Corporation M, a domestic corporation engaged in the hardware business, owned all of the common stock and 12 percent of the preferred stock of corporation N, a domestic corporation engaged in the appliance business at a different location. Both corporations had been engaged in the active conduct of their respective businesses for more than five years, and all of the stock of corporation N owned by corporation M had been owned by it for more than five years. The preferred stock of corporation N had no voting power, sole voting rights being vested in the common stock. The outstanding stock of corporation M consisted solely of common stock.

A group of dissatisfied stockholders, who owned approximately one-half of the stock of corporation M and who were primarily concerned with the business of corporation N, offered to surrender all of their M stock to corporation M in exchange for the common stock and preferred stock of corporation N owned by corporation M. The proposal was accepted by the other stockholders, and, in order to equalize the value of the stocks being exchanged, corporation M transferred an amount of cash to corporation N as a capital contribution. Prior to the separation, in pursuance of a plan of recapitalization, corporation N issued additional shares of its common stock in exchange for the outstanding shares of its preferred stock owned by stockholders other than corporation M, the exchange ratio being based upon the respective values of the preferred and common shares. The additional common shares so issued constituted seven percent of the common shares then of the outstanding common stock and 100 percent of the outstanding preferred stock. Corporation M distributed all of the common stock and preferred stock of corporation N owned by it to the group of dissatisfied stockholders in exchange for all of their stock of corporation M. Such group thereby acquired control of corporation N and continued the operation of its business under their management. Corporation M continued the active conduct of its business under the separate ownership and management of its remaining shareholders.

For purposes of section 355, the term "control," as defined in section 368(c), "means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation." Although corporation M owned over 80 percent of the voting common stock of corporation N throughout the entire 5-year period ending on the date of the distribution of the N stock, it owned only 12 percent of the nonvoting preferred stock of corporation N from the beginning of such period until the consummation of the recapitalization of corporation N, when the preferred shares owned by it became the only nonvoting shares of corporation N outstanding. Thus, corporation M acquired control of corporation N during the said 5-year period, but only by reason of such recapitalization, combined with acquisitions of N stock before the beginning of the 5-year period. However, since the recapitalization of corporation N constituted a reorganization within the meaning of section 368(a)(1)(E), and the exchanges made by the preferred stockholders in pursuance of such reorganization were nontaxable exchanges under the provisions of section 354(a)(1), control of corporation N was acquired by corporation M in a manner permitted by section 355(b)(2)(D)(ii).

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