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NOTES

Section 355's Active Business Rule—An Outdated Inefficacy*

I. Introduction

The consistent growth and development of our economy depends to a great extent upon the ability of business to adjust to changes in its economic environment. Congress has responded to the need for corporate structural flexibility by granting the business community tax-free status for certain corporate separations.[1]

These corporate divisions can be achieved by one of three methods: spin-offs, split-offs, and split-ups.[2] The spin-off is a distribution by the distributing corporation of the stock of its controlled subsidiary. This distribution may be non pro rata or may resemble a dividend[3] if the shareholders receive the stock of the distributed corporation pro rata. The split-off is identical to the spin-off except that the shareholders of the distributing corporation exchange part of their stock in the distributing corporation for stock of the distributed corporation. Like a spin-off, the stock of the controlled corporation in a split-off also may be distributed either pro rata or disproportionately. The distributing corporation in a split-up distributes its stock in two or more subsidiaries to the shareholders pursuant to a plan of complete liquidation.

The congressional purpose in granting tax-free treatment to corporate separations was to create an atmosphere that, uninhibited by fear of taxation, would enable the business community to adjust more freely its methods of conducting business. It was felt that as long as the business assets remained in "corporate solution," the taxation of gain should be deferred since no viable economic change resulted from a mere change in corporate form.[4] The intrinsic potential of corporate

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1. *See* Jacobs, Spin-Offs: *The Pre-Distribution Two Business Rule—Edmund P. Coady and Beyond*, 19 Tax L. Rev. 155, 156 (1963-64).

2. *See* B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders § 11.01, at 450-51 (2d ed. 1966) [hereinafter cited as Bittker & Eustice]. For a clear illustration of spin-offs, split-offs, split-ups see J. Reeves, Tax Aspects of Corporate Mergers, Exchanges, Redemptions, Liquidations and Reorganizations 103-06 (1967).

3. *See* Jacobs, *The Anatomy of a Spin-Off*, 1967 Duke L.J. 1, 2.

4. Jacobs, *supra* note 1, at 156.

separations to "bail out" earnings and profits by converting ordinary dividend income into capital gain, however, made it necessary to distinguish a valid corporate readjustment from an attempted bail out. The most recent tool created to tackle this problem is section 355 of the 1954 Internal Revenue Code, which outlines a mechanically strict and elaborately detailed set of rules for qualification as a tax-free separation.

Section 355 provides for nonrecognition, at the shareholder level, of gain or loss on stock distributed pursuant to the separation of one or more businesses formerly operated by a single corporation into two or more corporations.[5] Essentially, therefore, it permits a tax-free distribution by the distributing corporation of stock or securities in the distributed corporation if its requirements are satisfied. Briefly stated the five basic requirements of section 355 are as follows: (1) the distributing corporation must distribute stock of a corporation that it "controls" immediately before the distribution;[6] (2) immediately after the distribution, both the distributing corporation and the controlled corporation must be engaged in the active conduct of a trade or business;[7] (3) the businesses of both the distributing corporation and the controlled corporation must satisfy a five-year business history rule[8] by having actively conducted their trade or business throughout the five-year period ending on the date of distribution; (4) the distributing corporation usually must distribute all of its stock in the controlled corporation;[9] and, (5) the transaction must not be used principally as a device for the distribution of earnings and profits.[10]

5. INT. REV. CODE OF 1954, § 355. *See* Jacobs, *supra* note 3, at 2.

6. INT. REV. CODE OF 1954, § 355(a)(1)(A). "Control" is defined as stock ownership possessing: (1) at least 80% of the total combined voting power of all classes of voting stock, and (2) at least 80% of the total number of shares of all other classes of stock of the corporation. INT. REV. CODE OF 1954, § 368(c). The distributing corporation must own stock of a subsidiary in amounts satisfying this test in order to qualify under § 355.

7. Similarly, if the distributing corporation's assets consisted solely of stock in 2 or more controlled subsidiaries, each of the subsidiaries must be actively engaged in a trade or business BITTKER & EUSTICE § 11.03, at 458. The Code does not provide a definition of an "active business" and this has led to the major problems of interpretation in this area. The Treasury Regulations do provide a definition of this term in Treas. Reg. § 1.355-1(c)(1955).

8. In addition to the 5-year test alluded to in the text, 2 other tests must be satisfied. The business must not have been acquired in a taxable transaction within the 5-year period. *See* Lloyd Boettger, 51 T.C. 324 (1968). The business also must not have been conducted by another corporation, the control of which was acquired during the 5-year period in a taxable transaction. BITTKER & EUSTICE § 11.03, at 458.

9. If the distributing corporation fails to distribute all of its stock in the controlled corporation, it must distribute enough stock to constitute control and establish to the satisfaction of the Commissioner that retention of the stock was not in pursuance of a tax-avoidance plan. INT. REV. CODE OF 1954, § 355(a)(1)(D)(ii).

10. The mere fact that, subsequent to the distribution, stock of a distributed corporation is sold is not conclusive that the transaction was used principally as a device. INT. REV. CODE OF

These prerequisites to section 355 treatment, however, have not effectively isolated appropriate tax-free separations from obvious bail-out transactions; consequently the business world has been plagued with the fear that a good-faith, validly motivated separation might be taxed. The most troublesome of section 355's requirements to interpret and apply accurately has been the active business rule. This concept, although "it appears simple, is essentially unmanageable" and generates a difficult and expensive form of litigation whose increased volume has contributed little clarity to the area.[11] It therefore has become imperative that a workable solution to the problems generated by the active business rule be formulated to restore the confidence of the business community and insure corporate flexibility while adequately foreclosing use of corporate divisions for bail outs.

In order to delineate the problems inherent in the active business rule, this Note first will examine the legislative history of tax-free separations, isolating the primary purpose and policy of section 355. Regulatory and judicial interpretations of section 355 will also be analyzed to determine their propriety in light of the statute's purpose and to illustrate the confusion that exists in the area. This, in turn, will lead to a suggested approach for dealing with section 355 transactions in the future.

II. LEGISLATIVE HISTORY—PURPOSE AND POLICY

A. *Tax Approaches Prior to 1954*

The Revenue Act of 1924[12] evidenced the first congressional recognition of the desire to facilitate corporate structural flexibility by providing for tax-free separations.[13] It permitted a transfer by a corporation of part or all of its assets to a second corporation to be designated as a reorganization if the first corporation or its shareholders were in control of the second corporation immediately after the transfer. No gain was to be recognized by the shareholders of the first corporation

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1954, § 355(a)(2)(B). On the other hand, if an arrangement for the sale of the distributed stock were made prior to distribution, this would suggest strongly the existence of a tax-avoidance motive. For a discussion of general tax treatment in qualifying and nonqualifying § 355 transactions see Sealy, *The Functions of Spin-Offs and Partial Liquidations*, N.Y.U. 20TH INST. ON FED. TAX. 799 (1962).

11. *See* Brown, *The Revenue Act of 1964: A Survey*, TULANE 14TH ANN. INST. ON TAX. 39, 43 (1965).

12. Revenue Act of 1924, ch. 234, § 203(c), 43 Stat. 256. This section provided for tax-free treatment of spin-offs and a similar provision covered split-offs. Tax-free split-ups had been permitted as early as 1918. Revenue Act of 1918, ch. 18, § 202(b), 40 Stat. 1060.

13. *See* Jacobs, *supra* note 3, at 4.

if stock of the second corporation was distributed to them as part of a reorganization plan.[14] So broad an exemption invited abuse. A corporation could transfer any accumulations or liquid assets to a newly organized corporation and distribute the stock of the new corporation to its shareholders, who in turn could either sell their stock or liquidate the new corporation, thereby effectively "bailing out" the accumulated earnings of the distributing corporation.[15] Thus, the shareholders would avoid the tax on dividends at ordinary rates and pay only a capital gains tax on the difference between the adjusted basis of their stock of the distributed corporation and either the value of the assets received in liquidation or the sales price received for the stock.

In *Gregory v. Helvering*,[16] a taxpayer attempted a similar bail out by having her solely owned corporation transfer certain specific assets to a newly organized corporation in return for all the stock of that corporation. This stock was then distributed by the original corporation to the taxpayer who in turn liquidated the corporation and received the desired assets. Then, to complete the planned transaction, the taxpayer sold the assets at capital gains rates to the third party who wanted the assets in the first place.[17] The Board of Tax Appeals held that since the taxpayer had complied with the statute she was entitled to tax-free treatment even though a tax avoidance device was employed.[18] The Supreme Court, however, held that the distributions were dividends and that corporate separations must be motivated by a valid business purpose and not tax avoidance.[19]

Congress reacted, perhaps too hastily, by enacting the Revenue Act of 1934 before the Supreme Court decision in *Gregory* was rendered. Had Congress awaited the decision, it might have preserved the

14. BITTKER & EUSTICE § 11.02, at 451.

15. *Id.*

16. 293 U.S. 465 (1935).

17. Evelyn F. Gregory, 27 B.T.A. 223 (1932), *rev'd*, 69 F.2d 809 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935). The taxpayer utilized this plan in order to avoid the dividend tax. If the corporation had sold the assets to the third party it would have paid only a capital gains tax on that transaction, but Mrs. Gregory would not have received the cash since it remained in corporate solution. If the corporation had distributed the cash to the taxpayer, the ordinary dividend tax would have been imposed since such distribution would be a dividend. *See* BITTKER & EUSTICE § 11.02, at 451.

18. "A statute so meticulously drafted must be interpreted as a literal expression of the taxing policy, and leaves only the small interstices for judicial consideration." 27 B.T.A. at 225. Apparently the court felt it could not disregard the detailed provisions of the statute when they were complied with, even if the Congress had overlooked potential tax-avoidance situations in drafting.

19. The Court noted that the corporation carried on no viable functions except to achieve the purpose of the taxpayer's plan to avoid taxes. This case has permeated all tax law and was a significant impetus in the creation of the device requirement of § 355 of the 1954 Code.

exemption, and left the courts to distinguish legitimate business-motivated spin-offs from tax-avoidance schemes.[20] Instead, the new statute eliminated the tax-free spin-off provision and in effect treated all spin-offs as dividends.[21] In recommending this change, the House Ways and Means Committee stated that by using spin-offs, "corporations have found it possible to pay what would otherwise be taxable dividends, without any taxes upon their shareholders" and that "this means of avoidance should be ended."[22] After seventeen years, however, Congress recognized that it is "economically unsound to impede [legitimately motivated] spin-offs which break up businesses into a greater number of enterprises,"[23] and once again provided for tax-free spin-offs. In an effort to alleviate the abusive schemes for which the prior exemption had been used, Congress, in its 1951 Act, introduced for the first time two prerequisites for tax-free treatment:[24] (1) the active business rule, and (2) the device clause.

