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Subchapter C of the Internal Revenue Code of 1954 III

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SUBCHAPTER C OF THE INTERNAL REVENUE CODE OF 1954

III. CORPORATE ORGANIZATIONS AND REORGANIZATIONS

The subject of corporate organizations and reorganizations is proverbially the most complicated in the revenue laws. Intricate as the statutory provisions themselves are, it is not in their literal application that the trouble lies, for, with one or two exceptions, this involves little more than the patient deciphering of precisely stated formulae; almost all the problems originate in the requirement that there must be compliance with the spirit as well as the letter of the law. The margins of the statute are filled with administrative and judicial gloss, which it is not possible and would not be desirable entirely to eliminate. While we may disagree with the standards of judgment employed in devising particular tests or disposing of particular cases, it is difficult to quarrel with the right to prevent perversions of the statute.

Yet a special taxpayer problem exists in this field, in the form of the practical necessity of obtaining advance approval by the Bureau of proposed transactions. Therefore, unfavorable Bureau interpretations, whether right or wrong, have more pronounced *in terrorem* effects in this area than in others, where the taxpayer is relatively free or may be compelled by circumstances to act on his own judgment and fight the matter out later, if need be. The same is true of what may be no more than a narrow ruling policy, set without reference to whether a serious attempt would be made to attack certain types of transactions which the Bureau is nevertheless not willing to encourage through advance approval.

So taxpayers and their advisers continue to grumble at the tyranny of the courts and the Bureau and to argue that the law ought to be made so clear that there is no room for interpretation. But as soon as there is a serious attempt to substitute mechanical rules for judgment rules, as, for example, relative to continuity of interest and business purpose, they shy away. This is because it then becomes evident that the price of certainty is a narrowing of the scope of permissible transactions. At once, as was said at the start of this article, the need for greater flexibility is stressed, and we return to the old set-up, with relatively minor changes in isolated areas where special problems capable of solution by rule of thumb have developed. The unfortunate thing is that this experience has to be constantly repeated. Presumably we are now at the trough, but as the remembrance of the House Bill fades we are sure to reach another peak with time. Nor is it to be supposed that absolute mathematical certainty would be possible even if taxpayers were willing to pay the price. In the very nature of the case, unless the policy of non-recognition were abandoned entirely, no amount of mathematical precision in definition will prevent instances of literal compliance from arising which the courts will feel they must defeat in the interests of public morality. The question is one of degree. Moreover, overparticularization must always fail, for no one knows enough to cover every case that can arise.

After more than a generation of specific statutory enactments on the subject of corporate organizations and reorganizations little time and attention need be given to the period prior to the Revenue Act of 1918, when the law was silent. Some attempts were made administratively to exclude a limited class of the property-for-stock or stock-for-stock exchanges involved in this area from the category of closed, or tax-generating, transactions, but it was soon decided that the problem was too big for anything but a legislative solution. The story of these pre-historic developments and the case law, which, though forming part of it, was handed down after the era of statutory treatment had begun,[1] is well summarized elsewhere.[2]

The two classes of transactions—corporate organizations and corporate reorganizations—involved in this part of our subchapter C analysis are quite different in their problems and the space devoted to them in the statute. A corporate organization is the mere conversion of direct ownership of property into indirect ownership, as upon the incorporation of a sole proprietorship or a partnership. A reorganization covers the broad field of the rearrangement of businesses already in corporate form, such as by merger, consolidation, division, migration of corporate charter, or recapitalization. In certain instances there may be an overlap between the two, but generally speaking they are separate. Most of the complications and almost all the evolution are to be found in the reorganization field, where the possible variations and opportunities for manipulation are virtually limitless as compared with the problems surrounding corporate organizations which, though basic, are relatively few. Nevertheless, at first blush, especially if the opportunities for rigging are ignored and a purely conceptual view is taken, there appears to be more reason for treating business rearrangements as mere paper transactions, at least from the shareholders' point of view, where there is no change in their form of ownership, *i.e.*, where the business is already in corporate form and remains in corporate form after the various shifts have been made, than there is where the comparatively radical change from the status of direct owner of a business to the status of shareholder is involved. At any rate, a non-rec-

1 United States v. Phellis, 257 U.S. 156 (1921); Rockefeller v. United States, 257 U.S. 176 (1921); Cullinan v. Walker, 262 U.S. 134 (1923); Weiss v. Stearn, 265 U.S. 242 (1924); Marr v. United States, 268 U.S. 536 (1925).

2 Paul, *Studies in Federal Taxation* 3 (3d Series 1940).

ognition provision covering corporate organizations took three years, or one revenue act, longer to appear in the tax laws than did the first feebly articulated provision relative to corporate reorganizations. And this is true despite the fact that both problems were raised at the same time. If either should have given Congress pause on the basis of potential difficulties it should have been the one dealing with reorganizations.

The subject of corporate organizations is covered by Section 351[3] of the new Code. On the surface it does not appear much different from its predecessor, Section 112(b)(5) of the old Code, which ran back to the Revenue Act of 1921,[4] and in the general run of cases its effect is the same. What it provides is that where one or more persons transfer property to a corporation in exchange solely for its stock or securities and after such transfer are in control of the corporation, no gain or loss is recognized upon the exchange. If, in addition to the transferee corporation's stock or securities, other property or money is received, then, though loss will continue to be unrecognized (a refinement overlooked until the Revenue Act of 1924[5]), gain, computed in the usual manner, *i.e.*, by taking into account the full value of all the consideration, including the stock or securities, received, will be recognized, but in an amount not exceeding the money and the fair market value of the other property received.[6] Since, with the exception of certain liquidation provisions discussed in a previous installment of this article, non-recognition of

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3 INT. REV. CODE of 1954, § 351, 68A STAT. 111 (1954).

4 Revenue Act of 1921, § 202(c)(3), 42 STAT. 230 (1921).

5 Revenue Act of 1924, § 203(f), 43 STAT. 257 (1924).

6 In the original 1921 enactment (section 202(e)) gain was recognized in these so-called "boot" cases only if and to the extent the money and fair market value of the other property received, taken by themselves, exceeded the basis of the property transferred, or, to put it another way, only to the extent there would have been gain had the boot been the only consideration received. This was corrected by Section 2 of the Act of March 4, 1923, effective January 1, 1923. Revenue Act of 1923, § 2, 42 STAT. 1560 (1923).

gain or loss is theoretically tax postponement rather than tax forgiveness, the transferors will take as their basis of the stock and securities received the same basis as they had in the property transferred, adjusted only for recognized gain and money received,[7] and the corporation will take over the property at the same basis it had in the hands of the transferors, increased only in the amount of gain recognized to them.

The principal change in this provision as compared with prior law is the elimination of the proportionate interest test. Beginning with the first enactment in 1921 and continuing through all successive revenue acts including the Internal Revenue Code of 1939, it was required in the case of multiple transferors that:[8]

> . . . the amount of stock and securities received by each [be] substantially in proportion to his interest in the property prior to the exchange.

What the reason was for this long-continued rule is obscure, though it could doubtless be rationalized along lines similar to those in the loss-of-control cases where loss of control is brought about by commitments to dispose of all

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[7] For this purpose, liabilities of the transferors assumed by the transferee or subject to which the property is transferred are treated as money. This is not true for purposes of recognition of gain, however, except in the presence of a tax avoidance motive or the absence of a bona fide business purpose or except where the liabilities in question exceed the basis of the property. See Section 357. In the latter situation recognition of gain is limited to the excess of the liabilities over the basis of the property, which is different from the general boot rule and represents a return, under very limited circumstances, to the original 1921 Act provision. This exception is new in the 1954 Code and was enacted because of the practical impossibility of effecting postponement by means of a minus basis. Under prior law such gain escaped tax.

