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Reconciling Business Purpose with Bail-out Prevention: Federal Tax Policy and Corporate Divisions

Stephen B. Cohen*

I wish to direct my attention for a few moments to that often misunderstood and I am sure seldom-heard-of subject of corporation spin-off. That always makes me think of the Fourth of July. I remember the spinners which were so popular among children on the Fourth of July, so when I speak of spin-offs I am reminded of those spinners.

Senator Hubert Humphrey[1]

Corporate divisions—spin-offs, split-offs, and split-ups—unfortunately pose a more complex problem than Senator Humphrey's childlike vision would lead one to believe: the reconciliation of competing goals of maximizing business flexibility and minimizing tax avoidance.[2] It is widely believed that divisions are essential to business planning;[3] thus, tax-free treatment promotes business flexibility. Yet, an untaxed division may allow tax avoidance through "bail-out" of corporate earnings and profits at capital gain rates.[4]

A specific illustration helps crystallize the dilemma. Suppose that X Corp. executes a division to immunize its real estate assets from risks of its business operations. X Corp. places the realty in newly formed Y Corp. and distributes the Y stock to its shareholders.[5] Tax-free treatment of the division promotes business flexibility and seems consistent with the basic rule against taxing mere changes in the form of stock ownership, such as stock

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1. 97 CONG. REC. 11,812 (1951).

2. *See* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS §§ 13.01–13.02 (3d ed. 1971); Whitman, *Draining the Serbonian Bog: A New Approach to Corporate Separations Under the 1954 Code*, 81 HARV. L. REV. 1194, 1194–97 (1968).

3. *See* notes 111–13 *infra* and accompanying text.

4. *See* notes 92–100 *infra* and accompanying text.

5. A corporation does not effect a division by placing some assets in a subsidiary without more; the subsidiary's stock must be distributed so that assets previously in one corporation are divided among two unconnected shells. Divisions come in three varieties: spin-offs, split-offs, and split-ups. "A spin-off is a distribution by one corporation of the stock of a subsidiary corporation. . . . The split-off is identical with the spin-off, except that the shareholders of the parent corporation surrender part of their stock in the parent in exchange for the stock of the subsidiary. . . . In a split-up, the parent corporation distributes its stock in two or more subsidiaries in complete liquidation." B. BITTKER & J. EUSTICE, *supra* note 2, at 13-3.

dividends or splits.[6] The division resembles a tax-free stock dividend: assets are not distributed out of corporate solution, but simply rearranged in two corporate shells instead of one.[7]

However, should nonrecognition be granted, the division sets the stage for tax avoidance by disguising an ordinary income distribution as a capital gain event. Distribution of the real estate in complete liquidation of Y Corp. appears to merit capital gain.[8] Yet capital gain is improper in this case, since a distribution of the real estate by X Corp., before the division, would be nonliquidating and produce ordinary income.[9]

In 1954, Congress established a specific barrier to nonrecognition with the requirement of Section 355(b) that for nonrecognition to be granted "each surviving corporation [must] contain a business which was actively conducted by the original corporation."[10] However, two recent circuit court decisions—*Rafferty v. Commissioner*[11] and *King v. Commissioner*[12]—have lowered this statutory hurdle[13] and left in its place a test for nonrecognition that weighs business purpose against bail-out potential in each individual case.[14] The weighing process is best described as a balancing test, although neither decision adopted that precise label. Both *Rafferty* and *King* were influenced by a commentator who argued that the weighing process should replace the "definitional filagrees" of Section 355 which have proven impossible to apply in a clear and meaningful fashion.[15] Yet, in the haste to bury Section 355, scant attention was paid to the inadequacy of the proposed replacement. The balancing test requires factual determination of appalling complexity and fails to reconcile the competing goals of business flexibility and bail-out prevention.

We do not, however, have to accept the confusion arising from either Section 355 or the balancing test. One possible solution is a "tainting method" that grants nonrecognition to *all* divisions. Post-division stock is "tainted" so that special rules govern its disposition. These rules aim to tax the

6. *See* INT. REV. CODE OF 1954, § 305(b) [hereinafter cited by section].

7. The 1924 Revenue Act uncritically accepted the analogy between a corporate division and stock dividends by providing for unqualified nonrecognition. *See* 43 Stat. 256 (1924). Judge Learned Hand explained the rationale: "The purpose of this section is plain enough; men engaged in enterprises—industrial, commercial, financial, or any other—might wish . . . . to divide . . . their holdings. Such transactions were not to be considered as realizing any profit, because the collective interests still remained in solution." Helvering v. Gregory, 69 F. 809, 810–11, 13 AFTR 806 (2d Cir. 1934).

8. *See* § 331(a)(1).

9. *See* § 301.

10. § 355(b).

11. 452 F.2d 767 (1st Cir. 1971).

12. 458 F.2d 245 (6th Cir. 1972).

13. One commentator observed that in *Rafferty*, "The active business test was perforce downgraded in importance with repudiation of virtually all the provisos of the active business regulations." Lee, *Functional Divisions and Other Corporate Separations Under Section 355 After Rafferty*, 27 TAX L. REV. 453, 479 (1971).

14. *Id.* at 495–97.

15. The proposal was made by Whitman, *supra* note 2, at 1252–57, and cited with approval by *Rafferty*. *See* 452 F.2d at 770.

disposition of tainted stock as if no division had taken place. Unfortunately, it is difficult to design a scheme that is administratively feasible without undue sacrifice of business flexibility so that even an acceptable tainting method would impose substantial administrative costs. Therefore, the conventional wisdom—that divisions provide significant benefits—should be reexamined to see if the game is worth the candle. If business need is much weaker than generally thought, perhaps the benefits do not justify tax-free treatment.

Part I of this Article demonstrates the failures of current law. Part II explores the conceptual and practical difficulties of a tainting method. Part III reexamines the premise that divisions are essential tools of business planning.

By way of limitation, the division dilemma is basically a problem of small closely held businesses. Public issue corporations rarely divide,[16] and when they do, bail-out potential is virtually never created.[17] In addition, this Article does not question the basic structure of corporate shareholder taxation under the existing code. Within these constraints, tainting and taxing divisions (in appropriate combination) should be the solution to reconciling business purpose with bail-out prevention. However, this proposal is not a panacea since the dilemma is rooted in the basic structure of corporate-shareholder taxation contained in Subchapter C of the Internal Revenue Code. Without transformation of the structure, divisions will remain a troublesome problem.

I. Business Purpose and Bail-out Potential: The Balancing Test and Current Taxation of Corporate Divisions

A. *How the Balancing Test Supplanted the Two 5-Year Active Business Rule*

Congress attempted to overhaul the corporate division area in 1954 by enacting Section 355.[18] The statute grants tax-free treatment only if the

16. The reason stems from the well-documented separation of widely spread ownership of stock from ensconced management control. Management has a substantial interest in maximizing the enterprise's size because executive salaries are "far more closely correlated" with "the scale of operations in the firm than its profitability." See W. Baumol, Business Behavior, Value, and Growth 46 (1959); O. Williamson, The Economics of Discretionary Behavior 79–84 (1964). A division that reduces the size of the corporate pie will rarely be pursued by management whose salaries may be adversely affected. Antitrust law enforcement—through an actual or possible divestiture order—is what typically motivates division of a public-issue corporation.

17. Public-issue stock is by definition marketable; therefore, shareholders in a publicly owned corporation can convert all or part of its holdings into cash at capital gains rate, and therefore need not make use of § 355. In contrast, a division may render close corporation stock more salable by separating marketable assets in one corporation and by enabling the owner to realize cash without diluting his interest in some assets owned by the original corporation.

18. *See* B. Bittker & J. Eustice, *supra* note 2, at § 13.01–.15; Lee, *supra* note 13; Whitman, *supra* note 2.

division is "not a device for the distribution of earnings and profits as capital gain,"[19] and the regulations require a business purpose.[20] Combined, these rules suggest that bail-out potential and business purpose are decisive factors to be weighed in taxation of divisions. Yet the reported cases and rulings have focused primarily on the additional requirement of Section 355(b): namely that "each surviving corporation contain a business which was actively conducted by the original corporation . . . ."[21] The Treasury originally read this sentence to mean that the original corporation must have "*actively* conducted *two separate* businesses for 5 years *prior* to the division [emphasis added]."[22] Thus, Section 355 could not be used to divide a single business.[23] In addition, the regulations stated that the holding of investment property, such as securities or owner-used real estate, could not qualify as an "actively conducted business."[24]

Despite 22 years of exegesis, the difference between one and two businesses and the definition of active conduct are as clear as a "Serbonian Bog."[25] Given the lack of precise or meaningful guidelines, courts have

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19. § 355(a)(1)(B).
20. *See* Treas. Reg. § 1.355-2(c).
21. § 355(b)(1).
22. Treas. Reg. § 1.355-1(c) (emphasis added).
23. Treas. Reg. § 1.355-1(a). Soon after the regulations were issued, the Treasury's position that § 355 could not be used to divide a single business came under a continuous barrage by the commentators on grounds of both economic policy and statutory interpretation. It was argued that the Treasury's position hampered economic activity by unduly restricting tax-free treatment to the unusual two active 5-year business cases, thereby discouraging necessary corporate adjustments. Moreover, the Treasury's position arguably reduced the device language in the statute to a mere superfluity. The two 5-year active business rule as interpreted by the regulations is identical to the two 5-year active business rule of § 346(b). *See* Treas. Reg. § 1.346-1. Thus, no qualifying division could possibly be a "device," since the distribution, if taxable, produces capital gain under § 346(b). *See* Whitman, *supra* note 2, at 1221-23; Jacobs, *The Anatomy of a Spin-off*, 1967 DUKE L.J. 1, 25-28; Massee, *Section 355: Disposition of Unwanted Assets in Connection with a Reorganization*, 22 TAX L. REV. 439, 460-64 (1967).
24. *See* Treas. Reg. 1.355-1(d), *examples* (1) and (2).
25. The image is borrowed from Whitman, *supra* note 2. *See generally* B. BITTKER & J. EUSTICE, *supra* note 2, at 1210-28.

