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Internal Revenue Code Section 355: Recent Trends

Katherine Corinne Hall

COMMENTS

INTERNAL REVENUE CODE SECTION 355: RECENT TRENDS

*by Katherine Corinne Hall**

The requirements for a tax-free distribution of stock and securities of a controlled corporation under section 355[1] of the Internal Revenue Code have

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1. I.R.C. § 355:

Distribution of stock and securities of a controlled corporation.

(a) Effect on distributees.

(1) General rule.

If—

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

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

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

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

(C) the requirements of subsection (b) (relating to active business) 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

shifted in recent years because of court decisions[2] and recently issued revenue rulings.[3] The provisions of section 355 govern the tax treatment given to distributions following a corporate division. No gain or loss is recognized upon a distribution which meets the requirements of this sec-

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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.

. . . .

(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 distribution,

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

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

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

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

2. Edmund P. Coady, 33 T.C. 771 (1960), *aff'd*, 289 F.2d 490 (6th Cir. 1961) (declaring invalid single business provision of § 355 regulations); United States v. Marett, 325 F.2d 28 (5th Cir. 1963) (agreeing with *Coady* that the single business provision was invalid); Rafferty v. Commissioner, 452 F.2d 767 (1st Cir. 1971), *cert. denied*, 408 U.S. 922 (1972) (discrediting the regulation's independent production of income requirement), *acq. in*, Rev. Rul. 75-160, 1975-1 C.B. 112; Commissioner v. King, 458 F.2d 245 (6th Cir. 1972) (following *Rafferty* with regard to both the single business provision and the independent production of income requirement); Harry B. Atlee, 67.32 T.C.M. (P-H) (Dec. 8, 1976) (in analyzing the statutory active business test the court focused upon the "functional relationship" between the assets transferred to the distributee corporation and those retained by the corporate distributor) (see text accompanying notes 223-29 *infra* for a discussion of the new language in the proposed regulations concerning "related functions" of such assets).

3. Rev. Rul. 77-22, 1977-4 I.R.B. 7 (business purpose requirement satisfied where distribution made to secure separate borrowing limits for parent and subsidiary corporations); Rev. Rul. 77-11, 1977-2 I.R.B. 13 (receipt of operating assets by transferee corporation prevented denial of § 355 treatment since the transaction thus could not be a prohibited exchange of stock at the shareholder level); Rev. Rul. 76-528, 1976-52 I.R.B. 22 (continuity of interest was maintained by individual partners where distribution of stock by a partnership was followed by the partnership's dissolution); Rev. Rul. 76-527, 1976-52 I.R.B. 21 (distribution made to make a subsidiary's stock acceptable in a proposed merger held made pursuant to valid business purpose); Rev. Rul. 75-469, 1975-2 C.B. 126 (no device where distribution was made pursuant to a valid business purpose); Rev. Rul. 75-406, 1975-2 C.B. 125 (no device where there was no evidence of a prearranged sale); Rev. Rul. 75-337, 1975-2 C.B. 124 (valid business purpose where distribution of stock was germane to the continuation of shareholders' business in reasonably foreseeable future); Rev. Rul. 75-321, 1975-2 C.B. 123 (transaction not used as a device where the reason for the distribution was involuntary in nature); Rev. Rul. 75-160, 1975-1 C.B. 112 (abandonment of the independent production of income requirement of the § 355 regulations).

tion.[4] Nonqualifying distributions, however, are taxed as ordinary income to the shareholder.[5] In the past the Internal Revenue Service has determined the tax consequences of divisive distributions through stringent application of the active business test[6] and its regulation-defined components, the single business[7] and independent-production-of-income[8] requirements. The Service relied more heavily upon the active business test than upon either the statutory "device" restriction[9] or the regulation's business purpose test.[10] Recent rulings indicate that greater emphasis will now be placed on the business purpose and device tests.[11] Conversely, the Service's insistence on compliance with portions of the active business requirements is decreasing.[12] The single business provision has long since been declared invalid by

4. I.R.C. § 355(a)(1). Although basis and boot treatment for § 355 transactions are not covered by the scope of this Comment, the applicable Code provisions are §§ 355(a)(3) and 356(a), (b) which operate to deny tax-free treatment to distributions or exchanges to the extent to which boot is received. Section 356(a) determines the tax consequences when boot is received in an exchange under a § 355 split-off or split-up. When received in a § 355 distribution or spin-off, however, boot treatment is provided for in § 356(b). *See generally* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 13-39 to -41 (3d ed. 1971). See § 358 for treatment of basis of property received by the distributee in a § 355 transaction. *See generally* B. BITTKER & J. EUSTICE, *supra*, at 13-41 to -43 (discussion of § 358).

5. *See* [1975] STAND. FED. TAX REP. (CCH) ¶¶ 2517.01(4), (5). I.R.C. § 301 governs the tax consequences of nonqualifying distributions. Corporations and shareholders generally prefer § 355 treatment for distributions since capital gain treatment is often desirable. Section 355 treatment is not, however, always desirable. B. BITTKER & J. EUSTICE, *supra* note 4, at 13-35, offers an example of a shareholder who is denied recognition for a loss realized because "his adjusted basis for the surrendered stock exceeds the fair market value of the stock or securities received" when he surrenders his stock for that of a subsidiary in a split-off.

6. The statutory active business test is contained in § 355(b)(1)(A), (B). The regulations expand upon the statutory language, providing:

> [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. It does not include—
>
> (1) The holding for investment purposes of stock, securities, land or other property, including casual sales thereof (whether or not the proceeds of such sales are reinvested),
>
> (2) The ownership and operation of land or buildings all or substantially all of which are used and occupied by the owner in the operation of a trade or business, or
>
> (3) A group of activities which, while a part of a business operated for profit, are not themselves independently producing income even though such activities would produce income with the addition of other activities or with large increases in activities previously incidental or insubstantial.

Treas. Reg. § 1.355-1(c) (1955).

7. Treas. Reg. § 1.355-1(a) (1955) provides: "Section 355 does not apply to the division of a single business." See Edmund P. Coady, 33 T.C. 771, 775-79 (1960), for a detailed discussion of the statutory construction and history of the provision following which the court held that portion of the regulations to be invalid.

8. Treas. Reg. § 1.355-1(c)(3) (1955), *supra* note 6. This provision, too, was discredited by the courts as a mere restatement of the rejected single business provision. *See* text accompanying notes 56-62 *infra*.

9. I.R.C. § 355(a)(1)(B).

10. *See generally* Lee, *Functional Divisions and Other Corporate Separations Under Section 355 After Rafferty*, 27 TAX L. REV. 453, 455-74 (1972).

11. *See* Meyer, *Active Business Requirement of 355 Eased, But E & P Bail-Out Provision Tightened*, 43 J. TAX. 270 (1975); rulings cited note 3 *supra*.

12. *Id.* Although the emphasis is shifting from the active business test to the device and business purpose tests, the former remains in use. Recent § 355 cases which used the test are Harry B. Atlee, 67.32 T.C.M. (P-H) (Dec. 8, 1976), and Riener C. Hielsen, 61 T.C. 311 (1973). A recent § 346 case which relied upon the § 355 active business test is Mains v. United States, 508 F.2d 1251 (6th Cir. 1975). For a discussion of use of the test by § 346 cases and possible effects of the proposed regulations see note 70 *infra*.

the courts,[13] and other sections of the active business regulations, though not expressly invalidated, have been discredited by extension of the reasoning in these opinions.[14] Recently proposed rules for section 355 would amend the current regulations to reflect these shifts in emphasis.[15] Specifically, the proposed amendment would revise the present regulations by describing factors to be used in determining whether a transaction was used principally as a device for tax avoidance, by allowing a more stringent business purpose test, and by providing for the separation of single businesses.[16]

This Comment examines the requirements for tax-free distributions of stock and securities under section 355 and analyzes pertinent rulings and cases to determine what factors presently influence the Service to accord nonrecognition to such distributions. Of primary concern are the trends affecting (1) the functional division of single businesses, (2) the independent production of income provision, (3) the business purpose requirement, (4) the continuity of interest test, and (5) the device provision.

I. HISTORY

A transaction must fulfill five statutory requirements in order to qualify for tax-free treatment under section 355. The first requirement is that one corporation must distribute the stock or securities of another corporation of which it has control.[17] In addition, both corporations must be engaged in the active conduct of a trade or business immediately after the distribution.[18] In the event that the distributing corporation's assets consisted solely of stock or securities in two or more controlled corporations, then following the distribution each of the controlled corporations must be engaged in the active conduct of a trade or business.[19] Section 355 also requires the active conduct of a business for a predistribution period of five years.[20] This requirement may be fulfilled by showing that a trade or business was conducted throughout a five-year period ending on the date of the distribution, that it was not acquired within that period in a taxable transaction, and

13. United States v. Marett, 325 F.2d 28 (5th Cir. 1963) (following *Coady*), *acq. in*, Rev. Rul. 64-147, 1964-1 C.B. (pt. 1) 136; H. Grady Lester, 40 T.C. 947 (1963) (Tax Court reexamined its invalidation of the single business provision in *Coady* and reaffirmed its holding); Edmund P. Coady, 33 T.C. 771 (1960) (invalidating the single business provision), *acq. in*, Rev. Rul. 64-147, 1964-1 C.B. (pt. 1) 136.

14. The independent production of income requirement was attacked by the *Rafferty* and *King* courts as a restatement of the invalid single business provision. See Lee, *supra* note 10, at 473, for a discussion of the apparent downfall of all but one of the active business provisions, the holding of "stock, securities, land or other property" for investment purposes.

15. Proposed Treas. Reg. § 1.355-1, -2, 42 Fed. Reg. 3866, 3867-71 (1977).

16. Proposed Treas. Reg. § 1.355-1, -2, 42 Fed. Reg. 3867-68 (1977).

17. I.R.C. § 355(a)(1). Corporations engaging in a § 368(a)(1)(D) reorganization generally transfer stock and securities to the shareholders or security holders in one of three ways: a spin-off, a split-off, or a split-up. "A spin-off is a distribution by one corporation of the stock of a subsidiary corporation." B. BITTKER & J. EUSTICE, *supra* note 4, at 13-3. The subsidiary can be either newly created or already existing. The only difference in a split-off is that "the shareholders of the parent corporation surrender part of their stock in the parent in exchange for the stock of the subsidiary." *Id.* "In a split-up, the parent corporation distributes its stock in two or more subsidiaries in complete liquidation." *Id.* The nature of these three types of divisions differs in that a spin-off is a distribution whereas a split-off and split-up are exchanges. This governs their treatment under the boot provisions of § 356, discussed in note 4 *supra*.

18. I.R.C. § 355(b)(1)(A).

19. *Id.*

20. *Id.* § 355(b)(2)(B).

that it was not conducted by another corporation the control of which was acquired within those five years in a taxable transaction.[21] With regard to the amount of stock and securities required to be distributed, the distributing corporation is allowed two alternatives.[22] Section 355(a)(1)(D) requires the distribution of either "all of the stock and securities in the controlled corporation held by it immediately before the distribution," or an amount sufficient to constitute control as defined by section 368(c)[23] as well as to establish to the Treasury's satisfaction that "the retention . . . of 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." The final requirement is that the transaction not be used principally as a device to distribute the earnings and profits of either or both corporations.[24]

To qualify for nonrecognition under section 355, a distribution must meet the requirements provided in the statute, as well as those in the regulations and in certain judicial doctrines.[25] Of the statutory provisions discussed above, only the device test[26] is of interest here. It is designed to prevent the bail-out of corporate earnings and profits. A bail-out occurs when earnings and profits are distributed to the shareholders in such a way that they can realize capital gain or loss upon disposition of the stock or securities distributed.[27] Since shareholders are usually taxed at ordinary rates upon receipt of stock or securities,[28] a bail-out presents an opportunity to reduce taxes. To prevent such avoidance, the device test may be invoked upon distribution.[29] The nature of the test is not, however, well understood, and until

21. *Id.*

22. *Id.* § 355(a)(1)(D).

23. *Id.* § 368(c) provides: "[T]he term 'control' means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation."

24. *Id.* § 355(a)(1)(B).

25. See Treas. Reg. § 1.355-1(c) (1955), *supra* note 6, for the Service's interpretation of the statutory active business test. This regulation added the single business and independent production of income provisions to the statutory requirements. A recent case dealing with these provisions is Riener C. Nielsen, 61 T.C. 311 (1973), in which the taxpayer sought to prove that two hospitals were conducted as a single business in order to tack the holding period of one onto the other to achieve the minimum five-year predistribution active business period. The court, however, found that there was no integration of the hospitals' income-producing activities, that there were two separate businesses, and that § 355 did not apply since only one of the hospitals met the predistribution active business test. This was a reversal of roles since in the past the Service argued that § 355 did not apply to the division of single businesses while the taxpayers countered with the argument that they were conducting two businesses, not one. For earlier cases involving the single versus double business distinction see H. Grady Lester, Jr., 40 T.C. 947 (1964), in which different activities conducted by a single corporation constituted separate businesses. *But see* Theodore F. Appleby, 35 T.C. 755, *aff'd*, 296 F.2d 925 (3d Cir. 1962) (rental of a building used to house taxpayer's principal business did not qualify as a separate active business). The regulations also incorporate the judicial business purpose and continuity of interest doctrines in Treas. Reg. § 1.355-2(c) (1955). For the language of these doctrines see notes 101, 151 *infra*. Both doctrines are retained in Proposed Treas. Reg. § 1.355-2(b)(1), 42 Fed. Reg. 3867 (1977).

26. I.R.C. § 355(a)(1)(B); *see* note 172 *infra* and accompanying text. For a discussion of the device restriction see generally B. BITTKER & J. EUSTICE, *supra* note 4, at 13-27 to -32; Lee, *supra* note 10, at 474-95.

27. B. BITTKER & J. EUSTICE, *supra* note 4, at 10-1, define bail-out as a "plan by which shareholders [can] withdraw corporate earnings and profits as long-term capital gains."

28. *See* note 5 *supra* and accompanying text.

29. Disposition of the stock or securities received in a § 355 transaction may not be a prerequisite to characterization as a device. *See* B. BITTKER & J. EUSTICE, *supra* note 4, at

recently the restriction was infrequently used.[30]

The regulations also contain tests created by the Treasury for the purpose of determining the fulfillment of the statutory requirements. Two examples of such nonstatutory tests are the single business test[31] and the independent-production-of-income test.[32] The single business test was designed to bar tax-free treatment for distributions following vertical or horizontal spin-offs of stock or securities to shareholders.[33] The independent-production-of-income test was also intended to prevent tax-free treatment for a divisive distribution if, prior to the distribution, one of the corporations derived income solely from a business conducted with regard to the other corporation.[34] Both of these tests were intended to bar corporations from isolating liquid assets in a separate corporation and distributing stocks and securities to shareholders who could then sell them to receive capital gains treatment. In the past these tests were used to determine whether the active business requirement had been met. The current tendency is to disregard them.[35]

The judicial doctrines of business purpose[36] and continuity of interest[37] are also set forth in the regulations. The first requires that a business purpose motivate the divisive distribution. A personal purpose is viewed as suspect since the Service fears that the shareholders will be tempted to bail-out earnings and profits.[38] A distribution undertaken for business purposes is less likely to be a device than a distribution designed to accomplish personal goals. The continuity of interest test is also intended to prevent bail-out.[39] If the shareholders maintain their continuity of interest following

13-31. If a corporation owns a large amount of liquid assets, a divisive distribution might be a device to distribute them even though the shareholders would retain the stock and securities which they received.