[8] INT. REV. CODE of 1939, § 112(b)(5), 53 STAT. 37 (1939). The exact wording dates from Section 203(b)(4) of the Revenue Act of 1924, 43 STAT. 256, but Section 202(c)(3) of the Revenue Act of 1921, 42 STAT. 230, was in all essential respects the same. The unenacted clause in Section 202(b) of the Revenue Act of 1918, 40 STAT. 1060, would have provided simply for nonrecognition of gain or loss "when a person or persons owning property receive in exchange for such property stock of a corporation formed to take over such property." SEIDMAN'S LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS 1938-1861, 898 (1938).

or part of the acquired stock or securities, as to which more later. But, regardless of the reasons underlying the requirement, it was productive of much controversy and was often a trap for the unwary. Moreover, there were two schools of thought concerning the proper method of its application, which only added to the confusion. The whole subject, starting out as a relatively simple concept, became highly esoteric. Even the labels were confusing. One approach, known as the relative-value test, measured disproportionateness by comparing the extremes of deviation in terms of adding the plus or minus percentages. The other, known as the control test, added the plus or minus percentage points. Let us assume two transferors, *A* and *B*, and that *A* transfers 80 percent of the property for 72 percent of the stock and *B* 20 percent of the property for 28 percent of the stock. The advocates of the relative value test would say that the deviation was 50 percent, composed of a 10 percent deficiency in stock interest on the part of *A* and a 40 percent excess on the part of *B*. To the advocates of the control test, on the other hand, the deviation would be only 16 percent, consisting of the 8 percentage points *A* was below an amount equivalent to his interest in the property and the 8 percentage points by which *B* exceeded it. Passing the point of whether the transaction would not fail under either test, there is obviously a wide difference. Moreover, is there any reason why the matter should have been allowed to turn on arithmetic alone in any event, as opposed to an exercise of judgment after looking at the transaction as a whole, the question being, was there a pooling of properties, or a shifting of properties, or a sale?

The rationale of the new Code is that a proportionate interest test is really irrelevant to the question of whether gain or loss should be recognized in a corporate organization. If any substantial shift in interests is really a gift or compensation by one transferor to another or something else in disguise, it should be recognized and taxed as such without invalidating the tax-free nature of the property-for-stock transaction. Where such an ulterior motive is present, the transaction is reconstructed for what it is, with all the usual tax consequences. For example, if the excessive stock received by *B* in the illustration set forth in the preceding paragraph was really compensation for services performed by him for *A*, it would be deemed to have been received first by *A* and then paid over to *B*, with the result that not only would *B* be taxed on its fair market value as compensation but *A* would be taxed on its disposition as though he had sold it for its fair market value.

One of the requirements of Section 351, as of all its predecessors, is that the transferors must be in control of the transferee corporation immediately after the exchange, control being defined in Section 368(c)[9] to mean ownership of 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. Where there is a prior binding agreement to transfer a portion of the stock immediately upon receipt and the retained stock does not meet the control requirement, particularly where such agreement is part of the organization plan, there is a question whether the control requirement is satisfied.[10] To make certain that, where one of the transferors is a corporation and it distributes the stock it receives to its shareholders, the transaction will not fail for lack of control,[11] the new Code provides a special rule, as follows:

> (c) *Special Rule.* — In determining control, for purposes of this section, the fact that any corporate transferor distributes part or all of the stock which it receives in the exchange

9 INT. REV. CODE of 1954, § 368(c), 68A STAT. 121 (1954).

10 See discussion of this subject in American Bantam Car Co., 11 T.C. 397 (1948), *aff'd,* 177 F.2d 513 (3d Cir. 1949), *cert. denied,* 339 U.S. 920 (1950).

11 Section 351 speaks of control in the transferor, not, like the corresponding reorganization provision, of control in the transferor or its shareholders or both. INT. REV. CODE of 1954, § 351, 68A STAT. 111-12 (1954).

to its shareholders shall not be taken into account.

This does not mean that the shareholders will receive the stock tax-free, but merely that non-recognition will continue to be accorded at the transferor level. But how about other disposition cases? Are any inferences to be drawn from the fact that the statute covers distributions and not other forms of disposition? And just how does the abandonment of the proportionate interest test, with the injunction that wrapping up other deals with the organization transaction will not destroy non-recognition but merely cause the other deals to be taxed for what they are, fit into the pattern? In our *A* and *B* example both parties were property transferors, but suppose the facts had been that all the stock received by *B* had been received as compensation for services rendered to *A*. Reconstruction of the transaction would regard *A* as receiving all the stock for property in the first instance, but would the fact that the plan called for 28 percent to go to *B*, a non-transferor, cause the transaction to fail? It is not believed that Congress intended this.

At this point the exact meaning and effect of the sentence, not found in prior law, that stock or securities issued for services shall not be considered as issued for property, is likewise of interest. This is not the type of case we have just considered, but one where the corporation is issuing stock for services rendered or to be rendered to it. According to the House Report,[12] the sentence is intended merely to make certain that such stock will be fully taxable as compensation and its application is not to vitiate the remaining portion of the transaction. The Treasury's proposed regulations[13] give as an example a case where the individual being compensated is also a property transferor, thereby avoiding the question of the effect of the

12 H.R. REP. No. 1337, 83d Cong., 2d Sess. A117 (1954).

13 Proposed regulations under subchapter C, § 1.351-1(a)(2), Example (3).

issuance of such stock upon the control requirement. But suppose only 79 percent of the stock is issued to the property transferors and 21 percent to a non-transferor as compensation. It is difficult to see how the entire transaction will not be vitiated under such circumstances, despite the Committee Report. Perhaps, though it is unlikely and would seemingly be in the teeth of the statute, an analogy could be drawn from the money transferor, to whom the section is obviously inapplicable in any practical sense, but who is nevertheless regarded as a transferor for purposes of the control test.[14] So a participant who receives stock for services could, if the result is desired strongly enough, be regarded as not being a property transferor for purposes of himself obtaining non-recognition of gain, while still constituting a transferor for purposes of the control test.

Coming now to reorganizations, perhaps the most convenient way to provide the necessary framework for the subsequent discussion is to outline briefly the 1954 Code provisions on the subject. These fall generally into two categories: first, a listing of the types of corporate adjustments covered, *i.e.*, the definition of "reorganization", and second, a spelling-out of the tax treatment to be accorded the various exchanges and distributions effected pursuant thereto.

In order to be a reorganization within the meaning of the Code the transaction at the corporate level must be one of six types[15]—(1) a statutory merger or consolidation; (2) an acquisition of stock of one corporation by another corporation solely for its voting stock, provided the acquiring corporation has control after the transaction; (3) the acquisition of at least 80 percent of the assets of one corporation by another corporation for its own voting stock

[14] Halliburton v. Commissioner, 78 F.2d 265 (9th Cir. 1935).

