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BUSINESS PURPOSE AND THE SUBCHAPTER S INSPIRED REORGANIZATION

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THE potentially advantageous treatment under subchapter S permitting certain corporations to elect to pass through corporate income and losses to the shareholder, and to avoid the corporate tax, is the result of two different pressures. Tax collector and taxpayer have long been at odds over the purported double taxation of corporate earnings. The limited disregard of the corporate entity as a taxpaying entity then becomes another phase[1] in the cycle begun in 1936, when dividends were subjected to full taxation at the shareholder level. The more recent concern for small business and the small business man has resulted in the several tax concessions enacted into law by Congress in 1958.[2] The dual pressure produced the limited relief from double taxation of corporate earnings provided for the "small business corporation."

The tax concessions granted by subchapter S might be attractive to corporations which are now precluded from electing that treatment. This suggests an examination of corporate adjustments enabling effective election.

Recapitalization. The "small" in "small business corporation" refers not to size of the business in either the physical or fiscal sense, but rather to the size of the owner group and to the complexity of the way in which they have arranged their ownership.[3] Of particular significance is the requirement that the corporation, to be eligible, have only one class of stock.[4] This limitation may create problems since quite often the closely held corporation does not have so simple a capital structure.

Prior to the enactment of subchapter S, a major theme in planning the financial structure of a closely held corporation was the utilization of the premium placed on debt financing. Interest paid on shareholder-owned debt passed through corporate income by qualifying the corporation for a deduction. Non-tax pressures,

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1 In 1954, this double taxation was eased by the enactment of I.R.C., §34, granting a 4% dividends received credit, and of I.R.C., §116, granting a $50 dividend exclusion.

2 See Wright and Libin, "Impact of Recent Tax Stimulants on Modest Enterprises," 57 MICH. L. REV. 1131 (1959). See also note, 72 HARV. L. REV. 710 (1959).

3 A "small business corporation" can have no more than 10 shareholders. I.R.C., §1371 (a) (1). Nor can a trust be among the owners. I.R.C., §1371 (a) (2).

4 I.R.C., §1371 (a) (4).

from third-party creditors, often caused the corporation to subordinate the shareholder debt. Business considerations also at times required that interest payments be conditioned upon profits, or that a potentially harassing maturity date remain unmentioned. These special characteristics of shareholder-owned debt made the corporate interest deduction somewhat vulnerable.[5] They might also disqualify an election made by a corporation which apparently meets the one class of stock requirement.

The provisions of debt which are incompatible with true debt might support description of the shareholder-creditor's interest as equity. The qualification of the corporation under section 1371-(a) (4) would then depend upon whether the disguised equity was considered a *second* class of stock. The hybridness of the debt suggests that the residual characteristics of debt might negate full equation with the one class of outstanding stock,[6] and rather that it would be considered a preferred stock.[7]

The corporation in this predicament should consider the feasibility of eliminating the potentially disqualifying debt by way of recapitalization.[8] This might also be desirable where more than one class of true stock is outstanding.

Corporate Separation. Another requirement of subchapter S treatment, expressed in the form of a terminating event, is that the electing corporation not have more than 20 percent of its gross receipts from royalties, rents, dividends, interest, annuities and gains on the sale or exchange of stock or securities.[9] This requirement could prevent the owners of a single corporation with diversified income-producing activities from taking advantage of subchapter S. It might be advantageous tax-wise to effect a corporate division, isolating the activities with qualifying income into one

[5] See, generally, Weyher and Weithorn, "Capital Structure of New Corporations," SIXTEENTH ANNUAL N.Y. UNIV. INST. ON FEDERAL TAXATION 277 (1958); Bittker, "Thin Capitalization: Some Current Questions," 34 TAXES 830 (1956), reprinted with minor modifications, 10 UNIV. FLA. L. REV. 25 (1957).

[6] The regulations adopt the view that "stock which is improperly designated as a debt obligation" shall be considered a separate class of stock. Proposed Treas. Reg. §1.1371-1 (g), 24 FED. REG. 1793 (1959).

[7] See Anthoine, "Federal Tax Legislation of 1958: The Corporate Election and Collapsible Amendment," 58 COL. L. REV. 1146 at 1152 (1958); Manly, "Election Under Subchapter S Can Eliminate Thin-Incorporation Problem," 9 J. of TAXATION 322 at 323, n. 2 (1958).

[8] If the recapitalization can be effected tax-free, it would be preferable to redemption. Even if the cash position of the business justified buying back the stock, or paying off the "debt," the tax impact on the shareholder could be severe. Dividend treatment under I.R.C., §302 might result.

[9] I.R.C., §1372 (e) (5).

corporate shell, and then elect subchapter S treatment for this entity.

Merger. This same tainted income might also prompt a combinative reorganization to qualify for subchapter S treatment. An individual who now has an enterprise doing business under separate corporate shells may find that the 20 percent rental income limitation prevents effective election. For example, an individual who separately incorporated physical facilities and manufacturing enterprise, with the enterprise paying a fair rental for the use of facilities, would not be able to qualify the rental corporation because of section 1372 (e) (5). A merger, which would eliminate the intercorporate rental income, would seem to be the answer.

Selection of reorganization as the preliminary step to subchapter S election would quite likely depend upon whether the corporate adjustment could be made "tax-free."[10] This would require fulfilling the literal criteria of the pertinent statutory provisions;[11] it might require something more. Each of these corporate adjustments could be said to be motivated *solely* by the desire to escape federal taxes which could not otherwise be avoided. Each could be said to be lacking in "business purpose."

