

CORPORATE SEPARATIONS: AN ANALYSIS
OF THEIR TAX IMPLICATIONS

by

George Frederick Lamberth

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APPROVED:

Chairman, Dr. James H. McLean

Dr. William J. Crasty

Dr. Norman L. Brown

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CHAPTER I

INTRODUCTION

The separation or division of a corporation and the related transfer to its shareholders of the separated part involves intricate corporate and tax procedures. Section 355 of the Internal Revenue Code of 1954 governs the general statutory scheme of corporate separations. According to the related regulations, this section "provides for the separation, without recognition of gain or loss to the shareholders and security holders, of two or more existing businesses formerly operated, directly or indirectly, by a single corporation."¹ Actually, Section 355 recognizes that a mere change in corporate form does not effect an economic change, and it thus permits the postponement of tax on the gain realized in the division of corporate structures.

Basically, a corporate separation is an arrangement whereby the shareholders of a single corporation split up their investment among several corporate shells. This separation may take one of several forms, but it must comply with the requirements of Section 355 in order to achieve

¹Internal Revenue Regulations, Section 1.355-1(a).

the tax-free status. These several forms of corporate separation have become known as spin-offs, split-offs, and split-ups.

In a spin-off one corporation distributes to its shareholders the stock of either an existing corporation or a newly created subsidiary corporation to which the distributing corporation has conveyed a part of its assets. The shareholders receiving the distribution do not surrender any of their stock in the distributing corporation. A split-off is identical, except that on the distribution the shareholders receiving the stock of the subsidiary corporation surrender all or a part of their stock in the distributing corporation. A split-up occurs when a corporation transfers its assets to two or more newly created corporations in exchange for their stock and then effects a complete liquidation by transferring to its shareholders the stock in the new corporations in exchange for their distributing corporation's stock.

The economic result of each of these three forms of corporate separation is ultimately the same. Before the division the shareholders own the stock of a corporation which conducts one or more businesses either directly or through subsidiaries. After the separation, the same shareholders own the stock of two or more corporations, each of which conducts one or more businesses, either directly or

through subsidiaries. The surviving corporations collectively own the same assets and conduct the same business or businesses that the predecessor corporation owned and controlled.

Purpose

The basic purpose of this thesis is to analyze Section 355 of the Internal Revenue Code of 1954 in light of subsequent developments in order to set forth the current tax treatment of corporate separations. This analysis seems to be necessary because of the many and varied court decisions and Revenue rulings which have occurred in recent years concerning the tax treatment of corporate separations. These court decisions and Revenue rulings have produced significant changes in and new interpretations of the tax effects of corporate separations.

Also, through this analysis, the basic trends which have developed in this area of tax law will be determined. These trends will concern the manner in which the Internal Revenue Service and the courts have treated and ruled on the various requirements governing the tax treatment of corporate separations. Furthermore, any recommendations which seem necessary will be presented and discussed.

Methodology

The primary method of study utilized in this thesis consists of library research. Numerous articles from various periodicals have been reviewed and studied in light of their relevance concerning the tax treatment and effects of corporate separations. Section 355 of the Internal Revenue Code of 1954, along with the related regulations, have been studied and analyzed. Also, all subsequent Revenue rulings and court cases which are relevant to the purposes of this thesis have been reviewed and analyzed in order to determine their effects, both present and future, on the tax status of corporate separations.

Chapter Synopsis

A synopsis of each chapter contained in this thesis is presented in this section in order to set forth the plan and the approaches utilized in achieving the stated purposes. The intent and content of each chapter is explained in the hope that this explanation will facilitate the reading and understanding of the material presented in this thesis.

Chapter I, the present chapter, needs no real explanation since the material presented is mainly introductory in nature. This chapter serves as the introduction to the thesis and includes an explanation of the purpose and the method of study, along with the present chapter synopsis.

Also included in this chapter by way of introduction is an explanation of the corporate separation and its various forms, along with the basic purpose of Section 355 concerning the tax-free status of corporate separations.

In Chapter II, the historical development of the tax treatment of corporate separations is presented up to 1954 when the currently effective Internal Revenue Code was enacted. The purpose of this history is to provide the necessary background material for the discussion and analysis of Section 355 of the 1954 Code. Also, this material will be utilized where needed in the determination and analysis of the trends which have developed in the tax treatment of corporate separations.

Chapter III presents an analysis of the current tax treatment of corporate separations. The focal point of this analysis is Section 355, which will be discussed and analyzed in light of the various subsequent developments which have occurred since the 1954 Code was enacted. This analysis is divided according to the requirements of Section 355 and its related regulations. Also, the tax effects of corporate separations are discussed in this chapter.

In the final chapter, Chapter IV, a concise summary of the requirements of Section 355 is presented, along with a brief historical outline of the pre-1954 tax treatment of corporate separations. Following this summary, the

trends which have developed in the tax treatment of corporate separations are presented. Also, this chapter includes several recommendations which concern ways in which the present tax laws could be amended in order to simplify or improve the requirements currently being utilized to determine the tax status of corporate separations.

CHAPTER II

HISTORICAL DEVELOPMENT OF TAX

TREATMENT TO 1954

This chapter traces the historical development of the tax treatment of corporate separations up to the enactment of the Internal Revenue Code of 1954. The purpose of this history is to provide the background material necessary in the discussion and analysis of Section 355 of the 1954 Code and in the determination of the trends which have developed in this area of taxation.

Prior to the enactment of Section 355 of the 1954 Code, the three types of corporate separations, spin-offs, split-ups, and split-offs, were treated as separate cases by the law and by the courts. The tax consequences of these three methods of dividing up a corporate investment were thus quite divergent, despite the fact that their economic consequences were ordinarily almost identical. This chapter will therefore separately trace the pre-1954 history of each of the three types of corporate separations.

Spin-Offs

Basically, a spin-off is a distribution by one corporation of the stock of a subsidiary corporation. Under the 1954 Code, the stock of either an existing subsidiary or a newly created one can qualify for a tax-free spin-off. However, before 1954 the subsidiary had to be created for the purpose of a corporate separation or, if an existing subsidiary was used, the distributing corporation was required to transfer additional assets to it as part of a plan of reorganization.

Nonrecognition of gain to shareholders involved in a spin-off was first provided for by Section 203(c) of the Revenue Act of 1924.¹ Prior to this provision a spin-off was considered to be a severance of assets of the distributing corporation and, to the extent that it could be measured by earnings and profits of the distributing corporation, was considered taxable on the stock distribution as an ordinary dividend.²

¹S. Laurence Shaiman, "Corporate Divisions: Does Section 355 Require the Existence of More Than One Separate Active Business Prior to the Distribution of Stock?" Taxes, XLII (May, 1964), 281. (Hereinafter referred to as "Corporate Divisions.")

²Alvin M. Simon, "Tax-Free Corporate Divisions: They Are Still a Danger Area After Ten Years," The Journal of Taxation, XXIII (July, 1965), 24. (Hereinafter referred to as "Tax-Free Corporate Divisions.")

The Revenue Act of 1924 permitted a spin-off to be accomplished tax-free by providing that the transfer by a corporation of part or all of its property to a second corporation constituted a reorganization if the first corporation or its shareholders (or both) were in control of the second corporation immediately after the transfer and that no gain was to be recognized by the shareholders of the first corporation if stock of the second corporation was distributed to them as part of the reorganization plan.³ Since there were no restrictions as to what could be spun off, this opened up the possibility of converting dividend income to capital gain. A corporation could transfer its excess liquid assets to a newly organized corporation and distribute the stock of the new corporation to its shareholders who would in turn liquidate this corporation and dispose of the assets, incurring only capital gains tax in the entire transaction.

Attempts were made by the Commissioner of the Internal Revenue Service to prevent the many abuses of this spin-off provision by arguing in the courts that when the entire transaction lacks a business purpose other than mere tax avoidance, the transaction should be treated as a dividend

³Boris I. Bittker and James S. Eustice, Federal Income Taxation of Corporations and Shareholders (2nd ed.; Hamden, Conn.: Federal Tax Press, 1966), p. 451. (Hereinafter referred to as Federal Income Taxation.)

even though it fits within the literal language of the statute.⁴ In 1935 this position was upheld by the Supreme Court in Gregory v. Helvering,⁵ one of the most far-reaching and widely cited cases in the entire realm of Federal income taxation.

In this case the Supreme Court held that full compliance with the letter of the spin-off statute was not enough if the transaction was otherwise indistinguishable from an ordinary dividend.⁶ The taxpayer in this case, Mrs. Gregory, owned all the stock of United Mortgage Corporation. This corporation in turn owned one thousand shares of stock in the Monitor Securities Corporation which the taxpayer desired to sell to a third party for her individual profit. In order to make the Monitor Securities stock available to Mrs. Gregory for sale with minimum tax, United Mortgage organized Averill Corporation and two days later transferred the Monitor Securities stock to Averill in return for Averill's stock, which the taxpayer received. A few days later Averill was liquidated and dissolved, distributing the Monitor Securities stock to Mrs. Gregory, who sold it the same day to the third party and reported the

⁴Shaiman, "Corporate Divisions," p. 282.

⁵Gregory v. Helvering, 293 U.S. 465, 14 AFTR 1191 (1935).

⁶Bittker and Eustice, Federal Income Taxation, pp. 451-52.

profit realized as capital gain.

A deficiency was determined on the theory that the net result of the actions taken by the taxpayer in this case was an ordinary dividend distribution of the Monitor Securities stock held by United Mortgage to Mrs. Gregory.⁷ The Board of Tax Appeals, forerunner to the Tax Court of today, held for the taxpayer by stating that the distribution of the Averill stock was tax-free to Mrs. Gregory under the spin-off provision in Section 112(g) of the Revenue Act of 1928, and that she realized a capital gain upon the liquidation of Averill Corporation.⁸

However, the Internal Revenue Service was successful in the Court of Appeals for the Second Circuit. This court reversed the Board's decision by finding that the transaction lacked business purpose and business continuity, and therefore was not a reorganization within the meaning of Section 112 of the applicable statute. Hence, United Mortgage's distribution of Averill's stock to Mrs. Gregory constituted a taxable dividend.⁹ The Supreme Court's affirmation made it clear that the spin-off provision need not

⁷Ibid., p. 452.

⁸Seymour S. Mintz, "Divisive Corporate Reorganizations: Split-Ups and Split-Offs," Tax Law Review, VI (May, 1951), 369. (Hereinafter referred to as "Divisive Corporate Reorganizations.")

⁹Ibid., p. 370.

be feared as a vehicle of flagrant tax avoidance.

While the Gregory case was moving from the Court of Appeals to the Supreme Court, Congress enacted the Revenue Act of 1934, which eliminated the previously tax-free treatment accorded a spin-off. The House Committee on Ways and Means had recommended this elimination of the statutory provision due to the fact that this provision had permitted corporations to pay what would otherwise be taxable dividends, thereby allowing their shareholders to avoid the payment of any taxes on these dividends.¹⁰ Congress thus reduced all spin-offs, whether serving business purposes or not, to the level of ordinary distributions taxable as dividends to the extent of the corporation's earnings and profits accumulated since 1913.

