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USE OF INTERNAL REVENUE CODE SECTION 355 TO SEPARATE SHAREHOLDER INTERESTS IN CROSS-OWNERSHIP SITUATIONS

by J. Timothy Philipps & Gregg D. Hackethal***

I. BACKGROUND

Section 355 of the 1954 Internal Revenue Code (IRC)[1] provides that a shareholder of a distributing corporation shall not recognize gain or

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1. With respect to the distribution of stock and securities of a controlled corporation, I.R.C. § 355 provides:

(a) **Effect on distributees.—**

(1) **General rule.—If—**

(A) a corporation (referred to in this section as the "distributing corporation")—

(i) distributes to a shareholder, with respect to its stock, or

(ii) distributes to a security holder, in exchange for its securities, solely stock or securities of a corporation (referred to in this section as "controlled corporation") which it controls immediately before the distribution,

(B) the transaction was not used principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both (but the mere fact that subsequent to the distribution stock or securities in one or more of such corporations are sold or exchanged by all or some of the distributees (other than pursuant to an arrangement negotiated or agreed upon prior to such distribution) shall not be construed to mean that the transaction was used principally as such a device),

(C) the requirements of subsection (b) (relating to active businesses) are satisfied, and

(D) as part of the distribution, the distributing corporation distributes—

(i) all of the stock and securities in the controlled corporation held by it immediately before the distribution, or

(ii) an amount of stock in the controlled corporation constituting control within the meaning of section 368(c), and it is established to the satisfaction of the Secretary that the retention by the distributing corporation of stock (or stock and securities) in the controlled corporation was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax,

then no gain or loss shall be recognized to (and no amount shall be includible in the income of) such shareholder or security holder on the receipt of such stock or securities.

loss upon the receipt of stock in another corporation if the following conditions are satisfied:

(1) The corporation distributes to one or more of its shareholders, with respect to their stock, all of the stock of another corporation which the distributing corporation controlled immediately prior to the distri-

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(2) **Non pro rata distributions, etc.**— Paragraph (1) shall be applied without regard to the following:

(A) whether or not the distribution is pro rata with respect to all of the shareholders of the distributing corporation,

(B) whether or not the shareholder surrenders stock in the distributing corporation, and

(C) whether or not the distribution is in pursuance of a plan of reorganization (within the meaning of section 368(a)(1)(D)).

(3) **Limitation.**—Paragraph (1) shall not apply if—

(A) the principal amount of the securities in the controlled corporation which are received exceeds the principal amount of the securities which are surrendered in connection with such distribution, or

(B) securities in the controlled corporation are received and no securities are surrendered in connection with such distribution.

For purposes of this section (other than paragraph (1)(D) of this subsection) and so much of section 356 as relates to this section, stock of a controlled corporation acquired by the distributing corporation by reason of any transaction which occurs within 5 years of the distribution of such stock and in which gain or loss was recognized in whole or in part, shall not be treated as stock of such controlled corporation, but as other property.

(4) **Cross reference.**—

For treatment of the distribution if any property is received which is not permitted to be received under this subsection (including an excess principal amount of securities received over securities surrendered), see section 356.

(b) **Requirements as to active business.**—

(1) **In general.**—Subsection (a) shall apply only if either—

(A) the distributing corporation, and the controlled corporation (or, if stock of more than one controlled corporation is distributed, each of such corporations), is engaged immediately after the distribution in the active conduct of a trade or business, or

(B) immediately before the distribution, the distributing corporation had no assets other than stock or securities in the controlled corporations and each of the controlled corporations is engaged immediately after the distribution in the active conduct of a trade or business.

(2) **Definition.**—For purposes of Paragraph (1), a corporation shall be treated as engaged in the active conduct of a trade or business if and only if—

(A) it is engaged in the active conduct of a trade or business, or substantially all of its assets consist of stock and securities of a corporation controlled by it (immediately after the distribution) which is so engaged,

(B) such trade or business has been actively conducted throughout the 5-year period ending on the date of the distribution,

(C) such trade or business was not acquired within the period described in subparagraph (B) in a transaction in which gain or loss was recognized in whole or in part, and

(D) control of a corporation which (at the time of acquisition of control) was conducting such trade or business—

(i) was not acquired directly (or through one or more corporations) by another corporation within the period described in subparagraph (B), or

(ii) was so acquired by another corporation within such period, but such control was so acquired only by reason of transactions in which gain or loss was not recognized in whole or in part, or only by reason of such transactions combined with acquisitions before the beginning of such period.

bution.[2]