The difference between one and two businesses is unclear and arbitrary. One possible criterion is qualitative differences between corporate activities. A hotel and a movie theater, for example, would then constitute two different businesses. But what about a hotel and a motel or two movie theaters located in different cities? The Service takes the position that, despite the absence of qualitative differences, separate geographical locations may indicate that two separate businesses exist. For example, a corporation owning one department store which builds a second store in a different location operates two businesses, whereas a decision to construct an addition to the original store does not result in two businesses. However, if the two geographically separate department stores share the same warehouse and management, they may fail the test.

Equally troublesome is the distinction between active and passive assets, especially in the case of rental real estate. For example, if the scale of rental activity is the primary consideration, then a 200-unit apartment building would constitute an active business, while a 6-unit dwelling might not. But suppose the 200-unit building is managed by an independent contractor for a corporate owner that passively collects rent net of management fees, while the 6-unit dwelling is actively managed by the sole shareholder of its corporate owner. Although a degree-of-corporate-involvement rule more accurately reflects the common sense definition of "active," there are considerable difficulties in determining in practice the degree of corporate involvement required to constitute active management. Moreover, notwithstanding questions of applicability, the relation of tax policy to the question of whether corporate assets are managed by regular employees or by an independent contractor is difficult to perceive.

often inserted balancing test criteria into the two 5-year active business rule.[26] When a compelling purpose exists, two separate businesses are more likely to be discerned.[27] Similarly, hard-to-market assets that do not create bail-out potential are more likely to be regarded by courts as "actively" managed.[28]

Rafferty v. Commissioner[29] and *King v. Commissioner*,[30] however, have gone far beyond a *sub rosa* conversion of the two 5-year active business rule into a balancing test. In both cases, primary focus shifts to *explicit* weighing of business purpose against bail-out potential.[31] The position that Section 355 does not apply to a single business is expressly repudiated.[32] In affirming that the businesses of the surviving corporations need not have been separate prior to the division, *Rafferty* and *King* follow earlier decisions in two other circuits.[33] The active conduct rule is rendered ineffective by the holding of *King* that ownership of real estate rented to a corporation under a net lease—long thought to epitomize the excluded passive investment—constitutes an "actively conducted business."[34] The conclusion that similar real estate failed to qualify in *Rafferty* appears inseparable from a simultaneous finding of substantial bail-out potential in that case.[35] Although a 5-year history must still be established for the activity of each surviving corporation, neither decision paid much attention to whether proper aging had occurred.[36] With the downgrading of virtually all its provisions, the

26. B. Bittker & J. Eustice, *supra* note 2, § 13.04, at 13–22; Lee, *supra* note 13, at 472–73; Whitman, *supra* note 2, at 1223–27.

27. In H. Grady Lester, Jr., 40 T.C. 947 (1963), the Tax Court had no trouble finding two separate businesses where the taxpayer sold to two sets of customers. The dividing corporation, an auto parts supplier, sold to jobbers and also directly to dealers. Whitman observes, "The court seemed far more interested in legitimate reasons offered by the taxpayer to support his separation than in the definitional problem." Whitman, *supra* note 2, at 1227.

28. For example, the real estate operations in *King* were found to constitute an "active business" even though the only income was from a net lease with the operating business. 458 F.2d at 249.

29. 452 F.2d 767 (1st Cir. 1971).

30. 458 F.2d 245 (6th Cir. 1972).

31. The *Rafferty* court stated that "the question must be whether . . . estate planning was a sufficient . . . business purpose" and "whether the substance of the transaction is such as to leave the taxpayer in a position to distribute the earnings and profits of the corporation away from, or out of the business." 452 F.2d at 770 and 771.

The *King* court accepted the alleged purpose, rejected a Tax Court finding that the spun-off corporation did not constitute an "active business," and then focused on whether the division might enable taxpayers to bail-out earnings and profits as capital gain. *See* 458 F.2d at 249–50.

32. The court in *Rafferty* stated, "The correctness of these regulations is questionable in view of the rejection of the separate business requirement of § 1.355–1(a) in *United States v. Marett*, [325 F.2d 28 (5th Cir. 1963)] and *Coady v. Comm'r*, [289 F.2d 490 (6th Cir. 1961)] . . . . Moreover we find that the regulations in this area are so broadly drawn that they may in some instances defeat the congressional intent." 452 F.2d at 772.

33. *See* United States v. Marett, 325 F.2d 28; Coady v. Comm'r, 289 F.2d 490 (6th Cir. 1961); (5th Cir. 1963). Moreover, the Service has acquiesced in the results of all four circuit court decisions. Rev. Rul. 75-160, 1975-18 Int. Rev. Bull. 8.

34. In order to reach this result, the Circuit court reversed the carefully documented finding of the Tax Court that such activity did not constitute an "active business." 458 F.2d at 247–49.

35. 452 F.2d at 771–72.

36. Even if the aging requirement is considered by a court, it is unlikely to prove troublesome provided that the original business has been concluded for five years.

demise of the two 5-year active business rule is at hand.[37] The balancing test—embodied in the business purpose regulation and the device clause of Section 355—has taken center stage.[38]

B. *Application of the Balancing Test*

At first blush, application of the balancing test does not seem unduly burdensome. Business purpose and bail-out potential are independently evaluated and then weighed against each other. If bail-out potential has less significance than business purpose, the division is tax-free.[39] If bail-out potential is more substantial than business purpose, the division is taxed.[40]

Under the superficial simplicity, however, lies an appalling sinkhole. First, business purpose and bail-out potential cannot be evaluated without complex predictions of future legal and economic phenomena. Second, even if such labyrinthian judgments can be made, no evident legal standard exists for balancing a nonquantifiable business purpose against a nonquantifiable bail-out potential. Finally, whenever business purpose and bail-out potential co-exist, the balancing test requires an either-or decision and thereby fails to reconcile the two competing goals. If the division is not taxed, business flexibility thrives at the cost of tax avoidance.[41] If the division is taxed, the revenues are guarded, but a tax barrier is erected to corporate adjustments.[42]

1. *Source of the balancing test:* Gregory v. Helvering.

The roots of the balancing test lie in *Gregory v. Helvering*,[43] where evaluation of business purpose and bail-out potential was judicial gloss on the 1924 Revenue Act grant of automatic nonrecognition to all divisions.[44] Disposition of this case proceeded with uncommon ease because the very special facts allowed *restrospective* evaluation of business purpose and bail-out potential. Ms. Gregory owned all the stock of United Mortgage Corporation. United Mortgage Corporation transferred its liquid assets to newly-formed Averill Corporation and distributed the Averill Corporation stock to Ms. Gregory. The liquid assets were then distributed to Ms. Gregory in complete liquidation of Averill.

With the benefit of hindsight, the *Gregory* court harbored no doubt about bail-out potential or of business purpose. The immediate liquidation

37. See note 13 *supra*.
38. *See* note 14 *supra* and accompanying text.
39. *See* note 12 *supra*.
40. *See* note 11 *supra*.
41. *See* note 12 *supra*.
42. *See* note 11 *supra*.
43. 293 U.S. 465 (1935).
44. *See* 43 Stat. 256 (1924).

of Averill consummated the bail-out and compelled the inference of no business purpose, and thus, no conflict existed in this uncommon case between promoting business flexibility and minimizing tax avoidance. Consequently, tax-free treatment was denied.[45]

2. *Application of the balancing test: post-*Gregory *decisions.*

While *Gregory* was on appeal, Congress replaced the "automatic nonrecognition" treatment of division contained in the 1924 Revenue Act on which Ms. Gregory had relied with statutory mechanisms, as opposed to judicial doctrine, to police the division area. It is only with judicial repudiation of the two 5-year active business rule of Section 355 that the focus is explicitly shifting back to lines suggested by *Gregory* in 1934. Yet application of the balancing test in most cases will require a *prospective* assessment of business purpose and bail-out potential that was unnecessary in *Gregory.*

45. 293 U.S. at 466. Ms. Gregory's scheme was governed by the 1924 Revenue Act which granted nonrecognition to all divisions. *See* note 7 *supra.* The Supreme Court held that compliance with the letter of the statute was insufficient because the only purpose was tax avoidance, 293 U.S. at 469-70. The Supreme Court could have reached the same result by adopting a tainting method instead of the balancing test. An imaginary *Gregory* opinion using a tainting method might have concluded as follows. "We accept the claim of nonrecognition when the division occurs. *At that point,* no assets are distributed out of corporate solution. There is simply a rearrangement of assets among shells.

"We intend to focus on the second step, the complete liquidation of A Corp. We are disturbed by the suggestion that Congress intended to grant capital gain treatment to this sort of complete liquidation.

"Congress clearly intended that nonliquidation pro rata distributions be taxed as dividends. A distribution of assets by United Mining Corp. in one step, without an intervening division, is obviously a dividend. Yet, the two-step transaction chosen by Ms. Gregory produces exactly the same economic result.

". . . the second step is a complete liquidation only in the isolated context of Averill Corp. But, the Averill corporation is not the correct reference point. The correct frame of reference is the original, pre-division corporation. And, in that context, the distribution is obviously a nonliquidating, pro rata dividend.

"Therefore, we hold that, when a corporate division has occurred, whether any subsequent distribution constitutes a complete liquidation or not is to be judged with reference to the original, predivision corporation.

"Congress could not have intended any other result. The argument that our decision ignores the plain words of the complete liquidation statute is without merit. The taxpayer's position, if sustained, would effectively repeal the plain words of the statute that a nonliquidating distribution causes ordinary income.

"Our holding today is easily restated in the language of form and substance. The taxpayer chose a form which appears to cause a complete liquidation. The Commissioner, however, need not accept as controlling a form which fails to reflect the economic substance. Here, the substance was a nonliquidating pro rata distribution. The Commissioner may, therefore, ignore the liquidation form.

"We feel constrained to add one final observation. It is often argued that the Commissioner may disregard the form only if the transaction lacks a nontax business purpose. No such purpose existed here. The only reason for the corporate division and "complete liquidation" was tax avoidance. However, existence of a nontax business purpose should make no difference whatsoever. For example, suppose that the division occurs to segregate hazardous activities in a separate corporation from low-risk assets, and that several years later, the separated corporation alone is liquidated. The business purpose does not alter the underlying economic fact that a liquidation of one corporation alone is a nonliquidating distribution, in the context of the original, predivision corporation. Therefore, a business purpose would not change our conclusion that complete liquidation of the distributed corporation alone produces ordinary income.

