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Taxation-Federal Income Taxation-Examination of Certain Problems Under Section 335

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COMMENTS

TAXATION—FEDERAL INCOME TAXATION—EXAMINATION OF CERTAIN PROBLEMS UNDER SECTION 355—Stock and securities of controlled corporations may be distributed to shareholders, tax free, in cases of corporate separations which qualify under section 355 of the *Internal Revenue Code of 1954*. A corporate separation is effected by the transfer of part of a corporation's assets to a subsidiary, the stock of which is distributed to the parent's stockholders. Such distributions are generally classified into three categories: spin-off, split-off, and split-up. A spin-off occurs when corporation *A* forms corporation *B* to which *A* transfers certain assets, receiving in exchange, the stock[1] of corporation *B*. *A* then distributes the stock of *B* to its shareholders in the form of a simple dividend of stock. A modified version of this would be a case in which *A* merely distributes the stock of a controlled subsidiary. A split-off differs only in that the stock of *B* is distributed to *A*'s stockholders in exchange for some of their stock in *A*. A split-up takes place when *A* forms two (or more) corporations—*B* and *C*—to which *A* transfers all of its assets, in exchange for all the stock of *B* and *C*, which stock is then distributed to *A*'s stockholders in complete liquidation of *A*. An alternative method for classifying these distributions would divide them into only two groups—those which are in the form of an exchange of stock (split-up and split-off) and those which are in the form of a simple dividend of stock (spin-off).

I. THE GRANT OF DEFERRED TAX STATUS

A. *A Glance at Statutory Development*

Prior to the enactment of the reorganization provisions, all types of stock distributions in corporate separations were held taxable, and the gain realized was taxed as ordinary income.[2] Corporate separations today, which do not meet the requirements of section 355 are also subject to taxation at ordinary income rates.[3] The year 1918 marked the advent of the first reorganization

1 Securities of the controlled corporation may also be distributed tax free under § 355.

2 See, *e.g.*, Rockefeller v. United States, 257 U.S. 176 (1921).

3 See, *e.g.*, Isabel A. Elliott, 32 T.C. 283 (1959). This refers to a corporate separation which does not meet the requirements of § 355 because of the nature of the separation.

provisions under which distributions in the form of exchanges of stock were accorded nonrecognition treatment.[4] The rationale of Congress for this preferred treatment was to negative the assertion of tax in certain purely paper transactions.[5] Taxation was postponed until there was a more final change of position. In 1921, a more sophisticated attempt was made[6] to render the reorganization provisions workable. At that time the congressional purpose was stated to be encouragement of business adjustments necessary to the economic health of the country through elimination of taxation in cases where the corporate organization and ownership had been changed in form but where, in substance, no gain was realized.[7] In 1924 the spin-off was recognized and accorded tax-free treatment[8] because it was thought to be substantially similar to the exchange types of separations.[9] However, in 1934, it was eliminated on the ground of being productive of tax avoidance.[10] But, in 1951, congressional tax winds were blowing the other way, and the spin-off was re-included, although subject to a restrictive set of rules.[11] The rationale rested again on the

A corporate division which does not meet the requirements of § 355 would be taxed under the provisions of § 356 if, in addition to property permitted to be distributed under § 355, there is also distributed non-qualifying other property (boot).

4 Revenue Act of 1918, ch. 18, § 202(b), 40 Stat. 1060. The question whether split-offs qualified, however, was for a time a subject of controversy. See Mintz, *Divisive Corporate Reorganizations: Split-ups and Split-offs*, 6 TAX L. REV. 365 (1951).

5 S. REP. No. 617, 65th Cong., 3d Sess. 5-6 (1918).

6 Revenue Act of 1921, ch. 136, § 202(c) (2), 42 Stat. 230. See generally Hellerstein, *Mergers, Taxes and Realism*, 71 HARV. L. REV. 254 (1957).

7 See H.R. REP. No. 350, 67th Cong., 1st Sess. 11-12 (1921); S. REP. No. 275, 67th Cong., 1st Sess. 10 (1921).

8 Revenue Act of 1924, ch. 234, § 203(c), 43 Stat. 256.

9 The House Ways and Means Committee and the Senate Finance Committee reports contained identical statements in regard to spin-offs:

"[U]nder the existing law, the same result, except as to tax liability, may be obtained by either of two methods [spin-off or split-up]; but if the first . . . is adopted the gain is taxable, while if the second . . . is adopted, there is no taxable gain . . . . The first method [spin-off] represents a common type of reorganization and clearly should be included within the reorganization provisions of the statute." H.R. REP. No. 179, 68th Cong., 1st Sess. 14 (1924); S. REP. No. 398, 68th Cong., 1st Sess. 15 (1924).

10 See SUBCOMMITTEE OF HOUSE COMM. ON WAYS AND MEANS, 73d CONG., 2D SESS., PREVENTION OF TAX AVOIDANCE, PRELIMINARY REPORT 40 (Comm. Print 1934). In discussing omission of the spin-off provision from the 1934 act, both the House Ways and Means Committee and the Senate Finance Committee stated that "by this method corporations have found it possible to pay what would otherwise be taxable dividends, without any taxes upon their shareholders. . . . [T]his means of avoidance should be ended." H.R. REP. No. 704, 73d Cong., 2d Sess. 14 (1934); S. REP. No. 558, 73d Cong., 2d Sess. 16 (1934).