[15] INT. REV. CODE of 1954, § 368(a), 68A STAT. 120 (1954).

or that of its parent; (4) the transfer of property by one corporation to another corporation if, immediately after the transaction, the transferor, or some or all of its shareholders, or both are in control of the transferee and certain distribution requirements are satisfied; (5) a recapitalization; or (6) a mere change in identity, form, or place of incorporation, however effected. A party to a reorganization is any corporation involved in one of the foregoing transactions as a resulting corporation, an acquiring corporation, a corporation the stock or property of which was acquired, a recapitalized corporation, etc.[16]

Qualification of the underlying transaction as a reorganization merely sets the stage for operation of the tax-free exchange and distribution provisions which are separately stated in the statute. These are of two kinds, those which are directed to the corporate participants in the transaction and those which are directed to the shareholders and security holders. On the corporate side it is provided that no gain or loss shall be recognized if a corporation which is a party to a reorganization exchanges property pursuant to the reorganization plan for stock or securities in another corporation a party to the reorganization, with suitable provision for partial recognition of gain in boot cases to the extent the boot is not distributed to shareholders. On the shareholder side the situation is somewhat more complicated. In general, exchanges of stock for stock and distributions of stock are tax-free, but exchanges of stock for securities and distributions of securities are taxable. Security holders may exchange securities for securities tax-free, except to the extent the principal amount of the securities received exceeds the principal amount of those surrendered. The receipt of boot will, of course, result in a partial recognition of gain in any case. Moreover, recognized gain, if it has the effect of a dividend, will be taxed

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16 INT. REV. CODE of 1954, § 368(b), 68A STAT. 121 (1954).

as such rather than as a capital gain. To round out this preliminary thumbnail sketch, it should also be added that, in addition to permitting tax-free exchanges and distributions incident to a reorganization, these shareholder provisions now for the first time cover spin-offs or split-offs taking the form of distributing the stock of existing subsidiaries.

The scheme, as has been mentioned before, is tax-postponement, not tax forgiveness. Consequently, appropriate basis rules are provided to preserve the unrecognized gain or loss for future recognition. The shareholder keeps his old basis, as do transferor corporations; transferee corporations take over the basis of their transferors. Thus, assuming no recognition of gain anywhere along the line on account of boot, everyone and everything is *in statu quo*, which is exactly what the statutory rules are intended to accomplish.

Until the 1954 revision, the statutory definition of a reorganization, except for the 1939 Act legislation to take care of the *Hendler* case,[17] had remained unchanged for twenty years. It was a far cry from the first enactment in 1918, which merely provided for non-recognition of gain or loss to shareholders or security holders who exchanged their stock or securities for stock or securities of no greater aggregate par or face value in a merger, consolidation, or reorganization—without any attempt at definition. The 1921 Act, however, filled this void, in the following terms, though it used the word "includes" rather than "means":[18]

> The word "reorganization," as used in this paragraph [section 202 (c) (2)], includes a merger or consolidation (includ-

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[17] U.S. v. Hendler, 303 U.S. 564 (1938). This case unexpectedly held that assumptions of liabilities constituted other property or money, *i.e.*, boot, and aroused immediate consternation, not only that most reorganizations would be blocked for the future and that many unanticipated tax liabilities had been created, but also because many taxpayers would claim a step-up in basis on account of past transactions where gain had not been recognized, but should have been.

[18] Revenue Act of 1921, § 202(c) (2), 42 STAT. 230 (1921).

ing the acquision by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or of substantially all the properties of another corporation), recapitalization, or mere change in identity, form, or place of organization of a corporation, (however effected).

Section 203(h)(1)[19] of the 1924 Act converted the definition into an exclusive one by substituting the word "means" and added one more category, *viz.*, control reorganizations. In addition, there was a much more complete articulation of the mechanics of non-recognition than had been the case with the prior Act. The par or face value approach had already been abandoned in the 1921 Act.

With only one important exception the reorganization pattern adopted in the Revenue Act of 1924 remained substantially unchanged until the Revenue Act of 1934. That exception related to basis of property in the hands of an acquiring corporation. A carry-over basis was required only where interest or control of 80 percent or more remained in the same persons or any of them. If such interest or control was less than 80 percent, basis was permitted to be stepped up to fair market value. On the ground that it was too easy to obtain temporary outside capital of 21 percent merely for purposes of stepping up basis, Section 113(a)(7)[20] of the Revenue Act of 1932 reduced the 80 percent test to 50 percent.

By the time the Revenue Act of 1934 was in the offing, however, basic objections to postponing the recognition of gain in corporate reorganizations, as well as other areas, had developed. A strong recommendation for the complete abolition of the tax-free exchange and reorganization provisions was presented by a Ways and Means Subcommittee on Prevention of Tax Avoidance, on the dual ground

19 Revenue Act of 1924, § 203(h)(1), 43 STAT. 257 (1924).

20 Revenue Act of 1932, § 113(a)(7), 47 STAT. 198 (1932).

that it would close the door to one of the most prevalent methods of tax avoidance and would simplify the income tax law by eliminating some of its most complicated provisions. A Joint Committee Staff memorandum, included as an exhibit, supplied considerable ammunition in the form of a list of horror cases. But the Treasury objected, partly for fear that, under depression conditions, the immediate result would be a flood of deductible losses rather than taxable gains. It was argued that it might be better to attempt to remedy the situation, not by repeal, but by making the statute less rigid and giving the Commissioner more of an opportunity to separate the sheep from the goats. Much of the difficulty, it was alleged, lay in over-particularization.

What Congress did was to retain the reorganization set-up with slightly more restricted coverage and even greater particularization. The old parenthetical clause which gave such broad meaning to mergers and consolidations was dropped. At first nothing was substituted; since at the same time the word "statutory" was inserted before "mergers and consolidations", this threatened to make the statute discriminatory, at least geographically, since a number of States and, ironically, the District of Columbia had no merger statutes. To avoid this it was therefore necessary to add the solely-for-voting-stock class of reorganization, that is, the acquisition of at least 80 percent of the stock or substantially all the assets of another corporation solely for voting stock of the acquiring corporation. In addition to this narrowing of the basic definition, there was a tightening up of other provisions. It was alleged that one of the most conspicuous tax-avoidance tools was the privilege of distributing reorganization stock as a dividend without requiring the surrender of any old stock. The Section granting this privilege was repealed[21] and was not restored until the Revenue Act of 1951.[22] Finally, the

Footnotes 21 and 22 on page 630.

carry-over basis rule for acquiring corporations was applied to all cases regardless of the extent of the interest or control remaining in the former owners.

Broadly speaking, this was the form of the statutory law when the framers of the 1954 Code set to work. Meanwhile two judicial doctrines had grown up in an attempt to confine the operation of the reorganization provisions to cases which met the test of their basic philosophy. These were the business purpose and the continuity of interest rules. The former is essentially a rule against sham transactions; the latter is a conceptual approach and holds that, unless a substantial proprietary interest, as opposed, for example, to a creditor interest, is retained by the old owners in the new enterprise, the underlying requirements of the reorganization concept have not been satisfied. In addition, the Supreme Court had greatly restricted certain types of recapitalizations pursuant to which part of a shareholder's interest was upgraded into bonds or debentures for the purpose of subsequent redemption at capital gains rates.[23] A direct distribution of such instruments would be a dividend. The Court held that the cloak of a purported recapitalization was an ineffective disguise. Per-

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[21] The offending section had come into the statute in 1924 on the ground that it represented only one of three ways to accomplish exactly the same thing and, since the other two could be used without recognition of gain, so should it be possible for this one to be. Since the repealer was only of the distribution provision and left the alternatives untouched, it seems to have run to the means and not to the end, though the situation became thoroughly confused because of the inferences that could be drawn from old Section 115 (g) in partial redemption cases and the substance *vs.* form argument that could be made in any divisive reorganization even where the last step was the complete liquidation and dissolution of the old corporation. Fortunately, one provision in the 1954 Code, Section 355, 68A STAT. 113, now covers all three methods and, while it may be overoptimism to say all differences have been eliminated, they should at least be reduced to a minimum. See generally *infra* in the text.