"Our observations on business purpose pose no conflict with Congress' desire to promote business flexibility. Nonrecognition continues to be granted to all divisions. We merely interpret the statute to require that the disposition of post-division stock be judged as if no division had occurred.

"A contrary result would fail to maintain tax neutrality. For example, not taxing the division and accepting a subsequent liquidation at face value would create an incentive to divide."

Moreover, application of the test in pro rata divisions requires a choice between competing goals whenever business purpose and bail-out potential co-exist. Post-*Gregory* decisions illustrate the formidability of this task.

Assessing business purpose. Although making business purpose one of two decisive factors, *Rafferty v. Commissioner*[46] failed to produce meaningful criteria for evaluating its importance. Rafferty's purpose was to devise operating assets and real estate assets of his wholly owned steel business to his sons and daughters, respectively.[47] The motives behind this estate plan were to prevent future battles over managing the business and to provide his daughters with investment assets safe from fluctuations of the steel business.[48] The *Rafferty* court, reversing a tax court opinion,[49] refused to accept the stated purpose. Avoiding future battles was belittled as "only an envisaged future possibility"[50] that was "so completely under taxpayer's control that the purpose could not satisfy taxpayer's burden."[51] Although safeguarding investment assets was not explicitly rejected, the court emphasized that facilitating a particular estate plan constituted a personal, rather than corporate, purpose.[52]

None of these considerations is particularly relevant. Disputes between siblings over managing the business were "future" events because ownership was to be transferred only at Rafferty's death. Yet the court's rejection of this eventuality as a mere "possibility" does ignore the fact that family discord often disrupts small businesses.[53] Furthermore, neither psychology nor common sense justifies the court's assertion that Rafferty could control family discord from the grave. Finally, the distinction between personal and corporate purpose can have no meaning in Rafferty's wholly owned business unless the court meant to exclude estate planning as a personal nonprofit consumption motive. Yet what could be more germane to continued profitability of the enterprise than designation of successors to current management? Moreover, *Rafferty* ignores the well-documented failure of tax provisions whose application turns on motives and other psychological states.[54]

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46. 452 F.2d 767 (1st Cir. 1971).

47. 452 F.2d at 769.

48. The Court found that, "On various occasions Rafferty consulted his accountant about estate planning . . . . While he anticipated that his sons would join [the business], he wanted to exclude his daughters (and/or future sons-in-law) from the active management of the steel business. He wished, however, to provide them with a steady source of income, but to avoid a possible interference with the operation of the steel business by future sons-in-law." 452 F.2d at 769-70.

49. 55 T.C. 491 (1971).

50. 452 F.2d at 770.

51. *Id.* at 771.

52. *Id.*

53. *See, e.g.*, Ringling Bros. Barnum and Bailey Combined Shows, Inc. v. Ringling, 29 Del. Ch. 610, 53 A.2d 441 (Sup. Ct. 1942); Galler v. Galler, 32 Ill. 2d 16, 203 N.E. 2d 533 (1964).

54. *See* Blum, *Motive, Intent and Purpose in Federal Income Taxation*, 34 U. CHI. L. REV. 485 (1967).

If the *Rafferty* opinion produced irrelevant criteria for assessing business purpose, *King v. Commissioner*[55] produced none at all. The business justification—combining real estate assets into one corporation not subject to ICC regulation[56]—was accepted without explanation or justification. The *King* court asked merely whether the division served some business need,[57] failing to ask, as other courts have, whether an alternative technique—without bail-out potential—could have accomplished the alleged purpose.[58] As noted by one dissenter:

> The fact that there may have been valid business reasons for the spin-off does not, in my opinion, necessarily foreclose a finding that the transaction was a "device for distributing earnings and profits. There may have been other means of separating the real estate . . . that would not have resulted in placing the shareholders in a position to realize capital gains on earnings and profits."[59]

Given its simultaneous downgrading of the more mechanical two active business rule and increasing reliance on a balancing approach, it is curious that the *King* court did not subject the alleged purpose to more critical evaluation.

Careful evaluation of business purpose is impossible in case by case adjudication because it entails predictions about future legal and economic phenomena. Neither the IRS, nor the courts, are well-equipped to make factual determinations about complex events that have not yet occurred. The evaluation of business purpose in *Bonsall v. Commissioner*[60] reflects this weakness. ALC Corp., a wholesaler, obtained mortgage financing for an addition to its existing building. The mortgagee required ALC Corp. to effect a division and place the real estate in a separate corporation. The apparent object was protection of the lender's interests from competing creditors of ALC Corp.'s wholesale business. The critical question, therefore, was whether the demand of the outside party could constitute a valid business purpose. A careful resolution of the critical question is not easy. Since the mortgage lien would typically secure the building from all competing claimants, protection of the mortgagee's security is needed only if the mortgage interest is not perfected. Moreover, the exclusive transfer of

55. 458 F.2d 245 (6th Cir. 1972).
56. *Id.* at 250.
57. *Id.* at 250.
58. *See, e.g.*, Wilson v. Comm'r, 353 F.2d 184 (9th Cir. 1965); Bonsall v. Comm'r, 317 F.2d 61, (2d Cir. 1963); Parshelsky's Estate v. Comm'r, 303 F.2d 14, 2d Cir. 1962).

However, the courts often fail to inquire thoroughly into alternative techniques—a failure that is quite understandable given the complexity of the issue. *See* notes 67–69 *infra*, and accompanying text. Moreover, one recent decision expressly validated a division even though its purpose could have been achieved in a different manner. *See* Hansen v. United States, 338 F. Supp. 602 (Mont. 1971). A court following this approach only makes the limited inquiry as to whether tax counsel has "dreamed up" the requisite business purpose.

59. 458 F.2d at 251.
60. 317 F.2d 61 (2d Cir. 1963).

the wholesale business to a subsidiary eliminates the risk of imperfection only if the subsidiary's limited liability is respected.[61] To properly assess business purpose, the court must estimate the chance that a security interest will be judged imperfect and predict whether a court would pierce a subsidiary's corporate veil.[62] Furthermore, even if the creation of a subsidiary was founded in business purpose, the court must decide whether a spin-off of the subsidiary was necessary and judge if piercing of the corporate veil is less likely in the spin-off situation.

Even if such issues are justiciable, their resolution merely determines whether a mortgagee's insistence on a division is rational. Rationality cannot be absolutely determinative because ALC Corp. must comply whether or not a rational foundation exists for the division. Perhaps the mortgagee demanded the division because the arrangement looked simpler and cleaner that way. Or, as perhaps the *Bonsall* court assumed, the absence of rational explanation indicates that the requirement was the product of collusion. The courts have taken inconsistent positions on whether outside party demands constitute a valid business purpose. In *U.S. v. Marett*, the court reasoned that customer demands justified a division, because the corporation had to comply or lose the customer's business.[63] Yet the *Bonsall* court belittled the corporation's dilemma, because the outsider's purpose allegedly did not require a division.[64]

As noticed earlier, because of the danger of bail-out potential, a division should occur tax-free only when an alternative technique cannot adequately serve the taxpayer's needs. This key issue—whether the purpose can be served by an alternative technique—has not been faced with consistency or logic. The IRS commonly asserts that risk-minimization does not require a division,[65] yet the Service, on occasion, has validated the purpose without explanation.[66]

The unwillingness of the courts to logically face the issue of alternative techniques may reflect the difficulty of case by case adjudication. In *Rafferty*,[67] the petitioner wished to devise the operating and real estate assets of his wholly owned business to different legatees. To accomplish this purpose, the real estate was transferred to a separate corporation and its stock

61. *See, e.g.*, Consolidated Rock v. DuBois, 312 U.S. 510 (1941). The corporate veil is sometimes pierced in the parent-subsidiary relationship.

62. The *Bonsall* court summarily dismissed corporate need for the division, apparently on this rationale that there was no valid shareholder business purpose for the distribution of the shares. The reasons for the creation of the subsidiary were adequate, but no necessity for the distribution of its stock was shown.

63. 325 F.2d 28 (5th Cir. 1963).

64. 317 F.2d at 65.

65. *See* Rev. Rul. 56-554, 1956-2 CUM. BULL. 198; Rev. Rul. 56-555, 1956-2 CUM. BULL. 210; Rev. Rul. 56-557, 1956-2 CUM. BULL. 199.

66. *See, e.g.*, Rev. Rul. 59-197, 1959-1 CUM. BULL. 77.

67. 452 F.2d 767 (1st Cir. 1971).

distributed to Rafferty. Under Rafferty's will, the executor was to transfer the stock of each corporation to the designated legatees.

Instead of a division, the will could have directed a tax-free liquidation after Rafferty's death, followed by transfer of the assets according to the estate plan. This technique allows greater flexibility for changing the dispositive pattern.[68] However, a division may render the disposition less vulnerable to postmortem attack,[69] thereby isolating the real estate from risks of the operating assets.[70] If a business planner advises that a division is the better technique, the law cannot realistically demand reassessment of this advice in every case.

Finally, even if the alleged purpose can be evaluated, foresight and duplicity are rewarded because "business purposes are often manufactured in the offices of attorneys."[71] Randolph Paul wrote of this practice:

> [S]uch tests actually stack the cards against him [the Commissioner]; the advantage of sweeping definitions and of whatever presumptions may be available to the government will remain more than offset by the fact that the evidence as to motive is almost entirely in the possession of the taxpayer, unless psychology devises a better mental X-ray than has so far been discovered.[72]

Assessing bail-out potential. According to *Rafferty* and *King*, bail-out potential exists whenever one surviving corporation owns substantial amounts of marketable assets.[73] Yet the key question—whether specific assets are marketable—had never been openly addressed before these decisions, because attention had been focused on the Section 355 requirement that each surviving corporation conduct an active business. By excluding passive investment from the definition of active business, the regulations imply that investment assets, such as real property, should be viewed as marketable, whereas operating assets, such as machinery, should not.[74]

The regulations are questionable because the categories are imprecise and imperfectly correlated with marketability.[75] Thus, the *Rafferty* and

68. Because the assets are not yet divided, Rafferty can modify the plan by changing his will. But if a division has occurred, one corporation must transfer assets to the other, almost certainly resulting in a constructive dividend to Rafferty.

69. If the assets are divided into two corporations years before Rafferty's death, dissatisfied legatees may be less able to upset Rafferty's decision to exclude them from participating in real estate (or operating) assets because courts would be averse to unscrambling a finished transaction.