Even though this legislative action in 1934 robbed the Supreme Court's decision in the Gregory case of some of its immediate importance, this decision has since permeated much of tax law by disallowing tax avoidance as a valid business purpose in tax matters. Furthermore, this decision has had a special impact on the reorganization provisions of the Internal Revenue Code, and the later history of corporate separations has been constantly haunted by the fear that a divisive distribution may in fact be treated as a taxable dividend.

¹⁰Bittker and Eustice, Federal Income Taxation, p. 454.

After 1934 there were several unsuccessful proposals made to restore the tax-free treatment to spin-offs, with appropriate restrictions to prevent its use primarily for tax avoidance.¹¹ In 1951 these efforts were finally successful. Through Section 317 of the Revenue Act of that year, the Internal Revenue Code of 1939 was amended to restore in Section 112(b)(11) the tax-free spin-off of the common stock of a subsidiary pursuant to a plan of reorganization. However, this legislation was cautious in its reinstatement of the spin-off in that a spin-off was not to be tax-free if it appeared that any corporation which was a party to such a reorganization did not intend to continue the active conduct of a trade or business after the reorganization, and, also, if it appeared that the spin-off of the subsidiary's stock was used principally as a device for the distribution of earnings and profits to the shareholders of any corporation involved in the reorganization.¹²

The Senate Finance Committee which recommended the enactment of Section 112(b)(11) stated that as long as a spin-off is undertaken for legitimate business purposes, it is economically unsound to impede this type of corporate separation which breaks-up a business into a greater number

¹¹Shaiman, "Corporate Divisions," p. 283.

¹²Simon, "Tax-Free Corporate Divisions," p. 24.

of enterprises.¹³ It was hoped that the limitations imposed as conditions for the nonrecognition of gain in a spin-off, which were for the first time expressly stated in the Act itself, would prevent the tax avoidance which had resulted from the prior nonrecognition provisions.¹⁴

From the enactment of Section 112(b)(11) in 1951, nothing further was done to change the spin-off provisions until they were supplanted by the more elaborate provisions of Section 355 of the Internal Revenue Code of 1954. However, as will be seen, the 1951 legislation concerning spin-offs did foreshadow several limitations which were incorporated into Section 355 of the currently effective 1954 Code.

Split-Ups

The type of corporate separation known as a split-up occurs when a single existing corporation is replaced by two or more new corporations, the stock in the new corporations being distributed to the shareholders of the existing corporation, which then effects a complete liquidation. This transfer of corporate assets to two or more new corporations was first recognized as a tax-free reorgan-

¹³Herman Wolff, Jr., "Divisive Reorganizations as Affected by the Revenue Act of 1951," Taxes, XXXI (September, 1953), 717. (Hereinafter referred to as "Divisive Reorganizations.")

¹⁴Shaiman, "Corporate Divisions," p. 283.

ization by Section 202(b) of the Revenue Act of 1918. The rationale of Congress for this special treatment was to nullify the imposition of tax in certain purely paper transactions, thereby postponing the tax until there was a more final change of position.¹⁵

In 1934, when Congress stripped the spin-off type of corporate separation from its tax immunity, it took no action against the nonrecognition of gain upon the distribution of stock in a split-up.¹⁶ This seems rather strange since the split-up presented an opportunity for tax avoidance just as the spin-off did before the passage of the Revenue Act of 1934. Perhaps the split-up was left untouched in 1934 because the spin-off had most often been used as the method of distributing corporate earnings and profits without any incidents of tax falling upon the shareholders. The reason for this was probably due to a desire to have the parent corporation continue in business because of the good-will it had developed, which, along with possible franchises and contracts, might be lost if the parent corporation was dissolved through a split-up.¹⁷

¹⁵Roger B. Harris, "Elimination of Certain Problems Under Section 355," Michigan Law Review, LX (April, 1962), 763.

¹⁶Bittker and Eustice, Federal Income Taxation, p. 456.

¹⁷Shaiman, "Corporate Divisions," p. 283.

However, whatever the reason behind the lack of legislative action concerning this type of corporate separation, the Supreme Court's decision in the Gregory case operated thereafter as a safeguard against the possible use of a split-up for tax avoidance purposes.

The split-up has therefore, since 1918, been recognized under tax law as a nontaxable method of dividing corporations. However, before 1954, the parent corporation was required either to create the subsidiaries as part of a plan of reorganization or to transfer additional assets to existing subsidiaries.¹⁸ Neither of these steps is now required under the Internal Revenue Code of 1954.

Split-Offs

The split-off type of corporate separation is identical with the spin-off, except that the shareholders of the parent corporation surrender part of their stock in the parent in exchange for the stock of the subsidiary. However, the historical development of split-offs as taxable or nontaxable reorganizations is not as clear-cut as it is for the other two types of corporate separations.

The first statutory provision for the nonrecognition of gain to the shareholders in a corporate separation was contained in Section 202(b) of the Revenue Act of 1918.

¹⁸Bittker and Eustice, Federal Income Taxation, p. 451.

This section provided that in the case of a reorganization, consolidation, or merger, if a shareholder receives in place of stock or securities owned by him, new stock or securities of no greater aggregate par or face value, then no gain or loss shall be deemed to have occurred from the exchange. However, if the new stock or securities were of greater aggregate par or face value, then gain was recognized to the extent of the difference between the fair market value of the new stock or securities and the basis for the old stock or securities.¹⁹ By its very terms, this section applied to the split-up transaction already discussed, and it definitely did not apply to the spin-off transaction in which the shareholder does not relinquish any of his stock or securities in the original corporation.

It would also seem that this section should have applied to a split-off transaction wherein the shareholder relinquishes part of his stock in the original corporation. However, this applicability to split-offs is denied by those who assert that in a split-off transaction the pro rata transfer to the original corporation of part of its own stock by its shareholders is a formal act not substantially affecting such corporation or its ownership or operation, but merely reducing the number of its outstanding shares and hence, leaving the split-off essentially indistinguish-

¹⁹Shaiman, "Corporate Divisions," p. 281.

able from the spin-off.²⁰ The exact status of the split-off in terms of the Revenue Act of 1918 is thus doubtful.

This dubious status of the split-off continued until the passage of the Revenue Act of 1924, which granted the tax-free treatment of spin-offs. From the passage of this act until the Revenue Act of 1934, when the spin-off provision was eliminated making the spin-off transaction taxable, split-offs were treated as tax-free. However, it is not clear whether they were accorded this status because they resembled split-ups or because they were like spin-offs.²¹

When the spin-off was stripped of its tax immunity by the Revenue Act of 1934, no action was taken on the split-off, although it could be utilized as a substitute for the spin-off in achieving a tax-free distribution to the shareholders. This seems even stranger than the situation described above concerning the split-up, since in a split-off transaction the parent corporation remains intact. However, even though no action was taken against the split-off by the Revenue Act of 1934, the Treasury Department continued to rule favorably on this type of corporate separation.²²

So far as the language of the various Revenue Acts

²⁰Mintz, "Divisive Corporate Reorganizations," p. 367.

²¹Ibid., pp. 368-69.

²²Wolff, "Divisive Reorganizations," p. 717.

after 1934 and the Internal Revenue Code of 1939 were concerned, the split-off transaction met the literal requirements of a tax-free reorganization. However, it was arguable, as before, that a split-off was no more than a spin-off coupled with a surrender of stock in the original corporation that was a meaningless gesture if pro rata.²³

Nevertheless, the Treasury Department generally accepted the split-off as a tax-free reorganization, at least where the Gregory case was not applicable, until 1948. This position was taken because, due to the exchange feature of the split-off, it was considered as essentially the same as a split-up and therefore nontaxable.²⁴

In 1948, however, the Treasury Department discontinued the issuance of favorable rulings on the split-off because of a divergence of opinion as to whether it was essentially equivalent to a spin-off and, therefore, taxable at ordinary dividend rates, or whether it was essentially equivalent to a split-up and, therefore, a valid, tax-free reorganization.²⁵ Thus, starting in 1948, the Treasury Department refused to rule favorably as to distributions in split-offs, apparently in the belief that they were es-

²³Bittker and Eustice, Federal Income Taxation, p. 456.

²⁴Wolff, "Divisive Reorganizations," p. 717.

²⁵Ibid., p. 717.

entially indistinguishable from spin-offs.²⁶

Within a few years after 1948, however, the courts had put their stamp of approval on split-offs serving a business purpose, though the criteria for tax-free status was not entirely clear.²⁷ This approval probably stemmed from the passage of the Revenue Act of 1951, which restored the tax-free treatment to spin-offs. Furthermore, in 1953, the Internal Revenue Service ruled favorably on a pro rata split-off serving a business purpose.²⁸

Thus, on the eve of the adoption of the Internal Revenue Code of 1954, the split-off, as well as the spin-off and split-up, were all recognized as tax-free corporate separations, subject to such judicial safeguards as the business purpose doctrine of the Gregory case. The history of these three types of corporate separations was then taken into consideration by Congress when it further altered and restricted them in enacting Section 355 of the 1954 Code, which is discussed and analyzed in the next chapter.

²⁶Mintz, "Divisive Corporate Reorganizations," p. 371.

²⁷Bittker and Eustice, Federal Income Taxation, p. 456.

²⁸Ibid.

CHAPTER III

CURRENT ANALYSIS OF TAX TREATMENT

Section 355 of the Internal Revenue Code of 1954 is discussed and analyzed in this chapter.¹ This analysis covers the basic requirements of Section 355, along with the pertinent Revenue rulings and court cases which have occurred since its enactment. The current tax treatment and tax implications of corporate separations is thus developed through this analysis, which is divided according to the distribution, device, business purpose, active business, and five-year business history requirements of Section 355 and its related regulations. Also, at the end of this chapter, the tax effects of corporate separations are discussed.

As explained in Chapter II, the spin-off, the split-off, and the split-up were handled as separate cases prior to the enactment of the 1954 Code. However, since the economic result is substantially the same regardless of the form of the corporate separation, all three types are now accorded the same treatment and must meet the same

¹Section 355 is given in its entirety in the Appendix to this thesis.

statutory requirements as contained in Section 355.

Basically, this section is comprised of a single set of tests designed to distinguish between those corporate separations which are deserving of tax-free treatment, and those which merely represent a means of distributing the earnings and profits of a corporation without incurring dividend treatment. In order to achieve this result, the requirements of Section 355, which must be met before a corporate separation will be granted tax-free status, were made very stringent, and are much more restrictive than the pre-1954 Code requirements governing corporate separations.

Distribution Requirements

In order for a corporate separation to qualify under the rules of Section 355, there must be a distribution by the distributing corporation of stock or of stock and securities of a corporation which it controls immediately before the distribution.² The distribution must include either all the distributing corporation's stock and securities in the controlled corporation or at least enough stock in the controlled corporation to constitute control within the meaning of Section 368(c).³ However, a distribution of

²Internal Revenue Code of 1954, Section 355(a)(1)(A). (Unless otherwise noted, all future references to the Code or its Sections are to the Internal Revenue Code of 1954.)