[22] Section 317, Revenue Act of 1951, 65 STAT. 493, added Section 112 (b) (11) and Section 113 (a) (23) to the 1939 Code to cover these "spin-off" transactions under restrictions designed to prevent their use for tax-avoidance purposes.

[23] Bazley v. Commissioner, 331 U.S. 737 (1947).

haps the so-called *Groman*[24] and *Bashford*[25] rule could also be laid to the desire to police the reorganization field and keep it from getting out of hand, at a time when the excesses of earlier days and the frankly restrictive purpose of the 1934 Act provisions were fully understood. Reduced to its simplest terms, the *Groman* and *Bashford* rule was that, if the assets of the *Y* Corporation were being acquired for stock of the *X* Corporation, they would have to go to and be retained by *X* and could not wind up in a wholly-owned subsidiary of *X* either on a direct transfer from *Y* or via *X*.

With the passage of time sentiment began to build up for achieving greater certainty or outright change in these areas. In addition other problems had accumulated to meet which it was felt some statutory modifications were necessary. Included in the dossier were such subjects as corporate divisions involving a parting of the ways by conflicting groups of shareholders, creeping control in certain acquisition-for-voting-stock cases, relaxation of the solely-for-voting-stock requirement in property-acquisition cases, liquidations followed by reincorporation, and certain borderline cases which pointed up the conflict between reorganization concepts, on the one hand, and liquidation concepts, on the other.

A more detailed description of the 1954 Code as finally enacted will show how these problems were met. Some of the solutions have already been briefly indicated in the thumbnail sketch set forth at the start of this discussion. Let us retrace our steps first to the definition of reorganization. Three parts were left unchanged from prior law — those dealing with statutory mergers and consolidations, recapitalizations, and mere changes in identity, form, or place of incorporation, however effected. But those dealing

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24 Groman v. Commissioner, 302 U.S. 82 (1937).

25 Helvering v. Bashford, 302 U.S. 454 (1938).

with acquisitions solely for voting stock and with control reorganizations were considerably revised.

The provision of prior law dealing with the acquisition of stock of one corporation by another solely for its voting stock was in the following terms:[26]

> (1) The term "reorganization" means . . . (B) the acquisition by one corporation in exchange for all or a part of its voting stock, of at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of another corporation . . . .

In any case in which the acquiring corporation already owned 21 percent of the stock of the other corporation, it was manifestly impossible to comply with this provision, no matter how the 21 percent had been acquired. Moreover, though as little as 80 percent could qualify as a permitted acquisition under clause (B), if more than that was acquired in a single transaction it would all have to be acquired for voting stock; in other words, it would not be sufficient to acquire merely 80 percent for such consideration, and to give non-voting stock, or bonds, or cash, for the remainder. Under the new Code this solely-for-voting-stock requirement still applies to the entire transaction, but the 80 percent minimum does not. Any acquisition solely for voting stock, no matter how small, will qualify if after the acquisition (whether or not as a result of it) the acquiring corporation is in control of the acquired corporation, pursuant to the general definition. The proposed regulations take the view that the "single transaction" may be a stretched-out affair, covering as much as twelve months.[27] A six-month continuing offer by a corporation to exchange its own voting stock for stock of

26 INT. REV. CODE of 1939, § 112(g) (1) (B), 53 STAT. 40 (1939).

27 Proposed regulations under subchapter C, § 1.368-2(c). Actually the regulations speak of a single transaction or a series of transactions. Since it all has to be pursuant to a reorganization plan, however, the two terms in this context appear to be synonymous.

another corporation is given as an example. This can, of course, be very helpful. It lets the earlier acquisitions in the series qualify, though they could not on their own, because the requisite control does not come into being until the last few acquisitions. It could also be disadvantageous. A lone acquisition during the period of the "single transaction" which is not solely for voting stock could be the one rotten apple that spoils the whole barrel.

An esoteric result of this change may well be its effect upon the acceptability to the Bureau of the *Winston Brothers* case.[28] That case, which arose under the 1928 Act, involved a situation where an acquiring corporation in a parenthetical clause reorganization already owned stock in the corporation whose assets it wished to acquire. It nevertheless purported to issue its own stock for all the assets of the to-be-acquired corporation. Upon the dissolution of that corporation the issuing corporation, of course, received a portion of its own stock back. The Commissioner took the position that substance should prevail over form and that the assets which underlay the acquiring corporation's stock interest were not acquired for its own stock, but by way of liquidation. Hence it was not a qualifying reorganization. The Courts rejected the Commissioner's analysis and held for the taxpayer. While the Bureau originally non-acquiesced in the decision of the Board of Tax Appeals,[29] not only was the non-acquiescence later withdrawn and acquiescence substituted[30] but the Bureau affirmatively approved a similar transaction under the 1932 Act in G.C.M. 21873.[31] In fact, this ruling went even further and permitted the acquiring corporation to avoid the step of issuing so much of its own stock as it would receive back by giving a waiver.

28 Helvering v. Winston Bros. Co., 76 F.2d 381 (8th Cir. 1935).

29 XIII-2 CUM. BULL. 38 (1934).

30 1941-1 CUM. BULL. 11.

31 1940-2 CUM. BULL. 223.

In recent years, however, the Bureau has been taking the position, without publishing it until last year,[32] that the changed definition of a reorganization in the 1934 Act made the *Winston Brothers* case inapplicable thereafter. Why this should be true has never been clear, and the 1954 ruling says nothing to make it so. To the uninitiated the Bureau appears to be repudiating rather than distinguishing its prior position. Admittedly the *Winston Brothers* case would not qualify after 1934 on its facts (voting stock was not the sole consideration), but the principle — that the acquisition was not by way of liquidation, but for stock — if valid prior to 1934, was valid thereafter. The Bureau's real reason is believed to be that it was unwilling to recognize the validity of such a circumvention unless the acquiring corporation could have acquired the rest of the other corporation's stock tax-free and then liquidated the corporation under the intercorporate liquidation provisions, also tax-free. Prior to the 1954 Code, this could be done only if the stock already owned was 20 percent or less, for there had to be at least 80 percent outstanding in the hands of others to be acquired. But, since under the 1954 Code the only test is whether the acquiring corporation has control after the clause (B) acquisition, it is always theoretically possible to route the transaction that way. Perhaps, therefore, if we have correctly read between the lines, the Bureau will be able to see its way clear to withdraw its objections to the *Winston Brothers* technique. This is about as good an example as may be found of the hidden ways of reorganization law.