(2) Both the distributing and controlled corporations, immediately after the distribution, are engaged in the active conduct of a trade or business.[3] Such trade or business has to have been conducted actively throughout the five-year period ending on the date of distribution;[4] it cannot have been acquired within the five-year period in a taxable transaction;[5] and it may not have been conducted by another corporation the control of which was acquired directly or indirectly by the distributing corporation in a taxable transaction during the five-year period.[6]

(3) The transaction is not being used principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both.[7]

Both section 355 and its predecessor under the 1939 Code[8] have proven to be a fertile source of disagreement and litigation between taxpayers and the Commissioner. However, the majority of reported cases and revenue rulings have centered on the control and active business requirements and although the courts and the Service have dealt with the device restriction on numerous occasions, one common factual situation has not been considered adequately, namely, that in which two or more shareholders own all of the stock, in varying porportions, of more than one corporation. This situation is often termed cross-ownership.

To take a simple example, assume that two shareholders, X and Y, own all of the stock, in varying proportions, in three separate corpora-

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2. *Id.* § 355(a)(1)(D)(i). The corporation may also distribute an amount of stock constituting "control" (as defined by § 368(c)) of such other corporation if it is established to the satisfaction of the Secretary that retention of the remaining shares by the distributing corporation was not pursuant to a plan having as one of its principal purposes the avoidance of federal income tax. *Id.* § 355(a)(1)(D)(ii).

3. *Id.* § 355(a)(1)(C), (b)(1)(A). In order to accommodate the holding company situation, corporations may also qualify as actively engaged in business if such active engagement occurs immediately after the distribution, and if immediately before the distribution, the distributing corporation had no assets other than stock or securities in the controlled corporations. *Id.* § 355(b)(1)(B).

4. *Id.* § 355(b)(2)(B).

5. *Id.* § 355(b)(2)(C).

6. *Id.* § 355(b)(2)(D).

7. *Id.* § 355(a)(1)(B).

> [T]he mere fact that subsequent to the distribution stock or securities in one or more of such corporations are sold or exchanged by all or some of the distributees (other than pursuant to an arrangement negotiated or agreed upon prior to such distribution) shall not be construed to mean that the transaction was used principally as such a device.

Id.

8. Int. Rev. Code of 1939, ch. 1, § 112(b), 53 Stat. 37 (1937) (now I.R.C. § 355).

tions, A, B and C. Each corporation has been involved actively in trade or business in excess of five years and has been owned by the two shareholders since its formation. Assume further that the two shareholders reach a point where, owing to either personal conflicts or irreconcilable differences of opinion over management of the enterprises, it becomes necessary for them to separate their interests in order to maintain the viability of the enterprises. To reach an equitable settlement and successfully continue in business, each shareholder requires assets from each of the three corporations. Consequently, a realignment of the assets scattered among the several corporations is necessitated.

Since the assets are in corporate solution, a direct distribution to the shareholders in complete liquidation would result in recognized gain or loss which normally would be treated as long-term capital gain or loss under IRC section 331.[9] Shareholders in such a situation commonly have a low basis in their stock and the corporate assets may be valued in millions of dollars; hence, this course of action would cause the shareholders to incur sizeable immediate personal tax liabilities. One possible solution is to attempt a division of the corporate assets tax-free under section 355. The problem, however, is that because the assets desired by each party are scattered among the three corporations, the control and active business requirements would be difficult, if not impossible, to fulfill. For example, the assets of corporation A which are desired by shareholder X may not constitute an active business in and of themselves; and if all of the assets of corporations A, B and C desired by shareholder X are transferred to a new corporation, D, to be split-off to X, then either two or all three of the distributing corporations will fail to be in control of D. Failure to meet either the active business or control requirements would, of course, preclude use of section 355.

II. SUGGESTED APPROACH

The approach presented in this article may serve to resolve this problem in application of section 355 and thereby obtain nonrecognition benefits for transactions such as the one discussed above. In order to effect this tax-free realignment of shareholder interests, the following transactional sequence is suggested:

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9. I.R.C. § 331 provides in relevant part:

(a) General rule.-

(1) Complete liquidations.—Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock.

(1) The existing corporations, A, B and C, would merge into a single corporation which would remain as the survivor. This transaction would receive nonrecognition treatment as a section 368 statutory merger.[10] Under the terms of the merger, the shareholders would maintain the same proportionate interests in the new corporation as they held in the three previously existing corporations.

