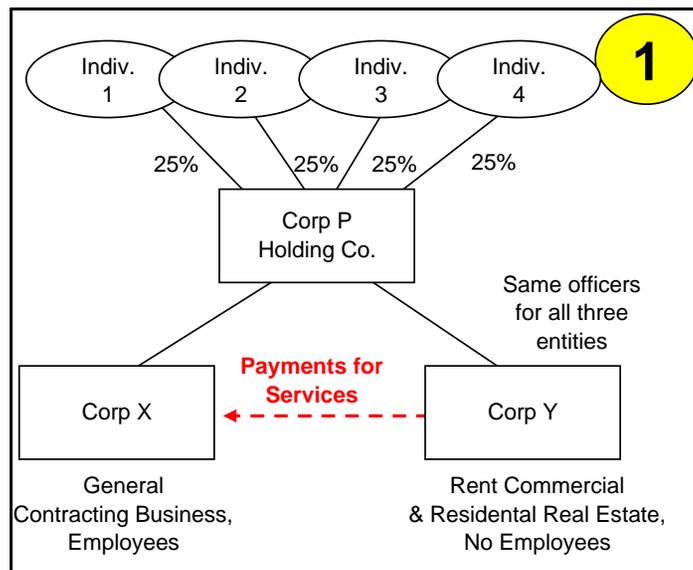
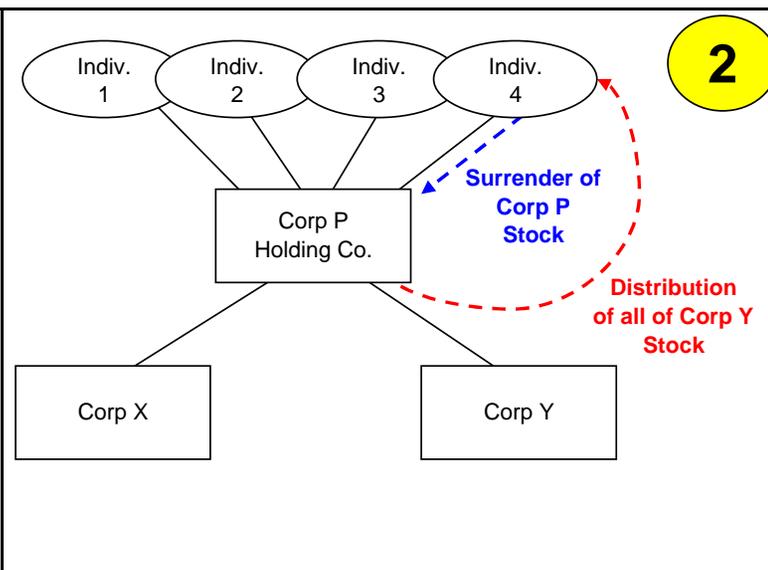


**Active Trade or Business
With No [Paid] Employees**

Initial Structure



Split-Off



The stock of corporation P is owned by four individuals who are not related within the meaning of section 318(a). For over five years, P has owned all the stock of corporations X and Y. During that period, P has acted solely as a holding company. For the same period of time, X has been engaged in the general contracting business, and Y has been engaged in renting its commercial and residential real estate to unrelated third parties. All operational activities in connection with the rental business of Y have been performed by employees of X. X has paid its employees for these services and has been reimbursed by Y. The three officers of Y, who are also officers of P and X, supervise, control and direct the employees of X performing work for Y. The officers of Y receive no compensation from Y for the amount of their time devoted to the management and supervision of Y's affairs. These officers are paid only by P and X, and P and X have been reimbursed by Y for the services rendered by the officers to Y.