The clause (C), or assets-for-voting-stock, type of reorganization was also liberalized. Looking at the clause itself, the only apparent change lies in permitting voting stock of a corporation in control of the transferee, in lieu of that of the transferee itself, to be employed, but it must

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32 REV. RUL. 54-396, 1954-38 INT. REV. BULL. 9.

be one or the other and not both. Thus, the *Groman* and *Bashford* cases are overruled. To take care of cases where the assets are routed through the parent, Section 368 (a) (2) (C)[33] provides that a Section 368(a) (1) (C)[34] transaction shall not be disqualified by reason of a transfer of all or part of the assets acquired to a controlled corporation. This rule also covers Section 368(a) (1) (A)[35] cases, that is, statutory mergers and consolidations. Note that in the direct case all the acquired assets must go to the subsidiary, whereas in the indirect case it is possible to divide them. Let us hope there are not too many instances of lack of sophistication penalized.

Two other major changes in clause (C) appear in a subordinate paragraph, headed "Special Rules Relating To Paragraph (1)". The first of these provides merely that if a given transaction is described both in clause (C) and in clause (D), it shall be treated only as described in clause (D). This is to insure the application of the proper shareholder provision. The other relaxes the solely-for-voting-stock requirement, permitting as much as 20 percent of the assets to be acquired for other types of consideration — including types which may result in partial recognition of gain. While the general rule in clause (C) reorganizations is that assumptions of liability are to be disregarded in determining whether the sole consideration is voting stock, if other consideration is employed, then, in determining whether the minimum of 80 percent of the assets is being acquired for voting stock, the liabilities assumed are to be treated as money paid for the property. Thus the new provision (that is, the rule permitting consideration other than voting stock) is unavailable when assumed liabilities equal or exceed 20 percent of the property acquired and in other cases they reduce the amount of con-

33 INT. REV. CODE of 1954, § 368(a) (2) (C), 68A STAT. 121 (1954).

34 INT. REV. CODE of 1954, § 368(a) (1) (C), 68A STAT. 120 (1954).

35 *Ibid.*

sideration other than voting stock that can be employed *pro tanto*. As usual, the phrase "assumed liabilities" includes subject-to liabilities.

From 1924 to 1954 the definition of a control reorganization remained unchanged and was as follows:[36]

> (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 its shareholders or both are in control of the corporation to which the assets are transferred.

There was at least one type of transaction for which a good case could be made that was not covered by this definition. Let us assume the *X* Corporation, owned equally by two shareholders, *A* and *B*, is engaged in two businesses, the drug store business and the hardware store business, to use the Committee Report example.[37] The businesses are of the same value. For some reason the shareholders would like to split the corporation, giving the drugstore business to *A* and the hardware store business to *B*. To make the case even more appealing, we will further assume that, upon the organization of *X*, the drugstore business was contributed by *A* and the hardware store business by *B*. It ought to have been possible to set up a new *Y* Corporation with the hardware store assets, for example, and distribute the *Y* stock to *B* in exchange for his *X* stock without any recognition of gain.. But this could not be done under the old law. It would not even have been possible to set up two new corporations, *Y* and *Z*, transferring one of the businesses to each, unless both shareholders wound up with stock in each corporation. The reason for this was that the control requirement of old Section 112(g) (1) (D) would not have been satisfied. Obviously control was not in the transferor, since the stock of *Y* in the first case and of *Y* and *Z* in the second was dis-

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36 INT. REV. CODE of 1939, § 112(g) (1) (D).

37 S. REP. No. 1622, 83d Cong., 2d Sess. 274 (1954).

tributed. It was not in the transferor's shareholders, since the section meant all,[38] not merely some, of them. The new Code remedies this by rephrasing the control requirement in terms of:[39]

> . . . the transferor, or one or more of its shareholders (including persons who were shareholders immediately before the transfer), or any combination thereof . . . .

Whether the new language will afford opportunities for manipulation, as where control of the transferee rests in a minor shareholder of the transferor apart from the particular transaction and substantially all the assets are transferred, and what new strain may be put upon the continuity of interest doctrine, are matters to be disclosed by future experience.[40] The particular point may appear far-fetched and may be modified by considerations of what could be done in a statutory merger, but the history of reorganizations is full of bizarre twists.

A second and even more far-reaching structural change in the clause (D) definition is the addition of the requirement that the stock or securities of the transferee be distributed by the transferor in a transaction to which Section 354,[41] 355,[42] or 356[43] applies, *i.e.*, in a non-recognition or a partial non-recognition transaction. Why this requirement the Committee Reports do not say. The transaction may still qualify under clause (C) at the corporate level. Even if it does not, non-recognition will be accorded to the transferor under Section 351, and the only difference in

38. Perhaps a *de minimis* rule would permit minor deviations under some circumstances, but this does not affect the general validity of the statement made in the text.

39 INT. REV. CODE of 1954, § 368(a)(1)(D), 68A STAT. 120 (1954).

40 See Cohen, Silverman, Surrey, Tarleau, and Warren, *The Internal Revenue Code of 1954: Corporate Distributions, Organizations, and Reorganizations*, 68 HARV. L. REV. 393, 419 (1955).

41 INT. REV. CODE of 1954, § 354, 68A STAT. 112 (1954).

42 INT. REV. CODE of 1954, § 355, 68A STAT. 113 (1954).

43 INT. REV. CODE of 1954, § 356, 68A STAT. 115 (1954).

result will be that earnings and profits will not go over to the transferee. It is at the shareholder level that the change is of greatest importance. Though this is tied in with the details of the new spin-off, split-off, and split-up provision (Section 355), the basic problem can be considered at this time.

Take first a case where there will likely be little quarrel with the result from the point of view of policy. The *X* Corporation, with substantial earnings and profits, wishes generally to liquidate, but a small portion of its business it wishes to retain in corporate form. It transfers that portion of the business to a new *Y* Corporation, reduces the rest of its assets to cash, and liquidates. This was a reorganization under the old law; gain was recognized to the shareholders to the extent of the boot received and, to the extent of the *X* Corporation's earnings and profits, was taxed to them as a dividend.[44] This was undeniably a harsh result and, even with no change in the definition of a clause (D) reorganization or the shareholder-exchange provision, might not be reached under the 1954 Code, in view of the inferences to be drawn from the new partial liquidation provisions on the question of distributions equivalent to a dividend.[45] But it is unnecessary to rely on this approach. The distribution to *X's* shareholders will not qualify under Section 354, 355, or 356, for Section 354 is applicable only to reorganizations where substantially all the assets of one corporation are acquired by another, Section 355 applies only where either the distributing corporation (*X*) is in business after the distribution or it had no assets prior to the distribution other than stock of controlled corporations, and Section 356 is merely the boot provision that goes with Sections 354 and 355. The transaction is there-

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[44] Lewis v. Commissioner, 176 F.2d 646 (1st Cir. 1949).

[45] See the first instalment of this article, Peterson, *Corporate Distributions and Adjustments—Subchapter C of the Internal Revenue Code of 1954,* 30 NOTRE DAME LAW. 191, 217-219 (1955).

fore not under clause (D). For the same reasons that Section 354 is inapplicable to the shareholder exchange, it is not under clause (C). There are no rules left to apply to the shareholders except the liquidation rules. The shareholders will thus receive capital gains treatment, but the taxable gain will include all the gain on the liquidation including that attributable to the value of the *Y* stock. Consider, however, the result if the sole shareholder of the *X* Corporation were the *Z* Corporation. The liquidation would then appear to be covered by Section 332[46] and there would be no recognition of gain whatever — still not an inappropriate result.

