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Taxation - Federal Income Tax - Section 355 Held Applicable to the Division of a Single Business

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TAXATION—FEDERAL INCOME TAX—SECTION 355 HELD APPLICABLE TO THE DIVISION OF A SINGLE BUSINESS—Petitioner, E. P. Coady, and M. Christopher each owned 50 percent of the stock of the Christopher Construction Co., a corporation engaged for more than five years prior to November 15, 1954, in the conduct of a construction business. On that day the parent, Christopher Company, organized a subsidiary, E. P. Coady & Co., to which it transferred approximately one half of its contracts, equipment, and cash. In exchange, the parent company received all the stock of the subsidiary. Immediately thereafter, the parent distributed to petitioner, one of the two equal shareholders of the parent company, all the stock of the subsidiary in exchange for petitioner's stock in the parent. Although the fair market value of the shares received exceeded the basis of the shares surrendered, petitioner reported no gain from the transaction. Respondent, relying upon Treasury Regulation 1.355-1 (a) which denies tax free distribution under section 355[1] upon the division of a *single* business, assessed a deficiency. In a Tax Court proceeding, *held,* for petitioner, six judges dissenting.[2] Section 355 may properly be applied to a single business; Treasury Regulation 1.355-1 (a) is invalid. *Edmund P. Coady and Virginia Coady,* 33 T.C. No. 87 (1960).

Without special statutory treatment the receipt of stock from a corporate separation would result in a taxable event to the individual shareholder.[3] Since 1918, however, Congress has provided relief from certain of these distributions,[4] section 355 being the latest, and most comprehensive, of these relief provisions. While removing many of the previous complications and restrictions,[5] the new code adds several of its own. The most restrictive of these is the five-year-active-business rule of section 355 (b) which is satisfied only if "the distributing corporation, and the controlled[6] corporation, . . . is engaged immediately after the distribution in the active conduct of a trade or business . . . [and] such trade or business has been actively conducted throughout the 5-year period ending on the date of the distribution. . . ."[7] Interpreting this language, the Treasury Regulations concluded, "Section 355 does not apply to the division of a single business."[8]

1 I.R.C., §355.

2 Upon the facts of this case a Treasury victory would have been an anomaly, emphasizing form over substance. Both before and after the described transaction Mr. Christopher and Mr. Coady were in essentially identical positions; yet it could not be contended that Mr. Christopher experienced a taxable event.

3 Rockefeller v. United States, 257 U.S. 176 at 183 (1921). See, generally, Young, "Corporate Separations: Some Revenue Rulings Under Section 355," 71 HARV. L. REV. 843 at 844 (1958).

4 Revenue Act of 1918, 40 Stat. 1060, §202 (b).

5 See, generally, Caplin, "Corporate Separation: The 5-Year Business Rule," PROC. N.Y. UNIV. 15TH ANNUAL INSTITUTE ON FEDERAL TAXATION 623 (1957).

6 Control consists of ownership of 80% of the voting stock and 80% of all other classes of stock. I.R.C., §368 (c).

7 I.R.C., §355 (b) (1) (A) and §355 (b) (2) (B).

8 Treas. Reg. §1.355-1 (a) (1955).

In the principal case, the validity of this regulation was for the first time subjected to judicial scrutiny. The Tax Court invalidated the regulation, the majority finding that the statute did not require the businesses of the separated corporations to have been conducted independently of one another during the five years prior to separation. As applied to the principal case this meant that it was sufficient if the activities of each surviving corporation stemmed from *a* "construction business" conducted during the five prior years. The dissenters would require that the resulting businesses have been conducted as independent trades or businesses for those five years. Both majority and dissenters believe support for their respective positions can be found in the legislative history of this section. In fact, however, this particular problem was not specifically discussed by the legislators and neither group can do more than point to discussions of other problems which inferentially and unintentionally may support their position.[9]

Lacking a specific mandate, the courts should interpret this section in a manner which will effectuate the general purpose and intent of Congress. This and predecessor sections were designed to allow those separations and distributions for which there was a legitimate business purpose,[10] while at the same time preventing a corporation from making a distribution which is essentially equivalent to a dividend.[11] The five-year-active-business rule was intended to "safeguard against avoidance"[12] by preventing the corporate earnings of one business from being drawn off and put into another,

[9] The dissenters relied primarily upon the following quotation taken from the "General Explanation," S. Rep. 1622, 83d Cong., 2d sess., p. 51 (1954): "Your committee returns to existing law in not permitting the tax free separation of an existing corporation into active and inactive entities. . . . *[B]oth* the business retained . . . and the business . . . distributed must have been actively conducted for the 5 years preceding the distribution, a safeguard against avoidance not contained in the existing law." (Emphasis added.) However, even this language does not compel the conclusion that the two ("both") resulting businesses must have been conducted independently before the separation. Moreover, it is likely that under the "existing law" in 1954 division of a single business could qualify. See Rev. Rul. 289, 1953-2 Cum. Bul. 37. Furthermore, in the "Detailed Discussion of the Technical Provisions of the Bill" (S. Rep. 1622 at p. 151) there is no language which suggests that the two resulting businesses must have originally been conducted independently. Quite the contrary, the two examples given (S. Rep. 1622 at p. 267)—division pursuant to an antitrust decree and division of ownership of a jointly-owned corporation—are quite as likely to occur where the original corporation conducts only one business. See, generally, Dean, "Spin-offs: General Rules; Requirements as to Active Business; Some Practical Considerations (Section 355)," PROC. N.Y. UNIV. 15th ANNUAL INSTITUTE ON FEDERAL TAXATION 571 at 576 (1957).

