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THE ANATOMY OF A SPIN-OFF

ROBERT A. JACOBS*

Section 355 of the Internal Revenue Code, which specially treats certain forms of corporate reorganization, has been the constant subject of both scholarly commentary and litigation. The experience of functioning under these spin-off provisions has resulted in clarification of the law and has also raised significant questions as to its scope. The precise limits of the section remain to some extent in a state of flux and await further exposition by the courts.

INTRODUCTION

IN THE twelve years since the enactment of the Internal Revenue Code of 1954, substantial progress has been made in determining what constitutes a tax-free corporate separation under section 355.[1] That the law in this area is still undergoing significant change and development may seem strange when one recalls that provisions allowing tax-free corporate separations have been in the tax law since 1918;[2] that the 1954 Code provisions[3] were in large measure carryovers from the 1939 Code;[4] and that the Treasury Regulations,[5] issued shortly after the 1954 Code was enacted, made a valiant attempt to answer many of the troublesome questions which the draftsmen anticipated would arise. The very nature of the corporate

* Member of the New York Bar. B.B.A., 1957, University of Texas; LL.B., 1960, LL.M. (in taxation), 1963, New York University. Mr. Jacobs is a member of the Office of the Chief Counsel, Internal Revenue Service. The views expressed are those of the author and not official opinions of the Treasury Department or any unit of that Department.

[1] INT. REV. CODE OF 1954, § 355. References in the text and notes are to the Internal Revenue Code of 1954 unless otherwise indicated.

[2] Revenue Act of 1918, ch. 18, § 202 (b), 40 Stat. 1060.

[3] INT. REV. CODE OF 1954, § 355.

[4] Int. Rev. Code of 1939, § 112 (b) (11), added by ch. 521, § 317 (a) (11), 65 Stat. 493 (1951).

[5] Treas. Reg. § 1.355 (1955).

separation, however, with its inherent potential for converting ordinary dividend income into immediate or ultimate capital gain, makes it important to develop easy-to-apply, clear-cut rules that determine whether or not the separation is tax-free. Unfortunately, a number of questions have not, as yet, been supplied with clear and definite answers.

Section 355 provides for the separation of one or more businesses formerly operated, directly or indirectly, by a single corporation into two or more corporate entities without the shareholder being required to recognize gain or loss with respect to stock distributed in connection with the separation process. It allows the shareholders of one corporation to divide their investment among two or more corporate entities. The post-distribution corporations collectively own the same assets and operate the same business or businesses that the single predecessor corporation formerly owned and operated.

The businesses separated must have been actively conducted for five years preceding the distribution and, in general, must have been owned for at least five years by the distributing corporation. Typically, the corporate structure after the separation will consist of two corporations owned directly by the shareholders. Before the distribution these corporations may have been a parent and subsidiary; the distributing corporation and a newly formed controlled corporation; or two newly formed controlled corporations.

The tax-free distribution may take any one of three forms:[6]

(1) The *spin-off* is similar to a dividend. Each shareholder of the distributing corporation receives a pro rata share of the stock of the distributed controlled corporation, while retaining his shares in the distributing corporation. Under the 1954 Code the stock of either an existing subsidiary or a newly created corporation can qualify for a spin-off.

(2) The *split-off* is identical with the spin-off, except that the stockholders of the distributing corporation surrender a portion of their stock in the distributing corporation in exchange for the stock of the controlled corporation. This method of corporate separation

[6] Under the 1954 Code all three methods of corporate separation are tax-free unless boot is involved or the separation fails to meet the requirements of § 355. In such cases, divergent tax treatment may be accorded the three methods.

Unless otherwise indicated, references to "spin-off" in the remainder of this article will also apply to split-ups and split-offs except where the context requires the restricted meaning.

involves a stock redemption. The stock of the controlled corporation may be distributed pro rata, as in the case of a spin-off, or where the parties desire, it may be distributed disproportionately.

(3) In a *split-up* the parent corporation distributes the stock of two or more of its subsidiaries to its shareholders as a part of a plan of complete liquidation. The subsidiaries may be pre-existing or newly created.

During the past twelve years the Internal Revenue Service, the courts, and tax advisors have frequently been called upon to determine whether a particular corporate separation should receive favorable treatment under section 355 in light of the statutory language and the underlying philosophy of that section. The purpose of this article is to examine the development and status of section 355 a dozen years after its enactment and where possible, to point to some of the problems which will confront taxpayers and the Service in the years ahead.

History

Spin-offs have a long and colorful tax history. They have been recognized as an important means of allowing the business community to adjust its method of conducting business. As early as 1918 Congress approved tax-free split-ups.[7] Spin-offs and split-offs were approved by Congress in 1924.[8] Congress and the courts have recognized that the shareholders who received spin-off distributions did not receive any additional economic interest as a result of the distributions where the changes in corporate organization were essentially changes only in form, with the stockholders continuing their former interest in the original enterprise.[9] Where before the corporate separation there was only one corporation owning assets and conducting business, after the distribution there are two corporations owning the same assets and conducting the same business. Where formerly there was only one stock certificate, after the distribution there are two. All the assets remain in "corporate solution" and

[7] Revenue Act of 1918, ch. 18, § 202 (b), 40 Stat. 1060.

[8] Revenue Act of 1924, ch. 234, § 203 (c), 43 Stat. 256 (spin-offs); Revenue Act of 1924, ch. 234, §§ 203 (b) (2), (h), 43 Stat. 256 (split-offs). Arguably, split-offs may have received tax-free treatment under § 202 (b) of the Revenue Act of 1918 and § 202 (c) (2) of the Revenue Act of 1921. See H.R. Rep. No. 179, 68th Cong., 1st Sess. (1924), reprinted in 1939-1 (Part 2) Cum. Bull. 241, 252-53.

[9] See H.R. Rep. No. 704, 73d Cong., 2d Sess. (1934), reprinted in 1939-1 (Part 2) Cum. Bull. 554, 564.

absent some subsequent act on the part of one of the corporations (for example, a liquidation) or the shareholder (for example, a sale of his stock in one of the post-distribution corporations) no economic change sufficient to warrant immediate taxation occurs. Thus, the spin-off is one of the few 1954 Code provisions that allow a corporation with ample earnings and profits to distribute property (stock in the controlled corporation) to its shareholders without the recognition of gain by the shareholder.[10]

The tax-free status of corporate separations evidences congressional recognition of the desirability of facilitating corporate structural flexibility. Prior to 1954, spin-offs, split-offs, and split-ups were tax-free under the general corporate reorganization provisions.[11] In *Evelyn F. Gregory*,[12] the taxpayer by meticulous compliance with these general provisions attempted to distribute accumulated earnings and receive capital gains treatment[13] for what were essentially dividends. This design was to be accomplished by transferring the corporation's cash and marketable securities to a newly formed corporation and then distributing the stock of the new corporation to the taxpayer. The immediate liquidation of the new corporation completed the series of steps necessary to place the assets in the hands of the shareholder. The Board of Tax Appeals held that, by complying with the letter of the "meticulously drafted" statute,[14] the

[10] In other contexts, earnings and profits may be distributed to shareholders without their recognizing any gain where fortuitous circumstances such as basis equal to distributions are present. See, *e.g.*, INT. REV. CODE OF 1954, §§ 302, 303, 346. See also § 354 (distribution of stock and securities in reorganizations); Treas. Reg. § 1.1502-31 (b) (2) (ii) (1955) (intercompany dividends eliminated in consolidated return).

[11] The spin-off was sanctioned by the reorganization definition which included a transfer of part of a corporation's assets to a newly formed corporation in exchange for a controlling stock interest, which was then distributed to the transferor's shareholder. See, *e.g.*, Revenue Act of 1932, ch. 209, § 112 (g), 47 Stat. 197. The split-off and split-up received similarly favorable treatment under other reorganization sections. Revenue Act of 1932, ch. 209, §§ 112 (b) (3), (i) (l) (B), (i) (2), 47 Stat. 196.

[12] 27 B.T.A. 223 (1932), *rev'd*, 69 F.2d 809 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935). See Jacobs, *Spin-Offs: The Pre-Distribution Two Business Rule—Edmund P. Coady and Beyond*, 19 TAX L. REV. 155, 157-59 (1964).

[13] The shareholder who receives stock in a spin-off must allocate his adjusted basis in the shares of the distributing corporation between the retained shares of the distributing corporation and the shares received in the controlled corporation in proportion to their respective fair market values. INT. REV. CODE OF 1954, § 358 (b) (2); Treas. Reg. § 1.358-2 (a) (2) (1955). In the *Gregory* setting this provision enabled the taxpayer to claim that her capital gain was properly measured by the difference between her basis and the fair market value of the assets received in liquidation.

[14] 27 B.T.A. at 225. See Revenue Act of 1928, ch. 852, §§ 112 (g), (i) (1) (B), 45 Stat. 818.

taxpayer was entitled to the unintended benefits of congressional oversight. Refusing to be guided by the form of a transaction which had as its purpose the avoidance of taxation, the Second Circuit and the Supreme Court held that the distributions were actually dividends.[15] In reversing the Board, the two courts engrafted upon the reorganization provisions the requirement that qualifying corporate separations must be motivated by a valid business purpose as opposed to the intent to avoid taxes.[16]

The congressional reaction to the Board of Tax Appeals *Gregory* decision was swift, albeit not too sure. Under the Revenue Act of 1934, *all* spin-off distributions were treated as dividends.[17] Surprisingly, Congress did not also prohibit pro rata split-offs and split-ups in the 1934 Act, even though some of these corporate separations achieved the same economic results and possessed the same tax avoidance potential as the prohibited spin-off.[18]

In 1951, however, Congress restored tax-free status to the spin-off under certain conditions designed to permit corporate flexibility and at the same time prohibit the distribution of disguised dividends.[19] The Revenue Act of 1951 provided that where, pursuant to a "plan of reorganization," a shareholder of a corporation which is a party to the reorganization receives non-preferred stock in another corporation which is also party to the reorganization, the shareholder-recipient recognizes no gain even though he is not forced to surrender any stock unless

> (A) any corporation which is party to such reorganization was not intended to continue the active conduct of a trade or business after such reorganization, or
> (B) the corporation whose stock is distributed was used principally

[15] The Supreme Court opinion in *Gregory* has since been cited for a multitude of propositions, many of which have no necessary relation to spin-offs or bailouts. Nonetheless, the importance of the bailout device in the *Gregory* setting cannot be overemphasized in understanding the legislative scheme and judicial approach to spin-offs under the 1954 Code.

