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ARTICLES

THE BUSINESS PURPOSE TEST IN SECTION 355 DISTRIBUTIONS: MAJOR PITFALLS FOR CLOSE CORPORATION PLANNING

*Brenda D. Crocker**

Since 1918, Congress has recognized the economic necessity of stimulating growth in the business sector by encouraging productive corporate divisions. The unhappy task of more than sixty years has been to draft a statute which maximizes flexibility while precluding tax avoidance abuses. Charting its way by piecemeal legislation, Congress appears to have intended tax-free treatment for stock distributions pursuant to corporate divisions motivated by reasonable business needs. Curiously, although Congress clearly has assumed that a valid business purpose must be the primary motivation for such transactions, it never has expressly addressed the matter by statute. Instead, it has devised numerous complex requirements and left the development of this capstone concept to the Treasury Department and the courts. In so doing, Congress has fostered unwarranted uncertainty in the business community and indirectly encouraged abuse and economic waste.

The business purpose doctrine was introduced by the United States Supreme Court in 1935. Its purpose was to defeat earnings and profits bail-out schemes through an articulation of the spirit of Congress' divisions and distributions enactments. Since 1935, the courts and the Internal Revenue Service have expended considerable effort in an attempt to hone the doctrine so as to limit tax-free status to distributions which are motivated by business exigencies. Although several identifiable decisional categories now cover the majority of possible factual settings, several troublesome areas remain. The purpose of this paper is to identify both the resolved

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and unresolved major issues which the close corporation shareholders or planner must face in devising a section 355 transaction.

I. THE LEGISLATIVE HISTORY OF CORPORATE DIVISIONS AND DISTRIBUTIONS

A cursory review of the legislative history behind section 355 should facilitate an understanding of its targets and limitations. The Revenue Act of 1918 was Congress's first attempt at encouraging corporate divisions. Although it provided for tax-free treatment for split-ups only,¹ Congress clearly recognized the economic benefit of encouraging corporate divisions with the assets remaining in corporate solution.² Expanding this theme in the Revenue Act of 1924, Congress elevated split-offs³ and spin-offs⁴ to this preferred

1. Revenue Act of 1918, ch. 18, § 202(a)-(b), 40 Stat. 1060 (current version at I.R.C. § 358). This provision read as follows:

(a) That for the purpose of ascertaining the gain derived or loss sustained from the sale or other disposition of property, real, personal, or mixed, the basis shall be—

(1) In the case of property acquired before March 1, 1913, the fair market price or value of such property as of that date; and

(2) In the case of property acquired on or after that date, the cost thereof; or the inventory value, if the inventory is made in accordance with section 203.

(b) When property is exchanged for other property, the property received in exchange shall for the purpose of determining gain or loss be treated as the equivalent of cash to the amount of its fair market value, if any; but when in connection with the reorganization, merger, or consolidation of a corporation a person receives in place of stock or securities owned by him new stock or securities of no greater aggregate par or face value, no gain or loss shall be deemed to occur from the exchange, and the new stock or securities received shall be treated as taking the place of the stock, securities, or property exchanged.

When in the case of any such reorganization, merger or consolidation the aggregate par or face value of the new stock or securities received is in excess of the aggregate par or face value of the stock or securities exchanged, a like amount in par or face value of the new stock or securities received shall be treated as taking the place of the stock and securities exchanged, and the amount of the excess in par or face value shall be treated as a gain to the extent that the fair market value of the new stock or securities is greater than the cost (or if acquired prior to March 1, 1913, the fair market value as of that date) of the stock or securities exchanged.

Arguably, Congress also intended to include split-offs in this provision. See H.R. REP. NO. 179, 68th Cong., 1st Sess. 14 (1924).

2. See H.R. REP. NO. 179, 68th Cong., 1st Sess. 14 (1924).

3. Revenue Act of 1924, ch. 234, §§ 203(b)(2), (h), (i), 43 Stat. 256 (current version at I.R.C. §§ 355, 368). These subsections read as follows:

(b)(2) No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the

status.

The difficulty with these statutes was that they vested a ritualistic procedure with preferred status. Providing neither admonition nor express protection against bail out intent, this broad exemption invited facile bail out of corporate earnings and profits. A corporation engorged with accumulated earnings or liquid assets only needed to transfer these items to a new corporation, distributing the new corporation's stock to the former corporation's shareholders. The shareholders then could sell the stock or liquidate the new corporation, receiving capital gains treatment on the "bailed out" assets in lieu of paying ordinary tax rates on a dividend.⁵

In full compliance with the letter of the statutes, the taxpayer in *Gregory v. Helvering*⁶ attempted just such a bail out. Mrs. Gregory, the sole shareholder of United Mortgage Corporation, caused the corporation to transfer its liquid assets to the newly formed

reorganization.

. . . .

(h) As used in this section and sections 201 and 204—

(1) The term "reorganization" means (A) a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation), or (B) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred, or (C) a recapitalization, or (D) a mere change in identity, form, or place of organization, however effected.

(2) The term "a party to a reorganization" includes a corporation resulting from a reorganization and includes both corporations in the case of an acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation.

(i) As used in this section the term "control" means the ownership of at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of the corporation.

4. Revenue Act of 1924, ch. 234, §§ 203(b)(2), (c), (h), 43 Stat. 256 (current version at I.R.C. § 355). Section 203(c) reads as follows:

(c) If there is distributed, in pursuance of a plan of reorganization, to a shareholder in a corporation a party to the reorganization, stock or securities in such corporation or in another corporation a party to the reorganization, without the surrender by such shareholder of stock or securities in such a corporation, no gain to the distributee from the receipt of such stock or securities shall be recognized.

5. See Revenue Act of 1924, ch. 234, §§ 200-203, 208, 43 Stat. 254 (current version at I.R.C. §§ 351-368).

6. 27 B.T.A. 223 (1932), *rev'd*, 69 F.2d 809 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935).

Averill Corporation, whose stock was then distributed to her.⁷ Mrs. Gregory immediately liquidated Averill Corporation, received its liquid assets, and sold them by prearranged plan to a third party at capital gains rates.⁸ By this procedure, she avoided ordinary tax treatment on a dividend from United Mortgage Corporation.⁹

Possibly assuming that Congress had overlooked the potential for tax avoidance under the statute, the Board of Tax Appeals held that Mrs. Gregory's literal compliance with the statute caused the transaction to be tax-free.¹⁰ Disagreeing, the Supreme Court held that distributions pursuant to corporate divisions motivated by tax avoidance and lacking in business purpose must be deemed dividends under the spirit of the statute.¹¹

By the time the Supreme Court reversed the Tax Board's decision in 1935, Congress had already reacted to that decision in denominating all spin-off distributions dividends, regardless of whether the motivation was business purpose or tax avoidance.¹² By 1951, however, Congress had recognized the economic inefficiency of continuing the preferred status of split-offs and split-ups, where abuses had continued to occur,¹³ while denying such status

7. 293 U.S. at 467.

8. *Id.*

9. *Id.*

10. "A statute so meticulously drafted must be interpreted as a literal expression of the taxing policy, and leaves only the small interstices for judicial consideration." 27 B.T.A. at 225.

11. 293 U.S. at 469-70.

12. H.R. REP. NO. 704, 73d Cong., 2d Sess. 12 (1934); S. REP. NO. 558, 73d Cong., 2d Sess. 13 (1934). For congressional discussion following House Ways and Means Committee and Senate Finance Committee reports, see 78 CONG. REC. 5847, 5864, 5960 (1934). The House Ways and Means Committee clearly stated congressional intent behind the statutory revision.