The Business Purpose Requirement. Gregory v. Helvering,[12] decided by the Supreme Court in 1935, added to the literal criteria of the statutory sections governing tax-free reorganization the requirement that a reorganization, to be a "reorganization," must have a *business purpose.* Faced with a divisive reorganization in which the taxpayer had caused her wholly-owned corporation to transfer liquid securities to a corporate shell, and then had liquidated the new corporation, thereby obtaining the assets at capital gain rather than dividend rates, the Court declared that no statutory reorganization had taken place. The insulation provided by the non-recognition provisions was not available since that treatment was reserved for the sort of transaction that Congress must have had in mind at the time of enactment—a reorganization of business in response to a felt business need.

This case and its philosophy, verbalized as the business purpose doctrine, became the cornerstone for a Commissioner's weapon which may be encountered whenever a taxpayer approaches

[10] The tax is usually only postponed, since a substituted basis is acquired for the property received in the exchange. I.R.C., §§358 and 362.

[11] I.R.C., Subchapter C, Part Three, Corporate Organizations and Reorganizations.

[12] 293 U.S. 465 (1935).

the line separating legitimate tax avoidance from illegitimate tax evasion. Not only in reorganization, but throughout tax law,[13] the presence of strong tax motivations or the absence of business motivations may cause close scrutiny by the Commissioner and by the courts to see if the transaction is really what it is purported to be. This fairly well describes the reorganization effected to qualify the resulting business form for taxation under subchapter S. Not only is this corporate adjustment prompted by the desire to reduce taxes, but there is no affirmative business reason (other than tax) to support it.

Business purpose is still a requirement[14] for tax-free reorganization, and for corporate division, under the 1954 code, even though the statute incorporates, as codified safeguards, protection against many of the practices formerly questioned on business purpose grounds. It would be appropriate therefore to trace business purpose through its outcroppings in other tax-saving patterns of reorganization in order to evaluate the risk that it poses for the subchapter S inspired reorganization.

In the discussion to follow, it should be kept in mind that the evaluation is limited to the impact of the extra-statutory business purpose test. No attempt has been made to consider the codified statutory safeguards, which of course would also have to be satisfied before the reorganization would qualify for tax-free status.

I. BUSINESS PURPOSE AND RECAPITALIZATION

The Tax Stimulus. The business purpose requirement became a factor in the recapitalization corridor of tax-free reorganization in the early forties, a few years after the *Gregory* decision. Rising tax rates coupled with increasing corporate earnings, both largely due to the mobilization of productive resources immediately prior to the second World War, further stimulated the ever-present desire to minimize the tax costs of doing business. The subjection of dividend income to full taxation by the Revenue Act of 1936 created a situation which made it comparatively expensive

[13] Illustratively, business purpose is a significant factor in a recent series of cases involving the deductibility of interest on large scale borrowings prompted largely by the availability of the interest deduction. See, e.g., Weller v. Commissioner, (3d Cir. 1959) 270 F. (2d) 294; Sonnabend v. Commissioner, (1st Cir. 1959) 267 F. (2d) 319; Goodstein v. Commissioner, (1st Cir. 1959) 267 F. (2d) 127. See also other recent applications of Gregory in Gilbert v. Commissioner, (2d Cir. 1957) 248 F. (2d) 399 and Granite Trust Co. v. United States, (1st Cir. 1956) 238 F. (2d) 670.

[14] The regulations provide that both reorganizations and corporate divisions must be "required by business exigencies." Treas. Reg. §1.368-1(b) (1955) and §1.355-2(c) (1955).

to pay out earnings in the form of dividends. Consequently other methods of extracting income were sought; tax-free recapitalization was a key step in several of these alternatives.

Recapitalization Patterns. One such pattern of recapitalization had as its theme the placing of salable shares of preferred stock in the hands of the stockholders. This made possible a sale of the preferred, with the consequent indirect realization of corporate earnings at capital gains rates, without loss of voting control by the owners. The direct route for achieving this position, a preferred stock dividend, might have been subjected to tax;[15] a recapitalization, with common and preferred issued in return for common, achieved essentially the same result with at least apparent insulation by statutory reorganization. A variation of this pattern had even greater tax-saving potential. By placing debt instruments in the hands of shareholders, the same sell-off situation was created, and in addition the corporation qualified for a deduction for the interest paid on the bonds. Here a direct distribution would certainly have been taxed as a dividend, while recapitalization offered the more favorable "boot" taxation[16] when accompanied by an exchange of stock. A non-pro-rata recapitalization offered the opportunity to by-pass another sort of taxable event. Shareholders were prompted to effect shifts in respective ownership interests without payment of the usual capital gains tax upon sale or exchange of property.[17]

In view of the inroads upon the integrity of the statutory scheme for taxation of corporate distributions and disposition of property, it is not surprising that the Commissioner resorted to argument based upon *Gregory* in an attempt to deny tax-free status to the

[15] During the period 1936 to 1954 stock dividends were subject to tax to the extent that the 16th Amendment permitted. Revenue Act of 1936, §115(f)(1), 49 Stat. 1688. Generally speaking, a stock dividend was taxable if it changed the proportional interest of the shareholder. Koshland v. Helvering, 298 U.S. 441 (1936). But the tax impact of a preferred stock dividend on common, no other issue outstanding, was uncertain until 1943. Then, in Helvering v. Sprouse (Strassburger v. Commissioner), 318 U.S. 604 (1943), it was held to be tax-free.

[16] The striking difference between "boot" taxation and dividend taxation is that the former offers the possibility of tax at capital gain rates. "Boot" taxation is also limited to the *gain* in the exchange. I.R.C., §§356 and 361.

