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Functional Divisions and Other Corporate Separations Under Section 355 After Rafferty

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TWO OF the prerequisites for application of section 355, the exclusive vehicle for tax-free fragmentation of a single corporation, are meeting the active business tests and passing the anti-bail-out device test.[1] For almost a decade the question whether section 355 permitted functional divisions of a functionally or vertically integrated business enterprise, *i.e.*, a business in which a single entity controls all the functional stages in an industry from top to bottom, was unresolved.[2] Although the regulations defining an active business for purposes of section 355 seem to deny such status to components of a functionally integrated corporation,[3] commentators thought such divisions were consonant with the purpose of the active business test.[4] The issue is now answered. The First Circuit in *Rafferty v. Commissioner* [5] has recently held

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1 I.R.C. §§ 355(a)(1)(C) and 355(b); 355(a)(1)(B). A spin-off is similar to a dividend with each shareholder receiving a pro rata share of the stock of the spun-off corporation while retaining his stock in the distributing corporation. A split-off is similar to a stock redemption with the distributee shareholders surrendering all or a portion of their stock in the distributing corporation for stock of the controlled corporation. The stock of the split-off corporation need not be distributed pro rata. A split-up is similar to a complete liquidation with the parent corporation distributing stock of two or more subsidiaries to its stockholders as a plan of complete liquidation. *See generally* Jacobs, *The Anatomy of a Spin-Off*, 1967 DUKE L.J. 1, 2-3; Morris, *Combining Divisive and Amalgamating Reorganizations: Section 355 Fails Again*, 46 TEXAS L. REV. 315, 316 (1968).

2 Lee, *Section 482 and the Integrated Business Enterprise*, 57 VA. L. REV. 1376 (1971).

3 Reg. §§ 1.355-1(c) and (d) Exs. 2, 5, 11 and 12.

4 *See, e.g.*, Whitman, *Draining the Serbonian Bog: A New Approach to Corporate Separations Under the 1954 Code*, 81 HARV. L. REV. 1194, 1221-23 (1968); Massee, *Section 355: Disposal of Unwanted Assets in Connection with a Reorganization*, 22 TAX L. REV. 439, 460-64 (1967); Jacobs, *The Anatomy of A Spin-Off*, 1967 Duke L.J. 1, 25-28.

5 452 F.2d 767 (1st Cir. 1971), *cert. denied*, 40 U.S.L.W. 3617 (June 27, 1972).

that functional divisions of an existing business can actively conduct separate trades or businesses.

In *Rafferty* a steel processing and distributing corporation had transferred its business premises to a newly formed subsidiary (Teragram) which then leased the premises back to its parent under a long-term lease. Teragram subsequently built a plant on raw land it had purchased and leased the plant to another related corporation. Shortly thereafter (which happened to be five years and two months after the initial transfer of the steel business premises), the parent spun off the Teragram stock for the primary purpose of facilitating its dominant shareholder's estate plan—exclusion of his many daughters from the management of the steel business and at the same time providing them with investment assets insulated from the fluctuations of the steel business. The Tax Court held, rejecting the Commissioner's arguments to the contrary, that the estate planning motive constituted a valid nontax reason for the separation and spin-off of Teragram.[6] It further held, however, that Teragram was not engaged in the active conduct of a trade or business for the five year period preceding distribution and that, regardless of the valid business purpose of the transaction, the parent's shareholders had extracted passive, investment type assets thereby bailing out earnings and profits of both corporations and, hence, the transaction constituted a "device."

The First Circuit affirmed the Tax Court but did so within a completely different conceptual framework. Whereas the lower court had found a business purpose for the spin-off but had denied tax-free treatment principally on the basis of the Commissioner's active business regulations (with some indication that transactions with related parties only or renting property could not constitute the active conduct of a trade or business), the appellate court was disturbed by the "somewhat uncritical nature of the Tax Court's finding of a business purpose" and liberalized, indeed deemphasized, the active business test by restricting it to a showing of objective criteria manifesting that entrepreneurial activities quantitatively and qualitatively distinguished the corporate operations from mere investments—a test which the taxpayers did not pass. As a concomitant of this approach, the First Circuit made the device test a more formidable barrier to tax-free divisions. For under its formulation of the device test, if a distribution has considerable potential for use as a device for

[6] Joseph V. Rafferty, 55 T.C. 490 (1970).

distributing earnings and profits (where for example the assets of one of the postdistribution corporations have a readily realizable value and their sale does not impair the taxpayer's equity interest in the other corporation), the distribution will not qualify for tax-free treatment under section 355 on the basis of shareholder motives unless those motives are germane to the continuance of the corporate business. The taxpayers also failed this test.

This article examines the *Rafferty* resolutions of most of the controversies under the active business and device restrictions in the context of their earlier development and considers probable answers to remaining questions including the status of the existing active business and device regulations under the court's restatement of these requirements. The active business concept is dealt with first because it had traditionally been thought to be the primary barrier to tax-free divisions, particularly functional divisions.

Active Business Requirement

BACKGROUND—THE *Rafferty* CASE

The active business prerequisites for nonrecognition of gain in a corporate separation under section 355 are (1) immediately after the distribution of stock in a controlled or spun-off corporation, the distributing and spun-off corporation must be "engaged in the active conduct of a trade or business" and (2) such businesses must have been actively conducted during the five-year period ending on the date of distribution.[7] The terms "active conduct of a trade or business" and "trade or business" are, however, nowhere defined in the Internal Revenue Code. Consequently, the definition in the regulations came to be of paramount importance:

> [F]or purposes of section 355, a trade or business consists of a specific existing group of activities being carried on for the purpose of earning income or profit from only such group of activities, and 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—
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> (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),
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> (2) The ownership and operation of land or buildings all or sub-

[7] I.R.C. § 355(b)(1).

stantially 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.[8]

This definition is illustrated by examples, a number of which indicate that the components of an integrated business previously conducted by a single corporation do not constitute an active business or are not *continuing* the active conduct of the trade or business formerly conducted by the predivision single corporation.[9]

The authority of these regulations was questioned by commentators on the grounds that they appeared to rest at least in part upon another provision of the regulations [10] that prohibited application of section 355 to the division of a single business, but which had been rejected in the landmark case of *Edmund P. Coady*.[11] Furthermore, the other theories which might be formulated from results stated in these regulations to support the conclusion that functional divisions of vertically integrated corporations cannot actively conduct separate trades or businesses were not thought to be mandated by the purpose, as announced by *Coady*, of the active business requirement: "to prevent the tax free separation of *active* and *inactive* assets into *active* and *inactive* corporate entities." [12] Accordingly, commentators uniformly concluded that section 355 did apply to divisions of a vertically integrated corporation. The Tax Court, however, in several post-*Coady* decisions [13] approved the main definitional portion of the regulations and in several cases that appeared to involve functional divisions "carefully avoided the implications of the *Coady* rationale by finding that the separated activities constituted an independent

8 Reg. § 1.355-1(c).

9 Reg. § 1.355-1(d) Exs. 2, 5, 11 and 12.

10 Reg. § 1.355-1(a).

11 35 T.C. 771 (1960), *aff'd per curiam*, 289 F.2d 490 (6th Cir. 1961), *nonacq.*, Rev. Rul. 61-198, 1961-2 C.B. 61, *nonacq. revoked*, Rev. Rul. 64-147, 1964-1 C.B. (Part 1) 136. *See* Cohen, *Current Partial Liquidation and Spin-Off Problems*, 41 TAXES 775, 779-780 (1963).

12 Edmund P. Coady, 35 T.C. 771, 777 (1960). *See* E. Ward King, 55 T.C. 677, 696 (1971), *rev'd*, 458 F.2d 245 (6th Cir. 1972).

13 E. Ward King, 55 T.C. 677, 696 (1971), *rev'd*, 458 F.2d 245 (6th Cir. 1972); Andrew M. Spheeris, 54 T.C. 1353, 1362 (1970), *aff'd*, 461 F.2d 271 (7th Cir. 1972); Patricia W. Burke, 42 T.C. 1021, 1028 (1964).

five-year-old business or came within the 'geographical' concept of the *Coady* case."[14]

The First Circuit in *Rafferty* has now confirmed the view that the correctness of section 1.355–1(c) and the examples contained in section 1.355–1(d) of the regulations is questionable in light of the *Coady* rejection of the separate business restriction. The court pointed out that a broad reading of the phrase in the regulations that excludes from the active business definition activities which were not themselves independently producing income was largely a restatement of the erroneous separate business requirement and believed the *Coady* rationale also applicable to functional divisions of existing businesses.[15]

Had the appellate court said no more, ambiguity might have arisen as to whether its objections extended beyond the independent production of income aspects of the regulations. However, the *Rafferty* court further stated that the provisions were so broadly drawn as to be inconsistent with congressional purpose in some instances. An illustration was that "the regulations could be construed to deny [section] 355 treatment to a large hotel chain which spun-off its land purchasing, hotel construction, and leasing activities from its hotel management operations if the spun-off corporation leased the completed hotels exclusively to the management corporation. We are reluctant to approve such regulations which appear to fly in the face of Congressional intent."[16] Cases such as *Bonsall v. Commissioner*,[17] *Theodore F. Appleby*,[18] and *Isabel A. Elliot*[19] had held that operation of owner-occupied real estate primarily used in the principal business of the distributing corporation during the five year predisposition period did not qualify as an active business and that the activities connected with rental income from outsiders were too incidental to constitute

[14] BITTKER & EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 13.04, at 14 (3d ed. 1971). Under the geographic rule (contained in section 1.355–1(d) examples 8, 9, 13, 14, 15, and perhaps 10, of the regulations) if the business operations in one geographic area are virtually complete in themselves, similar operations in a different geographic locale constitute a separate business. This test has been rejected by Lockwood's Estate v. Commissioner, 350 F.2d 712, 715 (8th Cir. 1965). A similar test is applicable in determining business purpose under sections 269 and 1551. *See also* Reg. §§ 1.382(a)–1(h)(5) and (6) (substantially same trade or business and changes in location); Dubin, *Unscrambling an Acquisition*, 49 TAXES 849, 852 (1971).

[15] 452 F.2d at 772 n.10; *accord*, King v. Comm'r, 458 F.2d 245 (6th Cir. 1972).

[16] 452 F.2d at 772 n.12.

[17] 317 F.2d 61 (2d Cir. 1963).

[18] 35 T.C. 755, 764 (1961), *aff'd*, 296 F.2d 925 (3d Cir.), *cert. denied*, 370 U.S. 910 (1962).