30. *See* Whitman, *Draining the Serbonian Bog: A New Approach to Corporate Separations Under the 1954 Code*, 81 HARV. L. REV. 1194, 1234 (1968).

31. See note 7 *supra* for the text of the single business test.

32. See note 6 *supra* for the text of the independent-production-of-income test.

33. *See* B. BITTKER & J. EUSTICE, *supra* note 4, at 13-13 to -19. For the Tax Court's analysis of this argument and its invalidation of the provision see Edmund P. Coady, 33 T.C. 771, 775-79 (1960).

34. Treas. Reg. § 1.355-1(c)(3) (1955), *supra* note 6.

35. *See* Rev. Rul. 75-160, 1975-1 C.B. 112, announcing that the Service will follow *Coady, Marett*, and *Rafferty* in the future. These cases discredited the independent production of income requirement and the single business restriction. *See also* Proposed Treas. Reg. § 1.355-1, -2, 42 Fed. Reg. 3866-68 (1977) and text accompanying notes 69-100 *infra*. *But see* note 70 *infra* regarding the continued use of these two provisions in § 346 cases.

36. *See* note 101 *infra*.

37. *See* note 151 *infra*.

38. See Estate of Parshelsky v. Commissioner, 303 F.2d 14, 19 (2d Cir. 1962), discussing the precursor of § 355, § 112(b)(11) of the 1939 Code, in which the court discussed the need for a business purpose. The court stated:

> Normally when a corporation distributes assets to its shareholders or sells the assets and distributes their proceeds, a dividend results and the shareholders pay ordinary income tax. However, if the corporation is permitted to transfer the assets to a new corporation and distribute the new corporation's stock to its shareholders in a tax-free spin-off, the shareholders could completely liquidate the new corporation or sell its stock, thus realizing capital gain rather than ordinary income. Because of these tax-avoidance possibilities, Congress intended to limit tax exemption to those spin-offs where the taxpayer had corporate or shareholder purposes such as would motivate a reasonable businessman to effect a spin-off.

Id. at 20.

39. The device, business purpose, and continuity of interest tests are all designed to prevent tax-free treatment for tax-avoidance schemes or bail-outs which attempt to disguise themselves as § 355 transactions. Although the Service views them as separate tests, the

a divisive distribution, there is no bail-out because there is no disposition of the stock or securities.[40]

It is difficult to determine whether the device or active business tests have been met since fulfillment of each is measured by vague standards.[41] Predicting the validity of a particular business purpose is also difficult.[42] The success of certain corporate transactions, however, depends upon such determinations, and, thus, compliance with these judicial requirements becomes mandatory. For this reason it is important to note any changes with respect to these tests. Recent revenue rulings, cases, and a newly proposed amendment to the regulations under section 355 reveal that the Service is engaged in a transition from a period in which it emphasized fulfillment of the active business test to one in which the device test will be more heavily weighted.[43] Having to some extent rejected the independent-production-of-income test and the single business proviso, the Service appears to be paying increased attention to the business purpose and continuity of interest requirements.[44]

The case law in this area is also reflective of the shifts in emphasis with regard to section 355 requirements. In 1960, showing scanty respect for the regulations, the Tax Court held in *Edmund P. Coady*[45] that the vertical division[46] of a business could qualify for tax-free treatment despite the

boundary lines between the three are not always clear. *See* Rev. Rul. 75-406, 1975-2 C.B. 125 (not a device since continuing stock interest in business enterprise was maintained); Rev. Rul. 55-103, 1955-1 C.B. 31 (indicates that the Service views the device test as a means of enforcing the continuity of interest requirement); B. BITTKER & J. EUSTICE, *supra* note 4, at 13-27 (device rule seems aimed at "serving as a statutory 'business purpose' rule"); Morris, *Combining Divisive and Amalgamating Reorganizations—Section 355 Fails Again*, 46 TEXAS L. REV. 315, 328-29 (1968). The author points out that the regulations treat the statutory device test:

> as a continuity of interest test, as a ban on the bail-out of earnings and profits by prohibiting (through its requirement of a continuing interest by the shareholders in both corporations) the separation of a corporation and the sale of the stock of one of the resulting corporations at capital gains rates . . . .

Id.

40. *But see* note 29 *supra* (disposition may not be necessary for characterization as a device).

41. *See* Meyer, *supra* note 11, at 270.

42. For example, *Rafferty* held that an estate planning motive was an insufficient business purpose in view of the court's finding of bail-out potential. The court wrote that "there was, at best, only an envisaged possibility of future debilitating nepotism." Rafferty v. Commissioner, 452 F.2d 767, 770 (1st Cir. 1971). Rafferty's family, however, "had once lost its business to an in-law" and the desire to prevent a reoccurrence seems like a reasonable motivation. Brief of Petitioner at 15, Rafferty v. Commissioner, 452 F.2d 767 (1st Cir. 1971). Since the first circuit balanced the business purpose involved against the likelihood of a bail-out, the case signifies that the estate planning purpose was lacking in weight, not that it was an inherently suspect purpose. Compare this case with Rev. Rul. 75-337, 1975-2 C.B. 124, where a similar purpose to facilitate estate planning satisfied the Service when viewed in light of the circumstances. See text accompanying notes 108-13 *infra* for a discussion of Rev. Rul. 75-337.

43. *See* notes 3, 15 *supra* and accompanying text.

44. See text accompanying notes 101-71 *infra* for a discussion of the current business purpose and continuity of interest requirements.

45. 33 T.C. 771 (1960) (split-off of a sewage construction corporation as a result of differences between two co-owner shareholders). The Commissioner argued that the taxpayer could not receive tax-free treatment under § 355 because the regulations denied such treatment to the division of a single business. The court declared that the provision was not reflective of either the statutory language or the congressional intent and was, therefore, invalid. The distribution was allowed tax-free treatment. The facts of this case are mirrored in Proposed Treas. Reg. § 1.355-3(c), ex. 10, 42 Fed. Reg. 3871 (1977).

46. B. BITTKER & J. EUSTICE, *supra* note 4, at 13-14, describes a vertical division as one in which "each of the post-distribution businesses carrie[s] on all stages or functions of the original business." Compare this with the definition of a horizontal division contained in note 52 *infra*.

Treasury's prohibition.[47] Furthermore, the court noted that in view of the facts that neither the language of section 355 nor its legislative history seemed designed to prevent the tax-free division of a single business, the regulations prohibiting nonrecognition treatment for such a division were invalid.[48] Three years later, in *United States v. Marett*,[49] the Court of Appeals for the Fifth Circuit agreed that Congress had not intended to deny the benefits of nonrecognition to a single business.[50] Subsequently, the Commissioner issued Revenue Ruling 64-147[51] which stated that the Internal Revenue Service would follow the *Coady* and *Marett* decisions to the extent that they held the single business provision to be invalid. Since both of the cases involved vertical divisions, however, there remained some question as to the likelihood that the horizontal division[52] of a single business would receive tax-free treatment upon distribution.[53]

Then, in 1971, the Court of Appeals for the First Circuit issued an opinion which favored nonrecognition treatment for the functional division of a single business. In *Rafferty v. Commissioner*[54] the court stated in a footnote: "[W]e believe the *Coady* rationale is also applicable to functional divisions of existing businesses."[55] The court directed its attention to the requirement that a group of activities must independently produce income in order to qualify as an active business. The court decided that this requirement was largely a "restatement of the rejected separate business requirement."[56] One commentator interpreted this to mean that functional divisions of an existing business would henceforth be viewed as actively conducting separate trades or businesses.[57] Distributions following a functional division would thus merit nonrecognition treatment. Another commentator, however, disagreed.[58] The tax consequences of a distribution following a functional division remained subject to speculation.

47. 33 T.C. at 780. See note 7 *supra* for the text of the single business provision.

48. 33 T.C. at 780.

49. 325 F.2d 28 (5th Cir. 1963). In *Marett* a spin-off of assets and accounts receivable to the newly formed corporation was made in exchange for all of its outstanding shares which were then distributed proportionately to shareholders of the parent corporation. The distribution was in response to the objections of a major client-competitor. The court agreed with *Coady* that § 355 applied to the division of a single business.

50. *Id.* at 30, 31.

51. 1964-1 C.B. (pt. 1) 136.

52. A horizontal or functional division occurs when "one post-distribution business takes over one or more functions of the original business (*e.g.*, production, distribution, real estate ownership, management, storage, research, or financing), while the other post-distribution business carries on the remaining functions." B. BITTKER & J. EUSTICE, *supra* note 4, at 13-14. Treas. Reg. § 1.355-1(d), exs. 5, 11, 12 (1955), dealing with functional divisions, are of dubious validity in light of *Rafferty* and *Coady*. These examples are set out in note 77 *infra*. Lee, *supra* note 10, at 457.

53. *See generally* B. BITTKER & J. EUSTICE, *supra* note 4, at 13-21; Lee, *supra* note 10, at 453 (commenting upon the uncertainty of the tax consequences for horizontal divisions).

54. 452 F.2d 767 (1st Cir. 1971). Motivated by concern for planning his estate, Rafferty spun-off the stock of a real estate holding corporation to his daughters. The First Circuit decided that his fear of take-over by future sons-in-law was a remote danger which could be circumvented in some other way, and, weighing the remoteness of the danger against the strong likelihood of bail-out, the court held the transaction was a device. The ease with which the assets could be sold and the fact that their retention was not necessary to either continuance of the enterprise or accomplishment of the shareholders' purposes influenced the court to deny § 355 treatment to the distribution.

55. *Id.* at 772 n.10.

56. *Id.*

57. Lee, *supra* note 10, at 454.

58. Klinger, *Satisfying the "Active Business" Requirement for Tax-free Spin-off of a*

In *King v. Commissioner*[59] the Court of Appeals for the Sixth Circuit agreed that the regulations designed to prevent tax-free distributions following a horizontal division were overbroad.[60] The court also characterized them as questionable in light of *Coady, Marett*, and *Rafferty*.[61] Failure to produce income independently was determined to be no bar to satisfaction of the active business test.[62]

In addition to casting doubt upon the regulations' active business test, *Marett, Raferty*, and *King* signaled an increasing interest in the business purpose doctrine.[63] In particular, *Rafferty* and *King* focused attention on balancing business purpose against bail-out potential.[64] The result of these three cases is that, insofar as case law is concerned, (1) vertical divisions of a single business will be allowed to qualify for tax-free treatment, (2) horizontal divisions of a single business similarly may be allowed to qualify, (3) the Treasury regulation requiring the independent production of income has been invalidated, and (4) courts will in the future rely more heavily upon the business purpose doctrine.[65] Following these cases, though, the Service's position on these issues remained uncertain; not until 1975 did the Service issue any revenue rulings sufficiently definitive to indicate what its future policy might be.[66] In January 1977 the Service issued a set of proposed

Functional Division, 38 J. TAX. 10 (1973). Klinger argues that there is no clear indication that a corporation could "spin off part of its operations constituting a functionally integrated division tax-free under the provisions of section 355 if such division produces no independent income." *Id.* A functional portion of a business is unlikely to produce income independently. *See* Treas. Reg. § 1.355-1(d), exs. 5, 11, 12 (1955).

59. 458 F.2d 245 (6th Cir. 1972). The Commissioner attacked a spin-off of leasing subsidiaries to shareholders, claiming the distribution was a device. The Sixth Circuit disagreed, noting, among other things, (1) that the corporations had not been formed to transfer anything of value to the shareholders, but had been created for valid business purposes several years earlier, (2) they were not terminated after the spin-off, (3) the transaction was motivated by a valid business need, and (4) the unique character of the transferred property made sale or liquidation unlikely since either would result in impairment of the continued operations of both the parent corporation and its subsidiaries. The court also found that none of the taxpayers had or could withdraw any funds due to the reorganization's plan. The transaction, therefore, merited § 355 treatment.

60. *Id.* at 249.

61. *Id.*

62. *Id.* The court agreed with the *Rafferty* holding that the independent production of income provision was questionable, concluding: "This . . . makes it unnecessary to pass upon the applicability of the regulations to the factual situation here present, but we express some reservation in this regard." Meyer, *supra* note 11, at 272, wrote that "the Sixth Circuit expressed reservations as to the test . . . that to be an active business a group of activities must be independently producing income." The court, however, did not express reservations as to the *test*, having previously declared that portion of the regulations to be imprecise and questionable. Their reservations seemed directed toward the question of whether the subsidiaries actually did independently produce income and whether, as a matter of policy, that factor should have been taken into account. In other words, aside from the dubious validity of the provision, the question may have remained in the court's mind whether the distinction was a valuable one with respect to enforcing the policy of § 355. The Service, in issuing the proposed regulations, either did not examine or was not influenced by such policy considerations; the requirement was omitted.

63. *See* Cohen, *Reconciling Business Purpose with Bail-out Prevention: Federal Tax Policy and Corporate Divisions*, 28 STAN. L. REV. 1077, 1079-82 (1976); note 177 *infra* (shift from active business test to weighing business purpose against device potential). *See also* Meyer, *supra* note 11, at 272-73.

64. *See* note 177 *infra*.

65. See note 42 *supra* and text accompanying notes 101-50 *infra* for discussion of business purpose.

66. See note 3 *supra* for the trend in recent revenue rulings.

regulations which further clarified the status of some section 355 requirements.[67]

II. SECTION 355: RECENT TRENDS

A. *Independent Production of Income*

As mentioned earlier, the active business test has been subject to erosion by court action. Two branches of the test, the provisions dealing with independent production of income and division of a single business, were in effect splintered by the force of the emphatic disapproval of the courts.[68] In 1975 the Service issued Revenue Ruling 75-160,[69] signifying the Service's abandonment of its requirement that each business must engage in the independent production of income to satisfy the active business test.[70] The example involved three related corporations which were declared to be engaged in the active conduct of a trade or business. One corporation manufactured solely for the benefit of a second corporation which sold no goods but those manufactured by the first corporation. Neither produced income independently through dealings with other businesses. Since the Service declared the corporations to be actively conducting a trade or business despite the lack of independently produced income, the ruling denotes abandonment of the requirement.