(2) The new corporation would transfer to a newly organized subsidiary the assets necessary for one shareholder, say shareholder X, to satisfy his proportionate interest and to conduct a separate business in exchange for all of the stock of the subsidiary. This transaction would be tax-free under section 361[11] as a section 368 reorganization[12] or, in

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10. *Id.* § 368 provides in relevant part:

(a) Reorganization.—

(1) In general.—For purposes of parts I and II and this part, the term "reorganization" means—

(A) a statutory merger or consolidation;

(B) the acquisition by one corporation, in exchange solely for all or a part of its voting stock (or in exchange solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation), of stock of another corporation if, immediately after the acquisition, the acquiring corporation has control of such other corporation (whether or not such acquiring corporation had control immediately before the acquisition);

(C) the acquisition by one corporation, in exchange solely for all or a part of its voting stock (or in exchange solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation), of substantially all of the properties of another corporation, but in determining whether the exchange is solely for stock the assumption by the acquiring corporation of a liability of the other, or the fact that property acquired is subject to a liability, shall be disregarded;

(D) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor, or one or more of its shareholders (including persons who were shareholders immediately before the transfer), or any combination thereof, is in control of the corporation to which the assets are transferred; but only if, in pursuance of the plan, stock or securities of the corporation to which assets are transferred are distributed in a transaction which qualifies under section 354, 355, or 356;

(E) a recapitalization; or

(F) a mere change in identity, form, or place of organization, however affected.

Although the choice of survivor may not normally be of great concern from a business standpoint, that choice is significant here in order to avoid application of the "step transaction" doctrine and afford the greatest chance for nonrecognition treatment. *See* note 14 *infra* and accompanying text. Therefore, the surviving corporation should be one which will continue in existence following the split-off as described in step (3) *infra*.

Alternatively, the shareholders might cause one of the corporations to exchange its stock for shares held by the shareholders of the remaining corporations. The controlled corporations then would transfer their assets to the controlling corporation. This transfer would qualify as either a *B* reorganization followed by a § 332 liquidation or, most likely, as a *C* reorganization. *See* Rev. Rul. 67-274, 1967-2 C.B. 141.

11. I.R.C. § 361 provides in relevant part:

No gain or loss shall be recognized if a corporation a party to a reorganization ex-

the alternative, under section 351 as a transfer to a controlled corporation.[13]

(3) The new corporation would then distribute the subsidiary's stock to shareholder X in exchange for all of his stock of the parent corporation.

The net result of the above transactions is in literal compliance with all of the requirements of section 355 and successfully separates the shareholders' business interests. The transactions are not a device for the distribution of earnings and profits of the distributing or the controlled corporations, because all of the assets of the original three corporations continue to be employed productively in corporate solution. In substance, all that has occurred is a realignment and separation of the shareholders' business interests. No bailout has occurred.

III. Difficulties with the Approach

The primary obstacle to successful implementation of the approach outlined above is the "step transaction" doctrine. Under this doctrine a series of related transactions are treated as a single transaction for tax purposes. As applied to section 355 transactions, the doctrine is embodied in Treasury Regulation section 1.355-3(a)[14] which states that

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changes property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation a party to the reorganization.

12. *Id.* § 368(a)(1)(D). *See* note 10 *supra*.

13. *Id.* § 351 provides in relevant part:

> No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation. For purposes of this section, stock or securities issued for services shall not be considered as issued in return for property.

14. Treas. Reg. § 1.355-3(a) provides:

> The rule of section 355(a)(1) prescribing that gain or loss will not be recognized applies whether or not the distribution is pro rata with respect to the interests of all the shareholders in the distributing corporation provided all other requirements of section 355 are satisfied. For example, if two individuals, A and B, own all of the stock of Corporation X which operates two active businesses, one business may be transferred to a new corporation in exchange for all of its stock and such stock distributed to either A or B in exchange for all of his stock of Corporation X. Similarly, if, in the above example, only a part of the stock of the new corporation is transferred to one of the shareholders in exchange for all of his stock of Corporation X and the balance of such stock is distributed to the other shareholder (whether or not such other shareholder surrenders stock in Corporation X), no gain or loss will be recognized. The same rule will be applicable if the stock of an existing controlled corporation is distributed to the shareholders even though such distribution is not pursuant to a plan of reorganization. Section 355 does not apply, however, if the substance of the transaction is merely an exchange between shareholders or security holders of stock or securities in one corporation for stock or securities in another corporation. For example, if two individuals, C and D, each own directly fifty percent of the stock of Corporation M and fifty percent of the stock of Corporation N, section 355 would not apply to a transaction in which C and D transfer all of their stock in Corporation M and Corporation N to a new corpora-

the nonrecognition benefits of section 355 are not available to a shareholder if the substance of a transaction is merely an exchange between shareholders of the stock of one corporation for the stock of another corporation. The Treasury Regulation sets forth the following example:

> [I]f two individuals, C and D, each own directly fifty percent of the stock of Corporation M and fifty percent of the stock of Corporation N, section 355 would not apply to a transaction in which C and D transfer all of their stock in Corporation M and Corporation N to a new Corporation, P, for all of the stock in Corporation P, and Corporation P then distributes the stock of Corporation M to C and the stock of Corporation N to D.[15]

In essence, this regulation states that if the same end will result if the shareholders' simply exchange their respective stock interests in the existing corporations, then a series of steps altering the form but not the substance of the transaction will not satisfy the requirements of section 355.