[19] 32 T.C. 283 (1959).

an active business; therefore, the spun-off real estate rental business was lacking the requisite five year history. Furthermore, separately incorporating and aging for five years the rental activities would not in substance differ from the operation of owner occupied real estate.[20] Under this rationale, as long as a spun-off corporation's leasing activities were limited to related parties, it could not satisfy the postdistribution active business requirement either. Thus, the First Circuit, in giving its imprimatur to a functional separation of previously owner-occupied real estate which is thereafter leased back to the distributing corporation, has not only overruled the proviso of the regulations that owner-occupied real estate does not constitute an active trade or business but has also cast considerable doubt upon the reasoning of *Bonsall, Appleby* and *Elliot.*

Equally significant is the assumption inherent in the example contained in the *Rafferty* opinion that a spun-off corporation dealing only with related entities can nevertheless be engaged in the active conduct of a separate trade or business.[21] This dictum in *Rafferty* has since become the Sixth Circuit's implicit conclusion in *King v. Commissioner*,[22] a recent section 355 decision strongly molded by *Rafferty.* Of prime importance to the Tax Court's conclusion below that the rental real estate activities of the spun-off corporations did not qualify as active businesses was that they all rented to a related tenant only. The review court in *King* reversed the Tax Court on the active business issue without even commenting on this fact, except to express considerable reservation as to the validity of the "imprecise" active business regulations and their independent production of income requirement.[23]

Having disposed of the active business regulations, the appellate court in *Rafferty* set forth its own formulation of the active business requirement: "a corporation must engage in entrepreneurial

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[20] E. Ward King, 55 T.C. 677, 700 n.9 (1971), *rev'd*, 458 F.2d 245 (6th Cir. 1972); Lee, *"Active Conduct" Distinguished from "Conduct" of a Rental Real Estate Business*, 25 TAX LAWYER 317, 328 (1972).

[21] *Elliot, Appleby* and *Bonsall* have been approvingly read to deny active business status "unless a substantial portion of the gross income attributable to [rental] property is derived from other than related corporations." Massee, *Section 355: Disposal of Unwanted Assets in Connection with a Reorganization*, 22 TAX L. REV. 439, 457–59 (1967). In an interesting reversal of traditional positions the taxpayer, in Hanson v. United States, 338 F. Supp. 602 (D. Mont. 1971), conceded that real estate leased after the division to a related corporation did not constitute an "active" business; in *Elliot* the government conceded that it did.

[22] 458 F.2d 245 (6th Cir. 1972), *reversing* 55 T.C. 677 (1971).

[23] 458 F.2d at 249.

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."[24] The spun-off corporation (Teragram) in *Rafferty* failed the first part of this test. During the first four years of the five year predisposition period Teragram had leased back to its parent its only asset, the business premises used by the parent, for a fixed return, *i.e.*, under a net lease, "an activity, in economic terms, almost indistinguishable from an investment in securities."[25] The spun-off corporation also failed the "objective indicia" component of the court's bipartite active business test. During this same period it paid neither salaries nor rent, did not employ independent contractors and its only activities were collecting rent, paying taxes and keeping separate books. The court did not reach the more difficult question in its view: whether Teragram's activities during the fifth year of the five year predisposition period when it purchased unimproved real estate and financed and built a plant, and incurred substantial repair expenses, constituted an active trade or business.

EFFECT OF *Rafferty* ON RECENT ACTIVE BUSINESS CASES

Activities Performed by Independent Contractor

The Tax Court in *Rafferty* had stated that although the fact that Teragram had financed the construction through a mortgage on which it alone was liable was an indication of some independent activity by Teragram, it was by no means conclusive.[26] This

[24] 452 F.2d at 772.

[25] 452 F.2d at 772. The appellate opinion never explicitly categorizes the lease in question as a net lease; however, its terms as set forth in the opinion below (lessee to pay fixed monthly rent and all taxes and to maintain and repair premises) manifest that it was a net lease, *i.e.*, all or virtually all expenses, such as maintenance, repairs and taxes were paid by the lessee. Insurance and some taxes (for which the subsidiary was apparently reimbursed) were paid by the lessor. Joseph V. Rafferty, 55 T.C. 490, 491–92, 499 (1970). *See* E. Ward King, 55 T.C. 677, 697–98, (1971), *rev'd*, 458 F.2d 245 (6th Cir. 1972). While ownership of property leased under a net lease may in economic terms be almost indistinguishable from an investment in securities, a legal distinction has developed in ascertaining whether ownership and operation of rental real estate constitutes a trade or business. Where securities are owned, the stockholder cannot claim the income generating activities as his own in determining his trade or business status, whereas the activities of operating rental real estate are imputed to the owner. *See* Lee, *"Active Conduct" Distinguished from "Conduct" of a Rental Real Estate Business*, 25 TAX LAWYER 317, 323 (1972).

[26] Joseph V. Rafferty, 55 T.C. 490, 499 (1970).

could have meant the court felt the activities did not constitute the active conduct of a trade or business or, as is more likely in view of its subsequent decision in *E. Ward King*,[27] they were not in substance its own activities. In *King* the taxpayer maintained that the acquisition, financing and construction of terminals, leased by the subsequently spun-off subsidiaries on a net lease basis to their parent, constituted the active conduct of a trade or business. The Tax Court held that the subsidiaries performed the activities in name only—they were performed by employees of the parent. The court implicitly disregarded the separate existence of the subsidiaries.[28] In doing so the Tax Court overlooked a closely analogous and contrary trend in the case law development under the active business provisions of section 921(2). A recurring issue in these cases is whether sales made by an export subsidiary of a United States manufacturing corporation constitute the active conduct of a trade or business where the subsidiary has no staff of its own, but instead relies upon the parent to supply salesmen and other staff. The courts have uniformly held that the lack of a complete employee organization does not in and of itself preclude qualification. Thus, for example, the active trade or business requirement has been held satisfied where the subsidiary paid a management fee for services rendered and the subsidiary had at least one employee who kept its books and reviewed all of its paper work.[29]

The *Rafferty* appellate opinion speaks indirectly to this area. In its discussion of the "objective indicia" portion of the bipartite active business test it adopted, the court noted that the spun-off corporation had not employed independent contractors. The court thereby implicitly answered the question whether the active conduct of a trade or business for purposes of section 355 is present where the major entrepreneurial activities, such as leasing, repair-

27 55 T.C. 677 (1971).

28 55 T.C. at 699–700 ("On brief the petitioners urge us not to disregard the sanctity of the corporate entity, but, on facts such as those presented here, the dependence of the subsidiary corporations serves to underline the petitioners' failure to show the active conduct of a business"); Note, *Section 355's Active Business Rule—An Outdated Inefficacy*, 24 VAND. L. REV. 955, 985 (1971). The Sixth Circuit so concluded on appeal and reversed the Tax Court on this point, 458 F.2d at 248.

29 *See, e.g.*, Frank v. International Canadian Corp., 308 F.2d 525 (9th Cir. 1962); A.P. Green Export Co. v. United States, 284 F.2d 383 (Ct. Cl. 1960). The subsidiaries in *King* had a single employee in the first three years of the five year predistribution period and later paid their common parent a management fee for such services. However, the acquisition, financing and construction activities were performed by employees of the parent who were also officers of the subsidiaries but were not compensated by them for their services.

ing and maintenance, are conducted by an independent contractor rather than by an employee of the corporation owning the property. While under some other active business provisions, the operation of a rental real estate business does not constitute an active business if the rental activities are performed by an independent contractor,[30] it was thought that supervision of such independent contractors might constitute the active conduct of a trade or business under section 355.[31] Moreover, some judicial development under section 355 suggested that a business could be actively conducted by a third party,[32] and it was well established under the usual trade or business provisions that management and rental activities of an agent or independent contractor on behalf of an owner were imputed to the owner in determining his trade or business status.[33]

Although use of an independent contractor might appear to place a corporation more in the position of a passive investor, it certainly does not make the corporate assets used in the business any less active and, as discussed below, corporate assets should be the primary focus of the active business test, for that is where the bail-out potential lies.[34] Thus the *Rafferty* court's implicit resolution of this issue was in agreement with its general adoption of a transactional approach under which the active business and device tests are applied in accordance with their underlying purpose—prevention of a bail-out—and its opposition to the tendency of these tests to develop independent significance apart from this purpose.[35] Moreover, *Hanson v. United States*,[36] a recent district court section 355 decision, held that the fact that a business had no telephone or separate business address, conducted no advertising or even held itself out to third persons as a separate business address or entity, though relevant, was not dispositive of the active business test. The court approvingly quoted a non-

[30] See Reg. §§ 1.954-2(d)(1)(ii)(b)(3)(i) and 1.954-2(d)(1)(ii) Ex. (4).

[31] COHEN, CORPORATE SEPARATIONS—ACTIVE BUSINESS REQUIREMENTS A-6 (B.N.A. 224 T.M. 1969).

[32] W.E. Gabriel Fabrication Co., 42 T.C. 545, 556 (1964).

[33] *See, e.g.*, Reiner v. United States, 222 F.2d 770 (7th Cir. 1955); Gilford v. Comm'r, 201 F.2d 735 (2d Cir. 1953); *cf.* Voss v. United States, 329 F.2d 164 (7th Cir. 1964); *see generally* Lee, *"Active Conduct" Distinguished From "Conduct" of a Rental Real Estate Business*, 25 TAX LAWYER 317, 321-22 (1972).

[34] *Rafferty* speaks of sale of both stock and assets, but it is clear that the stock had a readily realizable value because the assets were highly liquid.

[35] *See* text accompanying notes 96-105 *infra* for an explanation of the court's general approach.

[36] 338 F. Supp. 602 (D. Mont. 1971).

section 355 case which had concluded that a business without employees may be conducted through agents.[37]

Consequently, the Tax Court's conclusion in *King* that the subsidiaries performed these activities in name only is questionable.[38] Indeed the Sixth Circuit in its reversal of the Tax Court in *King* disagreed with the Tax Court's conclusion that the subsidiaries performed the acquisition of property, financing, construction and expansion of the terminals in name only. The appellate court believed this conclusion was based on the interdependence between the parent and subsidiaries and that the Tax Court had disregarded the separate entities of the real estate holding subsidiaries. The Sixth Circuit ruled that the Tax Court's conclusion here was "violative of the principle that, especially for tax purposes, separate corporations, even parent and wholly owned subsidiary, must be treated as separate entities, no matter how closely they may be affiliated. The separate corporate entity may not be disregarded."[39]

The "Entrepreneurial Activities" Test

Since these management activities were conducted by the subsidiaries in *King,* the question arises whether they constitute the active conduct of a trade or business. This requires analysis of the *Rafferty* "entrepreneurial activities" test—"entrepreneurial activities of such a nature and to such an extent as to qualitatively distinguish its operations from mere investments." Both *King* and *Rafferty* involved rental of real estate and the usual, *i.e.,* not "active," trade or business test applied to such activities is regular and continuous management or rental activities. Such activi-

[37] American Savings Bank, 56 T.C. 828, 839 (1971) (section 61 "sham" issue). Other section 355 decisions have held that cases decided under Code provisions not containing the qualification "active" are not authority upon the question of what constitutes an active business. *E.g.,* E. Ward King, 55 T.C. 677, 700 (1971). *Hanson* appears on this point more in agreement with Parshelsky's Estate v. Commissioner, 303 F.2d 14 (2d Cir. 1962), decided under the 1939 Code predecessor to section 355, which held that the traditional trade or business cases are authority as to what constitutes an active business. *Cf.* George Rothenberg, 48 T.C. 369, 373 (1967); Reg. § 1.761-1(a)(1).