[16] The business purpose doctrine is discussed at notes 96-116 *infra* and accompanying text.

[17] Treas. Reg. 86, Art. 112 (g)-5 (1935); H.R. REP. No. 704, 73d Cong., 2d Sess. (1934), reprinted in 1939-1 (Part 2) CUM. BULL. 554, 564. The method chosen to accomplish this result was to eliminate the tax-free spin-off provision, Revenue Act of 1932, ch. 209, § 112 (g), 47 Stat. 197, from the act. See generally BITTKER, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 322-28 (1959); Jacobs, *supra* note 12, at 157-67.

[18] See, *e.g.*, Chester E. Spangler, 18 T.C. 976 (1952).

[19] See authorities cited note 48 *infra*.

as a device for the distribution of earnings and profits to the shareholders of any corporation a party to the reorganization.[20]

Only the separation of assets associated with the conduct of an active business could be spun off, while the tax-free separation of an existing corporation into active and inactive entities was prohibited.

SECTION 355

In large measure the 1951 legislation is important because the general restrictions which it imposed on spin-offs—the active business test and the device clause—serve as the cornerstones of the 1954 Code treatment which imposed the following prerequisites for a tax-free corporate separation:

1. Stock of a "controlled" corporation must be distributed.[21]

2. The spin-off must not be used principally as a device for distributing the earnings of the distributing or controlled corporation.[22]

3. Immediately after the distribution both the distributing and controlled corporations must be engaged in the active conduct of a trade or business.[23]

4. The business of both the distributing and controlled corporations must satisfy the five-year business history rules.[24]

5. Generally, the distributing corporation must distribute all of the stock and securities which it owns in the controlled corporation.[25]

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[20] Int. Rev. Code of 1939, § 112 (b) (11), added by ch. 521, § 317 (a) (11), 65 Stat. 493 (1951).

[21] INT. REV. CODE OF 1954, § 355 (a) (1) (A). Control is defined in § 368 (c) to mean the ownership of stock possessing at least eighty per cent of the total combined voting power of all classes of stock entitled to vote and at least eighty per cent of the total number of shares of all other classes of stock of the corporation. See Rev. Rul. 59-259, 1959-2 CUM. BULL. 115, which holds that control means the ownership of stock possessing at least eighty per cent of the total combined voting of *all classes* of voting stock and the ownership of at least eighty per cent of the total number of shares of *each class* of nonvoting stock.

[22] INT. REV. CODE OF 1954, § 355 (a) (1) (B).

[23] INT. REV. CODE OF 1954, § 355 (b) (1).

[24] INT. REV. CODE OF 1954, § 355 (b) (2).

[25] INT. REV. CODE OF 1954, § 355 (a) (1) (D). All of the stock in the controlled corporation must be distributed unless the Commissioner is satisfied that the retention of stock in the controlled corporation is not pursuant to a plan of tax avoidance. *Ibid.* Presumably, retention of some shares to satisfy state law requirements regarding corporate names or compliance wtih employee stock option plans is permitted. Retention of shares acquired within five years which would constitute taxable boot to the shareholders under §§ 355 (a) (2) and 356 (a) is not likely to win the Commissioner's favor. Query: What if the reason for the retention is to allow the officers and directors of the

(1) *Distributing the Stock of a Controlled Corporation.* Under the 1954 Code the stock in a "controlled corporation"[26] may be distributed to a shareholder in a tax-free spin-off. The controlled corporation may be a pre-existing subsidiary of the distributing corporation or, if the distributing corporation does not have a pre-existing controlled corporation, it may transfer the assets to be spun off to a newly created subsidiary and then distribute the stock of the new corporation to its shareholders. The latter type of section 355 distribution is a reorganization under section 368 (a) (1) (D).[27] In general, the controlled corporation must have been controlled by the distributing corporation for five years preceding the distribution, or control must have been acquired in a nontaxable transaction, and in either case, the control must not be illusory.[28]

(2) *Device Test.* The device test of section 355 is one of the qualifications specifically aimed at preventing shareholders from bailing out the earnings and profits of the corporation. Obviously, when a shareholder receives the stock of a controlled corporation and then sells the stock or liquidates one of the post-distribution corporations, he, in effect, converts corporate earnings into cash. The economic effect of a stockholder's receiving property in this manner may be equivalent to his receiving a dividend. Consequently, where a

distributing corporation to maintain effective control of the affairs of the controlled corporation?

[26] See definition of "controlled corporation" note 21 *supra.*

[27] As indicated at note 6 *supra* and accompanying text, a corporate separation may take any one of three forms—spin-off, split-off or split-up—and may be either pro rata or non-pro-rata. INT. REV. CODE OF 1954, § 355 (a) (1) (A) (ii) also accommodates the distribution of stock in a controlled corporation to a security holder in exchange for securities. Since the non-recognition of gain provisions of §§ 311 and 336 are not available to the distributing corporation in such cases, any gain (the difference between the distributing corporation's adjusted basis for the stock in the controlled corporation and the amount of its indebtedness) on such exchanges would presumably have to be recognized by the distributing corporation. See INT. REV. CODE OF 1954, § 61 (a) (12). The exchanging security holders would, however, enjoy the tax-free treatment accorded by § 355 (a).

[28] In Rev. Rul. 63-260, 1963-2 CUM. BULL. 147, "*A* owned all of the stock of X which owned 70 shares of the stock of *Y*. *A* also owned the remaining 30 shares of *Y* stock directly. *A* contributed 10 shares of his *Y* stock to X. Immediately thereafter, X distributed all 80 shares of *Y* stock now held by it to *A*.

"*Held,* the distribution by X does not qualify . . . under the provisions of section 355 . . . because X did not have 'control' of *Y* . . . immediately before the distribution except in a transitory and illusory sense." *But see* Rev. Rul. 56-117, 1956-1 CUM. BULL. 180, where a recapitalization of the controlled corporation, immediately prior to the distribution, gave the distributing corporation "control," only long enough for it to distribute the stock of the controlled corporation in a non-pro-rata split-off.

sale or liquidation of one of the corporations is arranged prior to the spin-off, the spin-off will ordinarily be treated as a device to distribute earnings and profits which will deny the benefits of section 355 to the shareholders.[29] Such a sale is prearranged if enforceable rights to buy or to sell existed before the spin-off or if all the facts and circumstances indicate an arrangement had been negotiated.[30] Read literally, the statute appears to deny section 355 benefits to any spin-off which is part of a prearranged plan to sell or liquidate one of the participating corporations even though there is no actual conversion of dividend income to capital gain. Moreover, where a sale is made after the spin-off—although it is not pursuant to a previously negotiated arrangement—it may still be evidence that the spin-off was used principally as a device.[31] However, where the separation involves two businesses which qualify for partial liquidation treatment under section 346 (b), it has been argued that a split-off followed by a sale of one of the corporations by the shareholders should not be treated as a device.[32]

The foregoing discussion pertains to transfers by shareholders which remove earnings and profits from "corporate solution" and effect a bailout. Arguments for a similar restriction on alienation of the stock of either of the post-distribution corporations may be advanced even where there is no withdrawal of assets from "corporate solution" and no conversion of dividend income. Such a situation arises where the acquiring corporation in a reorganization does not wish to acquire all of the assets of the acquired corporation and therefore chooses to have the acquired corporation distribute the unwanted assets to its shareholders via a tax-free spin-off. But this procedure runs the double risk of having either the spin-off or the reorganization fail to satisfy the requirements for tax-free treatment.[33]

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[29] In Rev. Rul. 55-103, 1955-1 CUM. BULL. 31, *X* corporation, which owned eighty per cent of the stock of *Y* corporation, proposed to spin-off the *Y* corporation stock to the shareholders of *X*, immediately prior to their sale of *X* stock to *Z* corporation. *Held*, the distribution of the *Y* stock did not qualify under § 355 since the distribution was a device for the distribution of *X*'s earnings to its shareholders. *But see* Rev. Rul. 59-197, 1959-1 CUM. BULL. 77, where a sale of stock by a shareholder immediately before a non-pro-rata split-off (which had the same effect as a sale after the split-off) pursuant to a previously negotiated agreement was held not to constitute a device under the particular facts.

[30] Treas. Reg. § 1.355-2 (b) (2) (1955).

[31] Treas. Reg. § 1.355-2 (b) (1) (1955).

[32] *E.g.*, Lipnick, *Nontaxable Corporate Liquidations*, 2 HOUSTON L. REV. 344, 361 (1965); see Jacobs, *supra* note 12, at 170.

A spin-off followed by a prearranged reorganization might fail to satisfy the requirements of section 355 where the shareholders of the predistribution corporation do not control both of the post-distribution corporations. Section 368 (a) (1) (D), which provides for one of the two forms a spin-off may take, requires that the distributing corporation's shareholders (or former shareholders in the case of a non-pro-rata separation) must control the controlled corporation after the separation. If control is relinquished through a prearranged reorganization with another unrelated corporation, can it be said that a *D* reorganization (including the section 355 distribution) has been effected? But, even assuming that there is no *D* reorganization, should the transaction be treated as a section 351 exchange followed by a section 355 distribution? Under the 1939 Code[34] a spin-off must have been pursuant to a reorganization, and the reorganization provisions required that the shareholders of the distributing corporation must have controlled the controlled corporation after the spin-off. Where the shareholders had contracted to divest themselves of control prior to the reorganization, the control requirements were not satisfied.[35] Although Congress, in the 1954 Code, eliminated this reorganization requirement in corporate separation cases,[36] there is no expression of congressional intent regarding the question of whether it also intended to relax the strict control requirements imposed by the *D* reorganization provision of the 1939 Code. It is questionable whether spin-offs utilizing pre-existing corporations should be held to any lesser standards than spin-offs consummated by a *D* reorganization.

In *Curtis v. United States*,[37] the Sixth Circuit held that a spin-off followed by a prearranged statutory merger of the distributing corporation into an unrelated corporation, did not qualify under section 355 on the grounds that the distributing corporation did not continue in the active conduct of business after the spin-off. The court left unanswered the question of whether it would have reached the

[33] See Helvering v. Elkhorn Coal Co., 95 F.2d 732 (4th Cir. 1937), *cert. denied*, 305 U.S. 605 (1938). "Substantially all of the properties" requirement of § 368 (a) (1) (C) is not complied with when a substantial amouut of unwanted assets are spun off prior to a prearranged acquisition. 95 F.2d at 735.