³Ibid., Section 355(a)(1)(D).

less than all the stock and securities will not be permitted unless the taxpayers involved establish to the satisfaction of the Commissioner of the Internal Revenue Service that such retention was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax.⁴ Such approval can be difficult to obtain, however, because the Internal Revenue Service holds that the usual business reasons for a corporate separation ordinarily require a distribution of all stock and securities in the controlled corporation.⁵

Definitions of several of the terms used in Section 355 are hereby given in order to help facilitate the understanding of this section. The term "distributing corporation" means the corporation holding the stock or securities, or both, in an existing corporation which it controls, or the corporation holding stock or securities, or both, which it has received in exchange for assets transferred to a new corporation which it controls. The term "controlled corporation" means the corporation whose stock is held, in an amount constituting control, by the distributing corporation, or the newly organized corporation to which assets have been transferred by the distributing corporation in exchange for the stock and securities of the new corporation. Finally,

⁴Internal Revenue Regulations, Section 1.355-2(d).

⁵Ibid.

the term "control," as defined in the Code, means "the ownership of stock possessing at least eighty per cent of the total combined voting power of all classes of stock entitled to vote and at least eighty per cent of the total number of shares of all other classes of stock of the corporation."⁶

With regard to the control requirement, the Internal Revenue Service has issued one pertinent Revenue ruling, which also helps to illustrate the restrictive attitude taken by the Service in dealing with corporate separations. In this ruling, A owned all the stock of X which owned seventy of the one hundred shares of Y stock. A contributed ten shares of Y stock to X, which then distributed all eighty shares of Y stock to A. This distribution was not a tax-free distribution under Section 355. X did not have control of Y just before the distribution except in a transitory and illusory sense.⁷

The actual distribution of the stock or the stock and securities by the distributing corporation may be either proportionate or nonproportionate with respect to its shareholders.⁸ As long as one shareholder receives a controlling portion of stock, the control requirement may be satisfied. A frequent form of corporate separation is the proportionate,

⁶Internal Revenue Code, Section 368(c).

⁷Revenue Ruling 68-260, 1968-2 CB 147.

⁸Internal Revenue Code, Section 355(a)(2)(A).

or pro rata, spin-off. In such a spin-off, the shareholders of the distributing corporation receive stock in the controlled corporation in proportion to their shareholdings in the distributing corporation. However, as already stated, the distribution need not always be pro rata. That is, an existing corporation may split up into two separate corporations with one group of stockholders assuming the complete ownership of the stock of one corporation and a different group of stockholders assuming the ownership of the stock of the other. This type of transaction is often favored by the Internal Revenue Service. In fact, the Service has indicated that it will apply less stringent active business tests in a non-pro rata corporate separation.⁹

In practice, a non-pro rata corporate separation may provide a means for the shareholders of a small, closely-held corporation to go their separate ways in a tax-free transaction. For example, all the shares of the controlled corporation might be distributed to one group of the shareholders in exchange for their shares in the distributing corporation. This group would now control the split-off corporation exclusively, while the remaining shareholders would own the distributing corporation free from any inter-

⁹Revenue Ruling 64-102, 1964-1 CB 136.

ference.¹⁰

There is one common situation, however, where the tax-free separation rules of Section 355 may be unavailable to the shareholders involved. This situation arises in the case of brother-sister corporations in which two groups of shareholders each own fifty per cent of the shares of two corporations. In this case, a non-pro rata distribution may not be utilized to accomplish what is in essence a stock swap, resulting in each group of shareholders completely owning one of the two corporations. The regulations state that "Section 355 does not apply if the substance of the transaction is merely an exchange between shareholders or security holders of stock or securities in one corporation for stock or securities in another corporation."¹¹ Thus, such a transaction will constitute a taxable exchange between the two groups of shareholders of the stock which they respectively gave up.

Under Section 355 of the 1954 Code, a plan of reorganization is not required for the distribution of stock or securities of an existing controlled corporation or corpo-

¹⁰Martin Stephen Turner, "Splitting the Small Corporation by Divisive Reorganization: Internal Revenue Code, Sections 355 and 368(a)(1)(D)," University of Florida Law Review, XVIII (Fall, 1965), 337. (Hereinafter referred to as "Splitting the Small Corporation.")

¹¹Internal Revenue Regulations, Section 1.355-3(a).

rations.¹² Such a distribution is thus tax-free, whereas according to the pre-1954 law, the creation of, or a transfer of assets to, the controlled corporation was an essential prerequisite to a tax-free distribution.

Also, Section 355 differs from the pre-1954 law in permitting preferred stock as well as common stock to be distributed tax-free, whereas Section 112(b)(11) of the 1939 Code prevented a distribution of preferred stock in a spin-off transaction. The probable reason for this previous restriction was a fear that a tax-free distribution of preferred stock could be used to bail out earnings and profits, since the shareholders could sell the preferred stock, while retaining the common stock in both corporations. However, with the enactment of Section 306 of the 1954 Code as a safeguard against the preferred stock bail-out in all of its aspects, it is not surprising that this restriction on preferred stock was not carried forward into Section 355 of the 1954 Code. Thus, preferred stock can now be distributed under Section 355, but such stock must run the gauntlet of Section 306.

Another area of concern regarding the distribution in a corporate separation is that of "boot." If anything else besides stock or securities is distributed in a corporate separation, it will constitute "boot," the tax treatment of

¹²Internal Revenue Code, Section 355(a)(2)(C).

which is prescribed by Section 356.¹³ Boot includes money and any other property which cannot be distributed tax-free in a corporate separation. Securities of the controlled corporation will constitute boot to the extent that their principal amount exceeds the principal amount of the securities which are surrendered in the distribution. If no securities are surrendered, the full fair market value of any securities received will be treated as boot. Also treated as a boot distribution is the stock of a controlled corporation, if it was acquired directly or indirectly within five years of the distribution by means of any transaction in which gain or loss was recognized in whole or in part.¹⁴ However, any stock so acquired within the five-year period is still considered as "stock" for the purpose of the requirement respecting the distribution of stock of the controlled corporation as provided in Section 355(a)(1)(D).¹⁵

When the shareholders of the distributing corporation surrender stock in order to receive new stock or securities in the controlled corporation or corporations, as in a split-off or split-up, any gain that the recipients may have on the exchange shall be recognized, but in an amount

¹³Ibid., Section 355(a)(4).

¹⁴Ibid., Section 355(a)(3)(E).

¹⁵Internal Revenue Regulations, Section 1.355-2(f)(1).

not in excess of the value of the boot received.¹⁶ This gain which must be recognized from any boot distribution is usually taxed as a dividend to the extent of each shareholder's ratable share of post-1913 earnings and profits.¹⁷ The balance of this recognized gain, if any, is treated as a capital gain.¹⁸ Also, Section 356(c) prohibits the recognition of any loss incurred by the shareholders in a tax-free corporate separation. This provision prevents the shareholders from realizing losses by causing boot to be distributed in an otherwise tax-free transaction.

Whenever boot is received in exchange for Section 306 stock, the fair market value of the boot is treated as a distribution of property under Section 301, regardless of whether the shareholder realizes gain or loss on the exchange.¹⁹ This means that the boot will be taxed as a dividend to the extent of the shareholder's ratable share of the distributing corporation's post-1913 earnings and profits. Furthermore, if boot is received in a corporate separation in which no stock or securities are surrendered, as in a spin-off, then the boot is again treated as an ordinary distribution of property under Section 301, and will be

¹⁶Internal Revenue Code, Section 356(a)(1).

¹⁷Ibid., Section 356(a)(2).

¹⁸Ibid.

¹⁹Ibid., Section 356(e).

taxed as a dividend as above.²⁰

According to the regulations, stock rights or stock warrants are not included in the term "stock and securities" for the purpose of Section 355.²¹ Thus, it would seem that an incidental distribution of stock rights or warrants would constitute taxable boot. Also, if stock rights or warrants are distributed instead of stock, it would seem that this distribution would not produce a tax-free corporate separation. This situation where stock rights were distributed instead of stock brings up two rather interesting and important cases which are now before the Supreme Court awaiting a decision. Both of these cases evolved from an identical set of facts.

Pacific Telephone and Telegraph Company, an eighty-nine per cent-owned subsidiary of the American Telephone and Telegraph Company, provided telephone services for California and the Pacific Northwest. In 1961 Pacific's management decided, for a number of valid business reasons, to transfer its non-California operations to Pacific Northwest Bell Telephone Company, a corporation which Pacific formed for the purpose of conducting those operations. In return for Pacific's non-California assets, Northwest gave Pacific a demand note and all of its stock. Also, in order to pro-

²⁰Ibid., Section 356(b).

²¹Internal Revenue Regulations, Section 1.355-1(a).

vide additional capital to finance Pacific's operations in California, Pacific offered its shareholders rights to buy the stock of Northwest below fair market value.

Two of Pacific's shareholders, Baan and Gordon, exercised their stock rights in 1961 and did not report as ordinary income the difference between the price at which they purchased the stock and its fair market value, claiming that the transaction was tax-free under Section 355. The Tax Court sustained the taxpayers' contention by holding that the transaction qualified as a tax-free spin-off.²² This decision primarily involved the requirement of distribution of "solely stock or securities" of the controlled corporation.²³ The court in its decision disregarded the explicit language of the regulations²⁴ by stating that the exercise of stock rights is equivalent to the distribution of stock and that this is the only possible reading of the Code which is in accordance with the intent of Congress.²⁵

The Commissioner of the Internal Revenue Service then appealed this decision to each of the taxpayers' jurisdic-

²²Oscar E. Baan, 45 TC 71 (1965).

²³Internal Revenue Code, Section 355(a)(1)(A).

²⁴Internal Revenue Regulations, Section 1.355-1(a).

²⁵Charles J. Roedersheimer, "Income Taxation--Reorganization--Exercise of Rights Received in Spin-Off Held Non-taxable--Sale of Rights Taxable as Dividend," University of Cincinnati Law Review, XXXV (Spring, 1966), 256.

tions. In Commissioner v. Baan,²⁶ the Ninth Circuit reversed the decision of the Tax Court by holding that the transaction was not a tax-free spin-off since there was not a single distribution as required by Section 355. This court apparently premised its decision on the fact that Section 355 was designed to cover all transactions that Congress intended to be tax-free.²⁷

On the other hand, the Second Circuit in Commissioner v. Gordon,²⁸ took a different view of the transaction and upheld the same Tax Court decision. This court seemed to be interested in the substance rather than the form of the transaction and whether it conformed "in spirit" to the nonrecognition provisions of Section 355.²⁹

The final decision of the Supreme Court should settle this question concerning whether a corporation may distribute to its shareholders rights to acquire stock in a subsidiary in a tax-free spin-off under Section 355. If the Supreme Court sides with the Tax Court and the Second Cir-

²⁶Commissioner v. Baan, 382 F.2d 485, 20 AFTR 2d 5268 (CA-9, 1967).

²⁷"Circuits Split on the Use of Rights in a Tax-Free Spin-Off," The Journal of Taxation, XXVII (October, 1967), 210. (Hereinafter referred to as "Use of Rights in a Tax-Free Spin-Off.")