Y holds title to several commercial are residential rental buildings and associated realty. Y, through its officers and the employees of X, continuously seeks additional property of a similar nature for expansion of its rental business. When property is located, Y negotiates its purchase and required financing. Y is primarily obligated on the mortgages relating to its property and pays the principal and interest due thereon. Newly acquired buildings are renovated or altered so as to reflect the design by Y of custom floor plans that make the property suitable for rental. Existing property is periodically repainted and refurbished by Y. Y endeavors to keep its property rented at all times, and when new property is available or when existing property is vacated, Y immediately advertises to attract new tenants. Y verifies the information contained in a prospective tenant's application and negotiates the lease provisions. Pursuant to the terms of its leases, Y provides and pays for gas, water, electricity, sewage, and insurance for the property and pays the taxes assessed thereon. Moreover, Y is obligated under the lease agreement to provide day-to-day maintenance and repair services. These services include insect control, janitorial service, trash collection, ground maintenance, and heating, air conditioning and plumbing

maintenance. Y routinely inspects its properties. Separate records and accounts are maintained by Y to reflect income and expenses relating to each of Y's rental properties as well as Y's general expenses. The above described activity of Y in acquiring, renovating, refurbishing, maintaining, servicing and leasing its rental property is accomplished under the supervision and control of Y's officers using the employees of X.

For valid business reasons, P proposes to distribute all of the Y stock to one of its shareholders solely in exchange for all of that shareholder's P stock in a transaction intended to meet the requirements of section 355(a). The fair market value of the Y stock to be distributed and the P stock to be surrendered in the exchange are equal. After the proposed distribution, Y will continue its rental activities as discussed above, and will directly employ, on a full time basis, most of those employees who have worked on its behalf prior to the distribution.

In Rev. Rul. 75-160, the IRS announced that pending issuance of revised regulations under section 355, it will resolve cases involving the active trade or business requirement of section 355(b) in accordance with the decisions in *Rafferty v. Commissioner*, 452 F.2d 767 (1st Cir. 1971), cert. denied 408 U.S. 922 (1972); *United States v. Marett*, 325 F.2d 28 (5th Cir. 1963); and *Commissioner v. Coady*, 289 F.2d 490 (6th Cir. 1961). In *Rafferty*, the court concluded that "in order to be an active trade or business under section 355 a corporation must engage in entrepreneurial endeavors of such a nature and to such an extent as to qualitatively distinguish its operations from mere investments. Moreover, there should be objective indicia of such corporate operations."

Consistent with this approach Y will be considered to be engaged in an active trade or business following distribution of the Y stock. In a qualitative sense Y's conduct of its rental activities demonstrates considerable day to day management and operational activity sufficient for purposes of distinguishing such conduct from passive investment in real estate. Furthermore, objective criteria such as Y's acquiring, renovating, refurbishing, maintaining, leasing and servicing its rental property, and its payment of salaries and expenses support this conclusion. Y's conduct of its rental operations prior to the distribution of Y stock cannot be qualitatively or objectively distinguished from its conduct of such operations subsequent to the distribution, except for the fact that prior to the distribution Y performed its activities through employees of X and had no employees of its own other than its officers, who served without compensation from Y. However, prior to the distribution, Y had no salaried employees in connection with its rental activities, unlike the situation that exists following the distribution.

The court in *Rafferty* considered the absence of salaried employees to be one of several objective factors tending to prove a corporation is not engaged in the active conduct of a trade or business within the meaning of section 355(b). However, the *Rafferty* approach to the active trade or business issue necessarily requires that consideration be given to all the surrounding facts and circumstances of a particular case. No one factor should be considered determinative. The only factor tending to prove the lack of a predistribution active trade or business conducted by Y is the absence of salaried employees of Y. Given the nature of Y's conduct of its pre-distribution rental operations, and the existence of substantial objective factors discussed above that otherwise adequately demonstrate the active conduct of a trade or business, Y's failure to have salaried employees should not, without more, result in failure to meet the active trade or business requirement of section 355(b). However, the presence or absence of formal employment of employees other than officers, in the distributing corporation or the controlled corporation will be one factor for consideration in making this determination under section 355(b).

Based on all the facts and circumstances, Y was engaged in the active conduct of a trade or business within the meaning of section 355(b) for the five year period preceding distribution of its stock, notwithstanding the fact that during that period it had no employees other than its officers. Moreover, Y will be engaged immediately after the distribution in the active conduct of a trade or business. See also Rev. Rul. 80-181.

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