[T]he committee recommends that section 112(g) be omitted from the bill. This paragraph provides that a corporation by means of a reorganization may distribute to its shareholders stock or securities in another corporation a party to the reorganization without any tax to the shareholder. By this method corporations have found it possible to pay what would otherwise be taxable dividends, without any taxes upon their shareholders. The committee believes that this means of avoidance should be ended.

H.R. REP. NO. 704, 73d Cong., 2d Sess. 14 (1934).

13. See, e.g., *Spangler v. Commissioner*, 18 T.C. 976 (1952) (dividend treatment accorded spin-offs not applicable where taxpayer has literally complied with tax-free provisions for split-off). *Accord*, Rev. Rul. 53-289, 1953-2 C.B. 37. See Revenue Act of 1934, ch. 277, § 115(h), 48 Stat. 712 (current version at I.R.C. § 355); Revenue Act of 1932, ch. 209, §§ 112(b)(3), (g), (i)(1)(D), (i)(2), 47 Stat. 196 (tax-free reorganizations) (replaced by Reve-

to spin-offs.¹⁴ Consequently, Congress restored the spin-off to grace and added two safeguards.¹⁵ The first safeguard was the post-distribution "two active businesses" rule, whereby both the distributing and distributed corporations must continue in the active conduct of a trade or business after the spin-off.¹⁶ The second safeguard was the "device clause," under which the prompt sale of distributed stock, especially where prearranged, created a presumption that the spin-off was a pretext for a dividend.¹⁷

By 1953 the Treasury Department had well established an extremely liberal regulatory interpretation of the 1951 revision.¹⁸ For

nue Act of 1934, ch. 277, § 115(h), 48 Stat. 712).

14. S. REP. No. 781, 82d Cong., 1st Sess. 58 (1951).

15. Revenue Act of 1951, ch. 521, § 317(a), 65 Stat. 493 (current version at I.R.C. § 355).

16. Revenue Act of 1951, ch. 521, § 112(b)(11), 65 Stat. 493 (current version at I.R.C. § 355) provided as follows:

Distribution of Stock not in Liquidation—If there is distributed, in pursuance of a plan of reorganization, to a shareholder of a corporation which is a party to the reorganization, stock (other than preferred stock) in another corporation which is a party to the reorganization, without the surrender by such shareholder of stock, no gain to the distributee from the receipt of such stock shall be recognized unless it appears that (A) any corporation which is a party to such reorganization was not intended to continue the active conduct of a trade or business after such reorganization, or (B) the corporation whose stock is distributed was used principally as a device for the distribution of earnings and profits to the shareholders of any corporation a party to the reorganization.

Senator Hubert Humphrey's remarks contain an example of the abuses at which this statutory revision was aimed:

Corporation A, claiming some trumped up business purpose, would transfer the cash and bonds to new corporation X, in exchange for X's stock, and then would distribute X's stock to the stockholders of corporation A. After permitting a decent interval to elapse, corporation X would be liquidated. Corporation X would thus be set up by means of funds obtained from the operations of corporation A. The stockholders of corporation A would have all the stock in the new corporation X.

The stockholders would receive the cash and bonds in liquidation—which transaction gives rise to a capital gain, rather than to ordinary income; or the stockholders could merely sell their stock and "cash in" on their dividend at capital gain rates.

Paragraphs (A) and (B) [of section 112(b)(11)] prevent this type of avoidance by requiring that in order for the distribution of stock in corporation X to be tax-free, both corporations A and X must be intended to carry on active business after the reorganization.

96 CONG. REC. 13685 (1950) (remarks of Senator Humphrey concerning section 207(a) of Senate Finance Committee Bill which in 1951 became section 112(b)(11) of the 1939 Code).

17. See S. REP. No. 781, 82d Cong., 1st Sess. 58 (1951).

18. The regulation stated that the "underlying assumption of section 112(b)(11) . . . is that the reorganization and distribution of stock must result in a continuation of the old business activities and in a continuation of the interests of the shareholders therein." Treas.

example, under the regulation, the new corporation could qualify shareholders for tax-free treatment by remaining in business for any limited amount of time.¹⁹ Such a statutory construction merely pointed up Congress' failure to specify in any of its enactments to that date its intent that a valid business purpose underlie every tax-free corporate division and distribution.

II. THE 1954 CODE: SECTION 355

Partly in response to the Treasury Department's misinterpretation of its intent, Congress overhauled its piecemeal provisions in 1954.²⁰ The new provision eliminated the requirement that divisions occur pursuant to a plan of reorganization,²¹ accorded virtually identical treatment to each of the three types of divisions,²²

Reg. 118, § 39.112(b)(11)(2)(a) (1954).

19. The Treasury Department's example of this assumption is as follows:

Corporation C owns and operates a department store. It decides to provide parking facilities for the customers of the store. In order to provide such facilities, Corporation C enters into a contract to purchase land adjacent to its premises. The purchase price of the land is \$100,000 and it is estimated that the cost of developing the parking lot will be \$50,000. In order to separate the operations of the parking lot from those of the department store, Corporation C transfers to a newly formed Corporation D \$90,000 in cash and \$90,000 in bonds, together with the contract for the purchase of the land, in exchange for all the stock of Corporation D, which stock is distributed pro rata among the shareholders of Corporation C. The purchase of the land is completed on the date fixed in the contract, and the parking facilities are developed and operated by Corporation D. There are no other relevant facts. The transfer of the cash, bonds, and contract to Corporation D in exchange for its stock is a reorganization under section 112(g)(1) and the distribution of stock (other than preferred stock) in Corporation D to the shareholders of Corporation C is within the terms of Section 112(b)(11).

Treas. Reg. 118, § 39.112(b)(11)(2)(d), ex. 2 (1953).

20. Int. Rev. Code of 1954, ch. 736, §§ 355, 356, 68A Stat. 113 (now I.R.C. §§ 355, 356).

21. I.R.C. § 355(a)(2)(C). Under the 1954 Code, a corporate division no longer necessitated the distribution of the transfer corporation shares. Moreover, there was no longer any necessity for transferring property to a controlled corporation before distributing the stock of a pre-existing subsidiary. See S. REP. No. 1622, 83d Cong., 2d Sess. 50, *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS 4621, 4681.

22. See S. REP. No. 1622, 83d Cong., 2d Sess. 266, *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS 4621, 4903. (Senate Finance Committee reporting that section 355 incorporates the 1939 Code provisions regarding split-ups, split-offs, and spin-offs). If the transaction fails to meet section 355 requirements, the results are not similar. Split-ups and split-offs likely will receive capital gain treatment under sections 302, 331, or 346; whereas, spin-offs will receive section 301 ordinary tax treatment. See generally I.R.C. § 356; B. BITTKER and J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS § 13.03 (4th ed. 1979).

and established the five requirements for tax-free status currently found in the Code.²³

The five statutory requirements for tax-free qualification under section 355 again suggest congressional intent that a valid business purpose underlie the division and subsequent stock distribution even though nowhere in the statute does Congress specify that intent.²⁴ The first requirement is that one corporation, denominated the distributing corporation under section 355, transfer assets to a second corporation, denominated the distributed corporation, in exchange for an amount of stock which constitutes "control" of the distributed corporation.²⁵ Under a second requirement, the distributing corporation then must distribute to its shareholders the stock and securities it owns in the distributed corporation.²⁶ A third condition requires both the distributing corporation and the distributed corporation to be engaged in the active conduct of a trade or business immediately after the distribution.²⁷ Under a fourth requirement, the distributing corporation must have carried on the trades or businesses of both the distributing and the distributed corporations for the five years immediately preceding the distribution.²⁸ Moreover, neither trade nor business may have been acquired directly or indirectly by either of these corporations within the preceding five years through a transaction in which gain or loss was recognized.²⁹

The remaining requirement contains the "device clause," which was first seen in the 1951 revisions.³⁰ This provision, which requires that the transaction not be used principally as a device to

23. For the full text of I.R.C. § 355, see App. I.

24. See App. I.

25. I.R.C. § 355(a)(1)(A). See App. I. I.R.C. § 368(a) defines "control" as ownership of at least eighty per cent of the total voting power of all classes of stock and at least eighty per cent of the total number of shares of all other classes.