11 Int. Rev. Code of 1939, § 112(b)(11), as amended by ch. 521, § 317(a), 65 Stat. 493 (1951).

spin-off's similarity to the exchange types of corporate separations.[12] Under the 1954 Code, all three types of separations are accorded the same treatment, and must meet the same statutory requirements. Section 355 is comprised of a single set of tests designed to distinguish between those corporate separations which Congress deems deserving of tax-free treatment in the interests of the national economy, and those which, in substance, are only dividends—whether the transaction takes the form of a spin-off, split-off, or split-up.[13]

B. *Effects of Section 355*

In the absence of section 355, all distributions to stockholders in corporate separations would be dividends, taxable at ordinary income rates, to the extent of the corporation's earnings and profits.[14] Under the 1954 Code, if the provisions of section 355 are complied with, there will be no taxation at the time of the distribution whether the separation be a spin-off, split-off, or split-up. However, if in addition to the stock, other property (boot) is distributed, the tax result will differ accordingly as the distribution is in the form of an exchange (split-off or split-up) or a simple dividend of the controlled corporation's stock (spin-off). If the distribution is in spin-off form, all the boot is taxed as a dividend to the extent of the corporation's earnings and profits.[15] On the other hand, if the exchange form is utilized, recognition is limited not only by the amount of the boot received, but also by the distributee's gain actually realized and his ratable share of the corporation's earnings and profits.[16]

II. PROBLEMS IN THE APPLICATION OF SECTION 355

There are four basic requirements with which all distributions must comply in order to qualify for tax-free treatment under

[12] See S. REP. No. 781, 82d Cong., 1st Sess. 58 (1951) stating, "this section has been included in the bill because your committee believes that it is economically unsound to impede spin-offs which break-up businesses into a greater number of enterprises, when undertaken for legitimate business purposes."

[13] This applies only to the distribution of stock. When securities are distributed the recipient must surrender securities of at least an equal principal amount. INT. REV. CODE OF 1954, § 355(a)(3).

[14] See INT. REV. CODE OF 1954, §§ 301(a), (c), 316(a); *cf.* Rockefeller v. United States, 257 U.S. 176 (1921).

[15] See INT. REV. CODE OF 1954, §§ 356(b); 301(a), (c).

[16] INT. REV. CODE OF 1954, § 356(a).

section 355. First, the distributing corporation must have been in "control" of the corporation or corporations the stock of which is distributed, immediately before the distribution,[17] and "control" must not have been acquired within five years of the date of distribution in a transaction in which gain or loss was recognized.[18] Second, with one exception,[19] all the stock and securities of the controlled corporation, held by the distributing corporation, must be distributed.[20] Third, the transaction may not be used principally as a "device for the distribution of earnings and profits."[21] Fourth, in the case of spin-offs and split-offs, both the distributing corporation and the controlled corporation must be engaged in the "active conduct of a trade or business"; while in the case of split-ups, each of the controlled corporations must be so engaged.[22] This comment will be limited to discussion of certain specific problems arising in the context of the third and fourth requirements.

A. *The Device Test*

Under the "device test" of section 355, in order to qualify for nonrecognition treatment a transaction must not be used principally as a device for the distribution of earnings and profits. This concept is neither new nor peculiar to section 355.[23] Soon after the enactment of the reorganization provisions, a number of cases arose in which transactions, in substance sales or distributions

[17] INT. REV. CODE OF 1954, § 355(a)(1). "Control" is defined in § 368(c) as the ownership of at least 80% of the voting stock of a corporation and 80% of the total number of shares of all other classes of stock.

[18] INT. REV. CODE OF 1954, § 355(a)(3). Thus, if "control" of the subsidiary corporation were acquired within five years of the separation in a reorganization under § 368(a)(1)(D), the distribution would qualify. However, if control were acquired by purchase, and no gain were recognized merely because no gain had been realized, it is doubtful that this requirement would be held to have been satisfied. This would not appear to be the type of transaction Congress envisaged. See S. REP. No. 1622, 83d Cong., 2d Sess. 49 (1954).

[19] A distribution may qualify if an amount of stock constituting "control" is distributed, and the Commissioner is satisfied that the retention of stock is not part of a plan of tax avoidance. INT. REV. CODE OF 1954, § 355(a)(1)(D)(ii). Ordinarily, however, all the stock of the controlled corporation will have to be distributed. See Treas. Reg. § 1.355-2(d) (1962). In this context, distribution of boot may be mandatory, as in the case of a distributing corporation which has owned 80% of a subsidiary for five years, but has acquired an additional 10% by purchase within five years. Upon distribution, 10% will be treated as boot. Treas. Reg. § 1.355-2(f) (1962).

[20] INT. REV. CODE OF 1954, § 355(a)(1)(D)(i).

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

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

[23] See PAUL, STUDIES IN FEDERAL TAXATION 89-145 (3d ser. 1940).

of dividends, were cast in such form as to satisfy the letter of the provision's requirements.[24] The device test of section 355 may be traced to judicial gloss added to the revenue statutes to combat such avoidance techniques.[25]

1. *Continuity of Interest*

The Internal Revenue Service has stated that section 355 is applicable only to "readjustment of corporate structures . . . required by business exigencies and which, in general, effect only a readjustment of *continuing interests* . . . under modified corporate forms."[26] Any disposition of the stock received in a corporate separation, if negotiated prior to the separation, will preclude the distribution from qualifying for section 355 treatment.[27] This would be true, presumably, even if the subsequent disposition were in the form of a tax exempt exchange under the reorganization provisions.[28] Subsequent disposition alone, however, unless negotiated prior to the distribution, is not to be construed to mean the transaction was used principally as a device,[29] although it will be considered as evidence that the transaction was so used.[30]

24 *E.g.*, Bus & Transp. Sec. Corp. v. Helvering, 296 U.S. 391 (1935); Gregory v. Helvering, 293 U.S. 465 (1935); Pinellas Ice & Cold Storage Co. v. Commissioner, 287 U.S. 462 (1933); see letter from Secretary of the Treasury Morganthau to Chairman Doughton of the House Ways and Means Committee, February 12, 1934, in 78 CONG. REC. 2512 (1934).