²⁸Commissioner v. Gordon, 382 F.2d 499, 20 AFTR 2d 5255 (CA-2, 1967).

²⁹"Use of Rights in a Tax-Free Spin-Off," p. 210.

cuit, then the tax-free spin-off could become a valuable financing device.

Device Requirement

Section 355(a)(1)(B) of the 1954 Code requires that the corporate separation must not be used principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both. This restriction is a carry over from the pre-1954 spin-off provision of Section 112(b)(11) of the 1939 Code.

Basically, the purpose of this provision is to prevent shareholders who receive the stock of a controlled corporation from selling the stock of or liquidating one of the post-distribution corporations, thereby converting corporate earnings into cash at the capital gain rate. The economic effect of a stockholder receiving property in this manner may well be equivalent to his receiving a dividend. Consequently, where part or all of the stock or securities of either corporation are sold or exchanged pursuant to an arrangement negotiated or agreed upon prior to the distribution, the corporate separation will ordinarily be treated as a device to distribute earnings and profits, which will deny the benefits of Section 355 to the shareholders involved.³⁰

³⁰Internal Revenue Regulations, Section 1.355-2(b)(1).

Generally, such a sale is considered to have been made pursuant to an arrangement agreed upon prior to the separation transaction where enforceable rights to buy or sell existed before the corporate separation, or where, if no enforceable rights existed, the facts and circumstances indicate an arrangement had been negotiated.³¹ A literal interpretation of the statute appears to deny the benefits of Section 355 to any corporate separation which is part of a prearranged plan to sell or liquidate one of the participating corporations even though there is no actual conversion of dividend income to capital gain. Furthermore, where a sale is made shortly after a corporate separation, even though it is not pursuant to a previously negotiated agreement, it may still be considered as evidence that the transaction was used principally as a device for the distribution of earnings and profits.³²

There have been several Revenue rulings concerning this device requirement which have helped to clear up various issues regarding the effects and interpretation of this provision. One such ruling held that the distribution of a parent's stock in its subsidiary just before completion of negotiations for a sale of the parent's stock by the parent's shareholders is not tax free. A sale of the par-

³¹Ibid., Section 1.355-2(b)(2).

³²Ibid., Section 1.355-2(b)(1).

ent's stock under circumstances where the negotiations for the sale were already in process is thus generally considered as sufficient evidence that the distribution is a device for distributing earnings and profits.³³ Another situation which will be treated as a device occurs when the earnings of one business are used to enlarge another business, which is then spun-off.³⁴

On the other hand, several of these rulings have illustrated situations in which there is no principal device to effect a distribution of earnings and profits. In one situation concerning a split-off, it was held that the transfer of cash to one corporation to make the value of the assets distributed to it correspond to that distributed to the other corporation will not cause the transaction to lose its tax-free status.³⁵ Another situation involved the sale of a minority stock interest to a key employee prior to a proposed split-off, thus giving the employee an interest in the business. This sale did not make the transaction a device for distributing earnings and profits.³⁶

Several court decisions have also been related to the

³³Revenue Ruling 55-103, 1955-1 CB 31.

³⁴Revenue Ruling 59-400, 1959-2 CB 114.

³⁵Revenue Ruling 56-655, 1956-2 CB 214.

³⁶Revenue Ruling 59-197, 1959-1 CB 77.

device requirement. In Patricia W. Burke,³⁷ the Tax Court held that the spin-off of a branch business in order to allow the branch manager to invest in the business was not a device to distribute earnings and profits. Also, in Sidney L. Olson,³⁸ it was decided by the Tax Court that the transfer by distributee-stockholders of stock received in a spin-off to trusts they had created for the benefit of their wives did not indicate that the stock distribution was used principally as a device for the distribution of the earnings and profits of either the distributing or the controlled corporation.

A further aspect of the device requirement concerns a particular evidence test employed by the regulations to determine whether a corporate separation is or is not a device to distribute earnings and profits. This test involves the percentage of active business assets of each of the post-distribution corporations. If substantially all of the assets of each of the corporations are and have been used in the active conduct of trades or businesses, an inference arises that the corporate separation was not used principally as a device.³⁹ A contrary inference may thus be created when only a small percentage of either of the

³⁷Patricia W. Burke, 42 TC 1021 (1964).

³⁸Sidney L. Olson, 48 TC 855 (1967).

³⁹Internal Revenue Regulations, Section 1.355-2(b)(3).

corporation's assets consists of active business assets, as opposed to investment assets. Generally, it seems that a good rule to follow is to have the active business assets of the distributing corporation and of the controlled corporation constituting more than half of each of their assets in order to satisfy the device requirement. Also, it should be realized that this percentage test may cause a corporate separation to be treated as a device for the distribution of earnings and profits even if the stockholders do not sell the stock distributed to them.

In contrast to this percentage test, the Internal Revenue Service has ruled that a non-pro rata split-off met the device requirement of Section 355 even though less than fifty per cent of the assets of one of the corporations were active business assets.⁴⁰ However, in this type of corporate separation the shareholders who participate in the non-pro rata exchange will usually qualify for capital gain treatment under section 302(b) if Section 355 does not apply. Thus, when this situation arises in a non-pro rata corporate separation involving an exchange of stock, the transaction will probably not be considered as a device for the distribution of earnings and profits at capital gain rates.

⁴⁰Revenue Ruling 64-102, 1964-1 CB 136.

Business Purpose Requirement

In addition to the negative requirement that a corporate separation must not be used as a device for the distribution of earnings and profits, there is an affirmative requirement that there be a valid business purpose for the distribution.⁴¹ The doctrine of business purpose was first enunciated in the classic Gregory case, which was discussed in Chapter II. Although no express business purpose language exists in Section 355 itself, there is considerable authority for the application of this doctrine to corporate separations through the courts and the Internal Revenue Service in their support of the Gregory decision.

Numerous examples of business purpose which would qualify as valid in a corporate separation have been given in various Revenue rulings and court cases. Some examples from the Revenue rulings include: segregation of a risky or speculative enterprise from a more stable one;⁴² partition of a business where the shareholders are in disagreement;⁴³ separation of a business to allow employees to share in ownership or profits;⁴⁴ provision of a greater incentive

⁴¹Internal Revenue Regulations, Section 1.355-2(c).

⁴²Revenue Ruling 56-554, 1956-2 CB 198.

⁴³Revenue Ruling 56-117, 1956-1 CB 180.

⁴⁴Revenue Ruling 59-197, 1959-1 CB 77.

to the management of the separated company;⁴⁵ separation to permit shareholders interested in only one corporate business to restrict their investment to that business;⁴⁶ and separation of a corporation's two businesses to eliminate customer friction.⁴⁷

The decisions in various court cases involving corporate separations have provided several other examples of a valid business purpose. In Bondy v. Commissioner,⁴⁸ the business purpose test was met where the main purpose of the separation was to guard against cancellation of a valuable car dealership. In Patricia W. Burke,⁴⁹ the spin-off of a branch store was tax-free, with the business purpose being to allow the branch manager to invest in the branch outlet only. Also, in Sidney L. Olson,⁵⁰ the desire to contain the spread of union organizing activities was held to be a valid business reason for the spin-off involved. Several other valid business purposes could be to comply with state or local law requiring two businesses to be separated, to

⁴⁵Revenue Ruling 56-451, 1956-2 CB 208.

⁴⁶Revenue Ruling 56-655, 1956-2 CB 214.

⁴⁷Revenue Ruling 56-450, 1956-2 CB 201.

⁴⁸Bondy v. Commissioner, 269 F.2d 463, 4 AFTR 2d 5362 (CA-4, 1959).

⁴⁹Patricia W. Burke, 42 TC 1021 (1964).

⁵⁰Sidney L. Olson, 48 TC 855 (1967).

separate a regulated enterprise from an unregulated one, and to comply with an antitrust decree.

Very frequently, the purpose of a corporate separation is actually to resolve personal problems of the shareholders involved. In the past, such a purpose has not been considered as valid. However, it now appears that the business purpose may be either corporate or shareholder motivated. In Parshelsky's Estate v. Commissioner,⁵¹ the distributing corporation was engaged in a successful lumber business. Its sole owner caused the real estate used in the business to be spun-off to a newly formed subsidiary, whose stock was then distributed. The stockholder in this case wanted the real estate to be a separate part of his estate when he died. The Second Circuit held that this personal business purpose was valid and that the spin-off should be tax-free. The business purpose doctrine was thus broadened when this court held that a spin-off could be tax-free if prompted by either a corporate or shareholder purpose which would motivate a reasonable businessman to effect a spin-off.

In addition to broadening the business purpose doctrine, the Second Circuit in Parshelsky indicated that the purpose, whether corporate or shareholder, must be one which requires a distribution and not merely the formation of a

⁵¹Parshelsky's Estate v. Commissioner, 303 F.2d 14, 9 AFTR 2d 1382 (CA-2, 1962).

new subsidiary. The court pointed out there should be valid reasons not only for the separation, but also for the direct ownership by the shareholders. Thus, where the shareholder or corporate business purpose can be readily achieved by a transaction which does not require a distribution, the choice of a plan requiring a distribution may well result in a taxable corporate separation.⁵²

The Ninth Circuit emphasized the affirmative requirement of the business purpose doctrine in Commissioner v. Wilson.⁵³ In this case a corporation in the retail furniture business found itself selling a substantial quantity of furniture under conditional sales contracts. It decided that the business should form its own finance company. This was accomplished by transferring to a new corporation all conditional sales contracts and certain other assets in exchange for the latter's stock, which was then distributed to the shareholders.

The Tax Court had decided that the transaction was not a device to distribute earnings and profits, thus meeting the requirements of Section 355(a)(1)(B). However, the Ninth Circuit sidestepped the device question and read into Section 355 the business purpose requirement of Gregory.

⁵²Richard G. Cohen, "Current Partial Liquidation and Spin-Off Problems," Taxes, XLI (December, 1963), 776.

⁵³Commissioner v. Wilson, 353 F.2d 184, 16 AFTR 2d 6030 (CA-9, 1965).

No valid business purpose was found to exist, and the Ninth Circuit thus held that the separation did not qualify for tax-free status under Section 355.

In rendering its decision, the Ninth Circuit held that a good business purpose is a necessary restriction to offset the natural advantage which a spin-off affords. It was unwilling to leave the shareholders with the ever-present tempting opportunity to liquidate the new corporation whenever they so chose, thus achieving capital gain treatment. Thus, even though there was no tax avoidance or device motive, the spin-off in this case was still not tax-free since no valid corporate or shareholder business purposes were advanced.

It can therefore be stated that without a valid corporate or shareholder business purpose, a corporate separation, even though it complies literally with every provision of Section 355, will not be granted tax-free status. Furthermore, in order to insure that the business purpose will be considered as bona fide, the taxpayers involved in a corporate separation should be able to show that it existed at the time of the transaction rather than constituting a mere after thought created when the transaction is under examination by the Internal Revenue Service or involved in litigation.