26. I.R.C. § 355(a)(1)(D). The transaction will qualify if the transferor corporation distributes an amount equaling control under section 368(c) and if the Commissioner is satisfied that no stock is retained for tax avoidance purposes. *Id.* See app. I.

27. I.R.C. § 355(b)(1)(A). See App. I.

28. I.R.C. § 355(b)(2)(B). See App. I.

29. I.R.C. § 355(b)(2)(C) and (D). See App. I.

30. I.R.C. § 355(a)(1)(B). See App. I. For discussion of the "device clause" requirement under the 1951 revisions, see note 17 *supra* and accompanying text. For comparison of the device clause to the business purpose test, see notes 34-53 *infra* and accompanying text.

bail out the earnings and profits of either corporation,³¹ is the nearest equivalent to a congressional requirement of a valid business purpose to appear in section 355. Obviously, if a shareholder sells the distributed stock or liquidates the new post-distribution corporation by design arranged before the corporate division, he quickly has converted his distribution into liquid form. Although the transaction gives the appearance of a capital transaction, it is in essence no more than a means for obtaining a dividend without incurring liability at ordinary income rates. Consequently, section 355 now treats such behavior as evidence of a bail out device.³² Moreover, even if the shareholder has not prearranged the transaction, immediate sale or liquidation may present strong evidence of such a device, as will a pro rata distribution to the shareholders.³³

III. NON-STATUTORY REQUIREMENTS: THE BUSINESS PURPOSE TEST

In addition to the statutory requirements under section 355, the Internal Revenue Service and the courts have imposed specialized controls on section 355 transactions. The most significant of these limitations is the business purpose doctrine, under which the shareholder must show a valid business purpose for the division and stock distribution in order to receive tax free treatment. Although the doctrine has been in existence since the Supreme Court's 1935 decision in *Gregory v. Helvering*, several attendant issues remain unresolved.

The issue of least consequence to the close corporation is that of whether the business purpose test exists separately from or as a part of the device test. Since the corporation and its few share-

31. I.R.C. § 355(a)(1)(B).

32. Treas. Reg. § 1.355-2(b)(1) (1980).

33. Treas. Reg. § 1.355-2(b)(1) (1980). The House bill, H.R. 8300, provided for dividend treatment for shareholders who sold their distributed shares within ten years of receipt unless for five years the distributing corporation had conducted the distributed corporation's trade or business, separate business records were maintained, and at least ninety per cent of the distributed corporation's annual gross income was other than personal holding company income. H.R. 8300, 83d Cong., 2d Sess. § 353(c) (1954). The Senate Finance Committee rejected the House version. S. REP. No. 1622, 83d Cong., 2d Sess. 50-51, reprinted in [1954] U.S. CODE CONG. & AD. NEWS 4623, 4681-82. The proposed regulations also treat a "pro rata or substantially pro rata" distribution as significant evidence of a device. Prop. Treas. Reg. § 1.355-2(c) (1980).

holders are so closely interwoven in a close corporation, there may be in reality little practical distinction between the operations of the device test and the business purpose test. Two issues of extreme significance to the close corporation remain, however. The first is whether a shareholder purpose can constitute a sufficient business purpose for section 355 preferred status. The second concerns how to predict whether the asserted business purpose will win official approval. Subsumed under this second issue is the question of whether the asserted business purpose will support both the division and the distribution of shares.

Lacking guidance from Congress, the distributee of a close corporation division faces an unreasonable choice. Typically, as both shareholder and corporate officer, he may participate in a division and stock distribution with little assurance that he can make the requisite business purpose showing. Conversely, he may encourage a deferral of the division, thereby risking a needless loss of corporate and economic benefit. Were a clearer statement of congressional intent forthcoming, what now proceeds as a transaction sparked by guesswork could be reduced to a rational business decision between definite alternatives.

A. *Business Purpose Versus Device*

In initially determining how to meet the business purpose requirement, the taxpayer must consider its relationship to the device test. Whereas the device test exists to prevent bail out by monitoring shareholders' intended disposition of stock distributed in a section 355 transaction, the business purpose test exists to police the transaction for bail out potential before it occurs. This business purpose test, a product of judicial³⁴ interpretation of congressional intent and the Internal Revenue Service³⁵, requires the taxpayer to make an affirmative showing of a valid corporate purpose behind both the division and stock distribution.³⁶ Further, whereas the device test appears to cause scrutiny for improperly

34. See notes 6-11 *supra* and accompanying text.

35. The business purpose test first appeared in the regulations after the *Gregory* decision. Treas. Reg. § 86 (1935). For the text of the current regulations, see note 51 *infra*.

36. For discussion of whether the purpose must be that solely of the corporation or that of the shareholders, see notes 56-83 *infra* and accompanying text.

motivated shareholder benefit, the business purpose test appears to cause scrutiny for lack of business exigencies behind the transaction. Only in tandem do the two tests evoke a monitoring of the entire spectrum of steps involved in a section 355 transaction.

Although the courts and the Service agree that tax-free status hinges on meeting both tests,³⁷ they do not agree on whether the tests exist separately or the business purpose test is included within the device test. In the most prominent case, *Commissioner v. Wilson*,³⁸ the Ninth Circuit reviewed the Tax Court's allowance of tax-free status in the spin-off of a financing corporation from a retail furniture corporation and clearly denominated the tests as separate requirements for section 355 purposes. The owners of the furniture company had transferred the outstanding conditional sales contracts to Wil-Plan, its own financing agency, in exchange for all of the Wil-Plan stock.³⁹ The Tax Court found the taxpayers' alleged business reasons for spinning-off Wil-Plan insufficient.⁴⁰ The court allowed section 355 treatment, however, since it also found that the taxpayers had not employed a device for tax avoidance purposes.⁴¹ Unable to hold that either finding was clearly erroneous, the Ninth Circuit squarely faced the issue of whether each test must be met on its own merits. It held that Congress' overriding purpose in enacting section 355, as discussed in *Gregory*,⁴² was "to give to business enterprisers leeway in readjusting their corporate arrangements to better suit their business purposes."⁴³ Where no business purpose exists, the transaction cannot be tax-free, irrespective of whether or not it was a bail out device.⁴⁴

Reaching the same result on different grounds, the First Circuit

37. See, e.g., *Rafferty v. Commissioner*, 452 F.2d 767 (1st Cir. 1971); Rev. Rul. 59-197, 1959-1 C.B. 77, 79 ("There must be good business reasons for the transaction and it must not be a device for the distribution of earnings and profits.").

38. 353 F.2d 184 (9th Cir. 1965), *rev'g* 42 T.C. 914 (1964).

39. 353 F.2d at 185.

40. 42 T.C. at 922.

41. *Id.* at 923.

42. See notes 6-11 *supra* and accompanying text.

43. 353 F.2d at 187. "If the rearrangement had that purpose, Congress was willing to concede them some possible tax advantages. If the rearrangement had no business purpose, let the taxes fall where they might." *Id.*

44. *Id.* at 187-88. *Accord*, *Gada v. United States*, 460 F. Supp. 859 (D. Conn. 1978).

in *Rafferty v. Commissioner*⁴⁵ treated the business purpose test as a step within the device test. Rafferty Brown Steel Company, Inc. of Massachusetts had spun-off Teragram Realty Company, Inc. and Rafferty Brown Steel Company, Inc. of Connecticut, distributing the new stock to the Massachusetts stockholders.⁴⁶ The Tax Court disagreed with the Commissioner and found that "there was no device because there was an adequate business purpose for the separation and distribution of Teragram stock."⁴⁷ Agreeing with the Tax Court on several grounds,⁴⁸ the First Circuit nevertheless denied the taxpayer's preferred section 355 treatment.⁴⁹ In explanation, it stated:

The business purpose here alleged, which could be fully satisfied by a bail-out of dividends, is not sufficient to prove that the transaction was not being principally so used.

