in exchange for stock of such subsidiary in a transaction in which no gain or loss is recognized (the acquisition), solely for purposes of applying section 355(b)(2)(C) or (D) with respect to the trade or business, partnership interest, or stock acquired by the subsidiary in the acquisition, the subsidiary's stock directly or indirectly owned by the SAG immediately after the acquisition is treated as acquired at the time of the acquisition in a transaction in which gain or loss is recognized.

This rule reflects the fact that although the acquiring subsidiary did not make the acquisition in exchange for its assets (it issued its own stock), the SAG that owns stock of the subsidiary has exchanged an indirect interest in the subsidiary's assets for an indirect interest in the trade or business acquired by the subsidiary in the acquisition. Thus, the SAG has indirectly acquired a portion of the subsidiary's newly acquired trade or business (equal to the shareholder's stock interest in the subsidiary immediately after the acquisition) in exchange for assets. Further, the IRS and Treasury Department believe that it would be inappropriate to allow such acquired trade or business to be relied on to satisfy the active trade or business requirement within five years of its acquisition because the historic owners of that trade or business would not participate in any distribution of controlled stock.

However, because such a transaction does not result in an acquisition of any pre-existing trade or business of the subsidiary, this rule merely treats the SAG's stock in the subsidiary immediately after the acquisition as acquired in a gain or loss transaction for purposes of applying section 355(b)(2)(C) or (D) to the newly acquired trade or business. Further, the impact of such a transaction on the ability to rely on the newly acquired trade or business to satisfy the requirements of section 355(b) depends upon how much subsidiary stock the SAG owns immediately after the transaction.

For example, assume D owns all of the sole class of stock of S, a corporation that does not conduct a five-year active trade or business. T, an unrelated corporation with a five-year active trade or business (ATBT), merges into S in a reorganization described in section 368(a)(1)(A) and (D) solely in exchange for 80 percent of the S stock, and no gain or loss is recognized. Immediately after the merger, D owns only 20 percent of the sole class of S stock. Solely for purposes of determining whether ATBT can be relied on to satisfy the active trade or business requirement, D is treated as having acquired its 20 percent of the S stock at the time of the merger of T into S in a transaction in which gain or loss was recognized. Accordingly, as described in section D.2.a. of this preamble regarding certain multi-step acquisitions of a subsidiary SAG member, if D subsequently acquired the 80 percent of the S stock held by the other shareholders solely in exchange for D voting stock in a reorganization described in section 368(a)(1)(B) in which no gain or loss was recognized, S would become a DSAG member and D could rely on ATBT to satisfy the active trade or business requirement.

Accordingly, in light of all of these concerns, these proposed regulations generally provide that acquisitions paid for in whole or in part, directly or indirectly, with assets of the DSAG will be treated as acquisitions in which gain or loss is recognized. However, if a DSAG member or controlled acquires the trade or business solely in exchange for distributing stock, distributing acquires control of controlled solely in exchange for distributing stock, or controlled acquires the trade or business from distributing solely in exchange for stock of controlled, in a transaction in which no gain or loss is recognized, the requirements of section 355(b)(2)(C) and (D) are satisfied. Such acquisitions are

not made in exchange for assets of the DSAG.

An additional question arising under section 355(b)(2)(C) and (D) is whether the assumption of liabilities is treated as a payment of money or other property, and hence the use of assets. See *United States* v. *Hendler*, 303 U.S. 564, reh'g denied, 304 U.S. 588 (1938) (viewing an assumption of a liability by a transferee as in substance a payment to the transferor). Congress has indicated that the assumption of liabilities is not to be treated as the payment of money or other property in certain transactions in which no gain or loss is recognized. For example, the assumption of liabilities is not treated as the payment of money or other property in certain exchanges to which section 351 or 361 applies. See section 357(a). Further, the assumption of liabilities does not violate the solely for voting stock requirement in a reorganization described in section 368(a)(1)(C) where the acquiring corporation does not otherwise exchange money or other property. See section 368(a)(1)(C) and (a)(2)(B). Because Congress has granted this special treatment for liability assumptions in certain nonrecognition transactions, the IRS and Treasury Department believe that similar treatment is generally appropriate for purposes of section 355(b)(2)(C) and (D). Accordingly, these proposed regulations provide that the assumption by the DSAG or CSAG of liabilities of a transferor shall not, in and of itself, be treated as the payment of assets if such assumption is not treated as the payment of money or other property under any other applicable provision.

Finally, these proposed regulations clarify that an acquisition to which section 304(a)(1) applies does not satisfy the requirements of section 355(b)(2)(C) or (D). The IRS and Treasury Department believe that a stock acquisition to which section 304 applies is a transaction in which gain or loss is recognized for purposes of section 355(b)(2)(C) and (D) even if it merely results in the transferor's receipt of dividend income. These proposed regulations clarify that, regardless of the tax consequences to the transferor, such a transaction is an acquisition made in exchange for assets, and therefore does not satisfy the requirements of section 355(b)(2)(C) and (D).

ii. Partnership Distributions

These proposed regulations provide that an acquisition consisting of a distribution from a partnership is generally treated as a transaction in which gain or loss is recognized because it constitutes an acquisition in exchange for assets. That is, the distributee partner is generally exchanging an indirect interest in all the assets of the partnership for a direct interest in the property distributed. However, these proposed regulations provide that if the corporation is already attributed the trade or business assets and activities of a partnership, the corporation's acquisition of such trade or business assets and activities from the partnership is not, in and of itself, the acquisition of a new trade or business. Further, these proposed regulations provide that an acquisition consisting of a pro rata distribution from a partnership of stock or an interest in a lower-tier partnership is not an acquisition in exchange for assets to the extent the distributee partner did not acquire the interest in the distributing partnership during the pre-distribution period in a transaction in which gain or loss was recognized and to the extent the distributing partnership did not acquire the distributed stock or partnership interest within such period. In such a case, the distributee partner has merely exchanged an indirect interest for a direct interest in the distributed stock or partnership interest, and continues to possess the same indirect interest in the remaining assets of the partnership.

iii. Lack of Transferred Basis

Section 1.355–3(b)(4)(i) provides that a trade or business acquired, directly or indirectly, within the pre-distribution period 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. These proposed regulations do not include a similar provision. The IRS and Treasury Department believe that the prohibition against acquisitions in exchange for assets fully addresses such acquisitions.

c. Application of Section 355(b)(2)(C) and (D) to Predecessors

Unlike § 1.355–3(b)(4)(i), which only took ''a predecessor in interest'' into account for purposes of applying section 355(b)(2)(D), these proposed regulations provide that any reference to a corporation includes a reference to a predecessor of such corporation in applying both section 355(b)(2)(C) and (D). The IRS and Treasury Department believe that predecessors should be taken into account in applying both section 355(b)(2)(C) and (D) because the same policy concerns exist regardless of whether the transaction involves the acquisition of assets or stock. For this purpose, the proposed regulations define a predecessor of a corporation as a corporation that transfers its assets to such corporation in a transaction to which section 381 applies. The IRS and Treasury Department believe that it is appropriate to take predecessors into account in applying these provisions in order to appropriately minimize the significance of which corporation is the acquiror and which corporation is the target.

Further, because the SAG rule effectively treats SAG members as a singly-entity for purposes of section 355(b), these proposed regulations also apply section 355(b)(2)(C) and (D) to acquisitions during the pre-distribution period by corporations that later become DSAG or CSAG members. These types of acquisitions are similar to predecessor asset acquisitions.

4. Requests for Comments Regarding Exceptions to Section 355(b)(2)(C) and (D)

The IRS and Treasury Department request comments regarding whether any additional exceptions to section 355(b)(2)(C) and (D) are appropriate. In particular, the IRS and Treasury Department request comments regarding whether acquisitions in which gain is recognized solely as a result of the application of section 367 should be treated as violating section 355(b)(2)(C) or (D). The IRS and Treasury Department also request comments regarding whether an exception should exist for taxable acquisitions made by distributing solely in exchange for distributing stock because such acquisitions are not made in exchange for distributing's assets and do not appear to violate the common purpose of section 355(b)(2)(C) and (D).

In addition, the IRS and Treasury Department request comments regarding whether a redemption of stock should be a transaction to which section 355(b)(2)(C) or (D) applies. Under current law, no relief is provided for such transactions. See *McLaulin* v. *Commissioner*, 276 F.3d 1269 (11th Cir. 2001) (concluding that section 355(b)(2)(D) applies when distributing acquires control of a subsidiary through a redemption of subsidiary stock). Compare Rev. Rul. 57–144 (1957–1 CB 123). Specifically, comments are requested on whether all types of redemptions should be subject to the same rule, whether the treatment of redemptions should be determined by the source of payment, whether the redemption constitutes an indirect exchange for assets of distributing or controlled, and the method of making these determinations. Alternatively, the

IRS and Treasury Department request comments on whether an exception should be provided for redemptions of shareholders that exercise dissenters' rights. Compare Rev. Rul. 68–285 (1968–1 CB 147) (concluding that cash paid to dissenting target corporation shareholders by the target corporation does not violate the solely for voting stock requirement of section 368(a)(1)(B)) with Rev. Rul. 73–102 (1973–1 CB 186) (concluding that cash paid to dissenting target corporation shareholders by the acquiring corporation is treated as money or other property paid by the acquiring corporation for the properties of the target corporation in a reorganization under section 368(a)(1)(C)). These proposed regulations do not include an exception for redemptions generally or for those in connection with the exercise of dissenters' rights.

Finally, the IRS and Treasury Department request comments regarding whether a transaction in which a distributee corporation acquires in a transaction in which no gain or loss is recognized newly issued stock of distributing in exchange for money or property previously acquired for cash during the pre-distribution period should be treated as a transaction in which gain or loss is recognized. For example, assume D and C have each engaged in the active conduct of a trade or business for more than five years. During the pre-distribution period, P, an unrelated corporation, purchases trucks and transfers them to D in exchange for D stock meeting the requirements of section 368(c) in a transaction to which section 351 applies. No gain or loss is recognized. D subsequently distributes all the C stock to P in a separate transaction within five years of P's acquisition of the D stock. Notwithstanding that this transaction satisfies the literal requirements of section 355(b)(2)(D), it appears to violate the *General Utilities* doctrine because it permits the distributee corporation, P, to receive a fair market value basis (or close to a fair market value basis) in the distributing stock, enabling the potential sale of controlled stock without the appropriate recognition of gain. Additionally, the IRS and Treasury Department are studying whether the principles of the foregoing rule should be extended to any distributee in regulations under section 355(d), and request comments on this point.

D. Treatment of Certain Multi-Step Acquisitions

These proposed regulations provide specific rules regarding the application of section 355(b)(2)(C) and (D) to certain multi-step acquisitions. Based on the interpretation of section 355(b)(2)(D), and the enactment of section 355(b)(3), the IRS and Treasury Department believe that it is appropriate to apply section 355(b)(2)(C) and (D) to multi-step acquisitions in a consistent manner. Further, the IRS and Treasury Department believe that it is appropriate to treat certain multi-step acquisitions of target corporation stock as satisfying the requirements of section 355(b)(2)(C) or (D) (as applicable) notwithstanding that some portion of the stock may have been acquired in a separate transaction in which gain or loss was recognized.

1. Multi-Step Acquisition of Control of Distributing or Controlled

a. Direct Acquisitions

Section 355(b)(2)(D) provides that control of distributing or controlled may be acquired within the pre-distribution period provided that ''in each case in which such control was so acquired, it was so acquired, only by reason of transactions in which gain or loss was not recognized in whole or in part, or only by reason of such transactions combined with acquisitions before the beginning of such period.'' The IRS and Treasury Department interpret this language to mean that at the time control is first acquired, the acquiring corporation (or its SAG) is required to own stock meeting the requirements of section 368(c) that was acquired in one or more transactions in which no gain or loss was recognized or by reason of such transactions combined with acquisitions before the beginning of the pre-distribution period. Thus, at the time an acquiring corporation (or its SAG) first satisfies the section 368(c) control requirement, the acquiring corporation (or its SAG) must possess section 368(c) control without relying on any stock acquired in a transaction in which gain or loss was recognized during the pre-distribution period.

For example, assume that C has two classes of stock outstanding. X owns all 95 shares of the class A stock of C representing 95 percent of the voting power and 70 percent of the value and Y owns all of the class B stock of C representing five percent of the voting power and 30 percent of the value. In year 1, unrelated D acquires 10 shares of the class A C stock from X in a transaction in which gain or loss is recognized. In year 2, D acquires an additional 80 shares of class A C stock from X in a separate transaction in which no gain or loss is recognized. In year 3, D acquires the remaining five shares of class A C stock from X in a separate transaction in which gain or loss is recognized. In year 4, D distributes the 95 shares of class A C stock to the D shareholders. Assuming all of the other requirements of section 355(b) are satisfied, the requirements of section 355(b)(2)(D)(ii) are satisfied because at the time D first acquired control of C (immediately after the year 2 acquisition), D owned an amount of C stock constituting control that was acquired in a transaction in which no gain or loss was recognized (the 80 shares of class A C stock acquired in year 2). (However, the 10 shares of class A C stock acquired in year 1 and the five shares of class A C stock acquired in year 3 may be treated as moot under section 355(a)(3)(B).)

On the other hand, assume the same facts as the previous example, except that, in year 2, D acquires only 75 shares of class A C stock from X. The requirements of section 355(b)(2)(D)(ii) are not satisfied because at the time D first acquired control of C (immediately after the year 2 acquisition), D did not own an amount of C stock constituting control that was acquired in one or more transactions in which no gain or loss was recognized or acquired prior to the pre-distribution period. D only owns C voting stock representing 75 percent of the total voting power that was acquired in a transaction in which no gain or loss was recognized. The result would be the same if the year 3 acquisition was also a transaction in which no gain or loss was recognized.

b. Indirect Acquisitions

These proposed regulations also provide that the principles of this rule will be applied with respect to an indirect acquisition of distributing or controlled stock. For example, assume T corporation owns stock of C (an unaffiliated subsidiary) constituting control (and no more). Unrelated D acquires 10 percent of the sole outstanding class of stock of T in a transaction in which gain or loss is recognized. In a separate transaction, T merges into D solely in exchange for D stock in a transaction in which no gain or loss is recognized. In applying this multi-step acquisition rule to D's subsequent acquisition of control of C in the merger, the prior acquisition of T stock in the transaction in which gain or loss was recognized is treated as an acquisition of 10 percent of the C stock owned by T (representing 8 percent of the total combined voting power of the C stock) in a transaction in which gain or loss is recognized. Accordingly, the requirements of section 355(b)(2)(D)(ii) are not satisfied because at the time D first acquires control of C, D does not own an amount of C stock constituting

control that was acquired in one or more transactions in which no gain or loss is recognized or acquired prior to the pre-distribution period. At that time, D had only acquired C stock representing 72 percent of the total combined voting power of the C stock in a transaction in which no gain or loss is recognized.