[17] Under the 1954 code tax-free division of a corporate business among the shareholders is expressly permitted. I.R.C., §355(a)(2). Under prior law there were problems. See, e.g., Frank Williamson, 27 T.C. 647 (1957). See also Lyons, "Realignment of Stockholders' Interests in Reorganizations Under Section 112(g)(1)(D)," 9 TAX L. REV. 237 (1954). Business purpose was one barrier. See, e.g., Marjorie Dean, 10 T.C. 19 (1948), where shifting control via recapitalization to active shareholders was considered a business purpose. See also Wolf Envelope Co., 17 T.C. 471 (1951).

shielding recapitalization. The judicial reaction to this argument should serve to indicate more definitively the role which business purpose may play in the matter under consideration: a recapitalization undertaken in order to qualify a corporation for an election to be taxed under subchapter S, which has as its main theme the saving of taxes.

Judicial Reaction. The initial limitation upon tax-free recapitalization imposed by business purpose was more verbal than factual. To insure that the readjustment was one which Congress would have intended to encourage (or at least not hinder)[18] the taxpayer was required to produce a business reason for the change effected. While this did prompt some astute selection of motive for judicial consumption, it did not prevent the use of recapitalization to save taxes.

Initially almost any plausible reason satisfied the business purpose requirement. The creation of marketable shares of preferred to provide a source of funds for the corporation and the shareholder was accepted.[19] The claim that wider holding of the created preferred had resulted in increased consumption of the corporation's products was considered favorably.[20] Watering down the common by a debenture recapitalization, which would enable the shareholders to purchase the stock of any of their number at his death and "assure the continuance of harmonious ownership and control . . . ,"[21] validated another recapitalization. The desire to reduce a preferred stock dividend rate of 6½ percent to a bond interest rate of 6 percent was a proper business purpose in yet another case.[22] There was even substantial judicial acceptance of the position that the obtaining of an interest deduction on bonds distributed in a recapitalization was a qualifying business purpose.[23]

[18] The purpose of the reorganization provisions, as stated by the sponsoring congressional committee, was as follows: "The preceding amendments, if adopted, will, by removing a source of grave uncertainty and by eliminating many technical constructions which are economically unsound, . . . only permit business to go forward with the readjustments required by existing conditions." S. Rep. 275, 67th Cong., 1st sess., pp. 11-12 (1921).

[19] Jacob Fischer, 46 B.T.A. 999 (1942), Commissioner's appeal dismissed (6th Cir. 1943); Bass v. Commissioner, (1st Cir. 1942) 129 F. (2d) 300.

[20] Jacob Fischer, 46 B.T.A. 999 (1942), Commissioner's appeal dismissed (6th Cir. 1943).

[21] Edgar Docherty, 47 B.T.A. 462 at 464 (1942), vacated and remanded per stip. (1st Cir. 1943).

[22] Annis Furs, Inc., 2 T.C. 1096 (1943).

[23] Five judges on the Tax Court dissented in Robert Bazley, 4 T.C. 897 (1945), taking the position that the obtaining of the interest deduction was alone enough to remove the case from Gregory. See 4 T.C. 906. See also the withdrawn opinion in Adam Adams, 4

Business purpose became a more confining limitation to the corporate tax planner in the mid-forties with the emergence of the requirement that a *corporate* purpose be served. A preferred stock recapitalization, undertaken in order to furnish salable preferred to the two shareholders in order that they might pay off debts incurred in buying the stock of a deceased colleague, was denied access to statutory tax-free status.[24] The asserted business purposes of maintaining continuity of control and protecting business processes, made possible by the utilization of non-voting preferred, were rejected by the Tax Court:[25] "The record fails to establish any need in the corporation itself, as distinguished from the petitioners-shareholders, for funds. . . . To pay the shareholders' personal obligations is not one of the transactions contemplated as the purpose of corporate reorganization."

This rationale resulted in the taxation of a bond recapitalization as a distribution in the Tax Court resolution of the *Bazley*[26] litigation. The creation of marketable securities, which would enable shareholders to meet estate taxes and retain control of the corporation, was classified as a non-corporate purpose. The same response was accorded the asserted need to put the shareholders on a par with creditors in the event that a new and risky business should prove unprofitable.[27] The Court of Appeals for the Third Circuit accepted the proposition that shareholder purposes were not enough, then concluded that the result was such in *Bazley* that tax should be exacted "whatever the motives of the Bazleys may have been. . . ."[28]

The Supreme Court, in affirming *Bazley,* almost pointedly avoided the use of the term "business purpose." The Court declined to premise its opinion on that rationale, and instead looked to the result achieved by the reshuffling of corporate paper:[29]

T.C. 1186 (1945), and Judge Kern's dissent in the substituted opinion. 5 T.C. 351 at 361 (1945). See notes 26 and 27 infra for the subsequent judicial history of both these cases. See also Penfield v. Davis, (N.D. Ala. 1952) 105 F. Supp. 292, affd. (5th Cir. 1953) 205 F. (2d) 798, where the tax saving incident to the interest deduction was considered a business purpose (105 F. Supp. at 300).

24 Louis Wellhouse, Jr., 3 T.C. 363 (1944). But there was no tax on the theory that no earnings had been capitalized.

25 Id. at 368.

26 Robert Bazley, 4 T.C. 897, affd. (3d Cir. 1946) 155 F. (2d) 237, affd. 331 U.S. 737 (1947), as amended by 332 U.S. 752 (1947).

27 Adam Adams, 5 T.C. 351 (1945) [superseding report at 4 T.C. 1186 (1945)], affd. (3d Cir. 1946) 155 F. (2d) 246, affd. sub nom. Bazley v. United States, 331 U.S. 737 (1947), as amended by 332 U.S. 752 (1947).