The recently proposed rules have notably omitted the express language of the requirement.[71] Nonetheless, the active conduct of a trade or business subsection contains four examples, two of which can be construed as support for an implied independent-production-of-income-in-the-future test. The other two can be viewed as support for an implied continuance of the present test, but there are problems with this approach. Disposing of the problematic examples first, proposed example six[72] involves a distribution

67. For an analysis of the changes contained in the Proposed Treas. Regs. see Lee, *Proposed Regs. under 355 overhaul device test and single-business divisions*, 46 J. TAX. 194 (1977).

68. *See generally* Lee, *supra* note 10, at 455-74.

69. 1975-1 C.B. 112.

70. Meyer, *supra* note 11, at 272 ("Rev. Rul. 75-160 signifies . . . abandonment of the independent production of income requirement."). Although the Service has abandoned the independent production of income test with respect to § 355, the test survives in § 346 cases. Treas. Reg. § 1.346-1(c)(2) (1955) provides: "The term 'active conduct of a trade or business' shall have the same meaning in this section as in paragraph (c) of § 1.355-1." Thus, § 346 cases continue to apply the words of the § 355 regulations even though said provisions have been invalidated by § 355 cases. For example, in Mains v. United States, 372 F. Supp. 1093, 1102-03 (S.D. Ohio 1974), the district court concluded that the business in question did not satisfy the requirements of § 1.355-1(c) since it was not a separate business and did not independently produce income. On appeal, the Sixth Circuit agreed with both conclusions. 508 F.2d 1251, 1257 (6th Cir. 1975). *Rafferty* and *King* earlier discredited both provisions with regard to § 355 cases. Revision of the current regulations will affect the § 346 active business test if the reference to the § 355 regulations is retained. The proposed regulations for § 355 provide: "Section 1.346-1 is amended by deleting the last sentence of paragraph (c) and by inserting in lieu thereof 'The term "active conduct of a trade or business" shall have the same meaning in this section as in § 1.355-3(b)(2).' " 42 Fed. Reg. 3871 (1977). Thus, it is probable that the interchange between the two sections will continue. Perhaps future § 346 cases will be more influenced by § 355 precedents since the proposed rules incorporate much of the prior judicial interpretation of § 355.

71. Compare the active business test contained in the current regulations, *supra* note 6, with the active business test contained in Proposed Treas. Reg. § 1.355-3(b), 42 Fed. Reg. 3869 (1977).

72. Proposed Treas. Reg. § 1.355-3(c), ex. 6, 42 Fed. Reg. 3870 (1977), provides:
Corporation F is engaged in the retail grocery business and owns all of the stock

of the stock of a corporation which derives all of its income from a lease with the controlling corporation. The Service declared that the controlled corporation could not be engaged in the active conduct of a trade or business after distribution since it had not actively conducted either one during the preceding five years. According to the current regulations, one of the requirements of an active business is that it independently produce income. That the income for this unqualified transaction was derived from the controlling corporation, rather than independently, may, therefore, support the existence of an implied requirement. Use of this example as such support, however, must be based upon weak foundations in light of two considerations: first, that the express requirement has been intentionally removed from the proposed rules; and second, that example six is a new example which is clearly intended to be reflective of other new material added simultaneously.[73] This reasoning is also applicable to the other example.[74]

There are two remaining examples which may indicate either a modification of the present test or a possible future trend. Example eight[75] of the proposed rules describes a functional division of the selling and processing activities of a single corporation in a spin-off of capital stock to the shareholders. Independent production of income is not mentioned, but it is clear that one of the corporations is unlikely to produce income independently. The processing corporation will apparently sell all of its meats to the selling corporation. Both businesses will be engaged in the active conduct of a business immediately following the distribution. Example fourteen[76] also

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of corporation G. Corporation G has for the past 10 years derived all of its gross income from the rental of its land and building to F under a lease in which G's principal activity consists of the collection of rent from the building. Corporation F proposes to distribute the G stock to its shareholders. Corporation G will not be engaged in the active conduct of a trade or business immediately after the distribution since it has not actively conducted a trade or business throughout the five-year period ending on the date of the distribution.

73. The new material is contained in Proposed Treas. Reg. § 1.355-3(b)(2)(iv), 42 Fed. Reg. 3870 (1977), which provides: "The active conduct of a trade or business does not include . . . (B) The ownership and operation (including leasing) of real or personal property used in a trade or business, unless the owner performs significant services with respect to the operation and management of the property."

74. Proposed Treas. Reg. § 1.355-3(c), ex. 13, 42 Fed. Reg. 3871 (1977).

75. *Id.* ex. 8, 42 Fed. Reg. at 3871, provides:

Corporation I has processed and sold meat products for 8 years. *It has no other income.* Corporation I proposes to separate the selling from the processing activities by forming a separate corporation, J *to purchase for resale the meats processed by I.* Corporation I will transfer to J certain physical assets pertaining to the sales function, plus cash for working capital, in exchange for the capital stock of J which will be distributed to the shareholders of I. *Immediately after the distribution corporation I will be engaged in the active conduct of meat products processing business and corporation J will be engaged in the active conduct of a meat distribution business. The business of each corporation is deemed to have been actively conducted from the date corporation I began its meat processing and sales business.*

Proposed ex. 8 is an expansion of Treas. Reg. § 1.355-1(d), ex. 11 (1955), set out in note 77 *infra* (pertinent additions to the language of the current example are italicized). Note that the assets transferred in this example as well as ex. 14, note 76 *infra*, are operating rather than liquid assets. The nature of the assets transferred and those retained was also an important consideration in Henry B. Atlee, 67.32 T.C.M. (P-H) (Dec. 8, 1976). See text accompanying notes 223-29 *infra* for a discussion of the new language in the proposed rules which deals with the "functional relationship" between such assets.

76. Proposed Treas. Reg. § 1.355-3(c), ex. 14, 42 Fed. Reg. 3871 (1977):

Corporation S has been engaged in the manufacture and sale of *household*

concerns the functional division of a single business. A corporation desires to separate its manufacturing and sales departments from its research department. The resulting corporations will satisfy the active business test following the distribution, but special note was made of the large number of workers presently employed in the research department as well as the fact that they are "actively engaged in the development of new products" and that they will continue research operations on a "contractual basis with several corporations including" the parent corporation.

In comparing the current and the proposed regulations' examples, certain distinguishing factors appear. In the three examples[77] of functional divisions in the present regulations, the spun-off activities were intended to serve only the parent corporation following the distribution. The activities could be characterized as passive activities since their success depended upon support from the controlling corporation. Presumably, the sale of the spun-off corporations would not impair the continuing operation of the surviving corporations. Furthermore, since each would continue to serve its parent corporation, the latter would be likely to assume the responsibility for creating legal obligations, if any, with respect to the subsidiary. The opposite is true with respect to the examples in the proposed regulations. In

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products for 8 years. Throughout this period, in connection with such manufacturing, it has maintained a research department for its own use. *The research department has 30 employees actively engaged in the development of new products*. Corporation S proposes to transfer the research department to a new corporation *and to distribute the stock of the new corporation to its shareholders. After the distribution the new corporation will continue its research operations on a contractual basis with several corporations including S. Immediately after the distribution the activities of the new corporation in connection with research will constitute the active conduct of a trade or business as will the activities of S in connection with manufacturing.*

Proposed ex. 14 is an expansion of Treas. Reg. § 1.355-1(d), ex. 5 (1955), set out in note 77 *infra* (pertinent additions to the language of the current example are in italics).

77. Examples 5, 11, and 12 of the current regulations concern functional divisions. Treas. Reg. § 1.355-1(d), ex. 5 (1955):

> Corporation E is engaged in the manufacture and sale of wood products. In connection with such manufacturing, it maintains a research department for its own use. It proposes to transfer the research department to a new corporation after which it will engage the services of the new corporation on a contract basis. The activities of the research department do not constitute a trade or business.

Id. ex. 11:

> Corporation K processes and sells meat products. It is proposed to separate the selling from the manufacturing activities by forming a separate corporation, L, to handle sales. Corporation K will transfer to Corporation L certain physical assets pertaining to the sales function plus cash for working capital in exchange for the capital stock of Corporation L which will be distributed to the shareholders of Corporation K. Since the manufacturing and selling operations constitute only one integrated business, neither Corporation K nor Corporation L will be continuing the active conduct of a trade or business formerly conducted by Corporation K.

Id. ex. 12:

> Corporation M is engaged in the manufacture and sale of steel and steel products. In addition, Corporation M owns and operates a coal mine for the sole purpose of supplying its coal requirements in the manufacture of steel. It is proposed to transfer the coal mine to a new corporation and distribute the stock of such new corporation to the shareholders of Corporation M. The activities of Corporation M in connection with the operation of the coal mine do not constitute a trade or business, since such activities are not themselves independently producing income although a part of the business operated for profit.

This example is retained as ex. 9 in the proposed regulations' section on the active conduct of a trade or business. Example 9, however, is beyond the scope of this discussion.

proposed example eight[78] the parent corporation has no source of income other than its present activities. Obviously a sale of the spun-off sales department would impair shareholders' equity interests in the parent. Moreover, in contrast with present example eleven, the proposed example's sales department would not merely "handle" sales, it would "purchase [meats] for resale."[79] Such an activity is one of an entrepreneurial nature. The success of the distributor corporation would thus depend upon the successful management and sales ability of the subsidiary. The subsidiary corporation would have to buy and sell at competitive prices; in order to serve the interests of the parent best, the subsidiary would have to promote its own interests as well. The active conduct of purchase and resale operations would also require that the subsidiary assume certain legal obligations. In proposed example fourteen[80] an attempt to bail-out earnings and profits by selling the research department would also be likely to impair the shareholders' equity interests.[81] Furthermore, since household products require constant innovation and updating in order to stay abreast of the market, the research department would have to conduct its business in an active and competitive manner. Since the department planned to work for both the parent and other corporations on a contractual basis, it would be assuming legal obligations of its own.

Although the express independent-production-of-income requirement has been deleted, an implied requirement that there be a likelihood of future independent production of income may be developing. The characteristics of such a test might be the likelihood of the following: a greater independence from parental control;[82] a business activity of an entrepreneurial nature;[83] the assumption of separate legal obligations;[84] and the existence of facts which make it unlikely that a bail-out will occur because of the adverse effect upon shareholders' equity interests.[85] Perhaps such a test would

78. See note 75 *supra* for text of ex. 8.
79. 42 Fed. Reg. 3871 (1977).
80. See note 76 *supra* for text of ex. 14.
81. See notes 158-89 *infra* and accompanying text for a discussion of impairment of equity interests.
82. The subsidiaries in the proposed examples would actively compete with other businesses rather than producing, selling, or researching solely for the parent corporation as is the case in the current examples. *See* note 97 *infra* and accompanying text (importance of working for corporations other than the parent).
83. *Id.* This characteristic may represent incorporation of the *Rafferty* version of the active business test:

> It is our view that in order to be an active trade or business under § 355 a corporation must engage in entrepreneurial endeavors of such a nature and to such an extent as to qualitatively distinguish its operations from mere investments. Moreover, there should be objective indicia of such corporate operations.

452 F.2d at 772. Thus the distinction between a parent corporation which contracts for the services of a subsidiary and a subsidiary which continues its operations on a contractual basis with several additional corporations may demonstrate the Service's view of what constitutes objective indicia of entrepreneurial endeavors.
84. The assumption of separate legal obligations by the subsidiary would lend credence to a taxpayer's claim that the transaction was covered by § 355. A subsidiary would, presumably, assume such obligations only if it intended to continue in business. If it intends to continue in business, it would satisfy the continuity of interest test, and be unlikely to be used as a device. See notes 151, 172 *infra* for the continuity of interest and device tests.
85. This characteristic also indicates that the business will be likely to continue in existence and thus produce income since a sale is improbable. *Rafferty* involved a similar consideration. The court there, however, held that the distribution was a device because:

partially revive the active business requirement. If so, that requirement together with the business purpose and device provisions would further restrict the accessibility of section 355.

B. *Division of a Single Business*

Although the current regulations under section 355 provide that the section is not applicable to the division of a single business, *Coady* and *Marett* both declared this portion of the regulations invalid.[86] Following these cases, it was agreed that vertical divisions of a single business merit tax-free treatment if the subsequent distributions fit within the statute.[87] A question remained, however, as to whether such treatment was to be extended to divisive distributions occurring after horizontal separations. One commentator claims that such distributions are now acceptable to the Service.[88] This commentator contends that Revenue Ruling 75-160 manifests the Service's willingness to accept vertical or horizontal apportionments of businesses. A problem arises if his conclusion is based upon the fact that the Service announced in the ruling that *Rafferty, Marett*, and *Coady* would henceforth be followed.[89] *Coady* and *Marett* dealt with the permissibility of vertical divisions. *Rafferty*, too, concerned a dispute about vertical separations. Functional divisions, far from being central to the court's opinion, were merely noted in passing when the court wrote, in a footnote, that it *believed* the *Coady* rationale was also applicable to functional divisions.[90] The fact that the Service has announced it intends the future disposition of cases in accordance with these three cases does not support the contention that section 355 is now applicable to horizontal apportionments.

One of the major changes suggested by the recently proposed amendment to the regulations deals with the separation of a single business. The introduction to the rules points out that the purpose of the revision is to "provide for the separation of a single business consistent with the holdings

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> [T]here was no evidence that the land and buildings at which RBS carried on its steel operations were so distinctive that the sale of Teragram stock would impair the continued operation of RBS, or that the sale of those buildings would in any other way impair Rafferty's control and other equity interests in RBS.

452 F.2d at 771. See Lee, *supra* note 10, at 481-88, for a discussion of impairment of equity interests in light of *Rafferty* and *King*.

86. *See* text accompanying notes 45-51 *supra*.

87. *See* Lee, *supra* note 10, at 456.

88. See Meyer, *supra* note 11, at 272, where the author writes that Rev. Rul. 75-160 signifies "[a]cceptance that a business can be apportioned vertically between manufacturing and sales, or horizontally as in *Marett* between geographic locations, or by division as in *Coady*, and in each the separate portions may constitute an active business for purposes of Section 355(b)." The transaction in *Marett*, however, involved the separation of several corporate entitites, not the separation of a single business. Therefore, this reference to *Marett* does not really address itself to the division of a single business as comprehended by the single business provision.

89. *See* Briner, *Federal Income Tax Developments: 1975*, 9 AKRON L. REV. 411, 515 (1976), discussing Rev. Rul. 75-160, 1975-1 C.B. 112:

> However, the IRS example promulgated in this ruling does not closely resemble *Coady* or the others. Instead of showing a split-up of a single business, the IRS example demonstrates a spin-off of two controlled integrated food manufacturing and retailing corporations from a parent furniture corporation. As a result, this example obfuscates the Commissioner's intention as to his forthcoming revised Regulations, since the factual situation as presented has never been a problem under Section 355 or Treasury Regulation 1.355-1(a).