Active Business Requirement

In seeking to prevent any tax abuse in corporate separations, Section 355 further requires that the distributing corporation and the controlled corporation or corporations must be engaged immediately after the distribution in the active conduct of a trade or business.⁵⁴ This provision applies to the spin-off and split-off types of corporate separations. In the case of a split-up, only the controlled corporations are required to conduct active trades or businesses immediately after the distribution, provided that the distributing corporation had no assets other than stock or securities in the controlled corporations immediately before the distribution.⁵⁵

This active business requirement constitutes the very heart of Section 355. Also, it is a carry over from the pre-1954 law. The Revenue Act of 1951, which restored the tax-free treatment of spin-offs, required that the tax-free spin-off be limited to situations in which each of the corporations involved in the reorganization intends to continue the active conduct of a trade or business after the reorganization.

Section 355 itself does not provide a definition for the crucial term "active conduct of a trade or business."

⁵⁴Internal Revenue Code, Section 355(b)(1)(A).

⁵⁵Ibid., Section 355(b)(1)(B).

However, the related regulations do provide the following definition:

. . . for 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 the activities included in such group must include every operation which forms a part of, or a step in, the process of earning income or profit from such group. Such group of activities ordinarily must include the collection of income and the payment of expenses.⁵⁶

The regulations go on to exclude from the concept of "active trade or business" the following activities: the holding of stock, securities, land, or other property for investment purposes;⁵⁷ the ownership and operation of land or buildings used in the owner's trade or business;⁵⁸ and a group of activities that do not independently produce income, even though capable of doing so with the addition of other activities or with an expansion in previously incidental activities.⁵⁹

The regulations also state that "Section 355 does not apply to the division of a single business."⁶⁰ However, this provision was held invalid by the Tax Court in Edmund

⁵⁶Internal Revenue Regulations, Section 1.355-1(c).

⁵⁷Ibid., Section 1.355-1(c)(1).

⁵⁸Ibid., Section 1.355-1(c)(2).

⁵⁹Ibid., Section 1.355-1(c)(3).

⁶⁰Ibid., Section 1.355-1(a).

P. Coady.⁶¹ In this case, because of management differences between Christopher and Coady, fifty per cent stockholders in a construction company, the company was cut in half by the use of the split-off type of corporate separation. Half the company assets went to the Coady Company, a newly formed subsidiary, and in exchange for all of his construction company stock, Coady became the sole owner of the new company. Each firm continued the construction business that had long been actively carried on. Coady reported no gain on receipt on his stock, but the Commissioner, relying on the above mentioned regulations, disagreed. The Tax Court, in siding with the taxpayer, found that, while Section 355 prohibits the tax-free separation of one corporation into an active and an inactive business, nothing in the statute bars such treatment for separations of a single active business into two that continue active. On appeal, the Sixth Circuit affirmed this decision of the Tax Court.⁶²

Despite this affirmance by the Sixth Circuit, the Internal Revenue Service maintained that it would not follow the Coady decision.⁶³ However, in 1963 the Coady decision

⁶¹Edmund P. Coady, 33 TC 771 (1960).

⁶²Coady v. Commissioner, 289 F.2d 490, 7 AFTR 2d 1322 (CA-6, 1961).

⁶³Revenue Ruling 61-198, 1961-2 CB 61.

was upheld by the Fifth Circuit in United States v. Marett.⁶⁴ This case involved Famous Foods, which processed pork skins for resale in three plants. Approximately seventy-five per cent of its pork skins were sold to one customer, while the balance were sold to competitors of that customer. In order to satisfy the objections of its principal customer, Famous Foods placed all the assets of one of its plants, which had only recently been opened, into a newly formed corporation and distributed all of the stock of that corporation to its shareholders. The Fifth Circuit held this spin-off to be tax-free, and in so doing, held the regulations⁶⁵ to be invalid insofar as they deny the benefits of Section 355 to a division of a single business. This decision thus applied the Coady decision to a distribution which was pro rata.

Also, in H. Grady Lester, Jr.,⁶⁶ the Tax Court reaffirmed its ruling in Coady. This case involved a spin-off of the wholesale operations from the retail operations of a distributor of automobile parts and equipment. The court held that the wholesale and retail activities did qualify as separate businesses prior to the separation even

⁶⁴United States v. Marett, 325 F.2d 28, 12 AFTR 2d 5900 (CA-5, 1963).

⁶⁵Internal Revenue Regulations, Section 1.355-1(a).

⁶⁶H. Grady Lester, Jr., 40 TC 947 (1963).

though they were conducted at the same location with the same employees and maintained only one set of books. Even though the court decided that two separate businesses did in fact exist, it still emphasized that it was immaterial whether only one integrated business was involved since the Coady decision was correct in allowing the division of a single business.

Finally, in 1964, the Internal Revenue Service yielded to the rationale of the Coady, Marett, and Lester decisions by stating that it will follow Coady and Marett to the extent they hold invalid the regulations barring Section 355 treatment to the division of a single business.⁶⁷ The previous ruling was thereby revoked, and the last trace of resistance by the Service in this area has been eliminated. This is evident in the case of Patricia W. Burke,⁶⁸ in which the Service agreed that Section 355 applies to a division of a single business.

However, the acquiescence by the Internal Revenue Service in Coady and Marett does not mean that any and all activities, irrespective of their nature and scope, may be treated as an active trade or business. It should be noted that the Coady doctrine, which now allows the division of a single business, does not protect a separation that

⁶⁷Revenue Ruling 64-147, 1964-1 CB 136.

⁶⁸Patricia W. Burke, 42 TC 1021 (1964).

actually involves the start of a new business activity or the separation of an activity that was not a business. According to the active business requirement, each group of activities must independently and actively produce income after the corporate separation has taken place. Thus, where a group of activities is an investment of, a function of, or incidental to the principal business, an attempted separation of these activities will fail to achieve tax-free status.⁶⁹

An excellent example of an attempted separation of an incidental activity and an investment occurred in Bonsall, Jr. v. Commissioner.⁷⁰ In this case, a distributor of floor covering materials owned the building used in its business. A small portion of the space in this building had been leased to one tenant for the preceding ten years for less than the fair rental value of the premises. A small adjoining building had not been leased for any substantial period of time during the three years immediately preceding the attempted spin-off of both parcels. The Second Circuit held that the rental activity in the larger building, carried on as an accomodation to the lessee and

⁶⁹Donald S. Jacobs, "IRS Now Concedes That a Single Business May Be Divided Under Section 355," The Journal of Taxation, XXI (July, 1964), 22.

⁷⁰Bonsall, Jr. v. Commissioner, 317 F.2d 61, 11 AFTR 2d 1447 (CA-2, 1963).

not an independent income-producing activity, was an incidental activity to the distributing business. Also, the court held that the rental activity in the case of the smaller adjoining building was so sparse that the parcel became an investment. Thus, since the rental activities did not result in the active conduct of a trade or business, the attempted spin-off was held taxable.

In relation to the other cases previously discussed in this section, it can easily be observed that the construction activities in Coady, the food processing activities in Marett, and the wholesale and retail activities in Lester met the requirements of an active conduct of a trade or business. In each of these cases, each group of activities independently and actively produced income after the separation, whereas in Bonsall this result was not achieved.

The Coady and Marett cases also illustrate a vertical separation of a business. In such a separation, a business is divided into two or more parts, with each part automatically including every operation which forms a part of, or a step in, the process of making income. A vertical separation is thus generally considered as satisfying the active business requirement.

Several examples of such tax-free corporate separations are contained in the regulations. Where a corporation manufactures and sells ice cream at a plant in State

X and at another plant in State Y, the transfer of the plant and related activities in State Y to a new corporation and a distribution of the latter's stock qualify.⁷¹ In a similar qualifying situation, a manufacturer of steel containers is involved, with sales of one plant going exclusively to a single customer.⁷² Likewise, where a corporation has separate suburban and downtown stores, each with their own managers having control over purchases, a spin-off of one of the stores will qualify.⁷³ Also, the Internal Revenue Service has ruled that the separation of a furniture branch and an appliance branch of an existing corporation was tax-free.⁷⁴ Furthermore, where a corporation published four trade magazines, one of which served the metal industry and the rest the electrical industry, the spin-off of the metal industry magazine was tax-free.⁷⁵

While a vertical separation will divide a business into two or more parts, a horizontal separation may simply separate out an investment, incidental activity, or function.

⁷¹Internal Revenue Regulations, Section 1.355-1(d), Example 8.

⁷²Ibid., Section 1.355-1(d), Example 13.

⁷³Ibid., Section 1.355-1(d), Example 10.

⁷⁴Revenue Ruling 56-655, 1956-2 CB 214.

⁷⁵Revenue Ruling 56-451, 1956-2 CB 208.

Unless the active business requirement is satisfied, the horizontal separation, as in Bonsall, will be held taxable.

With regard to investments, their ownership does not qualify as the active conduct of a trade or business, even though they independently produce income.⁷⁶ As the holding of the vacant building in Bonsall was an investment, so too is the holding of investment securities,⁷⁷ vacant land,⁷⁸ or mineral rights.⁷⁹ Also, the Service has ruled that the ownership and management of an investment portfolio of stocks and bonds does not constitute the active conduct of a business despite the size of the portfolio or the amount of activity involved in its management.⁸⁰

Incidental activities and functions are both active but neither independently produces income, and both are dependent upon the business enterprise for survival. Such groups of activities thus do not qualify as the active conduct of a trade or business.⁸¹ Basically, an incidental activity is an adjunct to a business, whereas a function is an integral part of a business.

⁷⁶Internal Revenue Regulations, Section 1.355-1(c)(1).

⁷⁷Ibid., Section 1.355-1(d), Example 1.

⁷⁸Ibid., Section 1.355-1(d), Example 6.

⁷⁹Ibid., Section 1.355-1(d), Example 7.

⁸⁰Revenue Ruling 66-204, 1966-2 CB 113.

⁸¹Internal Revenue Regulations, Section 1.355-1(c)(3).

An example of an incidental activity would be the operation of an executive dining room at a profit.⁸² Also, the rental of a small area in a building principally occupied by the lessor would constitute an incidental activity.⁸³ Furthermore, in two court cases it was held that an incidental rental activity does not amount to the active conduct of a business for the purposes of Section 355.⁸⁴ However, if the rental activity is more than merely incidental, it may be considered as a separate active business. The regulations give such an example where a bank utilizes one floor of an eleven-story office building in the conduct of its banking business, with the remaining ten floors being rented and managed by the bank's real estate department. Both the banking and rental activities are considered to constitute active businesses.⁸⁵ The Internal Revenue Service has also ruled favorably in a similar situation.⁸⁶

Several examples of integrated functions which do not constitute active businesses include the research de-

⁸²Ibid., Section 1.355-1(d), Example 16.

⁸³Ibid., Section 1.355-1(d), Example 4.

⁸⁴Isabel A. Elliott, 32 TC 283 (1959); Theodore F. Appleby, 35 TC 755 (1961).

⁸⁵Internal Revenue Regulations, Section 1.355-1(d), Example 3.