If the approach suggested here was implemented, it is possible that the Internal Revenue Service would contend that the preliminary merger, formation of a subsidiary, and subsequent split-off should be collapsed and disregarded under the step transaction doctrine. If the Service was successful, the result would be disqualification of the plan from section 355 nonrecognition benefits. Consequently, the distribution of assets would be taxable to the shareholders.

A. *Judicial Treatment of Similar Plans*

This was the principal argument advanced by the Service and rejected by the tax court, on similar facts, in the leading case of *Albert W. Badanes*.[16] In that case, the taxpayer and another individual owned equally the stock in two separate corporations. One corporation, Barq Bottle Co., Inc. (Barq-Cincinnati), was engaged in the bottling and distributing business through two plants, one in Cincinnati, Ohio and one in Portsmouth, Ohio. The other corporation, Fort Washington Realty Co. (Realty Company), owned and leased to Barq-Cincinnati real estate and commercial buildings which were used in Barq-Cincinnati's bottling business. The two shareholders experienced conflict in the management of Barq-Cincinnati and decided to divide their business

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> tion, P, for all of the stock of Corporation P, and Corporation P then distributes the stock of Corporation M to C and the stock of Corporation N to D.

Id.

Proposed Treas. Reg. § 1.355-4 (Jan. 1977) restates the principal of § 1.355-3(a) without significant change.

15. Treas. Reg. § 1.355-3(a).

16. 39 T.C. 410 (1969).

interests. The shareholders reached an agreement to accomplish the separation according to the following plan:

(1) The shareholders made capital contributions to Barq-Cincinnati in the form of their Realty Company stock.

(2) A new corporation, Barq Bottling Co. of Portsmouth (Barq-Portsmouth), was formed and, in exchange for all of its shares, received from Barq-Cincinnati all of the shares of the Realty Company, approximately $79,000 in cash, and all of the operating assets of what had been the Portsmouth division of Barq-Cincinnati. In short, Barq-Cincinnati became the sole owner of Barq-Portsmouth which was in turn the sole owner of the Portsmouth operations and the sole stockholder of the Realty Company.

(3) Barq-Cincinnati then distributed to the taxpayer all of the shares of Barq-Portsmouth in exchange for all of his shares in Barq-Cincinnati. The result was a separation of the two shareholders' business interests; the taxpayer was in control of the Portsmouth operations (and the Realty Company) and his former associate was in control of the Cincinnati operations.

Following the foregoing transactions, both Barq-Cincinnati and Barq-Portsmouth continued to actively carry on their respective bottling and distributing businesses. The Realty Company continued to own the same assets that it owned prior to the reorganization, and it leased the assets to Barq-Cincinnati and Barq-Portsmouth. All of the assets originally involved continued to be employed in corporate solution and in the active conduct of a business. Nonetheless, the Commissioner, applying the step transaction doctrine and citing Treasury Regulation section 1.355-3(a), contended that the transactions did not qualify for nonrecognition under section 355. He asserted that in substance nothing more than a stock swap had occurred in which the taxpayer had exchanged his bottling corporation stock for stock of the realty corporation.[17] The court rejected this argument stating that the facts assumed by the Commissioner with respect to the identity of the stock exchanged were contrary to the facts outlined above. The court stated: "In our view, the *substance* of what was done coincides with the facts . . . ."[18] The court held:

> The principal purpose of the transactions was to enable two businessmen, who could no longer agree between themselves as to the proper means for advancing their common business interest, to separate their interests and thereafter conduct through two corporations the businesses which they

17. *Id.* at 416.
18. *Id.* (emphasis added).

> had theretofore conducted through the use of a single corporate entity. We believe that such purpose was a sound and valid business purpose; and that the clear implication of the *Coady* case is that Congress, in enacting section 355, intended to provide a means whereby a separation motivated by such a purpose could be accomplished without the deterrent effect of being subjected to tax. Moreover, there is no evidence herein that the principal purpose of the transactions involved was other than the business purpose above mentioned . . . .[19]

In essence, the court viewed the initial transfer of the Realty Company shares as merely preparatory to the ultimate division of the business. The court recognized that a simple exchange of the Barq-Cincinnati and the Realty Company stock between the shareholders would not have been effective in equitably separating their business interests. Before practical division could be accomplished, it was necessary for their mutually owned assets to be consolidated under the umbrella of one corporation, and this is precisely what the court allowed. Therefore, the substance of the overall transaction was not merely an exchange of the shareholders' pre-existing interests.