The foregoing results, *i.e.*, a liquidating distribution rather than a reorganization exchange, can be produced by other sets of circumstances which disqualify the basic transaction as a reorganization. To go to the other extreme, suppose that 60 percent of the assets of the *W* Corporation are business assets and 40 percent consist of cash not needed in the business. If the cash were distributed to shareholders, there would be a taxable dividend. *W* transfers its business assets to a new *V* Corporation for all of *V's* stock and liquidates. May the shareholders thereby obtain capital gains treatment, at the price only of being taxed on the appreciation, if any, in their remaining investment in the business? It is one thing to hold, as the *Gregory* case[47] did, that a transaction is not a reorganization because it is a sham transaction and another to hold that a transaction is a reorganization because it is a sham transaction, particularly in the face of a rule that the reorganization provisions are to be construed narrowly and where they in terms exclude the transaction in question. Perhaps so bald a case as this could be defeated by an adaptation of the step transaction rule, for the end

46 INT. REV. CODE of 1954, § 332, 68A STAT. 102 (1954).

47 Gregory v. Helvering, 293 U.S. 465 (1935).

result is merely the distribution of a dividend and all that is required is to ignore the intervening steps.

One other type of transaction deserves to be considered in order fully to appreciate the scope of the 1954 change in the definition of a clause (D) reorganization. The *P* Corporation has two businesses, into one of which it wishes to bring new interests. For valid reasons it also wishes to put the other business into a new corporation. It therefore transfers one business to a new *Q* Corporation in exchange for all of *Q's* stock. The other business it transfers to a new *R* Corporation for 50 percent of *R's* stock, money and other property being transferred to the *R* Corporation by outside interests for the remainder of its stock. When this is accomplished *P* liquidates. Though *P's* transfers to *Q* and *R* are tax-free at the corporate level because of Section 351, its distribution of the *Q* and *R* stock to its shareholders appears to be a taxable liquidation (or tax-free, if *P* is owned by another corporation). The organization of *R* is obviously not a reorganization, because neither *P* nor its shareholders are in control of *R* nor did *P* transfer substantially all its assets to *R* for *R's* voting stock. This also prevents the transfer to *Q* from being a reorganization, despite the fact that, looked at alone, it appears to be. It cannot qualify under clause (C) for the same reason that the transfer to *R* does not and it fails to qualify under clause (D) because the distribution to shareholders is non-qualifying, *P* not remaining in business or owning, immediately prior to the distribution, only stock of controlled corporations. Under prior law the result would have been completely different: there would have been a reorganization, though the *R* stock would have constituted boot to the shareholders and its distribution as part of the plan would probably have defeated non-recognition of the *R* transaction even at the corporate level.

Before shifting to shareholder problems, some of which have already been anticipated, reference should be made in passing of the subject of liquidation followed by reincorporation. An approach was made to the problem in Section 357[48] of the House Bill, though many questions, such as how to handle taxes previously paid, were left unanswered. But the provision was dropped in the Senate and the omission was agreed to in Conference. The Conference Report stated:[49]

> The House bill in section 357 contained a provision dealing with a device whereby it has been attempted to withdraw corporate earnings at capital gains rates by distributing all the assets of a corporation in complete liquidation and promptly reincorporating the business assets. This provision gave rise to certain technical problems and it has not been retained in the bill as recommended by the accompanying conference report. It is the belief of the managers on the part of the House that, at the present time, the possibility of tax avoidance in this area is not sufficiently serious to require a special statutory provision. It is believed that this possibility can appropriately be disposed of by judicial decision or by regulation within the framework of the other provisions of the bill.

In view of past experience with the courts in this area, this confidence is somewhat surprising. The difficulties are not diminished by the problems in clause (D) reorganizations discussed above. But perhaps the bluff will work.

On the subject of shareholder treatment we have already referred to one major change from prior law, the treatment of securities as boot except to the extent an equal principal amount of securities is surrendered. It is important but need not be discussed further. From the Government's point of view it completes the *Bazley* campaign. The other major change is with reference to spin-offs, split-offs, and split-ups. The distinction between these mystifying terms is no longer of any but intellectual interest, since it is unnecessary now to distinguish between them. They all relate to corporate divisions. If a corpora-

48 House Bill Section 357, H.R. 8300, 83d Cong., 2d Sess. 86 (1954).

49 H.R. REP. No. 2543, 83d Cong., 2d Sess. 41 (1954).

tion with two businesses sets up one of them in a new corporation and distributes the stock of that corporation without taking back any of its own, it is a spin-off. If it takes back some of its own stock, *i.e.*, adopts the form of a partial liquidation, it is a split-off. If, instead of setting up one new corporation, it sets up two, one for each business, and then liquidates, it is a split-up. All are economically the same thing.

Prior to the Revenue Act of 1924 the statute contained only an exchange provision at the shareholder level. Indeed, on the surface it is difficult to see how a distribution provision could have served any practical function, since the clause (D) type of reorganization was not included in the definition of reorganization until that Act. Nevertheless, the Committee Reports speak of divisive reorganizations as being permitted under prior law and point to the necessity for a distribution provision at the shareholder level in order that spin-offs be treated the same as split-offs and split-ups, the latter already being tax-free.[50] The provision was a simple one and stated merely:

> (c) If there is distributed, in pursuance of a plan of reorganization, to a shareholder in a corporation a party to the reorganization, stock or securities in such a corporation or in

[50] H.R. Rep. No. 179, 68th Cong., 1st Sess. 14 (1924); S. Rep. No. 398, 68th Cong., 1st Sess. 15 (1924). At the same time, on page 16 of the House Report and page 17 of the Senate Report, in connection with the revised definition of reorganizations, the addition of the control type is stated to be a change from prior law, though it is also referred to as "a common type of reorganization." While subsidiaries could be organized under the tax-free organization provisions of prior law, putting such stock in the hands of the transferor's shareholders would not seem to have been possible, unless the transaction was likewise a reorganization, both because the control requirement of the organization provision would not have been satisfied (see the discussion of section 351, *supra*) and because the shareholder exchange provision spoke only of reorganization exchanges. The only explanation that remains is that, in defining a reorganization, the 1921 Act said "includes" rather than "means" and that a corporate division was so obvious a type of reorganization as not to require recital. With the use of "means" in the 1924 Act a complete spelling out was required. While at this distance and in the absence of direct authority one can only speculate, the opinion in Insurance & Title Guarantee Co. v. Commissioner, 36 F.2d 842 (2d Cir. 1929), *cert. denied*, 281 U.S. 748 (1930), plainly supports this conclusion.

> another corporation a party to the reorganization, without the surrender by such shareholder of stock or securities in such a corporation, no gain to the distributee from the receipt of such stock or securities shall be recognized.

Came the 1934 upheaval and, as has already been indicated, this provision was eliminated on the ground it constituted one of the most notorious avenues of tax-avoidance. Where did this leave the law? One answer was that it left the law where it was prior to 1924—that only spin-offs were taxable at the shareholder level, while split-offs and split-ups were still tax-free. At the opposite extreme it could be argued that all three were now ruled out, split-offs because, with Section 115(g)[51] in the law to cover redemptions essentially equivalent to a dividend (it did not appear as a general provision until 1926), a pro rata redemption of the transferor's stock was to be treated as a distribution rather than an exchange, and split-ups because they too were essentially the same thing. Which stock that was handed out in a split-up should be treated as the distribution and which as really stock of the old corporation might have presented a problem, but it could always be solved in favor of the maximum tax liability. In general, what the Bureau did was to continue to allow split-ups, but to ban split-offs as well as spin-offs. The fact that in 1952 the Bureau's split-off rule was rejected[52] does not mean that the Bureau's views were not the practical law of the land during the entire period a tax-free distribution provision was out of the statute.