28 Bazley v. Commissioner, (3d Cir. 1946) 155 F. (2d) 237 at 244.

29 Bazley v. Commissioner, 331 U.S. 737 at 742 (1947).

> "[T]he creation of new corporate obligations which are transferred to stockholders in relation to their former holdings, so as to produce, for all practical purposes, the same result as a distribution of cash earnings . . . cannot obtain tax immunity because cast in the form of a recapitalization-reorganization."

Evaluation. The non-use of a business purpose rationale in the *Bazley* opinion, and the coining of a "net effect" test indicated a judicial awareness of the shortcomings of business purpose as a control in recapitalization. While the clearest form of *Gregory*, the protection against the sham and ephemeral transaction, could be said to deny tax-free status to recapitalizations having only a fleeting impact upon capital structure, this was not an effective limitation. The by-passing of tax normally incident to distributions could be achieved by a recapitalization having a lasting effect upon the corporation.[30] The usually attendant insistence upon a "*bona fide* readjustment of the corporation's financial structure"[31] likewise posed little problem.

The requirement of a business reason for the readjustment, even a corporate business reason, likewise failed to reach the problem. A recapitalization might well have a sound business objective, and yet serve as a vehicle for a distribution of what otherwise would be a dividend. While, in the spirit of the reorganization provisions, this might not be an appropriate time to levy a tax upon the appreciation in value of the exchanged securities, there seems to be little justification for insulating what was in effect an accompanying dividend distribution. This is precisely the import of the *Bazley* decision. The net effect of the transaction might negate "reorganization," even if a business purpose for the end result of the corporate adjustment is shown.[32]

30 Bass v. Commissioner, (1st Cir. 1942) 129 F. (2d) 300 illustrates the significance of a "permanent revision of the capital structure." (p. 309) The tax court had found no "business purpose substance" [45 B.T.A. 1117 at 1120 (1941)] in a transaction which involved surrender of a certificate for 600,000 of common for a certificate for 300,000 of common and one for 30,000 shares of preferred. That same day the certificate for the common was replaced by one for 600,000 shares. The court of appeals reversed, finding Gregory satisfied; the recapitalization had lasting effect, since the success of the plan did not require an immediate redemption.

31 Edgar Docherty, 47 B.T.A. 462 at 464 (1942), vacated and remanded per stip. (1st Cir. 1943).

32 Heady v. Commissioner, (7th Cir. 1947) 162 F. (2d) 699, affg. P-H T.C. Mem. Dec. ¶45,261 (1945). Compare the tax court's emphasis upon the motive of the taxpayer, decided prior to Bazley, with the post-Bazley court of appeals' rejection of the taxpayer's reliance upon a business reason for a debenture recapitalization: "We think this analysis wrongly emphasizes the *motive* of the transaction rather than the ultimate effect of it." 162 F. (2d) at 702. See also Carl Ortmayer, 28 T.C. 64 (1957).

"Net effect" as a limitation upon the recapitalization in question can be dismissed almost summarily. An upstream recapitalization which results in the elimination of debt or preferred stock in return for common can hardly be said to result in the equivalent of a dividend,[33] and the courts have refused to apply *Bazley* in other than the shielded distribution situation.[34] Here, rather than a shielded distribution, the corporate investment is even more firmly in solution. Therefore the qualification of the recapitalization depends upon whether the older version of *Gregory* is satisfied.

It might be argued that the simplification of the capital structure effected by the recapitalization, in reducing the outstanding stock to only one class, is a satisfactory corporate purpose. This reason, and a corollary, the simplification of voting rights, has been accepted favorably by at least one court.[35] But the tax-saving motivation obviously gives pause for thought. While credence must be attached to the oft-repeated view that the business purpose doctrine is concerned with the presence of an affirmative business reason, and that the presence of a tax motive is immaterial,[36] the use of business purpose has been in areas where recapitalization has been used to reduce taxes. The judiciary has shown some inclination to disregard an asserted business reason when a tax-saving theme was predominant.[37] But is the tax-saving theme here the sort that should provoke disqualification of the recapitalization?

There are different kinds of tax savings made possible by the statutory opportunity to recapitalize. Using recapitalization as a route around the normal tax implications of a distribution, the setting for the development of business purpose in this area, illustrates one such saving. A distinction can be drawn, however, between reducing taxes by avoiding a normally taxable event, and

33 Treas. Reg. §1.368-2(e) (1955) classifies this type recapitalization as a "reorganization." See illustrations (1), (2) and (4). This regulation was issued prior to the enactment of subchapter S however.

34 See Tarleau, "Corporate Recapitalizations as Affected by the Adams and Bazley Cases," SIXTH ANNUAL N.Y. UNIV. INST. ON FEDERAL TAXATION 266 (1948).

35 Penfield v. Davis, (N.D. Ala. 1952) 105 F. Supp. 292 at 300, affd. (5th Cir. 1953) 205 F. (2d) 798.

36 Judge L. Hand, who had decided Gregory in the court of appeals, said of Gregory in a later case: "Had they really meant to conduct a business by means of the two reorganized companies, they would have escaped whatever other aim they might have had, whether to avoid taxes, or to regenerate the world." Chisholm v. Commissioner, (2d Cir. 1935) 79 F. (2d) 14 at 15.