25 *Cf.* 3 MERTENS, LAW OF FEDERAL INCOME TAXATION, §§ 20.54-59, 162 (rev. ed. 1957); Comment, 67 YALE L.J. 38, 56 (1957).

26 Treas. Reg. § 1.355-2(c) (1962) (emphasis supplied).

27 See INT. REV. CODE OF 1954, § 355(a)(1)(B).

28 See Dean, *Spin-offs: General Rules; Requirements as to Active Business; Some Practical Considerations (Sec. 355)*, N.Y.U. 15th INST. ON FED. TAX. 571, 586 & n. 47 (1957). But since a continuity of interest is also required under the reorganization provisions, to disqualify a distribution on these grounds would appear to be excessively restrictive.

29 INT. REV. CODE OF 1954, § 355(a)(1)(B).

30 Treas. Reg. § 1.355-2(b) (1962). Although a prior negotiated sale will preclude a transaction from qualifying for nonrecognition treatment under § 355, the transaction, in modified form, might still qualify for taxation at capital gain rates under the partial liquidation provisions of §§ 331 and 346. *Compare* Commissioner v. Court Holding Co., 324 U.S. 331 (1945) *with* United States v. Cumberland Pub. Serv. Co., 338 U.S. 451 (1950). In the *Court Holding* case, the proceeds of a sale of assets of a corporation received in complete liquidation, were taxed to the corporation, on the ground that the sale had been negotiated by the corporation. In the *Cumberland* case, on somewhat similar facts, the opposite result was reached, on the basis of evidence that the sale had, in fact, been made by the stockholder. This distinction was rejected by Congress in the context of complete liquidations under § 337. S. REP. No. 1622, 83d Cong., 2d Sess. 48-49 (1954). However, the Internal Revenue Service has indicated its adherence to the *Court Holding-Cumberland* distinction in partial liquidations. See Treas. Reg. § 1.346-3 (1962).

2. *Business Purpose and the Shareholder*

The principal thrust of the device test is in the requirement that the distribution have a legitimate corporate business purpose.[31] The regulations state the distribution "will not qualify under section 355 where carried out for purposes not germane to the business of the corporation."[32] A legitimate business purpose solely of the stockholder will not suffice.[33] Thus, the Service, in effect, postulates that a distribution pursuant to a stockholder business purpose, is principally a device for the distribution of earnings and profits. This distinction has been criticized as overly tenuous,[34] and in certain contexts it has been rejected.[35] The regulations' requirement of a corporate (rather than a stockholder) business purpose under section 355 is derived from the regulations promulgated under the corporate reorganization provisions of section 368.[36] But the underlying purpose of section 355 is to permit realignments of interests at the *stockholder* level, while that of section 368 is to permit realignments at the *corporate* level.

Prior to the 1954 Code, the application of the "business purpose" test was much less stringent.[37] Under the 1954 Code, although it has not always presented insuperable obstacles,[38] it

31 For a discussion of some legitimate business purposes, see Porter, *Spin-Offs in Oil and Gas Industry*, 9TH ANNUAL INSTITUTE ON OIL AND GAS LAW TAXATION 523, 525-28 (1958); Michaelson, *"Business Purpose" and Tax-Free Reorganization*, 61 YALE L.J. 14 (1952).

32 Treas. Reg. § 1.355-2(c) (1962).

33 The regulations also state that "all the requisites of business and corporate purposes described under § 1.368 (concerning corporate reorganizations) must be met to exempt a transaction from the recognition of gain or loss under this section." Treas. Reg. § 1.355-2(c) (1962).

34 See Dean, *supra* note 28, at 587; Spear, *"Corporate Business Purpose" in Reorganization*, 3 TAX L. REV. 225, 242-43 (1947).

35 See Estate of John B. Lewis, 10 T.C. 1080, 1086 (1948), *aff'd*, 176 F.2d 646, 649-50 (1st Cir. 1949); see also Survuant v. Commissioner, 162 F.2d 753 (8th Cir. 1947) (by implication).

36 *Cf.* Chester E. Spangler, 18 T.C. 976, 987 (1952), *acq.*, 1953-1 CUM. BULL. 6; see Buffalo Meter Co., 10 T.C. 83 (1948). *Compare* Riddlesbarger v. Commissioner, 200 F.2d 165 (7th Cir. 1952) (separation of ranch properties) *and* Rena B. Farr, 24 T.C 350 (1955), *acq.*, 1955-2 CUM. BULL. 6 (separation of real property and automobile dealership) *with* Bazley v. Commisioner, 331 U.S. 737 (1947).

37 See note 24 *supra.*

38 Bondy v. Commissioner, 269 F.2d 463 (4th Cir. 1959). In that case an automobile sales corporation segregated certain real estate holdings in a subsidiary, in order to avoid losing its franchise. Later, after the conclusion of divorce proceedings and a property settlement between taxpayer and his estranged wife, the corporation spun off the subsidiary's stock. The court held the corporate business purpose test was satisfied and the distribution was not a device.

is not difficult to imagine cases in which the separation is not predominantly corporate-business motivated, and, at the same time, not a device. Suppose, for example, a division of a corporation due to an irreconcilable conflict between the principal shareholders, or due to a desire to separate an established, conservative business from the liabilities of a speculative-risk business.[39] The "business purpose" component of the device requirement would be better served by a test which would differentiate proper from improper distributions on the basis of whether their purpose and effect were compatible with the policy of section 355—which does not necessarily coincide with the question of whether the distribution was motivated by corporate or stockholder business purpose.