70. *But see* notes 115–18 *infra*, and accompanying text.

71. Michaelson, *"Business Purpose" and Tax-Free Reorganization*, 61 YALE L.J. 14, 25 (1952).

72. R. PAUL, SELECTED STUDIES IN FEDERAL TAXATION 300 (2d Ser. 1938).

73. The *Rafferty* court stated, "The question here is whether the property transferred to the newly organized corporation had readily realizable value so that the distributee-shareholders could, if they ever wished, obtain such property or the cash equivalent thereof, either by selling the distributed stock or liquidating the corporation, thereby converting what would otherwise be taxable as ordinary income into capital gain [citations omitted]."

74. *See* Treas. Reg. 1.355–(d), examples (1) and (2).

75. *See generally* B. BITTKER & J. EUSTICE, *supra* note 2, § 13.04, at 13–19 to 13–21; Whitman, *supra* note 2, at 1216–21, 1257.

King courts insisted on evaluating marketability on the facts of each case rather than classifying assets as either investment or operating.[76] Unfortunately, their efforts raise serious doubts about the predictability of present and future marketability of specific assets. Rafferty and King, respectively, owned a steel processing business and a trucking company. In both cases, the division separated operating assets from real property used in the business. The *Rafferty* court held that bail-out potential was high because the property, a factory, was readily marketable and could be replaced without interfering with continued business operations.[77] Acknowledging that both cases involved real estate, the *King* court distinguished *Rafferty* on the ground that "a sale of the real estate properties [there] could be easily arranged in that the buildings were capable of multiple use," whereas in *King* the terminals were "single purpose facilities which required specialized equipment and construction."[78]

The *King* court reasoned that a bail-out was unlikely because single-use assets are hard to sell and replace.[79] Yet, the single-use/multiple-use distinction is unlikely to promote certainty or clarity. The question of whether an asset can be devoted to single or multiple uses is a question of degree, rather than one of hard and fast classification. Resolution depends on the degree to which different businesses require similar assets and on the conversion costs of eliminating unacceptable differences. Even if an asset could be unequivocably classified as "single purpose," that classification alone would not obviate bail-out potential. The single-use asset might still be sold to a similar (as opposed to different) business. Furthermore, the taxpayer can continue to use the asset and achieve bail-out by selling it to an outside party with a leaseback arrangement.

One commentator has argued that the issue should be motive rather than marketability—does the taxpayer intend the division as a vehicle for a bail-out?[80] But how is motive to be found except by self-serving statements or by predictions of future behavior? Without ready access to Freud or the Sybil, how can this inquiry be made?[81]

76. *Rafferty* noted "even if both corporations are actively engaged in their respective trades, if one of them is a business based principally on highly liquid investment-type, passive assets, the potential for a bail-out is real." 452 F.2d at 771.

77. The *Rafferty* court noted that a sale of the real estate properties could be "easily arranged" and that "there was no evidence that the land and buildings . . . were so distinctive that [a] sale . . . would impair the continued operation [of the business]." 452 F.2d at 771.

78. 458 F.2d at 250.

79. The *King* court noted "a sale or liquidation would have impaired the continued operation." 458 F.2d at 250.

The court also held bail-out potential was lower there than in *Rafferty*, because all the distributed stock was merged with a sister corporation and still locked in at the corporate level. 458 F.2d at 250.

However, the real estate is locked into the sister corporation only if the sister's other assets are substantial in amount and not readily marketable. Yet, since the sister's business was leasing cars, it is probable that its assets were insubstantial compared to the real estate and as easy to sell.

80. *See* Whitman, *supra* note 2, at 1243, 1253–55.

81. *See generally* Blum, *supra* note 54.

3. *Reconciling business purpose with bail-out prevention.*

Neither *Rafferty* nor *King* squarely faces the dilemma posed by the balancing test: the co-existence of compelling business purpose and substantial bail-out potential. The *Rafferty* court found little business purpose and substantial bail-out potential; therefore, the division was taxed. *King* found compelling business purpose and little bail-out potential, and nonrecognition was granted. Yet the suggestion that *King*'s purpose was more compelling simply underlines Rafferty's failure to consult an attorney at an early stage, and the assertion that bail-out was less likely in *King* can be sustained only if the single-use/multiple-use classification is given unwarranted significance. The dilemma avoided by the courts in these cases is likely to arise whenever a taxpayer's counsel thoroughly documents business purpose and the Service proves that the spin-off of even a single-use asset has bail-out potential. A difficult choice must then be made between taxing the division to prevent a bail-out or granting nonrecognition to promote flexibility. Whichever goal is chosen, the balancing test fails to reconcile business purpose with bail-out prevention.

II. A Proposed Tainting Method

A. *The Advantage of Tainting: Reconciling Business Purpose, Bail-out Prevention and Administrative Feasibility*

An ideal tainting[82] method would eliminate the dilemma inherent in the balancing test by maximizing both bail-out prevention and business flexibility. Business flexibility would be unimpeded by automatic tax-free treatment of *all* divisions, and tax avoidance would be eliminated by tainting post-division stock and taxing its disposition as if no division occurred. Unfortunately, such an *ideal* tainting method would be extraordinarily difficult to apply because the special disposition rules would be horribly complex. Administrative feasibility thus requires that a workable tainting method approximate rather than duplicate the ideal. Early tainting proposals, however, carried the pursuit of administrative feasibility too far. Simple, clear-cut rules were achieved at an excessive cost in sacrifice of both bail-out prevention and business flexibility.

On two prior occasions, specific tainting methods were proposed and

82. The suggestion that certain divisions ought to be tainted was made at least as early as 1951. In debate on the Revenue Act of 1951, ch. 521, § 317, 65 Stat. 493, Senator Humphrey proposed that tax-free treatment for spin-offs be contingent upon retention of the spun-off stock by the recipient shareholders and continuation of the business of the spun-off corporation for 3 years. *See* 97 Cong. Rec. 11,812–13, at 1, 213–14 (1951). It was unclear what the consequences of a sale of stock or discontinuation of the business during this period would be; one commentator has remarked that "presumably disqualification of the separation itself" would result. *See* Whitman, *supra* note 2, at 1250. Called "an unworkable" proposal by Senator George, Chairman of the Finance Committee, the amendment was rejected.

then rejected by Congress in favor of Section 355. The House version of the 1954 Code created a 10-year taint for stock received in certain corporate separations.[83] Ordinary income treatment would result if disposition occurred during the 10-year period; otherwise, the disposition would receive capital gain treatment. The Senate Finance Committee rejected the 10-year taint in its counterdraft to the House bill, stating that it did not wish "to permit a person in a position to afford a 10-year delay in receiving income to do so at capital gains rather than dividend rates."[84] Besides allowing a delayed bail-out, the House proposal imposed an impediment to flexibility by treating *any* disposition during the 10-year period as a dividend, even if no bail-out was attempted.[85]

In 1959, one commentator proposed that stock of only one surviving corporation be tainted, with the choice to go to the shareholder, so that disposition of tainted stock would produce ordinary income.[86] The obvious loophole in such a scheme is that a taxpayer could place liquid assets in a separate corporation, choose to have the operating corporation tainted, and then dissolve the nontainted corporation with liquid assets at capital gains rates. Even though disposition of the tainted corporation would still be taxed as a dividend, this event might occur years later, producing substantial deferral. This proposal, like the House bill, also impeded flexibility, since no exception was created for non-bail-out dispositions of tainted stock.

An acceptable tainting method must achieve a balance among administrative feasibility, bail-out prevention, and business flexibility. Administrative feasibility requires that a workable tainting method approximate rather than duplicate the ideal. On the other hand, both to prevent bail-outs and to maximize flexibility, the solution must be more refined than earlier proposals. For example, stock of both surviving corporations must be tainted and dispositions that cause a bail-out must be effectively distinguished from dispositions that do not. Fortunately, considerable simplification can be achieved by merely minor compromises of these policy goals.

By accepting a minor decrease in flexibility, the tainting method outlined in this part would be simpler than current law because its rules are essentially mechanical in operation. In contrast, the balancing test focuses on amorphous variables of business necessity, marketability and intent, and the Treasury position requires murky determination of the "active conduct" of "two separate businesses." Because administrative feasibility requires only

83. The House version, H.R. 8300, created a 10-year taint for stock received in a corporate separation if such stock represented an "inactive business." *See Hearings on H.R. 8300 Before the Senate Comm. on Finance*, 83d Cong., 2d Sess. 384–92, 1318–19, 1540, 1999–2020, 2083–84 (1954).

84. S. REP. No. 1622, 83d Cong., 2d Sess. 51 (1954).

85. As in the case where both surviving corporations are simultaneously sold or liquidated.

86. Brown, *An Approach to Subchapter C*, in 3 HOUSE COMM. ON WAYS AND MEANS, 86TH CONG., 1ST SESS., TAX REVISION COMPENDIUM 1619, 1624–25 (Comm. Print 1959).

a minor sacrifice in business flexibility, this proposal reconciles business purposes with bail-out prevention in most cases, even when both are present. In contrast, the balancing test and the Treasury approach must sacrifice either goal whenever business purpose and bail-out potential co-exist.

B. *Devising a Workable Tainting Method*

1. *The relationship of divisions and partial liquidations.*

An important first step is repeal of Sections 346(a)(2) and 346(b) which grant preferential capital gain treatment to distributions in partial liquidation. Both the two active business test and the corporate contraction theory, standing alone, are without justification.[87] Moreover, the two active busi-

87. Even if distribution is not complete liquidation of the corporation and is essentially pro rata (so that it does not produce a meaningful reduction in underlying proportionate interests), it will qualify for capital gain treatment if it meets the definition of "partial liquidation" of § 346 of Subchapter C.

Section 346(a)(2) states that a distribution is in partial liquidation "if not essentially equivalent to a dividend." A dividend is a distribution producing ordinary income. Therefore, the statute prescribes that a distribution is a partial liquidation and merits capital gain treatment when ordinary income treatment (*i.e.*, as a dividend) is inappropriate. The Senate Report on the 1954 Code saves us from wandering in a wilderness of circularity by stating that § 346(a)(2) is intended to include "cases involving the contraction of a corporate business. Such as for example, [the *Imler* case holding] that if the entire floor of a factory is destroyed by fire, the insurance proceeds received may be distributed pro rata to the shareholders [*sic*] without the imposition of a tax at the rates applicable to the distribution of a dividend, if the corporation no longer continues its operations to the same extent maintained by the destroyed facility. Voluntary bona fide contraction of the corporate business may of course also qualify." S. REP. No. 1622, 83d Cong., 2d Sess. 49, 262 (1954).