2. Other Multiple-Step Acquisitions

As discussed in sections A.1., B.1., and B.3. of this preamble, if D acquires section 1504(a)(2) stock of a corporation, the acquired corporation will become a DSAG member and the corporation will be treated like a division of D for purposes of the active trade or business requirement. As such, D is treated as if it acquired the assets and activities of the new subsidiary SAG member, and the acquisition must satisfy the requirements of section 355(b)(2)(C) rather than section 355(b)(2)(D). If D subsequently acquires the remaining stock of the corporation in a separate transaction, such acquisition is disregarded for purposes of satisfying the active trade or business requirement (regardless of whether gain or loss was recognized in the separate transaction) because the subsidiary is already treated as a division of D for this purpose. The IRS and Treasury Department believe that the order of these acquisitions should not be determinative in applying section 355(b)(2)(C), provided that at the time the corporation first becomes a subsidiary SAG member, the SAG owns section 1504(a)(2) stock in the corporation without relying on any stock acquired in a transaction in which gain or loss was recognized during the pre-distribution period.

a. Direct SAG Acquisitions

Consistent with the treatment of multi-step acquisitions of control of a corporation discussed in section D.1. of this preamble, these proposed regulations provide that multi-step acquisitions of stock resulting in a corporation becoming a subsidiary SAG member will satisfy the requirements of section 355(b)(2)(C), provided that at the time the corporation first becomes a subsidiary SAG member, the SAG owns section 1504(a)(2) stock in the corporation without relying on any stock acquired in a transaction in which gain or loss was recognized during the pre-distribution period.

For example, assume that in year 1, D does not conduct an active trade or business and has owned control of C for more than five years. C and T, an unrelated corporation, have each engaged in the active conduct of a trade or business for more than five years. In year 1, D acquires 10 percent of T's sole outstanding class of stock in a transaction in which gain or loss was recognized. In year 2, D acquires an additional 80 percent of T's stock in a separate transaction in which no gain or loss was recognized. T becomes a DSAG member as a result of the year 2 stock acquisition. In year 3, D distributes the C stock to the D shareholders. Assuming all of the other requirements of section 355(b) are satisfied, the requirements of section 355(b)(2)(C) are satisfied because at the time T first became a DSAG member (immediately after the year 2 acquisition), D owned an amount of T stock meeting the requirements of section 1504(a)(2) that was acquired in a transaction in which no gain or loss was recognized (the T stock acquired in year 2).

On the other hand, assume the same facts as the previous example except that, in year 2, D only acquires an additional 75 percent of T's stock. The requirements of section 355(b)(2)(C) are not satisfied because at the time T first became a DSAG member (immediately after the year 2 acquisition), D did not own an amount of T stock meeting the requirements of section 1504(a)(2) that was acquired in one or more transactions in which no gain or loss was recognized or acquired prior to the pre-distribution period. D owns only 75 percent of T's stock that was acquired in a transaction in which no gain or loss was recognized. The result would be the same even if, in year 3 prior to the distribution of the C stock, D acquired the remaining 15 percent of the T stock in a transaction in which no gain or loss is recognized.

b. Indirect SAG Acquisitions

Similar to the rule regarding multi-step acquisitions of control of distributing or controlled, these proposed regulations also provide that the principles of this rule will be applied with respect to an indirect acquisition by the SAG of stock of a corporation that becomes a SAG member. For example, assume a DSAG member acquires 25 percent of the sole outstanding class of stock of T, a corporation that wholly owns S, in a transaction in which gain or loss is recognized. In a separate transaction, another DSAG member acquires all of the stock of S from T solely in exchange for D voting stock in a reorganization described in section 368(a)(1)(B) in which no gain or loss is recognized. As a result, S becomes a DSAG member. In applying this multi-step acquisition rule to the DSAG's subsequent acquisition of S stock, the acquisition of 25 percent of the T stock in the transaction in which gain or loss was recognized will be treated as an acquisition of 25 percent of the S stock in a transaction in which gain or loss is recognized. Accordingly, the requirements of section 355(b)(2)(C) are not satisfied because at the time S first becomes a DSAG member, the DSAG does not own section 1504(a)(2) stock of S that was acquired in one or more transactions in which no gain or loss is recognized or acquired prior to the pre-distribution period.

c. Multi-Step Asset Acquisitions

Because stock acquisitions that result in a corporation becoming a subsidiary SAG member are treated as direct acquisitions of the target corporation's assets for purposes of applying section 355(b), these proposed regulations apply a comparable multi-step acquisition rule to acquisitions of stock in non-SAG members where such non-members' assets are subsequently directly acquired by a SAG member. Specifically, these proposed regulations provide that if immediately before a SAG's direct acquisition of a trade or business (or an interest in a partnership engaged in a trade or business) held by a corporation (owner) in a transaction to which section 381 applies and in which no gain or loss is recognized, the SAG owns an amount of stock of the owner that it acquired in one or more transactions during the pre-distribution period in which gain or loss was recognized such that all of the other stock of the owner does not meet the requirements of section 1504(a)(2), such direct acquisition shall be treated as a transaction in which gain or loss was recognized. Thus, these proposed regulations apply section 355(b)(2)(C) to multi-step acquisitions in the same manner regardless of whether the separate steps result in the target corporation becoming a subsidiary SAG member or result in a direct acquisition of the target corporation's assets.

For example, assume that in year 1, D does not conduct an active trade or business, and has owned control of C for more than five years. C and T, an unrelated corporation, have each engaged in the active conduct of a trade or business for more than five years. In year 1, D acquires 10 percent of T's sole outstanding class of stock in a transaction in which gain or loss was recognized. In year 2, in a separate reorganization described in section 368(a)(1)(A), T merges into D and the T shareholders receive solely D stock in exchange for their T stock. No gain or loss is recognized in the merger. In year 3, D distributes the stock of C to the D shareholders. Assuming all of the other requirements of section 355(b) are satisfied, the requirements of section

355(b)(2)(C) are satisfied because, at the time D acquires T's active trade or business, D did not own an amount of T stock that was acquired in one or more transactions during the pre-distribution period in which gain or loss was recognized such that all of the other T stock does not meet the requirements of section 1504(a)(2).

On the other hand, assume the same facts as the previous example except that in year 1 D acquires 21 percent of T's stock. The requirements of section 355(b)(2)(C) are not satisfied because, at the time D acquires T's active trade or business, D owned an amount of T stock that was acquired in one or more transactions during the pre-distribution period in which gain or loss was recognized such that all of the other T stock does not meet the requirements of section 1504(a)(2).

These proposed regulations also provide that the principles of this rule will be applied with respect to an indirect acquisition of the target corporation's stock by the SAG.

E. Expansion Acquisitions

The legislative history, the courts, and the current regulations acknowledge that a trade or business can undergo many changes during the pre-distribution period and still satisfy the requirements of section 355(b). See H.R. No. 83–2543, at 37, 38 (1954) (Conf. Rep.); *Estate of Lockwood* v. *Commissioner*, 350 F.2d 712 (8th Cir. 1965); and § 1.355–3(b)(3)(ii). Furthermore, § 1.355–3(b)(3)(ii) provides ''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.'' Therefore, an acquired trade or business that is an expansion of the original trade or business inherits the business history of the expanded business.

None of these authorities, however, addresses whether an existing trade or business can be expanded by acquiring the stock of a corporation engaged in a trade or business in the same line of business as the acquiror. Because the SAG rule causes a stock acquisition in which the acquired corporation becomes a subsidiary SAG member to be treated as an asset acquisition, a corporation engaged in a trade or business should be able to expand its existing trade or business by acquiring stock of a corporation (including controlled) engaged in a trade or business in the same line of business provided the acquisition results in the acquired corporation becoming a subsidiary SAG member.

On the other hand, section 355(b)(3) does not allow a corporation to rely on the trade or business of a non-SAG subsidiary—even if the corporation controls the subsidiary—to satisfy the active trade or business requirement. As such, it effectively precludes stock expansions where the acquired corporation does not become a subsidiary SAG member. The IRS and Treasury Department believe that section 355(b)(3) is the exclusive means by which a corporation is attributed the assets (or activities) owned (or conducted) by another corporation. Accordingly, a stock acquisition that does not result in the acquired corporation becoming a subsidiary SAG member should not be an expansion of the SAG's original business.

In addition, these proposed regulations provide certain facts and circumstances to be considered in determining whether one trade or business is in the same line of business as another trade or business. The inclusion of these facts and circumstances in these proposed regulations is not intended to be a substantive change, but merely to clarify and restate the current law regarding expansions. See Rev. Rul. 2003–18 (2003–1 CB 467) and Rev. Rul. 2003–38 (2003–1 CB 811). Some of the examples from the current regulations have been altered in these proposed regulations to reflect this inclusion (as well as certain stylistic changes).

F. Rules Related to Hot Stock

Section 355(a)(3)(B) provides that stock of controlled acquired by distributing during the pre-distribution period in a transaction in which gain or loss is recognized is treated as boot. Section 1.355–2(g) provides guidance regarding the application of section 355(a)(3)(B). The IRS and Treasury Department request comments regarding whether § 1.355–2(g) should be amended to adopt rules under section 355(a)(3)(B) similar to those provided in these proposed regulations for determining whether an acquisition is one in which gain or loss is recognized for purposes of section 355(b)(2)(C) or (D).

In particular, the IRS and Treasury Department request comments concerning the application of section 355(a)(3)(B) to acquisitions of stock of controlled in gain or loss transactions that, under these proposed regulations, are not treated as violating the requirements of section 355(b). For example, where distributing acquires stock of controlled in a gain or loss transaction that is treated as an expansion of distributing's existing trade or business (because controlled is in distributing's line of business and becomes a DSAG member), what portion, if any, of the acquired stock should be subject to section 355(a)(3)(B)?

The current authorities may suggest a linkage between the interpretation of sections 355(a)(3)(B) and 355(b). See § 1.355–2(g)(1) (not applying section 355(a)(3)(B) to a taxable acquisition from an affiliate); Rev. Rul. 78–442 (stating ''[l]ikewise, for the same reasons [that section 355(b)(2)(C) does not apply], section 355(a)(3)[(B)] of the Code is not applicable''). However, section 355(b)(3) by its literal terms does not appear to apply for purposes section 355(a)(3)(B).

The IRS and Treasury Department continue to study how to coordinate the application of these provisions and request comments in this regard. Accordingly, these proposed regulations contain no proposal to change § 1.355–2(g) at this time.

G. Limited Affiliate Exception

Other than with respect to transfers of assets (or activities) that are owned (or performed) by the SAG immediately before and immediately after the transfer, these proposed regulations do not include the special treatment accorded affiliated group members in § 1.355–3(b)(4)(iii). Thus, these proposed regulations treat non-SAG member affiliates of distributing or controlled in the same manner as unrelated persons for purposes of applying section 355(b)(2)(C) and (D). While distributing is the common parent of its SAG, distributing may be a subsidiary member of a larger affiliated group. Therefore, not all members of distributing's affiliated group are DSAG members.

Section 1.355–3(b)(4)(iii) provides that acquisitions by one member of an affiliated group from another member of the group are disregarded in applying section 355(b)(2)(C) and (D), even if gain or loss is recognized. Section 1.355–3(b)(4)(iii) provides for this treatment for affiliates because although ''[t]he 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 or business in a distribution to which section 355 would otherwise apply[,]'' acquisitions from affiliates are not the type of transaction to which these provisions were intended to apply. Section 1.355–3(b)(4)(iv) defines the term ''affiliated group'' as 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).

The IRS and Treasury Department believe that limiting this special treatment to transfers in which the assets (or activities) remain in the SAG (as opposed to the larger affiliated group) is more consistent with the purposes of section 355(b)(3). As discussed in section A.1. of this preamble, section 355(b)(3) states, in effect, that in determining whether distributing or controlled is engaged in a trade or business all DSAG or CSAG members, as the case may be, are treated as one corporation. Therefore, a transfer of trade or business assets (or activities) from one SAG member to another SAG member is disregarded, and is not an acquisition for purposes of section 355(b)(2)(C) (or section 355(b)(2)(D) in the case of stock of controlled that is not a DSAG member). The SAG rule implies a corollary, which is that if the trade or business assets (or activities) are not owned (or performed) by the SAG, such assets (or activities) should generally not be able to be acquired from outside the SAG in a transaction in which gain or loss is recognized. Thus, these proposed regulations generally do not permit taxable acquisitions of an active trade or business from outside the SAG.

The IRS and Treasury Department recognize that not providing this special treatment for non-SAG member affiliates is a change from how the law has been administered in various situations. Further, the IRS and Treasury Department recognize that this change can represent a relaxing or tightening of the law in this area, depending upon the circumstances. For example, under these proposed regulations the requirements of section 355(b)(2)(C) are satisfied where P, a higher-tier affiliate of distributing, purchases a trade or business for cash and contributes it to distributing solely in exchange for distributing stock in a transaction in which no gain or loss is recognized. On the other hand, under these proposed regulations, the requirements of section 355(b)(2)(C) are not satisfied where P has actively conducted a trade or business for more than five years and sells it to D in exchange for cash.

H. Activities Performed by Certain Related Parties

Current § 1.355–3(b)(2)(iii) provides, in part, that to satisfy the active trade or business requirement, the corporation itself generally is required to perform active and substantial management and operational functions. That regulation further provides that activities performed by the corporation itself generally do not include activities performed by independent contractors. In this regard, ''a corporation must engage in entrepreneurial endeavors of such a nature and to such an extent as to qualitatively distinguish its operations from mere investments [, and] * * * there should be objective indicia of such corporate operations.'' *Rafferty* v. *Commissioner*, 452 F.2d 767, 772 (1st Cir. 1971) *cert. denied* 408 U.S. 922 (1972) (concluding that a corporation that did not pay salaries or rent, did not employ independent contractors, and merely collected rent, paid taxes, and kept separate books, failed to satisfy these requirements). The IRS and Treasury Department believe that a corporation may rely on the activities performed by certain related parties in conducting its ''entrepreneurial endeavors,'' and such activities can constitute ''objective indicia'' of corporate operations.

While section 355(b)(3) treats all SAG members as one corporation, the IRS and Treasury Department are aware that affiliated groups of corporations that include non-SAG member affiliates might use employees of one member of the group to perform management or operational functions for another member of the group. The IRS and the Treasury Department believe that a corporation can satisfy the active trade or business requirement even if all the management and operational functions are performed by employees of affiliates that are not members of either the DSAG or CSAG. In other words, the DSAG or CSAG can be engaged in ''entrepreneurial endeavors'' that are distinguishable from mere passive investment even if the management and operational functions are performed for the DSAG or CSAG by employees of non-SAG affiliates. Such individuals bear a close enough relationship to the DSAG or CSAG to be distinguished from mere independent contractors for purposes of the active trade or business requirement. The IRS and Treasury Department believe that this treatment is appropriate and consistent with previously published guidance.

Issued prior to the enactment of section 355(b)(3), Rev. Rul. 79–394 (1979–2 CB 141), amplified by Rev. Rul. 80–181 (1980–2 CB 121), concludes that controlled satisfies the active trade or business requirement even though all of the operational activities of its business are conducted by an affiliate's employees before the distribution. The IRS and Treasury Department believe that extending the principles of Rev. Rul. 79–394 and Rev. Rul. 80–181 to the performance of management (in addition to operational) functions by employees of an affiliate is consistent with the purposes underlying the active trade or business requirement. Accordingly, these proposed regulations provide that, in determining whether a corporation is engaged in the active conduct of a trade or business, activities (including management and operational functions) performed by employees of the corporation's affiliates (including non-SAG members) are taken into account.

Furthermore, the IRS and Treasury Department believe that a corporation can satisfy the active trade or business requirement even if all the management and operational functions are performed by shareholders of the corporation if it is closely held. The shareholders of closely held corporations possess a close relationship with the corporation, similar to employees of affiliates. Accordingly, these proposed regulations provide that, in determining whether a corporation is engaged in the active conduct of a trade or business, activities (including management and operational functions) performed by shareholders of a closely held corporation are taken into account in certain cases.

The IRS and Treasury Department do not believe that the absence of an exception for acquisitions from non-SAG member affiliates is inconsistent with concluding that a corporation can satisfy the active trade or business requirement by relying on the management and operational functions performed by employees of non-SAG member affiliates. Relying on the activities of such employees does not involve the acquisition of a trade or business. As such, it is not the type of transaction or arrangement section 355(b)(2) was intended to address. Accordingly, the IRS and Treasury Department believe it is appropriate to apply a broader standard with respect to relying on employees of non-SAG member affiliates.