B. *The "5-Year Active Business" Test*

As stated previously, the "5-year active business" test requires in the case of spin-offs and split-offs, that both the distributing and the controlled corporation must be engaged in the "active conduct of a trade or business," and, in the case of split-ups, that each of the controlled corporations must be so engaged.[40] That test also requires that the business shall have been conducted "throughout the 5-year period ending on the date of distribution."[41] The purpose stated by Congress for the rule is prevention of the separation of active business assets from inactive or investment assets in anticipation of a distribution of the latter at capital gain rates in liquidation.[42] Section 355 provides no definitive statement of what constitutes the active conduct of a trade or business. The regulations, however, supply certain rules by which this is to be determined:

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

39 See Dean, *supra* note 28, at 587; *cf.* Rev. Rul. 56-554, 1956-2 CUM. BULL. 198, in which a bank was allowed to spin off certain real estate holdings which were thought to be so speculative as to affect adversely the bank's financial position.

40 INT. REV. CODE OF 1954, § 355(a)(1)(C) and § 355(b)(1)(A), (B).

41 INT. REV. CODE OF 1954, § 355(b)(2)(B).

42 See H.R. REP. No. 2543, 83d Cong., 2d Sess. 37-38 (1954); S. REP. No. 1622, 83d Cong., 2d Sess. 50 (1954); see generally 3 MERTENS, *op. cit. supra* note 25, at § 20.103.

> a part of, or a step in, the process of earning income or profit . . . ."[43]

Pursuant to this statement, the regulations provide that neither the holding of stock, land or other property for investment purposes, nor the ownership and operation of land substantially all of which is used by the owner in a trade or business is an active business.[44] Moreover, it is stated that section 355 applies only to the "separation . . . of two or more existing businesses formerly operated, directly or indirectly, by a single corporation."[45]

1. *The Growth Rule*

Where a business has undergone change during the five years preceding distribution, it is necessary to determine if the change is so great that the business cannot be considered the business of five years ago; *i.e.*, whether it may still be considered the original business of five years ago, although substantially expanded, or must be classified as a new business which developed during the five-year period. In this connection, the regulations, pursuant to a statement in the House Ways and Means Committee report,[46] provide that the determining factor will be the character of the change.[47] However, in cases where the change has been through growth and expansion, it was originally understood that the Service would follow a "50 percent test."[48] This test is designed to cope with the danger that a separation of a business which has undergone extensive growth during the five-year period preceding distribution could be a convenient vehicle for the distribution of accumulated earnings when a large percentage of the business' assets are not "5 year and over assets."[49] To comply

43 Treas. Reg. § 1.355-1(c) (1962).

44 Treas. Reg. § 1.355-1(c) (1962). Suppose, however, a case in which the owner of land transfers it to a subsidiary corporation whose only business is leasing the land to the previous owner. This raises the question of whether the 5-year active business requirement may be satisfied with patience alone. *Cf.* Rev. Rul. 57-464, 1957-2 CUM. BULL. 244, in which a subsidiary rented property to the parent and to outside sources, but which was held not an active business because net income from the "outside" leasing was negligible.

45 Treas. Reg. § 1.355-1(a) (1962).

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

47 Treas. Reg. § 1.355-4(b)(3) (1962).

48 See Çaplin, *Corporate Separations: The 5-Year Business Rule*, N.Y.U. 15TH INST. ON FED. TAX 623, 633 (1957); Mintz, *Corporate Separations*, 36 TAXES 882, 884-85 (1958); *cf.* Rev. Rul. 68, 1958-1 CUM. BULL. 183.

49 Mintz, *supra* note 48, at 884-85.

with this test, where a corporation actively conducting two businesses desired to separate one, and either of the two businesses had undergone considerable expansion during the preceding five years, it was required that the assets of the expanded business held for five years have (1) a net adjusted basis of at least 50 percent of all assets of the business at the time of distribution; (2) a net fair market value of at least 50 percent of all such assets; and (3) the capacity and likelihood of producing at least 50 percent of the income of the business. There was a degree of flexibility in that if, under certain conditions, only two of the 50 percent requirements were met, the business could still qualify.[50] In the application of the tests the Service has stated its rationale to be prevention of the earnings of one business from being placed in a second business so that what would ordinarily be taxed as dividends would be converted into capital gain upon liquidation or sale of the stock of the corporation operating the second business.[51] In accordance with this rationale, the Service, in an informal ruling, did not adhere to a strict 50 percent test but permitted a greater degree of flexibility.[52] This ruling, favorable to the taxpayer, came in a case in which it was desired to separate a rental business from a hotel business, where the rental business satisfied only one of the 50 percent tests. The basis for the ruling was that the expansion of the rental business was not attributable to acquisitions financed by earnings of the hotel business.[53] Thus, the inquiry appeared to be as to the source of funds for the expansion. Such an inquiry would do a better job of differen-

50 Caplin, *supra* note 48, at 633-34.

51 See the following statement in Rev. Rul. 400, 1959-2 CUM. BULL. 114:

"The purpose behind the five-year limitation in section 355 is to prevent the corporate earnings of one business from being drawn off for such a period and put into a new business and thereby, through the creation of a marketable enterprise, convert what would normally have been dividends into capital assets that are readily saleable by the shareholders.