90. *See* text accompanying note 55 *supra*.

in *Coady* . . . [and] *Marett*."[91] Since both cases involved vertical rather than horizontal divisions, the introduction is not a particularly favorable one from the viewpoint of horizontal divisions. Moreover, although Revenue Ruling 75-160[92] specifically noted that *Rafferty* would be followed, the introduction fails to mention that case, the only one of the three which even touched upon horizontal divisions.

The rules themselves, however, are more likely to be the basis for future decisions. Section 1.355-1(a)[93] announces that section 355 is now applicable to the division of "one or more existing businesses." This wording is neutral with respect to acceptance of tax-free horizontal divisions. Moreover, the subsection contains no examples to shed light upon the matter. Subsection two,[94] however, which deals with the requirements rather than the scope of the statute, is more helpful. It presents four examples, three dealing with vertical spin-offs and one involving a vertical split-off.[95] These examples, while not determinative of the question, are not encouraging. What is encouraging, assuming tax-free treatment of horizontal divisions to be desirable, is a statement contained in section 1.355-2(c)(iv): "[I]n a transaction which separates the manufacturing and sales operations . . . if the sales corporation merely functions as the exclusive agent for the manufacturing corporation after the transaction, this fact would be considered as evidence that the transaction was principally a device for the distribution of earnings and profits."[96]

If the sales corporation did not merely function as an exclusive agent for the manufacturing corporation after the transaction, then the separation of manufacturing and sales operations would not be considered a device. Since the only problem raised with such a transaction was that it might be a device, it may be assumed that if it is not a device, then there are no further objections under section 355. The distribution following what was patently a functional division would, therefore, merit nonrecognition treatment.[97]

Additional support for the view that the Service will thus apply section 355 is found in examples eight[98] and fourteen[99] of section 1.355-3(c).[100] Example eight involves the separation of a corporation's sales and processing activities. The Service held that each corporation was engaged in the active conduct of a business immediately after the distribution. Example fourteen involves a similar horizontal division. The facts illustrate a corporate separation following which the sales and manufacturing activities are

91. 42 Fed. Reg. 3867 (1977).
92. 1975-1 C.B. 112.
93. 42 Fed. Reg. 3867 (1977).
94. *Id.* at 3867-68.
95. *Id.*
96. *Id.* at 3869. This language has no parallel in the language of the current regulations.
97. This example can also be cited for the proposition that a functional division will be viewed as evidence that a transaction was used principally as a device where the subsidiary works solely for the parent corporation following the division. Compare these examples with proposed examples 8 and 14, notes 75-76 *supra* and accompanying text, in which the importance of conducting a business with respect to corporations or persons other than the parent corporation is noted.
98. See note 75 *supra* for text of ex. 8.
99. See note 76 *supra* for text of ex. 14.
100. 42 Fed. Reg. 3870 (1977).

isolated in one corporation and the research department in another. Here again the Service determined that immediately after distribution the activities of both corporations would constitute the active conduct of a trade or business.

A divisive distribution following the vertical separation of a single business will receive nonrecognition treatment under the rationale of the *Coady, Marett*, and *Rafferty* cases. Under the present regulations, such treatment is not extended to distributions which occur after horizontal apportionment. Although no revenue rulings support the contention that such separations deserve tax-free treatment, the proposed amendment to the regulations indicates that the Service will in the future apply section 355 to that type of divisive distribution.

C. *Business Purpose*

Regulation section 1.355-2(c)[101] requires that distributions be made only for purposes germane to the business of the corporations. The function of the business purpose test is to encourage continuation of the business, thus discouraging "tax avoidance through the interposition of short-lived corporate entities."[102] The requirement is not mandated by the language of section 355. It is a judicial limitation,[103] represented in the section by its statutory equivalent, the device provision.[104] The Service has in the past insisted that the business purpose doctrine exists independently of the device clause.[105] Following *Rafferty*, one commentator suggested that the test no longer possessed independent significance beyond its use as an element to be

101. Treas. Reg. § 1.355-2(c) (1955) provides:

> The distribution by a corporation of stock or securities of a controlled corporation to its shareholders with respect to its own stock or to its security holders in exchange for its own securities will not qualify under section 355 where carried out for purposes not germane to the business of the corporations.

Compare this with the business purpose test set forth in the proposed amendment to the regulations. *See* text accompanying note 120 *infra*. Commonly asserted business purposes are the following:

> 1. Compliance with local law requiring two businesses to be separated,
> 2. Compliance with Federal antitrust law,
> 3. Segregation of hazardous activities in a separate corporation,
> 4. Separation of a business to permit its employees to share in profits or ownership,
> 5. Settlement of a shareholder dispute by giving each group of shareholders control of ownership of one business.

B. BITTKER & J. EUSTICE, *supra* note 4, at 13-37;

> [6.] Disposition of unwanted assets in connection with a merger,
> [7.] Compliance with demands of a customer when a corporation produces items under its own label in competition with each other,
> [8.] Compliance with preconditions of a lender for granting a loan,
> [9.] Separation of activities subject to regulatory agency supervision.

Cohen, *supra* note 63, at 1100. *See also* Rev. Rul. 77-18, 1977-3 I.R.B. 8 which involved a reorganization plan and subsequent split-off in accordance with a plan devised by a trustee in bankruptcy.

102. Susman, *How unwanted assets can be spun off without destroying a reorganization*, 38 J. TAX. 360, 363 (1973); See also B. BITTKER & J. EUSTICE, *supra* note 4, 14-98 to -100 for a discussion of the business purpose test.

103. *See* Rafferty v. Commissioner, 452 F.2d 767 (1st Cir. 1971) (necessity of showing business purpose to prove transaction not used principally as device); Hanson v. United States, 338 F. Supp. 602, 609 (D. Mont. 1971) ("In addition to the literal requirements of section 355, both the regulations and case law require that the spin-off have a 'business purpose.' ").

104. B. BITTKER & J. EUSTICE, *supra* note 4, at 13-27.

105. *See* Meyer, *supra* note 11, at 273.

proved when a court determines the existence of bail-out potential.[106] A later commentator agreed that the requirement appears unnecessary in the light of *Rafferty*'s restated device test.[107] Nonetheless, indications are that the Service will continue to apply the test.

The issuance of Revenue Ruling 75-337[108] silhouetted the Service's determination to burden taxpayers with proof of a corporate business purpose even if the active business test had been met and the distribution was not likely to be used for bail-out purposes.[109] The ruling allowed tax-free treatment to a distribution of stock made to forestall an impending disruption of the business which might have been caused by the advanced age of the majority shareholder and the difficulty of renewing the business's franchise upon the majority shareholder's death or retirement.[110] Alleging concern for possibilities evident in the "reasonably foreseeable future," the Service held that the distribution of stock was supported by a valid business reason.[111] The ruling distinguished *Rafferty*, pointing out that there the possibility of future interference with the taxpayer's business operations was remote and that motivation had stemmed from personal rather than business reasons.[112] In the ruling, although the plan of distribution was "an important element in the individual's personal estate plan," the primary motivation was held to be a corporate business purpose.[113]

Later rulings have also demonstrated the Service's interest in the business purpose requirement. Revenue Ruling 76-13[114] held that a spin-off was carried out for purposes germane to the corporations' business since the transaction was motivated by a desire to minimize nationalization. Revenue

106. *See* Lee, *supra* note 10, at 493.

107. See Meyer, *supra* note 11, at 273, where the author notes:
> [T]he 'device' test as restated would appear to necessarily require an inquiry into the objects to be accomplished by the distribution of shares to assure that a bail-out is not likely. Under these revised standards, a separate corporate business requirement would seem to be unnecessary to secure the objects of Section 355.

108. 1975-2 C.B. 124.

109. *See* Meyer, *supra* note 11, at 273.

110. 1975-2 C.B. 125.

111. *Id.*

112. *Id.* See note 42 *supra* for a discussion of *Rafferty*'s purpose.

113. 1975-2 C.B. 125.

114. 1976-1 C.B. 96. The country in which a subsidiary was incorporated had issued a decree commencing a program of nationalization; the subsidiary's assets would have been affected. The Service declared that the § 368(a)(1)(D) reorganization was "carried out for purposes germane to the business of the corporations within the meaning of section 1.355-2(c) since *both* the transfer and the distribution were necessitated by the imminent nationalization of the assets transferred." *Id.* Both the present and the proposed regulations require a business purpose for the distribution only. Recent rulings, however, indicate that a valid business purpose is also necessary for the transfer. Of the eight 1975-77 rulings which dealt with § 355 transactions involving distributions or transfers (as of Feb. 28, 1977), four mentioned that both the distribution and the transfer were motivated by valid business reasons. In all four of the rulings which did not discuss a reason for the transfer no transfer was involved, only a distribution of the stock of an already existing subsidiary occurred. *See* Rev. Rul. 77-22, 1977-4 I.R.B. 7 (distribution with no transfer involved); Rev. Rul. 77-11, 1977-2 I.R.B. 13 (transfer and distribution pursuant to an integrated plan motivated by valid business reasons); Rev. Rul. 76-528, 1976-52 I.R.B. 22 (transfer of assets and subsequent distribution of stock for good business reasons); Rev. Rul. 76-527, 1976-52 I.R.B. 21 (distribution with no transfer involved); Rev. Rul. 76-187, 1976-1 C.B. 97 (transfer of stock for stock motivated for business reasons and subsequent distribution made for germane purposes); Rev. Rul. 76-13, 1976-1 C.B. 96 (transfer of assets and distribution made for germane purposes); Rev. Rul. 75-469, 1975-2 C.B. 126 (distribution with no transfer involved); Rev. Rul. 75-337, 1975-2 C.B. 124 (distribution with no transfer involved).

Ruling 76-187[115] showed that the Service also viewed as motivated by a valid business purpose a distribution to substantially reduce state and local tax liability. In a third ruling, Revenue Ruling 76-527,[116] the Service found a satisfactory business purpose where a distribution was made in order to make a subsidiary's stock acceptable in a proposed merger. Finally, in Revenue Ruling 77-22[117] a pro rata distribution satisfied the business purpose requirement when made to secure separate borrowing limits for a parent and subsidiary corporation. The ruling noted that credit was *essential* to both businesses and that the spin-off would prevent threatened curtailment of their established borrowing limits. These and other rulings indicate that the Service views business purposes arising from outside pressures far more favorably than it views those purposes stemming even in part from a desire to accomplish personal goals.[118]

The recently proposed amendment to the regulations preserves the business requirement as a test independent of the device provision. The two tests are discussed in separate subparagraphs of section 1.355-2[119] and each is illustrated by its own examples. The proposed rules differ from the present regulations in that they demand "real and substantial nontax reasons" germane to the business of the corporations.[120] They retain the principal policy given in the present regulations, that is, nonrecognition

115. 1976-1 C.B. 97. Under state and local law, both a parent corporation and its holding company had to pay a subsidiary capital tax on the value of a wholly owned subsidiary. The parent corporation distributed all of the subsidiary to the holding company in order to avoid the double tax. The Service characterized the distribution as necessary and allowed nonrecognition treatment.

116. 1976-52 I.R.B. 21. A subsidiary corporation negotiated for the acquisition of an unrelated corporation's television broadcasting properties. The latter, however, was unwilling to accept the subsidiary's stock as consideration for a merger since the former was controlled by a corporation whose business was unrelated to television broadcasting. A pro rata distribution was made of the subsidiary's stock to the controlling corporation's shareholders. The distribution qualified as a § 355 transaction. Similar transactions were contemplated in Commissioner v. Morris Trust, 367 F.2d 794 (4th Cir. 1966), *acq. in*, Rev. Rul. 68-603, 1968-2 C.B. 148, and Curtis v. United States, 336 F.2d 714 (6th Cir. 1964). In *Morris Trust* a bank spun-off its insurance business in a "D" reorganization to avoid a violation of federal banking laws and in order to facilitate a merger with another bank. The Commissioner argued that a simultaneous divisive and amalgamating reorganization failed to qualify under § 355 due to a lack of continuity of interest. The Second Circuit, however, disagreed. On the other hand, the Sixth Circuit denied nonrecognition treatment to a transaction where a spin-off occurred prior to a merger. The court found that the parent went out of existence because of the merger and, therefore, could not satisfy the active conduct of business test. The Service's acquiescence in *Morris Trust*, however, discredits *Curtis* since it is now clear that continuity of interest is not destroyed by a merger.

Continuity of interest was not a factor in Rev. Rul. 76-527. The ruling was limited to consideration of whether or not the distribution of the subsidiary's stock was undertaken for valid business reasons. In light, however, of the Service's liberal reading of the continuity test it is likely that the test would have been held satisfied had it been considered in this ruling. See text accompanying notes 161-66 *infra*, discussing the satisfaction of the requirement through indirect ownership.

117. 1977-4 I.R.B. 7. The bank which was the principal source of credit for both corporations informed them that it had been notified by the Comptroller of the Currency that only a single borrowing limit was allowed for parent-subsidiary corporations. Due to business conditions, the corporations had no other source of financing. The bank, however, also informed them that they would be entitled to the separate borrowing limits to which they were accustomed if they eliminated their parent-subsidiary relationship. The Service declared that the distribution necessary to accomplish this result was germane to the business of the corporations.

118. *See* text accompanying notes 123-41 *supra*.

119. 42 Fed. Reg. 3867-69 (1977).

120. *Id.* at 3867.

treatment for only those distributions incident to necessary readjustments of corporate structures and those in which a continuity of interest is maintained.[121]

Section 1.355-2(b) offers four examples to illustrate the new requirement that distribution occur for a "real and substantial nontax reason" germane to the business of the corporations.[122] The first example holds that the requirement is met when a corporation is ordered to divest itself of properties as a result of antitrust litigation.[123] A court order thus qualifies as a real, substantial, and nontax reason. In the second example the necessary business reason is supplied by disagreement between the only two active shareholders with regard to major decisions affecting the operation of the corporation.[124] This purpose, while arising from internal rather than external pressures, was clearly a substantial nontax business reason. The alternative of maintaining the business as a single corporation, torn by dissension, could have been disastrous to its survival. In the third example[125] the shareholders'

121. *Id.*

122. *Id.* at 3868.

123. *Id.* Proposed Treas. Reg. § 1.355-2(b)(2), ex. 1, 42 Fed. Reg. 3868 (1977) provides:

> Corporation P is engaged in the production, transportation, and refining of petroleum products. In 1962, P acquired all of the properties of corporation S, which was also engaged in the production, transportation, and refining of petroleum products. In 1968, as a result of anti-trust litigation, P was ordered to divest itself of all properties acquired from S. P proposes to transfer the assets acquired from S to a new corporation and to distribute the stock of such new corporation to its shareholders. In view of the divestiture order, the distribution of the stock of the new corporation to the shareholders of P will be considered to have been carried out for a real and substantial nontax reason germane to the business of the corporations.