Badanes was distinguished by the tax court in *Portland Manufacturing Co.*[20] In that case, Portland Manufacturing Co. (Portland) and Simpson Redwood Co. (Simpson) each owned 50% of the stock of Springfield Lumber Mills (Springfield). In addition, they each owned a 50% interest in an unincorporated joint venture, Albany Plylock (Plylock). Differences of opinion developed as to how the Springfield and Plylock businesses were to be conducted, and Portland and Simpson decided to separate their interests. To achieve this end, the following sequence of events occurred over a period of three weeks:

(1) Simpson organized the Albany-Plylock Corp. (APC).

(2) Simpson and Portland each transferred their one-half interests in the Plylock joint venture to Springfield.

(3) Springfield then transferred the Plylock assets to APC in exchange for all of its stock and proceeded to distribute the APC stock to Simpson in exchange for its Springfield stock.

(4) Simpson immediately liquidated APC and absorbed all of the assets of the old Plylock joint venture into its own corporate structure.

The final result of these transactions was that Simpson became the sole owner of the Plylock assets and Portland became the sole owner of the stock of Springfield.

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19. *Id.* at 415.
20. 56 T.C. 58, *aff'd,* 75-1 U.S.T.C. § 9449 (9th Cir. 1975).

The Commissioner attacked these transactions under the step transaction doctrine and alleged that a mere exchange of ownership interests, as had occurred, was ineligible for nonrecognition treatment under section 355.[21] The taxpayer relied on the reasoning of *Badanes*, but the court held that case inapposite stating that it primarily involved the separation of two bottling businesses which were already being conducted by one corporation, the transfer of the Realty Company shares being merely incidental to the main transaction.[22] Further, the court recognized that *Portland* presented a dissimilar factual situation. The court explained:

> Simply put, there was an exchange of interests, and the various steps taken to arrive at the final settlement were but component parts of a single transaction . . . . What took place was an exchange of interests and not simply a capital contribution followed by a redemption or a split-off.[23]

In short, unlike the facts in *Portland* "[h]ere the *substance* of the transaction was an exchange of interests."[24] This precise result could have been obtained had Portland simply exchanged its interest in the Plylock venture for Simpson's interest in Springfield and vice versa.

A similar situation faced the tax court in *James Kuper*.[25] Three brothers, Charles, James and George Kuper, owned equal shares in the stock of Kuper Volkswagen, an automobile dealership. They also held, pro rata, all of the stock of Kuper Enterprises, a realty company which leased land and buildings to Kuper Volkswagen. James and George disagreed over the management of the dealership. Consequently, George arranged to acquire a Volkswagen dealership in another state. In order to separate their existing business interests the three brothers engaged in the following transactions:

(1) Each of the three brothers contributed his one-third stock interest in Kuper Enterprises to Kuper Volkswagen's capital.

(2) Kuper Volkswagen made a capital contribution of $42,513.54 to Kuper Enterprises.

(3) Kuper Volkswagen exchanged its 100% ownership of Kuper Enterprises for George's one-third ownership of Kuper Volkswagen.

The result was that George owned 100% of Kuper Enterprises while James and Charles each owned 50% of Kuper Volkswagen. As in

21. *Id.* at 81.

22. *Id.* at 78. The Ninth Circuit did not deal with this contention in its 1975 affirming opinion.

23. *Id.* at 77, 79.

24. *Id.* at 79 (emphasis added).

25. 61 T.C. 624 (1974), *aff'd*, 533 F.2d 152 (5th Cir. 1976).

Portland, the Commissioner asserted the step transaction doctrine and successfully argued that the substance of the transaction was merely an exchange of stock among the three brothers.[26] The tax court observed that the transactional formalities of the capital contributions and the stock redemptions were "simply steps in a circuitous route deliberately taken in the futile hope of disguising the fundamental nature of the underlying stock-for-stock exchange transaction at the shareholder level."[27] As in *Portland*, the shareholders could have attained the same result by merely exchanging their interests in the existing corporations.

Portland and *Kuper* are similar to *Badanes* in that all of the original assets continued to be actively employed in corporate solution and no bailout had occurred. However, the similarity ends there. In *Portland* and *Kuper*, a straightforward exchange of stock between the shareholders would have accomplished the same result as the circuitous steps actually taken. By contrast, an exchange of stock by the shareholders in *Badanes* would not have served the purpose of separating their business interests. Read together, the three cases suggest that if a series of transactions is collapsed under the step transaction doctrine and the result is analogous to a stock swap as proscribed by Treasury Regulation Section 1.355-3(a), then the courts will observe substance over form and deny shareholders the nonrecognition benefits of section 355. On the other hand, nonrecognition treatment may be afforded if valid business purposes are present and if the shareholders could not achieve the desired apportionment of assets by merely exchanging existing stock in order to eliminate cross-interest ownership of the separate corporate entities. In such a case the necessity of adjustments prior to a division of the shareholders' interests will be recognized by the courts and thus will not prove to be an insurmountable barrier to obtaining the benefits of section 355. As emphasized by the court in all three of these cases, substance will govern over form.