While it is appropriate to consider the management and operational activities of employees of all affiliates in determining whether a corporation satisfies the active trade or business requirement, the IRS and Treasury Department believe that a corporation should satisfy the active trade or

business requirement only if it (or another SAG member, or a partnership from which the trade or business assets and activities are attributed) is the principal owner of the goodwill and significant assets of the trade or business for Federal income tax purposes. Accordingly, a corporation will be treated as engaged in the active conduct of a trade or business only if, for Federal income tax purposes, it (or its SAG member, or a partnership from which the trade or business assets and activities are attributed) is the principal owner of the goodwill and significant assets of the trade or business. Accordingly, some of the examples from the current regulations have been altered in these proposed regulations to reflect this goodwill and significant asset standard (as well as certain stylistic changes).

I. Activities Conducted by a Partnership

Revenue Ruling 92–17 (1992–1 CB 142) and Rev. Rul. 2002–49 (2002–2 CB 288) address in a number of fact situations whether a corporation that is a partner in a partnership can satisfy the active trade or business requirement by reason of its ownership of the partnership interest where the partnership conducts a trade or business. Those rulings illustrate that a corporation owning a 20-percent interest in a state law partnership or limited liability company (LLC) that is classified as a partnership for Federal income tax purposes can be treated as engaged in the active conduct of the trade or business of the partnership if the corporation performs active and substantial management functions for the partnership's business. In addition, Rev. Rul. 2002–49 concludes that such a corporation can be treated as engaged in the active conduct of a partnership's trade or business, even if another partner also performs active and substantial management functions for the partnership's trade or business.

Consistent with the principles set forth in Rev. Rul. 92–17 and Rev. Rul. 2002–49 regarding satisfying the active trade or business requirement through an interest in a partnership, these proposed regulations provide that for purposes of section 355(b) a partner will be attributed the trade or business assets and activities of a partnership if the partner (1) Performs active and substantial management functions for the partnership with respect to the trade or business assets or activities (for example, makes decisions regarding significant business issues of the partnership and regularly participates in the overall supervision, direction, and control of the employees performing the operational functions for the partnership), and (2) owns a meaningful interest in the partnership. Further, because a partnership might only conduct a portion of a trade or business, the IRS and Treasury Department believe that a partner that satisfies these requirements can be attributed the portions of a trade or business (or assets and activities) that are conducted by a partnership. Under these circumstances the IRS and Treasury Department believe that it is appropriate to aggregate the partnership's trade or business assets and activities with those of the partner for purposes of determining whether the partner satisfies the active trade or business requirement. However, the stock of a corporation held by the partnership is not attributed to a partner.

The IRS and Treasury Department understand that the facts presented in Rev. Rul. 92–17 and Rev. Rul. 2002–49 do not necessarily reflect the exclusive methods by which corporations engage in a trade or business through a partnership. In particular, the IRS and Treasury Department understand that both the management and operational activities of an LLC are often conducted by the LLC itself, rather than by its members, to protect its members from liability for the LLC's activities. In these cases, Rev. Rul. 92–17 and Rev. Rul. 2002–49 do not explicitly support the conclusion that a corporation may rely on the trade or business assets and activities of an LLC to satisfy the active trade or business requirement, since no activities are performed by the corporate partner.

The IRS and Treasury Department believe that, in certain cases, a partner that owns a significant interest in an entity that is treated as a partnership for Federal income tax purposes should be attributed the trade or business assets and activities of a partnership, even if the partner does not directly conduct any activities relating to the business of the partnership. By comparison, the IRS and Treasury Department have promulgated regulations regarding the treatment of acquired assets held by a partnership for purposes of satisfying the continuity of business enterprise requirement applicable to reorganizations. Those regulations provide that a partner will be treated as owning the acquired target business assets used in the business of a partnership in satisfaction of the continuity of business enterprise requirement if the members of the qualified group, in the aggregate, own an interest in the partnership representing a significant interest in that partnership business. See § 1.368–1(d)(4)(iii)(B)(*1*). Those regulations include an example concluding that the continuity of business enterprise requirement is satisfied where a partner owns a one-third interest in a partnership that continues the business of the target corporation, even though the partner performs no management or operational functions for that business. See § 1.368–1(d)(5) *Example 9.*

These proposed regulations yield results similar to the continuity of business enterprise rule in determining whether the active trade or business requirement is satisfied when a corporation conducts a trade or business or portions of a trade or business through a partnership but does not participate in the partnership's activities. Specifically, these proposed regulations provide that for purposes of section 355(b) a partner will be attributed the trade or business assets and activities of a partnership provided the partner owns a significant interest in the partnership. The IRS and Treasury Department intend that the term ''significant interest'' requires an ownership interest that is greater than that suggested by the term ''meaningful interest,'' which is the level of ownership required for a partner to be attributed the trade or business assets and activities of a partnership in cases where the partner performs active and substantial management functions for the partnership.

However, a partner will be attributed the trade or business assets and activities of a partnership only during the period it owns a significant interest or alternatively owns a meaningful interest and performs active and substantial management functions.

J. Additional Requests for Comments

The IRS and Treasury Department request comments regarding whether the regulations should include a rule that would treat an acquisition in which no gain or loss is recognized as an acquisition in which gain or loss is recognized if that would be the treatment had the transaction been executed in the opposite direction. For example, assume that, in year 1, P, a corporation not engaged in an active trade or business, acquires 50 percent of all of the outstanding stock of D (which is engaged in an active trade or business, and owns control of C, which is also engaged in an active trade or business) in a transaction in which gain or loss is recognized, and then, in a separate transaction in year 3, D merges into P solely in exchange for P stock in a transaction described in section 368(a)(1)(A) in which no gain or loss is recognized. P then distributes the C

stock to its shareholders in year 4. Under these proposed regulations, P is treated as having acquired D's trade or business and control of C during the pre-distribution period in a transaction in which gain or loss is recognized because P acquired more than 20 percent of D's stock during the pre-distribution period in a transaction in which gain or loss was recognized (see sections D.1.b. and D.2.c of this preamble). However, if P merges downstream into D solely in exchange for D stock in a reorganization described in section 368(a)(1)(A) and (D) in which no gain or loss is recognized, there literally is not an acquisition in which gain or loss is recognized under these proposed regulations, because D did not acquire any interest in an active trade or business from P. Comments are requested regarding whether the result should differ depending upon the direction of the merger. See and compare § 1.355–3(b)(4)(ii) (predecessor of distributing acquiring control of distributing).

Further, the IRS and Treasury Department request comments regarding the appropriate methods of measuring indirect acquisitions of stock for purposes of the rules regarding multi-step acquisitions, as discussed in section D. of this preamble. Specifically, comments are requested regarding how the indirect acquisition should be measured where the acquired corporation has multiple classes of stock outstanding, or where the acquired entity is a partnership. For example, assume T is a corporation that owns all of the stock of a subsidiary, S, and T has class A common stock, class B common stock, and preferred stock outstanding. If D acquires 10 percent of the T class A common stock, how should one determine what percentage of S stock D has indirectly acquired? Should it be based on the value of the T stock D acquired relative to the value of all of the T stock or other factors? How should the voting power of the acquired T stock be taken into account in applying these rules to potential indirect acquisitions of control?

In addition, the IRS and Treasury Department request comments regarding whether the parameters of the good faith and inadvertence exceptions in Notice 2004–37 (2004–1 CB 947) regarding the value requirement in section 1504(a)(2)(B) should apply for purposes of determining whether corporations are SAG members even if they are not members of a consolidated group. That is, the IRS and Treasury Department request comments regarding whether the policies underlying the SAG rule and the reference to section 1504(a) in section 355(b)(3)(B) suggest that the good faith and inadvertence exceptions should apply and be interpreted in the same way for SAG membership as for affiliation for purposes of filing consolidated returns.

The IRS and Treasury Department also request comments regarding whether the regulations should clarify the circumstances under which the separation of a segment of an active trade or business should be treated as a separate active trade or business after it is spun off and, if so, what the governing principle should be. See, for example, § 1.355–3(c) *Example (9)* (separation of a corporation's research department from the rest of its manufacturing business).

Although these regulations are generally proposed to be applicable to distributions that occur after the date these regulations are published as final regulations in the **Federal Register**, the IRS and Treasury Department invite comments regarding whether it would be appropriate and desirable to allow taxpayers to elect to apply these provisions retroactively (subject to the applicability of section 355(b)(3)).

Proposed Effective Date

These proposed regulations are proposed to apply to distributions that occur after the date these regulations are published as final regulations in the **Federal Register**.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and, because these regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, these regulations have been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small businesses.

Comments and Requests for Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and Treasury Department request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying. A public hearing will be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

Drafting Information

The principal author of these proposed regulations is Russell P. Subin of the Office of Associate Chief Counsel (Corporate). However, other personnel from the IRS and Treasury Department participated in their development.

Availability of IRS Documents

IRS revenue rulings, procedures, and notices cited in this preamble are made available by the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.355–0 is amended by revising the entries under § 1.355–3.

The revisions are as follows:

§ 1.355–0 Outline of sections.

* * * * *

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

(a) General requirements.
(b) Active conduct of a trade or business defined.
(1) In general.
(i) Directly engaged in a trade or business.
(ii) Treatment of a separate affiliated group.
(iii) Separate affiliated group defined.
(2) Active conduct of a trade or business immediately after the distribution.
(i) In general.
(ii) Trade or business.
(iii) Active conduct.
(iv) Limitations.
(v) Partner attributed the trade or business assets and activities of a partnership.
(A) In general.
(B) Significant interest.
(C) Meaningful interest.
(D) Other factors.
(3) Active conduct for the pre-distribution period.
(i) In general.
(ii) Change and expansion.

(iii) Certain transactions with partnerships that do not constitute acquisitions.
(4) Special rules for an acquisition of a trade or business.
(i) In general.
(A) Application of section 355(b)(2)(C).
(B) Application of section 355(b)(2)(D).
(C) Gain or loss recognized.
(ii) Certain transactions treated as transactions in which gain or loss is recognized.
(A) Certain tax-free acquisitions made in exchange for assets.
(B) Distributions from partnerships.
(iii) Certain transactions in which recognized gain or loss is disregarded.
(A) Transfers to controlled.
(B) Cash for fractional shares.
(C) Certain acquisitions of control of distributing.
(iv) Operating rules for acquisitions.
(A) Predecessors.
(B) Certain multi-step acquisitions of control of distributing or controlled.
(C) Certain multi-step acquisitions of a subsidiary SAG member.
(D) Certain multi-step asset acquisitions.
(E) Acquisitions involving the issuance of subsidiary stock.
(F) Acquisitions of controlled stock where controlled is or becomes a DSAG member.
(G) Treatment of stock received in certain tax-free exchanges.
(H) Situations where the separate existence of a subsidiary SAG member is respected.
(c) Definitions.
(1) Affiliate.
(2) Controlled.
(3) Distributing.
(4) Pre-distribution period.
(d) Conventions and examples.
(1) Conventions.
(2) Examples.

* * * * *

Par. 3. Section 1.355–1 is amended by revising paragraph (a) to read as follows:

§ 1.355–1 Distribution of stock and securities of a controlled corporation.

(a) *Effective date of certain sections.* Except as otherwise provided, §§ 1.355–1, 1.355–2, and 1.355–4 apply to transactions occurring after February 6, 1989. Section 1.355–3 applies to distributions after the date these regulations are published as final regulations in the **Federal Register**. For transactions occurring on or before that date but after February 6, 1989, see 26 CFR 1.355–3 (revised as of April 1, 2007). For all transactions occurring on or before February 6, 1989, see 26 CFR 1.355–1 through 1.355–4 (revised as of April 1, 1987). Sections 1.355–1, 1.355–2, and 1.355–4 do not reflect the amendments to section 355 made by the Revenue Act of 1987 and the Technical and Miscellaneous Revenue Act of 1988. For the effective date of §§ 1.355–6 and 1.355–7, see §§ 1.355–6(g) and 1.355–7(k), respectively.

* * * * *

Par. 4. Section 1.355–3 is revised to read as follows:

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

(a) *General requirements.* Under section 355(b)(1), a distribution of stock, or stock and securities, of controlled (as defined in paragraph (c)(2) of this section) qualifies under section 355 only if—

(1) Distributing (as defined in paragraph (c)(3) of this section) and controlled are each engaged in the active conduct of a trade or business immediately after the distribution (section 355(b)(1)(A)); or

(2) Immediately before the distribution, distributing had no assets other than stock or securities of the controlled corporations (without regard to paragraph (b)(1)(ii) of this section), 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 distributing shall be disregarded for purposes of this paragraph (a)(2).

(b) *Active conduct of a trade or business defined*—(1) *In general*—(i) *Directly engaged in a trade or business.* Section 355(b)(2) provides rules for determining whether a corporation is treated as engaged in the active conduct of a trade or business under section 355(b)(1). Sections 355(b)(2)(A) and (b)(3)(A) provide that a corporation is treated as engaged in the active conduct of a trade or business if and only if such corporation is engaged in the active conduct of a trade or business. Accordingly, except as provided in paragraph (b)(1)(ii) of this section, a corporation is not treated as engaged in the active conduct of a trade or business under such Internal Revenue Code sections solely as a result of substantially all of its assets consisting of stock, or stock and securities, of one or more corporations controlled by it (immediately after the distribution) each of which is engaged in the active conduct of a trade or business.

(ii) *Treatment of a separate affiliated group.* Under section 355(b)(3)(B), solely for purposes of determining whether a corporation is engaged in the active conduct of a trade or business, all members of a corporation's separate affiliated group (SAG) (as defined in paragraph (b)(1)(iii) of this section) shall be treated as one corporation. This treatment applies for all purposes of determining whether a corporation is engaged in the active conduct of a trade or business. Accordingly, for this purpose, transfers of assets (or activities) that are owned (or performed) by the SAG immediately before and immediately after the transfer are disregarded and are not acquisitions under paragraph (b)(4) of this section. Further, a transaction that results in a corporation becoming a subsidiary SAG member (a SAG member that is not the common parent of such SAG) is treated as an acquisition of any assets (or activities) that are owned (or performed) by the acquired corporation at such time. Therefore, the acquisition of additional stock of a current subsidiary SAG member has no effect for purposes of applying paragraph (b)(4)(i)(A) of this section.

(iii) *Separate affiliated group defined.* A corporation's SAG is the affiliated group which would be determined under section 1504(a) if such corporation were the common parent and section 1504(b) did not apply. Thus, the separate affiliated group of distributing (DSAG) is the affiliated group that consists of distributing as the common parent and all corporations affiliated with distributing through stock ownership described in section 1504(a)(1)(B) (regardless of whether the corporations are includible corporations under section 1504(b)). The separate affiliated group of controlled (CSAG) is determined in a similar manner (with controlled as the common parent). Accordingly, prior to a distribution, the DSAG may include CSAG members if the applicable ownership requirements are met. Further, the determination of whether a corporation is a DSAG or CSAG member shall be made separately for each distribution, and without regard to whether such corporation is a SAG member with respect to any other distribution. Any reference to DSAG or CSAG is a reference to distributing or controlled, respectively, if such corporation is not the common parent of a SAG (that is, such corporation does not own stock in any corporation that is a subsidiary member of its SAG). Further, any reference to a SAG is a reference to distributing or controlled, as the context may require, if such corporation is not the common parent of a SAG.

