In 1968, X, a widely held corporation, acquired all of the outstanding stock of Y corporation, which was owned by two shareholders (A and B), in a transaction qualifying as a reorganization within the meaning of section 368(a)(1)(B). No gain or loss was recognized in whole or in part in that transaction. Both corporations had been engaged in the active conduct of their respective business for more than five years. In 1970, for valid business reasons, X distributed all of the stock of Y to A and B in exchange for 85 percent of the X stock of each which was equal in fair market value to the Y stock received. Immediately prior to the exchange a substantial capital contribution was made by X to Y in order to reduce the disparity in the market values of the respective stocks. The capital contribution did not cause a change in the character of Y's business. The X stock owned by A and B, was less than five percent of the outstanding X stock and consisted solely of the stock received pursuant to the reorganization in 1968.

Section 355(a)(1) provides, in pertinent part, that no gain or loss will be recognized upon the distribution by a corporation to its shareholders of all the stock of a controlled corporation, if the transaction is not used principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both (section 355(a)(1)(B)), and the active business requirements of section 355(b) are satisfied. Section 355(a)(2)(A) provides that section 355(a)(1) will be applied without regard to whether the distribution is pro rata with respect to all of the shareholders of the distributing corporation.

A substantial capital contribution made to a subsidiary by its parent prior to a distribution of the subsidiary's stock to the parent's shareholders may be considered evidence of a device under section 365(a)(1)(B). However, in the instant case, if the distribution were considered taxable, it would not result in dividend income to the two shareholders receiving Y stock because the exchange of their X stock as to each would have been a substantially disproportionate redemption under section 302(b)(2) and thus would have been treated as a distribution in part or full payment in exchange for such stock under section 302(a). Consequently, the transaction is not a device to distribute earnings and profits (that is, to convert dividend income into capital gains). Compare Revenue Ruling 64-102, which holds similarly with regard to a transaction that, if it were considered taxable, would have qualified under section 302(b)(3) as a redemption in complete redemption of all of the stock of the corporation owned by the shareholders. Accordingly, no gain or loss is recognized to A and B upon the receipt of the Y stock in exchange for their X stock under section 355(a).

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