Proposed ex. 1 has no parallel in the current regulations.

124. *Id.* ex. 2, 42 Fed. Reg. at 3868 provides:

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

Proposed ex. 2 has no parallel in the current regulations. *Accord*, Riener C. Nielsen, 61 T.C. 311, 315 (1973) ("dispute became bitter and at one point legal action was threatened to resolve it"); Coady, 33 T.C. 771 (1960), *aff'd*, 289 F.2d 490 (6th Cir. 1961) (differences arose between two major shareholders); Rev. Rul. 75-469, 1975-2 C.B. 126 (valid business purpose in "satisfying the now dissident former Y shareholders whose actions have been injurious to the operations of X").

125. Proposed Treas. Reg. § 1.355-2(b)(2), ex. 3, 42 Fed. Reg. 3868 (1977) presents the following situation:

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

Proposed ex. 3 has no parallel in the current regulations.

motivation failed to satisfy the requirement of a substantial nontax business purpose. Desiring separation of the assets of one business from the "risks and vicissitudes" of another business in the corporation, the shareholders proposed a vertical spin-off. No reason was offered why the seemingly reasonable purpose of protecting one business from the risks of another failed to satisfy the test.[126] The fourth example assumes the same facts as the third, that is, the existence of two different types of business within one corporation.[127] But in this example the corporation also required outside financing to accomplish substantial expansion of one of the businesses. Moreover, the lender required separation of the two businesses as a condition of the loan, a requirement based upon customary business practice.[128]

126. Early rulings, Rev. Rul. 56-554, 1956-2 C.B. 198, and Rev. Rul. 56-287, 1956-1 C.B. 186, both held the segregation of a risky from a stable business to be a valid business purpose with regard to § 355. See Birmingham, *Business Purpose Requirement For Spin-Offs Under § 355*, 14 S.D.L. REV. 250, 255-58 (1969) for a discussion of the Service's view of separating liability as a business purpose. The author points out that the Service is suspicious of such purposes because of the increased potential for tax-avoidance. He analyzes Commissioner v. Wilson, 353 F.2d 184 (9th Cir. 1965), and Estate of Parshelsky v. Commissioner, 303 F.2d 14 (2d Cir. 1962), in light of their attempts to segregate safe from hazardous assets. In neither case did this motivation suffice as a valid business purpose. The most recent § 355 case, Harry B. Atlee, 67.32 T.C.M. (P-H) (Dec. 8, 1976), also involved a separation of low risk assets from high risk assets. The distribution did not merit § 355 treatment since it failed to satisfy the active business test (the business purpose test was not in issue). Tax-free treatment was denied because the transferor corporation retained "virtually all of the operating assets the corporation used in its business." *Id.* at 216-67. Although no one alleged that the purpose of the transaction was to segregate stable from risky assets, the court noted the high risk factor of the transferred assets. Although taxpayers may still desire to separate valuable assets from more speculative assets in divisive distributions, they may no longer argue that such desire is a valid business purpose due to adverse rulings on that point. For further discussion of this case see note 223 *infra* and accompanying text.

127. Proposed Treas. Reg. § 1.355-2(b)(2), ex. 4, 42 Fed. Reg. 3868 (1977) provides:

> The facts are the same as in example (3) except that T also requires outside financing in order to substantially expand its candy business. As a condition of the loan, in order to prevent the potential diversion of funds to the toy business, the lender requires the separation of the candy business and the novelty toy business and the distribution of the stock of the novelty toy corporation to the shareholders. The lender's requirements are based upon customary business practice. In this case, the distribution of the stock of the novelty toy corporation to the shareholders will be considered to have been carried out for a real and substantial nontax reason germane to the business of the corporations.

Proposed ex. 4 has no parallel in the current regulations.

128. A customary business practice was one of three factors in the modified business purpose approach relied upon in *King*. The Tax Court in *King* characterized a net lease transaction as: "the most advantageous method of doing business from the point of view of the leasing corporations;" "bona-fide" leases; and "of a type customarily used in the industry." 458 F.2d at 248. See Lee, *supra* note 10, at 464, for the argument that this type of approach is not responsive to whether such leasing activities satisfy the active business test. Compare the modified purpose approach with the new language in the proposed regulations, note 73 *supra*. If the proposed language dealing with leasing activities is adopted, the modified test would be overshadowed, at least with regard to net leases, by the requirement that the owner perform significant services with regard to both operation and management of his property. Proposed Treas. Reg. § 1.355-3(c), 42 Fed. Reg. 3870-71 (1977) provides four examples illustrating the Service's requirements with regard to leasing activities: ex. 4 (active conduct test satisfied where the transferee corporation "will manage the building, negotiate leases, seek new tenants, and will repair and maintain the building"); ex. 5 (active business test not satisfied where transferor corporation "will lease the space formerly occupied by it in the bank building from the new corporation and, under the lease, will repair and maintain its portion of the building and pay property taxes and insurance); ex. 6 (active business test not satisfied immediately after distribution since a subsidiary had "derived all of its gross income from the rental of its land and building to F, under a lease in which [the subsidiary's] principal activity consist[ed] of the collection of rent from the building"); ex. 13 (active business test not satisfied where following transfer, the distributing corporation "will lease the factory building under a long-term lease and will operate and maintain the building and the machinery in the building"). Also see *id.* exs. 2, 3 for situations involving holding land or mineral rights rather than leasing. Adoption of the

This distribution was considered to have been carried out for substantial nontax business reasons.

The two common denominators in the examples are a necessary objective and a reasonable method of attainment. In the first example a court order was issued to ensure that the corporation divest itself of its properties. There was no discussion of alternative means[129] by which the order could have been satisfied. This fact is reflective of the restated business purpose in the sense that it demonstrates that the Service is not seeking the best nontax reason but only a real and substantial one. The divisive distribution was a reasonable means of accomplishing a necessary objective. The second example also illustrated a reasonable way of attaining a necessary goal: the survival of a corporation. Had the shareholders foregone the opportunity for a vertical split-off, the business would probably have suffered economic ruin. In the third example the prospect of actual damage to the candy business was not shown to be immediate or probable.[130] In that instance the shareholders were motivated by personal reasons and there was no showing of necessity. The final paradigm retained the facts of the preceeding example and added to the recipe only one ingredient: necessity. The distribution was held to have satisfied the business purpose test.

The proposed rules have added three sentences to the subsection on business purpose.[131] None of them has any foundation in the business purpose language contained in the present regulations. The added language provides:

> Depending upon the facts of a particular case, a shareholder purpose for a transaction may be so nearly coextensive with a corporate business purpose as to preclude any distinction between them. In such a case, the transaction is carried out for purposes germane to the business of the corporations. On the other hand, if a transaction is motivated solely by the personal reasons of a shareholder, for example, if a transaction is undertaken solely for the purpose of fulfilling the person-

above portions of the proposed amendment would result in the paradoxical incorporation of the customary business concept within ex. 4 of the active business subsection as well as with regard to net leases, thus, simultaneously overruling the test's applicability to the fact situation from which it developed.

129. *See* Hanson v. United States, 338 F. Supp. 602, 613-14 (D. Mont. 1971). Since a spin-off and subsequent distribution were motivated by an adequate business purpose, it was irrelevant that "the same business purpose might have been equally well served by some other form of reorganization . . . ."); *But cf.* Cohen, *supra* note 63, at 1086 (due to the "danger of bail-out potential, a division should occur tax-free only when an alternative technique cannot adequately serve the taxpayer's needs"); Lee, *supra* note 10, at 491 (possibility that *Rafferty* may signal a new approach to analyzing business purpose with respect to spin-offs; court might "discount" business purposes if the same results could be achieved through payment of dividends). This type of analysis was used in *Parshelsky*, 303 F.2d at 19-20. The court there considered three reasons proffered in support of the validity of a spin-off. The court noted an alternative method of accomplishing each purpose. In *King*, 458 F.2d at 251, Judge McCree of the Sixth Circuit, dissenting in part, also discussed the possibility of alternatives which would have effectuated the business purpose without affecting the shareholders' interest in the distributing corporation. Due to the increasing interest in impairment of shareholder equity interests, perhaps more courts will begin to emphasize alternative methods of accomplishing the taxpayer's business purpose. The proposed regulations, however, do not do so.

130. *See* Rev. Rul. 75-337, 1975-2 C.B. 124 in which the Service distinguished the facts of the ruling from those in *Rafferty*, reasoning that "[t]he difficulties anticipated [in *Rafferty*] were so remote that they might never come to pass." Moreover, as discussed in note 126 *supra*, isolation of liabilities increases the potential for a bail-out of corporate earnings and profits.

131. Proposed Treas. Reg. § 1.355-2(b)(1), 42 Fed. Reg. 3867 (1977).

> al planning purposes of a shareholder, the distribution will not qualify under section 355 since it is not carried out for purposes germane to the business of the corporations.[132]

This language indicates the Service's agreement with certain judicial conclusions drawn in *Coady, Marett, Rafferty*, and *King*. This agreement is further mirrored in some of the proposed amendment's examples.

In the 1972 *King* case, for example, the Sixth Circuit examined the business reasons motivating the transactions before it. The court noted three motives: the desire to fulfill a business need of the parent corporation; the desire to enable the newly created subsidiaries to produce income; and the desire to raise the financial strength to a level such that the subsidiaries could engage in necessary construction. The court held the purposes to be immediate and germane to the continuance of the corporations.[133] The court also wrote: "If any stockholder purpose was served, it was a normal purpose in that the corporations in which they owned interests were enabled to expand and to become more profitable."[134] Some of the circumstances of this case are incorporated in example four of section 1.355-2(b)(2)[135] of the proposed regulations. This example involves a corporation which must obtain outside financing in order to expand one of its businesses substantially. Separation of the corporation's two businesses was required as a condition of the loan; the requirement was based on customary business practice. A comparison of the *King* case and the example reveals the following four similarities: the desire to fulfill a business need was present in each; both corporations wanted to increase their financial strength in order to engage in additional activities; necessity was a factor in each situation in the sense that one required a merger and the other required a separation in order to accomplish their business purposes;[136] and, in each, customary business practice was a consideration. Both the case and the example illustrate shareholder purposes coextensive with corporate business purposes.

Some of the above factors were present in the *Marett* case also. The business need involved was the need to preserve a major customer. The necessity for fulfilling this need via a corporate separation was created by the customer's objections to the business's form.[137] Moreover, the Service's agreement with the resolution of this case is exemplified in example eleven of proposed section 1.355-3(c)[138] which presents a similar fact situation. The

132. *Id.* This language has no parallel in the language of the current regulations.
133. 458 F.2d at 250.
134. *Id.*
135. See note 127 *supra* for text of ex. 4.
136. Brief for Appellant at 30, King v. Commissioner, 458 F.2d 245 (6th Cir. 1972) ("there was an immediate and compelling need to borrow large sums of money to provide terminal facilities vital to the operations of Mason & Dixon"); *accord*, Commissioner v. Morris Trust, 367 F.2d 794 (4th Cir. 1966), *acq. in*, Rev. Rul. 68-603, 1968-2 C.B. 148 (bank rid itself of its insurance business in order to avoid a violation of national banking laws as well as to facilitate a merger); United States v. Marett, 325 F.2d 28 (5th Cir. 1963) (separation caused by need to preserve customer); Bondy v. Commissioner, 269 F.2d 463 (4th Cir. 1959) (outside pressure forced separation, taxpayer was motivated by desire to preserve car dealership).
137. Brief for Appellee at 3, United States v. Marett, 325 F.2d 28 (5th Cir. 1963) ("it was necessary to produce and market this additional production of pork skins through a separately organized company so as to meet the objections of Tom Huston and preserve it as a customer").
138. 42 Fed. Reg. 3871 (1977).

case and examples also demonstrate coextensive shareholder and corporate purposes.

The facts of *Coady* as well are reflected in both the language discussing shareholder purpose and an example contained in the proposed rules. The second example in section 1.355-2(b)(2)[139] describes a corporation which owns and operates two retail clothing stores. The only two active shareholders reach the point where they can no longer agree on major decisions which affect the functioning of the corporation. They therefore propose a vertical split-off; the transaction received the blessings of the Service since it was carried out for a "real and substantial nontax reason germane to the business of the corporations."[140] *Coady*, too, involved a corporate separation agreed upon because of differences between two shareholders.[141] Thus it appears that when shareholder disagreements disrupt or threaten to disrupt the operations of a corporation, there is a valid business purpose for distributions under section 355. This is yet another instance of coextensive shareholder and corporate purposes.

The final sentence of the new business purpose language is intended to express the Service's position with respect to the *Rafferty* decision. It has been narrowly drawn, however, to encompass specific areas not presently covered by the *Rafferty* holding. Under *Rafferty* a distribution would be denied section 355 treatment even when motivated by a valid business purpose if the primary motivation was a personal reason and there was considerable potential for bail-out.[142] A personal reason could qualify, though, if it were "germane to the continuance of the corporate business."[143] In addition to requiring a "real and substantial nontax"[144] reason, the Service proposes to exclude from section 355 treatment personal purposes which are the sole motivating reasons for the transaction.[145] Thus the proposed regulations do not incorporate the *Rafferty* test. Presumably the Service intends to rely upon the holding as a judicial doctrine rather than include it in the regulations. Although the proposed sentence seems to allow more latitude for personal motivations, in one sense the new test would be harsher than that used in *Rafferty*. If not outweighed by bail-out potential, under *Rafferty* a distribution which is motivated solely by a personal pur-

139. See note 124 *supra* for text of ex. 2.

140. 42 Fed. Reg. 3868 (1977).

141. 33 T.C. at 773.

142. 452 F.2d at 770:

> This is not to say that a taxpayer's personal motives cannot be considered, but only that a distribution which has considerable potential for use as a device for distributing earnings and profits should not qualify for tax-free treatment on the basis of personal motives unless those motives are germane to the continuance of the corporate business.

143. *Id.* Also see Cohen, *supra* note 63, at 1084, criticizing the court's rejection of *Rafferty*'s reason as not germane:

> Disputes between siblings over managing the business were 'future' events because ownership was to be transferred only at Rafferty's death. Yet the court's rejection of this eventuality as a mere 'possibility' does ignore the fact that family discord often disrupts small businesses . . . . [W]hat could be more germane to continued profitability of the enterprise than designation of successors to current management?