(2) *Active conduct of a trade or business immediately after the 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 paragraphs (b)(2)(ii), (b)(2)(iii), and (b)(2)(iv) of this section. See paragraph (b)(2)(v) of this section for additional special rules that apply to determine whether a

corporation is attributed the trade or business assets and activities of a partnership.

(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 is 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 of 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. Activities performed by a corporation include activities performed by employees of an affiliate (as defined in paragraph (c)(1) of this section), and in certain cases by shareholders of a closely held corporation, if such activities are performed for the corporation. For example, activities performed by a corporation include activities performed for the corporation by its sole shareholder. However, the activities of employees of affiliates (or, in certain cases, shareholders) are only taken into account during the period such corporations are affiliates (or persons are shareholders) of the corporation. A corporation will not be treated as engaged in the active conduct of a trade or business unless it (or its SAG, or a partnership from which the trade or business assets and activities are attributed) is the principal owner of the goodwill and significant assets of the trade or business for Federal income tax purposes. Activities performed by a corporation generally do not include activities performed by persons outside the corporation, including independent contractors, unless those activities are performed by employees of an affiliate (or, in certain cases, by shareholders). However, a corporation may satisfy the requirements of this paragraph (b)(2)(iii) through the activities that it performs itself, even though some of its activities are performed by persons that are not its employees, or employees of an affiliate (or, in certain cases, shareholders). Separations of real property all or substantially all of which is occupied before the distribution by the DSAG or CSAG will be carefully scrutinized in applying the requirements of section 355(b) and this section.

(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.

(v) *Partner attributed the trade or business assets and activities of a partnership*—(A) *In general.* For purposes of section 355(b), a partner in a partnership will be attributed the trade or business assets and activities of that partnership during the period that such partner satisfies the requirements of paragraph (b)(2)(v)(B) or (b)(2)(v)(C) of this section. However, for purposes of this paragraph (b)(2)(v), the stock of a corporation owned by the partnership is not attributed to a partner. For purposes of determining the activities that are conducted by the partnership that may be attributed to the partner under this paragraph (b)(2)(v), the activities of independent contractors, and partners that are not affiliates (or, in certain cases, shareholders) of the partner, are not taken into account. For this purpose, the activities of partners that are affiliates (or, in certain cases, shareholders) of the partner are only taken into account during the period that such partners are affiliates (or, in certain cases, shareholders) of the partner.

(B) *Significant interest.* The trade or business assets and activities of a partnership will be attributed to a partner if the partner (or its SAG) directly (or indirectly through one or more other partnerships) owns a significant interest in the partnership.

(C) *Meaningful interest.* The trade or business assets and activities of a partnership will be attributed to a partner if the partner or affiliates (or, in certain cases, shareholders) of the partner performs active and substantial management functions for the partnership with respect to the trade or business assets and activities (for example, makes decisions regarding significant business issues of the partnership and regularly participates in the overall supervision, direction, and control of the employees performing the operational functions for the partnership), and the partner (or its SAG) directly (or indirectly through one or more other partnerships) owns a meaningful interest in the partnership. Whether such active and substantial management functions are performed with respect to the trade or business assets and activities of the partnership will be determined from all of the facts and circumstances. The number of partners providing management functions will not be determinative.

(D) *Other factors.* In deciding whether the requirements of paragraph (b)(2)(v)(B) or (b)(2)(v)(C) of this section are satisfied, the formal description of the partnership interest (for example, general or limited) will not be determinative and the extent to which the partner is responsible for liabilities of the partnership will not be relevant.

(3) *Active conduct for the pre-distribution period*—(i) *In general.* Under section 355(b)(2), a trade or business that is relied upon to meet the requirements of section 355(b) must have been actively conducted throughout the pre-distribution period (as defined in paragraph (c)(4) of this section) by the DSAG or CSAG, or actively conducted throughout the pre-distribution period and acquired during such period by the DSAG or CSAG in a transaction in which no gain or loss is recognized as provided in paragraph (b)(4) of this section. For purposes of section 355(b)(2)(B), activities that constitute a trade or business under paragraph (b)(2) of this section shall be treated as described in the preceding sentence if such activities were actively conducted throughout the pre-distribution period.

(ii) *Change and expansion.* The fact that a trade or business underwent change during the pre-distribution period (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 SAG engaged in the active conduct of one trade or business during the pre-distribution period (the original business) purchased, created, or otherwise acquired (either directly, through an interest in a partnership, or as a result of a corporation becoming a subsidiary SAG member) another trade or business (the acquired business) in the same line of business, the acquisition of the acquired business is ordinarily treated as an expansion of the original business, all of which is treated as having been actively conducted by the acquiring SAG during the pre-distribution period, unless the acquired business effects a change of such a character as to constitute the acquisition of a new or different business. For purposes of this paragraph (b)(3)(ii), in determining whether an acquired business is in the same line of business as the original business, all facts and

circumstances shall be considered, including the following—

(A) Whether the product of the acquired business is similar to that of the original business;

(B) Whether the business activities associated with the operation of the acquired business are the same as the business activities associated with the operation of the original business; and

(C) Whether the operation of the acquired business involves the use of the experience and know-how that the owner of the original business developed in the operation of the original business or, alternatively, whether the operation of the acquired business draws to a significant extent on the existing experience and know-how of the owner of the original business and the success of the acquired business will depend in large measure on the goodwill associated with the original business and the name of the original business.

(iii) *Certain transactions with partnerships that do not constitute acquisitions.* If a partner is attributed the trade or business assets and activities of a partnership under paragraph (b)(2)(v) of this section, the partner's acquisition of such trade or business assets and activities from the partnership is not, in and of itself, the acquisition of a new or different trade or business. In addition, if a partner transfers to a partnership trade or business assets and activities that the partner actively conducted immediately before the transfer and, immediately after the transfer, the partner is attributed the trade or business assets and activities of the partnership under paragraph (b)(2)(v) of this section, such transfer is not, in and of itself, the acquisition of a new or different trade or business by the transferor partner.

(4) *Special rules for an acquisition of a trade or business*—(i) *In general*—(A) *Application of section 355(b)(2)(C).* Under sections 355(b)(2)(C) and (b)(3), a trade or business or an interest in a partnership engaged in a trade or business relied on to meet the requirements of section 355(b) must not have been acquired by either the DSAG or CSAG during the pre-distribution period unless it was acquired in a transaction in which no gain or loss was recognized. Further, a trade or business must not have been acquired by either the DSAG or CSAG during the pre-distribution period as a result of a corporation becoming a subsidiary SAG member unless such corporation became a subsidiary SAG member as a result of one or more transactions in which no gain or loss was recognized or by reasons of such transactions combined with acquisitions before the pre-distribution period. This paragraph (b)(4)(i)(A) also applies with respect to any acquisition during the pre-distribution period of a trade or business, an interest in a partnership engaged in a trade or business, or stock of a corporation engaged in a trade or business by a corporation that later becomes a subsidiary SAG member. See paragraphs (b)(4)(iv)(C) and (b)(4)(iv)(D) of this section regarding the application of this paragraph (b)(4)(i)(A) to certain multi-step acquisitions.

(B) *Application of section 355(b)(2)(D).* Under section 355(b)(2)(D), control of distributing must not have been acquired (at the time it was conducting the trade or business to be relied on) directly or indirectly by any distributee corporation, and control of controlled must not have been acquired (at the time it was conducting the trade or business to be relied on) directly or indirectly by the DSAG, during the pre-distribution period in one or more transactions in which gain or loss was recognized. This paragraph (b)(4)(i)(B) also applies with respect to any acquisition of stock of controlled during the pre-distribution period by a corporation that later becomes a DSAG member. For purposes of this paragraph (b)(4)(i)(B), and paragraphs (b)(4)(iii)(C) and (b)(4)(iv)(B) of this section, all distributee corporations that are affiliates shall be treated as one distributee corporation. This paragraph (b)(4)(i)(B) does not apply with respect to an acquisition of stock of any corporation other than distributing or controlled. See paragraph (b)(4)(iv)(B) of this section regarding the application of this paragraph (b)(4)(i)(B) to certain multi-step acquisitions of control. Further, see paragraph (b)(4)(iv)(F) of this section regarding certain acquisitions of stock in controlled to which paragraph (b)(4)(i)(A) of this section (and not this paragraph (b)(4)(i)(B)) applies.

(C) *Gain or loss recognized.* Any reference to gain or loss recognized includes gain or loss treated as recognized under paragraphs (b)(4)(ii) or (b)(4)(iv) of this section.

(ii) *Certain transactions treated as transactions in which gain or loss is recognized.* The common purpose of section 355(b)(2)(C) and (D) is to prevent the direct or indirect acquisition of the trade or business to be relied on by a corporation in exchange for assets in anticipation of a distribution to which section 355 would otherwise apply. Generally, if a DSAG member or controlled acquires the trade or business solely in exchange for distributing stock, distributing acquires control of controlled solely in exchange for distributing stock, or controlled acquires the trade or business from distributing solely in exchange for stock of controlled, in a transaction in which no gain or loss was recognized, the requirements of section 355(b)(2)(C) and (D) are satisfied. On the other hand, if the trade or business is acquired in exchange for assets of distributing (other than stock of a corporation in control of distributing used in a reorganization) the requirements of section 355(b)(2)(C) and (D) are generally not satisfied. For example, acquisitions by controlled (while controlled by distributing) from an unrelated party made in exchange for controlled stock have the effect of an indirect acquisition by distributing in exchange for distributing's assets. Such acquisitions violate the purpose of section 355(b)(2)(C) even if no gain or loss is recognized. Therefore, as provided in paragraphs (b)(4)(ii)(A) and (b)(4)(ii)(B) of this section, if the DSAG or CSAG acquires a trade or business, an interest in a partnership engaged in a trade or business, or stock of a corporation engaged in a trade or business in exchange for assets of the DSAG in a transaction in which no gain or loss is recognized, for purposes of paragraph (b)(4)(i) of this section such acquisition will be treated as one in which gain or loss is recognized.

(A) *Certain tax-free acquisitions made in exchange for assets.* An acquisition paid for in whole or in part, directly or indirectly, with assets of the DSAG will be treated as an acquisition in which gain or loss is recognized even if no gain or loss is actually recognized. Acquisitions described in this paragraph (b)(4)(ii)(A) include for example, a transaction in which the DSAG or CSAG acquires stock of a corporation engaged in the trade or business to be relied on by transferring assets not constituting the trade or business to be relied on to such corporation in exchange for stock of such corporation, the DSAG or CSAG acquires an interest in a partnership engaged in the trade or business to be relied on by contributing assets not constituting the trade or business to be relied on to the partnership, the DSAG or CSAG acquires stock of a corporation engaged in the trade or business in an exchange to which section 304(a)(1) applies, or distributing acquires a trade or business in exchange for its stock and assets in a transaction in which no loss is recognized by virtue of section 351(b). See also paragraph (b)(4)(iv)(E) of this section regarding the extent to which an acquisition involving the issuance of subsidiary stock constitutes an acquisition paid for with assets.

However, the assumption by the DSAG or CSAG of liabilities of a transferor shall not, in and of itself, be treated as the payment of assets if such assumption is not treated as the payment of money or other property under any other applicable provision. In addition, an acquisition in which no gain or loss is recognized consisting of a pro rata distribution to which section 355 applies (to the extent the stock with respect to which the distribution is made was not acquired during the pre-distribution period in a transaction in which gain or loss was recognized), a distribution from a partnership that is explicitly excluded from paragraph (b)(4)(ii)(B) of this section, a reorganization described in section 368(a)(1)(E) or (F), and an exchange to which section 1036 applies, are not acquisitions described in this paragraph (b)(4)(ii)(A).

(B) *Distributions from partnerships.* An acquisition consisting of a distribution from a partnership is generally an acquisition paid for with assets of the DSAG, and will be treated as an acquisition in which gain or loss is recognized even if no gain or loss is actually recognized. However, an acquisition consisting of a pro rata distribution from a partnership of stock or an interest in lower-tier partnership is not an acquisition described in this paragraph (b)(4)(ii)(B) (and consequently not described in paragraph (b)(4)(ii)(A) of this section) to the extent the distributee partner did not acquire the interest in the distributing partnership during the pre-distribution period in a transaction in which gain or loss was recognized and to the extent the distributing partnership did not acquire the distributed stock or partnership interest within such period. This paragraph (b)(4)(ii)(B) (and consequently paragraph (b)(4)(ii)(A) of this section) does not apply to any partnership distribution to which paragraph (b)(3)(iii) of this section (regarding distributions from partnerships that are not, in and of themselves, the acquisition of a new or different trade or business) applies.

(iii) *Certain transactions in which recognized gain or loss is disregarded.* The common purpose of section 355(b)(2)(C) and (D) is to prevent the direct or indirect acquisition of the trade or business to be relied on by a corporation in exchange for assets in anticipation of a distribution to which section 355 would otherwise apply. An additional purpose of section 355(b)(2)(D) is to prevent a distributee corporation from acquiring control of distributing in anticipation of a distribution to which section 355 would otherwise apply, enabling the disposition of controlled stock without recognizing the appropriate amount of gain. The acquisitions described in paragraphs (b)(4)(iii)(A) through (b)(4)(iii)(C) of this section are not the types of acquisitions to which section 355(b)(2)(C) or (D) is intended to apply. Therefore, for purposes of paragraph (b)(4)(i) of this section, the recognition of gain or loss is disregarded if a trade or business, an interest in a partnership engaged in a trade or business, or stock of a corporation engaged in a trade or business is acquired in a transaction described in any of paragraphs (b)(4)(iii)(A) through (b)(4)(iii)(C) of this section.

(A) *Transfers to controlled.* An acquisition by the CSAG from the DSAG provided the DSAG controls controlled immediately after the acquisition.

(B) *Cash for fractional shares.* An acquisition that would satisfy the requirements of paragraph (b)(4)(i) of this section but for the payment of cash to shareholders for fractional shares in the transaction, provided that the cash paid represents a mere rounding off of the fractional shares in the exchange and is not separately bargained for consideration.

(C) *Certain acquisitions of control of distributing.* A direct or indirect acquisition by a distributee corporation of control of distributing, in one or more transactions, where the basis of the acquired distributing stock in the hands of the distributee corporation is determined in whole by reference to the transferor's basis. This paragraph (b)(4)(iii)(C) is only applicable with respect to a distribution by the acquired distributing, and does not apply for purposes of any subsequent distribution by any distributee corporation.

(iv) *Operating rules for acquisitions*—(A) *Predecessors.* References to a corporation shall include references to a predecessor of such corporation. For this purpose, a predecessor of a corporation is a corporation that transfers its assets to such corporation in a transaction to which section 381 applies.

(B) *Certain multi-step acquisitions of control of distributing or controlled.* A distributee corporation's acquisition of stock in distributing or a DSAG's acquisition of stock in controlled in one or more transactions in which gain or loss was recognized during the pre-distribution period will not prevent a distributee corporation's acquisition of distributing stock or a DSAG's acquisition of controlled stock constituting control of distributing or controlled in one or more separate transactions in which no gain or loss is recognized from satisfying the requirements of paragraph (b)(4)(i)(B) of this section, provided that, at the time control of distributing or controlled is first acquired, the acquiring distributee corporation owns an amount of distributing stock or the acquiring DSAG owns an amount of controlled stock, as the case may be, constituting control that was acquired in one or more transactions in which no gain or loss was recognized or by reason of such transactions combined with acquisitions before the pre-distribution period. The principles of this paragraph (b)(4)(iv)(B) will be applied with respect to an indirect acquisition of distributing or controlled stock.