[10] "[Y]our committee believes that it is economically unsound to impede spin-offs . . . when undertaken for legitimate business purposes." S. Rep. 781, 82d Cong., 1st sess., p. 58 (1951). For a partial list of legitimate business purposes, see Porter, "Spin-offs in Oil and Gas Industry," NINTH ANNUAL INSTITUTE ON OIL AND GAS LAW AND TAXATION 523 at 525-527 (1958). See also Michaelson, " 'Business Purpose' and Tax-Free Reorganization," 61 YALE L. J. 14 at 26 (1952).

[11] I.R.C., §355 (a) (1) (B).

[12] S. Rep. 1622, 83d Cong., 2d sess., p. 51 (1954).

thereby converting what would normally be dividends into readily salable capital assets.[13] However, although satisfaction of this mechanical requirement is a pre-requisite, it is not itself sufficient to qualify a division and distribution. To prevent abuse Congress has primarily relied upon the subjective requirement that "the transaction . . . not [be] used principally as a device for the distribution of earnings and profits"[14] of either corporation.[15] By limiting the scope of the mechanical five-year-active-business test the Tax Court in the principal case made possible the tax-free treatment dictated by the purpose of Congress.[16] The desire of co-owners to separate is certainly a legitimate business reason for division.[17] Because each resulting business had generated its own surplus, it could not be said that the distribution was a disguised dividend.[18] While the effect of the Tax Court's decision is to reduce to a minimum the mechanical hurdles preventing qualification under section 355, it cannot be said that the court has entirely eliminated the five-year-active-business rule established by the code. It is still necessary that the activities of each resulting entity have been conducted for the five prior years, and that they have been conducted as a "trade or business." The decision may, however, foreshadow an assault upon the Treasury's definition of "trade or business." The regulations require that each "group of activities ordinarily must include the collection of income and the payment of expenses" in order to comprise an active trade or business.[19] Thus the distributed stock of a "captive" coal mine, whose sole output is used by its owner to make steel, could not qualify for section 355 treatment.[20] Because the "captive" mine does not independently produce income, it is denied the dignity of being treated as a "business."[21] On the other hand, the construction activities in the principal case did independently produce income, and hence did satisfy the Treasury's definition of *a* "business." Thus it is not a necessary

13 Rev. Rul. 59-400, Int. Rev. Bul. 1959-1, 9.

14 I.R.C., §355 (a) (1) (B). This is essentially a codification of the "business purpose" doctrine espoused in Gregory v. Helvering, 293 U.S. 465 at 469 (1935). See Treas. Reg. §1.355-2 (c) (1955).

15 It is probable that even before this decision the Treasury was using a "device" or business purpose test though nominally relying upon the regulation that there be two or more businesses. Compare Rev. Rul. 56-451, 1956-2 Cum. Bul. 208 (publication of 4 magazines serving different trades constitutes more than one business) with Treas. Reg. §1.355-1 (d), ex. (16) (1955) (auto manufacturer's operation at profit of executive dining room is not a business). See also Rev. Rul. 58-54, 1958-1 Cum. Bul. 181. See, generally, Young, "Corporate Separations: Some Revenue Rulings Under Section 355," 71 HARV. L. REV. 843 at 858 (1958).

16 Also, permitting a single business to qualify under this section should make the law easier to administer, since the question whether the original enterprise constituted one trade or business or more has not proved easy to answer. See note 15 supra.

17 S. Rep. 1622, 83d Cong., 2d sess., p. 267 (1954).

18 See note 13 supra.

19 Treas. Reg. §1.355-1 (c) (1955).

20 Treas. Reg. §1.355-1 (d), ex. 12 (1955).

21 Note 20 supra.

consequence of this decision that vertically-integrated enterprises qualify for section 355 benefits. Nevertheless, the rather arbitrary distinction created by the five-year-active-business rule between vertically and horizontally organized enterprises[22] does provoke the question whether any mechanical tests are wise or necessary. The nature of the problem suggests that the interests of the taxpayer and the government would best be served by making the business purpose test not only the principal, but the sole, check upon abuse and evasion. Such proposals are now before the Congress.[23]

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[22] See comment, 67 YALE L. J. 38 at 46 (1957).

[23] H.R. 4459, 86th Cong., 1st sess. (1959) adds several additional mechanical requirements to §355, but in addition provides for tax-free distribution whenever "it is established to the satisfaction of the Secretary or his delegate that the distribution is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax. . . ."

At least two study groups have proposed similar legislation: THE AMERICAN LAW INSTITUTE, FEDERAL INCOME, ESTATE & GIFT TAX PROJECTS, INCOME TAX PROBLEMS OF CORPORATIONS AND SHAREHOLDERS 12, 13, 134, and 149 (1958), and U.S. Congress, House, Committee on Ways and Means, "Report on Corporate Distributions and Adjustments from Advisory Group on Subchapter C," 52 (1957). But see A.B.A. SECTION OF TAXATION, REPORT 19 (1959), refusing to recommend H.R. 4459, believing it to be too restrictive.