The active business rule required that both the distributing corporation and the distributed corporation were intended to continue the active conduct of a trade or business after the spin-off.[25] This requirement was designed to prohibit a corporation from separating its investment or liquid assets from its operating assets, placing the former in a new corporation not intended to carry on an active business, and distributing the stock of the inactive corporation to its shareholders, who in turn liquidate the inactive corporation at capital gains rates.[26] Ostensibly, the *Gregory* doctrine, requiring a valid business purpose for a tax-free separation, could have prevented this type of tax avoidance scheme, but Congress preferred to bolster *Gregory* with this new

20. *See* Jacobs, *supra* note 1, at 158.

21. *See* H.R. REP. No. 704, 73d Cong., 2d Sess. (1934). Congress surprisingly did not prohibit pro rata split-offs and split-ups in the 1934 Act, even though these arrangements achieved similar economic results to those of spin-offs. *See* Jacobs, *supra* note 3, at 5. The tax-free treatment of split-ups continued under the 1918 Act and split-offs continued to be tax-free under the 1924 Act.

22. H.R. REP. No. 704, 73d Cong., 2d Sess. 14 (1934); *see* BITTKER & EUSTICE § 11.02, at 454.

23. S. REP. No. 781, 82d Cong., 1st Sess. 58 (1951). One reason Congress enacted a provision for tax-free spin-offs was due to the abuses occurring under the 1934 Code with split-offs and split-ups. By extending tax-free treatment to all 3 types of divisions together with safeguards to prevent tax avoidance, it was felt a more equitable system would result. Jacobs, *supra* note 1, at 159.

24. Revenue Act of 1951, ch. 521, § 317(a), 65 Stat. 493. Similar to previous statutes, the tax-free treatment was provided in conjunction with a reorganization.

25. *Id.* § 317(a)(11)(A).

26. *See* Jacobs, *supra* note 1, at 160. This provision was drafted "to limit its benefits to reorganizations in which all of the new corporations as well as the parent are intended to carry on a business after the reorganization . . . ." S. REP. No. 781, 82d Cong., 1st Sess. 58 (1951).

statutory requirement.[27] The second prerequisite was that the distributed corporation could not be used principally as a device for the distribution of earnings and profits.[28] It is apparent that this requirement also resembled the *Gregory* doctrine and was aimed at preventing the exact tax avoidance schemes that the active business rule was devised to attack. Thus from the outset there is evidence that the purposes of the active business rule and the device requirement overlap.

B. The 1954 Solution

A liberal treasury regulation promulgated under the 1951 Act,[29] together with the failure of the Act to obviate all the tax avoidance schemes,[30] prompted Congress to undertake an extensive revision of the statute. This enactment of section 355 reflected the congressional decision not only to modify and strengthen prior law but to include all three types of corporate divisions under one section.[31] The device clause

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27. *See* Jacobs, *supra* note 1, at 160.

28. Revenue Act of 1951, ch. 521, § 317(a)(11)(B), 65 Stat. 493.

29. *See* Massee, *Section 355: Disposal of Unwanted Assets in Connection with a Reorganization,* 22 TAX L. REV. 439, 445 (1967). The Treasury described the following situation as a qualifying transaction: A department store transfers cash, bonds, and a contract to purchase land to a newly organized corporation with the intention that the new corporation would purchase the land, develop a parking lot, and operate it as a facility for the department store's customers. The stock of the new corporation was distributed pro rata to the shareholders of the department store. Apparently, no matter how long the new corporation operated the parking lot, it qualified for tax-free treatment. *See* Jacobs, *supra* note 1, at 162. The Treasury could have utilized the device clause to deny nonrecognition to this transaction but apparently it believed the device clause to be inadequate to tackle this problem. Most assuredly, this explains to some extent why Congress enacted the 5-year active business rule. Massee, *supra* at 445-46.

30. *See* Massee, *supra* note 29, at 446. One example where it was thought neither the device clause nor the active business rule would defeat nonrecognition was the following situation: "X Corporation is engaged in the lock and key business. It is desirous of getting out of the lock business. Upon receipt of an advantageous offer for the lock business, it transfers the lock assets to newly created Y Corporation and distributes the Y Corporation stock to its shareholders who would sell the Y Corporation stock to the interested purchaser. X Corporation would continue to engage in the key business." *Id.* It is submitted that this scheme is prohibited by the present device clause of § 355 requiring that "the transaction was not used principally as a device for the distribution of the earnings and profits of the distributing corporation." Although a subsequent sale of the stock is not by itself evidence of a device, if the sale is prearranged it is one factor militating toward that conclusion. It was obvious in the former example that no valid business purpose existed except avoidance of taxes. Instead of selling the lock business and distributing the proceeds to the shareholders at ordinary rates, the corporation delayed the sale until it had transferred the business to another corporation. After the sale, the corporation would be liquidated at capital gains rates. This was clearly a device transaction. *See* note 32 *infra* and accompanying text.

31. *See* Massee, *supra* note 29, at 447. The Senate rejected the House proposal that restricted the subsequent sale of any distributed stock in a corporate separation to dividend treatment if the stock was sold within 10 years of the separation. *See* Jacobs, *supra* note 1. Under this bill, it was "immaterial whether the assets [were] those used in an active business but if investment assets,

was expanded to clarify that a subsequent sale of the spun-off stock, other than one negotiated and arranged prior to distribution, would not per se make the distribution a device.[32] The most significant change wrought by the 1954 Act, however, was its introduction of the five-year active business requirement by which Congress hoped to retain corporate flexibility while more effectively preventing abuse.[33]

The five-year active business history rule requires that both the business retained by the distributing corporation and the business of the distributed corporation must have been actively conducted for five years preceding the distribution.[34] The purpose of the pre-distribution rule apparently was to insure that the surplus of one business would not be separated from its operating assets by allowing spin-offs of newly created businesses that eventually would be liquidated.[35] The five-year active business rule, therefore, actually supplemented the device clause[36] in providing "a safeguard against avoidance not contained in existing law."[37] In addition, the Senate Finance Committee described it as a "[return] to existing law in not permitting the tax-free separation of an existing corporation into active and inactive entities."[38]

III. Treasury and Judicial Interpretations of Section 355

A. *Valid Business Purposes*

The economic desirability of not recognizing gain or loss on a distribution of stock in a properly motivated corporate division is easily discerned.[39] If prior to the distribution corporate earnings have increased

for example, were separated into a new corporation, any amount received in respect of such an inactive corporation . . . would be treated as ordinary income for a period of 10 years from the date of its creation . . . . It is not believed that the business need for this kind of transaction is sufficiently great to permit a person in a position to afford a 10-year delay in receiving income to do so at capital gain rather than dividend rates." S. Rep. No. 1622, 83d Cong., 2d Sess. 50 (1964).

32. *See* Massee, *supra* note 29, at 448. This device clause of § 355 clearly prohibits specific pre-1954 tax-avoidance schemes that received tax-free treatment. *See* note 30 *supra*. The device clause was probably intended to prevent the separation of surplus corporate liquid assets, or property acquired therewith, from the assets that generated the surplus. *See* Massee, *supra* note 29, at 449.

33. *See* Jacobs, *supra* note 1, at 164.

34. S. Rep. No. 1622, 83d Cong., 2d Sess. 50 (1954).

35. Tax avoidance was achieved by "transferring corporate surplus to the company to be spun off with the eventual realization of capital gain on the sale or liquidations of the spun-off company by the stockholders." *Hearings on H.R. 8300 Before the Senate Finance Committee*, 83d Cong., 2d Sess. 501 (1954); Massee, *supra* note 29, at 449 n.41.

36. Massee, *supra* note 29, at 449.

37. S. Rep. No. 1622, 83d Cong., 2d Sess. 50 (1954).

38. *Id.*

39. *See* Shaiman, *Does Section 355 Require the Existence of More Than One Separate Active Business Prior to the Distribution of Stock?*, 42 Taxes 279, 280 (1964).

or assets have appreciated in value, a substantial tax burden could force shareholders with insufficient funds to liquidate the surviving corporation and sell the productive assets of the business.[40] To avoid this result section 355 permits this division of assets to be conducted tax-free and enables shareholders to continue the business activities in corporate solution with as little disruption as possible.[41] Since the onus of effecting this purpose has fallen upon the Commissioner and the courts, an analysis of their interpretations will provide some insight into why section 355 has generated such confusion and has proved to be an inadequate means of distinguishing a bail-out transaction from a legitimate corporate separation. It is desirable at the outset, however, to ascertain exactly what legitimate business reasons induce taxpayers to employ section 355 separations.

There are numerous reasons that induce shareholders to utilize the benefits of section 355. One appropriate business motive for a corporation to divest itself of some portion of its assets is compliance with antitrust laws or decrees.[42] This particular situation normally results in a division in which the shareholders retain their pro rata ownership in all the assets although they are apportioned in two or more separate corporations.[43] In addition to an antitrust incentive, it is often necessary to segregate a risky or speculative enterprise from a more stable one.[44] A corporate division also may be desired when shareholders disagree as to the management of the corporation and can no longer successfully conduct its business.[45] These divisions result in each shareholder or group of shareholders separately owning the stock of two or more corporations.[46] In scrutinizing these kinds of separations, the Commissioner has emphasized that primary focus be on the business purpose of the corporation and not on the shareholder's business purpose;[47] nevertheless, the courts generally have given weight to both

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40. *Id.* In a spin-off, the shareholders would receive dividend income to the extent of earnings and profits. In an exchange transaction, such as a split-off, the difference between the adjusted basis of the stock surrendered and the fair market value of the stock received would be capital gain to the shareholders.