[34] Int. Rev. Code of 1939, § 112 (b) (11), added by ch. 521, 65 Stat. 493 (1951).

[35] Compare Scientific Instrument Co., 17 T.C. 1253 (1952), *aff'd per curiam*, 202 F.2d 155 (6th Cir. 1953).

[36] S. Rep. No. 1622, 83d Cong., 2d Sess. 50, 266 (1954).

[37] 336 F.2d 714 (6th Cir. 1964), *affirming* 215 F. Supp. 885 (N.D. Ohio 1963).

same result had the distributing corporation been the surviving corporation in the merger. In *Mary Archer W. Morris Trust*,[38] the Tax Court held that a plan which called for a bank to spin off its insurance business and then consolidate with another bank qualified under section 355. The Tax Court distinguished *Curtis* on the grounds that the distributing bank in *Morris Trust* was deemed to have continued its banking business under the National Banking Act provisions whereas the distributing corporation in *Curtis* did not continue in business, since it was absorbed in the merger. This distinction was rejected by the Fourth Circuit in its affirmance of *Morris Trust*. The court of appeals held that the reorganization subsequent to the spin-off did not effect a discontinuance of the distributing corporation's banking business; that it made no difference whether the distributing corporation or the other party to the reorganization was the surviving corporation in the reorganization; that amalgamating reorganizations consummated subsequent to spin-offs will not impair the tax-free status of spin-offs even where the shareholders of the distributing corporation fail to retain control of the amalgamated corporation; and that while the National Banking Act did not continue the identity of the distributing corporation for federal tax purposes, if under any state or federal merger statute there is, in fact, substantive continuity of each constituent and its business, the requirements of section 355 are satisfied. The Fourth Circuit's opinion in *Morris Trust* leaves no doubt as to the conflict that now exists between the Fourth and Sixth Circuits.

One of the factors employed to determine whether a particular spin-off is a device to distribute earnings is the percentage of active business assets of each of the post-distribution corporations. If substantially all of the assets of each of the corporations are, and have been, used in the active conduct of business, an inference arises that the spin-off was not used principally as a device.[39] If only a small percentage of the corporation's assets consists of business assets, as opposed to investment assets, a contrary, but rebuttable, inference is created. Generally, the non-business assets of the distributing corporation and of the controlled corporation should constitute less than half of the corporation's assets if the device inference is to be over-

[38] 42 T.C. 779 (1964), *aff'd*, 367 F.2d 794 (4th Cir. 1966).

[39] Treas. Reg. § 1.355-2 (b) (3) (1955).

come.[40] For this purpose, however, it would appear that business assets associated with a business less than five years old would normally be deemed business assets, rather than non-business or investment assets. Accordingly, a recently purchased business could be spun off if the controlled corporation conducted a qualifying active business in addition to the purchased business. These observations apply equally to the asset and business composition of both the distributing and the controlled corporation.

In contrast, Revenue Ruling 64-102[41] held that a non-pro-rata split-off passed the device test even though less than fifty per cent of the assets were active business assets. Since a shareholder who participates in a completely non-pro-rata split-off could, in most cases, qualify for capital gain treatment under section 302 (b), the non-pro-rata split-off generally is said not to be a device to distribute earnings at capital gain rates.

Since one of the purposes of the device test is to prevent the substitution of tax-free distributions of stock in the controlled corporation for taxable dividends, would a distribution which meets all of the other tests of section 355 qualify if the business of the distributed controlled corporation is so small in relation to the size of the distributing corporation that it appears more like a dividend than a separation of two businesses? Could a corporation which conducts two businesses, one with assets of 1 billion dollars and an annual income of 300 million dollars, the other with assets of 50,000 dollars and an annual income of 15,000 dollars, spin off the smaller business? Although there have been no rulings or cases on this question, it would seem that the answer would depend upon whether the business reasons motivating the corporate separation are sufficiently cogent. If a large distributing corporation were systematically to distribute the stock of small controlled corporations to its shareholders, it would appear that the device clause could be successfully invoked by the Commissioner.

In every case involving the separation of two or more businesses, particularly where there is to be a non-pro-rata division, taxpayers are confronted with the problem of "equalizing" the corporations.

[40] An interesting problem is presented where non-business assets constitute more than fifty per cent of the value of both the distributing corporation and the controlled corporation. In such a case, it would appear necessary to present substantial proof of the absence of a device and cogent business reasons for the separation if the device inference is to be rebutted.

[41] 1964-1 (Part 1) CUM. BULL. 136.

For example, a corporation owned equally by two stockholders is engaged in the furniture and appliance business. Because of personal and business differences, the stockholders plan to transfer the assets of the existing corporation to two new corporations, one to be owned by each of the shareholders. The value of the furniture business exceeds the value of the appliance business. To equalize the two businesses, cash previously used in the furniture business is transferred to the appliance corporation. The transfer of the cash necessary to equalize the value of the two corporations is not a device to distribute earnings and will not impede a tax-free split-up.[42] But if the cash contribution to the controlled corporation constitutes a substantial part of the controlled corporation's net worth and is not an essential ingredient of a non-tax-motivated plan, such as an equalization of values prior to a non-pro-rata separation, the Service may deem the contribution a device for the distribution of earnings.[43]

A third type of cash contribution should be mentioned briefly, even though its importance is not in the device area of section 355. In the example of the two shareholders who owned the corporation which conducted the furniture and appliance business, let us assume that the corporation had no cash available to equalize the assets of the two businesses. If the furniture business was worth 8,000 dollars and the appliance business worth 4,000 dollars, could the tax-free separation be accomplished by:

(1) Placing the furniture business in a controlled corporation and distributing its stock to shareholder *A* in exchange for his stock in the distributing corporation and 2,000 dollars; or by

(2) Shareholder *A*'s purchasing 2,000 dollars of stock in the distributing corporation from shareholder *B* and then exchanging his 8,000 dollars worth of stock in the distributing corporation for the 8,000 dollars worth of stock in the controlled corporation?

Section 355 (a) (1) (A) requires that the distribution of stock in the controlled corporation must be with respect to stock. If cash rather than stock constitutes more than twenty per cent of the consideration for the distribution of the stock of the controlled corporation, the distributing corporation may be deemed not to have distributed "with respect to its stock" an amount of stock constituting

[42] Rev. Rul. 56-655, 1956-2 CUM. BULL. 214.

[43] Rev. Rul. 64-102, 1964-1 (Part 1) CUM. BULL. 136; Rev. Rul. 58-68, 1958-1 CUM. BULL. 183.

control of the controlled corporation as provided in section 368 (a) (1) (D).[44] Accordingly, since twenty-five per cent of the consideration for the furniture business stock (2,000/8,000) is cash, only seventy-five per cent of the stock may be deemed to have been distributed with respect to *A*'s appliance stock. The second alternative would require shareholder *B* to recognize gain or loss on the 2,000 dollars received for the shares sold to *A*.[45]

(3) *Active Business Requirements.* Section 355 (b) (1) requires, in general, that both the distributing corporation and the controlled corporation must be engaged in the active conduct of a trade or business immediately after the distribution. Section 355 (b) (2) defines the active conduct of a trade or business for this purpose. The first requirement is that each of the post-distribution corporations must be engaged in the active conduct of a trade or business.[46] The question of what constitutes the active conduct of a trade or business within the meaning of section 355 continues to be troublesome for both taxpayers and the Treasury.

The Revenue Act of 1951,[47] which restored tax-free spin-offs to the code, required that the tax-free spin-off be limited to situations "in which all of the new corporations as well as the present are intended to carry on a business after the reorganization."[48] The Senate Finance Committee in 1954 characterized section 355 as "not permitting the tax-free separation of an existing corporation into active and inactive entities . . . ."[49] With this background, it is not surprising that holding stock, securities, land, or other property for in-

[44] *But see* Oscar E. Baan, 45 T.C. 71 (1965) (on appeal to 2d and 9th circuits) (spin-off approved in transaction where rights and cash were exchanged for stock in the controlled corporation).

[45] In Rev. Rul. 59-197, 1959-1 CUM. BULL. 77, a sale of some shares from *B* to *A* prior to a non-pro-rata split-off was approved by the Service. The ruling carefully notes the unique facts which allowed the Service to rule that the sale and split-off were not a device to distribute earnings.

[46] INT. REV. CODE OF 1954, § 355 (b) (2) (A). This section also accommodates holding companies substantially all of the assets of which, immediately after the distribution, consist of stock and securities of a controlled corporation which is engaged in an active business.

[47] Ch. 521, 65 Stat. 452.

[48] S. REP. No. 781, 82d Cong., 1st Sess. 58 (1951), reprinted in 1951-2 CUM. BULL. 458, 499. See also 96 CONG. REC. 13685 (1950) (remarks of Senator Humphrey) (section 206 (a) of the Senate Finance Committee Bill, which in the 1951 Act became § 112 (b) (11) of the 1939 Code, was designed to prevent stockholders from converting dividends to capital gain by limiting spin-offs to corporations intended to carry on active businesses).

[49] S. REP. No. 1622, 83d Cong., 2d Sess. 51 (1954).

vestment or trading purposes does not constitute the active conduct of a trade or business.[50]

One of the difficulties frequently encountered is the determination of whether a corporate activity should be characterized as an investment or as an active business. For example, assume that a department store corporation has accumulated a substantial surplus and cash reserves. The corporation then establishes a separate department which manages its large securities portfolio.[51] Assume further that the department actively trades the securities. After completing the requisite five-year incubating period of section 355 (b) (2) (C), can the "investment trading business" be spun off? Section 1.355-1 (c) (1) of the regulations indicates that it cannot. The continuous sales on a daily basis are probably insufficient to convert the investment activities associated with these securities into an active business. No amount of "managing" or other investment activity will change the inherent investment character of these security holdings. Presumably, the department store corporation is not a dealer in securities. Consequently, gains and losses realized upon the disposition of the stocks result in capital, rather than ordinary, gain or loss.[52] Should it make any difference if the department store is a dealer and the sales produce ordinary income?