"It is the position of the Internal Revenue Service that where a corporation which is devoted to one type of business also engages in the rental business, and substantial acquisitions of new rental property are made within the five-year period preceding the separation of these businesses, a 'spin-off' transaction will not qualify under section 355 unless it can be shown that the property acquisitions were substantially financed out of the earnings of the rental business and not out of the earnings of the other business."

52 Letter from H. T. Swartz, Director, Tax Rulings Div., Int. Rev. Serv. to M. M. Caplin, Feb. 12, 1957, on file in University of Virginia Law Library, reported in Caplin, *Corporate Division Under the 1954 Code: A New Approach to the Five-Year "Active Business" Rule*, 43 VA. L. REV. 397 (1957).

53 See Caplin, *supra* note 52, at 401-02.

tiating transactions not worthy of tax-free treatment while permitting those which are worthy of such treatment to receive it; but it would seem more sensible to make this inquiry in connection with the device test since that test's purpose is to prevent tax-free separations which would have the effect of a distribution of earnings and profits. More basically, the inquiry does not provide an answer to the question of whether a business has been actively conducted for five years.[54] Questions concerning the growth of a business are distinguishable from questions concerning the source of funds for that growth.[55] In any event, expansion or growth alone should not preclude a business from being considered actively conducted. Congress has indicated it is the *character*, rather than the *extent*, of the change which is to be determinative.[56] Thus, a small business which because it is superior to its competition undergoes a great deal of growth should not be disqualified.

2. *"Two or More Businesses" Requirement*

The regulations provide that section 355 applies only to the separation of two or more existing businesses.[57] There has been a certain amount of disagreement with this view, which will be discussed below and which is manifested in the tax court's opinion in the case of *Edmund P. Coady*.[58] The majority in that case held the Service's requirement of two or more businesses invalid. In this regard, it must be remembered that such a view has no relation to, or effect upon, the case where there actually

[54] See Caplin, *supra* note 48, at 634-35.

[55] It is possible that source of funds problems might be alleviated if the expanding business executed notes for the repayment of funds borrowed from the parent. In such a situation, the earnings of the parent corporation would not have been "drawn off."

[56] See H.R. REP. No. 2543, 83d Cong., 2d Sess. 37-38 (1954); S. REP. No. 1622, 83d Cong., 2d Sess. 50 (1954); *cf.* Isabel A. Elliott, 32 T.C. 283 (1959). In that case, the parent corporation was engaged in the development of apparatus for use in liquid gas purification. The subsidiary owned a building, 50% of which was rented to the parent and the rest to other tenants. It was held the subsidiary was not engaged in the active conduct of a trade or business. In viewing the problem of change, the court made this statement at 290: "The Senate . . . chose the 5-year active conduct of a trade or business limitation as one method of safeguarding against tax avoidance. . . . The House accepted the Senate version but with the understanding that a trade or business which had been actively conducted throughout the 5-year period described would meet the requirements even though such trade or business underwent change during the 5-year period . . . ."

[57] See note 39 *supra* and accompanying text.

[58] 33 T.C. 771, 777 (1960), *aff'd*, 289 F.2d 490 (6th Cir. 1961), 58 MICH. L. REV. 942 (1960).

are two pre-existing separate business entities. In that situation it is obvious that both businesses must qualify as "active businesses." Moreover, where there is only one business in existence prior to the separation it would, of course, be required that following the separation there be two or more businesses being actively conducted. The separation of an inactive element of a single business would be no more permissible under this view than under that of the Internal Revenue Service.

In accordance with its "two or more businesses" requirement, the question for the Service has been whether there are two or more separate active businesses in existence prior to the distribution. Thus, the Service has ruled that a transfer by a bus company of all its busses to a subsidiary which would lease the busses to the operating parent and to other bus operators as well, would not qualify under section 355, since the leasing operations did not constitute a separate active business.[59] The separation was desired in order to insulate the operating bus company from possible accident liability the subsidiary might incur. It was disqualified even though some leasing operations had been occasionally carried on in the past. The Service has ruled more liberally in certain situations, however. In one case, a corporation was engaged in the business of publishing four trade magazines, three of which were directed to electrical industrial matters while the other was for the metal-working industry. The corporation was permitted to spin-off the metal-working magazine tax free.[60] In this situation, it could easily have been found that there was only one business—the publication of trade magazines generally. An even more liberal attitude was evidenced in a later ruling. Two brothers owned 50 percent each of the stock of a retail furniture and appliance sales business. Because of conflicts between the brothers, it was decided to

[59] Rev. Rul. 56-287, 1956-1 CUM. BULL. 186. *But cf.* Rev. Rul. 57-126, 1957-1 CUM. BULL. 123, where a fruit business, the activities of which had been very limited for over five years due to severe frost, was held to be "active."

[60] Rev. Rul. 56-451, 1956-2 CUM. BULL. 208; *cf.* Rev. Rul. 56-344, 1956-2 CUM. BULL. 195, in which a corporation engaged in a turkey raising business in state *A* had also engaged in the chicken raising business in state *B*. The business in state *B* had later been closed and then chicken raising operations were begun in state *C*. The corporation was allowed to separate the chicken raising business in state *C* on the ground that it was the same business as that which had previously been conducted in state *B*, and was independent from the turkey raising business in state *A*. For a discussion of the problems which would have been raised had the business in state *C* been commenced before that in state *B* was closed, see Young, *Corporate Separations: Some Revenue Rulings Under § 355*, 71 HARV. L. REV. 843, 862 (1958).