41. *Id.*

42. S. REP. No. 1622, 83d Cong., 2d Sess. 167 (1954).

43. Shaiman, *supra* note 39, at 280. This type of division would take the form of a spin-off.

44. Rev. Rul. 56-554, 1956-2 CUM. BULL. 198 (a bank distributed stock of a subsidiary that leased speculative property).

45. Rev. Rul. 56-117, 1956-1 CUM. BULL. 180; *see* Shaiman, *supra* note 39, at 280.

46. Shaiman, *supra* note 39, at 280. The most common example of this division would be a split-off.

47. Treas. Reg. §§ 1.368-1(b), -2(g) (1955); *see* BITTKER & EUSTICE § 12.19, at 555.

factors.[48] It is also frequently necessary to initiate corporate divisions in order to comply with a state or foreign law that prohibits, for example, the combination of several business functions in the same corporation.[49] Separation of a business to allow key employees to share in its ownership[50] is another valid purpose as is separation of a regulated enterprise from an unregulated one.[51] Furthermore, a separation to provide high-level management for one corporation and to allow the other corporation to expand its activities[52] also has been designated a valid motivation. The above reasons suggest why it is imperative that taxpayers have an efficient means to rearrange corporate structures. To provide this means was the obvious congressional intent for enacting section 355. Unfortunately, the Treasury has impaired the section's efficacy by burdening the taxpayer with the "active trade or business" requirement.

B. Active Trade or Business

In order to qualify for tax-free treatment under section 355 it is incumbent upon the taxpayer to prove first that the prospective assets for separation qualify as a business.[53] This requirement is of primary significance because the Service generally attacks the separated assets as not constituting an "active business" at all, which precludes the necessity of determining whether they possess the statutory five-year business history.[54] The taxpayer's problem is further aggravated by the fact that nowhere in the 1954 Code is there a definition of a "trade or business."[55] Likewise, the term, "the active conduct of a trade or business," is not explained.[56] It therefore is necessary to look at the definition of a "trade or business" found in the regulations:

> [F]or purposes of section 355, a trade or business consists of a specific existing group of activities being carried on for the purpose of earning income or profit from only such group of activities, and the activities included in such group must include every operation which forms a part of, or a step in, the process of

48. *E.g.*, Parshelsky's Estate v. Commissioner, 303 F.2d 14, 19-20 (2d Cir. 1962) (business purpose of the shareholders should be considered along with the corporate business purpose in determining the validity of the transaction).

49. BITTKER & EUSTICE § 11.01, at 449.

50. Rev. Rul. 59-197, 1959-1 CUM. BULL. 77.

51. BITTKER & EUSTICE § 11.01, at 449.

52. Rev. Rul. 56-451, 1956-2 CUM. BULL. 208. For a discussion of results commonly sought to be achieved by corporate divisions see 7 Z. CAVITCH, BUSINESS ORGANIZATIONS § 150.02 (1969).

53. *See* Whitman, *Draining the Serbonian Bog: A New Approach to Corporate Separations Under the 1954 Code*, 81 HARV. L. REV. 1194, 1215 (1968).

54. *Id.*

55. Massee, *supra* note 29, at 451.

56. *Id.*

> earning income or profit from such group. Such group of activities ordinarily must include the collection of income and the payment of expenses.[57]

The regulations further provide that certain activities do not constitute a trade or business. These include:

> (1) The holding for investment purposes of stock, securities, land or other property, including casual sales thereof (whether or not the proceeds of such sales are reinvested),
> (2) The 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, or
> (3) A group of activities which, while a part of a business operated for profit, are not themselves independently producing income even though such activities would produce income with the addition of other activities or with large increases in activities previously incidental or insubstantial.[58]

The specificity of the above regulations is deceptive, for the definition of an active trade or business under section 355 remains an illusive and vague term when applied to factual situations. It will be appropriate, therefore, in reviewing its interpretations to determine if it has been used consistently with the legislative purpose of the active business rule.

C. Division of a Single Business

1. *Treasury Viewpoint Prior to Coady.*—At the outset, the Treasury took the position that section 355 did not apply to the division of a single business.[59] In order to qualify for tax-free treatment, it therefore was necessary that there be two separate five-year-old active businesses in existence prior to the distribution.[60] The argument was made that the term "such trade or business" in section 355(b)(2)(B)[61] refers to the active conduct of the same trade or business that is required to be maintained after the distribution.[62] Since there must be two businesses after the distribution, the Treasury reasoned that there also must have been two separate and distinct businesses before the distribution.[63] This argument appeared tenuous at best. There was no indication from the language of section 355 nor from the Senate Finance

57. Treas. Reg. § 1.3551(c) (1955).

58. *Id.*

59. Treas. Reg. § 1.355-1(a) (1955) provides in part: "Section 355 provides for the separation, without recognition of gain or loss to the shareholders . . . of two or more existing businesses formerly operated . . . by a single corporation. . . . Section 355 does not apply to the division of a single business."

60. Shaiman, *supra* note 39, at 286.

61. INT. REV. CODE OF 1954, § 355(b)(2)(B) provides: "a corporation shall be treated as engaged in the active conduct of a trade or business if . . . such trade or business has been actively conducted throughout the 5-year period ending on the date of the distribution."

62. Massee, *supra* note 29, at 452.

63. *Id.*

Committee Report that the trade or business conducted by the distributed corporation after the distribution must have been a separate trade or business from that of the distributing corporation.[64] Moreover, section 346(b) requires a corporation to cease the conduct of one trade or business and to continue the conduct of another business in order to qualify for partial liquidation treatment.[65] Since section 346(b) clearly requires the existence of two separate businesses, Congress was free to use similar language had it wished to impose the same requirement under section 355.[66] Despite its logical infirmities, the Treasury's position retained its controlling status for some time. Thus the taxpayer seeking recognition in a corporate separation would contend that there were two distinct businesses already in existence. The Commissioner, on the other hand, would argue that there was only one business so that the separation would be prohibited by the regulations.[67]

2. *Coady and Its Aftermath.*—The doctrine of prohibiting the division of a single business met its demise in the landmark case of *Edmund P. Coady.*[68] A construction company, which had been actively engaged in the construction business for more than five years, was owned in equal proportion by two shareholders. Differences arose between the two shareholders, and they decided to separate the business. One-half of the assets were transferred to another corporation, and its stock was then distributed to one shareholder in exchange for all his stock in the original corporation.[69] The Commissioner contended that section 355 could apply only in the situation in which two separate active businesses exist after distribution and only if these same two separate businesses had been actively conducted for five years prior to the distribution. After examining the statutory language and the Senate Finance Committee Report, the court rejected the Commissioner's argument.[70] The court determined that the real purpose of the active business rule was to prevent the tax-free separation of active and inactive assets into active and inactive corporate entities and not to deny the division of a single trade or business.[71] Although the statute requires that after distribution

64. Jacobs, *supra* note 1, at 168-69.

65. INT. REV. CODE OF 1954, § 346(b); Jacobs, *supra* note 1, at 169.

66. *See* Jacobs, *supra* note 1, at 169.

67. *See* BITTKER & EUSTICE § 11.04, at 461.

68. 33 T.C. 771 (1960), *aff'd*, 289 F.2d 490 (6th Cir. 1961).

69. 33 T.C. at 772-73. The shareholders transferred one major construction contract, some cash, and part of the equipment of the old corporation to the new corporation. Similarly, the old corporation was left with a major contract, some equipment, and part of its cash. In effect, the 2 resulting corporations carried on the exact same business of the original corporation except on a smaller scale.

70. 33 T.C. at 779; *see* Jacobs, *supra* note 1, at 171.

71. 33 T.C. at 77-78.

the surviving corporations actively conduct a business with a five-year history, the court held it not necessary that each business have been conducted on an individual basis during that period.[72]

The *Coady* decision and its rationale were subsequently approved by the Fifth Circuit,[73] dealing the fatal blow to the Commissioner's single business prohibition. After resisting for almost ten years, the Internal Revenue Service finally conceded in Revenue Ruling 64-147[74] that a single business could be divided tax-free in a spin-off. In the same ruling, the Treasury stated that new regulations were being considered, but to date none have materialized. Since the Treasury's position and a number of the illustrative examples in the regulations[75] were predicated on the pre-*Coady* theory of no single business divisions, new regulations were a necessary concomitant to the Service's acceptance of *Coady*.[76] In their absence, an atmosphere of confusion has evolved.

3. *Confusion Run Rampant*.—In *Coady*, the court allowed nonrecognition for a "vertical" division of the pre-distribution business after which each of the post-distribution businesses carried on all stages or functions of the business. *Coady*, however, did not specifically determine the status of functional divisions in which one post-distribution business takes over only some functions of the original business—production, distribution, or financing—and the other post-distribution business assumes the remaining functions.[77] Although the court failed to address this point specifically, language suggests and certainly does not condemn the propriety of functional divisions.[78] Since *Coady*, courts have grappled with this problem but generally have avoided the precise issue of functional divisions by deciding the cases on other grounds.[79]

72. *Id.* at 778.

73. United States v. Marrett, 325 F.2d 28 (5th Cir. 1963) (3 factories owned by the same corporation were deemed to be a single business and the spin-off of one was held to be tax-free).

74. 1964-1 CUM. BULL. pt. 1, 136. The Service acquiesced and agreed to follow both United States v. Marrett, 325 F.2d 28 (5th Cir. 1963), and Commissioner v. Coady, 289 F.2d 490 (6th Cir. 1961), "to the extent they hold that section 1.355-1(A) of the Income Tax Regulations, providing that section 355 of the Internal Revenue Code of 1954 does not apply to the division of a single business, is invalid."

75. Treas. Reg. § 1.355-1(d), example (9) (1955) (corporation establishes a new plant in another state, but it cannot be separated tax-free for 5 years since it became a new business at the commencement of activity).

76. Whitman, *supra* note 53, at 1214-15.

77. BITTKER & EUSTICE § 11.04, at 462. The functional divisions also have been described as horizontal divisions.

78. 33 T.C. at 776-78.

79. *See* notes 155-68 *infra* and accompanying text; Marne S. Wilson, 42 T.C. 914 (1964), *rev'd on other grounds*, 353 F.2d 184 (9th Cir. 1965); H. Grady Lester, 40 T.C. 947 (1963).