If the investment department of the department store corporation speculates in real estate, rather than stocks and bonds, a different result may be indicated. Seemingly, if the corporation purchases, develops, and sells real property on a recurring basis, the activities qualify as an active business. The real estate in the corporation's portfolio, unlike securities, would probably be inventory or property held primarily for sale to customers in the ordinary course of business. If so, any gain derived from property sales would be ordinary income. Is this the distinction that allows a corporation to spin off a real estate trading activity, but not a stock-trading activity? Since the active business requirements of section 355 are not directed to capital gain considerations, the answer should be no. But can the

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[50] Rev. Rul. 66-204, 1966 INT. REV. BULL. No. 29, at 14.

[51] The taxpayer in this example, in addition to his spin-off problems, may be confronted with even greater accumulated earnings tax problems. See INT. REV. CODE OF 1954, §§ 531-37.

[52] *Compare* INT. REV. CODE OF 1954, § 1221 (gains and losses derived by a trader in securities result in capital gains) *with* INT. REV. CODE OF 1954, § 1236 (gains and losses derived by a dealer in securities, other than on investments, result in ordinary income and loss).

capital gain v. ordinary income principles be forgotten when one addresses himself to resolving *investment activities v. active business* questions?

Assuming that the department store's stock market activities fail to satisfy the active business tests of section 355, should we reach a similar answer in the case of a mutual fund (a regulated investment company) which desires to divide its "business" in half? Should trading in stocks and bonds be deemed only an investment activity of a dealer in securities such as an investment banking firm?

Activities relating to the ownership and management of real estate present some of the most troubling questions in the *investment v. active business* analysis. Minimal real estate activities may constitute a trade or business for many tax purposes,[53] but they do not necessarily constitute the *active* conduct of a trade or business required by section 355. Where real estate is leased to a tenant on a "net lease" basis, that is, under terms where the tenant is responsible for such items as taxes, insurance, and repairs in addition to specified rentals, the absence of substantial landlord activity may fail to satisfy the "active conduct" requirement of section 355. Similarly, if substantially all of the real estate activities–leasing, contracting for repairs, and maintenance–are conducted by an independent contractor (for example, a real estate management company), rather than by an employee of the owning real estate corporation, the corporation is arguably not properly regarded as being engaged in the active conduct of a real estate business.

The distinctions between the passive ownership of real estate investments and the active conduct of a real estate business are sometimes fine indeed.[54] If an employee of a corporation which owns a shopping center performs all those activities required, the corporation is probably actively conducting a real estate business. It would appear irrelevant that these activities–collecting rent; paying insurance, taxes, and other bills; leasing space; contracting for maintenance and snow removal services–require only a few hours each month. If these activities are all that the efficient operation of the

[53] See, *e.g.*, John D. Fackler, 45 B.T.A. 708 (1941), *aff'd*, 133 F.2d 509 (6th Cir. 1942) (the subleasing of a lease on a single building constitutes a trade or business for purposes of depreciation under the predecessor of § 167); Leland Hazard, 7 T.C. 372 (1946) (renting a former residence is a trade or business).

[54] *Cf.* INT. REV. CODE OF 1954, § 856, which makes a similar distinction for real estate investment trusts.

shopping center requires, perhaps section 355 should require no more.

Where a corporation uses a major portion of its real property in one of its principal trades or businesses, the ownership and operation of the real estate does not constitute the active conduct of a trade or business.[55] In view of the legislative background of the enactment of section 355 in 1954, the ownership of real estate by a subsidiary leased to and used in the parent's primary business should fare no better.[56]

In addition to the problems associated with determining whether a corporation's activities satisfy the "active" requirements of the active business test, it sometimes is necessary to determine what "business" the corporation has conducted. On at least one occasion the Service was confronted with the problem of characterizing the type of business engaged in by a corporation.[57] Corporation *A* had been in the business of selling and servicing Brand *X* automobiles in two locations for more than five years. In 1954 *A* acquired the franchise to sell and service Brand *Y* automobiles. All of the Brand *X* activities were moved to location one; all the Brand *Y* activities

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[55] Treas. Reg. § 1.355-1 (c) (1955).

[56] Section 353 (c) of H.R. 8300, 83d Cong., 2d Sess. (1954) contained the corporate separation provisions. Tax-free spin-offs were sanctioned only when certain requirements, including the maintenance of separate books and records for the spun-off business, were complied with. The Senate rejected the House proposal in favor of existing law which prohibited "the tax-free separation of an existing corporation into active and inactive entities." S. REP. No. 1622, 83d Cong., 2d Sess. 51 (1954). It may be questioned whether the renting of property to a related corporation can ever be deemed an active business as envisioned by the framers of § 355. Even the House bill denied active business status to corporate businesses which derived ten per cent or more of their gross income from personal-holding-company-type sources. Surprisingly, the courts have not yet clearly stated whether renting real estate to a related corporation can qualify as an active business under the 1954 Code. See Isabel A. Elliott, 32 T.C. 283, 290 (1959), where the Commissioner did not contest the petitioner's contention that a corporation was engaged in the active conduct of a real estate business which leased the major portion of its property to its parent corporation. The Commissioner's position in *Elliott* did not require him to contest this point. In Albert W. Badanes, 39 T.C. 410 (1962), the Commissioner stipulated that a real estate corporation that leased a bottling plant to its sister corporation was actively engaged in the real estate business. Stipulation (para. 12), Brief for Petitioner in Reply, p. 3. *But see* Bonsall v. Commissioner, 317 F.2d 61 (2d Cir. 1963), holding that a spin-off and leaseback of buildings used in a linoleum business did not meet the five-year active business tests of § 355 (b) (2) (B).

Under the 1939 Code, leasing property to related corporations apparently satisfied the active business tests. See Estate of Parshelsky v. Commissioner, 303 F.2d 14 (2d Cir. 1962), *on remand*, 32 P-H Tax Ct. Mem. 1036 (1963); Bondy v. Commissioner, 269 F.2d 463 (4th Cir. 1959); Wilkins v. United States, 188 F. Supp. 91 (S.D. Ill. 1960).

[57] Rev. Rul. 57-190, 1957-1 CUM. BULL. 121.

were moved to location two. In 1956, the Brand *X* activities were placed in controlled corporation *X* and the stock was spun off to the *A* shareholders. The question was whether the distributing corporation had been actively conducting its business for five years prior to the distribution. If one were to seek the answer by viewing the distributing corporation's activities in a generic sense, it seems clear that an automobile sales and service business had been conducted for five years. But the Service found two separate businesses—selling and servicing Brand *X* automobiles; and selling and servicing Brand *Y* automobiles. Accordingly, Revenue Ruling 57-190 held that the Brand *Y* sales and service acquired by purchase in 1954 was less than five years old in 1956.

Unfortunately, much of the uncertainty which pervades the definitional problems associated with the active conduct of a trade or business can be expected to remain until the courts have had an opportunity to pass on a number of varied situations. A substantial number of these cases will probably arise in litigation involving the five-year history rule.

(4) *The Five-Year Business History Rule.* Section 355 (b) (2) (B) requires that the trade or business actively conducted by the distributing corporation after the spin-off must have been actively conducted for five years preceding the distribution. The same rule is applicable to the business of the controlled corporation.

The business must not have been acquired directly or indirectly by either of the post-distribution corporations within five years of the distribution in a transaction in which gain or loss was recognized.[58] Unfortunately, neither the code nor the regulations are as clear on this point as one would desire. The purpose of the provision requiring that the business distributed may not have been acquired in a taxable transaction within five years is readily appreciated. Congress sought to limit the potential abuse of the spin-off provisions by limiting their benefits to distributions of well-established (five-year old) businesses. If a new business desired by one or more shareholders could be distributed tax-free, the bailout potential would be immeasurably increased. Only the limitations of the device clause and the problem of locating a willing buyer would stand between the shareholder and the receipt of corporate earnings

[58] INT. REV. CODE OF 1954, §§ 355 (b) (2) (C), (D).

at capital gain rates. As in the case of partial liquidations, Congress felt that if a corporation had to conduct a business actively for five years prior to distributing it to its shareholders, the opportunities for abuse would be effectively contained. Under section 355 a corporation cannot use its excess funds to purchase a business and then distribute the business to its shareholders, who could in turn sell the business to a willing purchaser.

The corporation can, however, acquire a business with its stock in a tax-free reorganization and distribute the acquired business to its shareholders, if no gain or loss was recognized in the reorganization transaction.[59] Since the acquiring corporation never recognizes any gain in a reorganization,[60] the reference to gain or loss must be read as applying to the "seller." Thus, if boot is paid in a reorganization, the distribution of the acquired business within five years of its acquisition will not qualify under section 355.[61] It is questionable whether such a strict rule furthers the purpose of the five-year requirement. If the acquisition of the business meets the continuity-of-interest requirements of a tax-free reorganization, even if some of the boot given in the transaction results in a recognition of gain to a transferor corporation under section 361 or to its shareholders under section 356, why should section 355 treat the acquisition exactly the same as if the business had been purchased for cash? If Congress intended to deny section 355 benefits to distributions of businesses acquired in essentially tax-free acquisitions within five years of a distribution, its judgment may be questioned. Conversely, the propriety of applying the limitations of section 355 (b) (2) (C) to certain cash acquisitions where gain is fortuitously not recognized is almost beyond question. Frequently, the basis for stock owned by a decedent at the time of his death is determined by its sales price. If a corporation purchases such stock, no gain or loss is recognized by either the buyer or the seller,[62] but no good reason exists for allowing the tax-free distribution of the acquired stock until five years have

[59] See *ibid.*

[60] INT. REV. CODE OF 1954, § 1032.

[61] See BITTKER, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 337 (1959).

[62] For purposes of applying § 355 (b) (2) (C), a better view might be to regard the sale of such stock as resulting in the recognition of gain, but since the basis of the stock under § 1014 is equal to the sales price, the amount recognized under § 1001 is zero. Such an analysis would seem to further the intent of § 355 without doing violence to the statutory language.

elapsed. Similarly, a corporation which fulfills the requirements of section 337 may sell a business to the distributing corporation for cash. Again, neither the buyer nor the seller recognizes any gain on the transaction. But here, the acquisition transaction could conceivably be deemed a taxable one since the shareholders will recognize gain or loss on the liquidation of the selling corporation. The Service can be expected to deny section 355 benefits to all distributions involving gain, including reorganization boot, as well as to purchases by the distributing corporation at the seller's basis and to purchases from corporations which are in the process of complete liquidation and which have obtained the benefits of section 337.