Taxpayers lay low for some time, but after the war began to advocate restoration of a tax-free distribution provision to the law. It was suggested that the Bureau and the courts had become much more astute to prevent abuse of the reorganization provisions than they had been in the

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51 See Revenue Act of 1926, § 201(g), 44 STAT. 11 (1926). *Cf.* Revenue Act of 1928, § 115(g), 45 STAT. 822 (1928).

52 Chester E. Spangler, 18 T.C. 976 (1952), *acq.*, 1953-1 CUM. BULL. 6; REV. RUL. 289, 1953-2 CUM. BULL. 37.

1920's and that, with the *Gregory* case on the books,[53] and with a few precautionary limitations in the provision itself, it could safely be restored. Though for the next few years such a provision was in and out of various revenue bills, it was not until the Revenue Act of 1951 that taxpayers' mission was accomplished. Section 317 of that Act added Section 112(b) (11)[54] to the 1939 Code permitting tax-free distributions connected with reorganizations in certain cases. Three limitations were imposed. First only common stock could be so distributed; a distribution of preferred stock or securities continued to be taxable. Second, it must not appear that any corporation a party to the reorganization was not intended to continue the active conduct of a trade or business after the reorganization. Third, it must likewise not appear that the corporation whose stock was distributed was used principally as a device for the distribution of earnings and profits to the shareholders of any corporation a party to the reorganization. Under this provision, if the business to be spun off was already in the form of a subsidiary, the stock of the subsidiary could not be distributed directly, but a new holding company had to be created, to which the stock of the subsidiary would be transferred, and the stock of the holding company spun-off to the shareholders. Moreover, the holding company would have to be continued, for an immediate merger with its operating subsidiary, whether upstream or downstream, would reflect back on the original transaction as a direct distribution of the subsidiary's stock, which was barred. How the creation of a holding company would satisfy the active business test may seem strange. Ordinarily the Bureau would have resisted such a construction tooth and nail. But its hands

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[53] In fact, in some quarters it was commonly stated that, had the *Gregory* case been decided earlier, the old distribution provisions might never have been eliminated.

[54] INT. REV. CODE of 1939, § 112(b)(11), *added by* 65 STAT. 493 (1951).

were tied by the Committee Report, which stated that just such a case was intended to qualify—"whether or not [the subsidiary was] wholly or even majority owned."[55] The Bureau squared itself with its conscience by taking the position in the regulations that a corporation could be regarded as being engaged in the active conduct of a trade or business if it:[56]

> . . . indirectly conducts the business through ownership of stock in another corporation actively conducting the business, which other corporation is a subsidiary (whether or not majority-owned) of the corporation, a party to the reorganization. For the purpose of the preceding sentence, a corporation is considered a subsidiary of another corporation if a majority of its voting stock is owned by the other corporation or if a part of its stock (whether or not a majority of its voting stock) is owned by the other corporation under such circumstances that the policies of the first corporation are directed by the second corporation.

The Internal Revenue Code of 1954 contains an entirely new shareholder provision covering both exchanges and distributions connected with corporate divisions. It is narrower than the old provision in some respects and broader in others. It is narrower in according non-recognition treatment only where the spun-off[57] business is in the form of a controlled corporation, *i.e.*, 80 percent owned, and in a much greater articulation of the test relative to active conduct of a trade or business. It is broader in permitting the spin-off of existing subsidiaries directly, in allowing—indeed, requiring in most cases—that all the stock and securities of the controlled corporation be distributed or exchanged, in recognizing non-pro-rata distributions, whereby one business can go to one group of shareholders and another to another, and in relaxing the

55 S. REP. No. 781, 82d Cong., 1st Sess., Part 1, pp. 57-58 (1951).

56 U. S. Treas. Reg. 118, § 39.112(b)(11)-2(b) (1953).

57 We shall hereafter use the spin-off language to embrace all three types of corporate division.

rule against sales of the spun-off or retained stock.[58] On the subject of securities it is well to repeat that they can be received tax-free only to the extent an equivalent principal amount of securities is surrendered. As to the treatment of boot, the tax consequences differ somewhat depending upon whether the transaction is a distribution or an exchange. If it is a distribution, the boot is treated as a property distribution to which Section 301[59] applies, *i.e.*, it will be a dividend or a return of capital in accordance with the state of the distributing corporation's earnings and profits account.[60] If it is an exchange, the gain limitation applies, that is to say, though the recognized gain is measured by the boot, it cannot exceed the realized gain, and the amount which may be taxed as a dividend will be similarly limited.

Two aspects of the new provision (Section 355) require further comment: the active business requirement and the requirement that the transaction is not a device for the distribution of earnings and profits. Taking first the active business requirement, we find that it in turn has two facets, first, the requirement itself and, second, the definition of the term. The general requirement, as has been mentioned previously in passing, is that either (1) both the distributing corporation and the controlled corporation or corporations whose stock is distributed must be actively engaged in business immediately after the distribution, or (2) immediately before the distribution:[61]

> . . . the distributing corporation had no assets other than stock or securities in the controlled corporations and each

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[58] The Bureau construed the rule of the old law that the corporation whose stock was distributed must not be used as a device for the distribution of earnings and profits as prohibiting immediate sale.

[59] INT. REV. CODE of 1954, § 301, 68A STAT. 84 (1954).

[60] The effect of an allocation of earnings and profits as between the various corporations involved, as provided by Section 312(i), 68A STAT. 98 (1954), is as yet unexplored.

[61] INT. REV. CODE of 1954, § 355(b) (1) (B), 68A STAT. 114 (1954).

> of the controlled corporations is engaged immediately after the distribution in the active conduct of a trade or business.

The first appears to present no problems at this writing except one which arises out of the definition of active conduct of a trade or business. The second, which is obviously the complete liquidation provision, is troublesome because of its reference to controlled corporations in the plural. Does this mean that the holding company of a single controlled subsidiary cannot avail itself of Section 355 for purposes of a tax-free liquidation whereas the holding company of two or more such subsidiaries can? It is possible that the use of the plural was inadvertent, since the draftsmen were doubtlessly thinking in terms of corporate divisions and did not visualize this case, but the proposed regulations do nothing to clarify the situation, confining themselves to a paraphrase, if not an exact quotation, of the statutory language—unless some special significance attaches to the opening sentence of such regulations, which describes the scope of Section 355 as follows:[62]

> Section 355 provides for the separation, without recognition of gain or loss to the shareholders and security holders, of two or more existing businesses formerly operated by a single corporation.

In general, a corporation is regarded as engaged in the active conduct of a trade or business if it is conducting a business directly or if substantially all of its assets consist of the stock of a controlled subsidiary which is so engaged.[63] The business in question must have been conducted by someone for a period of at least five years. If

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[62] Proposed regulations under subchapter C, § 1.355-1(a).

[63] Note the singular in this case as opposed to the plural in Section 355(b)(1)(B), 68A STAT. 114 (1954). If both are intended, then, reading the two requirements described in the preceding paragraph of the text together, we are forced to conclude that a pure holding company must have more than one controlled subsidiary and must distribute either the stock of all of them or the stock of all but one. On the surface this appears to be irrational.

acquired by the taxpayer or any member of the chain of controlled corporations within five years, it must have been in a tax-free transaction. Similar rules apply to acquisitions of control where the active business test is sought to be met derivatively, and stock acquired within five years in other than a tax-free transaction is ineligible for distribution tax-free. Thus, the practical control test contained in the old regulations has not survived, even for purposes of meeting the active business test, and safeguards have been erected to block the conversion of liquid assets into an active business for purposes of tax-free distribution.