(C) *Certain multi-step acquisitions of a subsidiary SAG member.* An acquisition of stock in a corporation (target) by a SAG in one or more transactions in which gain or loss was recognized during the pre-distribution period will not prevent a SAG's acquisition of target stock resulting in target becoming a subsidiary SAG member in one or more separate transactions in which no gain or loss is recognized from satisfying the requirements of paragraph (b)(4)(i)(A) of this section, provided that, at the time that target first becomes a subsidiary SAG member, the SAG owns an amount of target stock meeting the requirements of section 1504(a)(2) that was acquired in one or more transactions in which no gain or loss was recognized or by reason of such transactions combined with acquisitions before the pre-distribution period. The principles of this paragraph (b)(4)(iv)(C) will be applied with respect to an indirect acquisition of target stock by the SAG.

(D) *Certain multi-step asset acquisitions.* Notwithstanding paragraph (b)(4)(i)(A) of this section, if immediately before a SAG's direct acquisition of a trade or business (or an interest in a partnership engaged in a trade or business) held by a corporation (owner) in a transaction to which section 381 applies and in which no gain or loss is recognized, the SAG owns an amount of stock of the owner that it acquired in one or more transactions during the pre-distribution period in which gain or loss was recognized such that all of the other stock of the owner does not meet the requirements of section 1504(a)(2), such direct acquisition shall be treated as a transaction in which gain or loss was recognized. The principles of this paragraph (b)(4)(iv)(D) will be applied with respect to an indirect acquisition of the owner stock by the SAG.

(E) *Acquisitions involving the issuance of subsidiary stock.* If a SAG directly or indirectly owns stock of a subsidiary (including a subsidiary SAG member) and the subsidiary directly or indirectly acquires a trade or business, an interest in a partnership engaged in a trade or business, or stock of a corporation engaged in a trade or business from a person other than such SAG in exchange for stock of such subsidiary in a transaction in which no gain or loss is recognized (the acquisition), solely for purposes of applying this paragraph (b)(4) with respect to the trade or business, partnership interest, or stock acquired by the subsidiary in the acquisition, the subsidiary's stock directly or indirectly owned by the SAG immediately after the acquisition is treated as acquired at the time of the acquisition in a transaction in which gain or loss is recognized.

(F) *Acquisitions of controlled stock where controlled is or becomes a DSAG member.* With respect to an acquisition of stock in controlled, if controlled is or becomes a DSAG member, paragraph (b)(4)(i)(A) of this section applies and paragraph (b)(4)(i)(B) of this section does not apply for purposes of determining whether the requirements of section 355(b) are satisfied with respect to controlled.

(G) *Treatment of stock received in certain tax-free exchanges.* Any stock received in a reorganization described in section 368(a)(1)(E) or (F), or in an exchange to which section 1036 applies, in which no gain or loss is recognized is treated as acquired in the same manner as the stock surrendered.

(H) *Situations where the separate existence of a subsidiary SAG member is respected.* The separate existence of a subsidiary SAG member will be respected for purposes of determining whether a transaction qualifies for nonrecognition treatment under other provisions of the Internal Revenue Code. For example, for purposes of determining whether section 351 applies or whether the transaction qualifies as a reorganization described in section 368(a), the separate existence of the subsidiary SAG member is respected.

(c) *Definitions.* For purposes of this section the following definitions apply:

(1) *Affiliate.* An affiliate is any member of an affiliated group as defined in section 1504(a) (without regard to section 1504(b)).

(2) *Controlled. Controlled* is the controlled corporation.

(3) *Distributing. Distributing* is the distributing corporation.

(4) *Pre-distribution period.* The *pre-distribution period* is the five-year period ending on the date of the distribution.

(d) *Conventions and examples*—(1) *Conventions.* The examples in paragraph (d)(2) of this section illustrate section 355(b) and this section. No inference should be drawn from any of these examples as to whether any requirements of section 355 other than those of section 355(b), as specified, are satisfied. Throughout these examples, C, D, D2, P, S, S1, S2, S3, T, X, Y, and Z are corporations, and Partnership is an entity that is treated as a partnership for Federal income tax purposes under § 301.7701–3 of this chapter. Further, assume any transfer described in *Examples 1* through *25* that is not identified as a purchase (defined in paragraph (d)(1)(iii) of this section) satisfies all the requirements of paragraph (b)(4) of this section as a transaction in which no gain or loss is recognized. Except as otherwise provided, for more than five years D has owned section 368(c) stock (as defined in paragraph (d)(1)(iv) of this section) but not section 1504(a)(2) stock (as defined in paragraph (d)(1)(v) of this section) of C. Furthermore, the following definitions apply:

(i) *ATB. ATB* is any active trade or business. ATB1 and ATB2 are not in the same line of business under paragraph (b)(3)(ii) of this section.

(ii) *New subsidiary.* A *new subsidiary* is a newly formed wholly owned corporation.

(iii) *Purchase.* A *purchase* is an acquisition for cash.

(iv) *Section 368(c) stock. Section 368(c) stock* is stock constituting control within the meeting of section 368(c).

(v) *Section 1504(a)(2) stock. Section 1504(a)(2) stock* is stock meeting the requirements of section 1504(a)(2).

(2) *Examples.* Generally, *Examples 1* and *2* illustrate the general requirements in paragraph (a) of this section, *Examples 3* through *9* illustrate the SAG rules in paragraphs (b)(1)(ii) and (b)(1)(iii) of this section, *Examples 10* through *25* illustrate the rules regarding the active trade or business and active conduct for the pre-distribution period in paragraphs (b)(2) and (b)(3) of this section, *Examples 26* through *40* illustrate the acquisition rules in paragraphs (b)(4)(i) through (b)(4)(iii) of this section, and *Examples 41* through *51* illustrate the operating rules for acquisitions in paragraph (b)(4)(iv) of this section. The examples are as follows:

Example 1. Spin-off. For more than five years, D and C have engaged in the active conduct of ATB1 and ATB2, respectively. D distributes the C stock to the D shareholders, and each corporation continues the active conduct of its respective trade or business. Because both D and C are engaged in the active conduct of a trade or business immediately after the distribution and such trades or businesses have been actively conducted by such corporations throughout the pre-distribution period, the requirements of section 355(b) have been satisfied. See paragraphs (a)(1) and (b)(3) of this section.

Example 2. Split-up. The facts are the same as *Example 1* except that D transfers all of its assets (including ATB1) other than the C stock to new subsidiary S, and then distributes the C stock and S stock to the D shareholders. Because C and S are respectively engaged in the active conduct of ATB2 and ATB1 immediately after the distribution, ATB2 has been actively conducted by C throughout the pre-distribution period, and together D (prior to the transfer to S) and S (after the transfer to S) have actively conducted ATB1 throughout the pre-distribution period, the requirements of section 355(b) have been satisfied. See paragraphs (a)(2) and (b)(3) of this section.

Example 3. Subsidiary SAG member's business. For more than five years, D has owned section 1504(a)(2) stock but not section 368(c) stock of S . Throughout this period, C and S have engaged in the active conduct of ATB1 and ATB2, respectively. In year 8, D distributes the C stock to the D shareholders. Because D owns section 1504(a)(2) stock of S, S is a DSAG member. See paragraph (b)(1)(iii) of this section. D and S are treated as one corporation for purposes of determining whether D is engaged in an active trade or business. See paragraph (b)(1)(ii) of this section. Therefore, D is engaged in the active conduct of ATB2 both throughout the pre-distribution period and immediately after the distribution. Accordingly, D and C both satisfy the requirements of section 355(b).

Example 4. Additional subsidiary SAG member shares acquired. The facts are the same as *Example 3* except that in year 6, D acquires the remaining S stock. D's acquisition of the remaining S stock in year 6 has no effect for purposes of determining whether D satisfies the requirements of section 355(b)(2)(C) because the DSAG is already engaged in the active conduct of ATB2. See paragraph (b)(1)(ii) of this section. Section 355(b)(2)(D) does not apply to D's acquisition of S stock. See paragraph (b)(4)(i)(B) of this section. Accordingly, D and C both satisfy the requirements of section 355(b).

Example 5. Segmented CSAG business. For more than five years, C has owned all the stock of S1, S2, and S3. Throughout this period, D has engaged in the active conduct of ATB1. Throughout this same period, S1, S2, and S3 have each engaged in a different essential segment of ATB2. While the three segments of ATB2 would together constitute the active conduct of a trade or business, none of S1, S2, or S3 would be considered engaged in the active conduct of an ATB individually. In year 6, D distributes the C stock to the D shareholders. C owns section 1504(a)(2) stock of S1, S2, and S3, therefore,

C, S1, S2, and S3 are CSAG members. See paragraph (b)(1)(iii) of this section. C, S1, S2, and S3 are treated as one corporation for purposes of determining whether C is engaged in the active conduct of a trade or business. See paragraph (b)(1)(ii) of this section. Therefore, C is engaged in the active conduct of ATB2 both throughout the pre-distribution period and immediately after the distribution. Accordingly, D and C both satisfy the requirements of section 355(b).

Example 6. Segmented DSAG business. The facts are the same as *Example 5* except that D owns all of the C stock and all of the S3 stock, and D transfers the S3 stock to C immediately prior to the distribution. Prior to D's transfer of the S3 stock to C, D owns section 1504(a)(2) stock of S3 and C, and C owns section 1504(a)(2) stock of S1 and S2, therefore, D, C, S1, S2, and S3 are DSAG members. See paragraph (b)(1)(iii) of this section. D, C, S1, S2, and S3 are treated as one corporation for purposes of determining whether D and C are engaged in the active conduct of a trade or business, and accordingly the transfer of the S3 stock to C is disregarded. See paragraph (b)(1)(ii) of this section. After the transfer, C owns section 1504(a)(2) stock of S3, and the CSAG includes C, S1, S2, and S3. See paragraph (b)(1)(iii) of this section. C, S1, S2, and S3 are treated as one corporation for purposes of determining whether C is engaged in the active conduct of a trade or business. See paragraph (b)(1)(ii) of this section. Throughout the pre-distribution period, D, C, S1, S2, and S3 are treated as one corporation and both D and C are engaged in the active conduct of ATB1 and ATB2. See paragraphs (b)(1) and (b)(2) of this section. Immediately after the distribution, D is engaged in the active conduct of ATB1 and C is engaged in the active conduct of ATB2. Because D and C were engaged in the active conduct of ATB1 and ATB2 throughout the pre-distribution period and, immediately after the distribution, D is engaged in the active conduct of ATB1 and C is engaged in the active conduct of ATB2, D and C both satisfy the requirements of section 355(b).

Example 7. Failed segmented business. The facts are the same as *Example 6* except that D owns section 368(c) stock but not section 1504(a)(2) stock of C. Prior to D's transfer of the S3 stock, the DSAG includes only D and S3, and the CSAG includes only C, S1, and S2. See paragraph (b)(1)(iii) of this section. Therefore, prior to the transfer of the S3 stock, ATB2 does not exist because no one SAG conducts all three of the essential segments of the trade or business. Accordingly, C does not satisfy the requirements of section 355(b) because ATB2 was not actively conducted throughout the pre-distribution period. See paragraph (b)(3)(i) of this section.

Example 8. Jointly owned partnership. For more than five years, D has owned all of the stock of C, and D and C each have owned a 17-percent interest in Partnership. Throughout this period, D and Partnership have engaged in the active conduct of ATB1 and ATB2, respectively. In year 6, D transfers its 17-percent interest in Partnership to C and distributes all of the C stock to the D shareholders. Because D owns section 1504(a)(2) stock of C, C is a DSAG member. See paragraph (b)(1)(iii) of this section. D and C are treated as one corporation for purposes of determining whether D and C are engaged in the active conduct of a trade or business. See paragraph (b)(1)(ii) of this section. Accordingly, throughout the pre-distribution period, D and C are each treated as owning a 34-percent interest in Partnership. As such, both D and C are treated as engaged in the active conduct of both ATB1 and ATB2 throughout the pre-distribution period. See paragraphs (b)(2)(v)(A) and (b)(2)(v)(B) of this section. The transfer of the Partnership interest is disregarded because it is between SAG members. See paragraph (b)(1)(ii) of this section. After the distribution, C owns 34 percent of Partnership and is therefore engaged in the active conduct of ATB2. See paragraphs (b)(2)(v)(A) and (b)(2)(v)(B) of this section. Therefore, D and C both satisfy the requirements of section 355(b).

Example 9. Sequential application of the SAG rule—(i) *Facts.* For more than five years, D2 has owned all of the stock of D, and D has owned all of the stock of C. Throughout this period, D2 has engaged in the active conduct of ATB1 and ATB2, and D has engaged in the active conduct of ATB1. C, individually, has not engaged in the active conduct of any ATB. In year 6, D distributes all of the C stock to D2 (first distribution). Immediately thereafter, D2 transfers ATB2 to C and distributes all of the C stock to the D2 shareholders (second distribution).

(ii) *Analysis—first distribution.* Because D owns section 1504(a)(2) stock of C, C is a DSAG member prior to the first distribution. See paragraph (b)(1)(iii) of this section. D and C are treated as one corporation for purposes of determining whether D and C are engaged in the active conduct of a trade or business with respect to the first distribution. See paragraphs (b)(1)(ii) and (b)(1)(iii) of this section. Accordingly, throughout the pre-distribution period, D and C are each treated as engaged in ATB1 with respect to the first distribution. However, for purposes of determining whether D's distribution of the C stock to D2 satisfies the requirements of section 355(b) immediately after the first distribution, C is the only CSAG member (D2 is not a member of any SAG with respect to the first distribution). See paragraph (b)(1)(iii) of this section. Accordingly, C does not satisfy the requirements of section 355(b) with respect to the first distribution because C is not engaged in the active conduct of an ATB immediately after the first distribution.

(iii) *Analysis—second distribution.* Because D2 owns section 1504(a)(2) stock of D and C (and D owned section 1504(a)(2) stock of C before the first distribution), D2, D, and C are D2 SAG members throughout the pre-distribution period with respect to the second distribution. See paragraph (b)(1)(iii) of this section. Further, for purposes of the second distribution D's distribution of the C stock to D2 is disregarded because it is between D2 SAG members. See paragraphs (b)(1)(ii) and (b)(1)(iii) of this section. D2, D, and C are treated as one corporation for purposes of determining whether D2 and C are engaged in the active conduct of a trade or business with respect to the second distribution. See paragraphs (b)(1)(ii) and (b)(1)(iii) of this section. Accordingly, throughout the pre-distribution period, D2 and C are each treated as engaged in the active conduct of ATB1 and ATB2 with respect to the second distribution. The transfer of ATB2 to C is disregarded because it is between D2 SAG members. See paragraph (b)(1)(ii) of this section. Immediately after the second distribution, C is engaged the active conduct of ATB2. Therefore, D2 and C both satisfy the requirements of section 355(b) with respect to the second distribution.

Example 10. Limitations—securities and vacant land. For more than five years, D has owned investment securities and vacant land. D has conducted no activities with respect to the vacant land, but D will subsequently subdivide the vacant land, install streets and utilities, and sell the developed lots to various homebuilders. D cannot currently 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. Furthermore, no significant development activities have been conducted with respect to the vacant land. See paragraph (b)(3) of this section.

Example 11. Limitations—occupied real estate—active. For more than five years, D, a bank, has owned an eleven-story office building, the ground floor of which D has occupied while engaged in the active conduct of its banking business. The remaining ten floors are rented to various tenants. Throughout this period, the building has been managed, operated, repaired, and maintained by employees of D. D transfers the building along with the significant assets used to operate the building and the goodwill associated with the building to new subsidiary C and distributes the C stock to the D shareholders. Henceforth, C's employees will manage, operate, repair, and maintain the building. D and C both satisfy the requirements of section 355(b). See paragraph (b)(3) of this section.