Citing *Gregory v. Helvering*,[28] the court in *Portland* reaffirmed that "a taxpayer has the right to arrange his affairs so as to reduce the amount of tax incident to a transaction."[29] However, emphasizing the importance of substance over form, the court explained that "this means a taxpayer may resort to tax planning, and not alchemy whereby

26. *Id.* at 630.

27. *Id.* The court distinguished *Portland* on the basis that the distributing corporation in *Kuper* was not a newly created entity, but regarded the distinction as insignificant. *Id.*

28. 293 U.S. 465 (1935).

29. 56 T.C. at 77.

mixing a brew of incorporation, conveyance, and liquidation, and incanting the language of deeds, bills of sale, and corporate minutes, a taxable exchange is changed into a tax-free reorganization."[30] This language was quoted by both the tax court[31] and the court of appeals[32] in their respective opinions in the *Kuper* case. But the court of appeals recognized that some factual situations may arise in which application of the *Portland-Kuper* rationale might be inappropriate. The court stated:

> As a general matter, it is important to emphasize that we are not saying that the exigencies of business finance can never legitimize the taxpayers' choice of a route different from that favored by the Internal Revenue Service, or that in arranging business dealings taxpayers have no flexibility in structuring their transactions as their judgement deems best . . . . Because the background circumstances vary so greatly from case to case, we are unable to draw a single bright line separating in all instances unacceptable artifice from valid tax planning.[33]

The plan suggested here most certainly falls on the "valid tax planning" side of the line.

B. The Internal Revenue Service Position

On a number of occasions, the Internal Revenue Service has accepted this principle and has recognized that necessary corporate adjustments frequently must be made so that a split-off may qualify for nonrecognition under section 355.

In Revenue Ruling 56-117,[34] the Service allowed nonrecognition under section 355 to dissenting shareholders of a parent corporation who had exchanged their stock of the parent for stock of a subsidiary previously controlled by the parent. However, prior to the split-off, the following transactions occurred:

(1) In order to equalize the value of the stock exchanged, the parent transferred cash to its subsidiary as a capital contribution.

(2) The subsidiary issued additional shares of its common stock in exchange for its outstanding preferred shares owned by shareholders other than the parent. As a result, the parent, which owned 100% of the common and 12% of the preferred prior to the issuance, owned 93% of the common and 100% of the preferred after the issuance. This enabled the parent to meet the control requirement of section 355.

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30. *Id.*
31. 61 T.C. at 630.
32. 533 F.2d at 158.
33. *Id.* at 159.
34. Rev. Rul. 56-117, 1956-1 C.B. 180.

Although the split-off could not have qualified under section 355 without the prior transactions, the Service did not attempt to collapse those transactions under the step transaction doctrine.[35] The apparent rationale was that the steps had true economic significance which effectuated changes of an enduring nature rather than mere transitory or ephemeral ones.

The Service also allowed nonrecognition under section 355 in Revenue Ruling 70-18,[36] where state law required corporate adjustments prior to a split-off. A, an individual, owned all of the outstanding stock of corporations X and Y which owned 40% and 60%, respectively, of corporation Z. State law required the elimination of X's ownership of Z's stock. Corporation Y merged into X, giving X control over Z, whereupon X distributed all of the outstanding stock of Z to A. The Service, again emphasizing economic reality, found that sufficient business reasons existed to establish that the merger had a substantial business purpose and stressed that "there was a continuity of the entire business enterprise under modified corporate form and a continuity of interest therein by those persons who, directly or indirectly, were the owners of the enterprise prior to the exchange and distribution . . . ."[37]

The same result was reached in Revenue Ruling 71-593[38] on different facts. A and B, two individuals, each owned 50% of the stock of corporation X. They also owned 25% and 75%, respectively, of the stock of corporation Y. For valid corporate business purposes, A and B decided to separate their interests. A was to own all of the stock of Y and B was to own all of the stock of X. In order to equalize the value of their interests after the division, X transferred some of its assets to Y in exchange for newly issued stock of Y. As a result, X owned 90% of the Y stock. Corporation X then transferred all of its Y stock to A in exchange for all of A's stock of X. Following these transactions, A owned all of the Y stock and B owned all of the X stock. The Service did not attempt to collapse the transactions under the step transaction doctrine. The step which gave X control over Y was viewed as a meaningful exchange because it was value-for-value and necessary in

35. The same rationale was applied in Rev. Rul. 69-407, 1969-2 C.B. 50, in which a recapitalization occurred prior to a split-off. The recapitalization did not change the proportionate economic interests of the shareholders; rather, it served to alter the shareholders' proportionate voting rights in the controlled corporation so that the distributing corporation could meet the control requirements of § 355.