Given such a purpose, the only question remaining is 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.⁵⁰

The current and proposed regulations on this point offer limited support for the *Wilson* view rather than that of *Rafferty*, since they speak to the business purpose issue without discussion of the device test. The current regulations disallow section 355 qualification to transactions "carried out for purposes not germane to the business of the corporations," principally so as to limit readjustment "as is required by business exigencies."⁵¹ The proposed regu-

45. 452 F.2d 767 (1st Cir. 1971), *cert. denied*, 408 U.S. 922 (1972).

46. 452 F.2d at 768-69.

47. *Id.* at 769.

48. For further discussion of *Rafferty*, see notes 69-72 *infra* and accompanying text.

49. 452 F.2d at 771.

50. *Id.*

51. Treas. Reg. §§ 1.355-2(c), .368-1(b) read in part as follows:

(c) *Business purpose.* The distribution by a corporation of stock or securities of a controlled corporation to its shareholders with respect to its own stock or to its security holders in exchange for its own securities will not qualify under section 355 where carried out for purposes not germane to the business of the corporation. . . . [T]he application of section 355 [is limited] to certain specified distributions or exchanges with respect to the stock or securities of controlled corporations incident to such readjustment of corporate structures as is required by business exigencies Section 355 contemplates a continuity of the entire business enterprise under modified

lation merely adds examples of qualifying and nonqualifying business purposes without referring to the device test.⁵² The Service's position in Revenue Rulings to date appears to favor the *Wilson* approach,⁵³ notwithstanding the fact that the issue has not been presented squarely.

Arguably, the disagreement over whether the tests exist independently of each other or whether the business purpose showing is subsumed under the device test may have created a distinction without a difference. In practical terms the results in *Wilson* and *Rafferty* are consistent. Moreover, in cases involving close corporations the shareholders and the corporation are so closely interwoven that the business purpose and device tests may seek the same ends. The inherent danger in the *Rafferty* view, however, is that the courts would alter the business purpose doctrine in an effort to make its target coextensive with that of the device test. In so doing, the courts would be narrowing a doctrine created to monitor all phases of a transaction to a doctrine which governs only shareholder motivation.

B. *Predicting the Results: What Constitutes a Valid Business Purpose?*

The two issues of major importance which face the shareholders and planners in close corporation section 355 transactions involve the Service's and courts' definitions of business purpose. Despite

corporate forms and a continuity of interest in all or part of such business enterprise on the part of those persons who, directly or indirectly, were the owners of the enterprise prior to the distribution or exchange. . . .

Treas. Reg. § 1.355-2(c) (1980).

(b) *Purpose*. Under the general rule, upon the exchange of property, gain or loss must be accounted for if the new property differs in a material particular, either in kind or in extent, from the old property. The purpose of the reorganization provisions of the Code is to except from the general rule certain specifically described exchanges incident to such readjustments of corporate structures Requisite to a reorganization under the Code are a continuity of the business enterprise under the modified corporate form, and (except as provided in section 368(a) (1) (D)) a continuity of interest therein on the part of those persons who, directly or indirectly, were the owners of the enterprise prior to the reorganization.

Treas. Reg. § 1.368-1(b) (1980).

52. For the full text of the proposed regulation § 1.355-2(b), see App. II.

53. See, e.g., Rev. Rul. 59-197, 1959-1 C.B. 77.

its dramatic origin in *Gregory*,⁵⁴ the business purpose doctrine has engendered confusion in some areas. Indeed, in some cases, it has produced little more than an amalgamation of case-by-case advice. As a consequence, shareholders and planners may find themselves unable to predict accurately whether a certain fact pattern will qualify for preferred treatment under section 355.⁵⁵

A review of the administrative and judicial decisions does disclose a pattern of which taxpayers and planners should be aware. Once the taxpayer asserts a business purpose, the Service scrutinizes the transaction to determine whether the purpose is that of a shareholder or the corporation. Although some courts have approved both, the Service has not acquiesced in the former. Secondly, the Service scrutinizes the transaction for its factual support of a business purpose for the division. The final scrutiny is of the business purpose for the distribution of the stock. Of these three steps, the second presents the least difficulties, while the third presents the most.

1. Corporate Versus Shareholder Purpose

The first business purpose obstacle facing a close corporation shareholder or planner who seeks section 355 preferred status involves a determination of whether the alleged motivation for the division must be a corporate purpose or whether it may be solely a shareholder purpose. The courts and the Service have differed strongly on this point.

The Second Circuit in *Parshelsky's Estate v. Commissioner*⁵⁶ faced this issue squarely, holding that a shareholder's business reasons may suffice for section 355 purposes. There Parshelsky, the sole shareholder of a lumber and millwork business, caused the corporation to spin-off real estate and to distribute all of the new stock to him.⁵⁷ He alleged as the business purposes for the division and the distribution of new stock three reasons tied only to the corporation and one tied only to himself as the sole shareholder.⁵⁸

54. See notes 6-11 *supra* and accompanying text.

55. For discussion on this point, see notes 112-30 *infra* and accompanying text.

56. 303 F.2d 14 (2d Cir. 1962).

57. *Id.* at 15-16.

58. *Id.* at 16-17.

As his shareholder purpose, he alleged that he wanted to devise the real estate operations and remaining business separately.⁵⁹ The Tax Court held that the corporate purposes alleged were insufficient to confer section 355 tax-free status and that a shareholder purpose never could qualify a transaction for such status.⁶⁰ Reversing and remanding for consideration of the validity of the shareholder purpose, the Second Circuit held that a shareholder "personal non-tax-avoidance" purpose could so qualify the transaction.⁶¹ Unfortunately for planners, however, the court did not elucidate by examples of qualifying factual settings.

The Second Circuit noted that the Service⁶² restricts the definition of business purpose to corporate purpose and that while court decisions up to the mid-forties restricted it in similar fashion,⁶³ the judicial trend favors "an evaluation of all the non-tax-avoidance motives of both the corporations and shareholders involved."⁶⁴ According to the Second Circuit, the earlier judicial view which the Service still embraces emanates from two misconceptions.⁶⁵ First, the view assumes that the "business" purpose concept discussed in *Gregory* denotes an exclusively corporate purpose, even though in a close corporation corporate and shareholder benefit may be virtually indistinguishable.⁶⁶ The second misconception is that Congress' desire to promote economically beneficial corporate readjustments "for legitimate business purposes" precludes judicial and Service approval in cases involving only shareholder purpose.⁶⁷ In reality, the court noted, congressional intent was "to provide for nonrecognition . . . in cases which involve a mere rearrangement of the corporate structure or other shifts in the form of the corporate enterprise which do not involve any distribution of corporate

59. *Id.* at 17, 21.

60. *Id.* at 17. See *Estate of Parshelsky v. Commissioner*, 34 T.C. 946, 951 (1960). The Tax Court's decision was based on 26 U.S.C. § 112(b)(11) (1939), which is analogous to the present I.R.C. § 355.

61. 303 F.2d at 17.

62. *Id.* at 18 (citing Treas. Reg. 118, § 39-112(g)-2(g)).

63. *Id.* at 18 n.8.

64. 303 F.2d at 18.

65. *Id.*

66. *Id.* at 18-19.