Example 12. Limitations—occupied real estate—not active. For more than five years, D, a bank, has owned a two-story building, the ground floor and one half of the second floor of which D has occupied while engaged in the active conduct of its banking business. The other half of the second floor has been rented as storage space to a neighboring retail merchant. D transfers the building and the goodwill associated with the building to new subsidiary C and distributes the C stock to the D shareholders. After the distribution, D leases from C the space in the building that it formerly occupied. Under the lease, D will repair and maintain its portion of the building and pay property taxes and insurance. C 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 D with respect to the building prior to the separation would constitute the active conduct of a trade or business.

Example 13. No significant activities. For more than five years, D owned land on which

it has engaged in the active conduct of the 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. D has engaged in no significant activities in connection with its mineral rights. D transfers its mineral rights to new subsidiary C and distributes the C stock to the D shareholders. C will actively pursue the development of the oil producing potential of the property. C does not satisfy the requirements of section 355(b) after the distribution because D was not engaged in significant exploitation activities with respect to the mineral rights throughout the pre-distribution period. See paragraph (b)(3) of this section.

Example 14. Vertical division—state contracts. For more than five years, D has engaged in the active conduct of a single business of constructing sewage disposal plants and other facilities. D transfers one half of its assets to new subsidiary C. These assets include a contract for the construction of a sewage disposal plant in State M, construction equipment, cash, goodwill, and other tangible and significant assets. D retains a contract for the construction of a sewage disposal plant in State N, construction equipment, cash, goodwill, and other tangible and significant assets. D distributes the C stock to one of D's shareholders in exchange for all of his D stock. D and C both satisfy the requirements of section 355(b). See paragraphs (b)(2) and (b)(3)(i) of this section.

Example 15. Vertical division—location. For more than five years, D has engaged in the active conduct of owning and operating two men's retail clothing stores, one in the downtown area of the City of G and one in a suburban area of G. D transfers the store building, fixtures, inventory, and other significant assets related to the operations of the suburban store and the goodwill attributable to that store to new subsidiary C. D also transfers to C the delivery trucks and delivery personnel that formerly served both stores. Henceforth, D will contract with a local public delivery service to make its deliveries. D retains the warehouses that formerly served both stores. Henceforth, C will lease warehouse space from an unrelated public warehouse company. D then distributes the C stock to the D shareholders. D and C both satisfy the requirements of section 355(b). See paragraphs (b)(2) and (b)(3)(i) of this section.

Example 16. Horizontal division—research. For more than five years, D has engaged in the active conduct of manufacturing and sale of household products. Throughout this period, D 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. D transfers the research department (which has significant assets and goodwill) to new subsidiary C and distributes the C stock to the D shareholders. After the distribution, C continues its research operations on a contractual basis with several corporations, including D. D and C both satisfy the requirements of section 355(b). See paragraphs (b)(2) and (b)(3)(i) of this section. The result is the same if, after the distribution, C continues its research operations but furnishes its services only to D. See paragraphs (b)(2) and (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 17. Horizontal division—sales. For more than five years, D has engaged in the active conduct of processing and selling meat products. D derives income from no other source. D separates the sales function from the processing function by transferring the significant business assets related to the sales function, the goodwill associated with the sales function, and cash for working capital to new subsidiary C. D then distributes the C stock to the D shareholders. After the distribution, C purchases for resale the meat products processed by D. D and C both satisfy the requirements of section 355(b). See paragraphs (b)(2) and (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 18. Expansion and vertical division—location. For more than five years, D has engaged in the active conduct of owning and operating hardware stores in several states. In year 6, D purchased all of the assets of a hardware store in State M, where D had not previously conducted business. In year 8, D transfers the State M hardware store and related significant assets and goodwill to new subsidiary C and distributes the C stock to the D shareholders. After the distribution, the State M hardware store has its own manager and is operated independently of the other stores. Because—

(i) The product of the State M hardware store is similar to the product of D's hardware stores in the other states;

(ii) The business activities associated with the operation of the State M hardware store are the same as the business activities associated with the operation of D's hardware stores in the other states; and

(iii) The operation of a hardware store in State M involves the use of the experience and know-how that D developed in the operation of the hardware stores in the other states, the hardware store in State M is in the same line of business as the hardware stores in the other states. Therefore, the acquisition of the State M hardware store constitutes an expansion of D's existing business and its acquisition does not constitute the acquisition of a new or different business under paragraph (b)(3)(ii) of this section. Accordingly, D and C both satisfy the requirements of section 355(b).

Example 19. Expansion and horizontal division—Internet. For more than five years, D has engaged in the active conduct of operating a retail shoe store business, under the name D. Throughout this period, D's sales are made exclusively to customers who frequent its retail stores in shopping malls and other locations. D's business enjoys favorable name recognition, customer loyalty, and other elements of goodwill in the retail shoe market. D creates an Internet Web site and begins selling shoes at retail on the Web site. To a significant extent, the operation of the Web site draws upon D's existing experience and know-how. The Web site is named ''D.com'' to take advantage of the name recognition, customer loyalty, and other elements of goodwill associated with D and the D name and to enhance the Web site's chances for success in its initial stages. Eight months after beginning to sell shoes on the Web site, D transfers all of the Web site's assets and liabilities (all of which include the significant assets and goodwill associated with the Web site's business) to new subsidiary C and distributes the C stock to the D shareholders. The product of the retail shoe store business and the product of the Web site are the same (shoes), and the principal business activities of the retail shoe store business are the same as those of the Web site (purchasing shoes at wholesale and reselling them at retail). Although selling shoes on a Web site requires some know-how not associated with operating a retail store, such as familiarity with different marketing approaches, distribution chains, and technical operations issues, the Web site's operation does draw to a significant extent on D's existing experience and know-how, and the Web site's success will depend in large measure on the goodwill associated with D and the D name. Therefore, the creation by D of the Internet Web site does not constitute the acquisition of a new or different business under paragraph (b)(3)(ii) of this section. Accordingly, it is an expansion of D's retail shoe store business, all of which is treated as having been actively conducted throughout the pre-distribution period. Therefore, D and C both satisfy the requirements of section 355(b).

Example 20. Expansion—acquiring a SAG member. For more than five years, D has owned all of the stock of C. Throughout this period, C and unrelated T have engaged in the active conduct of ATB1. In year 6, D purchases all of the T stock. In year 8, D distributes all of the C stock to the D shareholders. Throughout the period that C is a DSAG member, D is engaged in the active conduct of ATB1. See paragraph (b)(1)(ii) of this section. Moreover, because D acquired section 1504(a)(2) stock of T, D is treated as having acquired T's assets (and activities), and that acquisition constitutes an expansion of ATB1. See paragraphs (b)(1)(ii) and (b)(3)(ii) of this section. Therefore, D and C both satisfy the requirements of section 355(b). The result would be the same if D had owned all of the T stock for more than five years, and purchased all of the C stock in year 6. See paragraphs (b)(1)(ii), (b)(3)(ii), (b)(4)(i), and (b)(4)(iv)(F) of this section.

Example 21. No expansion—acquiring only control of controlled. For more than five years, D and unrelated C have engaged in the active conduct of ATB1. In year 6, D purchases section 368(c) stock but not section 1504(a)(2) stock of C. In year 8, D distributes the C stock to the D shareholders. While D and C are in the same line of business, the acquisition does not result in an expansion of D's business under paragraph (b)(3)(ii) of this section because D is not treated as having acquired C's assets (and activities). Accordingly, D has acquired control of C in violation of section 355(b)(2)(D). See paragraph (b)(4)(i)(B) of this section. However, if D acquires additional C

stock thereby causing C to become a DSAG member, D would be treated as having acquired C's assets (and activities) and the acquisition would constitute an expansion of ATB1. See paragraphs (b)(1)(ii), (b)(3)(ii), (b)(4)(i), and (b)(4)(iv)(F) of this section. In such a case, D and C both would satisfy the requirements of section 355(b).

Example 22. Partnership—meaningful but not significant. For more than five years, unrelated X and Y have owned a 20-percent and 33 1/3-percent interest, respectively, in Partnership. The remaining interests in Partnership are owned by unrelated parties. For more than five years, Partnership has manufactured power equipment. But for the performance of all its management functions by employees of X, Partnership would satisfy all the requirements of paragraph (b)(2)(i) of this section. X and/or Y will be attributed the trade or business assets and activities of Partnership only if the corporation satisfies the requirements of paragraph (b)(2)(v)(B) or (b)(2)(v)(C) of this section. See paragraph (b)(2)(v)(A) of this section. While X does not satisfy the requirements of paragraph (b)(2)(v)(B) of this section because X's interest in Partnership is not significant, under paragraph (b)(2)(v)(C) of this section, X owns a meaningful interest in Partnership and performs active and substantial management functions for the trade or business assets and activities of Partnership. Therefore, X is attributed the trade or business assets and activities of Partnership. Accordingly, X is engaged in the active conduct of the business of manufacturing power equipment. See paragraph (b)(2) of this section. In determining whether Y is engaged in the business of manufacturing power equipment, the management functions performed by X for Partnership are not taken into account. See paragraph (b)(2)(v)(A) of this section. Therefore, although Y is attributed Partnership's trade or business assets and activities under paragraph (b)(2)(v)(B) of this section because Y owns a significant interest in Partnership, Y is not engaged in the business of manufacturing power equipment because neither Y nor Partnership perform any management functions for the business. See paragraph (b)(2)(iii) of this section.

Example 23. Partnership—significant but not meaningful. The facts are the same as *Example 22* except that all the management functions related to the business of Partnership are performed by employees of Partnership. Because employees of Partnership perform all of the management functions related to the trade or business assets and activities of manufacturing power equipment, Partnership itself satisfies all the requirements of paragraph (b)(2)(i) of this section. X neither owns a significant interest in Partnership nor performs active and substantial management functions with respect to the trade or business assets and activities of Partnership. Accordingly, X does not satisfy the requirements of paragraph (b)(2)(v)(B) or (b)(2)(v)(C) of this section, X is not attributed the trade or business assets and activities of Partnership's business of manufacturing power equipment, and X is not engaged in the active conduct of the business of manufacturing power equipment. On the other hand, because Y owns a significant interest in Partnership, Y satisfies the requirements of paragraph (b)(2)(v)(B) of this section. Therefore, Y is attributed the trade or business assets and activities of Partnership's business. Accordingly, Y satisfies the requirements of paragraph (b)(2)(i) of this section and is engaged in the active conduct of the business of manufacturing power equipment.

Example 24. Partnership—significant by many. The facts are the same as Example 23 except that X, Y, and Z each own a 33 1/3-percent interest in Partnership. Because X, Y, and Z each own a significant interest in Partnership, each of X, Y, and Z satisfy the requirements of paragraph (b)(2)(v)(B) of this section. Accordingly, each of X, Y, and Z are attributed the trade or business assets and activities of Partnership, satisfy the requirements of paragraph (b)(2)(i) of this section, and are engaged in the active conduct of the business of manufacturing power equipment.

Example 25. Non-SAG affiliates—(i) *Facts.* For more than five years, X has owned 10 percent of the stock of D2, D2 has owned all the stock of D and S, and D has owned all the stock of C. Throughout this period, D has manufactured furniture that it sells to furniture stores and has been the principal owner of the goodwill and significant assets associated with that business and C has owned and operated a laundry business and has been the principal owner of the goodwill and significant assets associated with that business. Throughout this period, however, employees of S have performed all the active and substantial management and operational functions of the furniture business for D and the laundry business for C. D distributes the C stock to D2 (first distribution) and D2 distributes the C stock to X in exchange for all of X's D2 stock (second distribution). After the distributions, employees of X perform all the active and substantial management and operational functions of the laundry business for C that the employees of S performed before the distributions and the employees of S continue to perform the same activities for D as they did before the distributions.

(ii) *Analysis—first distribution.* In determining whether the furniture manufacturing business and laundry business have been actively conducted throughout the pre-distribution period and immediately after the first distribution, the activities performed for those businesses include activities performed by employees of affiliates of D and C (even if they are not DSAG or CSAG members). Accordingly, such activities include the activities performed by the employees of S for D and C. See paragraph (b)(2)(iii) of this section. D and C own the goodwill and significant assets associated with their respective businesses both throughout the pre-distribution period and immediately after the first distribution, and are treated as performing active and substantial management and operational functions for their respective businesses both throughout the pre-distribution period and immediately after the first distribution. Therefore, D and C both satisfy the requirements of section 355(b) with respect to the first distribution.

(iii) *Analysis—second distribution.* Because D2 owns section 1504(a)(2) stock of D, C, and S (and D owned section 1504(a)(2) stock of C before the first distribution), D2, D, C, and S are D2 SAG members throughout the pre-distribution period with respect to the second distribution. See paragraph (b)(1)(iii) of this section. Accordingly, D2, D, C, and S are treated as one corporation for purposes of determining whether D2 is engaged in an active trade or business with respect to the second distribution. See paragraph (b)(1)(ii) of this section. Accordingly, for purposes of the second distribution, D2 has been engaged in the furniture manufacturing business and the laundry business throughout the pre-distribution period. Further, for purposes of the second distribution D's distribution of the C stock to D2 is disregarded because it is between D2 SAG members. See paragraph (b)(1)(ii) of this section. D and S continue to be D2 SAG members immediately after the second distribution. See paragraph (b)(1)(iii) of this section. Accordingly, D2 is engaged in the furniture manufacturing business immediately after the second distribution. In determining whether C is engaged in the active conduct of a trade or business immediately after the second distribution, the activities performed for the laundry business include activities performed by employees of affiliates of C (even if they are not CSAG members). Accordingly, immediately after the second distribution, such activities include the activities performed for C by the employees of X. See paragraph (b)(2)(iii) of this section. C owns the goodwill and significant assets associated with the laundry business both throughout the pre-distribution period and immediately after the second distribution, and is treated as performing active and substantial management and operational functions both throughout the pre-distribution period and immediately after the second distribution. Therefore, D2 and C both satisfy the requirements of section 355(b) with respect to the second distribution.

Example 26. Purchased ATB and SAG member. For more than five years, P has owned all of the stock of D and S1, and D and S1 have owned all of the stock of S2 and S3, respectively. Throughout this period, S1 and S3 have engaged in the active conduct of ATB1 and ATB2, respectively. In year 6, S2 purchases ATB1 and all of the S3 stock from S1 on the same day. In year 6, the DSAG acquired ATB1 and ATB2 (as a result of S3 becoming a DSAG member) in a transaction in which gain or loss was recognized. Accordingly, if D were to make a distribution, it could not rely on ATB1 or ATB2 to satisfy the requirements of section 355(b) unless the DSAG's year 6 acquisition of ATB1 and ATB2 is not in the pre-distribution period. See paragraph (b)(4)(i)(A) of this section. The fact that S2 acquired ATB1 and the S3 stock from an affiliate is not relevant.

Example 27. Purchased ATB prior to entering. For more than five years, T has engaged in the active conduct of ATB1. In year 6, S purchased ATB1 from T. In year 7, D acquired all of the S stock from the S shareholders solely in exchange for D stock

in a transaction to which section 351 applied and in which no gain or loss was recognized. As a result, S became a DSAG member. Although S became a DSAG member in a transaction in which no gain or loss was recognized, S, a corporation that later became a DSAG member, acquired ATB1 in a transaction in which gain or loss was recognized. Accordingly, if the D were to make a distribution, it could not rely on ATB1 to satisfy the requirements of section 355(b) unless S's year 6 acquisition of ATB1 is not in the pre-distribution period. See paragraph (b)(4)(i)(A) of this section.