37 See the tax court opinion in Bazley at 4 T.C. 897 at 905 (1945), where asserted business reasons were classified as "negligible and insubstantial." See also Heady v. Commissioner, (7th Cir. 1947) 162 F. (2d) 699, affg. P-H T.C. Mem. Dec. ¶45,261 (1945); Carl Ortmayer, 28 T.C. 64 (1957).

reducing taxes by changing the structure of the business to enable it to operate more cheaply from a tax standpoint. This latter type of tax saving, according to a substantial undercurrent of opinion, not only was not to be condemned but rather should be considered a business purpose.[38] Acceptance of this view was hindered, however, by the fact that the question usually was presented in a setting where there was also a disguised dividend, the best example being the *Bazley* situation. In that case, five judges of the Tax Court thought the obtaining of the interest deduction to be a corporate business purpose in spite of the obvious bail-out situation created by the recapitalization. Other tax savings of the latter type approved as valid business purposes were state franchise tax reduction made possible by a recapitalization reduction of capital stock[39] and transfer tax savings made possible by a rearrangement of capital structure.[40]

Summing up, it would seem that neither *Gregory* nor *Bazley* should disqualify a recapitalization undertaken to qualify for subchapter S election. The resulting change in form of ownership hardly resembles a dividend. The simplification of capital structure, by reducing to one class of stock, would seem to provide a business purpose, though perhaps of the token variety. This should suffice, though, in view of the lack of an unwarranted tax saving. The tax saving involved here may even furnish a business purpose to support the recapitalization: Judge Waterman commented in the *Kraft Foods* case, with regard to *Gregory* and *Bazley,* that "[w]e do not think that these cases hold that tax minimization is an improper objective of corporate management. . . ."[41] This conclusion appears to be sound. Where a recapitalization has no side effects of distribution, or other circumvented taxable event, there is no reason to deny corporate tax savings as a validating business purpose.

II. Business Purpose and Corporate Division

The Tax Stimulus. Divisive reorganization was used by taxpayers to exploit certain features of the statutory pattern applicable

[38] See Penfield v. Davis, note 35 supra. This view was also taken by the dissenting judges in the Bazley Tax Court opinion, 4 T.C. 897 (1945), and in the Adams Tax Court opinion which was withdrawn, 4 T.C. 1186.

[39] Daisy Seide, 18 T.C. 502 (1952). See also Commissioner v. Sullivan, (5th Cir. 1954) 210 F. (2d) 607 (redemption not equivalent to a dividend).

[40] Clarence Schoo, 47 B.T.A. 459 (1942), Commissioner's appeal dismissed (1st Cir. 1943).

[41] Kraft Foods v. Commissioner, (2d Cir. 1956) 232 F. (2d) 118 at 128.

to corporate transactions in order to reduce the tax cost of deriving income from a corporation. A merger was tax-free only if "substantially all the properties"[42] of the transferor were exchanged for stock of the transferee; a separation of the assets to be exchanged made possible, upon the subsequent transfer, a claim that "substantially all" the assets had been exchanged. Preferential capital gains treatment on liquidation of a corporation was assured only if a complete liquidation took place;[43] a divisive reorganization to segregate the assets to be distributed lent "completeness" to the subsequent liquidation. Proceeds from the sale of corporate assets could be obtained only by paying a dividend tax on their extraction from the corporation; a divisive reorganization, followed by a sale of the stock of the newly-created corporation, produced cash and by-passed the dividend.

The Commissioner attacked each one of the these plans at the key point. He sought to remove the tax-insulating shield of reorganization by arguing that the divisive reorganizations lacked business purpose.

Judicial Reaction. Following the lead of the Supreme Court in *Gregory,* the judiciary was willing to deny reorganization in the first two situations developed supra. Where the newly-created corporation existed only long enough to dispose of the assets received, and then passed out of existence, the artificiality of the purported reorganization was all too apparent.[44] Even where the corporation remained in existence, thus lending some support to the proposition that there had been a real corporate division, reorganization shelter was not necessarily assured. If the corporation served only the function of transfer agent, whether to the shareholders in liquidation,[45] or to another corporation by way of merger,[46] the judiciary was willing to treat the transaction as a disguised sale or distribution on business purpose grounds.[47] But

[42] This is still a requirement. I.R.C., §368 (a) (1) (C).

[43] A partial liquidation was subject to dividend treatment if it was essentially equivalent to a dividend. I.R.C. (1939), §115 (g).

[44] Gregory v. Helvering, 293 U.S. 465 (1935); Thomas Perkins, 33 B.T.A. 606 (1935); Robert McCormick, 33 B.T.A. 1046 (1936); Arthur Kleeman, 35 B.T.A. 17 (1936); Electrical Securities Corp., 34 B.T.A. 988 (1936), affd. (2d Cir. 1937) 92 F. (2d) 593; Philip Cogan, 36 B.T.A. 639 (1937), affd. (2d Cir. 1938) 97 F. (2d) 996.

[45] George Graham, 37 B.T.A. 623 (1938).

[46] Pickard v. Commissioner, (2d Cir. 1940) 113 F. (2d) 488.

[47] Royal Marcher, 32 B.T.A. 76 (1935), appeal dismissed (2d Cir. 1936); Flanders Investment Co., 33 B.T.A. 483 (1935); Kaspare Cohn Co., 35 B.T.A. 646 (1937), appeal dismissed per stip. (9th Cir. 1940) 109 F. (2d) 1014; Hendee v. Commissioner, (7th Cir. 1938) 98 F. (2d) 934; Weicker v. Howbert, (D.C. D.C. 1938) 38-2 U.S.T.C. ¶11,528, affd. without comment on this point (10th Cir. 1939) 103 F. (2d) 105.

business purpose received a sterner test where the corporate transferee both remained in existence and indefinitely held the transferred assets. And this is the particular application of business purpose with which we are concerned.

As a general proposition, the courts refused to deny tax-free status to a reorganization where the resulting corporations remained in being and conducted a business with the assets. Neither the intent to sell-off nor the fact of sell-off negated tax-free status to the division *on business purpose* grounds.[48] One court stated:[49] "It is well settled that if a transaction is such as to constitute a reorganization in reality, it is to be treated as nonetheless effective because of a motive to decrease or avoid taxes." Another said:[50] "That which gives character to a reorganization . . . is the entity or activity which is brought into being by the reorganization plan." Another court sought to limit *Gregory* to cases involving "artificial corporate reorganizations."[51] While there were indications that the transfer of liquid assets to a non-business receptacle would not satisfy the business purpose requirement,[52] the presence of a functioning business entity normally satisfied *Gregory*.