[38] Even if the subsidiaries were totally "inert" so that these activities were attributable to the parent, it could be argued that the parent was the true owner of the entire real estate aspects of the enterprise during the five year period. Thus, it would have actively conducted the acquisition, financing and leasing real estate business which it transferred to the subsidiaries as they were spun off. *But cf.* H.L. Morgenstern, 56 T.C. 44, 47 (1971). The only question (which is not answered by the record) would be whether the spun-off corporations were actively conducting a real estate business after the distribution.

[39] 458 F.2d 247.

ties generally involve more than investment and reinvestment in real estate, they constitute the management of real estate itself for profit. A distinction has been drawn by the Tax Court under another active business provision between the active conduct of rental business and the mere holding of property for investment based, in effect, upon regular and continuous management and rental activities.[40] Similarly for the purposes of an exception to the term "foreign personal holding company income" as used in the subpart F provisions, rents are considered under section 1.954-2(d)(1)(ii)(a)(2) of the regulations to be derived in the active conduct of a trade or business if generated by leasing "[r]eal property with respect to which the lessor performs active and substantial management and operational functions while the property is leased." This test is met where the owner of an office building acts as rental agent for the leasing of the offices and employs a substantial staff to perform other management and maintenance functions.[41]

Thus *Rafferty's* new test approaches the usual trade or business test applied to rental real estate by tribunals other than the Tax Court (which applies a more liberal test), and which has been relied upon in other active business provisions.[42] *Rafferty* may therefore signal a trend towards uniformity in the context of the section 355 active business concept not only as to other active business provisions but also as to the usual trade or business provisions—a goal advocated by some commentators. Significantly, although the net leases involved in *Rafferty* or *King* would not meet this test, the acquisition, financing and construction activities present in *King* (and in *Rafferty* in the fifth year) would.[43] The

40 For a discussion maintaining that the management activities test as applied to rental real estate distinguishes such activities from mere investments see Lee, *"Active Conduct" Distinguished From "Conduct" of a Rental Real Estate Business,* 25 TAX LAWYER 317, 323-24 (1972).

41 Reg. § 1.954-2(d)(1)(ii)(c) Ex. 5. However, these regulations state that examples such as the one in text constitute "specific cases in which rents . . . will be considered *for purposes of this subparagraph* to be derived in the active conduct of a trade or business." Reg. § 1.954-2(d)(1)(i) (emphasis added). The import may be that these definitional rules are considered by the Treasury to be of less than universal application to the term "active conduct of a trade or business." If so, the question arises as to the source of the authority to give the same phrase chameleon-like quality in different Code provisions. Moreover, the regulations disregard the activities of an independent contractor, such as a real estate management firm (hence the example in text notes that the owner acted as rental agent). Reg. § 1.954-2(d)(3)(i).

42 George Rothenberg, 48 T.C. 369, 373 (1967); Union National Bank v. United States, 195 F. Supp. 382 (N.D.N.Y. 1961).

43 It should be noted that another basis for the decision reached in *King* that none

Sixth Circuit's opinion in *King* is not entirely clear on this point. Its primary emphasis was on the construction activities of the terminal leasing subsidiaries but it also reiterated that they performed "all activities necessary to the operation of the real estate leasing business." Its response to the Tax Court's conclusion that income from net leases constituted pure passive income without the concomitant expenditure of money or effort on the part of the lessor was equally equivocal: (1) net leases represented the most advantageous method of doing business, were bona fide and of a customary type in the industry for a customary rent, and (2) leasing was far from the only activity conducted by the subsidiaries. The first response—apparently a modified business purpose approach—is not responsive to whether net leasing activities without more constitute the active conduct of a trade or business; the second implies that the construction activities alone or in conjunction with net leasing qualify as an active business.

Rafferty also requires objective indicia of the entrepreneurial activities and held that the failure of the spun-off corporation to pay salaries hardly constituted an indicium of corporate operations. In *King,* the Tax Court had noted that the spun-off corporations had only one employee for the first three years of the five year predistribution period and thereafter none, concluding that "objectively we find it quite difficult to perceive the *active* conduct of a trade or business when no *activities* are being performed by the corporations in question." The Sixth Circuit's answer to this conclusion by the Tax Court was that each subsidiary had four officers and at least four directors, who all rendered substantial services in acting for them and that officers and directors customarily serve without compensation in the absence of special provisions.

Since operating an apartment building would constitute an active business under the entrepreneurial activities approach, any implication that the section 355 active business test as applied to rental real estate requires in addition to regular and continuous management and rental services (furnishing of utilities, clearing of public areas, collection of trash, et cetera) "significant" additional services, such as mail services, to be rendered to tenants,[44] that might have arisen from the comparison by the lower court in

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of the real estate leasing corporations received rentals from outside parties, 55 T.C. 98, was expressly rejected in *Rafferty*, 452 F.2d at 772 nn.10 and 12.

[44] *E.g.*, Saunders, *"Trade or Business," Its Meaning under the Internal Revenue Code*, 1960 S. Calif. Inst. 693, 744.

Rafferty of the section 355 active business concept with the section 1372(e)(5) definition of "passive investment income," should be dispelled.

Although the Treasury has frequently utilized the technique of excluding "active business" type receipts from the definition of "rents" only if the recipient renders "significant services," this approach has not been universally applied. For example, sections 163(d)(3)(B) and 57(b)(2)(B) (the excess investment interest provisions) include rents in the term "investment income" but only to the extent such income is not derived from the conduct of a trade or business. The proposed regulations accompanying section 57 appear to equate this exception with the active conduct of a trade or business, but rely on the definition provided in the regulations of "property held for investment"—a key term undefined in the statute—for substantive content.[45] That term in turn is patterned after the statutory definition of investment income: Property held for production or collection of passive income, such as rent, unless such income is "derived from properties actively used in the conduct of a trade or business."[46] An earlier version of this exception followed the more traditional terminology of income derived from the active conduct of trade or business.[47]

This "actively used" exception clearly would not require the lessor to render significant additional services to the tenant since the proposed investment interest regulations further provide that property is not held for investment if expenses in connection with it are deductible under section 162,[48] one of the provisions under which the real estate rental business test of regular and continuous management and rental activities developed and which does not demand rendition of such significant additional services. Similarly, judicial interpretation of the phrase "actively carrying on a trade or business" used in section 1.761-1(a)(1) of the regulations has rested on case law development under section 162.[49] And just as the subpart F regulations offer rental of offices in an office building as an example of an active business, section 1.761-1(a)(1) illustrates actively carrying on a trade or business with the example of co-owners of an apartment building leasing space and

45 Prop. Reg. § 1.57-2(b)(4), 36 Fed. Reg. 12024 (1971); *cf.* Reg. § 1.1372-4(b)(5)(vi).

46 Prop. Reg. § 1.57-2(b)(2)(i), 36 Fed. Reg. 12023 (1971).

47 Prop. Reg. § 1.57-2(b)(2), 35 Fed. Reg. 19767 (1970).

48 Prop. Reg. § 1.57-2(b)(2)(i), 36 Fed. Reg. 12023 (1971).

49 George Rothenberg, 48 T.C. 369, 373 (1967).

providing services to the occupants directly or through an agent.[50] On the other hand, payments for use or occupancy of apartments or offices are generally treated as passive "rents" under the subchapter S regulations.[51]

In summary, the adoption with respect to other provisions dealing with active business or passive income of management and rental activities as an alternative to the restrictive significant additional services approach of the subchapter S regulations militates against reliance on the latter provision to determine whether the section 355 active business test is met in the context of a rental real estate business.

Current Production of Income

The *Rafferty* court's promulgation of the entrepreneurial activities test and rejection of the requirement of independent production of income do not directly answer the question of whether a prerequisite of actively conducting a business is current production of income. *Andrew M. Spheeris,*[52] decided by the Tax Court shortly before it handed down *Rafferty* and *King,* puts this issue in perspective. There a corporation was actively conducting a business of operating and leasing several commercial rental properties when fire gutted an office building located on one of the properties. Due to conflict among its shareholders as to whether to reconstruct the existing building or to undertake new improvements on a larger scale under a proposed city redevelopment project, the vacant building and its lot were placed in a new corporation (Anmarcon) which was then split off with two shareholders in the parent exchanging all their stock in the old corporation for all of the stock in the new corporation. Anmarcon's shareholders continued extensive activities and negotiations towards erecting an appropriate structure on the land and returning it to income producing status. Approximately a year later, the city abandoned the redevelopment project and after further negotiations to finance large scale improvements, Anmarcon transferred the property in a like-kind exchange.

The Service agreed that the division met all the requirements of section 355, with one exception—the postdistribution active business requirement. The Tax Court found that due to the activities to restore the property to income producing status the property

[50] Reg. § 1.954-2(d)(1)(ii)(c) Ex. 5.
[51] Reg. § 1.1372-4(b)(5)(vi).
[52] 54 T.C. 1353 (1970), *aff'd,* 461 F.2d 271 (7th Cir. 1972).

was not held by Anmarcon for investment purposes. Therefore, the split-off did not result in the separation of the old corporation's business and investment assets. But the court further announced that "Section 355(b) requires not only that the assets involved in a corporate separation be business assets, but that the assets so separated, together with the activities in connection therewith, constitute operating businesses immediately after such separation."[53] It found that the activities in themselves would not result in income or profit since the improvement projects would have required the acquisition of additional land and were contingent upon the city's plans for redevelopment.

Thus, the Tax Court in *Spheeris* decided that active business status was precluded by the proviso of the regulations that "a trade or business consists of a specific group of activities being carried on for the purpose of earning income or profit."[54] To the extent the opinion rests on the independent production of income doctrine—the activities would not in themselves result in income or profit—it obviously conflicts with the *Rafferty* rejection of that doctrine. The Seventh Circuit has recently affirmed *Spheeris*, agreeing with the Tax Court "that holding a fire-damaged, non-income-producing property did not constitute the active conduct of a trade or business."[55] In stark contrast with this conclusion is section 1.382(a)-1(h)(6) of the regulations and its accompanying Example 2 which reveal that the Treasury has on occasion committed itself to the position that a temporary suspension of a corporation's normal activities (such as manufacturing) due to a fire does not of itself constitute a failure to carry on an active trade or business. Although the corporation in the example engaged in substantial efforts to reactivate its business by reconstructing the damaged plant, there is no indication that it was producing income.

The Tax Court's limitation of active business status to operating businesses was based on legislative history accompanying the 1954 House proposals, which the court erroneously assumed were substantially similar to the Senate active business provision.[56] In fact, the underlying theory of the House corporate division

[53] 54 T.C. at 1362.

[54] Reg. § 1.355-1(c).

[55] Spheeris v. Comm'r, 461 F.2d 271 (7th Cir. 1972).