144. Proposed Treas. Reg. § 1.355-2(b), 42 Fed. Reg. 3868 (1977).

145. *See* text accompanying note 132 *supra*. See note 114 *supra* for discussion of purposes for distributions versus those for transfers.

pose would have an opportunity to qualify assuming the purposes were germane to the corporations' continuance.[146] The amendment, however, would establish an irrebuttable presumption that transactions motivated solely by personal reasons are "not carried out for purposes germane to the business of the corporations."[147] Therefore, while the Service is likely to rely upon *Rafferty* to bar section 355 treatment for distributions primarily motivated by personal reasons when bail-out potential exists, additional grounds for disqualification are being explored. The focus upon sole motivation would encompass less area than the *Rafferty* emphasis upon primary motivation. On the other hand, the proposed examination of the shareholder's reasons for undertaking the entire transaction certainly exceeds *Rafferty*'s concern for the reasons motivating the distribution. Moreover, the presumption that solely personal purposes are not germane to the business of a corporation overrides the *Rafferty* approach of examining the facts of each case to determine whether a purpose is germane.

The Service will place greater reliance on the business purpose test in the future. This trend stems from the *Rafferty* and *King* decisions' emphasis on bail-out potential and the use of the business purpose doctrine as a counterweight[148] in measuring the likelihood that a transaction will be used principally as a device. Both *Rafferty* and Revenue Ruling 75-337 indicate that taxpayers will have the burden of proof in showing a corporate business purpose.[149] Other revenue rulings as well as the proposed regulations demonstrate the Service's preference for necessary business purposes as opposed to purposes designed to accomplish personal plans. Furthermore, the Service seems interested in ensuring that the method for accomplishing the purpose is a reasonable one, or at any rate, that a customary business practice is involved. Finally, the test is likely to focus upon the purposes for the transaction;[150] if the motivation is solely personal, the transaction will be taxed.

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146. *See* 452 F.2d at 770.

147. 42 Fed. Reg. 3867 (1977).

148. The other "weight" is bail-out potential. See note 177 *infra* discussing a problem raised by the balancing test.

149. 452 F.2d at 769; Meyer, *supra* note 11, at 273.

150. *Parshelsky*, 303 F.2d at 19, held that both corporate and shareholder purposes were pertinent to a determination of the applicability of § 112(b)(11) of the 1939 Code, precursor to § 355, to a transaction. A later Ninth Circuit case, Commissioner v. Wilson, 353 F.2d at 129, stressed the need for a corporate business purpose in § 355 distributions. Although no tax avoidance purpose was evident in the transaction, the court feared that the lack of a corporate business purpose indicated the likelihood of a later bail-out. On the other hand, while *Rafferty* demonstrated the court's willingness to accept a shareholder purpose in satisfaction of the business purpose test, it established a balancing test which pitted device potential against business purpose. 452 F.2d at 770. Thus, the court appeared to handicap shareholder business purposes if intended to achieve personal motives. Following *Rafferty*, *King* strengthened the position of a corporate business purpose as against a personal business purpose. The court interpreted the *Rafferty* holding to be "that the distribution had been used principally as a device for the distribution of earnings and profits *because* the motive for the creation of the subsidiary corporation and eventual spin-off was an estate planning motive." *Id.* at 250 (emphasis added). This was a misrepresentation of *Rafferty*. What the court had actually held was:

> In the absence of any direct benefit to the business of the original company, and on a showing that the spin-off put saleable assets in the hands of the taxpayers, the continued retention of which was not needed to continue the business enterprise, or to accomplish taxpayers' purposes, we find no sufficient factor to overcome the Commissioner's determination that the distribution was principally a device to distribute earnings and profits.

D. *Continuity of Interest*

Continuity of interest[151] is one of the factors used by the Service to determine whether a transaction has been used principally as a device. The purpose of the test is to deny nonrecognition to "sales" that meet the letter but not the spirit of reorganization law.[152] One commentator has predicted that the significance of the test will probably be minimal where the *Rafferty* approach is followed.[153] More recently, however, Revenue Ruling 75-160, read in the light of *Rafferty* and *King*, appears to signal an increased emphasis on use of the test.[154]

Revenue Ruling 75-160 simply states that "Corporation A has no plans to dispose of any of its stock in these corporations."[155] It is difficult to conclude from these words alone that the Service is beginning to place greater emphasis on the test. The ruling dealt with continuity of interest as only one of many factors to be considered in determining whether the distribution was used as a device. Viewed from a policy perspective, however, there is a strong likelihood that the test will receive increased attention in the future. This test is designed, as are the "device" and business purpose tests, to "prevent the shareholders of an acquired corporation from 'cashing in' their investments while staying within the literal requirements of the tax-free reorganization provisions."[156] The most significant result of *Rafferty* is the court's adoption of the transactional approach, a balancing test designed to guard against the accomplishment of tax-free bail-outs.[157] In using this approach a court scrutinizes the transaction to see whether the distribution enables the taxpayer to draw earnings and profits out of the business without impairing his equity in the ongoing enterprise. If he sells the stock or securities received without impairing his equity, then he has bailed-out.[158]

Id. at 771. Thus, in *Rafferty* the motive was not strong enough to overcome the rebuttable presumption that the transaction was a device. The motive was not, however, the reason why the distribution was determined to be a device. The proposed test appears to stem from *King*'s interpretation of *Rafferty*. If a shareholder's personal reasons are the sole motivation for the transaction, then the distribution will not qualify for § 355 treatment.

151. Treas. Reg. § 1.355-2(c) (1955) provides: "[s]ection 355 contemplates a continuity of the entire business enterprise under modified corporate forms and a continuity of interest in all or part of such business enterprise on the part of those persons who, directly or indirectly, were the owners of the enterprise prior to the distribution or exchange." For a recent discussion of this test see Turnier, *Continuity of Interest—Its Application to Shareholders of the Acquiring Corporation*, 64 CALIF. L. REV. 902 (1976).

152. See B. BITTKER & J. EUSTICE, *supra* note 4, at 3-18, 13-38 to -39, 14-16 to -26 for a general discussion of the continuity of interest doctrine. With regard to its increasing use in the area of corporate reorganizations see Bloom & Sweet, *How IRS Uses Continuity of Interest to Raise New Problems in Reorganizations*, 45 J. TAX. 130 (1976).

153. *See* Lee, *supra* note 10, at 486.

154. See generally Meyer, *supra* note 11, at 272, where the author notes that *Rafferty* and *King* will only permit a distribution to "pass the 'device' test if the transaction did not place the shareholders receiving the distribution in a position to dispose of the shares without impairing their equity investment in the corporation from which the shareholders' distribution was received." Thus the continuity of interest test will be of increasing importance in view of the tendency to scrutinize impairment of equity interests.

155. 1975-1 C.B. 112.

156. Bloom & Sweet, *supra* note 152, at 136.

157. *See* Lee, *supra* note 10, at 479.

158. Proposed Treas. Reg. § 1.355-2(c)(1) denies § 355 treatment to bail-outs. See Lee, *supra* note 10, at 481, where the author states that "[n]o exact parallel to impairment of growth potential and earnings power is presented under existing Code provisions. The 'essentially equivalent to a dividend' provisions offer the closest analogy since they, too, are concerned with bail-outs." In fact, in Rev. Rul. 64-102, 1964-1 C.B. (pt. 1) 136 the Service indicated that it

On the other hand, if he maintains his interest in all or part of the business, he has not bailed-out.[159] In the latter event the shareholder satisfies not only the continuity or interest requirement but the device test as well. The *King* court, influenced by *Rafferty*, also analyzed the transaction before it for bail-out potential.[160] The preoccupation of the courts with bail-out potential and the issuance of Revenue Ruling 75-160 clearly signal an increasing reliance on the continuity of interest test as one factor useful in determining whether such potential actually exists.

Two subsequent rulings have also dealt with the requirement. Revenue Ruling 75-406[161] involved a spin-off followed by a statutory merger with an unrelated corporation. The disposition of the spun-off subsidiary's stock in exchange for the unrelated corporation's stock did not violate the required continuity of interest. The Service reasoned that the shareholders retained indirect ownership of the subsidiary due to their control of the unrelated corporation. The Service further noted that the shareholders were free to vote their subsidiary stock for or against the merger. Thus, continuity of interest alone may not be sufficient. The Service may demand that shareholders retain their interest in an active rather than an inactive form.[162] Revenue

equated the device requirement with the dividend equivalency test. This ruling was issued at a time when the Service emphasized the use of the active business test and avoided the use of the device test. *See* Lee, *supra* note 10, at 477. United States v. Davis, 397 U.S. 301 (1970), while centering upon § 302(b)(1) rather than § 355, may shed some light on a useful method for analyzing the shareholder's impairment of equity. The Supreme Court held in *Davis* that a "meaningful reduction of the shareholder's proportionate interest in the corporation" would be required to refute a charge of dividend equivalence. *Id.* at 313. The Court noted that a redemption which had the effect of transferring property from the company to the shareholders without a change in the "relative economic interests or rights" of those shareholders could not be said to have satisfied the "not essentially equivalent to a dividend" requirement. *Id.* The *Rafferty* court appears to have been influenced by this test. The First Circuit, however, did not limit its consideration to actual impairment of equity interest, rather it focused upon potential impairment of the taxpayers' equity interest. The court balanced this device potential against the fact that retention of the assets was not necessary to continuance of the business enterprise and concluded that the taxpayers had not overcome the presumption that the transaction had been used principally as a device.

The taxpayers were frustrated by similar treatment in the Tax Court. *See* Brief for Petitioners on Appeal from the United States Tax Court at 8, Rafferty v. Commissioner, 452 F.2d 767 (1st Cir. 1972). Counsel for the taxpayers stated:

> The Court seems to base its conclusion with respect to the 'device' clause on the fact that the stock of, or properties owned by Teragram or RBS could have been sold and the proceeds distributed to the stockholders thereof. This, in spite of the fact that no such sales have been made nor have they ever been contemplated, . . . and it is the motive to dispose of the properties in a sale or exchange which gives rise to the possibility of a 'device.'

See also B. Bittker & J. Eustice, *supra* note 4, at 13-31: "This stress on a lack of 'dividend equivalency' is likely to be confined to split-offs and split-ups that are non pro rata in character under § 302(b)(2) and (3); pro rata transactions will ordinarily invite closer scrutiny." Pro rata divisions are generally viewed as more threatening because there is no shift in underlying ownership interests and bail-out is thus more likely to occur. Cohen, *supra* note 63, at 1094. For a discussion of the effect of the § 302 test upon boot treatment in reorganizations see Levin, Adess, & McGaffey, *Boot Distribution in Corporate Reorganizations—Determination of Dividend Equivalency*, 30 TAX LAW. 287, 295 (1977) where the authors note:

> [S]ince the Service has correctly recognized that the effects of a distribution of a dividend test of section 356(a)(2) looks by analogy to the 'essentially equivalent to a dividend' test of section 302, it follows that a more-than-twenty percent reduction in equity interest should qualify boot received in a reorganization for capital gain treatment.

159. *But see* note 29 *supra* (a transaction may be characterized as a device to distribute earnings and profits even though the shareholder retains what he received in the distribution).

160. 458 F.2d at 250-51.

161. 1975-2 C.B. 125.

162. This would decrease the possibility of bail-out since inactive and liquid assets are easily sold to draw off earnings and profits without impairing equity interests.

Ruling 76-528[163] supports the view that the requirement may be satisfied by an indirect form of ownership. The ruling presents an example in which continuity of interest was maintained when partnership assets, stock interests in the distributing corporation, were distributed to individual partners. The test was met despite dissolution of the partnership. The Service based its conclusion upon the fact that the partners "stood in the shoes of the partnership as the only qualified parties to receive and continue the stock interests" in the realigned corporations.[164]

Prior to these rulings, Revenue Ruling 74-516[165] had held that the distribution of cash in a non pro rata split-off met the requirement despite the fact that the cash distribution resulted in a reduction of the taxpayer's proportionate stock interest. Although he terminated his investment in the distributing corporation, the taxpayer retained an equity investment in the continuing enterprise by maintaining "a direct stock interest in a portion of the assets in which he formerly held an indirect interest."[166] The significance of these three rulings is two-fold. First, they indicate that the Service does not require shareholders to maintain in direct form 100 percent of their former interest in the corporations. Second, they evidence the relationship between the continuity of interest test and the Service's concern for the amount of equity interest maintained by the shareholders. The Service seems to be balancing the express requirements of the continuity of interest with the measured variations in shareholder equity interests.[167]

The proposed rules retain the test, still noting that section 355 is intended to apply to "readjustment of continuing interest in property under modified corporate forms."[168] They have, however, deleted the express requirement contained in the current regulations which calls for "continuity of the entire business enterprise under modified corporate forms."[169] One interpretation of this is that while the Service will emphasize the test in the future, it will be more concerned with its application to the shareholder than to the business enterprise. Two other interpretations are also possible. One is that the Service considers the two phrases quoted above to be equivalent. In that event the deletion has no significance. The other alternative is that the Service decided to delete the phrase because continuity of business enterprise is more properly considered elsewhere since section 355 deals with tax-free treatment of distributions at the shareholder level and not with taxation at the corporate level.[170] The problem with this interpretation,

163. 1976-52 I.R.B. 22.
164. *Id.*
165. 1974-2 C.B. 121.
166. *Id.*
167. Although continuity of interest was not maintained in similar form or amount in any of the three rulings, the taxpayers did retain their equity interests in the ongoing enterprises. Thus, the Service appears to be stressing the test as a means of ensuring that no bail-out will occur while at the same time emphasizing the goal rather than the means of its achievements or the degree to which it is accomplished. This may be the reason that the Service allows taxpayers leeway in assessing the degree to which they have maintained continuity of interest. *But cf.* 7 TAX ADVISER 532 (1976) (the Service will question the validity of a reorganization where indirect continuity of interest is present).
168. Proposed Treas. Reg. § 1.355-2(b)(1), 42 Fed. Reg. 3867 (1977).
169. *Compare* note 151 and text accompanying note 168 *supra*.
170. *See, e.g.*, Treas. Reg. § 1.368-1(b) (1955) (necessity of continuity of the business enterprise).

however, is that continuity of business enterprise is one of the factors examined in determining whether or not a business was engaged in the active conduct of a trade or business. Where such continuity is not shown, nonrecognition treatment may be denied to the shareholders.[171] Because of the importance of continuity of the business enterprise, the most reasonable interpretation of the difference between the two sets of rulings is that the Service views the two phrases as equivalent. According to current regulations, proposed rules, and recent revenue rulings the Service remains interested in the continuity of interest requirement. In fact, in light of the increased interest in bail-out prevention, the test will probably receive greater use in the future.