Further confusion has resulted from *Coady's* effective reversal of the respective pre-*Coady* arguments of the taxpayer and the Commissioner. When a single five-year-old business is divided under *Coady*, each resulting business automatically shares in the history of the original business and thus will satisfy the five-year test. If each activity were deemed to be a separate business, however, each business would have to satisfy the five-year test in its own right.[80] Before 1964 the Service usually had argued that the separated assets did not constitute a separate business prior to the transaction and that they should be disqualified by the pre-*Coady* rule concerning the active conduct of a single business prior to separation. Having been deprived of that argument by *Coady*, the Service now argues for separate status prior to the distribution so that each business will need an independent five-year history before the separation can qualify.[81] On the other hand, the taxpayer hopes that what he previously had contended was a separate business will now be held to constitute an integral part of a single business, so that it need not establish an independent five-year history.[82] This reversal of roles has caused much uncertainty because to find separate businesses, the Commissioner can now utilize to his own advantage pre-*Coady* regulations that previously were favorable to the taxpayer. Although courts[83] generally have rejected attempts by the Commissioner to defeat taxpayers through use of these regulations, it is correct to say that the Internal Revenue Service has remained lax in its duty to administer effectively this specific tax law. The regulations[84] promulgated before *Coady* were obviously fashioned to aid the taxpayer

80. BITTKER & EUSTICE § 11.04, at 464.

81. *See* Whitman, *supra* note 53, at 1215. The Service also contended that the separated activities did not constitute an "active business" under the definition in the regulations. *See* notes 57 & 58 *supra* and accompanying text. This argument is still a viable one in present litigation and is utilized frequently by the Commissioner.

82. *See* Whitman, *supra* note 53, at 1215.

83. Estate of Lockwood v. Commissioner, 350 F.2d 712 (8th Cir. 1965); Patricia W. Burke, 42 T.C. 1021 (1964). Both courts rejected the use of the geographical test to find 2 separate businesses. The geographical test finds the existence of 2 separate businesses if a corporation has 2 stores or locations in different states. Although the trend of decisions clearly rejects the Commissioner's argument, it should be pointed out that the first case decided in the separate-versus-single business area was favorable to the Commissioner. In Albert W. Badanes, 39 T.C. 410 (1962), the Tax Court suggested that the operation of the same type business in different cities in the same state is the conduct of 2 businesses. The distributing corporation was engaged in the business of bottling and distributing soft drinks. *See* Massee, *supra* note 29, at 467-68.

84. *E.g.*, Treas. Reg. § 1.355-1(d), example (8) (1955) provides: "Corporation H manufactures and sells ice cream at a plant in State X and at a plant in State Y. Corporation H proposes to transfer the plant and related activities in State Y to a new corporation and distribute the stock of such new corporation to its shareholders. The activities in each State constitute a trade or business."

in his attempt to divide two separate businesses. There are numerous examples[85] suggesting certain factual situations, most of which are based on geographical location, that result in the existence of two separate businesses. By using these regulations based on pre-*Coady* theory, it is possible for the Commissioner now to require taxpayers to prove a five-year history for each business. In order to bring some semblance of order and clarity to this area, these regulations need to be revised in light of *Coady* and other decisions[86] that reject the geographical test of the Commissioner.

D. The Horizontally Structured Business—"Single" Versus "Separate" Business

1. *Separations Defined.*—As previously noted, the vertical division of a single business occurs when each of the post-distribution businesses carries on all stages or functions of the original business.[87] It is imperative at this point also to define two other problem areas in interpreting section 355. The first surrounds the horizontally structured business, which is a corporation that has been actively conducting two or more distinct and readily identifiable lines of business,[88] such as a munitions plant and a motel chain. In the separation of such a corporation, each activity will constitute a separate income-producing business for purposes of the regulations' definition and thus require a separate five-year history.[89] A more difficult horizontal problem exists with a large business that has a number of branches and locations in different geographical areas.[90] The problem is whether the branches are an integral part of a single business or constitute separate businesses that require a five-year history in their own right. The second troublesome area involves the vertically integrated business, which is a corporation comprised of a number of functions—production, distribution, management, research, or financing—all of which direct their activity toward one line of business.[91] When such a business attempts to separate these functions under section 355, the paramount

85. Treas. Reg. § 1.355-1(d), examples (10), (13)-(15) (1955).

86. *See* Estate of Lockwood v. Commissioner, 350 F.2d 712 (8th Cir. 1965); Patricia W. Burke, 42 T.C. 1021 (1964).

87. *See* note 77 *supra* and accompanying text.

88. *See* BITTKER & EUSTICE § 11.04, at 464.

89. *Id.*

90. *See* R. COHEN, CORPORATE SEPARATIONS—ACTIVE BUSINESS REQUIREMENT A-13 to -15 (BNA Tax Management Portfolio No. 224, 1969).

91. *See* BITTKER & EUSTICE § 11.04, at 462. Vertical integration also includes division of "layers," such as a wholesaling or retailing subsidiary.

issue becomes whether the separated function constitutes an independent income-producing business.[92] Examination of judicial analysis made in both these areas will illustrate the initial liberality of the courts in aiding the taxpayer, and the subsequent failure of the courts and of the active business rule to achieve the legislative purpose of section 355.

2. *Geographical Test Provides Relief.*—Prior to *Coady*, the regulations allowed large nationwide companies with numerous local facilities to receive the benefits of section 355 by providing relief from the no-single-business-division rule because of their geographical distribution.[93] Since *Coady*, the regulations still rely heavily on the geographical situs of the activities and on the quality and nature of those activities in determining the existence of separate business status.[94] So long as the activities are conducted independently,[95] the manufacture and sale of the same product in two different states[96] constitutes separate businesses as does a new plant's production of the same product in a separate state.[97] Similarly, operation of two retail clothing stores, each in a different area of the same city, each selling the same products, but each having its own manager with control over purchases, constitutes two separate businesses.[98] Although the geographical test was the safest route to qualification, the service also recognized the characterization of two businesses on the basis of differentiation of product[99] or of customers serviced.[100]

92. *See* notes 135-42 *infra* and accompanying text. Generally the Commissioner attacks the function as not satisfying the defnition of an active trade or business. He contends that it was only an incidental activity and did not independently produce income. *See* Treas. Reg. § 1.355-1(c)(3) (1955).

93. *See* Whitman, *supra* note 53, at 1224. Each separate business, of course, must prove its independent 5-year active business history in order to qualify.

94. *See* BITTKER & EUSTICE § 11.04, at 464.

95. Rev. Rul. 58-54, 1958-1 CUM. BULL. 181, 182; *see* 3 J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 20.103, at 536 (1965).

96. Treas. Reg. § 1.355-1(d), examples (8), (14) (1955); *see* Treas. Reg. § 1.355-1(d), example (13) (1955) (manufacture of same product in 2 different states constitutes 2 separate businesses).

97. Treas. Reg. § 1.355-1(d), example (9) (1955).

98. Treas. Reg. § 1.355-1(d), example (10) (1955); *see* BITTKER & EUSTICE § 11.04, at 465. The examples were unclear as to the degree of independence that must exist in order to satisfy the separate business test.

99. *See* Whitman, *supra* note 53, at 1224; *cf.* Rev. Rul. 56-655, 1956-2 CUM. BULL. 214 (a furniture and appliance business).

100. *See* Rev. Rul. 56-451, 1956-2 CUM. BULL. 208. Additional examples of horizontally structured businesses qualifying for separation are Rev. Rul. 57-126, 1957-1 CUM. BULL. 123 (marketing fresh fruits and cotton compressing business) and Rev. Rul. 56-450, 1956-2 CUM. BULL. 201 (typesetting and electrotyping business separate from commercial printing business). *See* *Simon, Tax-free Corporate Divisions: They Are Still a Danger Area After Ten Years*, 23 J. TAXATION 22, 25 (July 1965).

3. *Judicial Rejection of the Geographical Test.*—The *Patricia W. Burke* case[101] was a taxpayer victory that initiated the eventual demise of geographical location as a test for separate business status. In *Burke*, a corporation, engaged in the radio parts and supplies business, opened a branch outlet in another community of the same state. Within three years the branch outlet was incorporated and its stock was spun-off in order to allow the branch manager to receive an investment in its operation.[102] The Commissioner contended that the establishment of the new branch constituted a separate business, and, since it had not been operated for five years, it failed to satisfy the active business rule. The Tax Court, however, rejected this contention, stating that the branch "did not carry on 'every operation which forms a part of, or a step in, the process of earning income or profit from such group.' "[103] The court concluded that the branch was only a continuation and furtherance of the existing business and not the establishment of a new business.[104]

The geographical situs argument was again rejected in *Estate of Lockwood v. Commissioner.*[105] A Nebraska corporation, engaged in the manufacture and sale of farm machinery, established a branch office in Maine. Within five years and pursuant to a plan of reorganization, the branch was incorporated and shortly thereafter was spun-off to the shareholders. The Tax Court accepted the Commissioner's contention that the Maine business must independently satisfy the five-year history requirement. The Eighth Circuit reversed the Tax Court and held that neither the statutory language nor the legislative history contemplated a geographical test. The true test was whether the distributing corporation for five years had been actively conducting the type of business now performed by the branch without reference to the geographic area.[106] Since the Nebraska corporation was engaged in active business for five years and the branch had continued in the same

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101. 42 T.C. 1021 (1964).

102. 42 T.C. at 1021-27. The original business was organized in 1947 in Pueblo, Colorado. The branch was established in 1954 with the acquisition of a store and warehouse in Grand Junction, Colorado.

103. 42 T.C. at 1028. The court cited the Commissioner's own definition of a trade or business to support the theory that the branch did not constitute a separate business.

104. 42 T.C. at 1028. Various factors were cited by the court which suggested that the branch was a continuation of the existing business and not the creation of a new business. The merchandise sold in the Grand Junction branch was obtained ordinarily from Pueblo and was sold by Pueblo salesmen. The branch had no outside salesmen and had no bank account except for a transfer account. Finally, all the branch accounts receivable, credit matters, and collections were handled by Pueblo.

105. 350 F.2d 712 (8th Cir. 1965).

106. 350 F.2d at 717.

business, the branch, sharing its parent's history, had satisfied the five-year rule.[107] The opinion points out that had the parent spun-off a new business or one different from its own, the branch necessarily would have had to exhibit its own independent five-year history.[108]

Both the legislative history and the purpose of the active business rule support the *Lockwood* rationale. The house report states that an active trade or business meets the requirements of section 355, even though it undergoes a change during the five-year period "by the addition of new, or the dropping of old products, changes in production capacity, and the like, provided the changes are not of such a character as to constitute the acquisition of a new or different business."[109] Clearly the branch was not a new business but rather a business identical on a smaller scale to that of the parent.[110] Although *Lockwood* and *Burke* directly contravened the geographical test of the regulations, both decisions sustained the basic purpose of the active business rule—prevention of the tax-free separation of active and inactive assets.[111] The branch outlets in both decisions were neither shells for inactive assets nor functional avenues for the bail out of earnings. The liberal interpretation[112] by both courts illustrated a judicial awareness that legitimately motivated separations consistent with the purpose of the active business rule should be upheld. This enlightened awareness, however, was soon to be clouded by a rigidly mechanical approach to interpretation adopted by the Tax Court.