separate the furniture from the appliance division. The separation was permitted tax free.[61] It is doubtful that the Service would permit an extension of the rationale of these two rulings. Consider, in regard to the trade magazines ruling, whether the separation of one of the electrical magazines would be permitted on the ground that it dealt solely with certain specialized matters in the industry, while the other two were concerned generally with the entire field. Or, consider, in the context of the furniture-appliance ruling, what would be the result if it were claimed that the furniture business should be allowed to separate its kitchen furniture department from its living-room department.[62]

The *Coady* case, mentioned above, marks the first time the one business-two businesses issue has been actually presented to the tax court. In that case a corporation, owned 50 percent each by two shareholders, had for over five years been engaged in the active conduct of a construction business. Because of personal differences between the stockholders, it was agreed to divide the business. Accordingly, a new corporation was formed to which the old corporation transferred approximately one-half its business assets in exchange for all the stock of the new corporation. This stock was then distributed to one of the shareholders—Edmund P. Coady—in exchange for all his stock in the old corporation. The Commissioner contended, in accordance with the regulations, that this was not a tax-free split-off within the purview of section 355, because there was merely a division of a single business. The tax court decided in favor of the taxpayer, holding the regulations on this question invalid, and the Sixth Circuit affirmed.[63]

In justification of its interpretation, the Service relied on certain language in section 355, requiring that immediately after the distribution, both the controlled corporation and distributing corporation be engaged in the active conduct of a trade or business.[64] The definitional provision in that section states that

61 Rev. Rul. 56-655, 1956-2 CUM. BULL. 214. In this case, a transfer was made to the appliance business to equalize values, and the Service ruled the division was not thereby disqualified. The ruling did not discuss the question whether there were two businesses or only one.

62 *Cf.* Young, *supra* note 60, at 865.

63 33 T.C. 771 (1960), *aff'd*, 289 F.2d 490 (6th Cir. 1961), 58 MICH. L. REV. 942 (1960). Certiorari was not applied for; however, the Service has indicated it will not follow the Sixth Circuit's decision. Rev. Rul. 61-198, 1961 INT. REV. BULL. No. 45 at 6.

64 INT. REV. CODE OF 1954, § 355(b)(1).

in order for a corporation to be treated as engaged in the active conduct of a trade or business, such trade or business must have been conducted for the five years preceding the distribution. In the case of a division of a single business, although there may be two businesses in existence subsequent to the distribution, the Service contended that the corporations operating these two businesses cannot be thought engaged in the "active conduct of a trade or business" per section 355, since only one business could have been so conducted for five years. Therefore, the division of a single business can never qualify for tax-free treatment under section 355.

This interpretation presents something of an anomaly. Although, in such cases, two businesses have not been conducted for five years, one certainly has. The question then arises as to which of the two businesses in existence subsequent to the division is to be considered as the one so conducted. To say it is that portion of the original business which remains in the old corporation does not provide a very satisfying answer. In the *Coady* case, subsequent to the distribution, the taxpayer and his erstwhile co-shareholder were in identical positions. Each was the sole owner of a corporation conducting one-half the business formerly conducted by the old corporation; yet it could not be contended that the present owner of the old corporation incurred a taxable event.[65] Moreover, pursuant to this rationale, if the separation had taken the form of a split-up instead of split-off, neither of the businesses conducted by the new corporations would be considered actively conducted for five years. In effect, the 5-year active conduct aspect of the business of the old corporation would be totally lost. Both of the old corporation shareholders would be subject to tax, although in the case of a split-off, where the identical result is achieved, only one shareholder is sought to be taxed.[66] Such an anomalous result is unnecessary. Instead of stating that neither of the corporations subsequent to a split-up is engaged in the active conduct of the business formerly conducted by the original corpo-

65 See 58 MICH. L. REV. 942, 942 & n. 2 (1960).

66 In this split-up—split-off dichotomy, the tax consequences will depend on the form adopted for the separation. Thus another anomaly is produced. The Treasury has historically asked the courts to apply a formula of "substance over form." See, *e.g.*, Gregory v. Helvering, 293 U.S. 465, 467 (1935). Here, however, the shoe would be on the other foot, and the Treasury's request would have to be for emphasis of form over substance.

ration, it could be said that *both* corporations were engaged in the active conduct of that business. Similarly, in the case of the split-off, it could be reasoned that each corporation, subsequent to the distribution, was engaged in the active conduct of a business, which business had been previously carried on for more than five years by the original corporation.

But the Commissioner also relies on the following statement made in the Senate Finance Committee report on section 355:

> "Your committee requires that both the business retained by the distributing company and the business of the corporation the stock of which is distributed must have been actively conducted for the 5 years preceding the distribution, a safeguard against avoidance not contained in existing law."[67]

The basic purpose of the provision is to avoid taxing purely "paper profits" or technical gains.[68] The problem arises in distinguishing between those corporate separations which are legitimate "business adjustments" and those which are mere avoidance techniques for the segregation of unwanted or inactive assets in a separate corporation which may then be liquidated or the stock of which may be sold at capital gain rates. The House version of section 355[69] would have dealt with this problem by providing that any amounts received by a shareholder within ten years following the date of distribution, whether from sale, liquidation, or redemption of the distributed stock, would be taxed as ordinary income, if the stock were of an "inactive corporation" as defined in that section. In general, an "inactive corporation" would have been one holding "inactive assets"—assets held principally for investment purposes.[70] The Senate version modified this in the manner described in their committee report:

> "Present law contemplates that a tax free separation shall involve only the separation of assets attributable to the carrying on of an active business. . . . Your committee returns to existing law in not permitting the tax free separation of an

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

68 See notes 5 and 7 *supra*, and accompanying text. For a view questioning the economic wisdom of the reorganization provisions generally, see Hellerstein, *Mergers, Taxes, and Realism*, 71 HARV. L. REV. 254 (1957).