The net-effect rationale supplied by *Bazley* failed to have any significant impact upon a division into semi-permanent corporate shells. Aside from an initial Tax Court application of *Bazley,* taxing the split-off of a ranch because the "sole purpose of the 'reorganization' . . . was to avoid the incidence of any tax on the distribution,"[53] later reversed by the Seventh Circuit,[54] the Commissioner was singularly unsuccessful in preventing segregating reorganizations prompted by the advantageous tax consequences

48 Lea v. Commissioner, (2d Cir. 1938) 96 F.(2d) 55. See also Bremer v. White, (D.C. Mass. 1935) 10 F. Supp. 9.

49 Ardbern Co., 41 B.T.A. 910 at 927 (1940), modified and remanded (4th Cir. 1941) 120 F. (2d) 424.

50 Lyon v. Commissioner, (6th Cir. 1942) 127 F. (2d) 210 at 213.

51 Braicks v. Henricksen, (W.D. Wash. 1942) 43 F. Supp. 254 at 258, affd. (9th Cir. 1943) 137 F. (2d) 632.

52 See Perry Bondy, 30 T.C. 1037 (1958), where a spin-off of the shares of stock of a corporation owning the realty of the parent corporation was taxed as a distribution on Gregory grounds. The new corporation remained in existence, but the reorganization lacked business purpose since the corporation's ". . . sole use was that of a container. . . ." 30 T.C. at 1043. See also William Hay, 2 T.C. 460 at 470 (1943), affd. (4th Cir. 1944) 145 F. (2d) 1001: "Petitioner's counsel ask . . . 'If Colonial's *holding* $2,000,000 in cash for five years — awaiting a favorable opportunity to put it to work earning a return and with a minimum of risk — is not a business activity, then what is it?' It is perhaps enough to say only that it is not a business activity as that term is usually applied to corporate enterprises." Cf. Bertha Bailey, 37 B.T.A. 647 (1938), where liquid assets were immediately converted into business assets, satisfying Gregory.

53 Rufus Riddlesbarger, 16 T.C. 820 at 836 (1951), revd. (7th Cir. 1952) 200 F. (2d) 165.

54 Riddlesbarger v. Commissioner, (7th Cir. 1952) 200 F. (2d) 165.

of a subsequent sale. The extra statutory requirements for reorganization were usually satisfied by a division having lasting significance at the corporate level.

The taxpayer's motive for the division was of questionable significance. Allegiance was paid the proposition that a motive to save taxes was immaterial. But whether the production of sound business justification for the division was required is not certain. Quite often the courts commented on the asserted business reason for reorganization: separation of incompatible businesses was approved;[55] so was the isolation into another shell of a risky business;[56] the segregation of an activity questionable under the corporate charter of the parent was justified in yet another case;[57] and the incidental watering down of the common of the parent, to enable a prospective manager to buy in, necessary to retain a franchise, also was favorably received.[58] Yet those same courts suggested that perhaps the reason for the adjustment was not so material. In *Rena Farr*,[59] the court stated that "the presence of a business purpose is not controlled by the motive of the stockholder. . . ." In *Ethel Lesser*,[60] the court remarked that there was no real dispute that a business purpose existed where "[t]he business of [the old corporation] was carried on by the two new corporations. . . . The motives of the shareholders are immaterial if there has been, in fact, a reorganization."

This tendency to discuss the reason for a division, and yet to question its relevance, evident in these recent cases, was probably prompted by business purpose developments in parallel reorganization corridors. During the mid-forties, recapitalization was the focal point for evolution of the *Gregory* principle. In that setting, there was little else to examine, by way of verifying the recapitalization, other than the reason for the adjustment. There we saw the real beginning of the intense judicial examination into the purpose of the change, and we saw the introduction of "corporate" business purpose. Even the *Bazley* case, while deciding on "net effect" grounds, did not reject an examination of the reason for recapitalization. But where external rather than internal relation-

55 Ibid., Thomas Williams, P-H T.C. Mem. Dec. ¶53,063 (1953).

56 Chester Spangler, 18 T.C. 976 (1952). Cf. Giles Bullock, 26 T.C. 276 (1956). See also Ethel Lesser, 26 T.C. 306 (1956).

57 Thomas Williams, P-H T.C. Mem. Dec. ¶53,063 (1953).

58 Rena Farr, 24 T.C. 350 (1955). Cf. Perry E. Bondy, 30 T.C. 1037 (1958) where the Tax Court refused to accept the tendered business reason of franchise retention, on grounds that the division failed to achieve the desired objective.

59 24 T.C. 350 at 368 (1955).

60 26 T.C. 306 at 312 (1956).

ships were altered by the corporate adjustment, the propriety of examining motivation was challenged.

The stereotype which prompted this reappraisal was a liquidation of a corporation and a reincorporation of the working assets into a new shell. Liquidation treatment would have resulted in capital gain, and a stepped-up basis for the assets retransferred to the new corporation. Reorganization resulted in "boot" taxation of the excess assets and a substituted basis for the retransferred assets. The taxpayer preferred the former and argued that there was no business purpose to support reorganization since the plan had been developed with only tax consequences in mind.