4. *Tax Court's Strict Mechanical Approach.*—In *Lloyd Boettger*,[113] Oak Park Community Hospital, Inc., organized in 1956, began actively to conduct a hospital business in Stockton, California. In 1961 in a taxable asset acquisition, Oak Park purchased a hospital in Los Angeles using available corporate funds. Approximately two and

107. 350 F.2d at 715. Although the opinion never states specifically that the subsidiary branch shares in the business history of the parent, it is apparent that the intention of the court was to imply this conclusion.

108. 350 F.2d at 718. This was in answer to the Commissioner's contention that the court's reasoning would allow any kind of separation regardless of the nature of the separated business as long as it was integral to the active business of the parent.

109. H.R. REP. No. 2543, 83d Cong., 2d Sess. 38 (1954).

110. 350 F.2d at 715. The court stated that "the crucial question becomes whether or not the 2 corporations existing after distribution are doing the same type of work and using the same type of assets previously done and used by the prior *single* existing business." 350 F.2d at 717.

111. 350 F.2d at 716. The court cites *Coady*.

112. Using the geographical standard and the fact that each branch was less than 5 years old, the courts in both cases could easily have decided against the taxpayer. Instead they chose not to use a strict mechanical approach but to interpret the statute in light of its basic purpose. This approach, in that sense, is deemed to be a liberal one.

113. 51 T.C. 324 (1968).

one-half years later during the course of Oak Park's operation of the two hospitals, a dispute arose among the stockholders and they decided to "split-up" the two hospitals. Each hospital was transferred to a new corporation in exchange for stock, with the Stockton hospital going to Oak Park North and the Los Angeles hospital going to GERM Hospital, Inc. Pursuant to the split-up plan, Oak Park distributed the stock of one hospital corporation to one group of shareholders and the stock of the other hospital to the remaining shareholders. Oak Park was then liquidated.[114] In order to satisfy the active business rule under section 355(b)(2)(C), a trade or business that is separated must not have been acquired within five years of the distribution in a taxable transaction.[115] The Commissioner contended, therefore, that since the Los Angeles hospital was purchased in a taxable transaction less than five years before the split-up, it failed to satisfy the active business requirements. He further asserted that each hospital constituted a separate business and that the Los Angeles hospital was actively conducted for only two and one-half years.[116] The taxpayers argued that the Los Angeles hospital did not constitute a separate trade or business but that Oak Park was engaged in a single hospital business. Thus, according to the taxpayer, the new hospital should be allowed to share Oak Park's business history. Emphasizing the statutory language as its authority,[117] the court determined that GERM's business of operating the Los Angeles hospital after the distribution was the same business that Oak Park acquired in a concededly taxable transaction two and one-half years earlier. The court stated that the purpose of section 355(b)(2)(C) was to prevent a corporation from using accumulated earnings to purchase a going business as a temporary investment in anticipation of a tax-free division.[118] Although recognizing that the instant transaction had no tax avoidance motive, the court concluded that the distributions failed to qualify under section 355 because the

114. *Id.* at 324-28; *see* Emory, *Tax Court Further Narrows Tax-Free Corporate Separations*, 47 TAXES 219, 220 (1969).

115. INT. REV. CODE OF 1954, § 355(b)(2)(C): "[S]uch 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 . . . ."

116. 51 T.C. at 329. This contention is presumed from the language of the case although the court did not specifically articulate that contention in the terms used.

117. *Id.* at 330. The court stated that § 355(b)(2)(C) prohibits a corporation from separating a business that was purchased in a taxable transaction within 5 years of the distribution. It then reasoned that the "such" trade or business in § 355(b)(2)(C) refers to the same trade or business engaged in by the controlled corporation after the distribution. Since that same trade or business was acquired less than 5 years before the distribution in a taxable transaction, the transaction failed to satisfy § 355.

118. 51 T.C. at 330.

separated hospital was acquired in a taxable transaction within five years of the distribution.

The Tax Court refused to decide the case on the basis of the single versus separate business issue despite voluminous evidence to indicate the general unitary nature of the enterprise.[119] Instead, the court categorically concluded that the trade or business acquired in a taxable transaction in section 355(b)(2)(C) refers to the same business the controlled corporation is engaged in after the distribution and refused to decide if the business of GERM was the same or different from that of Oak Park North.[120] As previously stated, Congress intended to prevent a corporation from using liquid assets to purchase a new trade or business in anticipation of effecting a tax-free separation. In selecting the term "such trade or business" in section 355(b)(2)(C) to prevent a bail out, Congress must have intended the term to refer only to a trade or business separate and distinct from that operated by the original corporation.[121] Any other intepretation will dangerously restrict, if not totally destroy, the right of shareholders of an expanding corporation to effect a tax-free separation unless the assets have been sufficiently aged.[122]

The Tax Court did state that whether the Los Angeles hospital constituted an integral part of Oak Park's previous business was irrelevant in determining tax-free status.[123] This reasoning contradicts both the legislative history and previous case law. The House Report states that section 355 requirements are met even though the separated trade or business underwent a change during the five years preceding distribution. Thus the "addition of new, or the dropping of old products, changes in production capacity, and the like, provided the changes are not of such a character as to constitute *the acquisition of a new or different business*"[124] will not disqualify the transaction from tax-free

119. *See* Emory, *supra* note 116, at 220. Among the various indicia implicative of a single business were: 1) Oak Park employed the same accounting firm and attorney to represent it in all its accounting and legal matters with respect to both hospitals; 2) the same insurance company wrote the insurance for both hospitals; 3) nonperishable foods served at both hospitals were purchased from the same supplier; and, 4) Oak Park consistently presented its financial statements on a consolidated basis without differentiating one hospital from the other. There was other evidence, however, that did suggest separateness, such as separate bank accounts and separate medical staffs. 51 T.C. at 326-27.

120. *See* Emory, *supra* note 116, at 221.

121. *Id.* This is particularly evident in a situation, such as *Boettger*, in which the newly acquired business is not an inactive asset and is engaged in exactly the same business that the original corporation conducts.

122. *Id.*

123. 51 T.C. at 330.

124. H.R. REP. No. 2543, 83d Cong., 2d Sess. 38 (1954) (emphasis added).

treatment. The paramount interest of Congress, therefore, was to preclude an acquisition of a completely new and different business since that type of business is particularly vulnerable to bail out treatment. In *Boettger*, however, the newly acquired business was not different from the business of the original corporation but precisely identical to it. Although the Tax Court refused to find the two hospitals to be separate businesses,[125] its conclusion that Oak Park acquired a trade or business during the tainted period must have assumed that the new hospital was a separate business.[126] This interpretation may well have reinstated the previously discarded geographical test and cast doubt upon both *Burke* and *Lockwood*, since the two hospitals in question were located in different cities.[127] The commencement of an activity with liquid assets at a new location as in *Burke* and *Lockwood* seems to involve the same avoidance of the five-year rule as does the purchase of a new activity with liquid assets in *Boettger*.[128] In each case liquid assets are invested in a new activity, and, within less than five years, the stock of a corporation comprised of those assets is distributed to the shareholders of the distributing corporation.[129] Consequently, the difficulty of reconciling the *Boettger* decision with both *Burke* and *Lockwood* has precipitated confusion in an area previously favorable to the taxpayer.[130]

Of greater concern is the profound change in the Tax Court's approach to interpreting section 355's active business rule suggested by the *Boettger* decision. The court apparently has adopted a strictly mechanical construction of the detailed provisions at the expense of disregarding the section's essential policy. The avowed purpose of the active business rule was to prevent the separation of active and inactive assets and to supplement the potency of the device clause to prevent a bail out of earnings. Moreover, section 355 was designed to effectively distinguish valid corporate separations from tax avoidance schemes. In this regard, the *Boettger* court specifically noted that the case did not present a purposeful attempt to bail out corporate earnings by the acquisition of a business for intended later distribution.[131] It further

125. 51 T.C. at 330 n.8. The court stated that it would not express an opinion on the question of whether Oak Park operated a single business in 2 locations or operated 2 separate businesses.

126. *See* Emory, *supra* note 114, at 221-22.

127. *Id.* at 222.

128. *See* R. COHEN, *supra* note 90, at A-16.

129. *Id.*

130. *Id.* Uncertainty presently exists in the area for 2 reasons: (1) the Service has failed to acquiesce in *Burke*, and (2) *Boettger*, the most recent case concerning horizontal integration, was a strong government victory.

131. 51 T.C. at 331. This supports the contention that the court's hands were tied by virtue of the literal statutory language. The court recognized that *Boettger* was appropriate for the use of § 355, but because of the strict statutory language the court was forced to hold against the taxpayer.

declared that the record clearly established a valid business purpose for the distribution and that it was not a device for distributing earnings and profits.[132] Despite these utterances, the court denied the taxpayer tax-free treatment because of the literal statutory language of section 355(b)(2)(C).

The disparity between the *Boettger* decision and the purpose of section 355 is not the fault of the court but the failure of section 355 to implement successfully its legislative purpose. *Boettger* merely exposes the active business rule as an attempt to eliminate all tax avoidance schemes by use of an ineffective shotgun approach that necessarily kills valid corporate separations in its path. Consequently, the responsibility for remedying the undesired results of the decision should be borne by Congress rather than by the judiciary. The difficulty of the task, however, is further complicated by the failure of section 355 to treat adequately either vertical integration situations or real estate transactions.

E. *The Vertically Integrated Business—Functional Divisions*

1. *Arguments Employed To Defeat Functional Divisions.*—The vertically integrated business is a corporation composed of various functions, all of which direct their activity toward one line of business.[133] As previously noted, a division of these businesses can be described as a functional division when after the separation one business takes over some of the functions of the original business and the other business takes over the remaining functions.[134] Prior to *Coady* this type of separation, however, was rarely utilized since the Commissioner had two powerful weapons to defeat functional divisions. First, there were a number of examples provided in the regulations describing functional divisions that were disapproved for failure of the particular function to constitute a trade or business. Under the regulations, for example, neither a research department of a manufacturing corporation[135] nor the executive dining room of a car manufacturer[136] constituted a trade or business. Other examples prevented the breakup of the manufacturing

132. *Id.*

133. *See* note 91 *supra* and accompanying text.