Example 28. ATB (or new SAG member) for stock of distributing or a corporation in control of distributing in a reorganization—transfer of ATB to controlled. For more than five years, unrelated T and Z have owned all of the stock of X and Y, respectively, and X and Y have engaged in the active conduct of ATB1 and ATB2, respectively. Unrelated P owns all of the stock of D. In year 6, D acquires all of X's assets (including ATB1) from X solely in exchange for D stock in a reorganization described in section 368(a)(1)(A), and all of Y's assets (including ATB2) from Y solely in exchange for P stock in a reorganization described in section 368(a)(1)(A) by reason of section 368(a)(2)(D). No gain or loss is recognized on either acquisition. In a separate transaction, D transfers ATB2 to new subsidiary C in exchange for all of the C stock in a transaction that satisfies the requirements of section 351 and in which no gain or loss is recognized. If D were to distribute the C stock in a separate transaction, D and C can rely on ATB1 and ATB2, respectively, to satisfy the requirements of section 355(b). ATB1 and ATB2 were acquired in transactions in which no gain or loss was recognized, and were not acquired in exchange for assets of the DSAG. See paragraph (b)(4)(ii) of this section. The result would be the same if D acquired all of the assets of T (including the X stock) and Z (including the Y stock) in the reorganizations instead of acquiring the assets of X and Y, and then transferred the Y stock to C. See paragraphs (b)(1)(ii) and (b)(4)(ii) of this section.

Example 29. Taxable transfer of ATB by distributing to controlled. The facts are the same as the original facts in Example 28 except that before and after the transfer to C, D owned section 368(c) stock but not section 1504(a)(2) stock of C, and recognized gain under section 357(c) gain on the transfer of ATB2 to C. D and C can rely on ATB1 and ATB2, respectively, to satisfy the requirements of section 355(b). See paragraph (b)(4)(iii)(A) of this section. The result would be the same if C purchased ATB2 from D. The result would also be the same if D acquired all of the assets of T (including the X stock) and Z (including the Y stock) in the reorganizations instead of acquiring the assets of X and Y, and then C purchased the Y stock from D. See paragraphs (b)(1)(ii) and (b)(4)(iii)(A) of this section.

Example 30. Assets for controlled stock in a section 351 transaction. For more than five years, unrelated D and C have engaged in the active conduct of ATB1 and ATB2, respectively. In year 6, D transfers trucks to C to be used in ATB2 in exchange for section 368(c) stock of C in a transaction to which section 351 applies and in which no gain or loss is recognized. If D were to distribute the C stock, C could not rely on ATB2 to satisfy the requirements of section 355(b) unless D's year 6 acquisition of the C stock is not in the pre-distribution period because D acquired section 368(c) stock of C, a corporation engaged in ATB2, in exchange for assets not constituting the trade or business. See paragraphs (b)(4)(i)(B) and (b)(4)(ii)(A) of this section. The result would be the same even if C became a DSAG member as a result of the year 6 transfer. See paragraphs (b)(4)(i)(A) and (b)(4)(ii)(A) of this section.

Example 31. ATB for controlled stock in a reorganization. For more than five years, unrelated D and T have engaged in the active conduct of ATB1 and ATB2, respectively. Throughout this period, D has owned all of the sole class of C stock. In year 6, T merges into C solely in exchange for C stock in a reorganization described in section 368(a)(1)(A) and in which no gain or loss is recognized. As a result, the T shareholders receive 20 percent of the sole class of C stock. Because C acquired ATB2 in exchange for C stock, solely for purposes of determining whether ATB2 can be relied on to satisfy the requirements of section 355(b), D is treated as having acquired its 80 percent of the C stock in year 6 in a transaction in which gain or loss was recognized. See paragraph (b)(4)(iv)(E) of this section. Accordingly, if D were to distribute the C stock, C could not rely on ATB2 to satisfy the requirements of section 355(b) unless C's year 6 acquisition of ATB2 is not in the pre-distribution period because ATB2 was in effect indirectly acquired in exchange for D's assets. See paragraphs (b)(4)(i)(A), (b)(4)(ii)(A), and (b)(4)(iv)(E) of this section.

Example 32. ATB and controlled stock for distributing stock in a section 351 transaction. For more than five years, T and unrelated C have engaged in the active conduct of ATB1 and ATB2, respectively. Unrelated P owns all of the stock of D. In year 6, P purchases ATB1 from T, and section 368(c) stock of C from the C shareholders. In year 6, P contributes the C stock and ATB1 to D solely in exchange for additional D stock in a transaction to which section 351 applies and in which no gain or loss is recognized. If D were to subsequently distribute the C stock in a separate transaction, D can rely on ATB1, and C can rely on ATB2 to satisfy the requirements of section 355(b) because neither ATB1 nor control of C were acquired in exchange for assets of the DSAG. See paragraphs (b)(4)(i)(A), (b)(4)(i)(B), and (b)(4)(ii) of this section. The fact that P, an affiliate of D, purchased ATB1 and section 368(c) stock of C in year 6 is not relevant.

Example 33. ATB for distributing stock in a section 351 transaction with section 357(c) gain. The facts are the same as *Example 32* except that D has owned section 368(c) stock of C for more than five years, P only purchases ATB1 from T, and P recognizes under section 357(c) gain on the transfer of ATB1 to D as a result of D assuming liabilities of P. D cannot rely on ATB1 to satisfy the requirements of section 355(b) until D's year 6 acquisition of ATB1 is no longer in the pre-distribution period because D acquired ATB1 in a transaction in which gain or loss was recognized. See paragraph (b)(4)(i)(A) of this section.

Example 34. Partnership distributions. For more than five years, X and Y have engaged in the active conduct of ATB1 and ATB2, respectively. Throughout this period, unrelated D has owned a 90-percent interest in Partnership. D is attributed any trade or business assets and activities of Partnership under paragraph (b)(2)(v) of this section. In year 6, Partnership purchases ATB1 from X and all of the Y stock from its owner. In year 9, Partnership distributes ATB1 and all of the Y stock to D in a non-liquidating distribution. Assume that no gain or loss is recognized by Partnership or any partner on the distribution. As a result of the distribution, Y becomes a DSAG member, and D is treated as having acquired Y's assets (and activities). See paragraphs (b)(1)(ii) and (b)(1)(iii) of this section. If D were to make a distribution, ATB1 could not be relied on to satisfy the requirements of section 355(b) unless Partnership's year 6 acquisition of ATB1 is not in the pre-distribution period. See paragraphs (b)(2)(v), (b)(3)(iii), and (b)(4)(ii)(B) of this section. If D were to make a distribution, ATB2 could not be relied on to satisfy the requirements of section 355(b) unless D's year 9 acquisition of the Y stock is not in the pre-distribution period. See paragraphs (b)(2)(v)(A) and (b)(4)(ii)(B) of this section. Alternatively, if in year 9 Partnership only makes a pro rata distribution of all the Y stock to its partners such that D receives 90 percent of the Y stock, ATB2 cannot be relied on until Partnership's year 6 acquisition of all of the Y stock is no longer in the pre-distribution period. See paragraph (b)(4)(ii)(B) of this section.

Example 35. Partnership distribution (new SAG member). For more than five years, D has owned a 50-percent interest in Partnership. The remaining interests in Partnership are owned by unrelated parties. Throughout this period, Partnership has engaged in the active conduct of ATB1, and D has been attributed the trade or business assets and activities of Partnership's ATB1 under paragraph (b)(2)(v) of this section. In year 6, pursuant to an integrated plan, Partnership contributes ATB1 to new subsidiary S, and distributes all of the S stock to D in liquidation of D's 50-percent interest in Partnership. Assume that no gain or loss is recognized by Partnership or any partner on the distribution. As a result, S becomes a DSAG member, and D is treated as having acquired S's assets (and activities). See paragraphs (b)(1)(ii) and (b)(1)(iii) of this section. Because D was attributed ATB1 immediately before the incorporation and distribution by Partnership, and S became a DSAG member as a result of the distribution, Partnership's distribution of the S stock to D is not an acquisition of ATB1. See paragraphs (b)(3)(iii) and (b)(4)(ii)(B) of this section. Accordingly, if D were to make a distribution, it can rely on ATB1 to satisfy the requirements of section 355(b).

Example 36. Transfer of partnership in a reorganization and distributions. For more than five years, T has owned a 40-percent interest in Partnership which has engaged in the active conduct of ATB1. Throughout this

period, T has been attributed the trade or business assets and activities of Partnership's ATB1 under paragraph (b)(2)(v) of this section. In year 6, T merges into S, a wholly owned subsidiary of unrelated D, solely in exchange for D stock in a reorganization described in section 368(a)(1)(A) by reason of section 368(a)(2)(D). No gain or loss is recognized. If D were to make a distribution, D can rely on ATB1 because ATB1 has been actively conducted throughout the pre-distribution period, and the interest in Partnership was acquired in a transaction in which no gain or loss was recognized and was not acquired in exchange for assets of the DSAG. See paragraphs (b)(2)(v), (b)(3)(i), and (b)(4)(ii) of this section. The results would be the same if T owned only a 20-percent interest in Partnership, employees of T performed active and substantial management functions for Partnership's trade or business assets and activities prior to the merger, and employees of S (or an affiliate of S) performed active and substantial management functions for Partnership's trade or business assets and activities after the merger. See paragraphs (b)(2)(iii), (b)(2)(v), (b)(3), and (b)(4)(ii) of this section.

Example 37. Transferred ATB sold (SAG member). For more than five years, D and unrelated T have engaged in the active conduct of ATB1 and ATB2, respectively. In year 6, D contributes ATB1 to T in exchange for T stock in a transaction to which section 351 applies. No gain or loss is recognized on the contribution. Immediately after the contribution T is a DSAG member. In year 8, in response to unanticipated market changes, T sells ATB1 to an unrelated third party. Although T became a DSAG member as a result of D acquiring T stock in exchange for ATB1 in a transaction in which no gain or loss was recognized, ATB1 is not the trade or business to be relied upon. Accordingly, D cannot rely on ATB2 until the year 6 transaction is no longer in the pre-distribution period because D acquired ATB2 in exchange for D's assets not constituting the active trade or business to be relied on. See paragraphs (b)(4)(i)(A) and (b)(4)(ii)(A) of this section.

Example 38. Transferred ATB sold (partnership). The facts are the same as *Example 37* except that, in year 6, D and T contribute ATB1 and ATB2, respectively, to Partnership in a transaction to which section 721 applies. In the exchange, D and T each receive a 50-percent interest in Partnership. In year 8, in response to unanticipated market changes, Partnership sells ATB1 to an unrelated third party. If D were to make a distribution, D could not rely on ATB2 under paragraph (b)(2)(v)(B) of this section unless the year 6 transaction is not in the pre-distribution period because D acquired ATB2 in exchange for D's assets not constituting the trade or business to be relied on. See paragraphs (b)(4)(i)(A) and (b)(4)(ii)(A) of this section.

Example 39. Indirect acquisition of control of distributing's ATB. For more than five years, D and T have engaged in the active conduct of ATB1 and ATB2, respectively. All of the T stock is owned by individuals. In year 6, T purchases all the stock of D in a transaction in which gain or loss is recognized. In a separate transaction, T merges downstream into D solely in exchange for D stock in a reorganization described in section 368(a)(1)(A) and (D). No gain or loss is recognized. In year 7, D transfers ATB2 formerly conducted by T to new subsidiary C, and then distributes the C stock to the D shareholders. Although D acquired ATB2 solely in exchange for D stock in a transaction in which no gain or loss was recognized, the requirements of section 355(b) are not satisfied because ATB1, the business of D, was indirectly acquired by T, a predecessor of D, during the pre-distribution period in a transaction in which gain or loss was recognized. See paragraphs (b)(4)(i)(A) and (b)(4)(iv)(A) of this section. The result would also be the same if prior to the year 6 acquisition D and wholly owned subsidiary C were engaged in the active conduct of ATB1 and ATB2, respectively, and T had no ATB.

Example 40. Exception for corporate distributee. For more than five years, T has owned all of the stock of D which in turn owned all of the stock of C. Throughout this period, D and C have engaged in the active conduct of ATB1 and ATB2, respectively. In year 6, P purchases all the stock of T. In year 7, P liquidates T in a transaction in which no gain or loss is recognized under section 332. Under section 334(b), P's basis in the D stock is determined in whole by reference to T's basis in the D stock. In year 8, D distributes the C stock to P. While the D stock was indirectly acquired in a taxable transaction, the adjusted basis that P, the distributee corporation, has in the D stock was determined in whole by reference to T's adjusted basis. Accordingly, D and C satisfy the requirements of section 355(b). See paragraph (b)(4)(iii)(C) of this section. If P were to distribute either the D stock or C stock, neither ATB1 nor ATB2 could be relied on unless the year 6 acquisition of the T stock is not in the pre-distribution period. See paragraph (b)(4)(iii)(C) of this section. The result would be the same if P acquired all of T's assets in exchange for P stock and other property in a reorganization described in section 368(a)(1)(A).

Example 41. Acquisition of section 368(c) stock of controlled, DSAG member. For more than five years, D has owned section 1504(a)(2) stock but not section 368(c) stock of C. Throughout this period, C has engaged in the active conduct of ATB1. In year 6, D purchased additional shares of C stock. As a result, D acquired section 368(c) stock of C. If D were to make a distribution of the C stock, C could rely on ATB1 to satisfy the requirement of section 355(b). C was a DSAG member, so D was engaged in ATB1 prior to the year 6 purchase of additional C stock. Accordingly, D's acquisition of additional stock of a DSAG member is disregarded in applying paragraph (b)(4)(i)(A) of this section, and paragraph (b)(4)(i)(B) of this section does not apply to this acquisition of additional C stock. See paragraphs (b)(1)(ii) and (b)(4)(iv)(F) of this section.

Example 42. Controlled becoming a DSAG member. For more than five years, D has owned section 368(c) stock but not section 1504(a)(2) stock of C. Throughout this period, D and C have engaged in the active conduct of ATB1 and ATB2, respectively. In year 6, D purchases the remaining C stock. If D distributes all the C stock, C could not rely on ATB2 to satisfy the requirements of section 355(b) because C became a DSAG member (and thus D acquired ATB2) in a transaction in which gain or loss was recognized. See paragraphs (b)(1)(ii), (b)(4)(i)(A), and (b)(4)(iv)(F) of this section.

Example 43. Nontaxable multi-step acquisition of control. For more than five years, unrelated D and C have engaged in the active conduct of ATB1 and ATB2, respectively. C has two classes of stock outstanding. X owns all 95 shares of the class A stock of C, representing 95 percent of the voting power and 70 percent of the value, and Y owns all of the class B stock of C, representing five percent of the voting power and 30 percent of the value. In year 6, D acquires 10 shares of class A C stock from X in a transaction in which gain or loss was recognized. In year 7, in a separate transaction, D acquires an additional 80 shares of class A C stock from X solely in exchange for D voting stock in a reorganization described in section 368(a)(1)(B). No gain or loss is recognized. In year 8, in a separate transaction, D acquires the remaining five shares of class A C stock from X in a transaction in which gain or loss was recognized. Because D only acquires 70 percent of the value of C stock, C does not become a DSAG member. In year 9, D distributes the 95 shares of class A C stock to the D shareholders. At the time D first acquired control of C, D owned an amount of C stock constituting control that was acquired in a transaction in which no gain or loss was recognized. Accordingly, D and C both satisfy the requirements of section 355(b). See paragraphs (b)(4)(i)(B) and (b)(4)(iv)(B) of this section.