36. Rev. Rul. 70-18, 1970-1 C.B. 75.

37. *Id.*

38. Rev. Rul. 71-593, 1971-2 C.B. 181.

order to equalize the values of the stocks to be received and surrendered by A. The Service realized that a mere exchange between A and B of their existing interests would not achieve the desired result and recognized the validity and necessity of the corporate adjustments prior to the split-off.

In all of these rulings, the key factor seems to have been that the pre-split-off adjustment continued to have economic significance following the split-off. For example, in Revenue Ruling 70-18 the merged corporation, X, continued in existence after the split-off; therefore, the merger was more than a mere transitory step.

The Service also has allowed the employment of pre-split-off adjustments to satisfy the active business requirement of section 355. In Revenue Ruling 74-79,[39] corporation X owned all of the outstanding stock of corporations M and N, each of which was engaged in the active conduct of a business. Corporation X, which never directly engaged in active business itself, liquidated corporation M and distributed the stock of N to the shareholders of X. The Service found that the distribution qualified for nonrecognition and viewed the liquidation as a valid step taken in order for X to meet the active business requirement of section 355.

Furthermore, the Service has allowed nonrecognition in a transaction resembling that in *Badanes*. In Revenue Ruling 77-11,[40] individuals A and B each owned 50% of corporations X and Y, both of which were engaged actively in the construction business. The net worth of X substantially exceeded that of Y. For valid business purposes, A and B decided to separate their business interests. Corporations X and Y each transferred one half of their assets to a new corporation, Z, in exchange for its stock. (Corporation X, due to its relative size, owned more than 80% of the outstanding shares of Z.) The stock of Z was then distributed to individual B in exchange for his stock of X and Y corporations. As a result, A owned all of the stock of X and Y, and B owned all the stock of Z. All three corporations continued to be actively engaged in the construction business following the transaction. The exchange by B of his X stock for Z stock qualified for nonrecognition under section 355.[41] The Service did not apply the step transaction doctrine and stated that Treasury Regulation § 1.355-3(a) was inapplicable for two reasons: (1) Corporation Z was not utilized to

39. Rev. Rul. 74-79, 1974-1 C.B. 81.

40. Rev. Rul. 77-11, 1977-1 C.B. 93.

41. The exchange by B of his stock of Y for the remainder of the Z stock was taxable to B because Y did not control Z within the meaning of § 355.

disguise a stock exchange at the shareholder level because Z received operating assets to be used in its business, and (2) there was no exchange of stock by A who continued as a shareholder of X and Y. The Service recognized that in substance there was no exchange of stock between A and B and, therefore, that the transaction qualified under section 355. The exchange by B of his Y stock was treated as a section 302 redemption rather than a section 355 split-off because Y did not satisfy the control test.

In each of the factual situations in the above revenue rulings, the corporate adjustments prior to the split-off had substantial economic significance beyond their tax consequences. The *substance* of each transaction was to effect a permanent realignment of the shareholders' interests. At the same time, the assets of the original corporate entities continued to be utilized actively in a trade or business in modified corporate form. When these elements are present in a given transaction, corporate adjustments made in order to qualify for nonrecognition under section 355 should not be vulnerable to collapse under the step transaction doctrine.

This principle has been accepted by both the courts and the Service in the situation in which a split-off *precedes* a merger. In *Commissioner v. Morris Trust,*[42] a state and a national bank consolidated under the national bank's charter. Before the merger could occur, federal law required the state bank to divest itself of an insurance brokerage business which it had been operating. The state bank organized a new corporation to which it transferred the insurance business in exchange for all of the corporation's stock. The corporation's stock was then immediately distributed to the bank's shareholders. The Commissioner argued that the state bank was not engaged actively in the conduct of a trade or business immediately after the merger and, therefore, the distribution did not qualify for nonrecognition under section 355. The court rejected this assertion stressing the fact that there was a strong business purpose for both the split-off and the merger and no tax avoidance purpose was involved. The court held that the technicality of the identity of the surviving corporation was irrelevant.[43] In Reve-

42. 367 F.2d 794 (4th Cir. 1966).