134. *See* note 77 *supra* and accompanying text.

135. Treas. Reg. § 1.355-1(d), example (5) (1955). After separation, the research corporation was to serve the original corporation on a contract basis.

136. Treas. Reg. § 1.355-1(d), example (16) (1955) provides: "Corporation R manufactures and sells automobiles and operates an executive dining room primarily for the convenience of its executives. The dining room is managed and operated as a separate unit and the executives are charged for their meals. Corporation R derives a profit from the operation of the dining room. The activities connected with the executive dining room do not constitute a trade or business."

and selling operations of the same corporation[137] and prohibited a steel manufacturer from spinning-off a coal mine used as a supply outlet.[138] Secondly, the definition of a trade or business in the regulations was particularly narrow.[139] The third proviso of the definition of a trade or business excluding any "incidental activity"[140] was an especially potent argument to deny functional divisions. Thus attempts by large corporations to spin-off part of their total operation, such as a research department, ran afoul of this third negative proviso and were characterized as incidental activities.[141] Furthermore, a separation of one of the corporation's vertical "layers," such as the wholesaling subsidiary, could be attacked as only a step in the income producing process and thus not an active business.[142]

2. *Arguments for Functional Divisions.*—The basic layer theory, derived from the pre-*Coady* concept that a single business could not be divided, prohibited different levels of a business, such as retail and wholesale departments, from being separated.[143] *Coady* not only destroyed the rationale of the layer prohibition, but its emphasis on the active-inactive distinction suggested that if each layer conducts active business operations, it could constitute a trade or business.[144] An executive dining room maintained by a manufacturing company is economically viable if after being separated from the original business it operates profitably and does not constitute a passive investment. Assuming this to be true, the dining room's separation seems no more objectionable than the separation of a more crucial function of the original business.[145] Moreover, in terms of economics, assets connected with a coal mine, a research department, or even a sales department

137. Treas. Reg. § 1.355-1 (d), example (11) (1955); *see* Rev. Rul. 58-54, 1958-1 CUM. BULL. 181 (soft drink bottling and distributing business could not separate its 3 distribution operations).

138. Treas. Reg. § 1.355-1 (d), example (12) (1955) provides: "Corporation M is engaged in the manufacture and sale of steel and steel products. In addition, Corporation M owns and operates a coal mine for the sole purpose of supplying its coal requirements in the manufacture of steel. It is proposed to transfer the coal mine to a new corporation and distribute the stock of such new corporation to the shareholders of Corporation M. The activities of Corporation M in connection with the operation of the coal mine do not constitute a trade or business, since such activities are not themselves independently producing income although a part of the business operated for profit."

139. Treas. Reg. § 1.355-1 (c) (1955); *see* note 57 *supra* and accompanying text.

140. Treas. Reg. § 1.355-1 (c)(3) (1955); *see* note 58 *supra* and accompanying text.

141. Whitman, *supra* note 53, at 1221; *see* Treas. Reg. § 1.355-1(d), example (5) (1955).

142. Whitman, *supra* note 53, at 1222; *see* Treas. Reg. § 1.355-1(d), example (11) (1955); Rev. Rul. 58-54, 1958-1 CUM. BULL. 181.

143. *See* Whitman, *supra* note 53, at 1223.

144. *Id.*

145. *See* BITTKER & EUSTICE § 11.04, at 463. Bittker uses this factual situation to illustrate the fallacy in prohibiting functional divisions.

are clearly not passive or inactive, because they account indirectly for a portion of the profits realized by the corporation.[146] These assets contribute to the success of their businesses as a whole and do not constitute the types of assets a corporation would willingly spin-off to its shareholders as a bail out.[147] These assets will require active management immediately after separation and generally would be spun-off in connection with an expansion in the scope of their operation.[148] Certainly, the Senate Finance Committee did not envision these types of assets as coming within the congressional interdiction of bail outs achieved by separating inactive from active assets.[149]

Since separate entities may be able to borrow additional capital more easily than can an integrated whole, functional divisions appear to be economically desirable.[150] They also can provide a means for needed expansion as well as a mode for strengthening efficiency.[151] As a matter of section 355 policy, therefore, it is difficult to see any compelling reason why a new active function of a business cannot be spun-off within five years of its creation.[152] As long as no bail out was intended and no device was employed to separate active and inactive assets, a function of an active business operated for profit should qualify for section 355 treatment whether or not it has a five-year history of independently producing income.[153] Today's active business rule, however, prevents these functional divisions unless the five-year history requirement is satisfied.[154] Since the active business rule stifles these

146. *See* Massee, *supra* note 29, at 463.

147. *See* Whitman, *supra* note 53, at 1223.

148. *See* Massee, *supra* note 29, at 463-64. This expansion could result from a number of causes, such as a new discovery in research that would justify the operation of the research department as a separate corporation. Furthermore, a selling activity might be separated so that the sales department could increase efficiency by selling other lines of products. *Id.* at 464.

149. *Id.* at 463.

150. *See* Whitman, *supra* note 53, at 1223. A manufacturing corporation that also conducts a speculative oil drilling business might find difficulty in obtaining loans because of its speculative nature. By separating the oil business from the manufacturing enterprise, the manufacturing should be able to secure financial assistance more readily from any lending institution.

151. *See* note 148 *supra* and accompanying text.

152. *See* R. COHEN, *supra* note 90, at A-23.

153. *Id.* at A-20. The incidental activity language is misleading and vague since it fails to determine if a business is active or not. The basic policy of § 355 is to allow the separation of 2 active businesses. If a bank owns a cigar store located on the ground floor of its office building, and that cigar business is actively conducted, there seems to be no reason why the bank cannot separate that cigar store if it plans to expand that store's business. There is no doubt, however, that the cigar business is incidental to the main activity of the bank. Thus the separation of the cigar store would be prohibited.

154. Taxpayers frequently have utilized a "separate incorporation" argument to provide an operation with active business status when undergoing a functional division. There is some authority

important divisions, its inability to accomplish its intended purpose of insuring corporate flexibility whenever possible is again apparent.

3. *Tax Court Decisions.*—In *H. Grady Lester*,[155] a corporation engaged in the business of selling automobile parts and supplies, acted as both a warehouse distributor and as a jobber. As a distributor it sold to jobbers, and as a jobber it sold to dealers.[156] Although the corporation kept one overall set of books, it did not maintain separate books for each business. The general managers, however, kept records to compute the approximate profits being earned by the warehouse distribution activity and the corporation's sales as a jobber. Because of other jobbers' complaints about the corporation's dual function and because of a possible violation of the Robinson-Patman Act, the warehouse business was spun-off to the corporation's shareholders.[157] The Tax Court held that the original corporation conducted two separate businesses for at least five years prior to the distribution.[158] The court further stated that although the two activities were conducted by the same company, at the same location, and with the same employees, the activities were two separate businesses.[159] The court's refusal to find a single business and thereby meet the functional division issue squarely makes this decision an important one. A corporation in the auto parts industry that serves as a distributor and as a jobber is similar to a corporation that both manufactures and sells one product. These two activities in a sense form layers of the corporation, and their separation can easily be treated as a functional division.[160] Although not couching its decision in functional

for the proposition that mere incorporation of an activity carried on by a business will be sufficient to give that activity an active business status. *See* Isabel A. Elliott, 32 T.C. 283, 291 (1959). On the other hand, the Commissioner combats functional divisions with arguments that attack the active business status of the separated function. If 2 businesses are separately identifiable, but the earnings of one have been employed to finance substantial growth in the other during the 5 year period preceding the separation, the Commissioner may contend that § 355 cannot be used. BITTKER & EUSTICE § 11.05, at 473; *see* Rev. Rul. 59-400, 1959-2 CUM. BULL. 114 (§ 355 did not apply where the earnings of a separate hotel business were used to acquire rental properties rather than the earnings of the rental business).

155. 40 T.C. 947 (1963).

156. *Id.* at 948. In the automotive parts business, the principal service the warehouse distributor renders is to keep a large stock of inventory on hand locally so that it is readily available to the jobber in filling his orders. As compensation for performing this service, the manufacturer will sell to the distributor at a lower price than to the jobber or will allow the distributor a commission on sales to jobbers.

157. *Id.* at 949. Customers of the jobbers became aware that they could buy directly from the corporation which was a jobber at their own jobber's price and save his markup. The jobbers, of course, were displeased with this loss of business.

158. *Id.* at 957.

159. *Id.* at 958.

160. *Id.* at 957. The court stated that there are 4 distinct and separate phases of distribution and sales in the auto parts industry: (1) the manufacturer, (2) the distributor, (3) the jobber, and

division terms, the court in *Lester* approved this kind of division by giving separate trade or business status to an activity heretofore denied such status. Notwithstanding a regulation suggesting the contrary,[161] the *Lester* decision recognized that a function of a corporation can constitute a trade or business when its separate activities have been conducted for more than five years. The more difficult decision, however, that has not yet been decided is the separation of a function without a five-year history.[162]

In a later case, *Marne S. Wilson*,[163] a retail furniture corporation spun off its credit financing activities. Initially, the corporation had begun selling on credit and had handled as many conditional sales contracts as possible. The financing business grew substantially to encompass outside financing and at the time of the spin-off, the financing operation accounted for nearly one-third of the corporation's profits.[164] The Tax Court held that "the financing activities here involved were of sufficient magnitude and character throughout the five-year period to constitute an actively conducted business."[165] Although the court again failed to use functional division language, it made another broad step by upholding a purely functional division, especially in light of the liquidity element of the installment contracts that were transferred.[166]

The Service has bolstered these two judicial interpretations with Revenue Ruling 68-407,[167] concerning a corporation engaged in both a wholesale and a retail drug business. The retail operation purchased 65 percent of its merchandise from the wholesale division. Eighty percent of all the sales of the wholesale division were made to the retail operation and the remaining sales were made to various unrelated retailers. Each

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(4) the dealer. The distributor maintains an inventory that he warehouses; the jobber, on the other hand, does not warehouse but sells directly to the dealer.

161. Treas. Reg. § 1.355-1(d), example (11) (1955).

162. If the court were to approve a functional division of an activity performed for less than 5 years, it would necessarily decide the case by finding a single business, allowing the function to share in the parent's business history. This would be a completely different tack and probably the Tax Court is unwilling to go that far.

163. 42 T.C. 914, *rev'd on other grounds*, 353 F.2d 184 (9th Cir. 1965).

