

Part I

Section 355.00-00.—Distribution of Stock and Securities of a Controlled Corporation

26 CFR 1.355-3: Active conduct of a trade or business.

Rev. Rul. 2002-49

ISSUE

Under the facts described below, is the 5-year active conduct of a trade or business requirement of § 355(b) of the Internal Revenue Code satisfied when, during the 5-year period prior to a transaction that otherwise meets the requirements of § 355, a corporation holding a membership interest in a member-managed limited liability company purchases the remaining interests in that limited liability company, contributes a portion of the business to a newly formed controlled subsidiary, and then distributes the stock of the controlled subsidiary to its shareholders?

FACTS

Situation 1. As of the first day of Year 1, LLC is a domestic member-managed limited liability company that has been classified as a partnership for Federal tax purposes since its date of organization. As of that day, LLC owns several commercial office buildings that it leases to unrelated third parties. On the first day of Year 1, D, a corporation, owns a 20 percent profit/loss and capital interest in LLC (the Interest). At that time, D has no business assets other than the Interest. In addition, at that time, X, a corporation, owns a 20 percent profit/loss and capital interest in LLC and one or more persons hold the remaining 60 percent profit/loss and capital interests of LLC.

LLC periodically repaints and refurbishes its existing properties. In addition, LLC continuously seeks to acquire additional properties to expand its rental business. When

a property is located, LLC negotiates its purchase and financing and determines whether renovations or alterations are necessary to make the building suitable for rental.

Pursuant to the terms of its leases, LLC provides day-to-day upkeep and maintenance services for its office buildings. These services include trash collection, ground maintenance, electrical and plumbing repair, and insect control. Additionally, LLC advertises for new tenants, verifies information contained in lease applications, negotiates leases, handles tenant complaints, prepares eviction notices and warnings for delinquent tenants, collects rent, and pays all expenses, including gas, water, sewage, electricity and insurance for the office buildings. LLC also maintains financial and accounting records to reflect income and expenses relating to each of its rental properties as well as LLC's general expenses.

Throughout the period during which D owns the Interest, D and X jointly manage LLC and have equal control over the management of LLC. D's and X's officers perform active and substantial management functions with respect to LLC's activities, including the decision-making regarding significant business decisions of LLC (e.g., decisions with respect to significant renovations of properties, the purchase and sale of properties, and significant financings and refinancings). Neither D nor X, however, can make a significant business decision without the consent of the other. In addition, D's and X's officers regularly participate in the overall supervision, direction, and control of LLC's employees in their performance of LLC's operational functions. None of the members of LLC other than D and X participate in the management or operational functions of LLC.

On the first day of Year 3, D purchases all of the remaining interests in LLC (the Remaining Interests) from the other members of LLC. At all times prior to the first day of Year 3, the other members of LLC are unrelated to D, X, or their respective shareholders. In connection with D's purchase of the Remaining Interests, LLC becomes an entity disregarded as an entity separate from D. After the purchase of the Remaining Interests, D's officers continue to conduct the activities and functions with respect to LLC that they and X's officers conducted prior to D's purchase of the Remaining Interests and LLC's employees continue to conduct the activities and functions with respect to LLC that they conducted prior to D's purchase of the Remaining Interests.

On the first day of Year 6, for a valid business purpose, when D owns no business assets other than those that it owns through LLC, D causes LLC to distribute to D rental properties that constitute 40 percent of the value of LLC's rental properties. D then transfers those properties to C, a newly formed, wholly owned subsidiary of D, and distributes the stock of C pro rata to D's shareholders in a transaction intended to meet the requirements of § 355. After the distribution, D and LLC, together, and C will conduct the same activities and functions with respect to the portions of the business that they each own after the distribution that D and LLC conducted as of the beginning

of Year 1. Assume that, except for the issue of whether the distribution satisfies the requirements of § 355(b), D's distribution of C stock otherwise satisfies all of the requirements of § 355.

Situation 2. The facts are the same as in Situation 1 except that, instead of owning the Interest on the first day of Year 1, on the first day of Year 2, D acquires the Interest by contributing appreciated securities to LLC in a transaction described in § 721.

LAW

Section 355(a) provides that, under certain circumstances, a corporation may distribute stock and securities in a corporation it controls to its shareholders and security holders in a transaction that is nontaxable to such shareholders and security holders. Sections 355(a)(1)(C) and 355(b)(1) require that both the distributing and controlled corporations be engaged, immediately after the distribution, in the active conduct of a trade or business. Section 355(b)(2)(B) requires that such trade or business have been actively conducted throughout the 5-year period ending on the date of the distribution. In addition, under § 355(b)(2)(C), that 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 5-year period.

Section 1.355-3(b)(2)(iii) of the Income Tax Regulations provides, in part, that 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. Generally, activities performed by the corporation itself do not include activities performed by independent contractors. A corporation, however, may satisfy the active conduct of a trade or business requirement through the activities that it performs itself even though some of its activities are performed by others. Under § 1.355-3(b)(2)(iv), however, the active conduct of a trade or business does not include 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.

Section 1.355-3(b)(3)(ii) provides that the fact that a trade or business underwent change during the 5-year period preceding the distribution (for example, by the addition of new or the dropping of old products, changes in production capacity, and the like) shall be disregarded, provided that the changes are not of such a character as to constitute the acquisition of a new or different business.