Underlying the verbal structure of the active business test is the problem of identification of the business and its separateness in relation to other activities of the taxpayer. The necessity for doing this arises out of the five-year requirement. Under the old law presumably it would have been possible for a manufacturing corporation to separate its fixed investment from its operations by creating a separate corporation to conduct one activity or the other and distributing the stock of that corporation to its shareholders. Under the new law as interpreted by the Bureau in tentative regulations,[64] such a spin-off would apparently not be possible, at least until five years after segregation has taken place by creation of a subsidiary. The proposed regulations[65] state first that:

> . . . a trade or business consists of a specific existing group of activities being carried on by a corporation or individual for the purpose of earning income or profit from only those specific activities. Such group of activities ordinarily must include the collection of income and the payment of expenses.

Various exclusions are then listed, consisting of the holding of property for investment purposes, groups of activities which, while a part of a business operated at a profit,

64 Proposed regulations under subchapter C, § 1.355-1(c) and (d).

65 *Ibid.*

are not themselves producing income, and[66]

> . . . ownership and operation of land or buildings all, or substantially all, of which are used and occupied by the owner in the operation of a trade or business.

Nine examples are given illustrating both compliance and non-compliance. There may be a tendency to criticize the Bureau for undue narrowness, but it is believed that, in the fixed-assets type of case, both conceptually and as a matter of definition the Bureau is probably right. To take the partial liquidation analogy, should distribution of a factory building, which the shareholders will then lease to their company, be properly classified as a liquidating distribution? Perhaps taxpayers are fortunate that, in the spin-off field, the possibility exists that they need wait only five years after separation through the creation of a subsidiary. In other aspects of the definition there may be more question from the point of view of policy, as, for example, where it is sought to divide up a vertically integrated business, but the question is one of legislative, not administrative, policy and the restrictions lie in the language of the statute. Before we leave the question of the definition of a trade or business, it would also be well to note again the problem of lack of continuity because of changes in the taxpayer's business substantial enough to constitute the acquisition of a new or different business.[67]

As in the case of the former provision, an over-all limitation on the operation of the section is that:[68]

> . . . 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 . . . .

This time there is added, however, the following paren-

66 *Ibid.*

67 Peterson, *op. cit. supra* note 35, at 219; proposed regulations under subchapter C, § 1.355-4(b)(3).

68 INT. REV. CODE of 1954, § 355(a)(1)(B), 68A STAT. 113 (1954).

thetical clause:[69]

> ... (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).

Had the parenthesis within the parenthesis been omitted we would have had a much more logical provision. As it stands, a sale pursuant to prior negotiations or agreement may, of itself, cause the distribution to become disqualified, but the taxpayer ought to be permitted to argue his case. The main purpose of the parenthetical clause was to negative an inference. The inclusion of an exception ought not to create one. It ought merely to leave the case where it would be if there had been no parenthetical clause at all. But, beyond this, it is illogical. The whole point of the parenthetical clause is that the spin-off problem is merely an aspect of the partial liquidation problem. Since in the main the partial liquidation tests and the spin-off tests are the same and since by definition a partial liquidation is not a distribution of earnings and profits in a dividend sense, a sale of spun-off or retained stock, whether or not pursuant to prior agreement, will ordinarily not convert the transaction into a device for such a distribution. Something more must be present. It would be better to focus on the two respects in which a spin-off may differ from a partial liquidation in the end-result. One of these is connected with the bail-out problem dealt with in Section 306.[70] Since under Section 355 preferred as well as common stock may be distributed, such a transaction could be used to set the stage for a bail-out. The other is that spin-offs afford the opportunity for placing non-business assets in a position to be liquidated out at capital gains rates with-

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69 *Ibid.*

70 INT. REV. CODE of 1954, § 306, 68A STAT. 90 (1954).

out winding up the entire business. In a partial liquidation only the business assets may be received at capital gains rates; non-business assets distributed along with them are taxed at dividend rates.

No description of the 1954 Code provisions dealing with reorganizations would be complete without some reference to the provisions of the House Bill on the subject. To describe them in their entirety would be unnecessarily repetitious at many points, but there were some significant innovations—dropped in the Senate—which deserve mention. One of these was a quantitative continuity of interest test, the so-called 25-400 percent rule. Except in the case of statutory mergers or consolidations of publicly-held companies,[71] tax-free combinations could take place only if the shareholders of each constituent enterprise wound up with at least a 20 percent interest in the combined enterprise, *i.e.*, at least 25 percent of the interest of the shareholders of any other participant, 400 percent being the reciprocal. Acquisitions of stock of another corporation were assimilated to acquisitions of assets by requiring a transfer of the asset basis to the stock. Also the terms "participating stock" and "non-participating stock" were used and the term "securities" defined. Apart from certain technical defects, one result was to transfer certain types of income debentures and subordinated debt from the category of securities to the category of non-participating stock, with the horrifying results of bringing them within the dividend-equivalence provisions on redemption and denying an interest deduction. Still another departure from prior concepts was abandonment of the gain limitation in reorganization exchanges at the shareholder level involving boot, where dividend equivalence was present. Finally, on

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[71] A corporation was deemed to be publicly held unless ten or fewer shareholders owned more than 50 percent either of the total combined voting power or of the total value of all classes of stock, the rules of constructive ownership, discussed in the first part of this article, being fully applicable. House Bill Section 359(a), H.R. 8300, 83d Cong., 2d Sess. 87 (1954).

the subject of spin-offs, though there was no active business requirement to impede the distribution, it was applied with a vengeance with respect to the tax treatment of any amounts received by shareholders or security holders within ten years after the distribution upon the disposition of spun-off stock or retained stock "by liquidation, sale, redemption, or otherwise"[72] or as distributions. If the corporation was of a certain type, such amounts were treated as ordinary income, unless for the five years preceding such realization 90 percent or more of the corporation's gross income had not been personal holding company income. The concept employed for this purpose was that of an inactive corporation. An inactive corporation was defined as a corporation other than one whose business (for which separate books and records must also have been maintained) had been held for five years directly or indirectly by the distributing corporation or, subsequent to the distribution, by the corporation whose stock was distributed, provided also that 90 percent or more of the gross income of such business for the five-year period was other than personal holding company income. The curse of being an inactive corporation could extend not only to the spun-off corporation but also to the retained corporation.

We do not have the House Bill. But we do have enough changes in detail from existing law, verbal and otherwise, that, in a field where every comma counts, as it does in the case of the law dealing with corporate distributions and adjustments, lawyers, accountants, taxpayers, the Bureau, and the courts will be kept busy for many years.[73]

*C. Rudolf Peterson**

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72 House Bill Section 353(b)(1), H.R. 8300, 83d Cong., 2d Sess. 83 (1954).

73 This is the third and final instalment of Mr. Peterson's article *Corporate Distributions and Adjustments—Subchapter C of the Internal Revenue Code of 1954*. Part I, *Corporate Distributions*, see 30 NOTRE DAME LAW. 191 (1954), Part II, *Corporate Liquidations*, see 30 NOTRE DAME LAW. 360 (1955).

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