Ridge Pallets, Inc. (Ridge) has been a central Florida corporation engaged in the forest products business. It was equally owned by Douglas P. McLaulin, Jr., Augustus H. King III, and Alfred E. and Lynn B. Holland. Ridge is an S Corporation. As a pass-through corporate entity, its taxes flow directly to its shareholders. In 1993, S Corporations were not permitted to have a wholly owned subsidiary. Once Ridge acquired control of Sunbelt, in order to maintain its S Corporation status, it was forced to spin it off. The law was later modified to allow ownership under certain conditions.

Sunbelt Forest Products, Inc. (Sunbelt) has been engaged in the production and sale of pressure-treated lumber in central Florida. It was equally owned by Ridge and John L. Hutto. Hutto served as Sunbelt's chairman of the board of directors and as president. Dissatisfied with Hutto's management of Sunbelt, Ridge sought to purchase Hutto's 50% stock ownership interest in Sunbelt or sell its 50% interest to Hutto. Ridge loaned $900,000 cash to Sunbelt. Sunbelt used part of that cash to redeem Hutto's shares for $829,000, plus real property worth $101,000, resulting in a taxable gain to him of approximately $860,000. After the redemption, Ridge owned 100% of Sunbelt. In an effort to maintain its S Corporation status, Ridge spun off all its Sunbelt shares pro rata to the Ridge shareholders, resulting in a brother-sister relationship rather than a parent-subsidiary relationship.

The active business requirement is defined in Section 355(a)(1)(C). The definition is refined later in the statute by four statutory conditions. Specifically: (1) Sunbelt must be engaged in the active conduct of a trade or business, Section 355(b)(2)(A); (2) Sunbelt's trade or business must have been actively conducted for the previous five years, Section 355(b)(2)(B); (3) Sunbelt's trade or business must not have been acquired within five years in a transaction in which gain or loss was recognized, Section 355(b)(2)(C); and (4) control of Sunbelt was not acquired within the five-year period, or if it was acquired within such five-year period, it was acquired by reason of a transaction or transactions in which no gain or loss was recognized, Section 355(b)(2)(D)(ii).

The facts of Rev. Rul. 57-144 were not distinguishable from the present case. A parent corporation [Ridge] acquired control of a subsidiary corporation [Sunbelt] by virtue of the subsidiary [Sunbelt] corporation's redemption of the stock of another shareholder [Hutto], whose interest in the subsidiary [Sunbelt] before the redemption exceeded 20 percent [Hutto owned 50 percent]. Gain was recognized on the acquisition. The active business requirement was not met.