Section 721(a) provides that no gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership.

Rev. Rul. 92-17, 1992-1 C.B. 142, considers whether D, a corporate general partner in a limited partnership, is engaged in the active conduct of a trade or business within the meaning of § 355(b). For more than 5 years, D owned a 20 percent interest in LP, a limited partnership that owned several commercial office buildings leased to unrelated third parties. D's officers performed active and substantial management functions with respect to LP, including the significant business decision-making of the partnership, and regularly participated in the overall supervision, direction, and control of LP's employees in operating LP's rental business. Rev. Rul. 92-17 concludes that D is engaged in the active conduct of trade or business within the meaning of § 355(b).

Rev. Rul. 99-6, 1999-1 C.B. 432, considers the Federal income tax consequences of one person's purchase of ownership interests in a limited liability company that is classified as a partnership for Federal tax purposes. In Situation 1 of Rev. Rul. 99-6, A and B are equal partners in AB, a domestic limited liability company. A sells A's entire interest in AB to B. After the sale, the business is continued by the limited liability company, which then is owned solely by B. After the sale, no entity classification election is made under § 301.7701-3(c) of the Procedure and Administration Regulations to treat the limited liability company as an association for Federal tax purposes. Rev. Rul. 99-6 holds, in part, that, when B purchases A's entire interest in AB, the AB partnership terminates. For purposes of determining the treatment of B, AB is deemed to make a liquidating distribution of all its assets to A and B, and, following this distribution, B is treated as acquiring from A the assets deemed to have been distributed to A in liquidation of A's partnership interest.

ANALYSIS

Situation 1. In order to satisfy the active conduct of a trade or business requirement of § 355(b), each of D and C must be engaged in the active conduct of a trade or business immediately after the distribution in Year 6. In this case, immediately after the distribution, each of D and C are engaged in commercial office leasing activities that constitute the conduct of an active trade or business. See § 1.355-3(b)(2)(iv).

Under § 355(b)(2)(B) and (C), this trade or business must have been actively conducted throughout the 5-year period ending on the date of the distribution, and must not have been acquired within that 5-year period in a transaction in which gain or loss was recognized in whole or in part. During Years 1 and 2, while D owns the Interest, D conducts active and substantial management functions with respect to LLC, and regularly participates in the overall supervision, direction, and control of LLC's employees. Accordingly, consistent with Rev. Rul. 92-17, for purposes of § 355(b), during that period, D is engaged in the active conduct of the commercial office leasing business.

The commercial office leasing business actively conducted by D during Years 3, 4, and 5 is the same commercial office leasing business actively conducted by D in

Years 1 and 2. Therefore, D's purchase of the Remaining Interests on the first day of Year 3, which causes the LLC to become disregarded as an entity separate from D, does not result in the acquisition of a new or different business. See § 1.355-3(b)(3)(ii). Because this transaction does not result in the acquisition of a new or different business, the requirements of § 355(b)(2)(B) and (C) are satisfied even though gain or loss is recognized in the transaction.

Because immediately after the distribution of C stock to D's shareholders each of D and C will be engaged in the active conduct of a trade or business that is treated as having been actively conducted throughout the 5-year period ending on the date of the distribution and that was not acquired during that period in a transaction prohibited by § 355(b)(2)(C), the distribution satisfies the 5-year active conduct of a trade or business requirement of § 355(b).

Situation 2. As in Situation 1, for purposes of § 355(b), prior to D's purchase of the Remaining Interests, while D owns the Interest, conducts active and substantial management functions with respect to LLC, and regularly participates in the overall supervision, direction, and control of LLC's employees, D is engaged in the active conduct of the commercial office leasing business. In addition, as in Situation 1, D is not treated as acquiring a new or different trade or business as a result of purchasing the Remaining Interests on the first day of Year 3.

Unlike in Situation 1, however, D will be treated as having acquired such trade or business in a transaction in which gain or loss was recognized within the 5-year pre-distribution period in violation of § 355(b)(2)(C). Although D's acquisition of the Interest on the first day of Year 2 was a transaction in which no gain or loss was recognized (under § 721(a)), had D instead directly acquired the trade or business that the Interest represents in exchange for the property D contributed to LLC, such exchange would have been a transaction in which gain or loss was recognized. For purposes of § 355(b), therefore, D will be treated as acquiring the trade or business attributable to the Interest on the first day of Year 2 in a transaction in which gain or loss was recognized.

Because both immediately before and immediately after the distribution D and C are engaged in a trade or business that is treated as having been acquired in a transaction in which gain or loss was recognized within the 5-year pre-distribution period, the distribution violates the prohibition of § 355(b)(2)(C). Accordingly, the distribution does not satisfy the 5-year active conduct of a trade or business requirement of § 355(b).

EFFECT ON OTHER REVENUE RULING(S)

Rev. Rul. 92-17 is amplified.

DRAFTING INFORMATION

The principal author of this revenue ruling is Russell P. Subin of the Office of Associate Chief Counsel (Corporate). For further information regarding this revenue ruling, contact Mr. Subin at (202) 622-7790 (not a toll-free call).