Gregory did not prevent reorganization.[61] The "personal reasons" of the shareholders were considered neutral, and the judicial inquiry centered on the permanence of the adjustment. The " 'question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended.' "[62] And apparently the statute intended reorganization status where "the new Corporation . . . continued to carry on the same identical corporate business which had been operated by the Company since its organization. . . ."[63] Indeed, it did not matter that the new corporation carried on a different business with the assets received.[64] In the second *Lewis* case the Court of Appeals for the First Circuit went even farther in limiting the reach of *Gregory:*

> "Whatever hesitation we may have had earlier, we are now convinced that emphasis upon "business purpose" as a requisite for statutory reorganization is futile on the facts here presented. . . . This is not a situation as in the Gregory case where the new corporation was an evanescent creature. . . ."[65]

The explanation offered by the court for this position deserves examination, also, since it provides what may be the key thought

[61] Survaunt v. Commissioner, (8th Cir. 1947) 162 F. (2d) 753, affg. 5 T.C. 665 (1945). Cf. Standard Realization Co., 10 T.C. 708 (1948), where reorganization was denied on business purpose grounds since the corporate transferee sold the assets rather than carry on a business with them. Also cf. United States v. Arcade Co., (6th Cir. 1953) 203 F. (2d) 230. In a slightly different context, where the old corporation transferred part of its assets for stock, then distributed the stock and the remaining assets, taxpayer's Gregory argument likewise failed to prevent reorganization treatment. See Lewis v. Commissioner, (1st Cir. 1949) 176 F. (2d) 646; Estate of Elise W. Hill, 10 T.C. 1090 (1948); Ernest Becher, 22 T.C. 932 (1954), affd. (2d Cir. 1955) 221 F. (2d) 252; Liddon v Commissioner, (6th Cir. 1956) 230 F. (2d) 304.

[62] Survaunt v. Commissioner, (8th Cir. 1947) 162 F. (2d) 753 at 757.

[63] Id. at 757-758.

[64] Becher v. Commissioner, (2d Cir. 1955) 221 F. (2d) 252; Pebble Springs Distilling Co., 23 T.C. 196 (1954), affd. (7th Cir. 1956) 231 F. (2d) 288.

[65] Lewis v. Commissioner, (1st Cir. 1949) 176 F. (2d) 646 at 650.

with respect to evaluation of the corporate division route enabling subchapter S qualification.

> "The controlling factor which we have concluded brings this case within the statute is that a basic element of the plan was the continuance of the chemical manufacturing business in the corporate shell of the new company, with the gain . . . not having sufficiently crystallized for recognition, because the collective interests of the shareholders 'still remained in solution.' "[66]

Evaluation. A division of corporate business into two separate compartments, each of which continues in existence and carries on a business with the assets received, with the proportional interests of the shareholders remaining constant, would apparently not fall short of tax-free reorganization status on business purpose grounds, even though prompted by the desire to qualify one of the entities for the tax savings possible under subchapter S taxation. The tax motive has been repeatedly declared to be immaterial, and the maximum reach of *Gregory* has been to deny tax-free status where there was no lasting significance to the rearrangement of corporate business. While the courts have frequently verbalized the requirement that a non-tax business need of the corporation must prompt the division, no divisive reorganization was subjected to tax *solely* on grounds of lack of a business need. The prime reason for this limitation of the scope of *Gregory* is reflected in the quotation from *Lewis* above: the collective interests of the shareholders still remain in solution; there are no overtones of distribution. Also, the technical readjustment of corporate form does not seem an appropriate time to levy tax on the unrealized appreciation inherent in the property exchange. Thus there seems to be no real reason for denying access to statutory reorganization.

III. BUSINESS PURPOSE AND CORPORATE COMBINATION

The Tax Stimulus. Relatively few opportunities were present in combinative reorganizations to extract earnings from the corporation. This might explain the infrequent occurrence of mergers which evoked a *Gregory* response from the Commissioner. One pattern of combinative reorganization, however, deserves attention in view of its resemblance to the combination to qualify for subchapter S treatment.

[66] Ibid.

Judicial Reaction. The subjection of the personal holding company to tax, in 1934,[67] so penalized the holding company structure that it became unprofitable to carry on business in that form. The elimination of a holding company by liquidation would have been a taxable event, albeit at capital gains rates. Some form of combinative reorganization, on the other hand, would be tax free. The choice of reorganization to effect a liquidation was attacked by the Commissioner on, among others, business purpose grounds. The uniform response of the judiciary was that the reorganizations were "reorganizations" within the meaning of the statute.[68] Attaching significance to the permanence of the resulting corporate form, and to the fact that the merger had significant legal impact upon the parties, the courts found *Gregory* satisfied. The end result, elimination of a tax on holding company income, was apparently a proper business purpose.[69] The fact that there was no non-tax business reason for choice of reorganization over liquidation, which would have given the same result, was immaterial.[70]

The failure of the judiciary to require more than a token[71] business purpose in this setting makes strange reading in the light of the recurrent theme that reorganizations must be business adjustments prompted by (non-tax) business conditions. The business condition prompting the mergers under consideration was the change in the tax laws which made it unprofitable in a tax sense to continue the existing form of doing business. The explanation for tax-free status to the reorganization can be found in Judge Goodrich's remarks in *Gilmore:*

> ". . .There was no conversion into cash on withdrawal. Rather, the entire history of the two corporations reveals that

67 Now contained in I.R.C., subchapter G, part II. For a discussion of the origination of these provisions, see PAUL, TAXATION IN THE UNITED STATES 176, 177, 207 (1954).