Only a few cases have explored the application of the no-gain-or-loss requirements of section 355 (b) (2) (C). In *Gabriel Fabrication Co.*,[63] W. E. Gabriel and his brother were the principal shareholders of Boiler Corporation, which had for more than five years conducted three businesses. The brothers agreed to separate their business interests. Before arrangements for a split-off could be completed, the brothers agreed between themselves to divide Boiler. The assets of two of the businesses were "loaned" to one of the stockholders, W. E. Gabriel, who operated the businesses for fourteen months as a sole proprietor. Then, legal title to the assets was transferred by Boiler to its subsidiary, Engineering, the stock of which was distributed to Gabriel in exchange for his Boiler stock.

In *Gabriel*, the Commissioner argued that the five-year history rule of section 355 required that the business of the controlled corporations must have been conducted by the distributing corporation or the controlled corporation for the full five-year period preceding the distribution. The court, however, held for the taxpayer, noting that neither the code nor the regulations require that the business conducted during the five-year period shall have been conducted by either the distributing or the controlled corporation. Since the business could have been conducted by a stranger during most of the period, so long as its acquisition by the distributing corporation was tax-free, the court saw no reason why the conduct of the business by Gabriel should receive less favorable treatment.

Although the Tax Court in *Gabriel* acknowledged difficulty in discerning the specific congressional purpose for enacting section

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[63] 42 T.C. 545 (1964), *acq.* 1965-1 CUM. BULL. 4.

355 (b) (2) (C), it quoted the following analysis from an article by Cohen, Silverman, Surrey, Tarleau, and Warren[64] with apparent approval:[65]

> This requirement [355 (b) (2) (C)] is apparently intended to prevent temporary purchases of going businesses as a method of distributing liquid assets to shareholders. Accordingly, the test has the general purpose of differentiating between acquisitions for cash or other liquid assets, which will not qualify, and acquisitions for stock, which will qualify.[66]

Since the businesses involved in *Gabriel* were not acquired by Boiler or Engineering for cash or other liquid assets within five years, the Tax Court's holding appears correct. Had the loan of the business assets to Gabriel or their return to Boiler been deemed a taxable transaction, however, a contrary result would appear inevitable.

Section 355 (b) (2) (C) requires that the business conducted by the controlled corporation after the spin-off must not have been acquired within five years in a transaction in which gain or loss was recognized in whole or in part. Section 1.355-4 (b) (1) of the regulations provides that gain or loss must not have been recognized when the business was acquired by either the distributing corporation or the controlled corporation. Thus, if a corporation transfers a business to a newly formed controlled corporation in exchange for all of the stock of the controlled corporation and other property (for example, a short-term note), any gain to the transferor corporation on the exchange will be recognized under the provisions of section 351 (b). Accordingly, a distribution of the stock of the controlled corporation within five years will not satisfy the requirements of section 355 (b) (2) (C).

In *Oscar E. Baan*,[67] the distributing corporation, Pacific Telephone & Telegraph Co. ("Pacific") transferred its telephone business located in several northwestern states to a newly formed controlled corporation, Pacific Northwest Bell Telephone Co. ("Northwest") in exchange for all of Northwest's stock and a 200 million-dollar note.

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

[65] 42 T.C. at 557.

[66] Cohen, Silverman, Surrey, Tarleau & Warren, *supra* note 64, at 430; see discussion by the court in *Gabriel*, 42 T.C. at 563.

[67] 45 T.C. 71 (1965) (on appeal to the 2d and 9th Circuits).

The Commissioner determined that the note was other property,[68] and thus concluded that the controlled corporation had acquired its business in a transaction in which gain or loss had been recognized within the prohibited five-year period. During 1961, the year in which the described exchange transaction was consummated, both Pacific and Northwest were subsidiaries of American Telephone & Telegraph Co. and joined with it in the filing of a consolidated return. Thus, the gain resulting from the transfer of the business assets which might have otherwise been subject to tax was eliminated from the then applicable consolidated return regulations.[69] The Commissioner, while conceding that the gain was eliminated under the consolidated return regulations, argued that since the gain was "recognized" under section 351 (b), Northwest did not acquire its business in a transaction in which gain was not recognized within the prohibited five-year period. The Tax Court held that the elimination of gain or loss under the consolidated return regulations satisfied the no-recognition-of-gain-or-loss requirement of section 355 (b) (2) (C). The ultimate resolution of this issue in *Baan* can have a significant effect on the tax status of many spin-offs involving affiliated groups which have filed consolidated returns within five years of the separation.[70]

(5) *Distribution of All Stock and Securities.* Section 355 (a) (1) (D) requires that the distributing corporation must either (1)

[68] The taxpayers argued that the note was a security, which like stock, can be received without the recognition of gain under INT. REV. CODE OF 1954, § 351 (a). Since the court found that no gain would be recognized in any event because of the consolidated return regulations, it was unnecessary to determine whether the note was, in fact, boot. 45 T.C. at 92.

[69] Treas. Reg. § 1.1502-31 (b) (1) (1955). For treatment under the new consolidated return regulations, see Treas. Reg. § 1.1502-13 (b), Example (2) (1966).

[70] The new consolidated return regulations provide that intercompany exchanges result in a recognition of gain to the exchanging parties, but the gain is deferred until a subsequent event. Treas. Reg. § 1.1502-13 (1966). In view of the significantly different treatment accorded exchanges under the old and new consolidated return regulations, it is questionable whether the Tax Court would reach the same result as it did in *Baan* in a case governed by the new regulations.

A distributing corporation may acquire control of the controlled corporation in a taxable transaction, within the prohibited five-year period, even though the distributing corporation was not a party to the transaction. Assume that *P* corporation owns seventy-five per cent of the stock of *S* corporation. In the current year *S* redeems the twenty-five per cent stock interests owned by the minority shareholders. The redemption is a transaction in which gain or loss is recognized by the redeeming shareholders and is the transaction by which *P* obtained control of *S*. Consequently, *P* cannot distribute the *S* stock under § 355 until five years after the date of the redemption. Rev. Rul. 57-144, 1957-1 CUM. BULL. 123.

distribute all of its stock and securities in the controlled corporation; or (2) distribute at least enough stock to constitute "control," as defined in section 368 (c) (1),[71] and must establish to the satisfaction of the Commissioner that the stock and securities not distributed were not retained in pursuance of a plan of tax avoidance. Generally, all the stock and securities of the controlled corporation must be distributed, even though their distribution may result in the shareholder receiving taxable boot.[72]

SPLITTING A SINGLE BUSINESS

A corporation is engaged in the active conduct of a trade or business if a specific group of activities are being carried on by such corporation for the purpose of earning income or profit from such group of activities, and the activities included in such group include every operation which forms a part of, or a step in, the process of earning income or profit from such group.[73]

Section 355 (b) (1) requires that each post-distribution business must be actively conducted immediately after the distribution—a post-distribution two-business rule. Section 355 (b) (2) (B) requires that each of the post-distribution businesses must have been "actively conducted throughout the 5-year period ending on the date of the distribution." The regulations[74] provide that the active business and the five-year history requirements are satisfied only when there are two separate trades or businesses, each with a five-year history, immediately prior to the distribution. The regulations are based on the argument that the term "such trade or business" in section 355 (b) (2) (B) refers to the active conduct of the *same* trade or business for five years prior to the distribution. Since two businesses are required after the separation by virtue of the post-distribution rules of section 355 (b) (1), the regulations require that there must

[71] "For purposes of Part I (other than section 304), Part II and this part, the term 'control' means the ownership of stock possessing at least 80 per cent of the total combined voting power of all classes of stock entitled to vote and at least 80 per cent of the total number of shares of all other classes of stock of the corporation." INT. REV. CODE OF 1954, § 368 (c) (1).

[72] Any stock of a controlled corporation which was acquired within five years of the distribution in a transaction in which gain or loss was recognized will be boot when distributed. See INT. REV. CODE OF 1954, § 355 (a) (3); Treas. Reg. § 1.355-2 (f) (1) (1955).

[73] See Treas. Reg. § 1.355-1 (c) (1955).

[74] Treas. Reg. §§ 1.355-1, -4 (1955).

have been two businesses prior to separation. The present regulations reason that where there is only one business prior to distribution it may not be separated tax-free, because each of the two resulting businesses differs from the one business from which it came. This is true even though the assets and activities of the two post-distribution businesses are the same as the assets and activities of the one pre-distribution business. Since one-half or one part of a business is not the same as the whole business, neither of the post-distribution businesses satisfies the five-year history requirements of section 355 (b) (2) (B). Accordingly, a set of assets and activities constituting a single business cannot be divided tax-free under the present regulations.

In *Edmund P. Coady*,[75] the two shareholders of a small construction company decided to divide their business. The division was to be accomplished by a "vertical slice." Each of the post-distribution corporations was to take approximately one-half of the pre-distribution corporation's assets and each corporation (after the split-off) would perform all those activities forming a part of or a step in the process of earning income from the construction business.

The Tax Court rejected the Commissioner's argument that the distribution in *Coady* failed to meet the requirements of section 355. The regulations, which supported the Commissioner's position,[76] were held invalid to the extent they provided that section 355 does not apply to the division of a single business. The Tax Court concluded that, although the statute requires two active businesses after the distribution, each with a five-year history, it does not require that

> each such trade or business necessarily must have been conducted on an individual basis throughout the 5-year period. As long as the trade or business which has been divided has been actively conducted for 5 years preceding the distribution, and the resulting businesses . . . are actively conducted after the division, we are of the opinion that the active business requirements of the statute have been complied with.
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> . . . .
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> There being no language, either in the statute or committee report, which denies tax-free treatment under section 355 to a transaction solely on the grounds that it represents an attempt to divide a single trade or business, the Commissioner's regulations

[75] 33 T.C. 771 (1960), *aff'd*, 289 F.2d 490 (6th Cir. 1961).
[76] Treas. Reg. § 1.355-1 (a) (1955).

which impose such a restriction are invalid, and cannot be sustained.[77]

The Fifth Circuit Court of Appeals agreed with this view in *United States v. Marett*[78] stating that the regulations' pre-distribution two-business rule "is more than an attempt to put a 'gloss' on the statutory requirement. It is an attempt to add a restriction to the statute which is not there."[79] In Revenue Ruling 64-147[80] the Service announced that it would follow *Coady* and *Marett* to the extent that they hold that a single business may be divided under section 355 and that consideration would be given to a modification of the regulations.