[56] Andrew M. Spheeris, 54 T.C. 1353, 1362 n. 4 (1970). "Subsection (c) of section 353 defines the term 'inactive corporation' . . . . [T]he transfer to newly created subsidiary of a portion of its [the distributing corporation] business and the distribution of such stock . . . to the shareholders will not qualify . . . *unless such assets constitute an operating business.*" H.R. REP. No. 1337, 83d Cong., 2d Sess. A123-24 (1954). (Emphasis added).

section was completely rejected by the Senate: "Under the House bill, it is immaterial whether the assets are those used in an active business . . . . Your committee returns to existing law in not permiting the tax free separation of an existing corporation into active and inactive entities." [57]

It is somewhat surprising that the Tax Court held that though the assets were active,[58] the corporation, in effect, was not: It seems unlikely that the *Coady* rationale contemplated the application of different criteria to determine whether assets or the corporate entity were active or inactive. Furthermore, since Anmarcon's development activities manifested that it did not hold the property for investment purposes, those same activities meet the *Rafferty* active business test—distinguishing the corporate operations from mere investments.[59] Moreover, an operating business is not a reliable test: The spun-off corporation in *Rafferty* although an operating business was "in economic terms, almost indistinguishable from an investment in securities."

The Tax Court, however, also observed that the activities of Anmarcon "were, at most, no more than preliminary to actually

[57] S. REP. No. 1622, 83d Cong., 2d Sess. 50–51 (1954); *see also* W.E. Gabriel Fabrication Co., 42 T.C. 545, 555 (1964). The House bill was intended to change the existing law and make it immaterial whether assets were used in an active business or were investment assets. Under the House Bill if stock of an "inactive corporation," one with more than 10 per cent of personal holding company income, was disposed of within ten years of a corporate division, the proceeds would be taxed as ordinary income. A "good" corporation had 90 per cent of its income generated by "assets constituting an operating business" or by "operating assets." *Spheeris* was not the first court to misread the legislative history in this area. *See* Parshelsky's Estate v. Comm'r, 303 F.2d 14, 17–18, n.14 (2d Cir. 1962).

[58] "In the instant case, after the building situated on the Wells Street property was destroyed by fire [the taxpayer] engaged in numerous activities, first on behalf of the company and then on behalf of Anmarcon, which were directed toward ultimately returning the property to an income-producing status. We do not, therefore think that the Wells Street property was abandoned as a business asset by the company prior to [the time when] such property was transferred to Anmarcon, nor do we think the record supports the view that the property was thereafter held by Anmarcon for investment purposes. It seems clear, therefore, that the transfer of the Wells Street property to Anmarcon and the distribution of Anmarcon's stock to [the taxpayer] did not result in the separation of a corporation's business and investment assets." 54 T.C. at 1361.

[59] Active development and management and maintenance of rental properties removes a corporation from "mere holding or investment company status" under section 533 where "mere" distinguishes between holding or investment corporations that are strictly passive in nature and those that engage in some measure of business activity. Dahlem Foundation, Inc., 54 T.C. 1566, 1576–78 (1970). The implication is, however, that such activities (which were more extensive than the development activities in *Spheeris*) would not remove a corporation from classification as an investment company.

engaging in a business."[60] Under the "preopening" expense cases, the rule is seemingly well established that to the extent a business has not begun to function as a going concern and to perform those activities for which it was organized it is not engaged in carrying on any trade or business within the meaning of section 162(a).[61] The Seventh Circuit in sustaining the Commissioner's and the Tax Court's position in *Spheeris* relied in major part on this approach—in its view Anmarcon through its sole stockholder was engaging in a search for ventures which would be new and more profitable than the old rental business which, the court concluded, had been discontinued. These activities were categorized as investigative and promotional in nature.[62]

Just as any nonproduction of income basis for the *Spheeris* conclusion is weak, the rationale that the split-off corporation was not actively conducting a business because it was merely investigating a new business is subject to criticism. The pre-operating or investigatory expense rule does not apply where the investigated opportunity is related to a previously existing business, *i.e.*, investigatory expenses are not per se capital, rather they must be related to an existing business.[63] Thus, the Fourth Circuit, in *York*

[60] 54 T.C. at 1363.

[61] *See* Richmond Television Corp. v. United States, 345 F.2d 901, 905–07 (4th Cir.), *vacated and remanded per curiam on other grounds*, 382 U.S. 68 (1965). The largest body of authority on "preparatory expenses" is to be found in the area of farming expenses, *see, e.g.*, Maple v. Comm'r, 440 F.2d 1055 (9th Cir. 1971); Worrell v. United States, 254 F. Supp. 992, 996 (S.D. Tex. 1966); Edwin H. Miner, 21 T.C.M. 1173, 1176 (1967). Despite the Service's heavy reliance on *Richmond Television* in that area there is some question as to whether commencement of commercial enterprises and of farming operations are true analogues.

The rationale of the preopening expense concept is subject to strong criticism. The argument that capitalization is required because such expenditures increase the earning capacity of a business, Mid-State Prods. Co., 21 T.C. 696, 714 (1954), is contradicted by the fact that similar expenditures to expand an existing business are currently deductible. *See* York v. Comm'r, 261 F.2d 421 (4th Cir. 1958). The other rationale, espoused in *Richmond Television*, that a preopening enterprise is not engaging in a trade or business conflicts with the Service's position in other areas, *e.g.*, Reg. § 1.248-1(a)(1), Rev. Rul. 72-220, 1972-18 I.R.B. 16, and earlier case law, *e.g.*, 379 Madison Ave., Inc. v. Comm'r, 60 F.2d 68 (2d Cir. 1932).

[62] "Investigative" connotes a preoperating expense, *see* Morton Frank, 20 T.C. 511, 513 (1933); "promotional" on the other hand connotes the *Higgins-Whipple* nonbusiness expense or investment activities development. Investigation by itself is not, in the eyes of the Service, a section 355 trade or business. *See* Rev. Rul. 57-412, 1957-2 C.B. 247; Fleischer, *The Tax Treatment of Expenses Incurred in Investigation For a Business or Capital Investment*, 14 TAX L. REV. 567, 568 n.10 (1959). However, the *Higgins* trend is properly limited to the distinction between activities of a shareholder and his corporation. Promotional activities by a corporation would seem the essence of the entrepreneurial process, the approach taken in *Rafferty*.

[63] It is possible that the expense need only be related to a future business, rather

v. Commissioner,[64] reversed the Tax Court's position that expenditures by a residential and commercial real estate developer to determine the potential of a tract of land for industrial development were nondeductible exploratory expenditures to determine whether to venture into a new line of business on the grounds that the activity was still intramural, not a new pursuit, apart from his general occupation. Similarly, the recent employment agency fee cases in the Tax Court indicate that investigative activities are deductible if made in the same general type of business in which the taxpayer has been engaging.[65]

Since section 355(b) contemplates the possibility of continuance of the same predisposition business across corporate lines, a newly created spun-off corporation should retain the status of the predisposition business conducted by the distributing corporation in the same manner as if it had conducted the business for the purpose of determining whether the new corporation is merely preparing to engage in a new business or is attempting to expand from an existing predisposition business into a related and, hence, not new pursuit. Following this approach it would not matter that the prior real estate activities were "discontinued" since trade or business status does not cease to exist during a reasonable period of transition. An illustration is the taxpayer in *Harold Haft* [66]

than an existing business. *See* Eugene A. Carter, 51 T.C. 932, 935 (1969); *accord*, David J. Primuth, 54 T.C. 374, 380–81 (1970) (alternative holding).

[64] 261 F.2d 421 (4th Cir. 1958).

[65] David J. Primuth, 54 T.C. 374, 378, 381–82 (1970) (alternative holding and concurring opinion); *cf.*, Leonard F. Cremona, 58 T.C. No. 20 (1972). The Seventh Circuit did not directly answer the taxpayer's argument that the corporation continued to engage in the same type of business.

[66] 40 T.C. 1, 6 (1963); *cf.* Penton v. United States, 259 F.2d 536, 539 (6th Cir. 1958) (continuity of business not destroyed by temporary cessation of business activities; no discontinuance of operation of business regularly carried on); United States v. Hercules Mining Co., 119 F.2d 288, 291 (9th Cir. 1941), *cert. denied*, 314 U.S. 658 (1941) (despite temporary cessation of milling business corporation doing business for capital stock tax under section 701(a) of the Revenue Act of 1934).

Similarly, the regulations under section 382(a), apparently reflecting the *Penton* pre-1954 net operating loss deduction trend, provide that a corporation has not continued to carry on a trade or business substantially the same as that conducted prior to a change of ownership if it is "not carrying on an active trade or business at the time" of such change. Reg. § 1.382(a)-1(h)(6); *accord*, S.F.H., Inc., 53 T.C. 28, 33 (1969), *aff'd*, 444 F.2d 139 (3d Cir. 1971). As an illustration, they further conclude that a temporary suspension of a corporation's normal activities due to involuntary abnormal circumstances, such as a fire, does not of itself constitute a failure to carry on substantially the same (active) trade or business. Reg. § 1.382(a)-1(h)(6) Ex. 2; *accord*, Glover Packing Co. v. United States, 328 F.2d 342, 348 (Ct. Cl. 1964). The corporation in the above example suspended its manufacturing activities due to a fire and thereafter made substantial efforts to reactivate its business who did not cease to be in the costume jewelry business simply because he was temporarily unemployed and had no merchandise to sell. There the taxpayer was actively seeking a suitable connection commensurate with his status in the costume jewelry field, and the court found the transition period (over four years) a reasonable one. In *Spheeris* the nexus between Anmarcon's real estate development activities, implicitly active in the eyes of the Tax Court, and the predisposition rental real estate business was such that they were incurred in a trade or business and not preliminary to actually engaging in a business.

Even if Anmarcon's development activities related only to a new business, under the organizational expenditures provision a corporation is deemed to have begun business (the starting point for a 60 month amortization period) when its activities have advanced to the extent necessary to establish the nature of the business.[67] Certainly Anmarcon's acquisition of property suitable only for rental, in one form or another, established that it was in the rental real estate business. Third, the pre-operating expense trend has on occasion been utilized in applying a "going trade or business" test,[68] which appears closely analogous to the House's proposed "operating business" concept discarded by the Senate in favor of the active business test.

Beyond the preoperating business question, it is clear that a corporation operating as a going concern may be engaged in a trade or business without producing current profit or income.[69] Thus, it may be concluded that at least where a corporation is engaged in a trade or business under the traditional tests and also meets the active business activities and objective criteria tests of *Rafferty,* it should qualify as an active business despite the fact that it may not be currently generating profit or income. An example would be if a corporation like Anmarcon had immediately begun reconstruction or expansion of improvements upon

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by reconstructing the damaged plant—a factual pattern closely analogous to that in *Spheeris.* Thus, the split-off corporation in *Spheeris* was arguably conducting an active business under this approach.

[67] Reg. § 1.248-1(a).

[68] *See* John F. Koons, 35 T.C. 1092, 1099 (1961).