67. *Id.* at 19.

assets to shareholders.”⁶⁸ Without more, the Second Circuit opined, one cannot reasonably infer that Congress intended to restrict business purpose to corporate rather than shareholder purpose.

Taking a more moderate approach, the First Circuit stated in *Rafferty v. Commissioner*⁶⁹ that the distinction between qualifying and non-qualifying business purposes lies not in whether the motivation was that of the shareholder or the corporation, but whether the reason was “germane to the continuance of the corporate business.”⁷⁰ The First Circuit cautioned that it would not adopt what it considered the *Parshelsky* court’s suggested wholesale approval of all shareholder investment purposes.⁷¹ Instead, it would limit each case to its facts.⁷² In so doing, however, the *Rafferty* court moved no closer to a clear guideline on which close corporation shareholders and planners could rely when developing a section 355 transaction plan. In view of this weakness, the Service’s view takes on greater strength.

The Service’s position consistently has been that a shareholder purpose is an insufficient basis for tax-free treatment under section 355. The current regulations require purposes which are “germane to the business of” the corporation and engendered by “business exigencies.”⁷³ In an obvious attempt to tighten this language, the proposed regulations expressly preclude preferred treatment in shareholder purpose cases unless the shareholder purpose is “so nearly coextensive with a corporate business purpose as to preclude any distinction between them.”⁷⁴

Two significant illustrations of the Service’s view are Revenue Ruling 69-460⁷⁵ and Revenue Ruling 75-337.⁷⁶ In Revenue Ruling 69-460 the Service set forth three examples of corporate divisions

68. *Id.* (citing H.R. REP. No. 1337, 83d Cong., 2d Sess. 34 (1954)). *Accord*, S. REP. No. 1662, 83d Cong., 2d Sess. 42 (1954).

69. 452 F.2d at 770.

70. *Id.* (quoting *Lewis v. Commissioner*, 176 F.2d 646, 647 (1st Cir. 1949)).

71. 452 F.2d at 770.

72. *Id.*

73. Treas. Reg. § 1.355-2(c) (1980). *See also* Treas. Reg. § 1.368-1(b) (1980).

74. Prop. Treas. Reg. § 1.355-2(b)(1) (1980).

75. 1969-2 C.B. 51.

76. 1975-2 C.B. 124.

and attendant stock distributions.⁷⁷ In answer to the business purpose questions raised by each example, the Service emphasized the requirement of a corporate purpose.⁷⁸ Its unmistakable position was that approved purposes emanate solely from "reasons germane to corporate business problems and necessary for the future conduct of the business."⁷⁹

In Revenue Ruling 75-337, however, the Service modified its position, sanctioning a shareholder purpose which was fully coextensive with a corporate purpose. There, the manager and fifty-three percent shareholder of a franchised automobile dealership caused the corporation to distribute the stock of a wholly-owned subsidiary to two inactive shareholders in exchange for their dealership shares.⁸⁰ The alleged corporate purpose was to ensure continuation of the franchise which required either a group of shareholders each of which was an active shareholder or a majority shareholder.⁸¹ The obvious shareholder purpose was to transmit profitable business operations by devise to the majority shareholder's five daughters.⁸² Since this purpose was coextensive with a valid corporate purpose, the Service approved the transaction.⁸³ It did so, however, solely on corporate purpose grounds.

In developing a section 355 transaction plan, the close corporation shareholder or planner should be familiar with the Second Circuit's reasoning in *Parshelsky*. In developing an evidentiary background, however, a shareholder or planner must be aware that the only safe route is one in which a corporate business purpose is either the singular or the dominant alleged motivation for the division and distribution.

2. Approved Business Purposes

Once the close corporation shareholder or planner is satisfied that the alleged motivation for the division and distribution is

77. 1969-2 C.B. at 52.

78. *Id.*

79. *Id.*

80. 1975-2 C.B. 124.

81. *Id.*

82. *Id.* at 125.

83. See Prop. Treas. Reg. § 1.355-2(b)(1) (1980).

fully coextensive with or is solely a corporate purpose, a determination must be made as to whether the purpose can qualify as a valid business purpose. Throughout this analysis the planner must be aware of two factors, which, if ignored, may preclude tax-free treatment under section 355. The first factor is that the decisions on business purpose validity questions tend to fall into the categories of voluntarily or involuntarily motivated divisions and distributions. While involuntarily motivated transactions gain approval virtually without question, those which are voluntarily motivated attract official scrutiny. The second factor is that the alleged business purposes for the transaction must support both the corporate division and the subsequent distribution of stock to its shareholders.⁸⁴ Although this concept constitutes the core of section 355, it equally constitutes the most elusive concept because of the Service's tendency to define it through facile examples.⁸⁵

Of all the possible business purposes behind a section 355 transaction, compliance with antitrust laws or decrees is the one purpose which will gain approval without invoking official scrutiny. Both Congress⁸⁶ and the Treasury Department⁸⁷ have illustrated the valid business purpose concept with this example. In such a situation the corporation involuntarily segregates one business operation from the others and divests itself of all or part of the stock pursuant to official requirements.

The Service, apparently considering involuntariness central to the issue, has extended this category of approval to include compliance with other federal regulatory provisions. In Revenue Ruling 75-321⁸⁸ the Service approved a transaction in which a corporation engaged in several areas of business divested itself pursuant to federal banking regulations of all but five percent ownership in a wholly owned subsidiary. In this ruling, the narrow point of which went to the issue of whether a valid business purpose underlay the stock distribution, the Service also made clear its favorable dispo-

84. For a general discussion of business purpose supporting both the division and distribution, see notes 112-30 *infra* and accompanying text.

85. *Id.*

86. S. REP. NO. 1622, 83d Cong., 2d Sess. 167 (1954).

87. Prop. Treas. Reg. § 1.355-2(b)(2), ex. 1. See App. II.

88. 1975-2 C.B. 123.

sition toward involuntary divestiture stemming from federal regulations. Extending this principle, the Service also has approved transactions undertaken to prevent the expropriation of assets contained in foreign subsidiaries.⁸⁹ Further extension of this category may include those segregations which are required by state and local law.⁹⁰

Outside of this involuntariness category, however, lies a spectrum of business purposes with which a close corporation shareholder or planner must be thoroughly familiar in order to predict successfully the likelihood of favorable section 355 treatment. While each case turns on its peculiar facts, five discernible patterns appear among voluntary transaction cases. These patterns include reasonable business responses to pressures outside of the corporation, management and personnel friction reduction measures, responses to shareholder pressure, transactions to enable a subsidiary to engage in a reorganization, and segregation of a risky business operation to insulate a stable operation.

a. Reasonable Business Responses to External Pressures

The first pattern, reasonable business responses to external pressures, consistently has evoked official approval. In Revenue Ruling 77-22⁹¹ the Service approved tax-free treatment for a parent corporation's distribution of subsidiary stock to the parent's shareholder where the business purpose was to maintain their necessary flow of business capital from a local bank. When the bank conditioned the continuation of former borrowing limits upon the complete financial segregation of these operations, the parent responded with a distribution which the Service denominated "germane to the business of the corporation."⁹² Similarly, in Revenue Ruling 76-187⁹³ the Service upheld as a valid business purpose a parent corporation's establishment of a new corporation to which the parent subsequently distributed all of the stock of a subsidiary to ef-

89. Rev. Rul. 78-383, 1978-2 C.B. 142.

90. B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS § 13.09 (4th ed. 1980).

91. 1977-1 C.B. 91.

92. *Id.*

93. 1976-1 C.B. 97. See also Prop. Treas. Reg. § 1.355-2(b)(1). See App. II.

fect "a substantial reduction in the amount of state and local taxes." Additionally, in Revenue Ruling 75-337⁹⁴ the Service allowed tax-free status to a transaction to remove inactive shareholders and thereby ensure compliance with the franchise agreement.