69 H.R. 8300, 83d Cong., 2d Sess. § 353(b) (1954).

70 See H.R. 8300, 83d Cong., 2d Sess. § 353(c) (1954); H.R. REP. No. 1337, 83d Cong., 2d Sess. A123-24 (1954).

> existing corporation into active and inactive entities. It is not believed that the business need for this kind of transaction is sufficiently great to permit a person in a position to afford a 10-year delay in receiving income to do so at capital gain rather than dividend rates. [Here follows the sentence quoted *supra* upon which the Commissioner relies.]"[71]

From the full context of the statement, it appears the requirement that both businesses must have been actively conducted for five years was intended to obviate the possibility of a separation of a corporation into active and inactive entities. But there is nothing to indicate Congress intended to proscribe the division of one active business entity into two active entities. In such case, there does not exist the same possibility for tax avoidance as in the case of separation of inactive assets. Each of the corporations formed by the separation would have proportionately the same history of earnings and profits as did the old corporation. Therefore, a shareholder would not be able to liquidate his holdings of unwanted, inactive assets since there would be none segregated. Thus, the reason for prohibiting a division of a business into active and inactive entities does not exist in the case of a division into two active entities. Moreover, in setting forth its reasoning in regard to the active business requirement, the finance committee stated it was returning to existing law and it would appear that under the then "existing" law such a separation was permissible.[72] In discussing the restoration of the spin-off as a means of tax-free corporate separation,[73] the finance committee stated, "it is intended that section 317 [of the 1951 Revenue Act] shall be applicable even though the *portion of the business* which is spun off is already organized as a separate corporation . . . ."[74]

There is an additional argument which might be made in favor of the Commissioner's interpretation. The word "separation"

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

[72] See Rev. Rul. 270, 1953-2 CUM. BULL. 35, permitting a bank to transfer its branch offices to new corporations, the stock of which was then distributed to the bank's stockholders; *cf.* Rev. Rul. 289, 1953-2 CUM. BULL. 37.

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

[74] S. REP. No. 781, 82d Cong., 1st Sess. 57-58 (1951) (emphasis supplied). In connection with this provision, Senator Humphrey stated, "if there is a real legitimate business purpose, corporations can be divided. The stockholders merely continue to operate the *same business* through two entities rather than one." 97 CONG. REC. 11812-13 (1951).

was used exclusively by the finance committee in referring to the general type of transaction which section 355 would govern.[75] "Separation," in one sense, could be said to apply only to two or more things; there cannot be a "separation" of one thing in the sense that there can be a division of one thing. Thus, it is said that the finance committee, by choosing the word "separation," evidenced the intent that section 355 apply only to the separation of two or more businesses since there can be no separation, but only a division, of a single business. But there is no indication in the report that the committee was using the word in this restricted sense. Moreover, this argument may prove too much. Prior to the separation, there is only one corporation. It is only afterward that there are two corporations, and then there are also two businesses. Therefore, if the word "separation" were considered as used in this restricted sense in regard to corporations as well as businesses, section 355 would be rendered ineffectual.

Additional light is shed on the question of congressional intent for section 355 in the examples given by both the House Ways and Means Committee and the Senate Finance Committee regarding non-pro rata distributions of the type here involved.

> ". . . if two individuals, A and B jointly form a corporation and later wish to operate independently as corporations, this may be accomplished . . . through the formation of two new subsidiary corporations . . . and the distribution of the stock of each separately to A and B."[76]

According to the Commissioner's interpretation, if two separate businesses were combined under one corporate tent so that there was afterward only one business, a subsequent separation could not be effected tax free. But the only conclusion to be drawn from the example in the congressional committee reports is that exactly the opposite result was anticipated. However, a tax-free separation might be possible in this situation if each of the businesses was separately incorporated as a subsidiary of a holding company owned, in turn, by the individuals who previously owned the respective businesses. But there is nothing to

75 See note 71 *supra* and accompanying text.

76 H.R. REP. No. 1337, 83d Cong., 2d Sess. A121 (1954). S. REP. No. 1622, 83d Cong., 2d Sess. 266-67 (1954) contains almost identical language.

indicate that Congress intended such a circuitous method be necessary in order to achieve nonrecognition under section 355. Thus, the regulations requirement that two businesses exist prior to the separation does not appear, from any viewpoint, to be in accordance with the intent of Congress and should, therefore, be rejected.

3. *Vertically-Integrated Businesses*

The regulations provide that "a group of activities which, while a part of a business operated for profit, are not themselves independently producing income . . ." does not constitute an active business.[77] Thus, the research activities of a wood products manufacturing concern do not constitute an active business,[78] nor do the selling activities of a meat processing firm.[79] Similarly, the coal mining operations of a steel manufacturing corporation are not a separate active business.[80] These are all vertically-integrated businesses. They do not constitute separate active businesses because they do not of themselves produce income. On the other hand, horizontally-integrated businesses, such as manufacturing or sales activities, carried on in separate geographic areas, may qualify as active businesses.[81] In amplification of this distinction, the Internal Revenue Service has ruled in the case of a corporation engaged in refining, transporting, and marketing petroleum products, and in oil producing and exploration activities, that the latter activities do not constitute the active conduct of a business because they are not independently producing income.[82] Similarly, the Service has ruled that the distributing activities of a soft drink bottling corporation, carried on at three locations separate from each other and from the site of the bottling operations, could not be spun off tax free since all the activities were part of one business—the manufacture and sale of the soft drink.[83]