As of this writing, the new regulations have not been promulgated. Although one might initially think that the regulations could be modified to conform with the *Coady* and *Marett* decisions simply by deleting the objectionable sentence of section 1.355-1 (a) of the regulations which prohibits the division of a single business, careful study of the pre-distribution two-business rule contained in section 1.355-1 (c) of the regulations and illustrated by the examples in section 1.355-1 (d) of the regulations discloses that the entire regulation must be restructured if it is to conform with the court decisions.

In *Coady* and *Marett* there were "vertical splits" of a single business; that is, each of the post-distribution corporations conducted on a smaller scale the same business conducted by the single predecessor corporation. In *Coady*, both post-distribution corporations were actively engaged in the construction business after the split-off. In *Marett*, both of the post-spin-off corporations were engaged in the manufacture and sale of edible pork skins.[81] In order to change the emphasis of the regulations from the discredited pre-distribution two-business rule to a judicially acceptable post-distribution two-active-business rule (including the requisite five-year his-

[77] 33 T.C. at 778-79.

[78] 325 F.2d 28 (5th Cir. 1963).

[79] *Id.* at 30.

[80] 1964-1 (Part 1) CUM. BULL. 136.

[81] The courts have not yet clearly ruled on the related question of whether § 355 is also applicable to a "horizontal slicing" of a single vertically integrated business (*e.g.*, the spin-off of the sales function or the warehousing function of an integrated manufacturer). *But see* Lockwood v. Commissioner, 350 F.2d 712 (8th Cir. 1965), which apparently sanctioned the separation of a sales business from a manufacturing and sales business.

tory) it will be necessary to resolve the question of what assets and activities constitute a trade or business with a five-year history.

A number of questions could be raised as to the types of divisions of an integrated business that should receive tax-free treatment under section 355. Take, for example, an integrated department store enterprise which has the following components: (1) a main downtown store, (2) a suburban store, (3) a warehouse which stores goods only for the enterprise, (4) delivery trucks which deliver goods only for the enterprise, and (5) a parking lot, the use of which is free to patrons of the downtown store. Under what circumstances, if any, should the enterprise be permitted to spin off the suburban store? The warehouse? The delivery trucks? The parking lot?

The foregoing questions, of course, present in its most simple form the problem of what types of divisions are allowed by section 355. Example 10 of the present regulations[82] indicates that the downtown store and the suburban store may constitute two separate businesses within the meaning of section 355 under certain circumstances. Example 10 indicates that in order for these two stores to be two businesses, there must be separate management, separate purchasing, and separate warehousing for each store.[83] Since *Coady* apparently makes it of no consequence whether the suburban store is a separate department store business or part of a single department store business, the suburban store could presumably be separated from the downtown store under section 355.[84] But just what assets must be transferred to the controlled corporation to qualify as a trade or business with a five-year history? Recalling that section 1.355-1 (c) of the regulations requires that a post-distribution business consist of a group of activities which includes every operation which forms a part of, or a step in, the process of earning income or profit from the group, it would appear that the department store corporation conducts a number of activities—including warehousing, delivering, and parking, as well as buying and selling merchandise—to produce a single profit.

[82] Treas. Reg. § 1.355-1 (d) (1955).

[83] As to what constitutes a single business as opposed to two or more businesses, see discussion of *Lockwood* and *Burke* in text accompanying notes 94-95 *infra*.

[84] Note, however, the potential importance of the characterization of the suburban store as a separate business or as a part of a single business, if the suburban store (or the downtown store) has a history of less than five years. If they are separate businesses, each must possess the requisite five-year history.

Assuming for the moment that section 355 requires that any tax-free division of a single business must be a "vertical slice,"[85] how must the assets be divided? If, for example, there is only one delivery truck and only one warehouse, neither the truck nor the warehouse is readily susceptible to an equal division between the two retail outlets. The same could be said for the purchasing department if it was composed of only one employee. Distributing one-half of the downtown parking lot to the suburban store would be a fruitless, if not a senseless act. It seems likely then that the revised regulations must accept the fact that a perfect "vertical slice" is impractical in many, if not most, corporate separations. The solution therefore may be to allow the separation in situations where each of the two post-distribution businesses conducts the same business (the department store business) that was conducted by the single corporate predecessor. As a matter of applying the philosophy of section 355 to these cases, it would seem of little moment whether the suburban store acquired a delivery truck in the corporate separation, purchased a delivery truck with excess cash it received in the separation, contracted with a local delivery service for future deliveries, or began a new policy of no deliveries. Presumably, the warehouse and customer parking facilities could be treated in a similar manner. The important thing is that each of the two post-distribution corporations would be engaged in the department store business after the separation.

Although we can anticipate with some assurance that the assets and activities which constitute the retail suburban department store business can be separated from the assets and activities which constitute the retail downtown department store business, the fate of an attempted separation of a warehouse, delivery trucks, or parking lot operation, from a retail department store business is not so clear. Unquestionably, after the distribution, a corporation which owns the assets and conducts the activities formerly associated as a service arm or function of the primary business is conducting a business. Equally clear is the fact that the corporation which operates a warehouse is not an inactive entity of the type which is denied the benefits of

[85] The Eighth Circuit has on one occasion indicated that the spun-off business must be the same as the primary business of the distributing corporation. Lockwood v. Commissioner, 350 F.2d 712, 718 (8th Cir. 1965) (dictum).

section 355.[86] But is a corporation whose activities are limited to servicing the primary business of the corporation from which it was separated engaged in the active conduct of business as envisioned by section 355? If so, does the warehousing business have the five-year history required by section 355 (b) (2) (B)? The answers to these questions depend upon whether the distributing retail department store corporation is deemed to have ever been engaged in the warehousing business, and if so, whether that business has been actively conducted for the requisite five-year period.

Assuming that the downtown department store has conducted all of its activities for at least five years, the warehouse assets and activities, which after the distribution service the department store, apparently meet the definitional requirements of an active business set forth in section 1.355-1 (c) of the regulations. But can it be fairly said that the department store has ever been engaged in the warehousing business for the requisite five-year period?

On balance it would seem that the warehousing business, the delivery business, or the parking lot should qualify for separation under section 355. The assets and activities which comprise the business have been owned and conducted for the requisite period and have earned income, at least in an economic sense, throughout the period of operation. Further, the business purpose which motivates the corporate separation (for example, an antitrust decree or shareholder dispute) may require a horizontal rather than vertical slice. In such cases it would appear improper to limit the *Coady* and *Marett* decisions to their respective facts.

If the warehousing assets and activities meet the five-year active business requirements of section 355, then could not the assets and activities associated with the real estate employed in a corporation's primary business be spun off? Three cases have dealt, at least in part, with the real estate question. In *Theodore F. Appleby*[87] the court held the corporate activities of providing a building for the principal business (insurance) of the corporation did not constitute the active conduct of a trade or business under section 355. Similarly, the real estate activities of a wholesale linoleum company[88] and

[86] See S. REP. No. 1622, 83d Cong., 2d Sess. 50-51 (1954).
[87] 35 T.C. 755 (1961), *aff'd per curiam*, 296 F.2d 925 (3d Cir. 1962).
[88] Bonsall v. Commissioner, 317 F.2d 61 (2d Cir. 1963).

an engineering company[89] have failed to pass active business muster. Even if the regulations are liberalized to accommodate the horizontal division of vertically integrated businesses, it is doubtful whether real estate used in the principal business of the distributing or controlled corporation will qualify as an active business. Unless more than half of the real property is occupied by persons other than the distributing corporation, or a related corporation, the corporation conducting the real estate business may not satisfy the active business tests of section 355.

In *Marne S. Wilson*[90] the Tax Court held that the financing of installment notes receivable, acquired by a retail furniture business, constituted a separate active business conducted for the requisite five-year period. The court's finding that the financing business was a separate business precludes reading *Wilson* as holding that a single vertically integrated business may be divided under section 355. The *Wilson* financing activities produced interest income from its customers (not from a related party) and encompassed all the operations forming a part of or step in the process of earning income from financing.

If warehousing activities, parking lot activities, and delivery activities do not satisfy the active business tests of section 355 when, after the distribution, they derive income only from the other pre-distribution corporation, at what point will business transactions with unrelated parties convert these activities into active businesses? If, for example, for five years prior to the separation the warehouse owned by the department store has rented sixty per cent of its space to other merchants and after the separation derives sixty per cent of its income from these other merchants, it seems that the warehouse could be spun off under section 355. In fact, is not the corporation in the warehousing business?

A bank which rented ten of its eleven floors to various tenants has qualified as being in the real estate business under the present regulations.[91] Note, however, that another bank which leased only twenty-five per cent of its space to unrelated parties failed the active business test on the ground that renting such space was only inci-

[89] Isabel A. Elliott, 32 T.C. 283 (1959).

[90] 42 T.C. 914 (1964), *rev'd on other grounds*, 353 F.2d 184 (9th Cir. 1965).

[91] Treas. Reg. § 1.355-1 (d), Example (3) (1955).

dental to its banking business.[92] If our warehouse rents only thirty per cent of its space, or derives only thirty per cent of its income from transactions with unrelated parties, will it qualify as an active business? Unless transactions with unrelated parties constitute at least fifty per cent of the activities of any service function such as warehousing, delivery, or parking lot operations, corporate separations probably should not be advised without an advance ruling from the Service. Whether favorable rulings will be granted in these less than fifty per cent cases may depend on the tests promulgated by the new regulations.

ONE BUSINESS OR TWO: A NEW TWIST TO THE *Coady* PROBLEM

Prior to the Service's announcement that it would follow the *Coady* and *Marett* decisions, the typical spin-off case found the taxpayer arguing that he satisfied the pre-distribution two-separate-business test of the regulations while the Commissioner argued that only a single business was involved.[93] The Service now approves of the vertical slicing of a properly aged (five-year) single business, while the division of two separate businesses, one of which has not received the necessary five-year aging, remains taxable. In this setting, new litigation has arisen with the taxpayer arguing that there is only one business while the Commissioner maintains there are two businesses.

Prior to *Coady* a newly established branch of a business could not be spun off, since the branch would have been viewed as a new business without the necessary five-year history, or as an unacceptable division of a single business. In *Patricia W. Burke*,[94] however, the Tax Court held that the incorporation and distribution of a branch radio parts distributorship qualified as a tax-free spin-off, notwithstanding that the branch was less than five years old. The Tax Court found that the branch store, prior to its incorporation, did not carry on "every operation which forms a part of or step in the process of earning income from such group." Since the branch did not maintain a complete inventory, had no outside salesman, did not have a functioning bank account, and did not handle its own accounts receivable, the court found it was only a part of the single radio parts

[92] Treas. Reg. § 1.355-1 (d), Example (4) (1955).
[93] See, *e.g.*, H. Grady Lester, Jr., 40 T.C. 947, 956-58 (1963).
[94] 42 T.C. 1021 (1964).

business operated for more than five years by the distributing corporation. Accordingly, after citing *Coady* for the proposition that a single business may be divided, the "vertical slice" was approved.