68 Commissioner v. Kolb, (9th Cir. 1938) 100 F. (2d) 920; Helvering v. Schoellkopf, (2d Cir. 1938) 100 F. (2d) 415; Commissioner v. Whitaker, (1st Cir. 1938) 101 F. (2d) 640; Commissioner v. Food Industries, Inc., (3d Cir. 1939) 101 F. (2d) 748; Chester Souther, 39 B.T.A. 197 (1939), remanded and settled per stip. 42-1 U.S.T.C. ¶9444; Commissioner v. Gilmore's Estate, (3d Cir. 1942) 130 F. (2d) 791; Commissioner v. Webster's Estate, (5th Cir. 1942) 131 F. (2d) 426; Commissioner v. Kann, (3d Cir. 1942) 130 F. (2d) 797.

69 Anna Gilmore, 44 B.T.A. 881 at 886 (1941), affd. (3d Cir. 1942) 130 F. (2d) 791: "The merger of the corporations was brought about for two purposes—first, to enlarge the corporate powers of Warren Webster & Co.; and, secondly, to eliminate the tax liability of W.F.I. upon its income."

70 Commissioner v. Gilmore's Estate, (3d Cir. 1942) 130 F. (2d) 791 at 795.

71 See the ten business purposes listed by the court in Commissioner v. Kolb, (9th Cir. 1938) 100 F. (2d) 920 at 926.

> the interests obtained through the merger were to be continuing and the surviving corporation kept on doing business with no change in management or personnel after the merger."[72]

Thus the lack of bail-out potential appears to be more important than the presence of a non-tax corporate benefit.

Evaluation. The merger to qualify the resulting entity for subchapter S election is analogous to the merger to "take advantage" of the change in the tax structure applicable to personal holding companies. Both are prompted by desire to mend the corporate form of doing business to operate at the lowest tax cost. Neither presents a "conversion to cash on withdrawal"; in both the "interests obtained . . . were to be continuing."[73] This almost necessary by-product has caused one commentator to suggest that a business purpose is not required for mergers.[74]

CONCLUSION

A review of the cases shows that there was reasonably complete acceptance of the *Gregory* sanction against the sham reorganization. The ephemeral corporation, used as a conduit, fell quickly into disrepute. But where there was a reorganization which had lasting impact upon the legal relationships of the parties, the role of *Gregory* was more uncertain. In that setting the business purpose doctrine was verbalized as a requirement that a reorganization, to qualify for tax-free status, be sustained by non-tax business reasons.

This version of *Gregory* is almost hornbook tax law. It is supported by the legislative origins[75] of the reorganization provisions, the phraseology of the implementing regulations,[76] the opinions of commentators,[77] and statements in many cases. Yet it seems at least debatable whether there has ever been more than lip-service paid by the courts to this meaning of business purpose,

72 Commissioner v. Gilmore's Estate, (3d Cir. 1942) 130 F. (2d) 791 at 794-795.

73 Id. at 794.

74 Pollock, "An Outline of Possible Reorganization Alternatives a Corporation Has When It Joins with Other Corporations, Acquires Subsidiaries, Splits Up or Revamps Its Capital Structure," EIGHTH ANNUAL N.Y. UNIV. INST. ON FEDERAL TAXATION 143 at 152 (1950).

75 See note 18 supra.

76 See note 14 supra.

77 See Michaelson, " 'Business Purpose' and Tax-Free Reorganization,"61 YALE L.J. 14 (1952); Bittker, "What is 'Business Purpose' in Reorganization?" EIGHTH ANNUAL N.Y. UNIV. INST. ON FEDERAL TAXATION 134 at 136 (1950); Spear, " 'Corporate Business Purpose' in Reorganization," 3 TAX L. REV. 225 (1947-1948).

except perhaps in recapitalization.[78] The real focus of attention in a division or combination context seems rather to have been on the reality of the corporate adjustment.

The reorganization to qualify for subchapter S treatment might fail to qualify for tax-free treatment if more than formal allegiance is accorded the requirement of a non-tax business reason. But this would seem to be an unlikely result[79] in view of the absence of the unwarranted tax-savings normally associated with the business purpose application.

Even assuming that *Gregory* requires an affirmative business justification, in addition to an adjustment which has lasting legal significance, it may very well be that the tax saving made possible by qualification for subchapter S election will furnish just that justification. First it is necessary to strip the epithetical connotation from this suggested business reason by pointing out that this tax-saving is not the same as that in *Gregory,* or like cases, where a disguised dividend was cloaked by reorganization. Rather this would seem to be a reorganization in response to exactly the sort of changing business conditions envisioned by the framers of the tax-free reorganization provisions. What more significant change can occur in the business world than a major change in the taxation of business entities? In conclusion, it would seem that a reorganization by way of recapitalization, division or merger to qualify for subchapter S taxation, should constitute precisely the sort of technical adjustment that statutory reorganization should shield from operation of the basic provisions taxing gain from exchange of property.

[78] The view has been advanced that business purpose is dead in even the recapitalization corridor. See Barker, "Why Not Be Practical About Recapitalizations?" EIGHTH ANNUAL N.Y. UNIV. INST. ON FEDERAL TAXATION 227 at 234 (1950). "[I]t was as artificial as the devices against which it was directed. . . ."

[79] The Court of Appeals for the Second Circuit, in a series of cases involving the application of business purpose in other than reorganization situations, has apparently refused even lip-service to the business benefit requirement of the business purpose doctrine. See Loewi v. Ryan, (2d Cir. 1956) 229 F. (2d) 627 at 629; Kraft Foods v. Commissioner, (2d Cir. 1956) 232 F. (2d) 118 at 127-128; Gilbert v. Commissioner, (2d Cir. 1957) 248 F. (2d) 399. In Gilbert at 248 F. (2d) 404, Judge Medina makes the point that "the taxpayer's motive is not the crucial factor. This is but a corollary of the undoubted proposition, 'The incidence of taxation depends upon the substance of a transaction.'" In his discussion which follows, it is apparent that he is *consistently* reluctant to make taxpayer motivation a criteria.