Example 44. Taxable multi-step acquisition of control. The facts are the same as *Example 43* except that in year 7 D acquires 70 shares of class A C stock solely in exchange for D voting stock in a reorganization described in section 368(a)(1)(B). No gain or loss is recognized. At the time D first acquired control of C, D did not own an amount of C stock constituting control that was acquired in one or more transactions in which no gain or loss was recognized or by reason of such transactions combined with acquisitions before the pre-distribution period. Accordingly, C cannot rely on ATB2 to satisfy the requirements of section 355(b) until D's year 6 acquisition of the 10 shares of class A C stock is no longer in the pre-distribution period. See paragraphs (b)(4)(i)(B) and (b)(4)(iv)(B) of this section.

Example 45. Taxable acquisition of control. For more than five years, unrelated D and C have engaged in the active conduct of ATB1 and ATB2, respectively. In year 6, D acquires section 368(c) stock but not section 1504(a)(2) stock of C from unrelated T in a reorganization described in section 368(a)(1)(A) by reason of section 368(a)(2)(E) through the use of a newly created transitory subsidiary of D. In the reorganization, T receives consideration 95 percent of which is D voting common stock and five percent of which is cash. Because D acquired control of C in a single transaction in which gain or loss

was recognized, paragraph (b)(4)(iv)(B) of this section does not apply. Accordingly, C cannot rely on ATB2 to satisfy the requirements of section 355(b) until D's year 6 acquisition of control of C is no longer in the pre-distribution period. See paragraph (b)(4)(i)(B) of this section.

Example 46. Taxable multi-step indirect acquisition of control. For more than five years, C has engaged in the active conduct of ATB1. T owns exactly 80 percent of the total combined voting power of all classes of C stock entitled to vote and 80 percent of the total number of shares of all other classes of C stock, but T owns less than 80 percent of the total value of the C stock. In year 6, unrelated D acquires 10 percent of the sole outstanding class of stock of T in a transaction in which gain or loss is recognized. In year 8, in a separate transaction, T merges into D solely in exchange for D stock in a reorganization described in section 368(a)(1)(A). No gain or loss is recognized. As a result, D owns section 368(c) stock of C. Because D indirectly acquired 10 percent of the C stock owned by T in year 6, at the time D first acquired control of C, D did not own stock constituting control of C that it acquired in one or more transactions in which no gain or loss was recognized or by reason of such transactions combined with acquisitions before the pre-distribution period. Accordingly, C cannot rely on ATB1 to satisfy the requirements of section 355(b) until D's year 6 acquisition of the T stock is no longer in the pre-distribution period. See paragraphs (b)(4)(i)(B) and (b)(4)(iv)(B) of this section.

Example 47. Nontaxable multi-step acquisition of SAG member (or ATB). For more than five years, S has engaged in the active conduct of ATB1. X owns all 100 shares of the sole outstanding class of S stock. In year 6, unrelated D acquires 10 shares of S stock from X in a transaction in which gain or loss was recognized. In year 7, in a separate transaction, D acquires an additional 80 shares of S stock from X solely in exchange for D voting stock in a reorganization described in section 368(a)(1)(B). No gain or loss is recognized. As a result, S becomes a DSAG member. In year 8, in a separate transaction, D acquires another 5 shares of S stock from X in a transaction in which gain or loss was recognized. Because at the time S first became a DSAG member, D owned an amount of S stock meeting the requirements of section 1504(a)(2) that was acquired in a transaction in which no gain or loss was recognized, D can rely on ATB1 to satisfy the requirements of section 355(b) as of the year 7 transaction. See paragraphs (b)(4)(i)(A) and (b)(4)(iv)(C) of this section. The acquisition by D of other S stock in a separate transaction in which gain or loss was recognized during the pre-distribution period is disregarded. See paragraph (b)(1)(ii) of this section. The result would be the same if, in year 7, instead of acquiring S stock in a reorganization described in section 368(a)(1)(B), S merged into D in exchange for D stock in a reorganization described in section 368(a)(1)(A) in which no gain or loss was recognized. See paragraphs (b)(4)(i)(A) and (b)(4)(iv)(D) of this section.

Example 48. Taxable multi-step acquisition of SAG member (or ATB). The facts are the same as *Example 47* except that in year 6 D acquires 21 shares of S stock in a transaction in which gain or loss was recognized, and in year 7, in a separate transaction, D acquires an additional 79 shares of S stock solely in exchange for D voting stock in a reorganization described in section 368(a)(1)(B). No gain or loss is recognized, and S becomes a DSAG member. D cannot rely on ATB1 to satisfy the requirements of section 355(b) until D's year 6 acquisition of the 21 shares of S stock is no longer in the pre-distribution period because at the time S first became a DSAG member D did not own an amount of S stock meeting the requirements of section 1504(a)(2) that was acquired in one or more transactions in which no gain or loss was recognized or by reason of such transactions combined with acquisitions before the pre-distribution period. See paragraphs (b)(4)(i)(A) and (b)(4)(iv)(C) of this section. The result would be the same if, in year 7, in a separate transaction, instead of D's acquiring S stock, S merged into D in exchange for D stock in a reorganization described in section 368(a)(1)(A) in which no gain or loss was recognized. See paragraphs (b)(4)(i)(A) and (b)(4)(iv)(D) of this section. The result would also be the same if in year 6 D acquired 10 shares of S stock in a transaction in which gain or loss was recognized and, in year 7, in a separate transaction, D acquired an additional 70 shares of S stock solely in exchange for D voting stock in a reorganization described in section 368(a)(1)(B). See paragraphs (b)(4)(i)(A) and (b)(4)(iv)(C) of this section.

Example 49. Nontaxable multi-step indirect acquisition using subsidiary stock. For more than five years, X has owned all of the sole outstanding class of S stock. Throughout this period, S and unrelated T have engaged in the active conduct of ATB1 and ATB2, respectively. In year 6, T merges into S solely in exchange for S stock in a reorganization described in section 368(a)(1)(A). No gain or loss is recognized. Immediately after the merger, X and the former T shareholders own 80 percent and 20 percent of the S stock, respectively. In year 8, unrelated D acquires all of the S shares held by X solely in exchange for D voting stock in a reorganization described in section 368(a)(1)(B). No gain or loss is recognized. As a result, S becomes a DSAG member. Because D acquired ATB1 and ATB2 in a transaction in which no gain or loss was recognized, solely in exchange for D stock, D can rely on both ATB1 and ATB2 to satisfy the requirements of section 355(b). Because X is neither a predecessor of D nor a DSAG member, paragraph (b)(4)(iv)(E) of this section is not applicable.

Example 50. Taxable multi-step indirect acquisition using subsidiary stock. The facts are the same as *Example 49* except that, for more than five years, D has owned 50 percent of the sole outstanding class of X stock. In year 8, instead of D acquiring the S stock, S merges into D solely in exchange for D stock in a reorganization described in section 368(a)(1)(A). No gain or loss is recognized. Because D indirectly owned S stock and S acquired ATB2 in exchange for S stock, paragraph (b)(4)(iv)(E) of this section is applicable. Under paragraph (b)(4)(iv)(E) of this section, for purposes of applying paragraph (b)(4) of this section with respect to ATB2, D is treated as having indirectly acquired in year 6 the S stock it indirectly owns immediately after the merger of T into S in a transaction in which gain or loss was recognized. Thus, D is treated as having indirectly acquired 40 percent of the S stock in a transaction in which gain or loss is recognized at the time of the merger of T into S. Further, if the merger of T into S is in the pre-distribution period, under paragraph (b)(4)(iv)(D) of this section, D will be treated as having acquired ATB2 in a transaction in which gain or loss is recognized because, immediately before the merger of S into D, D indirectly owned 40 percent of the S stock that had been acquired in a transaction in which gain or loss was recognized. Accordingly, D cannot rely on ATB2 to satisfy the requirements of section 355(b) until the year 6 merger of T into S is no longer in the pre-distribution period. However, D can rely on ATB1 to satisfy the requirements of section 355(b). Alternatively, if X, instead if S, merged into D, S would become a DSAG member and X would be a predecessor of D. If so, for purposes of applying paragraph (b)(4) of this section with respect to ATB2, D is treated as having acquired 80 percent of the S stock in year 6 in a transaction in which gain or loss was recognized. Accordingly, D cannot rely on ATB2 to satisfy the requirements of section 355(b) until the year 6 merger of T into S is no longer in the pre-distribution period. See paragraphs (b)(1)(iii), (b)(4)(i)(A), (b)(4)(iv)(A), and (b)(4)(iv)(E) of this section. However, D can rely on ATB1 to satisfy the requirements of section 355(b).

Example 51. Taxable multi-step indirect acquisition of SAG member (or ATB). For more than five years, T has engaged in the active conduct of ATB1. Throughout this period, X owned all of the sole outstanding class of T stock, and D owned 50 percent of the sole outstanding stock of S. In year 6, S acquires 50 percent of the sole outstanding class of the X stock in a transaction in which gain or loss is recognized. In year 8, X merges into D solely in exchange for D stock. No gain or loss is recognized. As a result, T becomes a DSAG member. Because D indirectly acquired more than 20 percent of the T stock (D indirectly acquired 25 percent of T) in year 6, at the time T first became a DSAG member D did not own an amount of T stock meeting the requirements of section 1504(a)(2) that it acquired in one or more transactions in which no gain or loss was recognized or by reason of such transactions combined with acquisitions before the predistribution period. Accordingly, D cannot rely on ATB1 to satisfy the requirements of section 355(b) until D's year 6 indirect acquisition of the T stock is no longer in the pre-distribution period. See paragraphs (b)(4)(i)(A) and (b)(4)(iv)(C) of this section. The result would be the same if, instead of X, in year 8, T merged into D solely in exchange for D stock. See

paragraphs (b)(4)(i) and (b)(4)(iv) of this section.

Kevin M. Brown,

Deputy Commissioner for Services and Enforcement.

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BILLING CODE 4830–01–P

DEPARTMENT OF JUSTICE

28 CFR Part 16

[AAG/A Order No. 010–2007]

Privacy Act of 1974; Implementation

AGENCY: Department of Justice.

ACTION: Proposed rule.

SUMMARY: The Department of Justice proposes to amend the Privacy Act exemptions to the National Security Division's system of records as described in today's notice section of the **Federal Register**: Foreign Intelligence and Counterintelligence Records System (JUSTICE/NSD–001), which incorporates three previous systems of records of the Office of Intelligence Policy and Review (OIPR). These systems of records are the ''Policy and Operational Records System, OIPR–001'' last published in the **Federal Register** January 26, 1984 (49 FR 3281); ''Foreign Intelligence Surveillance Act Records System, OIPR–002'' last published in the **Federal Register** January 26, 1984 (49 FR 3282); and ''Litigation Records System, OIPR–003'' last published in the **Federal Register** January 26, 1984 (49 FR 3284).

DATES: Submit any comments by June 18, 2007.

ADDRESSES: Address all comments to Mary Cahill, Management and Planning Staff, Justice Management Division, Department of Justice, 1331 Pennsylvania Avenue, NW., Washington, DC 20530 (1400 National Place Building), Facsimile Number (202) 307–1853. To ensure proper handling, please reference the AAG/A Order No. on your correspondence. You may review an electronic version of this proposed rule at *http://www.regulations.gov.* You may also comment via the Internet to the DOJ/Justice Management Division at the following e-mail address: *DOJPrivacyACTProposedRegulations@usdoj.gov;* or by using the *http://www.regulations.gov* comment form for this regulation. When submitting comments electronically, you must include the AAG/A Order No. in the subject box.

FOR FURTHER INFORMATION CONTACT: GayLa Sessoms, (202) 616–5460.

SUPPLEMENTARY INFORMATION: The Department proposes to exempt JUSTICE/NSD–001 from 5 U.S.C. 552a(c)(3) and (4); (d); (e)(1), (2), (3), (4)(G), (H) and (I), (5) and (8); (f); (g); and (h). These exemptions will be applied only to the extent that information in a record is subject to exemption pursuant to 5 U.S.C. 552a(j)(2), (k)(1), (2) or (5).

This order relates to individuals rather than small business entities. Nevertheless, pursuant to the requirements of the Regulatory Flexibility Act, 5 U.S.C. 601–612, this order will not have a significant impact on a substantial number of small business entities.

List of Subjects in 28 CFR Part 16

Administrative practices and procedures, Courts, Freedom of Information, and Privacy.

Pursuant to the authority vested in the Attorney General by 5 U.S.C. 552a and delegated to me by Attorney General Order No. 793–78, it is proposed to amend 28 CFR part 16 as follows:

PART 16—PRODUCTION OR DISCLOSURE OF MATERIAL OR INFORMATION

1. The authority for part 16 continues to read as follows:

Authority: 5 U.S.C. 301, 552, 552a, 552b(g), and 553; 18 U.S.C. 4203(a)(1); 28 U.S.C. 509, 510, 534; 31 U.S.C. 3717, and 9701.

2. Section 16.74 is revised to read as follows:

§ 16.74 Exemption of National Security Division System-limited access.

(a) The following system of records is exempted from subsections (c)(3) and (4); (d); (e)(1), (2), (3), (4)(G), (H) and (I), (5) and (8); (f); (g); and (h) of the Privacy Act pursuant to 5 U.S.C. 552a(j)(2), (k)(1), (2) and (5): Foreign Intelligence and Counterintelligence Records System (JUSTICE/NSD–001). These exemptions apply only to the extent that information in the system is subject to exemption pursuant to 5 U.S.C. 552a(j)(2), (k)(1), (2), and (5).

(b) Exemptions from the particular subsections are justified for the following reasons:

(1) *Subsection (c)(3).* To provide the target of a surveillance or collection activity with the disclosure accounting records concerning him or her would hinder authorized United States intelligence activities by informing that individual of the existence, nature, or scope of information that is properly classified pursuant to Executive Order 12958, as amended, and thereby cause damage to the national security.

(2) *Subsection (c)(4).* This subsection is inapplicable to the extent that an exemption is being claimed for subsection (d).

(3) *Subsection (d)(1).* Disclosure of foreign intelligence and counterintelligence information would interfere with collection activities, reveal the identity of confidential sources, and cause damage to the national security of the United States. To ensure unhampered and effective collection and analysis of foreign intelligence and counterintelligence information, disclosure must be precluded.

(4) *Subsection (d)(2).* Amendment of the records would interfere with ongoing intelligence activities thereby causing damage to the national security.

(5) *Subsections (d)(3) and (4).* These subsections are inapplicable to the extent exemption is claimed from (d)(1) and (2).

(6) *Subsection (e)(1).* It is often impossible to determine in advance if intelligence records contained in this system are relevant and necessary, but, in the interests of national security, it is necessary to retain this information to aid in establishing patterns of activity and provide intelligence leads.

(7) *Subsection (e)(2).* Although this office does not conduct investigations, the collection efforts of agencies that supply information to this office would be thwarted if the agencies were required to collect information with the subject's knowledge.

(8) *Subsection (e)(3).* To inform individuals as required by this subsection could reveal the existence of collection activity and compromise national security. For example, a target could, once made aware that collection activity exists, alter his or her manner of engaging in intelligence or terrorist activities in order to avoid detection.

(9) *Subsections (e)(4)(G), (H) and (I), and (f).* These subsections are inapplicable to the extent that this system is exempt from the access provisions of subsection (d).

(10) *Subsection (e)(5).* It is often impossible to determine in advance if intelligence records contained in this system are accurate, relevant, timely and complete, but, in the interests of national security, it is necessary to retain this information to aid in establishing patterns of activity and providing intelligence leads.

(11) *Subsection (e)(8).* Serving notice could give persons sufficient warning to evade intelligence collection and anti-terrorism efforts.

(12) *Subsections (g) and (h).* These subsections are inapplicable to the extent that this system is exempt from