Here again, the question is whether the intent of Congress—to permit business to go forward with necessary adjustments without tax consequences[84]—has been effectuated. In the technical

[77] Treas. Reg. § 1.355-1(c)(3) (1962).
[78] Treas. Reg. § 1.355-1(d) Example (5) (1962).
[79] Treas. Reg. § 1.355-1(d) Example (11) (1962).
[80] Treas. Reg. § 1.355-1(d) Example (12) (1962).
[81] See Treas. Reg. § 1.355-1(d) Examples (8), (10), and (13) (1962).
[82] Rev. Rul. 57-492, 1957-2 CUM. BULL. 247.
[83] Rev. Rul. 54, 1958-1 CUM. BULL. 181.
[84] See notes 5, 7, and 68 *supra* and accompanying text.

discussion of the provisions of the 1954 Code, both the House Ways and Means Committee and the Senate Finance Committee submitted, as an example of the expected effect of section 355, the case of a split-up of a corporation due to an antitrust decree.[85] This is quite as likely to occur in a vertically-integrated business as in one horizontally integrated. Moreover, when the finance committee stated it was returning to "existing law" in limiting the applicability of section 355 to separations of active businesses, it gave no indication of an intent to create a new, additional requirement for the case of a vertically-integrated business.[86] Under the 1939 Code, the separation of one of the activities of a vertically-integrated corporation was permissible.[87] Another factor of importance is that there is little likelihood of a separation of part of such a business being used as a "device." If the activity separated is actually a part of an integrated whole, continuance of its operations would be of vital importance to the entire business. In view of these considerations, it would appear that the intent of Congress would be better effectuated if the active business test were administered following the separation. The question would then be whether, at that time, there were two separate active businesses. If there were, nonrecognition would be accorded; if not the gain would have to be recognized as ordinary income. Separation of inactive assets would be no more permissible under such an interpretation of the active business rule than under the present one. However, business would be much more free to go ahead with business adjustments necessary to the economic health of the country.

III. CONCLUSION

Because of the restrictive attitude of the Internal Revenue Service in regard to certain facets of the "5-year active business" requirement under section 355, and because of the uncertainty inherent in the test as it is now administered, the validity of all the rules in regard to the test, and the test itself, have been

85 H.R. REP. No. 1337, 83d Cong., 2d Sess. A121 (1954); S. REP. No. 1622, 83d Cong., 2d Sess. 267 (1954).

86 See note 71 *supra* and accompanying text.

87 See Stella K. Mandel, 5 T.C. 684 (1945); Estate of Howard T. McClintic, 47 B.T.A. 188 (1942); see generally Lyons, *Some Problems in Corporations Under the 1954 Code*, 12 TAX L. REV. 15, 22 (1956), suggesting this to be the "proper" result under the 1954 Code.

challenged.[88] But in adopting a confining interpretation of the test the Commissioner may have been concerned with the relation of the "5-year active business" test in section 346 regarding partial liquidations[89] which receive capital gain treatment under section 331.[90] Section 346 supplies the definition of a partial liquidation, and provides a "5-year active business" test, but does not supply the Commissioner with the "device" test which is provided as a weapon to combat avoidance under section 355. Moreover, the regulations promulgated under section 346 rely, for the definition of an "active business" on the definition of that term in the regulations under section 355. Thus, it may be that the Internal Revenue Service fears the possibility of avoidance under section 346 may be increased if a more liberal interpretation is made of the "5-year active business" rule under section 355. However, there is no reason why the rule under section 346 must have the same meaning as under section 355. The rationale for the rule in the respective sections is entirely different. The purpose for the requirement in section 346 is to ensure that that section will apply only in the case of a "*bona fide cessation* of an independent branch of a business of the corporation . . ." and not to a "mere contraction in the scope of a single business of the corporation."[91] On the other hand, section 355 is to apply only where there is a "readjustment of *continuing* interests . . . under modified corporate forms."[92] Therefore, the interpretation of the "5-year active business" test under section 346 may be different from the interpretation under section 355, and such as to prevent avoidance. On the other hand, the problem of avoidance under section 346

88 See COMM. ON TAXATION, ASS'N OF THE BAR OF THE CITY OF NEW YORK, RECOMMENDATIONS FOR REVISION OF INTERNAL REVENUE CODE OF 1954, 32 (1955), reprinted in 2 J. TAXATION 322, 331 (1955), and *Income Tax Problems of Corporations and Shareholders*, in ALI, REPORT FOR 1957-58, at 26 (1958), both recommending elimination of the "5-year active business" test; *Advisory Group Report to Subcommittee on Internal Revenue Taxation* (Government Printing Office, Dec. 24, 1957) recommending that an escape provision be added for cases in which the requirement is not met, but the Commissioner is satisfied that the distribution is not made to avoid federal income tax. *But cf.* Mintz, *Corporate Separations*, 36 TAXES 882, 886 (1958) criticizing this last as not being sufficiently specific as to provide necessary certainty.

89 See Caplin, *supra* note 48, at 635; *cf.* Giles E. Bullock, 26 T.C. 276 (1956), in which a spin-off was taxed as a partial liquidation. For a discussion of the rule under § 346, see Silverstein, *Stockholder Gains and Losses in Partial Liquidation*, N.Y.U. 14TH INST. ON FED. TAX. 707, 714-22 (1956).

90 *Cf.* authorities cited note 87 *supra*.

91 H.R. REP. No. 1337, 83d Cong., 2d Sess. A112 (1954) (emphasis supplied).

92 Treas. Reg. § 1.355-2(c) (1962) (emphasis supplied).

should not cause the tax-free treatment of section 355 to be unattainable for legitimate corporate separations.

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