The corporate contraction concept adopted by the Senate Report and presumably by § 346(a)(2) lies in nearly total disrepute. No meaningful criteria exist to distinguish a distribution in corporate contraction from any other distribution that is not on complete liquidation of the corporation, at least where a single business is concerned. For example, Professors Bittker and Redlich make the following critique: "[I]t is highly questionable that the standard of 'legitimate shrinkage' has any economic validity. Courts are impressed with the discontinuance of a part of the business. But what if we have a business which has accumulated a surplus in expectation of an expansion which, for some reason, never occurs? When this corporation distributes the surplus, the stockholders probably will not be protected by the shield of legitimate shrinkage. But in both cases the economic decision made by the directors was essentially the same. They decided that capital was no longer required for the needs of the stockholders through a redemption of capital stock. In one instance the capital had been used for an activity that was being curtailed. In the other, it was capital that had been saved for an activity which never took place. It is hard to understand why one distribution represents a more 'legitimate shrinkage' than the other or exhibits a more valid business purpose.

"And the 'legitimate shrinkage' concept becomes more meaningless when viewed as a standard of taxation under section [346(a)(2)]. That section is concerned with taxing distributions that are 'essentially equivalent' to dividends. No stockholder can escape paying a tax under section [301], the section which defines dividends, because the distribution represented a 'legitimate shrinkage' of the corporation's activities. A distribution is a dividend under section [301] when earnings and profits are separated from the corporation and distributed to the shareholders without altering their relative ownership interests. If the same result is achieved as a result of a redemption of stock, it should be taxed as a dividend. Obviously, if we are looking to see whether there has been a distribution of assets without a change in proportionate ownership, it is immaterial whether the distribution was caused by a legitimate shrinkage or by boom-year profits." Bittker and Redlich, *Corporate Liquidations and the Income Tax*, 5 TAX L. REV. 437, 472–73 (1950). *See also* Bittker, *Stock Redemptions and Partial Liquidations Under the Internal Revenue Code of 1954*, 9 STAN. L. REV. 13, 20–30 (1956).

An ALI study also attacked the corporate contraction idea of § 346(a)(2): "It is very doubtful if the contours of a contraction test can be prescribed with any measure of success. But even if we assume that we can define 'contraction,' what is its relevance? By hypothesis the corporation has accumulated profits and is distributing cash representing some of the profits. The corporation does

ness rule has clouded analysis of the division problem. Section 346(b) expressly demands *separation* of two businesses *prior* to the distribution, while Section 355(b) is vague on the issue of prior separation. The original Treasury regulations read Section 355(b) *in pari materia* with the partial liquidation provision. Thus, a division was tax-free only if no bail-out potential was created, because, if taxable, it would receive sale treatment under 346(b). Because taxpayers rarely claimed protection of 346(b), its primary function was to provide an example of tax-free divisions that did not create bail-out potential. However, the justification for Section 346(b)

not intend to conclude its existence, for the distribution is not one of a series of distributions in complete liquidation of the corporation. The shareholders remain as shareholders, their initial investment is still intact, and their relationships to the corporation and each other have not been altered. In such a setting, the distribution of cash should be treated for what it is—a distribution of profits. The activity at the corporate level which produced the cash and the motivation behind its distribution are not matters which should affect this conclusion.

"In this regard, we should not be moved by the emotional case in which cash results from an 'involuntary conversion' of a part of a business, as where a branch activity is destroyed by fire and instead of rebuilding the activity the corporation distributes the insurance proceeds. Such proceeds are simply cash profits being distributed. The fire unexpectedly forced the directors to make a decision involving the cessation of the activity. An unexpected but tempting offer to purchase the activity equally would have prompted a directors' meeting." *See* Cohen, *A Technical Revision of The Tax Treatment of Corporate Distributions to Shareholders*, 52 COLUM. L. REV. 1, 37–38 (1952).

As a practical matter, the IRS tends to resist taxpayers' attempts to obtain a favorable ruling that a distribution qualifies for capital gain as a corporate contraction. Bittker and Eustice point out that, "[i]n many instances, of course, the taxpayer's inability to obtain a favorable ruling under § 346 will result in abandoning the proposed distribution, because of the vagaries of litigation and the threat of a dividend tax under § 301 if he loses." B. BITTKER & J. EUSTICE, *supra* note 2, at § 9.53. Hopefully, the Service will continue to press this position, so that the corporate contraction definition has as little scope as possible, preferably limited to the single case explicitly mentioned in the Senate Report of the unusual contraction by fire.

If a corporation has actively conducted two or more different businesses for a period of 5 years, distribution of one of the businesses (or of the proceeds from its sale) is a partial liquidation as defined by § 346(b).

One possible justification for § 346(b) is that a distribution in complete liquidation of an entire single business should always produce capital gain, whether there is simply one business per corporate shell or more than one business in a given corporation. Since the complete liquidation idea obviously includes the one business per corporate shell case, the purpose of § 346(b) is to insure similar results when there are two or more businesses per shell. It is difficult to square this justification, however, with the distinctive 5-year requirement contained in § 346(b). To illustrate, suppose A purchases both a movie theater business and motel business, both of which A desires to operate in corporate form in the same shell. A transfers both businesses to a newly formed corporation, MTH Corporation, in return for all of its stock. After n years, each business has after-tax earnings of 100. All of the movie theater profits have been invested in new popcorn machines for the lobby, and all motel profits have been reinvested in "magic fingers" vibrators for the beds. At this point in time—after n years—A causes a distribution of the motel assets. Capital gain treatment is then arguably appropriate. A could have placed the motel business in its own separate shell from the start. In that case, a distribution of all motel assets out of corporate solution would have qualified for capital gain treatment under § 331. Therefore, with more than one business per shell, capital gains treatment should also result. Notice, however, that whether § 346(b) grants capital gain treatment or not depends on the lenth of time A has owned the business. If n is greater than 5 years, the two 5-year business requirement of § 346(b) is met and the distribution produces capital gain. If, however, n is less than or equal to five years, the distribution produces ordinary income. Surely the time period is irrelevant to whether ordinary income or capital gain treatment should be afforded in this example.

The 5-year line is also arbitrary, because it fails to ask to what extent profits of one business have been reinvested in the other business when there are two or more businesses per shell. To illustrate this failure, suppose A acquires a single business, a movie theater, that A decides to operate in corporate form. During its first year of operation the movie theater has after-tax profits of 100, that the corporation uses to acquire a motel. After n years, the motel has after-tax earnings of 400, that have been reinvested in "magic fingers" vibrators for the beds. At this point in time, after n years, the corporation distributes all the assets of the motel business, but retains the movie theater business. The distribu-

standing alone is highly suspect. No reason exists for special treatment of the distribution of a 5 year old business. The whole scheme amounts to a questionable bootstrap operation designed to avoid rational analysis of the basic problem of reconciling business purpose with bail-out prevention. There is no need to justify tax-free treatment by analogy to a rarely used and unjustifiable concept of partial liquidation when bail-out potential is regarded as nonexistent. Moreover, repeal of Section 346 simplifies design of a workable tainting method. Thus, the discussion which follows assumes repeal of Section 346.

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tion is in complete liquidation of the motel business which, it is true, could have been placed in its own corporate shell. However, 100 of the motel assets are traceable to the reinvestment of movie theater business profits. Moreover, the movie theater business remains unliquidated in corporate solution. Therefore, ideally, the distribution should be viewed as a pro rata nonliquidating *ordinary income* distribution to the extent the motel assets are traceable to earnings of the business remaining in corporate solution. The excess, if any, deserves capital gain.

This conclusion is reinforced by examination of the illustration from the perspective of the result if A had placed the motel in its own separate corporate shell. To achieve this, A might have caused a distribution of the movie theater's profits, used them to acquire the motel, and then placed the motel in its own shell. But then, the pro rata nonliquidating distribution of 100 of movie theater profits would have caused 100 of ordinary income gain to A.

To summarize, the liquidation of a single entire business merits capital gain treatment only to the extent its assets are not traceable to the reinvestment of earnings of the retained business. In contrast with the tracing rule suggested here, the 5-year rule of § 346(b) is an all or nothing approach. If more than 5 years have elapsed since movie theater profits were reinvested in the motel, the entire distribution produces capital gain. But if less than 5 years have elapsed, the entire distribution produces ordinary income. The 5-year time test, therefore, fails to distinguish between assets traceable to earnings of the retained business remaining in corporate solution and all other assets distributed in partial liquidation.

Is there any possible justification for the failure of § 346(b) to engage in tracing? As a practical matter, a tracing test could prove difficult to administer since it would require separate and accurate financial data for each business—a condition that may not be met very often with small corporations conducted in an informal manner. But if a tracing rule is simply infeasible, § 346(b) opens up an easy way to avoid paying ordinary income tax on pro rata nonliquidating distributions. The patient shareholder need only reinvest corporate profits in a separate business, wait 5 years, and then cause a distribution in partial liquidation of the 5-year business. Although this tactic might work, the catch is the requirement that both businesses have been actively conducted over the 5-year period. The regulations interpret *active conduct* to preclude classification of mere *passive investment* as an *active business*.

For example, a reinvestment of corporate earnings in IBM stock or in investment real estate will not qualify as an active business. In effect, § 346(b) requires active participation in a business involving entrepreneurial risks over 5 years. The disadvantage of exposing corporate profits to such risks over a 5-year period probably suffices to prevent widespread abuse of § 346(b).