The final component to the pattern of reasonable responses to external pressures is comprised of customer objections to an existing integration of operations. The Service in Revenue Rulings 59-197⁹⁵ and 59-450⁹⁶ clearly has sanctioned section 355 transactions where customers strongly object to one corporation's operation of wholesale distribution to them while engaging in the retail market in direct competition with them. In addition, the Tax Court in *Lester v. Commissioner*⁹⁷ approved the spin-off to separate an automobile parts supply warehousing business from a retail and service station parts business. The approved business reasons were area warehousing operation customers' objections over having to compete with the same company at the retail level and a growing concern that the dual operations could constitute a fair trade practices violation.⁹⁸

Although each of these cases turns on its peculiar facts, the close corporation shareholders or planners should be able to rely on the principle that, where external pressures are such that a reasonable businessman would choose no solution other than a division and distribution of shares, the valid business purpose requirement is satisfied.

b. Business Decisions Made to Reduce Employee Discontent

The second pattern of valid purposes within the involuntary segregation and distribution cases involves business decisions made to reduce potentially explosive employee discontent. The close corporation planner or shareholder should be aware that section 355

94. 1975-2 C.B. 124. For discussion of the facts in this case see notes 76-83 *supra* and accompanying text.

95. 1959-1 C.B. 77 (customer objection to brokerage of products similar to those it manufactures).

96. 1959-2 C.B. 201 (split-up of corporation containing printing business and typesetting and electrotyping business where customers of former in direct competition with latter).

97. 40 T.C. 947 (1963).

98. *Id.* at 949.

preferred status under this pattern may require more extensive fact gathering.

In *Boettger v. Commissioner*,⁹⁹ the Tax Court approved a section 355 transaction to squelch one management faction's severe dissatisfaction with another faction's performance. In *Olson v. Commissioner*¹⁰⁰ the Tax Court approved the segregation of two department stores into separate corporations "to contain [the severe labor] difficulties . . . and to avoid to the extent possible a spread of union organizing attempt[s]."¹⁰¹ Similarly, the Tax Court in *Badanés v. Commissioner*,¹⁰² approved a split-up where the two owners, who functioned also as management, demonstrated that they "could no longer agree between themselves as to the proper means for advancing their common business interests."¹⁰³ Following this pattern, the Service consistently has approved split-ups where owners who act as management cannot coordinate their ideas regarding policy.¹⁰⁴ In planning a section 355 transaction on this basis, the close corporation shareholder or planner should note that the focal point in these decisions appears to be a level of discord capable of seriously disrupting normal business operations.

This pattern also consists of those cases in which the corporation precipitates a section 355 transaction to provide dissatisfied management with increased responsibility or with a share of the corporate ownership. In Revenue Ruling 56-451,¹⁰⁵ the Service condoned a separation to elevate management and concomitantly to expand the business operations. Similarly, in Revenue Ruling 59-197,¹⁰⁶ it allowed tax-free treatment to a key employee who demanded an opportunity to buy into the business. Although these rulings do not emphasize the existence of discord which causes the demands, close corporation shareholders or planners who intend to utilize this avenue for tax-free status would be foolhardy in failing to

99. 51 T.C. 324 (1968) (§ 355 status denied on other grounds pursuant to five-year rule).

100. 48 T.C. 855 (1967).

101. *Id.* at 868.

102. 39 T.C. 410 (1962).

103. *Id.* at 415. *See also* Prop. Treas. Reg. § 1.355-2(b)(2), ex. 2. *See* App. II.

104. *See, e.g.*, Rev. Rul. 73-237, 1973-1 C.B. 185; Rev. Rul. 72-320, 1972-1 C.B. 270; Rev. Rul. 56-655, 1956-2 C.B. 214.

105. 1956-2 C.B. 208.

106. 1959-1 C.B. 77.

gather such evidence.

c. Reasonable Business Responses to Shareholder Pressure

The third pattern, comprised of reasonable business responses to shareholder pressure, may provide the close corporation shareholder or planner stable guidance in formulating a successful section 355 transaction as do the management cases. Two major revenue rulings demonstrate that the Service's position on shareholder pressure is virtually identical to its position on management discord. Considering the interwoven roles of management and equity holder in most close corporations, this position appears sound.

Revenue Ruling 56-117¹⁰⁷ resulted from a division and distribution after shareholder dissatisfaction with management's performance and operational policies had become "so pronounced that the shareholders concluded that they could not continue the united ownership" of the corporation.¹⁰⁸ Although less tumultuous, the facts behind Revenue Ruling 56-344¹⁰⁹ qualified the stockholders for tax-free treatment. There, the corporation, which handled and marketed turkeys, opened a branch to handle chickens also.¹¹⁰ Subsequent increases in competition led to shareholder division over whether to discontinue branch operations. For this business reason, the corporation spun-off the branch operation and received the Service's approval.¹¹¹ The ruling is peculiar in that the Service did not discuss the level of shareholder discord. Although one possible conclusion is that proof of severe disharmony is unnecessary, Revenue Ruling 56-117 and the analogous rulings concerning management dissatisfaction militate against so facile a resolution. Consequently, close corporation stockholders or planners who intend to employ this aspect of the business purpose concept should be prepared to make the stronger showing of management or shareholder discord which disrupts normal operations.

107. 1956-1 C.B. 180.

108. *Id.* at 181.

109. 1956-2 C.B. 195.

110. *Id.* at 196.

111. *Id.*

d. Segregation of a Business to Facilitate Reorganization

The fourth pattern which arises among voluntary division and distribution cases involves the segregation of a business so as to facilitate participation in a subsequent reorganization. Two types of cases arise under this pattern. In the first type, division and distribution occur in related transactions. In the second type, however, distribution is unrelated to the division. Curiously, the Service's position on these cases appears to be to grant preferred section 355 status, even though the subsequent reorganization easily could be arranged as part of a pretext for a bail out.

*Commissioner v. Morris Trust*¹¹² illustrates the first type of case, in which division and distribution occur in related transactions. American Commercial Bank, which operated an insurance department in addition to its banking divisions, negotiated a merger with Security National Bank of Greensboro, North Carolina.¹¹³ To avoid a violation of national banking laws, American spun-off its insurance department, distributing the new stock to its shareholders before attempting the merger.¹¹⁴ The Fourth Circuit, in finding that national banking law requirements supported both the division and the distribution, held that the distribution was tax-free under section 355.¹¹⁵

Revenue Ruling 76-527¹¹⁶ illustrates the second type of case in which the distribution is unrelated to the division. There, the Service allowed tax-free treatment to a parent corporation engaged in the construction materials business which distributed all of its stock in its television broadcasting subsidiary so that an unrelated broadcasting company would agree to acquisition by the subsidiary. In finding a valid business purpose, the Service determined that "to allow (the subsidiary) to use its own stock in the acquisition of the assets of (the unrelated corporation) it was necessary to separate the television broadcasting business of (the subsidiary) from the dominant reputation of the construction materials pro-

112. 367 F.2d 794 (4th Cir. 1966).

113. *Id.* at 795.

114. *Id.* at 795-96.

115. *Id.* at 799, 802.