⁸⁶Revenue Ruling 56-555, 1956-2 CB 210.

partment of a manufacturing business,⁸⁷ the sales operations of a manufacturing business,⁸⁸ and the operation of a coal mine by a steel manufacturer, the coal being used to meet the fuel requirements in the manufacture of steel.⁸⁹ Also, the exploration and drilling activities of a petroleum company were held by the Service as not constituting an active trade or business.⁹⁰

Furthermore, the regulations state that the ownership and operation of real estate, all or substantially all of which is used and occupied by the owner, does not constitute a separate active trade or business.⁹¹ To this effect, the Internal Revenue Service has issued two rulings which hold that a spin-off of such real estate is not a tax-free transaction.⁹²

Another aspect of the active business requirement was brought out in two recent cases in which opposite decisions were reached on a similar set of circumstances. In Curtis

⁸⁷Internal Revenue Regulations, Section 1.355-1(d), Example 5.

⁸⁸Ibid., Section 1.355-1(d), Example 11; Revenue Ruling 58-54, 1958-1 CB 181.

⁸⁹Internal Revenue Regulations, Section 1.355-1(d), Example 12.

⁹⁰Revenue Ruling 57-492, 1957-2 CB 247.

⁹¹Internal Revenue Regulations, Section 1.355-1(c)(2).

⁹²Revenue Ruling 56-266, 1956-1 CB 184; Revenue Ruling 57-464, 1957-2 CB 244.

v. United States,⁹³ the situation involved the merger of two corporations that were competitors in the school supply and stationery business. The surviving corporation did not want a warehouse that was operated as a separate active business by one of the two merging corporations. Therefore, as a part of the over-all plan, the corporation which owned the warehouse formed a new corporation, transferred the warehouse to it, and spun off the stock of the new corporation to its shareholders. The Sixth Circuit, in sustaining the Commissioner, held that the spin-off followed by a prearranged statutory merger of the distributing corporation into an unrelated corporation did not qualify under Section 355 on the grounds that the distributing corporation went out of existence as a part of the merger and, therefore, was "not engaged immediately after the distribution in the active conduct of a trade or business."⁹⁴

In Commissioner v. Morris Trust,⁹⁵ the situation involved the consolidation of a state bank with a national bank. The state bank had an insurance business which, although permissible under state laws, could not be conducted by a national bank. This insurance business qualified as

⁹³Curtis v. United States, 336 F.2d 714, 14 AFTR 2d 5685 (CA-6, 1964).

⁹⁴Internal Revenue Code, Section 355(b)(1)(A).

⁹⁵Commissioner v. Morris Trust, 367 F.2d 794, 18 AFTR 2d 5843 (CA-4, 1966).

a separate active business. The state bank thus disposed of it by transferring it to a newly created corporation and spinning off the stock of this new corporation to its shareholders as an integral part of the plan of reorganization. The new corporation continued the operation of the insurance business. The Fourth Circuit upheld the tax-free status of the spin-off. In doing so, the court stated that the merger subsequent to the spin-off did not effect a discontinuance of the distributing corporation's banking business, and, therefore, the underlying principles of Section 355 had not been violated. Also, the Fourth Circuit stated that there was an adequate continuity of interest in the state bank's shareholders, and that it made no difference whether the distributing corporation or the other party to the reorganization was the surviving corporation in the reorganization.

The main issue involved in both of these cases is whether or not Section 355 as a whole contemplates the combining of a merger with a spin-off. The Fourth Circuit's direct contradiction of the Sixth Circuit's reasoning thus creates a conflict that necessarily will produce troublesome and costly delays in the use of this type of plan of reorganization until the issue is decided by the Supreme Court or until the Commissioner decides to rule in favor of a plan of this type.

Five-Year Business History Requirements

In addition to requiring that each corporation emerging from a corporate separation must conduct an active trade or business, Section 355 further requires that such trade or business must have been actively conducted for five years preceding the distribution.⁹⁶ Furthermore, such trade or business must not have been acquired, directly or indirectly, within five years of the distribution in a transaction in which gain or loss was recognized in whole or in part.⁹⁷

These five-year business history requirements were not contained in any of the pre-1954 tax laws. They were introduced into the 1954 Code in order to further restrict corporate separations by rendering ineligible for tax-free separation any business either begun or purchased by the distributing or controlled corporations within the five years preceding the separation. Basically, the purpose of these requirements is to provide additional restrictions which further limit the potential use of a corporate separation for the purpose of avoiding dividend taxes. If a business has been conducted actively for five years, it was probably not created for tax avoidance purposes.

In order to implement the requirement that a business

⁹⁶ Internal Revenue Code, Section 355(b)(2)(B).

⁹⁷ Ibid., Section 355(b)(2)(C), (D).

be operated actively for five years, the date on which active business was begun, or from which it is properly measured, must be known. As a general rule, the active conduct of a trade or business will commence on the date that all the income producing activities of the business are present.⁹⁸ If there is a considerable lapse of time, however, between the date on which income producing capacity is present and the date on which the first sale receipts are received, the latter date will probably be of primary consideration.⁹⁹

When the distributing corporation's acquisition of an active business, or of a corporation conducting such business, is the result of a tax-free transaction, the history of such business is included in computing the required five-year business history period. An example of such a situation occurred in the case of Commissioner v. Wilson,¹⁰⁰ in which a business that was conducted by a partnership for three years was acquired by the distributing corporation in a tax-free exchange of assets for stock. The distributing corporation conducted the business for two more years, thus satisfying the five-year business history

⁹⁸Turner, "Splitting the Small Corporation," p. 345.

⁹⁹Revenue Ruling 57-492, 1957-2 CB 247.

¹⁰⁰Commissioner v. Wilson, 353 F.2d 184, 16 AFTR 2d 6030 (CA-9, 1965).

requirement. Also, the Internal Revenue Service has ruled favorably in a similar situation concerning the acquisition of control of a corporation through a nontaxable transaction.¹⁰¹

It must be remembered, however, that a business acquired in a taxable transaction must be conducted by the acquiring corporation itself for the full five-year period in order to meet the requirements of Section 355(b)(2). The date of acquisition determines the start of the five-year period in this situation. This date is either the date of execution of an unconditional contract to purchase, or the date of actual physical receipt of the purchased assets if the contract is conditional.¹⁰²

An interesting application of the five-year business history requirements occurred in W. E. Gabriel Fabrication Co.¹⁰³ In this case, the corporation temporarily transferred all the assets of two of its three businesses to one of its two principal shareholders fourteen months prior to the distribution in a planned split-up. This was done in order to expeditiously eliminate the shareholder from the corporation while the details of the corporate separation were being worked out. When the corporation was prepared

¹⁰¹Revenue Ruling 56-117, 1956-1 CB 180.

¹⁰²Edward H. Russell, 40 TC 810 (1963).

¹⁰³W. E. Gabriel Fabrication Co., 42 TC 545 (1964).

to place the two businesses in a controlled corporation, it reasserted authority over their assets. Since the shareholder had continued the active conduct of the two businesses during the fourteen month period, the Tax Court held that the transfer did not terminate the conduct of those businesses for purposes of satisfying the five-year requirement. There had been no taxable transaction involved in the transfer of the assets of the two businesses or in the reassertion of physical authority over them, and, thus, the corporation was entitled to include the fourteen month period in determining the five-year history of the two businesses.

It is also interesting to note that the requirement concerning the five-year time factor is being followed explicitly. In Edward H. Russell,¹⁰⁴ the distributing corporation split off a business it had acquired in a taxable transaction. The stock of the controlled corporation had been held for about six weeks less than the required five years, and the Tax Court thus held the distribution to be taxable.

The application of the five-year requirement is further complicated by several problems regarding the creation of a new business. If a business is not substantially the same as it was on the date from which the five-year period

¹⁰⁴Edward H. Russell, 40 TC 810 (1963).

is properly measured, it has become a new business and the five-year period must be measured from the date of the transformation.¹⁰⁵

The regulations state that changes in the business during the five-year period shall be disregarded, "provided the changes are not of such a character as to constitute the acquisition of a new or different business."¹⁰⁶ Several examples of changes which do not disrupt the continuity of a business include: merely changing the form of the organization in which business is conducted;¹⁰⁷ changing the productive capacity of a business;¹⁰⁸ adding new or dropping old product lines;¹⁰⁹ and shifting the location of a business.¹¹⁰ Also, a lull or cessation of business activity due to circumstances beyond the control of the corporation does not terminate a business if the owners intended all along to resume business activities when circumstances permitted. In this respect, a cooperative fruit market was

¹⁰⁵Mortimer Caplin, "Corporate Division Under the 1954 Code: A New Approach to the Five-Year 'Active Business' Rule," Virginia Law Review, XLIII (April, 1957), 403-04.

¹⁰⁶Internal Revenue Regulations, Section 1.355-4(b)(3).

¹⁰⁷W. E. Gabriel Fabrication Co., 42 TC 545 (1964).

¹⁰⁸Internal Revenue Regulations, Section 1.355-4(b)(3).

¹⁰⁹Ibid.

¹¹⁰Revenue Ruling 56-344, 1956-2 CB 195.

not viewed by the Internal Revenue Service as engaging in a new business when it resumed its marketing operations, which had been severely reduced for several years due to adverse weather conditions.¹¹¹

On the other hand, the Service has ruled that the acquisition by a dealer of a second franchise for the sale and service of a similar brand of automobile tires constituted the start of a new five-year business history period for the second franchise.¹¹² Also, the Fourth Circuit has held that if the activities of a business have declined to a virtual standstill, the business is over. A revival of the defunct business will thus constitute the beginning of a new business, with the five-year period being measured from a point no earlier than this new beginning.¹¹³

The Service has further indicated that if a business finances its own growth through plowed-back earnings, it will not be converted into a new business by substantial expansion, as long as the essential character of the business is maintained.¹¹⁴ However, if two businesses can be identified and the earnings of one have been employed to

¹¹¹Revenue Ruling 57-126, 1957-1 CB 123.

¹¹²Revenue Ruling 57-190, 1957-1 CB 121.

¹¹³Pridemark, Inc. v. Commissioner, 345 F.2d 35, 15 AFTR 2d 853 (CA-4, 1965).

¹¹⁴Revenue Ruling 59-400, 1959-2 CB 114.

finance substantial growth in the other during the five-year period, the Service may assert that Section 355 cannot be used to effect a tax-free separation of the two businesses. In this respect, the Service has ruled that Section 355 did not apply to the spin-off of a rental real estate business where the earnings of a separate hotel business were used to finance the growth of the rental business. The rental business became a new business on the date that the other business of the corporation contributed assets to it that composed more than fifty per cent of its value.¹¹⁵ This latter situation could also be attacked on the grounds that it constitutes a device for the distribution of earnings and profits through the translation of the hotel earnings into marketable rental property.

In relation to the expansion of a single business whose character is maintained, there is also the question of whether a newly opened branch business constitutes a new business which must independently satisfy the five-year business history requirement, or whether it constitutes an expansion of the pre-existing activity and is not a new business. The Commissioner, in Patricia W. Burke,¹¹⁶ took the former position when a corporation attempted to spin off its branch outlet located in another city. How-

¹¹⁵Ibid.

¹¹⁶Patricia W. Burke, 42 TC 1021 (1964).

ever, the Tax Court approved the spin-off by holding that the branch business was not a new business started within five years, but was merely the continuance of an existing business, and, as such, had been operated for the full five years as required.