[69] *See* Stephens, Inc. v. United States, 464 F.2d 53, 64-65 (8th Cir. 1972). It may be noted that although the *Rafferty* court approved functional divisions under section 355, the Tax Court has held that in a highly integrated enterprise conducted through multiple corporations, the management entity earns the entire income of the enterprise. Marc's Big Boy Prospect, Inc., 52 T.C. 1073 (1969), *aff'd,* 452 F.2d 137 (7th Cir. 1971). *But see* Your Host, Inc., 58 T.C. No. 2 (1972). Thus, spun-off nonmanagement functions would be actively conducting a business without producing income.

being spun off but was unable to lease to commercial tenants until a year or so later. A further variant of this problem is whether active conduct of a business requires profit as well as production of income: an example would be a used car business that only breaks even, but is nevertheless necessary to dispose of used cars acquired in a new car business.[70] In summation, to the extent the provisions of the regulations approved in *Spheeris* require a group of activities to be carried on for the purpose of earning *current* income or profit to qualify as a business under section 355 they are not in all instances a reasonable interpretation of the statute.[71]

Active Business Regulations After *Rafferty*

At this point a recapitulation of the current status of the active business regulations is in order. The starting point is that despite their heading, "active business," they do not profess to define an active trade or business, rather they state that "without regard to such rules (specific active conduct of a trade or business rules), for purposes of section 355, a trade or business consists of a specific existing group of activities," meeting the requirements set forth in the regulations.[72] When these requirements are compared with the development of the term "trade or business," as usually used in the Code, they lose much of their efficacy.

It seems the Treasury believes the term "trade or business" is quite malleable, having contradictory meanings when desired. For example, the Treasury has indicated that the standard meaning of the term "is not limited to integrated aggregates of assets, activities and good will which comprise businesses for the purposes of certain other provisions of the Internal Revenue Code."[73] This definition clearly conflicts with the definition of trade or business provided in the regulations under section 355. Of course, use by one section of terms also used in another section calls for practical and sensible interpretation in fitting the adopted terms into the adopting statute.[74] Here the only guidance as to any spe-

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[70] *See* Hanson v. United States, 338 F. Supp. 602 (D. Mont. 1971) (court assumed arguendo that predistribution used car business constituted active business, but noted absence of profit; such business was not continued after distribution).

[71] Comm'r v. South Texas Lumber Co., 333 U.S. 496, 501 (1948) (regulations that are reasonable and consistent interpretations of statutory provisions must be sustained).

[72] Reg. § 1.355-1(c).

[73] Reg. § 1.513-1(b). The term "trade or business" in this definition has the same meaning as in section 162.

[74] Warren R. Miller, Sr., 51 T.C. 755, 761 (1968).

cial meaning to be assigned to the term "trade or business" is the function of the active conduct of a trade or business requirement: "to prevent the tax free separation of *active* and *inactive* assets into *active* and *inactive* corporate entities."[75] Measured against this purpose, the regulations defining "active" business or trade or business for purposes of section 355 by and large do not constitute a reasonable interpretation of the statute nor do they reflect congressional intent.

Their requirement of independent production of income was expressly rejected by the First Circuit in *Rafferty*—a result concurred in by the Sixth Circuit in *King*. Similarly, the exclusion from trade or business status of the operation of owner-occupied real estate is implicitly rejected. The "incidental activity" concept—an activity incidental to the principal business or an incidental use of property used primarily in the principal business does not constitute a trade or business[76]—is contained in the same proviso of the regulations as the erroneous independent production of income doctrine and appears to reflect the two business requirements rejected by *Coady*. Furthermore, its probable broader basis, the theory that an active business must include every step in the process of earning income, is implicitly rejected by *Rafferty* in its conclusion that the *Coady* rationale applies to a functional division. As one commentator has pointed out, spun-off assets that comprise merely a single step or an incidental, as well as an integral, function in the total enterprise should qualify under the active business requirement "if they reflect a substantial level of business activity."[77] Broad readings of the requirement of activities being carried on for the purpose of earning income or profit from only such activities, though not directly questioned by *Rafferty*, are incompatible with its reasoning.[78] In short, the only provision of the active business regulations untouched directly or indirectly by the First Circuit's opinion is the exclusion from trade or business status of the holding for investment purposes of stock, securities, land or other property.

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[75] Edmund P. Coady, 33 T.C. 771, 777 (1960), *aff'd per curiam*, 289 F.2d 490 (6th Cir. 1961).

[76] Isabel A. Elliot, 32 T.C. 283, 280-90 (1959); *accord*, Theodore F. Appleby, 35 T.C. 755, 763 (1961), *aff'd*, 296 F.2d 925 (3d Cir.), *cert. denied*, 370 U.S. 910 (1962).

[77] BITTKER & EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 13-15—13-16 (3d ed. 1971).

[78] *Bonsall* and *Appleby*, which appear inconsistent with the *Rafferty* sanction of a functional division of owner-occupied real estate, rest in part on the regulation's requirement of inclusion of every operation which forms a step in the process of earning income.

Although the appellate court in *Rafferty* liberalized the active business test, it did so with the express design of utilizing instead the device test where a distribution possesses considerable potential for a bail-out of earnings and profits.[79] Accordingly, where a vertically integrated business is separated, and particularly, if real estate primarily used in the enterprise is separated, the focus may be expected to shift from the active business test, which heretofore has been the most troublesome requirement of section 355, to the device test.

Device Test

General

As a prerequisite to a tax-free corporate separation under section 355 the Code also requires that the division not be used "principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both."[80] The regulations under the device clause speak to four areas: (1) sale of the spun-off stock, (2) continuity of interest, (3) proportion of liquid assets of both corporations, and (4) relationship of the device test to the active business requirements.[81] They consider post distribution sales that are not pursuant to an arrangement agreed upon prior to the distribution as well as prearranged sales as evidence that the transaction was used principally as a device.[82] This focus of the regulations on post distribution sales is reinforced by their incorporation of the continuity of

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79 "We prefer this approach [*i.e.*, device test, requiring taxpayer showing of business purpose germane to continuance of corporate business where transaction has considerable bail-out potential] over reliance upon formulations such as 'business purpose', and 'active business.' " Rafferty v. Comm'r, 452 F.2d 767, 770 (1st Cir. 1971).

80 I.R.C. § 355(a)(1)(B).

81 Reg. § 1.355-2(b).

82 Reg. § 1.355-2(b)(1). Lest the Service take the view that every spin off followed by a sale violated the device provision, Congress added a parenthetical to the device clause: "(but the mere fact that subsequent to the distribution stock or securities in one or more of such corporations are sold or exchanged (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)." *See* COHEN, CORPORATE SEPARATIONS—GENERAL REQUIREMENTS A-13 (B.N.A. 233 T.M. 1969). Somewhat surprisingly, the regulations interpret this to mean that a nonprearranged sale is also evidence of a device, but not determinative. Apparently in "this rather subtle way" a greater onus was intended to be placed on prearranged sales. *Id.* at A-14 n.38. However, the prearranged sale exception in the statute has also been interpreted as permitting prearrangements to be construed as showing a device, but not requiring that conclusion. Mary Archer W. Morris Trust, 42 T.C. 779, 790 (1964), *aff'd*, 367 F.2d 794 (4th Cir. 1966).

interest doctrine[83]: "Section 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 . . . ." [84]

The other principal focus of the device regulations is on the proportion of active business assets held by the postdistribution corporation. For example, in application of a facts and circumstances approach to determine if a transaction was used principally as a device,

> consideration will be given to the nature, kind and amount of the assets of both corporations . . . immediately after the transaction. 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 . . . will be considered evidence that the transaction was not used principally as such a device.[85]

Thus, a distribution may constitute a device because of bail-out potential even though the distributee does not sell the stock or securities. For these regulations emphasize that in determining whether a distribution is a device, the percentage of active business assets held by the controlled and distributing corporations will be taken into account.[86] It would appear that if only a small percentage of either corporation's assets are business assets, a rebuttable inference is created that the transaction is a device. Indeed, one commentator has suggested that the nonbusiness assets should constitute less than half of both corporations' assets if such device inference is to be overcome.[87] Similar unofficial rules of thumb were originally set up by the Service under the active business test: At least half of the assets to be separated had (1) to

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[83] The classic continuity of interest doctrine requires both a continuity of the business enterprise under a modified corporate form and a continuity of interest therein on the part of those persons who were the owners of enterprise prior to the transaction. Reg. § 1.368–1(b). This doctrine, however, conflicts with the statute itself: (1) a non pro rata division (such as a split up with two 50 per cent shareholders each receiving a 100 per cent interest in one of the postdistribution corporations), expressly authorized by section 355(a)(2)(A), violates the classic continuity of interest doctrine since there is only a 50 per cent shareholder carryover into the resulting corporations; and (2) a postdistribution, but not prearranged sale, which in some instances is sanctioned by the parenthetical contained in section 355(a)(1)(B), would also break continuity.

[84] Reg. § 1.355–2(c).

[85] Reg. § 1.355–2(b)(3).

[86] Cohen, *Partial Liquidations and Spin-Offs of Real Estate Corporations*, 21 N.Y.U. INST. 685, 709 (1963).

[87] Jacobs, *The Anatomy of a Spin-Off*, 1967 DUKE L.J. 1, 10.

be five years old, (2) to constitute more than half of the fair market value of the new corporation, and (3) to be projected to produce more than half of the future income.[88] These tests have fallen into disrepute under the active business test. It may be noted that in their suggested reincarnation under the device test, five year aging for business assets is not thought necessary. The above outline of the device regulations manifests that the Service sees the relationship between the device and active business tests as being very limited: If substantially all the assets of both corporations are used in active business, an inference arises that the spin-off was not used principally as a device. Indeed, one commentator maintains that the essential weakness of the active business concept as fashioned by the current regulations is that whether the transaction satisfies the active business rules has very little effect on the determination of whether the transaction constitutes a device.[89]

The device restriction, however, is not the only anti-bail-out defense relied upon by the Service in addition to the active business requirement. Under regulations entitled, "Business purpose," the Treasury has taken the position that transactions will not qualify under section 355:

> where carried out for purposes not germane to the business of the corporations. The principal reason for this requirement is to limit the application of section 355 to certain specified distributions or exchanges . . . incident to such readjustment of corporate structures as is required by business exigencies and which, in general, effect only a readjustment of continuing interests in property under modified corporate forms . . . . All the requisites of business and corporate purposes described under § 1.368 must be met to exempt a transaction from the recognition of gain or loss under this section.[90]

Although the device test is itself descended from *Gregory v. Helvering*,[91] in which it was linked with the business purpose doctrine, the Commissioner has argued that the business purpose doctrine exists independently of the device clause. The Ninth Circuit has accepted this argument, denying the benefits of section 355 to a transaction that the Tax Court found complied with all the literal requirements of the statute including the device clause,

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[88] *See* Caplin, *Corporate Division Under the 1954 Code: A New Approach to the Five-Year "Active Business" Rule*, 43 VA. L. REV. 387, 403-04 (1957).