116. 1976-2 C.B. 103.

duction business of (the parent) in the investment community."¹¹⁷

Employing the same theme in Revenue Ruling 72-530,¹¹⁸ the Service opened the door to severe abuse through the business purpose doctrine. There, the parent corporation conducted a warehousing business and the subsidiary was engaged in the transportation business. An unrelated corporation, which conducted warehousing operations, entered negotiations to merge with the parent. Since the merger would strengthen the parent's competitive position in the market, the parent acquiesced in the unrelated corporation shareholders' demand that the parent promise them a post-merger one-half equity interest in the parent. To accomplish this purpose, the parent distributed its subsidiary stock to the parent shareholders. The Service found the distribution tax-free, noting that the only alternative, placing the parent and the unrelated corporation in a newly formed corporation, would have subjected the new corporation to "severe state licensing requirements."¹¹⁹

Close corporation shareholders and planners should become adept at developing the opportunities these rulings present. A parent corporation which is able to negotiate a transaction like that in Revenue Rulings 72-530 or 76-527 may allege that it wants to limit its shareholders' post-merger interest in the unrelated corporation. Conversely, the parent may be able to build an evidentiary background to demonstrate that the unrelated corporation prefers this arrangement or one similar to that involved in Revenue Ruling 76-527. Using such a purpose as background, the parent could distribute its subsidiary stock, thereby effectively bailing out subsidiary earnings and profits with full Service approval of a business purpose.¹²⁰

e. Segregation of a Risky Business from a Stable Business

The Service's position on this point appears even more anomalous in view of its concentration of the fifth case pattern, the segregation of a risky business from a stable business. Although the Ser-

117. *Id.*

118. 1972-2 C.B. 212.

119. *Id.*

120. Although such a transaction arguably could raise the device test issue, one might infer that the Service's approval of like transactions indicates that it is not a device.

vice has invested an inordinate amount of effort in defining when it will deny tax-free status to a distribution it considers unnecessary in accomplishing the alleged business purpose, it in fact has succeeded only in creating unwarranted uncertainty.

A comparison of examples from revenue rulings and a proposed regulation illustrates yet another unsatisfactory approach to section 355 transactions. In the proposed regulation example,¹²¹ a corporation attempts to shield its candy business from the vicissitudes of the novelty toy business by spinning off the toy business. The Service would disallow favored tax treatment here, since the protective purpose is accomplished as soon as the corporation has transferred the toy business to a separate corporation.¹²² Were the corporation simply to segregate the candy business and hold its newly issued stock, toy business creditors easily could reach the candy business. In such a case, then, the alleged valid business purpose underlies both the division and the distribution, as is required.¹²³

Revenue Ruling 56-554¹²⁴ supports this view. There, a bank wholly owned a subsidiary, which held land and other assets primarily for leasing. To segregate the speculative land operations from the stable operations, the bank directors transferred all of the subsidiary's assets except the land to a new corporation and distributed the newly issued stock to its shareholders. Sanctioning tax-free treatment, the Service found as follows:

The continued indirect ownership of the land had caused the directors of the bank much concern because of the highly speculative value of the land. They did not consider it desirable to continue to operate a wholly-owned subsidiary which owned and managed real estate. In addition, the uncertain value of the subsidiary's stock had hindered the expansion of the bank. From time to time, the bank's directors had considered increasing the capital stock of the bank by issuing and selling additional stock. Also, the uncertain value of the subsidiary corporation's stock presented a problem with respect to

121. Prop. Treas. Reg. § 1.355-2(b)(2), ex. 3. See App. II.

122. *Id.*

123. See, e.g., *Commissioner v. Wilson*, 353 F.2d 184 (9th Cir. 1965).

124. 1956-2 C.B. 198.

the expansion of the bank through mergers with other banks.¹²⁵

Thus, the Service appears to favor tax-free treatment pursuant to the segregation of a risky business from a stable business where the stable business is transferred to a new corporation. From such cases, the obvious corollary is that a distribution may be taxable if the transaction accomplishes the business purpose without requiring that the shareholders directly own both corporations. The difficulty in close corporation shareholders' and planners' extension of this principle beyond those cases which present exactly these facts, however, is that the Service has not consistently applied the corollary to different fact patterns.

Revenue Ruling 69-460¹²⁶ demonstrates the difficulty. In an attempt to pinpoint when a valid business purpose supported both the division and distribution so as to accord tax-free status, the Service set out three examples. The first involved the split-up of a corporation in which the two shareholders, who also functioned as management, have become so antagonistic toward each other that the usual business operations suffer. Obviously, in such a case, the business purpose supports both the division and distribution.

The third example in Revenue Ruling 69-460 sets out an equally simple case. One shareholder owns the parent corporation, which owns eighty-five percent of the subsidiary. The manager of the subsidiary demands the right to purchase a share in the subsidiary. To accomplish a valid business purpose,¹²⁷ the sole shareholder causes the parent to distribute the subsidiary stock to him, following which he sells some of the stock to the subsidiary's manager. As in the first example, the distribution is wholly unrelated to the accomplishment of the business purpose.¹²⁸

The planning difficulty, however, arises in cases such as the second example in Revenue Ruling 69-460. There, the parent owns all

125. *Id.*

126. 1969-2 C.B. 51. For a discussion of the Service's position in cases in which management demands an increased share of the business, see notes 75-79 *supra* and accompanying text.

127. For discussion of management demands, see notes 99-106 *supra* and accompanying text.

128. 1969-2 C.B. at 52.

of the stock of the subsidiary. As a needed incentive, the parent agrees to sell management part of its stock. To prevent management from obtaining any interest in the subsidiary, however, the parent distributes the subsidiary stock to the parent's shareholders before selling the parent stock.¹²⁹ The Service approves the need for the distribution on these facts,¹³⁰ despite the fact that there are alternative, if cumbersome, ways of accomplishing the business purpose without a distribution. Following the first and third examples in this ruling, one could infer that official sanction turns on whether or not the purpose can be achieved without a distribution. If read together, the proposed regulation and Revenue Ruling 56-554 suggest, however, that tax-free status turns only upon the method actually chosen. Such a reading is unlikely in view of the obvious abuse it would engender. Since it is unsettled, however, the close corporation shareholder and planner must approach a factually similar transaction with extreme caution.

IV. CONCLUSION

Congress' inartful attempt under the 1954 Code to preclude tax-free treatment for bail out transactions under section 355 has fostered a significant degree of confusion. The unmistakable congressional intent behind the corporate division and distribution enactments since 1918 has been to encourage economic efficiency and growth. Nevertheless, Congress' repeated decisions to leave the definition of valid business purposes to the courts and the Service has stimulated inefficiency through hesitancy and uncertainty.

In devising a section 355 transaction, the close corporation shareholder or planner should expect to evoke certain standard official responses and must be prepared to support the transaction from both device and business purpose standpoints. The shareholder or planner must be aware of judicial and Service disagreement over whether a shareholder purpose is a sufficient motivation and be prepared to argue a corporate purpose and be familiar with the fact patterns which have won approval as supported by a valid business purpose and attempt to conform the facts to them as nearly as is possible.

129. *Id.*

130. *Id.*

What the close corporation planner cannot expect, however, is to predict with any certainty whether the transaction will achieve tax-free status if the purpose could have been accomplished without a distribution of the stock. Lacking guidance from Congress and consistent decisions from the Service, the planner who faces non-classical facts must risk a denial of tax-free treatment or forego an economically efficient corporate division. In either case, the price is indefensibly high for both the economy and the business community.

APPENDIX I

SEC. 355. DISTRIBUTION OF STOCK AND SECURITIES OF A CONTROLLED CORPORATION

(a) EFFECT ON DISTRIBUTEES. —

(1) GENERAL RULE. —If—

(A) a corporation (referred to in this section as the “distributing corporation”)—

- (i) distributes to a shareholder, with respect to its stock, or
- (ii) distributes to a security holder, in exchange for its securities, solely stock or securities of a corporation (referred to in this section as “controlled corporation”) which it controls immediately before the distribution,

(B) the transaction was not used principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both (but the mere fact that subsequent to the distribution stock or securities in one or more of such corporations are sold or exchanged by all or some of the distributees (other than pursuant to an arrangement negotiated or agreed upon prior to such distribution) shall not be construed to mean that the transaction was used principally as such a device),

(C) the requirements of subsection (b) (relating to active businesses) are satisfied, and

(D) as part of the distribution, the distributing corporation distributes—

- (i) all of the stock and securities in the controlled corporation held by it immediately before the distribution, or
- (ii) an amount of stock in the controlled corporation constituting control within the meaning of section 368(c), and it is established to the satisfaction of the Secretary that the retention by the distributing corporation of stock (or stock and securities) in the controlled corporation was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax,

then no gain or loss shall be recognized to (and no amount shall be includible in the income of) such shareholder or security holder on the receipt of such stock or securities.