In *Lockwood v. Commissioner*,[95] the separation of a newly incorporated branch with less than a five-year history was allowed. The Eighth Circuit Court of Appeals reversed the Tax Court by holding that the geographical separation of corporate sales activities does not convert one business into two. Where each of the two post-distribution businesses is deemed to have a separate business predecessor, and where one of those predecessors does not possess the requisite five-year history, we can expect the Commissioner to renew the challenges made in *Burke* and *Lockwood*. But where two operations, such as a downtown and a suburban department store, constitute only a single business, the separation of the downtown and suburban stores would seem permissible, provided at least one of the two stores had been in business for five or more years.

THE EXPANDING BUSINESS-PURPOSE DOCTRINE

One of the requirements of a tax-free corporate separation is that it must be responsive to a business purpose. The Ninth Circuit's recent decision in *Commissioner v. Wilson*,[96] has been characterized as a "collector's item among the progeny of *Gregory v. Helvering*."[97] In *Wilson*, the Ninth Circuit dispelled the assumption that the presence of a business purpose and the absence of a tax avoidance motive are two sides of the same coin; the court held that both a valid business purpose and the absence of tax avoidance are required for a tax-free spin-off. The case began when the Wilson brothers, who owned all of the stock of Wilson's Furniture, Inc. ("Furniture"), decided to have their corporation transfer the conditional sales contracts it had acquired from the corporation's customers to a new corporation, Wil-Plan, Inc., which was to conduct a finance business. The stock of Wil-Plan was distributed pro rata to the Wilsons. The taxpayers treated the receipt of the Wil-Plan stock as a tax-free spin-off and reported no gain from the transaction in their 1958 returns. The Commissioner asserted deficiencies against the Wilsons claiming (1) that the transaction was used principally as a device for the distri-

[95] 350 F.2d 712 (8th Cir. 1965), *reversing* 33 P-H Tax Ct. Mem. 1350 (1964).

[96] 353 F.2d 184 (9th Cir. 1965), *reversing* 42 T.C. 914 (1964).

[97] Warren, Pugh & Hallawell, *Comment on Wilson*, CCH 1965-66 FEDERAL TAXATION, CURRENT LAW AND PRACTICE ¶ 1142, at 853.

bution of Furniture's earnings and profits,[98] (2) that the spin-off lacked a valid business purpose,[99] and (3) that the spin-off did not meet the active business requirements of section 355 (b).

The taxpayer advanced three specific business reasons to refute the Commissioner's assertion that the transfer of the conditional sales contracts and financing operations to the new corporation had as one of its principal purposes the distribution of earnings and profits.[100]

Although the Tax Court rejected each of the contentions as providing a valid business reason for the incorporation and distribution of Wil-Plan, it nevertheless found as a fact that the transaction was not used principally as a device for the distribution of earnings and profits.[101] The Court found that:

> Although the assets transferred to Wil-Plan had a high degree of liquidity, as stressed by the Government, we are satisfied by the evidence that the Wilsons intended to continue the financing activities with those assets, and that they had no intention either to liquidate Wil-Plan, to sell the stock of Wil-Plan, or in any other manner to siphon off for themselves the assets (or their equivalent) that had been transferred from Wilson's [Furniture] Inc., to Wil-Plan.[102]

This conclusion rested on the fact that there was credible evidence that no sale or liquidation was planned and no sale had in fact taken place in the five years that elapsed from the date of the spin-off to the Tax Court decision.[103] The Tax Court opinion did not deal with

[98] The accumulated earnings and profits of Furniture at the time Wil-Plan was incorporated were approximately $49,000. The fair market value of the Wil-Plan stock was approximately $138,000. To the extent a distribution exceeds the earnings and profits of the distributing corporation, it results in capital gain after all the shareholder's basis in his stock of the distributing corporation is consumed. INT. REV. CODE OF 1954, § 301 (c).

[99] While the Ninth Circuit's opinion in *Wilson* carefully notes that both the Commissioner and the taxpayers recognize that a valid business purpose is an essential element of a tax-free spin-off, Judge Raum's Tax Court opinion fails to indicate that the Commissioner argued that a spin-off must have a business purpose, as well as no device, to qualify under § 355. See Tax Court Brief for Respondent, pp. 18, 19, 24-32; Reply Brief for Respondent, p. 15.

[100] 42 T.C. at 922-23. The reasons were: (1) to enable the separate finance company to make repossessions and to bring suits for delinquent payments in its own name without unfavorable customer reactions and without jeopardizing the good will of Furniture; (2) to enable the separate finance company to purchase more easily conditional sales contracts from other retail stores; and (3) to make the sales program of Furniture more efficient by having its personnel devote all their time to selling.

[101] *Id.* at 923.

[102] *Ibid.*

[103] *Id.* at 924.

the Commissioner's argument that, notwithstanding the absence of a device, a spin-off must be a non-tax-motivated transaction which has sufficient valid business reasons for the separation of the businesses and the direct ownership of both by the shareholders.

On appeal, the Ninth Circuit found itself

> confronted with what may be a unique situation, that of a corporation reorganization which had no business reason and which had no tax avoidance purpose, but which had the effect of removing from the risks and vicissitudes of a retail furniture business accumulated earnings in a form readily convertible by the shareholders into cash, by selling their stock in the spin-off corporation or by liquidating it and receiving and selling those easily liquidated assets.[104]

The court of appeals found that the valid business purpose requirement cannot be satisfied by merely showing an absence of tax avoidance. The doctrine of *Gregory v. Helvering*[105] was held to require more than literal compliance with the statutory spin-off provisions; there must have been a valid business purpose.

The importance of the Commissioner's victory in *Wilson* is readily appreciated when one examines the implications of a contrary decision. Had the court held that spin-offs no longer had to satisfy business purpose tests but rather only had to satisfy the device clause requirements, taxpayers could spin-off any active business. After the period of limitations on assessment had run, if the Commissioner had not questioned the spin-off, the shareholders could sell or liquidate either one of the post-distribution corporations at capital gain rates. Presumably, even near-liquid assets, such as the installment notes receivable employed in a finance business, could have been distributed to the shareholders via this route. If the Commissioner asserted a deficiency against the shareholders during the period for assessment by claiming that the distribution was a device, the shareholders could have continued to hold their shares in both corporations until their case had been tried. Their failure to sell or liquidate either corporation in the five or seven years following the spin-off would have been cogent evidence of the absence of a device. Thus, in effect, the bailout of earnings could have been accomplished by means of a three- or five-year "holding period." Whether such a

[104] 353 F.2d at 187.
[105] 293 U.S. 465 (1935).

result was intended by Congress would appear to have been answered in 1954 by the Senate Finance Committee's rejection of the House bill's provisions permitting "a person in a position to afford a 10-year delay in receiving income do so at capital gain rather than dividend rates."[106]

Prior to the *Wilson* decision, the Second Circuit Court of Appeals in *Estate of Parshelsky v. Commissioner*,[107] had commented:

> In light of the tax-avoidance possibilities which a spin-off often provides, there must be non-tax reasons not only for separation of the two businesses but also for direct ownership of both by the shareholders.[108]

The *Wilson* and *Parshelsky* decisions leave little doubt that at least two circuits believe the business purpose requirements first enunciated in *Gregory* have continuing vitality under the 1954 and 1939 Codes. Although the legislative history accompanying section 112(b)(11) of the 1939 Code[109] and section 355 of the 1954

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[106] S. REP. No. 1622, 83d Cong., 2d Sess. 50-51 (1954).

[107] 303 F.2d 14 (2d Cir. 1962).

[108] *Id.* at 20.

[109] Int. Rev. Code of 1939, § 112(b)(11), added by ch. 521, 65 Stat. 493 (1951) was designed, in part, to prevent *Gregory*-type bailouts. It contained an active business requirement and a device clause. But these provisions were not intended to limit the Commissioner or the courts. This section "has been drafted so as 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), reprinted in 1951-2 CUM. BULL. 458, 499. Under the device clause of the 1951 Act where the stock of one of the two post-distribution corporations was sold or the corporation liquidated shortly after the spin-off, especially if the sale was pre-arranged, an inference would arise that the spin-off was a belated substitute for ordinary dividends and the spin-off would not enjoy tax-free status. *Ibid.*; see BITTKER, *op. cit. supra* note 61, at 326. Congressman Camp, sponsor of § 112(b)(11) in the House, addressed himself to the history of the taxation of spin-offs while discussing H.R. 7738 and H.R. 7725, 96 CONG. REC. A1978, A1980 (1950): "A similar provision was contained in section 112(g) of the Revenue Act of 1932 and prior acts but this was omitted in the Revenue Act of 1934 because the decision of the Board of Tax Appeals in *Evelyn F. Gregory* (27 B.T.A. 223 (1932)) indicated that such provision might be subject to abuse and held to apply to what was regarded as in substance the distribution of a dividend. The reversal of that decision in 69 F.2d 809 (2d Cir. 1934), *affirmed* 293 U.S. 465 (1935), removed the danger of such abuse. Judicial and administrative interpretation of the law since 1934 has established safeguards which now prevent such abuse of the reorganization provisions." In Estate of Parshelsky v. Commissioner, 303 F.2d 14 (2d Cir. 1962), the taxpayer argued that the two specific provisions of § 112(b)(11), the "active business" and "device" restrictions, have occupied the field so that the "business-purpose" method of statutory interpretation does not apply. The legislative history of the 1951 Act makes it clear that Congress was very concerned with tax evasion schemes of the *Gregory* type when it enacted § 112(b)(11). Representative Camp stated that if the bill was passed spin-offs would be "subject to

Code[110] amply demonstrate that Congress intended to pass legislation which prohibited a recurrence of *Gregory*-type devices, these courts and the regulations[111] have concluded that the statutory restrictions are nonexclusive remedies.