[89] Whitman, *Draining the Serbonian Bog: A New Approach to Corporate Separations Under the 1954 Code*, 81 HARV. L. REV. 1194, 1256 n.292 (1968).

[90] Reg. § 1.355-2(c).

[91] 293 U.S. 469 (1935).

but which the appellate court concluded had no business reason.[92] This doctrine has many ramifications. For example, the Service argues that a distinction should be drawn between corporate and shareholder purposes. However, the courts have refused by and large to make this distinction; the new tack that the *Rafferty* court has taken in this area is discussed below. In addition, such a purpose has been required for the distribution of stock and securities in the spun-off corporation as well as for the initial separation of the assets into subsidiary status.[93] The former business purpose is thought to be most troublesome in spin-offs and other pro rata transactions.

One commentator surveying such extra statutory judicial doctrines as the business purpose doctrine and continuity of interest and the reliance placed on them in comparison with the restricted view of the device clause displayed by the Service (as in Revenue Ruling 64-102[94] in which the Treasury indicated that it viewed the device requirement as a dividend equivalency test) has concluded that rather than reading the device provision broadly, the Service has chosen to rely on the familiar reorganization judicial doctrines.[95] Here, too, *Rafferty* charts a new course.

Rafferty: DEVICE AND BAIL-OUT POTENTIAL

In *Rafferty* the government's alternative position in the Tax Court had been that the taxpayer had not shown a valid corporate business purpose for incorporating the business premises of the controlling corporation and subsequently distributing the stock in the real estate subsidiary. The Tax Court accepted the taxpayer's contention that restructuring his stockholdings to facilitate estate planning and to avoid possible future interfamily conflict that might interfere with the operations of the controlling corporation

92 Comm'r v. Wilson, 353 F.2d 184 (9th Cir. 1965).

93 Estate of Parshelsky v. Comm'r, 303 F.2d 14, 20 (2d Cir. 1962).

94 1964-1 C.B. (Part 1) 136. *See also* Rev. Rul. 71-383, 1971-2 C.B. 180; Rev. Rul. 71-384, 1971-2 C.B. 181. This stress on dividend equivalency—if the transaction absent section 355 would give rise to capital gain or loss, rather than dividend income, it does not constitute a device—is likely to be confined to split-ups and split-offs that are non pro rata in character under section 302(b)(2). Although this approach has been criticized as an abdication of power by the Service, *see* Whitman, *Draining the Serbonian Bog: A New Approach to Corporate Separations Under the 1954 Code*, 81 HARV. L. REV. 1194, 1237 (1968), to the extent that such tax lore from the dividend equivalency area as the "strict net effect" test is thereby imported, the same questions will be raised as under the bail-out potentiality approach adopted in *Rafferty*, at least where the distribution is non pro rata.

95 Whitman, *Draining the Serbonian Bog: A New Approach to Corporate Separations Under the 1954 Code*, 81 HARV. L. REV. 1194, 1239 (1968).

constituted an adequate business purpose for the separation and distribution of the subsidiary's stock.[96] As to the corporate purpose versus shareholder purpose distinction urged by the Service, the Tax Court thought it unrealistic to distinguish between them in the case before it but acknowledged that it would draw a distinction in cases where the shareholder purpose was incompatible with the business purpose requirements of section 355.[97]

The appellate court agreed that a shareholder purpose could in some instances save a transaction from condemnation as a device. However, it viewed the correct rule to be 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."[98] Stated another way, if in other respects the transaction was a device, the personal shareholder purpose in *Rafferty* could not satisfy the taxpayer's burden of proving that the transaction was not being used principally as a device. The court preferred this approach to reliance upon such formulations as business purpose and active business.

Thus, *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 bailouts. Such reversal of tactics had been advocated by Whitman,[99] a commentator upon whom the circuit relied in supporting its approach. Whitman had objected to the predominant role assigned to the active business requirement on the grounds that it channeled analysis into a definitional approach—whether a business was active rather than transactional, whether the particular

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[96] The plan incorporated two objectives: (1) exclusions of daughters (taxpayer had four daughters and five sons) and future sons-in-law from active management of the principal (steel) business and (2) providing the daughters with investment assets that produced a steady income, as opposed to the violently fluctuating income of the steel business. 54 T.C. 490, 493–94, 496 (1970).

[97] [T]here are certain instances where a distinction between a corporate purpose and a shareholder purpose must be recognized, i.e., where a distribution is effected solely for the purpose of enabling a shareholder to 'milk' the parent corporation; where a distribution is effected for the purpose of meeting the personal obligations of the shareholders of the parent corporation and where a distribution is effected solely for the purpose of reducing accumulated earnings and profits of the parent corporation which have been permitted to accumulate beyond its reasonable needs.

54 T.C. at 497.

[98] 452 F.2d 767, 770 (1st Cir. 1971).

[99] Whitman, *Draining the Serbonian Bog: A New Approach to Corporate Separations Under the 1954 Code,* 81 HARV. L. REV. 1194, 1245, 1252–53 (1968).

separation should be allowed tax-free treatment.[100] Similarly, it was thought that a business purpose focus would lead to an abstract, almost definitional approach. A strengthened device test was proposed under which the taxpayer would have the burden of proving lack of device—until recently the Service had, in effect, assumed that burden. In essence the taxpayer would have to show that he was entitled to tax deferral as to his corporate separation. Suggested factors to be considered included business reasons, absence of a postdistribution sale, lack of dividend equivalency, and likelihood of bail-out. In short, most of the factors traditionally utilized by the Service and courts would still be available, but particular factors would no longer be crystalized as conclusive. The active business test would be quite restricted, but the thrust of the present device regulations as to the proportion of active business assets strengthened—the more liquid the assets of a postdistribution corporation were, the more likely that the transaction would constitute a device, even if there were good business reasons for the division.

The *Rafferty* court followed Whitman's overall proposed approach in broad outline. Its starting point was that the taxpayer has the burden of proving that the transaction was not used principally as a device.[101] There was a strong indication that business purpose is relevant only with respect to the issue of whether the taxpayer has shown that the transaction is not a device and has no independent significance. The active business test was perforce downgraded in importance with the repudiation of virtually all the provisos of the active business regulations. However, the most significant step taken by *Rafferty* was adoption of a transactional approach: whether the substance of the transaction was to leave the taxpayer in a position to distribute the earnings and profits of the corporation away from or out of the business without impairing his equity interest in the corporation. The content of this focus on bail-out potential in turn owes much to the analysis of Bittker and Eustice, the leading commentators in this area.[102]

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[100] *Id.* at 1211, 1215–16, 1256–57.

[101] The circuit court relied for this purpose upon a decision (Marne S. Wilson, 42 T.C. 914 (1964), *rev'd on other grounds*, 353 F.2d 184 (9th Cir. 1965)) that has been described as offering a promise of a new use for device—"a transactional test with elements considered as factors not terms"—and which allocated the burden of proving nondevice to the taxpayer. 81 HARV. L. REV. at 1245, 1244.

[102] BITTKER & EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 13–28 (3d ed. 1971).

SCOPE OF *Rafferty* DEVICE APPROACH

The court measured bail-out potentiality by two factors. The first was the well established factor of readily realizable value or proportion of liquid assets. The second was more directly responsive to the underlying theory of a bail-out: whether sale of the spun-off assets would adversely affect the shareholders of the ongoing corporation. The First Circuit pointed out that a spun-off corporation could be actively conducting a business, but, if it was based principally on highly liquid investment type assets, it would still have readily realizable value. The significance of whether a sale would impair control over the ongoing business lay in the conclusion that if it would, then the likelihood of bail-out was slight. "If sale would adversely affect the shareholders of the on-going company, the assets cannot be said to be sufficiently separated from the corporate solution and the gain sufficiently crystallized to be taxable."[103] In the case before it, the court determined that the land and buildings held by the spun-off corporation and in which the distributing corporation carried on its steel operations were not so distinctive that the sale of the spun-off corporation would impair the continued operation of the distributing corporation or that such sale would in any other way impair the taxpayer's control and other equity interests in the distributing corporation. The court noted that this determination was reinforced by the fact that the distributing corporation was guaranteed occupancy of the property under a long-term lease at fixed rents.

At first blush, this factor would appear irrelevant to determining whether a bail-out exists since the spun-off corporation is taxed at ordinary income rates on the amounts received in the intercompany transactions.[104] Closer analysis reveals the bail-out potential. The goal of any bail-out is to circumvent the double taxation inherent in dividend distributions—one tax at the corporate level on the profits of the venture and a second tax at the shareholder level on the distribution of such profits to the shareholders. In a *Rafferty* type arrangement, in effect, only the lessor corporation pays a corporate tax on the portion of the profits of the ongoing steel venture that are paid for rent since the lessee deducts such "rent."[105] If after accumulation of such "rent"

[103] 452 F.2d 767, 771 (1st Cir. 1971).

[104] I.R.C. § 61(a)(5).

[105] *See* BITTKER & EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 13–15 (3d ed. 1971) (implication that siphoning off future earnings may constitute a bail-out arrangement).

profits the spun-off corporation is disposed of at capital gain rates, arguably a bail-out has occurred at least as to the accumulated rental income. Although provisions such as section 482 can police this area by reaching excessive rental payments,[106] a fair market value rental charge would appear immune from attack[107] unless the spun-off corporation is a sham or the entire enterprise is considered a single integrated enterprise and the Service successfully applies the "generation of income doctrine" under section 482 to reallocate the net income of the entire venture to one taxpayer. Thus, the device clause may well be the Service's last major line of defense in this area since the accumulated earnings tax imposes only an upper limit on the amount of post-distribution earnings that can be bailed out by this technique, or more aptly device.

Impairment of Equity

The appellate opinion approvingly quoted commentators defining a bail-out as a drawing off of earnings and profits without impairing the shareholder's residual equity interest in the ongoing corporation's earning power, growth potential or voting control. The court added little to this definition other than to indicate that a device was not present if retention of the spun-off salable assets was needed to continue the business or if their sale would harm the taxpayer's control and other equity interest.

Impairment of voting control appears at first blush clear-cut; however, the question of the degree to which attribution rules are to be applied to determine voting control before and after the division is not as clear. No exact parallel to impairment of growth potential and earning power is presented under existing Code provisions. The "essentially equivalent to a dividend" provisions[108] offer the closest analogy since they, too, are concerned with bail-outs. Indeed, in the application of the "strict net effect" doctrine[109] developed under section 302(b)(1), one court has gone

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[106] *Ibid.* (assignment of income doctrine, sections 446(b) and 482 can be employed if anticipated manipulation occurs).

[107] Reg. §§ 1.482-2(c)(1) and (2).

[108] *See* I.R.C. §§ 302(b)(1), 346(a)(2), and 356(a)(2); Reg. § 1.306-3(d) ("cash substitution" test).

