

Section 355.—Distribution of Stock and Securities of a Controlled Corporation

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

Section 355. Whether creation of an Internal website to sell shoes at retail, by a corporation that conducts a retail shoe store business, is an expansion of the original business or an acquisition of a new or different business under section 355(b) of the Code.

Rev. Rul. 2003-38

ISSUE

Whether the creation by a corporation engaged in the retail shoe store business of an Internet web site on which the corporation will sell shoes at retail constitutes an expansion of the corporation's business rather than the acquisition of a new or different business under § 1.355-3(b)(3)(ii) of the Income Tax Regulations.

FACTS

Corporation D has operated a retail shoe store business, under the name "D," since Year 1 in a manner that meets the requirements of § 355(b) of the Internal Revenue Code. 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 recogni-

tion, customer loyalty, and other elements of goodwill in the retail shoe market. In Year 8, 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 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. In Year 10, D transfers all of the web site's assets and liabilities to corporation C, a newly formed, wholly owned subsidiary of D, and distributes the stock of C *pro rata* to D's shareholders. Apart from the issue of whether the web site is considered an expansion of D's business and therefore entitled to share the business's five-year history at the time of the distribution in Year 10, the distribution meets all the requirements of § 355.

LAW

Section 355(a) provides that a corporation may distribute stock and securities in a controlled corporation to its shareholders and security holders in a transaction that will not cause the distributees to recognize gain or loss, provided that, among other requirements, (i) each of the distributing corporation and controlled corporation is engaged, immediately after the distribution, in the active conduct of a trade or business, (ii) each trade or business has been actively conducted throughout the five-year period ending on the date of the distribution, and (iii) neither trade or business was acquired in a transaction in which gain or loss was recognized, in whole or in part, within the five-year period. Sections 355(b)(1)(A), 355(b)(2)(B), and 355(b)(2)(C).

In determining whether an active trade or business has been conducted by a corporation throughout the five-year period preceding the distribution, the fact that a trade or business underwent change during the five-year 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. Section 1.355-3(b)(3)(ii). In particular, if a corporation engaged in the active conduct of one trade or business dur-

ing 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 character as to constitute the acquisition of a new or different business. *Id.*

In Example (7) of § 1.355-3(c), corporation X had owned and operated a department store in the downtown area of the City of G for six years before acquiring a parcel of land in a suburban area of G and constructing a new department store. Three years after the construction, X transferred the suburban store and related business assets to new subsidiary Y and distributed the Y stock to X's shareholders. Citing § 1.355-3(b)(3)(i) and (ii), the example concludes that X and Y both satisfy the requirements of § 355(b).

In Example (8) of § 1.355-3(c), corporation X had owned and operated hardware stores in several states for four years before purchasing the assets of a hardware store in State M where X had not previously conducted business. Two years after the purchase, X transferred the State M store and related business assets to new subsidiary Y and distributed the Y stock to X's shareholders. Citing § 1.355-3(b)(3)(i) and (ii), the example concludes that X and Y both satisfy the requirements of § 355(b).

Rev. Rul. 2003-18, 2003-7 I.R.B. 467, concludes that the acquisition by a dealer engaged in the sale and service of brand X automobiles of a franchise (and the assets needed) to sell and service brand Y automobiles is an expansion of the brand X business and does not constitute the acquisition of a new or different business under § 1.355-3(b)(3)(ii) because (i) the product of the brand X automobile dealership is similar to the product of the brand Y automobile dealership, (ii) the business activities associated with the operation of the brand X automobile dealership (*i.e.*, sales and service) are the same as the business activities associated with the operation of the brand Y automobile dealership, and (iii) the operation of the brand Y automobile dealership involves the use of the experience and know-how that the dealer developed in the operation of the brand X automobile dealership.

ANALYSIS

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). 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. Nevertheless, 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. Accordingly, the creation by D of the Internet web site does not constitute the acquisition of a new or different business under § 1.355-3(b)(3)(ii). Instead, it is an expansion of D's retail shoe store business. Therefore, each of D and C is engaged in the active conduct of a five-year active trade or business immediately after the distribution. *See* Rev. Rul. 2003-18 and § 1.355-3(c), Examples (7) and (8).

HOLDING

The creation by a corporation engaged in the retail shoe store business of an Internet web site that sells shoes at retail constitutes an expansion of the retail shoe store business rather than the acquisition of a new or different business under § 1.355-3(b)(3)(ii).

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).