Likewise, in Lockwood's Estate v. Commissioner,¹¹⁷ the Eighth Circuit held that a branch office set up in another state was an integral part of the business of the corporation, and, therefore, did not have to be separately aged, but could inherit the business history of the entire corporation. Furthermore, the court stated that the test is not whether active business has been carried on in the geographical area later served by the controlled corporation, but, simply, whether the distributing corporation had been conducting the business for the required five years. Therefore, it now seems that the Commissioner can no longer allege that a branch operation constitutes a new business if it is geographically separated from the rest of the corporation.

¹¹⁷Lockwood's Estate v. Commissioner, 350 F.2d 712, 16 AFTR 2d 5592 (CA-8, 1965).

Tax Effects

When all the requirements of Section 355 are met, a taxpayer who receives stock or securities in a corporate separation does not recognize any gain or loss on the distribution.¹¹⁸ Where, however, anything else is distributed, it will constitute boot, the tax treatment of which was discussed earlier in this chapter under "Distribution Requirements."

The basis of property received by a shareholder or security holder is prescribed by Section 358(a) and (b). If no boot is received, the aggregate basis of the original stock or securities of the distributing corporation will be spread over both the distributed and the retained stock and securities, in proportion to their respective market values. If boot is received, then the basis of the qualified stock and securities is decreased by the fair market value of the boot plus any cash received, and increased by any gain recognized. The boot itself takes a basis equal to its fair market value.

The taxpayer's holding period for any qualified stock or securities received under Section 355 ordinarily includes the period he held the original stock or securities in the distributing corporation.¹¹⁹ The holding period of

¹¹⁸Internal Revenue Code, Section 355(a)(1).

¹¹⁹Ibid., Section 1223(1).

boot, however, commences with the determination of its basis at the time of the distribution.

When a corporate separation does not qualify under Section 355 and is taxed to the shareholders of the distributing corporation, the tax consequences will depend upon the type of corporate separation that was employed. In the case of a spin-off, the fair market value of the stock or securities distributed to a shareholder of the distributing corporation is treated as a dividend to the extent of the corporation's current and post-1913 accumulated earnings and profits,¹²⁰ and as a return of capital if it exceeds them.¹²¹ With respect to a split-off, which requires the surrender of stock in the distributing corporation, the exchange of stock or securities will be treated as a capital gain or loss if the transaction can qualify as a partial liquidation,¹²² as a non-liquidating redemption not essentially equivalent to a dividend,¹²³ or as a termination of the shareholder's interest.¹²⁴ Otherwise, the distribution will be treated as a dividend to the extent of available earnings and profits. Finally, in the

¹²⁰Ibid., Section 301(b).

¹²¹Ibid., Section 301(c)(2).

¹²²Ibid., Section 346(a)(2).

¹²³Ibid., Section 302(b)(2).

¹²⁴Ibid., Section 302(b)(3).

case of a split-up, the transaction should result in capital gain or loss treatment since actually it is a complete liquidation of the distributing corporation.¹²⁵

¹²⁵Ibid., Section 331(a)(1).

CHAPTER IV

SUMMARY AND CONCLUSIONS

This concluding chapter presents a concise summary of the basic requirements which must currently be met in order to achieve a tax-free corporate separation. Also included in this summary is a brief historical outline of the tax treatment of corporate separations prior to the enactment of the Internal Revenue Code of 1954.

Following this summary, the trends which have developed in the tax treatment of corporate separations are presented. These trends are both general and specific in nature and are primarily concerned with the manner in which the Internal Revenue Service and the courts have treated and ruled on the various requirements governing the tax treatment of corporate separations. Furthermore, the direction of these trends is analyzed in order to make predictions concerning the general tax treatment of corporate separations in the future.

After the trends have been considered, several specific recommendations are given which concern ways in which the present tax laws could be amended in order to simplify or improve the requirements currently being utilized to

determine the tax status of a corporate separation. Basically, these recommendations are made in the hope of improving the equitableness of the taxation of corporate separations in view of the economic results involved.

Finally, a general concluding statement is made. This statement sums up the conclusions reached in this chapter and closes with a suggestion regarding the actual employment of a corporate separation.

Summary

A corporate separation is basically an arrangement whereby the shareholders of a single corporation split up their investment among several corporate shells. The tax treatment of a corporate separation is governed by Section 355 of the Internal Revenue Code of 1954. This section allows the separation of two or more existing businesses of a single corporation to be tax-free if certain requirements are met.

Before the 1954 Code was enacted, however, the tax treatment of a corporate separation varied according to the form which the separation took, even though the economic results were substantially the same in all cases. The several forms which a corporate separation may take include the spin-off, split-up, and split-off.

In the case of a spin-off, which is basically a distribution by one corporation of the stock of a subsidiary

corporation, the first provision for the nonrecognition of gain to the shareholders involved occurred in the Revenue Act of 1924. However, in 1934, it was eliminated on the ground of being productive of tax avoidance, and, until 1951, any distribution in a spin-off was held taxable as a dividend. In 1951, the spin-off was restored as a tax-free corporate separation subject to the active business and device restrictions.

The type of corporate separation known as a split-up occurs when a single existing corporation is replaced by two or more new corporations. This type of separation was first recognized as tax-free by the Revenue Act of 1918. Even though a split-up represents an opportunity for tax avoidance just as the spin-off does, no action was taken against it in 1934 when the tax-free spin-off was eliminated. The split-up has thus maintained its tax-free status since 1918.

The split-off type of corporate separation is identical with the spin-off, except that the parent corporation's shareholders surrender part of their stock in exchange for the stock of the subsidiary, whereas in a spin-off no such surrender is made. The historical tax treatment of split-offs is not very clear-cut. However, it is known that they were treated as tax-free from 1924 until 1948, when the Treasury Department discontinued the issuance of favorable

rulings on this type of corporate separation. From around 1951 on, however, a split-off serving a business purpose has been approved as tax-free. Thus, on the eve of the adoption of the Internal Revenue Code of 1954, all three types of corporate separations were recognized as tax-free.

Under Section 355 of the 1954 Code, the three types of corporate separations are now accorded the same treatment, and must meet the same statutory requirements in order to achieve tax-free status. This section is basically comprised of a single set of tests designed to distinguish between those corporate separations which are deserving of tax-free treatment, and those which, in substance, merely represent dividend distributions. The requirements of this section and its related regulations have been undergoing significant changes and new interpretations through the many pertinent court cases and Revenue rulings which have occurred since the enactment of the 1954 Code.

According to the distribution requirements of Section 355, the distributing corporation must distribute either all of its stock and securities in the controlled corporation or at least enough stock to constitute eighty per cent control. The actual distribution of the stock or the stock and securities may be either proportionate or nonproportionate with respect to the shareholders. If anything else besides stock or securities is distributed, it will consti-

tute "boot," which will usually be taxed as a dividend. The distribution requirements are generally strictly enforced.

The device requirement requires that the corporate separation must not be used principally as a device for the distribution of earnings and profits. Where part or all of the stock or securities of any of the corporations involved in the separation are sold or exchanged pursuant to a prearranged plan, the corporate separation will ordinarily be treated as a device, which will cause the distribution to be taxable. Furthermore, even if no prearranged plan existed, such a sale or exchange may still be considered as evidence that the transaction was a device.

In addition to the negative requirement that a corporate separation must not be used as a device for tax avoidance purposes, there is an affirmative requirement that there be a valid business purpose for the distribution. This business purpose requirement grew out of the decision in the classic Gregory case. It has now been decided, however, that the required business purpose need not always be corporate oriented, but may also be shareholder oriented.

Section 355 further requires that the corporations which emerge from a separation be engaged immediately after the distribution in the active conduct of a trade or busi-

ness. In order to qualify as an active business for the purpose of satisfying this requirement, the business must consist of an existing group of activities which independently and actively produce income. A vertical division of a single business is generally considered as resulting in two separate active businesses for the purpose of satisfying this active business requirement. However, investment or incidental activities do not constitute an active business, and a separation of such an activity will thus fail to qualify as tax-free.

The last basic requirements to be satisfied in a corporate separation are the five-year business history requirements. In addition to the active business requirement, Section 355 further requires that the business must have been actively conducted for at least five years preceding the distribution. Also, such business must not have been acquired, directly or indirectly, within five years of the distribution in a transaction in which gain or loss was recognized in whole or in part. In relation to a branch business, the courts have held that opening a branch does not constitute the start of a new business, and, therefore, the branch can inherit the business history of the entire corporation in order to satisfy the five-year business history requirements.

When all of these requirements are satisfied, the

taxpayers involved in a corporate separation will not recognize any gain or loss on the distribution of stock or securities, unless boot has also been distributed. If one or more of the requirements are not satisfied, the corporate separation will fail to achieve tax-free status, with the shareholders being taxed according to the type of separation that was employed.

Trends

The underlying theory behind the tax-free treatment of corporate separations was very aptly described by the Senate Finance Committee which recommended the restoration of the tax-free spin-off in 1951. In effect, this committee stated that it is economically unsound to impede corporate separations which break-up businesses into a greater number of enterprises, as long as they are undertaken for legitimate business purposes.

The economic effects of corporate separations are beneficial in that they result in the formation and expansion of new corporations which are owned by individuals. However, due to the tax-free status accorded corporate separations, they must be policed in order to prevent the shareholders from feasting on corporate earnings and profits at capital gain rates instead of ordinary income tax rates.

Viewed in this context, the tax treatment of corporate separations, as provided for by Section 355 of the Internal

Revenue Code of 1954, essentially reflects an unresolved conflict within itself. This section desires to encourage, through tax deferment, those corporate separations which are motivated by valid business reasons, while at the same time it desires to impose ordinary income tax at the shareholder level in the case of those corporate separations which are disguised steps in a plan to distribute corporate earnings and profits without incurring the proper dividend treatment thereon.

Due to the desire to prevent any corporate separation from being utilized as a device to distribute earnings and profits, Section 355 was therefore made very restrictive in nature. Unless all of its specified requirements are absolutely complied with, a corporate separation will probably not be granted tax-free status. Also, even though a corporate separation may be held as not constituting a device to distribute earnings and profits, it will still not be considered as tax-free if it fails to meet any of the other requirements.

This restrictive attitude has always been exhibited by the Internal Revenue Service and the various courts to some degree. However, after the enactment of the 1954 Code, it has become especially prevalent, and, as such, it constitutes the primary trend which has developed in the tax treatment of corporate separations today. Also, in addition

to this general trend of a restrictive attitude, the Service and the courts seem to be keeping in mind, to some extent, the desirable economic effects of a corporate separation by discontinuing certain requirements which were not effective or useful as restraint measures.

In relation to the distribution requirements, the trend seems to be in favor of a very strict compliance with the statutory provisions. This is evident in a ruling made by the Service in which it held that the control requirement was not met except in a transitory and illusory sense.¹

Also, the device requirement has been, and still is, very strictly enforced. This restrictive provision is a carry-over from the pre-1954 spin-off provision of the 1939 Code. It serves as a tax avoidance test in preventing the corporate separation from being utilized as a device for the distribution of earnings and profits. The regulations further bolster this requirement by stating that any sale or exchange, even if not prearranged, of stock or securities after a corporate separation will be considered as evidence of a device.²

The business purpose doctrine was first enunciated

¹Revenue Ruling 63-260, 1963-2 CB 147.