[109] Under the "strict net effect" test, a court hypothesizes a situation where the corporation did not redeem any stock, but instead declared a dividend in an amount equal to the amount actually distributed in exchange for the stock redeemed. Then it compares, from the shareholder's vantage point, the "hypothetical" situation after the dividend with the actual situation after the redemption. The redemption is "essentially equivalent to a dividend" whenever the results (*e.g.*, payments received and

beyond mere hypothetical dividend consequences to consider relative changes with respect to shareholder rights to share in corporate earnings and to share in net assets on liquidation.[110] However, because this approach is intended to focus on changes at the shareholder level, its utility in development of the concept of impairment of equity would be limited to non pro rata distributions. Arguably, such distributions can never be used to bail out earnings and profits where the distributee shareholders' interests in the controlling corporation are completely terminated. Therefore, consideration of the net effect test is appropriate only where there has been a meaningful reduction of the distributee shareholders' interests in the remaining corporation,[111] but not a complete termination.

At least where section 355 distributions are proportionate,[112] guidance as to the contours of the impairment of equity doctrine must be sought in dividend equivalency approaches other than the net effect test. The *Rafferty* focus on whether sale of the spun-off real estate would impair the continued operation of the ongoing steel company business calls to mind the "corporate contraction" doctrine[113] applied to partial liquidations under section 346(a)(2). This doctrine, however, in its pristine form is broader than impairment of equity since it would permit, for example, distribution of the proceeds of sale of unwanted operating assets and the working capital attributable to termination of a business activity.[114] Guidance here would therefore be limited to whether the distribution (not termination) of a part of the ongoing business is sufficient to contract or restrict the continuance of the ongoing corporation's operations. Even if the sale of the distributed assets would impair the continued operations,

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the pattern of stockholder control) from the hypothetical dividend and the actual redemption are the same.

110 Himmel v. Comm'r, 338 F.2d 815, 818–20 (2d Cir. 1964).

111 *Cf.* United States v. Davis, 397 U.S. 301 (1970); Note, *United States v. Davis: What Remains of Section 302(b)(1)?*, 13 WM. & MARY L. REV. 202, 208–09 (1971).

112 It is possible that where distributions are disproportionate the taxpayer will have to show that the sale of the distributed stock would not only impair his equity interests ("net effect") in the distributing corporation but also would impair its continued operations ("contraction"). However, *Rafferty* speaks of these two facets of impairment of equity in the alternative.

113 One commentator has reasoned that a functional division involving for example assets connected with a coal mine or a research department would result in "a corporate contraction in operating assets" and accordingly concluded that such divisions merit tax deferral. Massee, *Section 355: Disposal of Unwanted Assets in Connection with a Reorganization*, 22 TAX L. REV. 439, 463 (1967).

114 Rev. Rul. 60-232, 1960-2 C.B. 115.

Rafferty implies that the further question of whether the ongoing corporation can readily replace such assets must be asked.[115]

The uncertainties which exist in the contraction doctrine prompted the active business safe harbor of section 346(b). Thus, paradoxically, *Rafferty* has swung full circle from the section 355 active business restriction intended to police bail-outs to an impairment of capital approach similar to the judicial doctrine which in another provision led to adoption of an active business provision as a safe harbor. Nevertheless, despite the fact that the perimeters of this concept are yet to be fully charted and that it may prove to be the soft spot of the *Rafferty* approach in terms of predictability for tax planning, it is more responsive than the active business requirement to the question of whether the transaction offers such bail-out potentiality that it is not entitled to tax deferral. The active business restriction suffers from being both too narrow and broad since whether the transaction satisfies the active business rules has very little effect on the determination of device.[116]

In addition to unanswered questions as to what constitutes an impairment of equity, an unresolved issue going to the heart of the concept of bail-out potentiality is the continued significance under this doctrine of postdistribution sales. The question is presented by alternative constructions of the impairment of equity factor: (1) if a sale would impair the taxpayer's equity in the continuing business, even should it occur such a sale would not likely result in a bail-out, or (2) if a sale would impair the taxpayer's equity, the likelihood of a sale itself would be slight and, therefore, the likelihood of a bail-out via a sale would also be slight. The significance of the latter construction is in its basic premise that any sale (even one which impairs residual equity) constitutes strong evidence of a device. Although both interpretations would lead to the same result as long as there is no sale,

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115 Clearly the distributing corporation would require some facilities (the spun-off assets consisted primarily of its business premises) in which to conduct its steel operations. *Rafferty* held that the land and buildings in which the distributing corporation carried on its steel operations were not so distinctive that their sale would impair the continuance of those operations. Consequently, the court must have meant that their sale would not impair the continuance of the business of the ongoing company because they could be easily replaced.

116 As the *Rafferty* opinion points out, "[e]ven if both corporations are actively engaged in their respective trades, if one of them is a business based principally on highly liquid investment-type passive assets, the potential for a bail-out is real." 452 F.2d at 771.

different conclusions might be reached where a postdistribution sale did occur.

The question is drawn into sharper focus by examination of Bittker and Eustice's critical analysis of the theory that a postdistribution sale is a method of bailing out earnings and profits. They point out:

> Such a sale spells a loss of control of one of the businesses (and a loss of the seller's share in the corporation's earning power and growth potential as well), whereas a bail-out ordinarily means that earnings and profits have been drawn off without impairing the shareholder's residual equity interest in the corporation's earning power, growth potential, or voting control.[117]

Assuming that the active business test did not permit segregation of cash or investment property in a corporation and distribution of its stock under section 355, they concluded that the bail-out analogy was invalid.[118] Thus, their analysis indicated that a sale, prearranged or not, of stock of a postdistribution corporation that was actively conducting a trade or business could not constitute a device. However, under the *Rafferty* active business test liquid assets can be held in an active corporation (for example, rental real estate business not restricted to granting net leases). Consequently, merely passing the active business test cannot preclude a finding that the transaction violated the device test. But if the sale would impair the taxpayer's equity interest in the continuing corporation, then, following the logic of these commentators' reasoning, such a sale would not be analogous to a bail-out. Since this appears the only possible synthesis of the *Rafferty* active business approach and Bittker and Eustice's critique of the bail-out concept, it is probable that the court intended that impairment of equity made the likelihood of a bail-out minimal even if there were a postdistribution sale. In addition, it may be argued that had the court meant to equate such a sale with a bail-out as the other construction does, it could have done so expressly.

The factors militating towards an interpretation in which a bail-out is equated with sale (but such a sale is unlikely because it would impair the continuing equity interest) do not arise from the theory underlying the bail-out concept or its common meaning but rather from the context in which the court used the term. For example, the court stated:

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117 BITTKER & EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 13-28 (3d ed. 1971).

118 *Id.* at 13-29.

> If the taxpayers could not effect a bail-out without thereby impairing their control over the on-going business, the fact that a bail-out is theoretically possible should not be enough to demonstrate a device because the likelihood of it ever being so used is slight.[119]

Yet under the Bittker and Eustice view, a sale which would impair such control could never constitute a bail-out and, thus, is not even theoretically possible. However, if the word sale is substituted for "bail-out," the same contradiction does not arise. Thus, bail-out seems to possess a broader meaning in *Rafferty*. Furthermore, the court stated that if a sale would adversely affect the taxpayer's residual equity, the assets could not be said to be sufficiently separated from the corporate solution and the gain sufficiently crystallized to be taxable. The authority for this statement, an earlier First Circuit split-off and liquidation-reincorporation decision, contains a paraphrase of it that served merely as a reformulation of the continuity of interest doctrine.[120] Consequently, if the *Rafferty* hypothesis that a sale which impairs residual equity does not constitute a device due to the slight likelihood of its use to bail out earnings and profits, is tested against the original version and context of this crystallization of gain metaphor, it fails. For a sale of the taxpayer's total interest in one of the postdistribution corporations violates the continuity of interest doctrine. To coexist with the continuity of interest doctrine impairment of capital must render both a sale and a bail-out highly unlikely, thus, the terms might as well be synonymous.

While equating sale and bail-out solves some minor conceptual lacunae in the *Rafferty* opinion, to do so requires more than a little casuistic reasoning. More fundamentally, the position that a sale is not a device if it impairs residual equity and therefore is probably not being used as a bail-out, is more consistent with

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[119] Rafferty v. Comm'r, 452 F.2d 767, 771 (1st Cir. 1971).

[120] Lewis v. Comm'r, 176 F.2d 646, 649 (1st Cir. 1949): "What is controlling is that in both the 'popular and economic sense', and the intendment of the statute, considerations of 'boot' aside, gain or loss is not sufficiently crystallized for recognition by the mere transfer of a going business to another corporation for operation indefinitely; 'the collective interests still remained in solution.' "

Liquidation-reincorporation refers to the situation in which shareholders of the "old corporation" liquidate it, withdraw accumulated earnings usually in the form of cash at capital gain rates, and obtain a stepped-up fair market value basis for the other assets, which are then transferred with a carryover basis to a "new corporation" owned in substantially the same proportions. One of the Service's counterattacks is that the entire transaction constitutes a reorganization with the cash being distributed as a boot dividend under section 356(a)(2), or preferably as a functionally unrelated dividend under section 301.

a transactional approach. The latter interpretation should and is likely to be the accepted reading of the *Rafferty* decision and the significance of postdistribution sales, prearranged or not, and the continuity of interest doctrine may be expected to be minimal where the *Rafferty* approach is followed.

A ramification of the bail-out potential approach involves a transaction that eliminates residual equity in one of the post-distribution corporations, such as a non pro rata split-up or split-off in which each group of shareholders possesses a continuing interest in only one of the corporations resulting from the division. Certainly a sale by one of the groups of their entire interest cannot be used to bail out earnings, rather it is more like a complete termination of interest.[121] It should be noted that here the usual alternative to tax deferral will not be ordinary income, but

> would presumably constitute a redemption in complete termination of the interest of one group of stockholders, so that the only tax incidents (absent § 355) would be at capital gains rates on those stockholders who give up their old stock in exchange for the stock of the new corporation. Nevertheless, the failure to obtain complete tax immunity in such circumstances could seriously impede the resolution of deadlock situations, since it would add to the other issues in controversy the question of which group of stockholders should bear this capital gains tax.[122]

While the absence of an equity interest in both corporations removes the danger of a bail-out, it also removes the brake on postdistribution sales of corporate assets with readily realizable value. In these circumstances it might be felt that the gain is sufficiently crystallized to be recognized; however, to do so would entail resuscitating the pre-*Rafferty* version of the active business restriction or giving the continuity of interest doctrine untoward emphasis. The simplest solution, therefore, is to grant tax deferral to divisions with complete terminations of interest in one of the resulting corporations if they pass the *Rafferty*

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[121] *Cf.* Rev. Rul. 64–102, 1964–1 C.B. (Part 1) 136; *accord,* Rev. Rul. 71–593, 1971–2 C.B. 181, which said that in the absence of section 355, the transaction would have been taxed as a capital gain to distributees under the termination of interest redemption safe harbor; therefore, no potential dividend income was being bailed out of the parent and, consequently, the transaction did not violate the device clause.