In the future, we can expect that the Commissioner will insist that there be substantial nontax reasons both for the separation of the businesses to be conducted after the distribution and for the direct ownership of both of the post-distribution corporations by the shareholders.[112] One can readily conceive of some situations which would meet these requirements. An antitrust divestiture order requiring the distribution of one of the businesses conducted by a corporation would be a substantial nontax reason both for the separation of the two businesses and for the direct ownership of each business by the shareholders.[113] Similarly, in situations like *Coady*, where the shareholders can no longer agree on the proper means of conducting a business, a non-pro-rata split-off satisfies the business purpose standards. The business must be divided and it is essential that the two post-separation businesses be separately owned by the shareholders. The *Parshelsky* decision indicates that the business purpose must be one which requires a distribution and not merely the formation of a new subsidiary. Even if the courts had accepted as valid the three purported business reasons for the *Wilson* spin-off,[114] it is questionable whether any of these reasons would satisfy

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the general limitations embodied in the *Gregory* case and subsequent decisions based thereon." 96 CONG. REC. A1978, A1980 (1950). "Therefore, to the extent that § 112(b)(11)'s two provisos are not as broad as the judicial safeguard of statutory interpretation, Congress did not intend to shackle the courts . . . ." Estate of Parshelsky v. Commissioner, *supra* at 18 n.7.

[110] "Congress, in enacting section 355 and its predecessors, was trying to give business enterprises leeway in readjusting their corporate arrangements to better suit their business purpose. If the rearrangement had that purpose, Congress was willing to concede them some possible tax advantages. If the rearrangement had no business purpose, let the taxes fall where they might." Commissioner v. Wilson, 353 F.2d 184, 187 (9th Cir. 1965).

[111] Treas. Reg. § 1.355-2(c) (1955). The regulations require that the distribution must be germane to the business "of the corporations." At least two courts have accepted the principle that valid shareholder purposes will also qualify. Estate of Parshelsky v. Commissioner, 303 F.2d 14, 20-21 (2d Cir. 1962); Lewis v. Commissioner, 176 F.2d 646, 649-50 (1st Cir. 1949).

[112] An example of a situation which prompted a favorable ruling from the Commissioner may be found in Rev. Rul. 56-554, 1956-2 CUM. BULL. 198, where a bank which considered the holding of relatively speculative assets undesirable was permitted to distribute them in a spin-off.

[113] See generally Cohen, *Current Partial Liquidation and Spin-Off Problems*, 41 TAXES 775-79 (1963).

[114] See note 100 *supra*.

this aspect of the business purpose doctrine set forth in *Parshelsky*. A subsidiary finance corporation could make repossessions and bring legal actions in its own name without jeopardizing the customer relations of its parent. The sales force of the parent could be completely separated from the financing activities of the subsidiary. Furthermore, it is at least questionable whether other retail stores would have any greater reluctance to sell conditional sales contracts to a subsidiary corporation than to a sister corporation of Furniture.

Where the business purpose is to insulate the assets of one business from the risks of another business, the purpose usually can be accomplished by placing the risky business in a subsidiary.[115] If both businesses are subject to extreme fluctuations, a bona fide intent to provide mutual limited liability might justify a spin-off. But could not the desired limited liability be achieved by forming two new subsidiaries?

Although the Commissioner lost the *Parshelsky* case on remand[116] because the Tax Court found that the shareholder's estate plan constituted a valid business purpose both for the separation of the two businesses and the direct ownership of each by the taxpayer, the Second Circuit opinion in conjunction with the Ninth Circuit opinion in *Wilson* should provide an interesting basis for the resolution of business purpose problems in the future. The newly vitalized business purpose doctrine looms as a substantial deterrent to those who might wish to utilize the spin-off provisions to bail out the earnings of their corporation.

SPIN-OFFS AND SMALL BUSINESS CORPORATIONS

Although the provisions pertaining to spin-offs and electing small business corporations are literally more than a thousand section numbers apart, their relationship is frequently considerably more proximate. A complete discussion of the interrelationship of section 355 and Subchapter S is beyond the scope of this article, but some of the problems and recent developments may be mentioned.

Assume that an electing small business corporation is engaged

[115] Where the affairs of a business subject to governmental regulation (*e.g.*, an insurance company) would be adversely affected by having its net worth continually fluctuate because of its investment in the economically gyrating subsidiary, a valid business purpose for the direct ownership of both corporations by the shareholders may be present.

[116] 32 P-H Tax Ct. Mem. 1033 (1963).

in two businesses—selling appliances and renting real estate. The corporation's accountant has advised the sole shareholder that the rental income from the real estate business will exceed twenty per cent of the corporation's gross receipts in its next taxable year. To avoid having the Subchapter S election terminated,[117] the shareholder proposes to spin off the real estate business. Since the avowed purpose of the spin-off is to retain the corporation's Subchapter S election, are the requirements of a substantial nontax reason for the separation and distribution satisfied? Furthermore, the mechanics of a spin-off present some substantial technical problems under Subchapter S. Section 1371 (a) excludes from the definition of a "small business corporation" any corporation which is a member of an affiliated group (as defined in section 1504) and any corporation which has another corporation as its shareholder. In order to effect a spin-off it is necessary to organize a controlled corporation, the stock of which is then distributed to the shareholder of the distributing corporation. If the real estate business is placed in the controlled corporation pursuant to the spin-off plan, there is a moment in time when the two corporations are members of the same affiliated group. If the appliance business is placed in the controlled corporation pursuant to the spin-off plan, in addition to the affiliated group problem, the controlled corporation also has a shareholder other than an individual, namely, the distributing corporation. The Service has not yet ruled whether momentary affiliation or a momentary corporate shareholder will terminate a Subchapter S election.[118]

The numerous section 355 safeguards designed to prevent the bailout of earnings by a corporation's shareholders were significantly blunted (albeit unintentionally) when Subchapter S was enacted in 1958. Assume that all of the stock of automobile dealership corpora-

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[117] INT. REV. CODE OF 1954, § 1372 (e) (5) provides, in part, that a Subchapter S election shall terminate if, for any taxable year, more than twenty per cent of its gross receipts are derived from passive income (royalties, rents, dividends, interest, annuities and gains on the sales of stock or securities). Note, however, the limited exception to the foregoing rule for certain new corporations contained in § 1372 (e) (5) (B) (added in 1966).

[118] *But cf.* Rev. Rul. 64-250, 1964-2 CUM. BULL. 333, where the Service held that a reorganization under § 368 (a) (1) (F) did not terminate a Subchapter S election. In an *F* reorganization, all of the assets of the transferor corporation are exchanged for all of the stock of the transferee corporations, INT. REV. CODE OF 1954, § 361, which is then distributed to the shareholders of the transferor corporation, INT. REV. CODE OF 1954, § 354. Thus, the *F* reorganization, like the spin-off, involves momentary affiliation and a momentary corporate shareholder.

tion *X* is owned by individual *A*. Over the years, successful operations have enabled *X* to purchase with retained earnings the land and buildings used in its business. A bank is willing to purchase the land and buildings, which have an adjusted basis of 50,000 dollars, from *X* for 250,000 dollars and then will lease the land and buildings back to *X* for thirty years at an annual rental of 10,000 dollars. Assuming that *A* can successfully overcome any sale-and-leaseback arguments which could be advanced by the Commissioner, *A* can bail out 250,000 dollars of *X*'s earnings if he can acquire title to the land and building prior to the sale to the bank.

If the property is distributed directly to *A* by *X*, it will be taxed as a dividend to him—a tax result he would not relish. A partial liquidation under section 346 cannot be effected since the real estate does not constitute a separate business under section 346 (b) and there is no corporate contraction as required by section 346 (a). Moreover, a tax-free spin-off is not available since the real estate activities do not satisfy the active business tests. Prior to 1966 a "one-shot" election under Subchapter S[119] might have achieved the desired result, at least to the extent of 200,000 dollars. Under this plan, the corporation would elect to be taxed as a small business corporation, and in the year of the election, X would sell the real estate to the bank and lease it back. The 200,000 dollars gain on the sale would be treated as long-term capital gain under section 1231, subject to the recapture provisions of section 1250. Moreover, the 200,000 dollars could be distributed to *A* by *X*. Thus, a single capital gain tax would be paid on the sale and distribution. Perhaps the only serious drawback to this arrangement is that all of the income from the automobile distributorship must be reported by *A* during the years the election is in effect.

In 1966, Congress substantially narrowed the scope of this bailout loophole.[120] Section 1378, for all taxable years beginning after April 14, 1966, provides that if the long-term capital gains of an electing small business corporation exceed 25,000 dollars in a given year and constitute more than fifty per cent of the corporation's taxable income (which must be more than 25,000 dollars), the corpo-

[119] The Service has apparently sanctioned Subchapter S elections even where the purpose of such elections was to pass through capital gains derived from the sale of corporate assets. See Rev. Rul. 65-292, 1965-2 CUM. BULL. 319, where a Subchapter S election was utilized to effect a partial liquidation on the installment basis.

[120] INT. REV. CODE OF 1954, § 1378.

ration must pay a tax equal to twenty-five per cent of the gain in excess of 25,000 dollars or an ordinary income tax on its taxable income, whichever is less. These additional tax provisions do not apply to electing small business corporations which have had an election in effect for at least three years preceding the taxable year of the capital gain, or to corporations which have been in existence for less than four taxable years and have elected Subchapter S treatment since their incorporation. Although some of its intricacies may be somewhat difficult to digest, section 1378 is intended to prevent a passthrough election which allows the corporation to avoid a capital gains tax[121] and incidentally prevents using Subchapter S elections to effect bailouts by the electing shareholder.

CONCLUSION

Our understanding of the purpose and application of section 355 has been significantly advanced in the dozen years since the 1954 Code was enacted. Yet, numerous significant questions remain for future resolution by the courts, taxpayers, the Treasury Department, and perhaps Congress. In the next twelve years we shall unquestionably learn more of what constitutes an active business within the historical and statutory framework of section 355; we can expect the courts to furnish additional guidance in the nebulous business purpose area; and we can look forward to more definitive administrative answers to numerous questions including the division of a single, vertically integrated business. If our experience in the last twelve years teaches us anything, it is that we cannot safely predict all the interpretative problems which will arise in the future or the contexts in which they will present themselves. No matter how they arise or whatever their context, we can safely predict that the coming years will produce greater understanding and appreciation of the problems which accompany the spin-off provisions.

[121] H.R. REP. No. 1238, 89th Cong., 2d Sess. 6-7 (1966); S. REP. No. 1007, 89th Cong., 2d Sess. 2, 6-8 (1966).