E. *The Device Test*

The device test,[172] designed to prevent bail-out of corporate earnings and profits, is the unknown quantity in the section 355 formula.[173] Although the absence of a clear-cut statutory or historical definition[174] for the test makes its use as a catch-all requirement attractive, in the past, the Service avoided relying upon it, preferring the active business instead.[175] Recent developments hint that the Service is shifting toward greater use of the device test. *Rafferty* is one of the causes of this transition since the court there showed preference for the device restriction while simultaneously downgrading the active business test.[176] There remains a question, however, as to the weight to be given the restriction.[177] Despite the fact that it is a codification of the

171. I.R.C. § 355(b)(1)(A).

172. *Id.* § 355(a)(1)(B). Concern for "device" potential originated in Gregory v. Helvering, 293 U.S. 465, 470 (1935), in which the Supreme Court attacked a reorganization which met the literal requirements of § 113(g) of the Internal Revenue Code of 1939, but which was viewed by the Court as "an elaborate and devious form of conveyance masquerading as a corporate reorganization, and nothing else." The word "device" was used in the Court's characterization of the reorganization:

> [It was] [s]imply an operation having no business or corporate purpose—a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganize a business or any part of a business, but to transfer a parcel of corporate shares to the petitioner.

293 U.S. at 469. This language was also the source of the business purpose test.

173. *See* Whitman, *supra* note 30, at 1234-35.

174. *Id.* at 1235-39.

175. *See* Meyer, *Corporate Strip Tease: Excluding Assets from a Corporate Reorganization*, 51 TAXES 453, 457 (1973).

176. *See* Lee, *supra* note 10, at 478, 495: "Rafferty reversed the trend favored by the Service of emphasis on the active business requirement and judicial doctrines instead of the device restriction to combat potential bail-outs." *See also* Meyer, *supra* note 11, at 272-73.

177. *Rafferty* and *King* do not clearly indicate the amount of weight to be assigned the business purpose and device tests when balancing the two. *See* Cohen, *supra* note 63, at 1081. Both *Rafferty* and *King* shift from the active business test to an "explicit weighing of business purpose against bail-out potential." The author further notes:

> At first blush, application of the balancing test does not seem unduly burdensome. Business purpose and bail-out potential are independently evaluated and then weighed against each other. If bail-out potential has less significance than business purpose, the division is tax-free. If bail-out potential is more substantial than business purpose, the division is taxed. Under the superficial simplicity, however, lies an appalling sinkhole. First, business purpose and bail-out potential cannot be evaluated without complex predictions of future legal and economic phenomena. Second, even if such labyrinthian judgments can be made, no evident legal standard exists for balancing a nonquantifiable business purpose against a nonquantifiable bail-out potential. Finally, whenever business

business purpose test, the Service apparently views the two tests as independent of one another.[178] This is not really clear, however, since some court opinions and revenue rulings discuss the tests as if one were the equivalent of the other.[179] In fact, the difficulty in estimating the importance of the device test lies in part in the Service's concurrent use of the business purpose requirement.[180] A recent commentator noted that courts are balancing the two tests in an attempt to serve the policy of section 355.[181] While true of the courts, this statement is not reflective of the Service's use of the tests. The Service requires the taxpayer to prove satisfaction of both requirements.[182] The result is that while a taxpayer may prove the transaction

> purpose and bail-out potential co-exist, the balancing test requires an either-or decision and thereby fails to reconcile the two competing goals. If the division is not taxed, business flexibility thrives at the cost of tax avoidance. If the division is taxed, the revenues are guarded, but a tax barrier is erected to corporate adjustments.

Id. at 1082.

178. *See* text accompanying note 105 *supra*; Commissioner v. Wilson, 353 F.2d 184 (9th Cir. 1965) (the court upheld a business purpose requirement in addition to the statutory device test). Analysis of the following revenue rulings supports the contention that the Service views the two tests as independent of one another: Rev. Rul. 77-22, 1977-4 I.R.B. 7 (discusses business purpose for distribution, no mention of device test); Rev. Rul. 76-527, 1976-52 I.R.B. 21 (pro rata distribution carried out for germane purposes, no mention of device test); Rev. Rul. 76-13, 1976-1 C.B. 96 (necessary transfer and distribution characterized as germane to the business of the corporations, but qualification under § 355 dependent upon fulfillment of its other requirements); Rev. Rul. 75-469, 1975-2 C.B. 126 (valid business purpose for the distribution; additionally, the transaction was not used as a device); Rev. Rul. 75-406, 1975-2 C.B. 125 (valid business purpose for pro rata distribution; distribution was not a device since continuity of interest in the business enterprise was maintained); Rev. Rul. 75-337, 1975-2 C.B. 124 (germane business purpose for distribution; device not mentioned); Rev. Rul. 75-160, 1975-1 C.B. 112 (valid business purpose for corporate realignment; distribution was not a device).

179. Commissioner v. King, 458 F.2d at 250, in which the court found that there was no device because:

> all transactions involved were motivated by valid business reasons. If any change occurred in the tax status, it was simply an incidental result and not a motivating purpose. Furthermore, the distribution could not have been used as a device because the plan of distribution required that the stock received be exchanged immediately for the stock of Crown.

Rafferty v. Commissioner, 452 F.2d at 770:

> Our question, therefore, must be whether taxpayers' desire to put their stockholdings into such form as would facilitate their estate planning, viewed in the circumstances of the case, was a sufficient personal business to prevent the transaction at bar from being a device for the distribution of earnings and profits.

Analysis of the following rulings supports the contention that the two tests are each other's equivalent: Rev. Rul. 77-11, 1977-2 I.R.B. 13 ("For valid business reasons it was decided that B should be the sole owner of a corporation . . . . [p]ursuant to an integrated plan to achieve the desired objective, which was not a device to distribute earnings and profits . . . ." Both business purpose and device can be described as reasons for wanting to accomplish a corporate division. If equated in this manner, then they do not appear to be separate tests; a valid business purpose is a good reason and a device is a bad reason. The two can be distinguished, however, upon grounds that a business purpose is the motivation, but a device is the result, that is, the distribution of earnings and profits); Rev. Rul. 76-187, 1976-1 C.B. 97 (result of a necessary distribution examined and determined not to be a device; business reasons for transfer were noted but not discussed); Rev. Rul. 75-321, 1975-2 C.B. 123 (A valid business purpose existed for the distribution. The ruling also notes that "[t]he proposed distribution will accomplish that result" and "[t]he facts also establish that the transaction is not a device for the distribution of earnings and profits . . . ." Here again the two tests can be equated since each may be viewed as intended to achieve a certain result.).

180. See discussion of *Rafferty* and *King, supra* notes 54, 59 (Service argued transaction was used principally as a device and that there was no valid business purpose for the distribution).

181. See discussion by Cohen, *supra* note 177.

182. See note 178 *supra* discussing rulings which indicate the two tests are applied independently.

was not a device and otherwise satisfy the statutory requirements, he may further be required to show that a corporate business purpose was a prime motivation for the distribution.[183] The relationship between these two tests is important since the Service's varying interpretations of this relationship may affect the taxpayer's burden of proof. Assuming the business purpose requirement to be only one element of the device test, the taxpayer's burden of proof on that particular point is less onerous than in an instance where he has to satisfy two full-fledged requirements.

Revenue Ruling 75-160[184] is an example of a ruling in which the Service uses both tests without delineating the boundaries of either. This ruling described a transaction which was declared not to be a device. The facts upon which the determination was made were not specified. A commentator wrote that the ruling foreshadows a tendency on the part of the Service to require that business considerations make disposition of the spun-off stock unlikely due to the adverse effect on the shareholders' equity interests.[185] This conclusion, though not apparent from the ruling's facts, is substantiated by an examination of *Rafferty* and *King*. The court in *Rafferty* found that a sale of stock would not impair the continued operation of the corporation; nor would the sale of certain buildings impair the owner's control or other equity interests in the business.[186] The court therefore concluded that the spin-off had put saleable assets into the taxpayers' hands and that bail-out was a possibility.[187] *King* also discussed bail-out potential, disting-

183. *See* Meyer, *supra* note 11, at 273:

> Revenue Ruling 75-160 indicates that notwithstanding the revised interpretation of the requirements of Section 355, the Service's position is that even if the active business test is met and it is unlikely that the distribution would be used by the distributees to accomplish a bail-out, a corporate business purpose must still be a prime motivation for the distribution.

This is in keeping with Commissioner v. Wilson, 353 F.2d 184 (9th Cir. 1965), in which the court found that there was no device, but denied tax-free treatment under § 355 since no business purpose test was shown. The proposed regulations provide for a more stringent business purpose standard ("real and substantial nontax reason") than do the current regulations ("purposes . . . germane to the business of the corporations"). *See also* Whitman, *supra* note 30, at 1245: "If a non-device can still be disqualified under the resuscitated business purpose test, the focus must inevitably remain on business purpose . . . ."

The business purpose for § 355 originated in Gregory v. Helvering, 293 U.S. 465 (1935). Not until 1965, however, was its position with respect to the statutory requirements established. In *Wilson* the court stated that *Gregory*'s holding signified that "a literal compliance with the provisions of the statute relating to tax-free corporation reorganizations is not enough; that there must be a valid business purpose for the reorganization." 353 F.2d at 187-88. *Wilson* dealt with an unusual situation. The taxpayers had no business reason for the corporate reorganization; nor did they have a tax avoidance purpose. Although the statutory requirements were satisfied, the court expressed concern for the possibility of later bail-out. Analyzing the reorganization, the court determined that:

> [it] had the effect of removing from the risks and vicissitudes of a retail furniture business accumulated earnings in a form readily convertible by the shareholders into cash, by selling their stock in the spin-off corporation or by liquidating it and receiving and selling those easily liquidated assets. The shareholders have and will continue to have a tax advantage whenever they choose to make use of it . . . .

Id. at 187. The court concluded that even though there was no tax avoidance motive, § 355 was not applicable to the transaction because of the lack of a business purpose. For a discussion of whose business purpose is relevant to a determination of whether a transaction has been used as a device, see Estate of Parshelsky v. Commissioner, 303 F.2d 14 (2d Cir. 1962). The court there decided that both corporate and shareholder motives were pertinent to such an inquiry.

184. 1975-1 C.B. 112.

185. Meyer, *supra* note 11, at 272-73.

186. 452 F.2d at 771.

187. *Id.*

uishing its facts from those in *Rafferty* since the facilities in question were "single-purpose facilities which require specialized equipment and construction."[188] Because of this uniqueness,[189] the court decided that sale would impair the shareholder's equity in the spun-off corporation and, thus, bail-out was unlikely.[190] A commentator challenged the court's reasoning on this point, calling it "irrelevant to bail-out potential analysis [since] sale of the spun-off assets would always impair the shareholder's equity in the spun-off corporation; the question is whether it impairs their equity in the retained corporation and assets."[191] Although Revenue Ruling 75-160 does not explicitly discuss impairment of equity interests, it may be assumed that where, as in this ruling, one corporation manufactures products solely for sale by another corporation and the latter sells only products manufactured by the former, a sale of the assets of either will impair the shareholders' equity interests. Thus, increased attention will be focused upon the potential for impairment of equity interests. This factor is relevant to the question of whether bail-out is likely and, when found to be present, invokes the use of the device provision. The valid business purpose and device tests appear to be used here as independent tests.[192]

Another significant ruling, Revenue Ruling 75-337,[193] indicates that the Service will in the future require that a corporate business purpose be the primary motivation for the distribution. This requirement will have to be satisfied even in instances where it is unlikely that the transaction was used as a device. The ruling supports the theory that the device test and the business purpose requirement are independent of one another.

Three other 1975 rulings dealt with the device provision. In Revenue Ruling 75-406[194] the Service examined a transaction for evidence of a prearranged sale. Finding no such evidence, the Service concluded that the distribution was not used principally as a device to distribute earnings and profits.[195] The reason given was that the shareholders maintained a continuing stock interest in the business enterprise.[196] The continuity of interest requirement appeared to be used simply as a litmus test for determining the presence of a device.[197] Earlier, Revenue Ruling 75-321[198] had also declared a transaction not to be a device. Stressing the involuntary nature of the reason for the distribution, a need to comply with federal banking laws, the Service held that there was a valid business purpose.[199] The business pur-

188. 458 F.2d at 250.
189. *Id.* The significance of the court's statement about "single purpose facilities" is to be found in the fact of their uniqueness. The specialization of the equipment and facilities made it unlikely that either would be sold without impairing the equity interests of the shareholders. If the shares representing those assets were sold, the shareholder would impair his equity interest because his share in the growth potential or earning power of the corporation would be lost.
190. 458 F.2d at 250.
191. Lee, *supra* note 10, at 488.
192. *See* note 178 *supra*.
193. 1975-2 C.B. 124.
194. *Id.* at 125.
195. *Id.*
196. *Id.*
197. *Id.* ("the distribution . . . was not a transaction used principally as a device to distribute the earnings and profits of either corporation because afterwards the shareholders maintained a continuing stock interest in the business enterprise . . . .").
198. *Id.* at 123.
199. *Id.*

pose with which the ruling was primarily concerned was one justifying the retention of stock by the distributing corporation.[200] It was not the usual business purpose requirement which is generally used to test either the distribution or the reason for transfer of the businesses to separate corporations.[201] Furthermore, although the ruling stated that the facts established that the transaction was not a device, it neglected to specify which facts were pertinent to the finding. This circumstance plus the fact that the usual business purpose test was given only cursory treatment makes it difficult to ascertain the relationship here, if any, between the business purpose requirement and the device test. The two tests, however, do appear to have been equated with one another.[202] Revenue Ruling 75-469[203] also involved a transaction declared not to have been used as a device. Again the Service failed to state the facts upon which this conclusion was based. Although the distribution was declared to have been made pursuant to a valid business purpose, here again there are few facts upon which to determine how the Service views the relationship between the two tests. They appear to have been used independently.[204] There is no evidence in this ruling that the use of either is being emphasized. The fact that the device test is mentioned lends no credence to the claim that the Service will emphasize its use in the future. Support for such a claim should be found in the rulings only when the Service treats the test in-depth: that is, with a reasoned analysis of facts rather than a simplistic statement that a device does or does not exist.

The proposed regulations make substantial additions to the language dealing with the device provision. For example, the amendment states that the Service recognizes the potential for tax avoidance present in sales subsequent to the distribution or in liquidation of either corporation.[205] Shareholders can avoid payment of dividend tax by engaging in one or both of such actions.[206] Discussion of such tax avoidance potential has surfaced in several section 355 cases with respect to the device test.[207] Thus, the addition of this kind of statement highlights the possibility that the device test will be more heavily relied upon in the future.

The rules also add a rebuttable presumption that a pro rata, or substantially pro rata, distribution among shareholders of the distributing corporation is more likely to be a device than is a non pro rata distribution.[208] A limitation

200. *Id.*

201. Treas. Reg. § 1.355-2(d) (1955) provides:

> Where a part of either the stock or securities is retained under subparagraph (2) of this paragraph, it must be established to the satisfaction of the Commissioner that such retention was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax. Ordinarily, the business reasons (as distinguished from the desire to make a distribution of the earnings and profits) which support a distribution of stock and securities of a controlled corporation under paragraph (c) of this section will require the distribution of all of the stock and securities.

202. *But see* note 178 *supra* discussing recent rulings which indicate that the two tests are applied independently.