Despite the fact that it has not led to widespread abuse, § 346(b) makes little sense. Where there is a "tracing" problem the 5-year rule is overly generous in affording capital gain treatment to the entire distribution. And where there is no "tracing" problem—no cross-investment from one business to the other—it is not unreasonable to expect the taxpayer to use two different shells "right from the start." Such a use of two separate shells suffers from no disadvantage relative to placing both businesses in one shell. Whatever tax advantages inhere from having both businesses taxed as if in one shell can be obtained by filing consolidated returns for separate shells. Moreover, there may be significant nontax advantages, such as insulation of the assets of each business from the risks of the other. For these reasons, § 346(b) should be repealed. Such was the recommendation of an ALI study group: "We may also dismiss the argument based on rewriting history—viz., the corporation originally could have been two corporations, each operating a part of the business, so that a later sale of the assets of one of the corporations would have resulted in its complete liquidation and hence capital gain treatment. Usually the business of a corporation simply expands out of accumulated earnings, a pattern which does not permit the separate incorporation hypotheses. Moreover, even if the situation would have accommodated two corporations at the outset, the shareholders did choose a different route. And the activities of a single corporation over the years are different from the relationships and activities of several corporations over the same period of time. There is, therefore, no justification for discovering hypothetical twins at the last minute." Cohen, *supra*, at 37–38.

2. *The division event and tainting.*

An ideal tainting method grants nonrecognition to all divisions, with tax determinations reserved for later disposition. However, in some cases, administration can be simplified by making a final taxing decision at the point of division, with virtually no loss in business flexibility or bail-out prevention.

Bail-out is a constant threat in pro rata divisions that cause no shift in underlying ownership interests, because a pro rata distribution of property is usually a taxable dividend under Section 301. But since such divisions are *exactly* pro rata, it is not difficult to design rules to prevent any bail-out by disposition of post-division stock. Therefore, such divisions should not be taxed and stock of both post-division corporations should be tainted.

No bail-out potential exists when a division is substantially disproportionate because, if taxable, it would receive sale treatment under Section 302(b).[88] Therefore, tax-free treatment should be granted such divisions, and post-division stock need not be tainted.[89]

As an intermediate possibility, a division may be non-pro rata and yet, if taxable, be treated as a Section 301 distribution. Bail-out potential is created, yet because the division is not exactly pro rata, disposition rules involve a conceptual and practical quagmire.[90] Such divisions can be taxed with minimal loss of flexibility, however, because they rarely or never occur,[91] nor have reasons been advanced that suggest any important business need for such adjustments.

3. *Disposition of tainted stock.*

The central disposition problem involves sales of common stock, since other securities will be taxed as "boot" in an exchange, and preferred stock rendered harmless by Section 306[92] or 305(c).[93] Dispositions of tainted stock that achieve a bail-out must be effectively distinguished from dispositions that do not. The key factor should be whether *the same proportion of stock in each surviving corporation* is transferred.

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88. *See* Rev. Rul. 64–102, 1964-1 CUM. BULL. 136; Whitman, *supra* note 2, at 1255.

89. The suggestion that such a division may produce unwanted deferral is without merit because assets remain in corporation solution and § 531 is the suitable weapon for attacking unreasonable liquid asset accumulation. *See* B. BITTKER & J. EUSTICE, *supra* note 2, § 13.06, at 13–32; Whitman, *supra* note 2, at 1238.

90. The problem arises because of the difficulty of constructing an interest consisting of stock of both surviving corporations which replicates an interest in the original corporation when the division is not exactly pro rata.

91. *See* Prentice-Hall, Federal Taxes, ¶ 18,121.

92. *See* B. BITTKER & J. EUSTICE, *supra* note 2, § 13.06, at 13–38 and § 13.12.

93. If only one of two post-division corporations has preferred stock, the division may have the "result of (A) the receipt of preferred stock by some common shareholders, and (B) the receipt of common stock by other common shareholders" [§ 350(b)(3)]. Under § 305(c), the preferred stock may be taxed as a § 301 distribution.

a. *Proportionate transfers.* A proportionate transfer conveys the same interest as a transfer of stock when no division has occurred.[94] Thus, proportionate transfers do not require special treatment and should be taxed by the usual rules for sale, gift, redemption, and complete liquidation. However, when a proportionate gift occurs, the taint should follow the stock in the hands of the donee. Failure to continue the taint would permit easy evasion of special disposition rules by making a gift to a related party.

b. *Disproportionate transfer by sale or redemption.* The *proceeds* of a disproportionate transfer, by sale or redemption, should be treated as a Section 301 distribution to the transferor. A disproportionate sale produces a result that, without a division, requires a pro rata, nonliquidating distribution that is ordinarily taxable as a dividend. Therefore, the proceeds should be taxable in full under Section 301 unless the disproportionate transfer falls within either of the questionable theories of Section 346.[95]

To illustrate, assume that X Corp. owns a factory and land, each of which is worth 100. X Corp. places the land in Y Corp. and distributes the Y stock to its sole owner, A. A then sells one-half of his Y stock to B for 50. After the sale, A still owns all of X Corp. and the factory, but has sold to B a one-half interest in Y Corp. and the land, and has received 50. This result could be achieved without a division, however. Instead of distributing the Y stock, X Corp. sells one-half the Y stock to B. Afterwards, the ownership interests are identical to those after a division followed by a sale of Y stock to B. Through X Corp., A owns all of the factory and a one-half interest in the land. But one remaining difference is that X Corp., not A, has received 50 from B. Without a division, A receives the 50 only if X Corp. distributes the proceeds. Such a pro rata distribution would typically be considered a dividend unless classified as a partial liquidation.[96]

Similarly, a redemption of common stock is functionally equivalent to a sale only if the same proportion of stock in each surviving corporation is redeemed.[97] Thus, a redemption should also be taxed as a Section 301 distribution, except to the extent that the same proportion of stock in each surviving corporation is redeemed.

c. *Practical application.* A simple method exists for enforcing the pro-

94. Stock represents an undivided interest in *all* corporate assets. But stock of one post-division corporation, *alone*, is an interest in only part of assets owned by the original corporation. Identical proportions of stock in each post-division corporation must be combined to replicate stock of the original corporation.

95. *See generally* note 87 *supra.*

96. A decision not to repeal § 346 is accommodated with an exception for disproportionate transfers that have the effect of a partial liquidation as defined by § 346(a)(2) or § 346(b).

97. Under § 355(a)(1), a division can qualify for nonrecognition if the distributing corporation owns as little as 80% of the distributed stock of the new corporation. When the distributed corporation is less than wholly owned, shares of the distributing corporation should be equal in number to shares it owns of the new corporation.

portionate transfer test without unwieldly calculations. To obtain nonrecognition for a pro rata division, both post-division corporations should be required to have the same number of shares. This condition is easily met with a stock dividend or stock split. After the division, units would be created consisting of one share in each post-division corporation, so that one unit equals one share of the original corporation. Transfer of an unbroken unit would be proportionate and governed by the usual tax rules. If a unit were broken, however, the transfer would be disproportionate and, therefore, treated as a Section 301 distribution. After a disproportionate transfer was taxed as a Section 301 distribution, the taint could be removed from both shares of the unit because the bail-out threat would be ended.[98]

d. *Exceptions to the general rule for disproportionate transfers: gifts.* Disproportionate gifts also produce results that, without a division, require a Section 301 distribution. In the example above, suppose that after the division, A gives one-half the Y stock to B. Without a division, X Corp. could make the gift without actually distributing anything to A, but the gift would be treated as a constructive distribution because X Corp. has made a gift on A's behalf.[99] However, gain is usually not recognized on a gift transfer,[100] because of liquidity and valuation problems. Therefore, the gift of tainted stock should be tax-free, but the taint should be continued so that donee disposition is governed by Section 301.

Nonrecognition transactions. If the transfer qualifies as a nonrecognition transaction, such as a reorganization, taxation should be deferred because the investor's interest remains in corporate solution.[101] However, stock received in the exchange should, itself, become tainted and subject to the special disposition rules. To facilitate their application, nonrecognition should be allowed only if an adjustment is made so that units are created consisting of one share of the retained corporation, and one share of the stock received in reorganization.[102]

To illustrate, suppose that X Corp. transfers its real estate to Y Corp. and distributes the Y stock. Next, Z Corp., a real estate developer, acquires all the Y stock in exchange for Z stock. Because the transaction is a reorganization under Section 368(a)(1)(B), the disproportionate transfer is not recognized. However, the taint carries over to Z stock received in exchange for tainted stock, and adjustments are made so that the number of Z shares received equals the number of X shares retained. Special rules then govern transfer or split of a tainted stock unit consisting of one X share and one Z share.

98. *Cf.* §§ 306(a), 306(c).
99. *See* B. BITTKER & J. EUSTICE, *supra* note 2, ¶ 7.05.
100. Sections 1015(a), 1245(b), 1250(d).
101. *See* B. BITTKER & J. EUSTICE, *supra* note 2, ch. 13.
102. *See* text accompanying notes 97–98.

4. *Earnings and profits.*

A pro rata distribution is taxed as ordinary income only to the extent of earnings and profits of the distributing corporation.[103] After a tax-free division, the earnings and profits account of the original corporation is allocated between post-division corporations.[104] When a Section 301 distribution is made on tainted stock, reference should be made to the earnings and profits of both post-division corporations taken together. For example, suppose X Corp. with earnings and profits of 100 places half of its net assets in Y Corp. and distributes the Y stock. Assuming an allocation according to relative net worth, 50 of X Corp.'s earnings and profits are allocated to Y Corp. But if Y Corp. distributes 80, the entire amount should be taxable as ordinary income, because the earnings and profits of both post-division corporations taken together are 100.

5. *The surtax exemption.*

An important motive for a division may be the procurement of an extra surtax exemption on corporate income.[105] Current law restricts tax-

103. Sections 301(c)(1), 316(a).

104. Upon the occurrence of a corporate division, the earnings and profits of the pre-division corporation are to be allocated between the distributing and the controlled corporation. The legislative history of the 1954 Code demonstrates an initial preference for a method whereby the distributing corporation would reduce earnings and profits "in proportion to the adjusted basis of the assets transferred to the assets retained." *See* H.R. REP. No. 1337, 83d Cong., 2 Sess., A95-96 (1954). Other methods of allocation, suggested by the American Bar Association in testimony before the Senate Committee, laid out the framework for the present regulations to § 312(i). *See Hearings on H.R. 8300 Before the Senate Comm. on Finance*, 83 Cong., 2d Sess. 365 (1954); S. REP. No. 1622, 83rd Cong., 2d Sess. 250 (1954). The Code as enacted does not set forth the method of allocations. Instead, § 312(i) states that "proper allocation" of the distributing and controlled corporations' earnings and profits is to be made in accordance with the regulations to be prescribed by the Treasury.