164. 42 T.C. at 917; *see* Whitman, *supra* note 53, at 1227. Reasons given for the spin-off were: (1) to enable a separate finance company to make repossessions and bring suits without unfavorable customer reaction, (2) to enable the financing operation to purchase contracts more easily from other retail stores, and (3) to increase efficiency of the sales program. 42 T.C. at 922.

165. *Id.* at 925. The court remarked that the finance business carried on collection and repossession and produced significant amounts of income.

166. *See* Whitman, *supra* note 53, at 1227. This made it highly vulnerable to bail-out treatment.

167. 1968-2 CUM. BULL. 147.

division was separately located and had its own employees. The Service approved the spin-off of the wholesale division since it was effected for valid business purposes.[168] The Tax Court and the Commissioner, although refusing to articulate in terms of functional divisions, have thus upheld the validity of functional divisions in certain limited factual situations. It is hoped that they will remain flexible in this area, especially in situations where no motive of tax avoidance is present.

F. Real Estate and Investment Property

An increasing volume of recent litigation clearly evidences the difficulties encountered by the active business concept in the areas of real estate and investment property. A close scrutiny of the problems and judicial interpretations in this area will further substantiate the inadequacy of the active business rule.

1. *Investment Property.*—The potential for bailing out earnings is readily apparent in situations in which investment securities or other investment property are separated from the original corporation. In response to this danger, the regulations have provided that the holding of stock, securities, land, or other property for investment purposes does not constitute a trade or business.[169] The emphasis in *Coady* upon the active-inactive language of the Senate Report tends to confirm the validity of the regulations since nothing is less active than a corporation formed merely to hold securities with no active management.[170] The difficulty arises in determining the degree of activity required to remove the "investment" stigma.[171] In this area, the Service has apparently taken a rather extreme position regarding investment property. In Revenue Ruling 66-204,[172] the Service denied trade or business status to a controlled corporation holding an immense investment portfolio that was managed by twenty employees who performed research services, made investment decisions, and rendered accounting services to the corporation.[173] Ostensibly, no amount of management services will convert investment activities into an active trade or business.[174]

168. *Id.* at 147-48.

169. Treas. Reg. § 1.355-1(c)(1) (1955); *see* text accompanying note 58 *supra.*

170. *See* Whitman, *supra* note 53, at 1216.

171. *Id.* at 1217.

172. 1966-2 CUM. BULL. 113-14.

173. *See* Chodorow, *Recent Developments in Divisive Reorganizations Under Section 355,* 19 SO. CALIF. TAX INST. 183, 190 (1967).

174. *Id.* The income of the controlled corporation was substantially all realized on the sale of securities and evidenced 40% of the total income of both corporations.

2. *Real Estate.*—Since real estate, like investment property, poses a significant bail out threat, the regulations deny trade or business status to the "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."[175] The Commissioner, however, has a weaker argument in designating owner-occupied real estate as a non-business than he has in his characterization of investments, for here the occupied real estate involves at least some activity, such as the payment of taxes.[176] The regulations contain several examples of transactions involving real estate that fail to satisfy the business test. A manufacturing corporation, for example, cannot separate its own factory, because as owner-occupied real estate it does not constitute a trade or business.[177] A second example involves a bank that occupies the ground floor of its eleven-story office building and rents out the other ten floors to various tenants. Since the ten floors are rented, managed, and maintained by the real estate department of the bank, the activities connected with rental of the building constitute a trade or business.[178] On the other hand, a bank that occupies the ground floor and one-half of the second floor of its two-story office building and rents out one-half of the second floor to a merchant is not engaged in the active conduct of the rental business. This rental activity would only be incidental to its banking business.[179]

A trilogy of Tax Court decisions initially adopted a hard-line judicial approach toward real estate transactions and introduced a number of factors to be evaluated in the determination of trade or business status. In *Isabel A. Elliott*,[180] a corporation occupying one-half of its own building rented the remainder to others until the building was sold. The corporation then bought a larger building and transferred it to a newly formed subsidiary corporation that rented one-half of the building to the original corporation and the other one-half to outsiders. A spin-off four years later was held not to qualify under section 355, because the original corporation had not actively conducted a real estate rental business prior to the incorporation of its subsidiary; therefore, there was no satisfaction of the five-year active business requirement. The court

175. Treas. Reg. § 1.355-1(c)(2) (1955); *see* text accompanying note 58 *supra*.

176. *See* Whitman, *supra* note 53, at 1217. Apparently, the Service wanted to prevent a corporation from distributing its earnings tax-free by spinning off the land on which its own factory sits, especially when the transaction involves a long-term lease to the parent under advantageous conditions. *Id.*

177. Treas. Reg. § 1.355-1(d), example (2) (1955).

178. *Id.* at example (3).

179. *Id.* at example (4).

180. 32 T.C. 283 (1959).

held that mere passive receipt of income from property used in the principal trade or business does not constitute an active trade or business if only incidental to the principal business.[181] A peculiar aspect of this case was the apparent concession by the court that the separate incorporation of the rental business was sufficient to give it active business qualification.[182] It appears inconsistent, however, to say the rental business conducted by the original corporation could be converted to an active business from inactive status by mere incorporation.[183] The second case[184] followed the *Elliott* principle in disallowing trade or business status to the rental of one-half of an owner-occupied building.[185] Factors militating heavily in the court's decision were the small amount of square footage rented to others as compared with the owner-occupied footage, the absence of any substantial activity in managing the building, and the high ratio of rental income to total income.[186] The third case[187] found that a corporation's rental activity was merely an incidental part of the sole business of the corporation. It further warned that "careful scrutiny of purported 'real-estate rental' businesses is necessary to prevent evasion of the purposes of the statute."[188]

More recent litigation in the area confirms the Tax Court's strict approach to real estate and exposes yet another failure of the active business concept. *Andrew M. Spheeris*[189] involved a corporation engaged in the business of owning and operating commercial rental properties. After one of its properties had been destroyed by fire and a disagreement had arisen as to how that property should be rehabilitated, the property was transferred to another corporation whose shares were distributed in a split-off. Various activities were engaged in before and after the split-off to return the property to income-producing status, such as efforts to use the property for the development of a motor hotel or office building.[190] Although conceding that the original corporation and the destroyed property before the fire constituted an active business, the

181. *Id.* at 290.

182. *Id.* at 291.

183. *See* Whitman, *supra* note 53, at 1218-19.

184. Theodore W. Appleby, 35 T.C. 755 (1961), *aff'd per curiam,* 296 F.2d 925 (3d Cir.), *cert. denied,* 370 U.S. 910 (1962).

185. *See* Massee, *supra* note 29, at 456.

186. *Id.* at 457.

187. Bonsall v. Commissioner, 317 F.2d 61 (2d Cir. 1963), *aff'g* 21 CCH Tax Ct. Mem. 820 (1962). One factor emphasized by the court was that the buildings had never been listed with an agent nor were any signs made indicating that space was available. 317 F.2d at 64.

188. 317 F.2d at 65.

189. 54 T.C. 1353 (1970).

190. *Id.* at 1363. There were prospects that the property would be taken over by city authorities and that the particular area where the property was located would be redeveloped.

court held that the activities carried on in connection with the destroyed property after the fire did not constitute the conduct of an operating business. The activities themselves would not produce income and were no more than preliminary to actually engaging in a business. The court stated that, although there was not a separation of the corporation's business and investment assets, section 355(b) requires not only that the assets involved be business assets but that the assets together with related activities constitute an operating business.[191] The decision is logically correct since the property was not producing income and would fail to meet the regulations' definitional test. Furthermore, this type of property is readily disposable so that bail out opportunities are great.

One problem arises, however, with the court's holding that the corporation's efforts to redevelop the property did not constitute an active conduct of business. The court appears to be blinded to the economic realities of the real estate rental business. Concededly the *Spheeris* factual circumstances are unusual, but in the normal real estate situation, especially at the inception of a business, it may be months or years before the property produces any income. A significant amount of activity is contributed in deciding where to construct a building, in securing loans and insurance for its construction, and in realizing the finished product. Under the court's language, it would be difficult to include that first year of incorporation in the corporation's business history. It is submitted that any activity performed that will lead to the ultimate production of income should be considered an active trade or business. Until the approach of the Code and regulations change, however, courts will continue to be burdened with the task of making various fine distinctions concerning the definitions of an active business. Confusing language will persist and the eventual result will be to make an already unmanageable statute totally useless to the taxpayer.

In *Joseph V. Rafferty*,[192] a steel distributing corporation (RBS) transferred its real property to a newly formed corporation (Teragram) which in turn leased the properties back to RBS. For a valid business purpose,[193] RBS spun-off the Teragram stock. In arguing that the transaction met the active business requirements, the petitioners contended that Teragram had rented improved multi-purpose real estate,

191. *Id.* at 1361-62.

192. 55 T.C. 490 (1970).

193. *Id.* at 496. The contested business purpose was upheld by the Tax Court. The purpose of the distribution was to avoid possible inter-family squabbling or conflict over management of a closely held corporation by precluding any daughters or future sons-in-law from participating in the management of RBS.

maintained separate financial records, and filed its own federal and state income and excise tax returns. Furthermore, in the year of distribution, it had arranged for the construction of a building and related facilities by financing it through a mortgage on which it alone was liable.[194] These facilities were rented to another corporation solely owned by petitioners. The Tax Court held, however, that Teragram was not engaged in the active conduct of a trade or business for the five-year period preceding distribution. The court relied on a number of factors including the fact that under the lease, RBS was responsible for all maintenance and repair work required by the property. Furthermore, the sole source of Teragram's income was rent paid by RBS, its parent corporation. Teragram apparently had no employees, and it did not claim any deductions for compensation paid to its president. Although the court recognized the later mortgage as an indication of some independent business activity, it was deemed to be inconclusive, especially since it occurred in the year of distribution and not earlier.

The *Rafferty* decision compounds the problem of interpretation by approaching the task from a purely factual point of view. In determining whether an active trade or business exists, the courts apparently will now require substantial proof that a number of activities are being performed before stamping its imprimatur on the business in question. This is probably a desirable method to apply to an obviously vague definition until some rehabilitation is instituted by the Commissioner or by Congress. The most recent pronouncement by the Tax Court in the real estate area in January of 1971, however, marks the extreme limit to which the court will go in denying the active trade or business status. *E. Ward King*[195] involved a common carrier of freight that spun-off three of its solely owned subsidiaries.[196] These subsidiaries had leased motor carrier terminals to the parent on a net lease basis that required all expenses, such as maintenance, repairs, taxes, and insurance, to be paid by the parent-lessee. The Tax Court held that the three real estate corporations were not engaged in the active conduct of a trade or business during the five-year period prior to the distribution. In arriving at its decision, the court noted the paucity of real estate leasing

194. *Id.* at 497. They further asserted that if RBS had ceased to occupy Teragram's rental property, other tenants could have easily been found. *Id.* at 498.