203. 1975-2 C.B. 126.

204. See note 178 *supra* for mention of this revenue ruling.

205. Proposed Treas. Reg. § 1.355-2(c), 42 Fed. Reg. 3868 (1977).

206. *Id.*

207. *See* King v. Commissioner, 458 F.2d 245 (6th Cir. 1972); Rafferty v. Commissioner, 452 F.2d 767 (1st Cir. 1971).

208. 42 Fed. Reg. 3868 (1977), where Proposed Treas. Reg. § 1.355-2(c)(1) provides:

follows that statement, however, in that the determination of the existence of a device is still to be made from "all the facts and circumstances."[209] In addition to that presumption the rules establish what appears to be an irrebutable presumption that if an agreement for the sale or exchange of twenty percent or more of the stock of the distributing corporation or the controlled corporation exists, then the distribution will be considered to have been used as a device.[210] The language does not require that an actual sale or exchange occur since a prearranged agreement is itself sufficient. The words simply state that "if the stock . . . is to be sold . . . the distribution will be considered . . . a device."[211] If a similar agreement exists, but with respect to part or all of the securities or less than twenty percent of the stock of either corporation, then that fact will be considered to be substantial evidence that the transaction was used as a device.[212] Thus, the amount and subject matter of the sale or exchange determine whether the facts will be considered to show the existence of a device or whether they will be viewed as only substantial evidence of one. The problem with the twenty-percent formula is that it may be used to defeat a distribution which would otherwise qualify.[213] It is conceivable that a distribution primarily motivated by a real and substantial nontax reason could be taxed if the shareholders of only a twenty percent interest in the business had agreed to sell their interest prior to the distribution.[214]

Another proposed change affects the test for determining whether a sale was made pursuant to a pre-distribution agreement. The new language states that a sale is always pursuant to such an agreement if enforceable rights to

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> A distribution which is pro rata or substantially pro rata among the shareholders of the distributing corporation presents the greatest potential for the withdrawal of earnings and profits and is more likely to be undertaken principally as a device for the distribution of earnings and profits.

This language has no parallel in the current regulations. Compare it with Treas. Reg. § 1.355-3(a) (1955) which deals with non pro rata distributions. Some recent revenue rulings have described pro rata distributions which did satisfy either § 355 or one of the requirements thereunder. *See* Rev. Rul. 77-22, 1977-4 I.R.B. 7; Rev. Rul. 77-11, 1977-2 I.R.B. 13; Rev. Rul. 76-528, 1976-52 I.R.B. 22; Rev. Rul. 76-527, 1976-52 I.R.B. 21.

209. Proposed Treas. Reg. § 1.355-2(c), 42 Fed. Reg. 3868 (1977).

210. *Id.* Proposed Treas. Reg. § 1.355-2(c)(2) provides:

> If, pursuant to an arrangement negotiated or agreed upon before the distribution, *20 percent or more of the stock of either the distributing corporation or the controlled corporation is to be* sold or exchanged after the distribution, *the distribution will be considered to have been* used principally as a device for the distribution of earnings and profits of the distributing corporation, the controlled corporation, or both.

42 Fed. Reg. at 3868. The language added by this section which is not contained in Treas. Reg. § 1.355-2(b) (1955) is in italics. The principal changes are the addition of the 20% formula and the presumption discussed in the text. Since § 355 is generally used by small closely held corporations which do not have a "separation of widely spread ownership of stock from ensconced management control," 20% of such a corporation's stock may represent a substantial portion of both ownership and management interests. Compare this 20% formula with that used in determining satisfaction of the continuity of interest test. *See* Bloom & Sweet, *supra* note 152, at 132: "The Service will not definitely rule that a reorganization has not occurred because of lack of continuity of interest unless there is less than 20% aggregate continuity of interest on the part of the shareholders of the acquired corporation."

211. Proposed Treas. Reg. § 1.355-2(c)(2), 42 Fed. Reg. 3868 (1977).

212. *Id.*

213. This formula is imposed by neither the language, legislative history, nor judicial doctrines of § 355. Nor was it previously set forth in the regulations. Thus transactions which meet all of the traditional tests may be forced to hurdle yet another fence raised by the Service.

214. *But see* note 210 *supra* (20% may represent a substantial amount).

buy or sell exist before the distribution.[215] The present regulations seem to offer the test as a definition,[216] but in the proposed rules it appears to have become an irrebutable presumption. Moreover, the present regulations indicate that where the buyer and seller discuss a sale or exchange prior to distribution, but no enforceable rights to buy or sell exist before the distribution, then determination of whether the arrangement was negotiated within the meaning of section 355(a)(1)(B) is to be made upon the basis of all the facts and circumstances.[217] The proposed rules, however, undercut this earlier reliance upon individual facts and circumstances. They replace the old standard with a new one: "[i]f a sale was discussed by the buyer and the seller before the distribution and was reasonably to be anticipated by both parties, such sale shall ordinarily be considered as made pursuant to an arrangement negotiated or agreed upon before the distribution."[218] This indicates that even if there were no enforceable rights to buy or sell in existence before the distribution, reasonable anticipation alone would support a finding that the sale was made pursuant to a predistribution agreement. It seems unfair to attempt to label a transaction a device on the basis of the parties' anticipations; the restriction is designed to prevent the bailout of corporate earnings and profits, not to punish the desire for one.[219]

The proposed rules also add a paragraph dealing with liquid assets to the device subsection. The new paragraph provides:

> The transfer or retention of cash or liquid assets (for example, securities and accounts receivable) which is not related to the reasonable needs of the business of the transferee or retaining corporation will be considered as evidence that the transaction was used principally as a device for the distribution of earnings and profits.[220]

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215. 42 Fed. Reg. 3868 (1977), where Proposed Treas. Reg. § 1.355-2(c)(2) provides: "A sale is *always* pursuant to an arrangement *negotiated or* agreed upon before the distribution when enforceable rights to buy or sell exist before such distribution." Language proposed to be added is italicized.

216. Treas. Reg. § 1.355-2(b)(2) (1955).

217. *Id.*

218. Proposed Treas. Reg. § 1.355-2(c)(2), 42 Fed. Reg. 3868 (1977).

219. *See* Brief for Petitioners on Appeal from the United States Tax Court at 9, Rafferty v. Commissioner, 452 F.2d 767 (1st Cir. 1972):

> Surely the fact that a division of corporate assets facilitates the sale of part or all of the stock or assets at some indefinite point in the future cannot turn a transaction founded on a valid business purpose into a 'device,' particularly where no sale has been consummated or even contemplated.

See also Whitman, *supra* note 30, at 1246-47:

> [T]o have taxability turn on whether or not the disposition was arranged before the separation is not only unrealistic but also foreign to the flexibility of the device concept. It may be that there was no alternative for the Service short of allowing any and all pre-separation negotiations, but to make conclusive a factor merely probative as an indication of intent has the look of unenlightened enforcement.

220. Proposed Treas. Reg. § 1.355-2(c)(3)(ii), 42 Fed. Reg. 3868 (1977). The concern for asset liquidity is based upon the readily realizable value of such assets; § 355 was designed to prevent tax-free treatment for the separation of liquid assets from active assets. *See* Henry B. Atlee, 67.32 T.C.M. (P-H) (Dec. 8, 1976) (retention of operating assets by distributor corporation prevented satisfaction of active business test by distributee corporation). Note also that although no standard sets forth the criteria for determining "reasonable needs," some general guidelines are offered:

> In determining whether a transaction was used principally as a device for the distribution of earnings and profits of the distributing corporation, the controlled corporation, or both, consideration will be given to the nature, kind, and amount of the assets of both corporations (and corporations controlled by them)

The language appears to have been influenced by the active business test, the function of which was to "prevent the tax free separation of active and inactive assets into active and inactive corporate entities."[221] This new provision dealing with liquid assets reflects the same concern. It appears intended to replace the present language in the device regulations which deal with this concern in terms of the active business requirement.[222] In view of the courts' disfavor of the latter, the Service may have desired to imbue the device language with greater credibility by rephrasing it in terms of asset liquidity.

Following the language on liquid assets is a paragraph dealing with related functions.[223] It examines bail-out potential as evidenced by certain relationships between "the nature and use of the assets of the distributing corporation and the controlled corporation."[224] The relationships described as evidence of devices are remarkably similar to examples presented in the active business section of the present regulations.[225] One of the new examples

> immediately after the transactions and to the use of such assets by such corporations.

Proposed Treas. Reg. § 1.355-2(c)(3), 42 Fed. Reg. 3868 (1977).

221. Edmund P. Coady, 33 T.C. at 777.

222. Treas. Reg. § 1.355-2(b)(3) (1955) seems to be the precursor of the asset liquidity paragraph. It provides:

> The fact that at the time of the transaction substantially all of the assets of each of the corporations involved are and have been used in the active conduct of trades or businesses which meet the requirements of section 355(b) will be considered evidence that the transaction was not used principally as such a device.

223. Proposed Treas. Reg. § 1.355-2(c)(3)(iv) provides: "In certain cases the relationship between the nature and use of the assets of the distributing corporation and the controlled corporation will be considered as evidence that a transaction was used principally as a device for the distribution of earnings and profits." 42 Fed. Reg. 3868 (1977). In Harry B. Atlee, 67.32 T.C.M. (P-H) (Dec. 8, 1976), the Tax Court "focus[ed] on the assets transferred . . . and their functional relationship to the assets retained by [the transferor] . . . ." in determining whether the active business test had been satisfied. *Id.* at 67-215. The transferor retained almost all of the operating assets used in its business, transferring a "collection of unrelated assets never functionally integrated in any business activity" which, additionally, were speculative and not readily salable. *Id.* at 67-218. Among the assets transferred were a travel trailer, used car, and three second mortgage notes. Although the relationship between the nature and use of both corporations' assets was considered, it was not used as evidence that the transaction was a device. The court instead denied § 355 treatment because the active business test was not satisfied. *Id.* at 67-216. Note the differences in this type of "related functions" analysis and that discussed in the text.

224. Proposed Treas. Reg. § 1.355-2(c)(3)(iv), 42 Fed. Reg. 3868 (1977).

225. Compare Treas. Reg. § 1.355-1(d), exs. 5, 11, 12 (1955), *supra* note 77, with the three examples presented in the paragraph dealing with related functions, Proposed Treas. Reg. § 1.355-2(c)(3)(iv), which provides:

> For example, where the principal function of one corporation before the transaction is to perform services for or supply technical or research data to the other corporation and after the transaction that corporation continues to function on the same basis, this would be considered as evidence that the transaction was used principally as such a device. Thus, in example (9) of § 1.355-3(c), involving a controlled corporation operating a coal mine for the sole purpose of satisfying the requirements of the parent steel corporation before the transaction, if the coal mining business continued to operate on the same basis after the transaction, this fact would be considered as evidence that the distribution of the stock of the coal mining corporation in example (9) is principally a device for the distribution of earnings and profits. Similarly, in a transaction which separates the manufacturing and sales operations, as in example (8) of § 1.355-3(c), if the sales corporation merely functions as the exclusive agent for the manufacturing corporation after the transaction, this fact would be considered as evidence that the transaction was principally a device for the distribution of earnings and profits.

42 Fed. Reg. 3868-69 (1977). This language has no parallel in the language of the current regulations.

presents a hypothetical corporation whose principal function before and after the transaction was to supply research data to the other corporation.[226] Continuance of this relationship following the transaction was declared to be evidence that the transaction was used principally as a device. Another example involves the use of a controlled corporation's coal mine solely for the purpose of satisfying the requirements of the parent corporation.[227] Assuming that this continued after the distribution, it would be considered as evidence that the distribution of the controlled corporation's stock was made for purposes of drawing off corporate earnings and profits. The purpose of these examples in the current regulations is to illustrate that neither functional divisions nor those which fail to produce income independently merit nonrecognition treatment under section 355. These examples have been shifted from the active business section of the current regulations to the device section of the proposed rules. This is analogous to the rewording of certain active business terms in the device language to liquid asset terminology.[228] Perhaps the Service is attempting to salvage some remnants of the active business requirements by removing them from their own discredited section to one more favored by the courts.

In summary, recent cases indicate that courts are beginning to rely more heavily upon the device restriction than they have in the past. They are balancing the device test and the business purpose requirement against one another in an effort to serve the policy of section 355 rather than simply continuing to apply the mechanical requirements of the active business test. Much of the attention given to the device test is due to an increasing interest in the bail-out potential of transactions. The revenue rulings, however, are an infertile source of information with regard to the test. Rulings which deal with the test generally limit their activity to an announcement that the requirement has or has not been satisfied. On the other hand, the proposed regulations show numerous changes in the Service's attitude toward the device restriction. The proposed rules offer five major adjustments to the device language: (1) they establish a rebuttable presumption that pro rata distributions to shareholders are more likely to be evidence of a device than are non pro rata distributions; (2) they establish an irrebutable presumption that a predistribution arrangement for a sale or exchange indicates a transaction was used principally as a device; (3) they create an irrebutable presumption that a sale is always pursuant to predistribution arrangement if enforceable rights to buy or sell exist before the distribution; (4) they state that cash or liquid assets transferred in amounts in excess of the reasonable needs of the transferee or retaining corporation will be viewed as evidence that the transaction was used principally as a device; and (5) some functional divisions of corporations will be considered to be evidence that the transaction was used principally as a device.

226. *Id.*
227. *Id.*
228. *See* text accompanying notes 220-22 *supra*.

III. CONCLUSION

The Service has entered a transition period in which its position with regard to section 355 requirements is changing. Some shifts in emphasis have been reflected in cases, others in revenue rulings; still more changes are foreshadowed by the recently proposed amendment to the regulations. These changes signal the demise of both the independent-production-of-income test and the single business proviso. With the waning of these and other portions of the active business test, however, the Service's attention has turned from concentration on the mechanical rules of the section to an interest in its policy. This interest in bail-out prevention leads inevitably to increased use of the business purpose, continuity of interest, and device tests. Recent rulings indicate that the Service primarily views all of these tests as independent of one another. The result of the Service's reevaluation of section 355 requirements is that the taxpayer will, in the future, bear a heavier burden with regard to proving that a transaction is not a device. Moreover, even if he proves that a distribution was not used principally as a device, he will still be required to show a corporate business purpose.[229]

229. See note 150 *supra* discussing corporate business purpose. The trend begun in *Wilson* of requiring the taxpayer to prove a business purpose for the transaction even though the transaction was not used as a device, is strengthened by incorporation of the requirement into the proposed regulations. This results in favoring a judicial doctrine over its statutory equivalent. See the comment by Whitman, *supra* note 183. Conceivably, the courts could treat this section the way they treated the single business requirement: invalidating it as "an attempt to add a restriction to the statute which is not there." United States v. Marett, 325 F.2d at 30. In view, however, of the test's previous acceptance by the courts, it is unlikely that objections will be made.