The regulations provide that where the § 355 transaction constitutes a divisive Type D reorganization (*see* § 368(a)(1)(D)) earnings of the distributing corporation are allocated "generally . . . in proportion to the fair market value of the . . . [assets] retained by the distributing corporation and the . . . [assets] of the controlled corporation immediately after the transaction." Treas. Reg. § 1.312-10(a) (1960). However, "[i]n a proper case" (which is left to the imagination of the tax lawyer), allocation is to be made in proportion to the net bases (after reduction for liabilities) of the properties transferred and retained, "or by such other method as may be appropriate under the facts and circumstances of the case." *Id.* § 1.312-10(a) (1960). Bittker and Eustice suggest that this is an analogy and a general approach may be found in § 482 and § 446(b) permitting the Service to adjust accounting practices and methods in order to "clearly reflect income." B. BITTKER & J. EUSTICE, *supra* note 2, § 13.04 at 13-15.

If the § 355 transaction does not involve a reorganization (*i.e.*, a spin-off of the stock of a preexisting subsidiary) Treas. Reg. § 1.312-10(b) (1960) provides that the earnings and profits of the distributing corporation are decreased by the lesser of (a) the amount of the adjustment which would have been required had it transferred the stock of the controlled corporation to a new subsidiary and then spun off the latter in a Type D reorganization, or (b) the net worth of the controlled corporation.

The earnings and profits of the controlled corporation are unchanged if immediately prior to the transaction they exceed the amount of the decrease in earnings and profits of the distributing corporation. If the decrease in the distributing corporation's earnings and profits is greater than the earnings and profits of the controlled corporation immediately prior to the transaction (including the situation where the controlled corporation has a deficit) "the earnings and profits of the controlled corporation, after the transaction, shall be equal to the amount of such decrease." *Id.* § 1.312-10(b)(2) (1960). However, a deficit of the distributing corporation is never allocated to the controlled corporation. *Id.* § 1.312-10(c) (1960).

105. *See* B. BITTKER & J. EUSTICE, *supra* note 2, § 13.01, at 13-2. Corporate income above $50,000 a year is taxed at a flat rate of 48%, consisting of a normal rate of 22% and a surtax of

free treatment to divisions with a business purpose other than tax avoidance. Thus, a division cannot be effected simply to obtain an extra surtax exemption. But a tainting method, with automatic nonrecognition for all pro rata divisions, could be abused to obtain extra exemptions. If the multiple corporations statutes—the commissioner's primary weapons against multiplying exemptions—prove inadequate to stop the abuse,[106] the Code should be amended to allow only one surtax exemption after the division of a corporation.

6. *Recordkeeping.*

Keeping track of tainted stock is a serious administrative problem. The burden could be eased by requiring that (a) notice be given to the Service of all tax-free divisions; and (b) a claim of sale or nonrecognition treatment transferring tainted stock be substantiated on the return. Computerization of tax records can also aid the Service in keeping track of tainted stock.[107] The taxpayer's burden is surely no greater than documentation of business purpose and lack of bail-out potential for the purpose of nonrecognition under current law.

C. *The Tainting Method Compared with Section 306.*

A preferred stock dividend—like a division—may serve a business purpose while creating bail-out potential. The 1954 Code adopted a tainting method to govern this area. The distribution of preferred stock is tax-free, but tainted, and special rules in Section 306 govern its disposition.[108]

Although formulated in different terms, the tainting method proposed in this Article for divisions parallels Section 306 in most respects. The division method treats the disposition of tainted stock as a Section 301 distribution unless the transfer is: (1) of the same proportion of stock in each surviving corporation; (2) a gift; or (3) a nonrecognition transaction. Under Section 306(a), the non-gift disposition is ordinarily taxed as a dividend unless the transfer fits within exceptions of Section 306(b). The regulations interpret Section 306(b)(4) "transactions not in avoidance of federal income taxes" to encompass dispositions by shareholders of their Section 306 stock, along with an equal fraction of his original shares—which resembles the proportionate transfer of post-division stock.[109] The exception for non-

26%. However, the first $25,000 a year is exempt from the surtax and taxed at only 22%. Moreover, under the 1975 Tax Reduction Act, the second $25,000 is subject to a reduced surtax of only 22%, producing a 42% tax rate in conjunction with the normal tax.

106. Sections 269, 1551, 1562, 1564. *See generally* B. BITTKER & J. EUSTICE, *supra* note 2 §§ 15.01–15.04.

107. *See* B. BITTKER & L. STONE, FEDERAL INCOME ESTATE AND GIFT TAXATION 910-11 (1973).

108. *See generally* B. BITTKER & J. EUSTICE, *supra* note 2, ch. 10.

109. Treas. Reg. § 1.306-2(b)(4) (1968).

recognition transactions and the tainting of stock received in a tax-free exchange parallel identical provisions in Sections 306(b)(3) and 306(c)(1)(c).

The only important respect in which these two systems differ is the formula for calculating the amount taxable as a dividend on the *sale* of tainted stock. The division proposal simply refers to Section 301, so that the proceeds will be ordinary income to the extent of current accumulated earnings and profits *when the disposition occurs*. However, Section 306 contains a formula that looks backward to earnings and profits when the Section 306 stock was distributed tax-free.[110] Since redemptions of 306 stock are taxed under Section 301 on the theory that a sale of 306 stock is equivalent to a redemption,[111] this curious formula appears without rational basis and can be ignored as a statutory quirk.

III. Business Purpose Revisited: A Reevaluation of the Business Justification for Corporate Divisions

Does the division uniquely meet needs that alternative techniques (less objectionable from a tax standpoint) cannot? Would taxing divisions severely hamper small business flexibility?

A. *Reassessing the Benefits of Division.*

Both current law and the tainting method presume that corporate divisions furnish substantial benefits and, thus, should be entitled to tax-free treatment. If either system were costless, this presumption could remain unquestioned. However, granting tax-free treatment is anything but costless.

Under tainting, the cost arises from administering special rules to prevent a bail-out through disposition of post-division stock. Under current law, there are both administrative and revenue costs. First, there is a complicated inquiry into the relative importance of business purpose and bail-out potential in each particular case. Second, when nonrecognition is granted, a later disposition of post-division stock may be used to achieve a bail-out. Given these costs, divisions should be tax-free only when they provide substantial benefits.

The conventional wisdom that divisions contribute substantially to business activity has a weaker foundation than generally appreciated.[112] The principal issue is whether business purpose requires a "true" division rather than mere creation of a parent-subsidiary relation. In a division, ownership

110. *See* § 306(a)(1).
111. *See* Estate of Henry A. Rosenberg, 36 T.C. 716 (1961).
112. Commentators have made this assertion without providing evidence of critical analysis. *See, e.g.*, Whitman, *supra* note 2, at 1241–45.

of assets is divided at both corporate and shareholder levels. In a parent-subsidiary relation, ownership is divided only at the corporate level. The crucial difference—separation of ownership at the shareholder level—means that only a true division creates bail-out potential. Because distributions by the subsidiary are still judged in the frame of reference to the parent, no bail-out potential is created.

Ideally, empirical research should be conducted to determine the extent to which the asserted business purposes do, in fact, require a division and nothing else. Such studies have not been conducted, and it is difficult to imagine a plausible research design because the relevant variables probably cannot be controlled. Thus, the best one can do is to speculate on the feasibility of alternative techniques. The outcome of such speculation casts severe doubt on the importance of divisions to the business community. And, despite the absence of empirical evidence, this speculation may be useful in formulating policy recommendations. Given the highly uncertain prospect of substantial benefit—and the more certain costs of tax-free treatment, the proper outcome may be to tax nearly all divisions—at least until substantial benefits from tax-free treatment, sufficient to outweigh the costs, are demonstrated.

This Section compares a division with the mere creation of a parent-subsidiary relation in ability to achieve the following commonly asserted business purposes.[113]

1. Segregation of hazardous activities in a separate corporation.
2. Segregation of a business to permit its employees to share in profits or ownership.
3. Disposition of unwanted assets in connection with a merger.
4. Compliance with demands of a customer when a corporation produces items under its own label, in competition with each other.
5. Compliance with preconditions of a lender for granting a loan.
6. Separation of activities subject to regulatory agency supervision.
7. Settlement of a shareholder dispute by giving each shareholder ownership of one business.

The purpose of compliance with a divestiture decree of antitrust law is considered in a separate section, because this situation involves an inescapable conflict between the goals of promoting competition and minimizing tax avoidance.

To aid comparison, the listed business purposes are analyzed within the framework of two general categories of divisions: divisions that are pro rata and cause no change in underlying ownership interests, and divisions that are disproportionate and cause fundamental realignment of such in-

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113. This list is borrowed, in part, from B. BITTKER & J. EUSTICE, *supra* note 2, ¶ 13.09.

terests. The general category of pro rata divisions is subdivided further depending on whether the division is effected unilaterally or in compliance with requirements of an outside party. The three resulting classifications are (1) unilateral pro rata divisions; (2) pro rata divisions at the request of an outside party; and (3) substantially disproportionate divisions.

The business purposes for unilateral pro rata divisions are the least compelling, because an equally satisfactory alternative to a division can always be constructed. While alternatives can also be constructed for divisions in classification two, business purpose may be more compelling than in unilateral situations because the outside party may irrationally refuse to accept anything short of an actual division.[114] Business purpose is most compelling in classification three, where no alternative but a division can achieve the purpose of realigning ownership interests.

1. *Unilateral pro rata divisions.*

a. *Segregation of hazardous activities in a separate corporation.* Recall the introductory example of X Corp.[115] X Corp. wishes to immunize its real estate assets from the risks of its business operations. X Corp. can achieve this goal by effecting a division, *i.e.*, by placing the hotel in a newly formed subsidiary, Y Corp., and distributing the Y stock to its shareholders. But why is distribution of Y stock necessary to protect the land from liabilities of the hotel? If Y Corp. remains a subsidiary of X Corp., the subsidiary's limited liability will protect the land from any risks of the business. Creation of a subsidiary corporation, without more, realizes the business purpose. Moreover, this technique does not create bail-out potential, since any distribution of the land alone will be viewed as a non-liquidating ordinary income distribution.