(2) NON PRO RATA DISTRIBUTIONS, ETC. — Paragraph (1) shall be applied without regard to the following:

- (A) whether or not the distribution is pro rata with respect to all of the shareholders of the distributing corporation,
- (B) whether or not the shareholder surrenders stock in the distributing corporation, and
- (C) whether or not the distribution is in pursuance of a plan of reorganization (within the meaning of section 368(a)(1)(D)).

(3) LIMITATIONS.—

(A) **EXCESS PRINCIPAL AMOUNT** — Paragraph (1) shall not apply if—

- (i) the principal amount of the securities in the controlled corporation which are received exceeds the principal amount of the securities which are surrendered in connection with such distribution, or
- (ii) securities in the controlled corporation are received and no securities are surrendered in connection with such distribution.

(B) **STOCK ACQUIRED IN TAXABLE TRANSACTIONS WITHIN 5 YEARS TREATED AS BOOT** — For purposes of this section (other than paragraph (1)(D) of this subsection) and so much of section 356 as relates to this section, stock of a controlled corporation acquired by the distributing corporation by reason of any transaction—

- (i) which occurs within 5 years of the distribution of such stock, and
- (ii) in which gain or loss was recognized in whole or in part, shall not be treated as stock of such controlled corporation, but as other property.

(C) **PROPERTY ATTRIBUTABLE TO ACCRUED INTEREST**—Neither paragraph (1) nor so much of section 356 as relates to paragraph (1) shall apply to the extent that any stock, securities, or other property received is attributable to interest which has accrued on securities on or after the beginning of the holder's holding period.

(4) CROSS REFERENCES.—

(A) For treatment of the exchange if any property is received which is not permitted to be received under this subsection (including an excess principal amount of securities received over securities surrendered, but not including property to

which paragraph (3)(c) applies) see section 356.

(B) For treatment of accrued interest in the case of an exchange described in paragraph (3)(c), see section 61.

(b) REQUIREMENTS AS TO ACTIVE BUSINESS.—

(1) IN GENERAL.—Subsection (a) shall apply only if either—

(A) the distributing corporation, and the controlled corporation (or, if stock of more than one controlled corporation is distributed, each of such corporations), is engaged immediately after the distribution in the active conduct of a trade or business, or

(B) immediately before the distribution, the distributing corporation had no assets other than stock or securities in the controlled corporations and each of the controlled corporations is engaged immediately after the distribution in the active conduct of a trade or business.

(2) DEFINITION.—For purposes of paragraph (1), a corporation shall be treated as engaged in the active conduct of a trade or business if and only if—

(A) it is engaged in the active conduct of a trade or business, or substantially all of its assets consist of stock and securities of a corporation controlled by it (immediately after the distribution) which is so engaged,

(B) such trade or business has been actively conducted throughout the 5-year period ending on the date of the distribution,

(C) such trade or business was not acquired within the period described in subparagraph (B) in a transaction in which gain or loss was recognized in whole or in part, and

(D) control of a corporation which (at the time of acquisition of control) was conducting such trade or business—

(i) was not acquired directly (or through one or more corporations) by another corporation within the period described in subparagraph (B), or

(ii) was so acquired by another corporation within such period, but such control was so acquired only by reason of transactions in which gain or loss was not recognized in whole or in part, or only by reason of such transactions combined with acquisitions before the beginning of such period.

APPENDIX II

Proposed Regulation § 1.355-2(b) reads as follows:

(b) *Business purpose and continuity of interest.* (1) *In general.* A distribution by a corporation of stock or securities of a controlled corporation to its shareholders with respect to its own stock or to its security holders in exchange for its own securities will qualify under section 355 only if carried out for real and substantial nontax reasons germane to the business of the corporations. The principal reason for this requirement is to provide nonrecognition treatment only to those distributions or exchanges of stock or securities of the controlled corporation which are incident to such readjustment of corporate structures as is required by business exigencies and which effect only a readjustment of continuing interests in property under modified corporate forms. Depending upon the facts of a particular case, a shareholder purpose for a transaction may be so nearly coextensive with a corporate business purpose as to preclude any distinction between them. In such a case, the transaction is carried out for purposes germane to the business of the corporations. On the other hand, if a transaction is motivated solely by the personal reasons of a shareholder, for example, if a transaction is undertaken solely for the purpose of fulfilling the personal planning purposes of a shareholder, the distribution will not qualify under section 355 since it is not carried out for purposes germane to the business of the corporation. Section 355 contemplates a continuity of interest in all or part of the business enterprise prior to the distribution or exchange. For rules with respect to the requirement of a business purpose for a transfer of assets to a controlled corporation in connection with a reorganization described in section 368(a)(1)(D), see § 1.368-1(b).

(2) *Examples.* The provisions of paragraph (b) (1) of this section may be illustrated by the following examples:

Example (1). Corporation P is engaged in the production, transportation, and refining of petroleum products. In 1962, P acquired all of the properties of corporation S, which was also engaged in the production, transportation, and refining of petroleum products. In 1968, as a result of anti-trust litigation, P was ordered to divest itself of all properties acquired from

S. P proposes to transfer assets acquired from S to a new corporation and to distribute the stock of such new corporation to its shareholders. In view of the divestiture order, the distribution of the stock of the new corporation to the shareholders of P will be considered to have been carried out for a real and substantial nontax reason germane to the business of the corporations.

Example (2). Corporation R owns and operates two men's retail clothing stores. The outstanding stock of R is owned equally by two brothers, A and B, and F, their father, who does not take an active part in the retail clothing business. A and B no longer can agree on major decisions affecting the operation of the corporation. Corporation R proposes to transfer one store to a new corporation and distribute 66.7 percent of the stock of such new corporation to one brother in exchange for all of his R stock. The other 33.3 percent of the stock of such new corporation will be exchanged for one-half of F's stock of corporation R. In view of the disagreement between managing shareholders, the distribution of the stock of the new corporation will be considered to have been carried out for a real and substantial nontax reason germane to the business of the corporations.

Example (3). Corporation T is engaged in the manufacture and sale of children's novelty toys. It also manufactures and sells candy and candy products. The shareholders wish to separate the candy business from the risks and vicissitudes of the novelty toy business. It is proposed that the assets and activities associated with the toy business be transferred to a new corporation, the stock of which would then be distributed to T's shareholders. The purpose of protecting the candy business from the risks of the novelty toy business, which is fulfilled when the novelty toy assets and activities are transferred to the new corporation, does not satisfy the requirement there be a substantial nontax reason, germane to the business of the corporation, for the distribution of the stock of the new corporation to the shareholders.

Example (4). The facts are the same as in example (3) except that T also requires outside financing in order to substantially expand its candy business. As a condition of the

loan, in order to prevent the potential diversion of funds to the toy business, the lender requires the separation of the candy business and the novelty toy business and the distribution of the stock of the novelty toy corporation to the shareholders. The lender's requirements are based upon customary business practice. In this case, the distribution of the stock of the novelty toy corporation to the shareholders will be considered to have been carried out for a real and substantial nontax reason germane to the business of the corporations.