²Internal Revenue Regulations, Section 1.355-2(b)(1).

in the famous Gregory case of 1935,³ and has since been strictly adhered to. As a result of a recent case, this doctrine is now even more strictly enforced.⁴ The court in this case held that a good business purpose is a necessary restriction to offset the natural advantage which a corporate separation affords. Also, this restrictive attitude was present in another court decision in which the court indicated that the business purpose must be one which requires a distribution.⁵ The trend in the application of this requirement thus seems to indicate that the business purpose doctrine will continue to be strictly applied, and will probably be even more restrictive in the future.

With regard to the active business requirement, it is observed that a strict interpretation is placed on the meaning of what constitutes an active trade or business. Each group of activities must independently and actively produce income after the corporate separation has taken place in order to satisfy this requirement. However, the requirement that a single business cannot be divided has

³Gregory v. Helvering, 293 U.S. 465, 14 AFTR 1191 (1935).

⁴Commissioner v. Wilson, 353 F.2d 184, 16 AFTR 2d 6030 (CA-9, 1965).

⁵Parshelsky's Estate v. Commissioner, 303 F.2d 14, 9 AFTR 2d 1382 (CA-2, 1962).

now been eliminated by the courts and the Internal Revenue Service. This single business restriction had in the past unnecessarily prohibited the tax-free separation of an otherwise valid corporate separation. Thus, even though the trend is restrictive concerning the requirements for an active business to be present, the elimination of the single business restriction indicates that the disirable economic effects concerning the underlying purpose of Section 355 are still being considered.

Finally, in relation to the five-year business history requirements, which were incorporated into the 1954 Code as additional restrictions against the improper use of a corporate separation, it is evident from the various court cases and Revenue rulings that these restrictions are also interpreted rather strictly. This strictness and rigidity is evident in the decision of the Tax Court that an active business held for six weeks less than five years did not qualify.⁶ However, the underlying trend to further consider the actual economic results is also observed with respect to these requirements as evidenced by two recent court decisions which held that a branch business can inherit the business history of the entire corporation.⁷

⁶Edward H. Russell, 40 TC 810 (1963).

⁷Patricia W. Burke, 42 TC 1821 (1964); Lockwood's Estate v. Commissioner, 350 F.2d 712, 16 AFTR 2d 5592 (CA-8, 1965).

Thus, regarding all of the basic requirements concerning corporate separations, it is fundamentally observed that the Internal Revenue Service and the courts have taken a restrictive attitude toward the tax treatment of corporate separations. This restrictive attitude has resulted from the possible use of corporate separations to distribute earnings and profits at capital gain rates. Also, for the same reason, it is likely that this restrictive attitude will continue to persist in the future.

However, in opposition to this restrictive trend, there is also an underlying trend to further consider the economic effects of otherwise valid corporate separations in cases where an unnecessary restrictive technicality blocks their tax-free status. This underlying trend will probably become more and more important in the future as new cases bring out various aspects of the corporate separation requirements which unduly restrict the tax treatment of corporate separations in light of the basic economic purpose for their tax-free status. Perhaps these two trends will someday combine to provide a more equitable and better understood set of requirements for the tax treatment of corporate separations.

Recommendations

In Chapter III, two rather interesting cases were discussed which concerned the question of whether or not a corporate separation may distribute to its shareholders rights to acquire stock in a subsidiary in a tax-free spin-off under Section 355.⁸ The two courts involved reached opposite decisions on the same set of facts. These cases are now before the Supreme Court.

With regard to the trends previously discussed in this chapter, it appears that one of the two circuit courts involved took the restrictive attitude while the other took the attitude concerning the actual economic result based on the intent of Section 355. In view of the fact that the corporate separation involved in these cases neither contains nor threatens to create the evil that the requirements in Section 355 were designed to prevent, it is recommended that the transaction in this situation, and in all future transactions similar to it, be considered as tax-free. Furthermore, Section 355(a)(1) should be amended to include the distribution and exercise of stock rights as a qualifying distribution for the purpose of granting tax-free status to a corporate separation. However, it should also be stipulated that the rights must be exercised within

⁸Commissioner v. Baan, 382 F.2d 485, 20 AFTR 2d 5268 (CA-9, 1967); Commissioner v. Gordon, 382 F.2d 499, 20 AFTR 2d 5255 (CA-2, 1967).

a reasonable length of time, say a year, in an amount sufficient to constitute at least eighty per cent control.

Two other court cases which involved conflicting decisions yet to be resolved were also discussed in Chapter III.⁹ The main issue involved in these two cases was whether or not Section 355 contemplates the merger of a distributing corporation with another unrelated corporation pursuant to a spin-off of an unwanted business of the distributing corporation.

Considering the situation involved in these two cases, it is recommended that the difference between a taxable distribution and a tax-free distribution should not depend upon whether the distributing corporation is kept alive or technically terminated, but rather on the end results of the transaction as viewed in the light of the intent of Section 355. It is unsound to make the tax consequences of a corporate separation turn wholly upon formalistic results. Therefore, Section 355(b)(1)(A) should be amended to require the controlled corporation and the distributing corporation, or its successor in a qualified reorganization, to be engaged immediately after the distribution in

⁹Curtis v. United States, 336 F.2d 714, 14 AFTR 2d 5685 (CA-6, 1964); Commissioner v. Morris Trust, 367 F.2d 794, 18 AFTR 2d 5843 (CA-4, 1966).

the active conduct of a trade or business.¹⁰

One final recommendation concerns the unnecessarily restrictive attitude imposed by the five-year business history requirements. As it stands now, these requirements may prevent the tax-free treatment of a corporate separation which satisfies the economic intent of Section 355. An amendment should therefore be made to allow a corporate separation which does not meet the rigid five-year requirements, but which satisfies the other necessary requirements, to be granted tax-free status. However, there should still be a pre-distribution business history for each of the businesses separated. The length of the period involved should be made flexible.

From what has been previously discussed, it can therefore be seen that Section 355, because of its rigidity, could in many instances do an injustice to corporate separations which, although not tax motivated, would fail to qualify. Unless the statute is made more flexible, there will be many situations in which corporate separations meriting tax-free status will be denied that privilege.

¹⁰There have been no court cases or Revenue rulings to date concerning how long after the distribution the controlled and distributing corporations must be engaged in the active conduct of a trade or business. The author recommends that a definite period be required for this purpose in order to make the active business requirement less vague.

Conclusion

In order to successfully achieve a tax-free corporate separation, the requirements of Section 355 of the Internal Revenue Code of 1954 and its related regulations must be adhered to in light of the subsequent changes and new interpretations which have occurred through court decisions and Revenue rulings. Basically, the trend in the tax treatment of corporate separations is for these requirements to be interpreted strictly and rigidly. However, there is an underlying trend developing to further consider the economic results of corporate separations in light of the basic intent of Section 355.

There are still many unanswered questions concerning the tax treatment of corporation separations. Because of the uncertainty of this treatment and the problems and intricacies involved in corporate separations, and in view of the restrictive attitude usually taken by the Internal Revenue Service and the courts, a taxpayer seeking to separate a corporation should obtain a ruling before proceeding under Section 355, unless the situation is free of any doubt.

APPENDIX

INTERNAL REVENUE CODE OF 1954, SECTION 355:

DISTRIBUTION OF STOCK AND SECURITIES

OF A CONTROLLED CORPORATION

(a) Effect on Distributees.--

(1) General Rules.--If---

(A) a corporation (referred to in this section as the "distributing corporation")--

(i) distributes to a shareholder, with respect to its stock, or

(ii) distributes to a security holder, in exchange for its securities, solely stock or securities of a corporation (referred to in this section as "controlled corporation") which it controls immediately before the distribution,

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

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

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

(i) all of the stock and securities in the controlled corporation held by it immediately before the distribution, or

(ii) an amount of stock in the controlled corporation constituting control within the meaning of

section 368(c), and it is established to the satisfaction of the Secretary or his delegate that the retention by the distributing corporation of stock (or stock and securities) in the controlled corporation was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax,

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

(2) Non Pro Rata Distributions, Etc.--Paragraph (1) shall be applied without regard to the following:

(A) whether or not the distribution is pro rata with respect to all of the shareholders of the distributing corporation,

(B) whether or not the shareholder surrenders stock in the distributing corporation, and

(C) whether or not the distribution is in pursuance of a plan of reorganization (within the meaning of section 368(a)(1)(D)).

(3) Limitation.--Paragraph (1) shall not apply if--

(A) the principal amount of the securities in the controlled corporation which are received exceeds the principal amount of the securities which are surrendered in connection with such distribution, or

(B) securities in the controlled corporation are received and no securities are surrendered in connection with such distribution.

For purposes of this section (other than paragraph (1)(D) of this subsection) and so much of section 356 as relates to this section, stock of a controlled corporation acquired by the distributing corporation by reason of any transaction which occurs within 5 years of the distribution of such stock and in which gain or loss was recognized in whole or in part, shall not be treated as stock of such controlled corporation, but as other property.

(4) Cross Reference.--

For treatment of the distribution if any property is received which is not permitted to be received under

this subsection (including an excess principal amount of securities received over securities surrendered), see section 356.

(b) Requirements as to Active Business.--

(1) In General.--Subsection (a) shall apply only if either--

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

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

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

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

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

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

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

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

(ii) was so acquired by another corporation within such period, but such control was so acquired only by reason of transactions in which gain or loss was

not recognized in whole or in part, or only by reason of such transactions combined with acquisitions before the beginning of such period.

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CORPORATE SEPARATIONS: AN ANALYSIS
OF THEIR TAX IMPLICATIONS

by

George Frederick Lamberth

ABSTRACT

A corporate separation is an arrangement whereby the shareholders of a single corporation split up their investment among several corporate shells through a spin-off, split-off, or split-up. The tax treatment of a corporate separation is governed by Section 355 of the Internal Revenue Code of 1954, which allows the separation of two or more existing businesses to be tax-free provided certain requirements are met.

This thesis discusses and analyzes Section 355 and its related regulations in light of the various subsequent developments in order to expound the current tax treatment of corporate separations. Also, the historical development of the tax treatment of corporate separations up to 1954 is presented as background material.

Basically, Section 355 desires to encourage, through tax deferment, those corporate separations which are motivated by valid business reasons, while at the same time

imposing ordinary income tax on the shareholders in the case of those corporate separations which are merely being utilized as a device to distribute corporate earnings and profits at capital gain rates.

Due to the possible use of a corporate separation for tax avoidance purposes, Section 355 was made very restrictive and has usually been strictly interpreted by the Internal Revenue Service and the courts. This general restrictive trend will probably continue to persist in the future. However, there appears to be an underlying trend developing to further consider the economic results of otherwise valid corporate separations in cases where an unnecessary restrictive technicality blocks their tax-free status.