The division technique is a superior method of segregating risks only if there is a danger that the subsidiary's limited liability will not be respected.[116] If a court allows the creditors of the subsidiary to look to the assets of the parent, the purpose of protecting the land from liabilities of the hotel will not be achieved. Although this eventuality is possible, it is not important enough to justify creation of bail-out potential.[117] Moreover, there is no reason to assume that the land will be better protected simply because a division has taken place. A court willing to pierce the subsidiary's limited liability feature, for example, because parent and subsidiary assets have been commingled, should be equally willing to pool the assets of the

114. *See* text accompanying notes 63–64 *supra.*
115. *See* text following note 95 *supra.*
116. *See* note 61 *supra.*
117. *See* Landers, *A Unified Approach to Parent, Subsidiary, and Affiliate Questions in Bankruptcy,* 42 U. CHI. L. REV. 589 (1975).

two corporations, even if ownership is formally divided at the shareholder level.[118] Logically, a court's willingness to allow the creditors of Y Corp. to look to the assets of X Corp. should not depend on whether the shareholder holds the Y Corp. stock directly or indirectly (via X Corp.). Therefore, the proposition that a division is uniquely suited to achieving the segregation of risks purpose seems highly tenuous.

b. *Separation of a business to permit its employees to share in profits and ownership.* Suppose that A owns all the stock of A Corp., a retail clothing business with two stores (Store A and Store B) and that A wishes to sell the manager of each store an equity interest in the company, limited to the store that manager supervises.[119] Therefore, A is unwilling to sell stock in A Corp., since A stock includes an interest in the success of both stores. However, A Corp. could effect a division by transferring Store B to B Corp. and distributing the B stock. The original owner, A, could then sell A shares to the manager of Store A and B shares to the manager of Store B. The division permits A to sell each manager an interest limited to the store he manages.

However, consider the following alternative that obviates the need for a division. A Corp. could form two separate subsidiaries, B Corp. and C Corp. A Corp. becomes, in effect, a holding company for two separate subsidiaries, each of which owns one store. The final step is for A Corp. to sell C shares to Store A's manager and B shares to B's manager.

The mere creation of parent-subsidiary relations, without more, achieves the business purpose without creating bail-out potential. But does this technique possess any serious disadvantages relative to the division? The corporate holding company pattern appears more complex than a clean division of ownership interest at the shareholder level. But, as a logical matter, whether the majority owner, A, owns each of the operating corporations directly or through a holding company should not affect the rights and responsibilities of A as dominant owner. State corporations statutes should not impose different duties depending on the formal pattern of A's ownership.[120]

c. *Disposition of unwanted assets in connection with a merger.* Suppose that K Corp. owns a crayon business and a warehouse. L Corp. wishes to acquire the crayon business, but not the warehouse.[121] To pave the way for a merger of the crayon business, K Corp. transfers the warehouse to M Corp. and distributes the M stock. The unwanted warehouse has been eliminated through a division so that K Corp. and L Corp. may be merged.

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118. *Id.* at 607.
119. For a similar fact situation, see Rev. Rul. 69-460, 1969-2 CUM. BULL. 51.
120. *See, e.g.*, Landers, *supra* note 117.
121. For a discussion of a similar problem, see Massee, *supra* note 23.

However, a division is not necessary to achieve K's business purpose. Instead, K Corp. could create two subsidiaries, transferring the crayon business to one and the warehouse to the other. The crayon subsidiary and L Corp. may still be merged without the unwanted warehouse.

2. *Pro rata division at an outside party's request.*

a. *Compliance with demand of customer.* Suppose that Z Corp. operates two milk bottling plants. One plant bottles milk that Z Corp. sells under its own label; the other bottles milk for W that W sells under W's label. The Z Corp. milk and the W milk, both bottled by Z Corp., sell in competition in grocery stores. Suppose that W threatens to cease doing business with Z Corp. unless the ownership of the two bottling operations is separated.[122] One solution would be for Z Corp. to effect division by transferring one bottling plant to a subsidiary and distributing the subsidiary's stock. The result would be two separate corporations, each owned directly by the original owners of Z Corp.

Logically, however, W should be satisfied with the following alternative. Z Corp. could transfer each plant to a newly-formed subsidiary. The result would again be two separate corporations, each owning one bottling plant. The result is identical to a division, except that the two corporations are owned indirectly, via a parent intermediary, rather than directly, by the original owners of Z Corp. It is conceivable, of course, that W would find the second arrangement less aesthetically pleasing than an actual division. But W's possible insistence on an apparent, but unreal, advantage appears slight compensation for the problems raised by tax-free treatment.

The irrationality of W's insistence does not reduce business necessity for Z Corp. Congress, however, still might decide to tax such divisions if it believed that imposing a tax penalty on the division of Z Corp. would motivate Z's owners to convince W to opt for rational alternatives.

b. *Pro rata division to comply with government regulation.* Suppose that M Corp. is a motor common carrier under ICC regulation and that M Corp. owns, besides assets devoted to its common carrier activities, investment real estate. M Corp. wishes to place its real estate assets in a separate corporation not subject to ICC regulation.[123] To achieve this result, M Corp. transfers the real estate to a newly formed subsidiary and distributes the subsidiary stock to its shareholders. The corporate division immunizes the distributed corporation's assets from ICC regulation.

Why should the ICC demand a distribution of the subsidiary's stock as a condition for avoiding ICC regulation? Creation of a subsidiary, without more, to hold unregulated assets logically should be satisfactory. As a

122. For a similar fact situation, see U.S. v. Marett, 325 F.2d 28 (5th Cir. 1963).
123. *See* U.S. v. King, 458 F.2d 245 (6th Cir. 1972).

precautionary measure, Congress should make it clear, either in the tainting statute, or in its legislative history, that federal agencies should not demand unnecessary divisions.

3. *Substantially disproportionate division.*

Suppose that Q and R, each owning one-half of QR Corp., have decided to separate, dividing between them their interest in the corporate business.[124] QR Corp. transfers one-half its assets to a subsidiary and distributes the stock in redemption of R's entire interest in QR Corp. The result is complete separation of Q's and R's interest. Whereas before each owned one-half of QR Corp., each now owns 100 percent of a corporation with one-half of the assets that had been jointly owned. Obviously, to separate ownership of assets at the corporate level by merely creating a subsidiary will not (without more) suffice to achieve the business purpose. In addition, the subsidiary stock must be distributed in order to separate and realign shareholder ownership interests. Therefore, this presents the one case where tax-free treatment unquestionably should be allowed.

B. *Divisions and Divestiture Decreases: Tax Law and Trust Policy*

A close corporation dividing pro rata to comply with a divestiture decree creates an inescapable conflict between promotion of competition and minimization of tax avoidance. A pro rata division without more will not achieve divestiture since the underlying owners' control is unchanged. Divestiture also requires that the owners dispose of one post-division corporation. In contrast, a division will achieve divestiture of a public issue corporation because of the separation of ownership and control. But the division plus disposition is equivalent to a sale of property by the original corporation, followed by a pro rata nonliquidating distribution of the proceeds.

Congress might decide to grant nonrecognition to such pro rata divisions and refuse to taint post-division stock, in order to eliminate any tax penalty for compliance with antitrust law. However, this Article argues that the bail-out should not be permitted, notwithstanding the apparent conflict with antitrust policy. Either the division should be taxed, or, if nonrecognition is granted, post-division stock should be tainted so that a disproportionate transfer produces ordinary income gain. The resulting tax penalty on divestiture is no different in principle from the tax penalty generally imposed on a decision to distribute corporate profits rather than reinvest in expansion. The divestiture example is merely an illustration of the fact that preferential tax treatment afforded retained earnings works at cross-purposes with antitrust policy against excessive corporation expansion.

124. *See* Coady v. Comm'r, 289 F.2d 490 (6th Cir. 1961).

IV. Conclusion

Current law governing corporation divisions has reached a dead end. Both the balancing test and the two active business requirement fail the tests of administrative feasibility and reconciliation of business purpose with bail-out prevention. Congress should seriously consider the repeal of Section 355 and adoption of the following proposals.

Substantially disproportionate divisions should receive tax-free treatment without tainting. The benefits are substantial because it is the one purpose to which a division is, compared with creation of a subsidiary, uniquely suited. Moreover, the costs are minimal, because no bail-out potential is created.

Divisions that are essentially, but not exactly, non–pro rata should be taxed. The business need for such divisions appears practically nonexistent, and tax-free treatment under a tainting method requires disposition rules of substantial complexity.

The difficult issue is whether exactly pro rata divisions should be taxed or tainted. The choice depends on beliefs regarding the alleged benefits of pro rata divisions. If those benefits are regarded as substantial enough to justify the costs of tainting, all pro rata divisions should occur tax-free with special rules governing the disposition of tainted stock. However, serious doubt exists concerning the benefit of divisions that are essentially pro rata and produce no substantial realignment of underlying shareholder interests. Therefore, until greater benefit is convincingly shown, all unilateral pro rata divisions should be taxed.

Taxation of pro rata divisions that comply with outside party demands is justified if the tax impediment forces such parties to consider rational alternatives. However, outside party insistence, even for irrational reasons, might be viewed as sufficiently compelling to justify the costs of tax-free treatment, provided that the danger of collusion is not excessive. In that case, a tainting method should be applied to all pro rata divisions undertaken at the insistence of an outsider. The fact that the purpose is compliance with antitrust law should not receive consideration, unless imposition of a tax penalty on divesture is shown to be materially different from imposition of a tax penalty on corporate distributions in general. On the rare occasion when a public issue corporation divides, an exception should be made and nonrecognition granted, without tainting, because bail-out potential is virtually never created.

A final word should be added about divisions and the basic structure of corporate shareholder taxation. Bail-out potential could not be created without the basic distinction between ordinary income and capital gain distributions. Recent discussion of tax reform has centered around two

proposals that would eliminate the division problem as a by-product of a radical restructuring of the existing corporate shareholder system.[125] Under both reforms, corporate divisions could be ignored by the tax law. However, the ordinary income-capital gain dichotomy is likely to persist in the corporate-shareholder area because of technical and political obstacles to abolition, so that the corporate division problem will remain a persistent feature of the tax landscape for the foreseeable future.

125. First, shareholders of a corporation, like partners of a partnership, could be taxed on all annual earnings, whether distributed or retained. Consequently, a distribution per se would not be a taxable event. Alternatively, shareholder level taxation could be a function of whether distributions are devoted to consumption or savings. If consumed, the distribution would be taxable at ordinary rates; if saved, the distribution would be excluded from the tax base.