43. The court refused to follow the Sixth Circuit's decision in Curtis v. U.S., 336 F.2d 714 (6th Cir. 1964). In *Curtis*, nonrecognition treatment was denied shareholders on their receipt of the stock of an unwanted subsidiary which had been spun off by the parent corporation prior to the parent's merger with a third corporation. The court held that the parent was not engaged in the active conduct of a trade or business immediately after the distribution because the parent did not survive the merger.

nue Ruling 68-603,[44] the Service elected to follow this decision to the extent that it held that the active business requirements of section 355 were satisfied even though the distributing corporation, immediately after the split-off, merged into another corporation.

This decision is a reaffirmation of the principle that valid business reasons and the absence of a tax avoidance purpose are especially significant in corporate reorganization. The merger would not have been possible without the prior split-off. The court's logic is equally applicable to the situation in which, for valid business purposes, two businessmen are unable to untangle their assets spread out among several corporations, unless a merger precedes a split-off. A mere ordering of transactions should not cause different tax results if the assets remain in corporate solution and no bailout potential exists.

In a non pro rata split-off such as that postulated here, the underlying premises of section 355 are satisfied. Both the control and active business requirements are met. In addition, the transaction is not used as a device for the distribution of the earnings and profits of either the distributing corporation or the controlled corporation. The assets remain actively employed in corporate solution and no bailout occurs. All that transpires, in *substance*, is a mere realignment of the shareholders' interests in the various corporate assets, a result which could not have been accomplished by an exchange of stock. The underlying premise of the corporate reorganization provisions, continuity of the shareholder investment in modified corporate form, is satisfied. Since the step transaction doctrine is basically one of the several vague and nebulous doctrines, the purpose of which is to deter those taxpayer avoidance devices not in accord with the underlying premises of the Code, the doctrine should not be applied in this factual situation, either alone or in conjunction with Treasury Regulation section 1.355-3(a).[45]

IV. CONCLUSION

The possible tax consequences of a decision to go ahead with the suggested plan should be the final consideration in split-off situations involving corporations that are the subjects of cross-ownership. The following questions should be addressed when an analysis of tax conse-

44. Rev. Rul. 68-603, 1968-2 C.B. 148.

45. Doubt may be cast upon the validity of Treas. Reg. § 1.355-3(a). There is nothing specific in the text of § 355 which supports the regulation when the transaction is other than a mere avoidance device. And if the underlying premises of the reorganization provisions are complied with, there is no reasonable ground upon which to deny a taxpayer the benefits of § 355 merely because he could have taken a more expensive tax route.

quences is undertaken: 1) What results if the plan is not undertaken? 2) What results if it is undertaken and successful? 3) What results if it is undertaken and fails?

As to the first question, *i.e.*, the parties definitely have decided to separate but not to undertake the plan, the most obvious alternative to the section 355 split-off would be a direct distribution of corporate assets to some or all of the shareholders. Such a distribution most probably would trigger a capital gain tax to the shareholders under either sections 302, 331 or 346 of the Internal Revenue Code.[46]

On the other hand, if the suggested plan is attempted and successful, the separation can be achieved without any immediate recognition of gain to either the shareholders or the corporation.

If the suggested plan is attempted and fails to qualify for nonrecognition treatment under section 355, the shareholders will be in no worse a position than they would have been had they decided not to go ahead with the plan at all. In this case, the distribution of the stock to the shareholder receiving the split-off corporation stock would be considered a taxable distribution. However, because the distributee in this situation is giving up his stock in the distributing corporation, the distribution would be the equivalent of either a section 302 or section 346 transaction. The distributee shareholder would incur a capital gain tax and the amount realized would be equivalent to the value of the assets represented by the stock distributed to the shareholder. This amount would be reduced by the shareholder's basis in the stock he surrendered to the distributing corporation. The resulting amount represents the taxable gain. This is what the shareholder's tax liability would have been had the assets been distributed to him directly. As to the non-distributee shareholder, no immediate tax on the transaction should be incurred. There is no receipt of a distribution from any of the corporations; rather, the non-distributee shareholder merely becomes the sole shareholder of the distributing corporation.[47] Therefore, if the plan fails, the shareholders will not be in any more of a detrimental position[48] than they would have been had they not at-

46. There may also be recapture problems for the corporation under I.R.C. § 1245.

47. Rev. Rul. 77-11, 1977-1 C.B. 93. *See* Holsey v. Commissioner, 258 F.2d 865 (3d Cir. 1958); Ray Edenfield, 19 T.C. 13 (1952), *acq.* Rev. Rul. 69-608, 1969-2 C.B. 43.

48. Except for the fact that the shareholders would not be eligible for installment treatment under I.R.C. § 453 because all of the consideration to the distributee presumably would be treated as paid in one year.

tempted the approach suggested by this article in the first instance. Moreover, given the possibility of success (or even of compromise in the event of an attack by the Service), it would seem well worth pursuing in many instances.