195. 55 T.C. 677 (1971).

196. *Id.* at 697. After the spin-off, the shareholders exchanged the shares of the 3 subsidiaries for stock in another corporation owned by the shareholders of the motor carrier corporation. An additional exchange was made with another corporation and the result placed the carrier corporation and its operating subsidiaries in one group of corporations and the real estate holding companies in another.

employees and the lack of office, address, and telephone. The receipt of rentals on a net lease basis merely represented passive income without concomitant expenditure of money or effort by the lessor.[197] Finally, the lack of outside rentals from tenants other than the parent was an important determinant.

The major significance and impact of this case lies with the court's disposition of a persuasive argument made by the taxpayer that in addition to renting terminals to the parent, the real estate leasing corporations acquired property, arranged financing, and constructed the terminals.[198] The court found this to be an untenable contention since the acquisition and construction of terminals was conducted by parent employees. Furthermore, the financing also was arranged by parent employees and secured in part by the parent's obligation to pay rent.[199] Although the court correctly decided to disregard the separate existence of the corporate entities, it failed to address the issue whether the real estate leasing activities constituted a trade or business. The mere fact that the activities were being carried on by the parent and not by the three subsidiaries seems less than conclusive that those activities did not constitute an active trade or business. Conceding that the parent instead of the subsidiaries was conducting the real estate activities, it is submitted that these activities engaged in by the parent did constitute an active trade or business. Certainly the activities evidence more than a mere passive intake of income since they require a substantial contribution of time and effort. Moreover, it is not unusual for corporations to engage in more than one business. The court also failed to discuss whether these additional activities, if carried on continuously, would constitute an active business. While it is most important to determine if the activities performed were isolated corporate actions or were carried on year after year on a continuing basis, the court failed to decide and thereby left the question open. The thrust of the court's holding, although it was not articulated, was that acquiring property, arranging financing, and constructing buildings are not sufficient activities to warrant trade or business status. But in holding that the activities did not constitute an active business because the parent was engaged in the real estate activities and not the subsidiaries, it could

197. *Id.* at 697, 699.

198. *Id.* at 700. The parent would determine when a new facility was needed and the parent's employees would select its proper location. The employees would then acquire the property and work with the parent's architect to draw the plans. The court noted that these parent employees were also officers of the real estate leasing corporations, but were not compensated for their services.

199. *Id.*

easily be implied that the activities would have constituted an active business had they been conducted by the subsidiaries. Thus the inconsistencies and unanswered questions make it most difficult to interpret the decision's real meaning.

The *King* case goes further than any previous decision in denying trade or business status to a real estate corporation. The court's tenuous rationale illustrates the immense problems inherent in interpreting the meaning of an active trade or business. Until these problems are resolved, a real estate corporation in order to be separated must have outside rentals from tenants other than its parent, a going concern with a staff of employees, and be responsible for repairs and maintenance of the rented property.

IV. Proposed Solutions

The active business rule has exacerbated the difficult task of interpreting section 355 and has proved to be ineffective in distinguishing bail out transactions from legitimate corporate separations. As evidenced by the *Boettger* decision, many taxpayers who execute validly-motivated and non-device separations may be disqualified from tax-free treatment because of the active business rule. It is imperative, therefore, that section 355 be modified to permit more corporate flexibility while continuing its protection against abusive tax avoidance.

The active business rule and the device requirement are both aimed at the same evils—the separation of active and inactive assets and the bail out of earnings and profits. Consequently, the adoption of a device requirement as the principal method of testing the validity of corporate separations has been a suggested method of more appropriately policing this area.[200] The device requirement as the sole criterion for testing the validity of separations would allow for corporate flexibility and would provide an efficacious means of distinguishing bail out transactions from valid separations. The inherent disadvantage of this approach is its subjectivity and the uncertainty it would generate for the taxpayer in determining his qualification under the statute.

A second possible solution would be to retain the five-year active business rule and insert a hardship clause that would allow a taxpayer who did not fully meet the requirements of the sections to apply for a discretionary ruling by the Commissioner that a tax-free division is warranted. This proposal would maintain all of the present safeguards

200. *See, e.g.*, Caplin, *Corporate Division Under the 1954 Code: A New Approach to the Five-Year "Active Business" Rule*, 43 Va. L. Rev. 397, 408 (1957); Jacobs, *supra* note 1, at 177-78.

while relaxing the section's rigidity in those situations clearly meriting tax-free division.[201] This proposal, however, relies heavily on the discretion of the Commissioner and thus may run afoul of the same subjectivity argument.

A third suggested remedy would be to first include a far more extensive "device test" than the present device terminology of section 355.[202] In order for a transaction to qualify under this test: (1) the transaction could not be used principally as a device to bail out the earnings and profits of the distributing corporation, (2) it could not be used to separate active and inactive assets in order to achieve a bail out, and (3) the transaction would have to be motivated by a valid business purpose. This standard would not only serve the purpose of the active business rule and the device requirement but would provide the taxpayer with a better method of achieving corporate flexibility. In addition to the "device test," this method would preserve the active business rule to the extent that it would require each corporation to continue the active conduct of a trade or business immediately after the distribution.[203] This would supplement the device test by assuring that the separated business is not an inactive asset that is vulnerable to bail out treatment. These requirements might well eliminate undesirable decisions such as *Boettger* while providing adequate protection against tax avoidance schemes. In accord with the active business requirement as modified, the Commissioner should be authorized to provide through the regulations a more specific definition of a trade or business. This would clarify the defintion's present vagueness and eliminate the interpretative problems encountered in *Spheeris, Rafferty* and *King.*

Again, the criticism of this proposal would be its reliance on the subjective "device" standard. The objection, however, could be minimized by clear regulatory guidelines as to what constitutes a device and a valid business purpose.[204] Valid business purposes could include all the reasons previously mentioned[205] plus such judicially approved reasons as the one upheld in the *Rafferty* decision.[206] Examples of these situations would include: (1) the distribution of one business to

201. *See* Simon, *supra* note 100, at 26.

202. *See* Whitman, *supra* note 53, at 1253. This commentator also suggested a broader device test but did not spell out specifically what it included.

203. *See* Caplin, *supra* note 200, at 408.

204. *See* Whitman, *supra* note 53, at 1254.

205. *See* notes 42-52 *supra* and accompanying text. For a list of reasons that prompt merger-acquisitions and relate to § 355 transactions see C. DRAYTON, MERGERS AND ACQUISITIONS: PLANNING AND ACTION 38-39 (1963).

206. *See* note 193 *supra.*

shareholders only interested in that particular business;[207] (2) the distribution of one business to a specific group of shareholders to avoid disagreements in management;[208] (3) sale of stock to key employees prior to a distribution enabling them to obtain an interest in the distributed business;[209] and, (4) a separation or sale of stock that would qualify as a partial liquidation under section 346 or a redemption under section 302.[210]

Situations resulting in the existence of a device would include a sale of stock made subsequent to a distribution when the sale was not motivated by a valid business purpose;[211] and utilization of the earnings of one business to enlarge another business that is then distributed.[212] The above situations are only examples and not intended to be exhaustive. Any objective standards adopted should be devised in light of the purpose and policy of section 355 to provide tax-free treatment for valid corporate separations.

The argument may persist that in light of the administrative feasibility to the taxpayer, the proposed statute remains a hazard. Arguably, the taxpayer would still be unable to determine his qualification under the statute, and his confusion would result in increased litigation. In order to close the floodgates and provide taxpayers with a higher degree of certainty, it is suggested that each taxpayer be required to obtain from the Service a ruling that no device is involved in the contemplated transaction. The taxpayer would be required to obtain the ruling prior to the proposed transaction. It would be conclusive as to the particular transaction and hopefully would eliminate the threat of a subsequent tax being imposed by the Commissioner. It could also prevent any frivolous device transactions from being attempted since application for a ruling involving an obvious device transaction would be a totally useless venture.

One criticism of this procedure would be that the increased burden would cripple the presently efficient practice of the Service of issuing advance rulings on proposed section 355 transactions. One reason for so little litigation in this area is the already well-established practice of taxpayers to request rulings prior to corporate separations.[213]

207. Rev. Rul. 56-344, 1956-2 CUM. BULL. 195; *see* Simon, *supra* note 103, at 22.

208. Lloyd Boettger, 51 T.C. 324 (1968).

209. Rev. Rul. 59-197, 1959-1 CUM. BULL. 77.

210. This would not be objectionable since it only postpones a capital gain rather than ordinary income. *See* Jacobs, *supra* note 1, at 178; Simon, *supra* note 100, at 22.

211. *See* Cohen, *Partial Liquidations and Spin-Offs of Real Estate Corporations*, N.Y.U. 21ST INST. ON FED. TAX. 685, 711 (1963).

212. Rev. Rul. 59-400, 1959-2 CUM. BULL. 114; *see* Simon, *supra* note 100, at 22.

213. *See* Jacobs, *supra* note 1, at 182.

Consequently, making this procedure mandatory would not significantly increase the Service's work load. A second objection to the mandatory ruling proposal would be its effect of making the Internal Revenue Service the final authority. It might be necessary to provide for judicial review and this could cause additional uncertainty for the taxpayer. Perhaps the best safeguard would be to include in the statute a directive to the Service ordering a liberal interpretation of section 355 consistent with the policy of corporate flexibility.

Although none of the proposals suggested above are complete solutions, they all have distinct advantages that may prove desirable in formulating a final legislative solution. It is hoped that the mandatory ruling proposal would produce certainty in the minds of taxpayers concerning their proposed transactions and would contribute a new approach to a seemingly insoluble problem. The active business rule has ostensibly failed to achieve its intended purpose and has proffered much disorder in an already complicated area of the law. In light of the Tax Court's recent adoption of a restrictive, mechanical approach, the need for legislative action has never been more compelling. A decisive and diligent response must be forthcoming from congressional reformers if the original policy of corporate flexibility is to be restored.

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