[122] HERWITZ, BUSINESS PLANNING 932 (1966). Sections 302(b)(2) and (b)(3) provide mechanical tests under which redemptions qualify for capital gain treatment. Significantly under the latter safe harbor ("complete termination of interest") the attribution rules of section 318 are waived in some, but not all, instances. I.R.C. § 302(c)(2).

active business requirement.[123] Should this approach prove to be a means of avoiding the attribution rules applicable to a complete termination of interest under the redemption provisions, a solution would be to use those rules to determine whether the transaction has bail-out potential, *i.e.*, attribute to such taxpayers the residual interest of related parties in the other corporation and then determine whether a sale would impair such interest.[124] This is another area in which the expanded device test is a more flexible guard against bail-outs than the active business requirement. Since the latter does not draw a distinction between pro rata and non pro rata divisions, any stretching of the active business test to permit a particular non pro rata separation worthy of tax deferral becomes equally applicable to pro rata divisions.

The Sixth Circuit in *King,* in its application of the *Rafferty* bail-out potential approach, manifests some of the difficulties in this approach. The Tax Court had not reached the Commissioner's device or business purpose alternative contentions, and the government on appeal argued that if the active business issue were reversed, the case should be remanded to the Tax Court for further findings on these issues. A concurring and dissenting opinion agreed, but the majority, apparently not fully comprehending the *Rafferty* reformulation of device, proceeded to rule on these issues as well.

Its starting point was that all the transactions involved were motivated by valid business purposes. Next it concluded that since the stock of spun-off corporations was immediately exchanged in an amalgamating reorganization for stock in a sister corporation of the distributing parent corporation (thus the distributee stockholders owned both a trucking corporation and a separate holding company with terminal leasing subsidiaries), the distributed stocks were locked into the holding company as securely as they had been locked into the parent truck line operating cor-

123 *See* Whitman, *Draining the Serbonian Bog: A New Approach to Corporate Separations Under the 1954 Code,* 81 HARV. L. REV. 1194, 1255 (1968) (proposed burden test should not apply to transactions involving business divisions between shareholders or complete termination of any shareholder's interest via a split-off because these transactions are not capable of being used as bail-outs).

124 Although the attribution rules under section 318 are applicable only where expressly made so, I.R.C. § 318(a), and are not referred to in section 355, Revenue Ruling 64-102, 1964-1 C.B. (Part 1) 136, indicated a solution: The attribution rules would not be directly applied; rather the section 355 distribution would be compared with a hypothetical section 302 redemption (to which section 318 is expressly made applicable) to determine whether the transaction is capable of being used to bail out dividend income.

poration beforehand, "and the stockholders were as far removed from the earnings and profits after the distribution as they had been before, and could not abstract any accumulated earnings at capital gain rates." [125] Thus, the majority concluded the distribution could not have been used as a device. This reasoning overlooks the fact that if the terminals had a readily realizable value and their sale would not impair the stockholder's control over the ongoing trucking business, the potential for a bail-out through sale of the separate holding company is real—the holding company stock was not necessarily locked into the trucking company at all.

The *King* majority also held that (1) unlike the real estate in *Rafferty* which was readily salable because the improvements were capable of multiple use, the terminals were "single-purpose facilities which required specialized equipment and construction," (2) the retention of the properties by the spun off corporations was necessary for them to obtain financing and expand their facilities, and (3) a sale or liquidation would have impaired the continued operations of the ongoing trucking company. The second holding is irrelevant to bail-out potential analysis—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. The difficulty with the first and third holdings is that nowhere in the Tax Court or appellate opinions are there findings as to whether the spun-off terminals were readily salable, and if so, whether sufficiently similar terminals were available for leasing or could be constructed, or whether a sale and leaseback was possible. Without the answers to these questions the majority's conclusions here, although patterned after *Rafferty,* were without support in the record. It would appear that the majority was overly influenced by its conclusions that the shareholders had received in the distribution no cash or cash equivalent with which to pay the tax and that all the transactions were motivated by business purposes.

125 458 F.2d at 250. Both the Tax Court and the appellate opinion confusingly speak of the holding company that acquired the distributed stock in one place as a subsidiary of the distributing corporation and as another corporation owned by the shareholders of the distributing corporation, *i.e.*, a sister corporation. Since the net result and ostensible purpose of all the transactions was to place all of the trucking corporations in one group and all of the trucking terminal corporations in another, it is assumed that the holding company was a sister corporation to the trucking common parent corporation. Otherwise after the second reorganization in which the holding company acquired the distributed stock, it would have remained partially owned by the distributing corporation.

Business Purpose

In *Rafferty,* the court found that the transaction was in other respects a device and, in addition, the taxpayers' personal estate planning motives were not germane to the continuance of the corporate business since the need to prevent any future management conflict that might arise from debilitating nepotism was remote and completely within the taxpayers' control. Therefore, the taxpayers did not satisfy their burden of proving that the distribution was not being used principally as a bail-out device. Significantly, the court did not use the terms "purposes . . . germane to the business of the corporation" (the formulation of business purpose under section 1.355–2(c) of the regulations) but rather "motives . . . germane to the continuance of the corporate business."[126]

This formulation of business purpose highlights the fact that in the eyes of the court the concept of shareholder business purpose is linked with the impairment of equity factor. For if the shareholder motives are so germane, a postdistribution sale would probably retard their fulfillment. Although interrelated to the impairment of equity factor, this element is not identical to it. For example, the spun-off corporation's assets could consist of real estate leased to the ongoing company that the latter could readily replace without contracting its continued operations. If the shareholder's motives were such that for other reasons he could not as a practical matter dispose of either of the postdistribution corporations, then the purposes would appear germane to the continuance of the corporate business.[127] In effect, under this approach a taxpayer is given another bite at the apple to show that the likelihood of a bail-out is slight. If he cannot show that a sale would impair his continuing equity so that the likelihood of its use for a bail-out is slight, he may show that the likeli-

126 Rafferty v. Comm'r, 452 F.2d 767, 770 (1st Cir. 1971).

127 Bondy v. Comm'r, 269 F.2d 463, 466–67 (4th Cir. 1959). Whitman suggests that the taxpayer in *Bondy* had no intention of disposing of the spun-off real estate stock which was collateral for his alimony obligation. "If he defaulted on the alimony, his ex-wife would become his lessor. Business purpose or none, he did not, could not, contemplate a bail-out of earnings, and thus the transaction was not used as a device." 81 HARV. L. REV. at 1243.

The *Rafferty* business purpose discussion required that personal shareholder motives be germane to the continuance of the corporate business if the transaction was in other respects a device; in its summary of device the court concluded that the continued rentention of the salable assets was not needed to accomplish shareholder purposes. It may be inferred that shareholder purposes requiring retention of assets are germane to continuance of the corporate business.

hood of a sale itself occurring (and hence a bail-out via such sale) is slight due to the fact that personal motives require "the continued retention [of the salable assets] to accomplish [his] purposes."[128]

Rafferty retained, of course, corporate business purpose as a possible means of showing that a transaction is not being used principally as a device, although it is, in other respects, a device. Indeed, the majority opinion in *King* may be justified on this ground. The dissent, however, believed that valid business purposes did not necessarily foreclose a finding that a transaction is used as a device. The apparent criterion for determining if a corporate business purpose is present is whether the transaction renders "any direct benefit to the business of the original company." *Rafferty* unfortunately does not indicate what degree of business purpose (corporate or shareholder germane to continuance of the corporate business) must be shown to establish that the transaction was not being used "principally as a device" where the potential for a bail-out is real. The principal purpose test of section 269 may offer some guidance. Regulations under that section, echoing legislative history—"the section should be operative only if the evasion or avoidance purpose outranks, or exceeds in importance, any other one purpose"[129]—provide that "[i]f the purpose to evade or avoid Federal income tax exceeds in importance any other purpose, it is the principal purpose."[130] This leads to the interesting question of whether a transaction is used principally as a device if the bail-out purpose exceeds in importance both a shareholder purpose germane to continuance of the enterprise and a corporate business purpose, when measured against each purpose separately, but not when measured against both of them. The fact that the everyday sense of principally is "of first importance" or "primarily," as contrasted with "essential" or "substantial,"[131] suggests that the bail-out use must exceed all business purpose uses in the aggregate.

If, however, the development of the "business purpose" limitations of section 269 is fully applicable to section 355, this question

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[128] 452 F.2d at 771.

[129] S. REP. No. 627, 78th Cong., 1st Sess. 49 (1943).

[130] Reg. § 1.269-3(a)(2).

[131] *Cf.* Malat v. Riddell, 383 U.S. 569, 572 (1966) ("primarily" in section 1221(1) means "principally" or "of first importance"); *see* COLSON, FEDERAL TAXATION OF SALES, EXCHANGES AND OTHER TRANSFERS 61 (1971) (suggesting *Malat* overruled a conflicting interpretation of "essential" or "substantial").

may well prove academic since the courts, at least prior to recent trends, have seemed willing to give decisive weight to any reasonable business purpose posited by the taxpayer. Nevertheless, "courts generally have been more receptive to the business reasons which would justify separation of assets at the *corporate* level than to attempt to attain split ownership at the *shareholder* level under § 355," [132] and a business purpose is required for both the initial separation of assets into subsidiary status and the distribution of the subsidiary's stock to the parent's shareholders.[133]

In the context of the requirement of a separate business purpose for distribution of the stock of the spun-off corporation, the *Rafferty* court's observation that the alleged business purpose could be fully satisfied by a bail-out of dividends may prove highly significant. For *Parshelsky,* the decision adopting the requirement of nontax reasons, not only for the corporate division but also for direct ownership of both corporations by the shareholders, had reasoned that a business purpose which could be accomplished merely by separate incorporation could not justify a spin-off.[134] Due to this reasoning, commentators generalized that if a distribution by a spin-off was only one of several ways to accomplish a given purpose, courts might hold that the spin-off did not possess an adequate nontax purpose.[135] In *Rafferty,* the court pointed out that the alleged business purpose of providing daughters with investment assets safe from the fluctuations of the ongoing steel business could have been fully satisfied by payment of cash dividends to the taxpayers followed by their investing them to provide for their female descendents. This may portend an approach under which a business purpose for a spin-off is severely discounted if the same result could be obtained through payment of dividends.

On the other hand, it has been suggested that since the result secured under most spin-offs (including some approved by the Service in published rulings) can be achieved without a distribution, the possibility of accomplishing the same result without a spin-off should not be determinative [136]—"[m]en may arrange their

[132] BITTKER & EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 15-10 (3d ed. 1971).

[133] Estate of Parshelsky v. Comm'r, 303 F.2d 14, 20 (2d Cir. 1962).

[134] *Ibid.*

[135] Cohen, *Current Partial Liquidation and Spin-off Problems,* 41 TAXES 775, 779-80 (1963).

[136] *Id.* at 778.

affairs with an eye to reducing or avoiding taxes."[137] Moreover, even under section 269 where the previously liberal judicial attitude towards business purpose has turned critical, the hardened attitude "does not go so far as to compel the taxpayer to adopt the least favorable tax route out of several possible alternatives."[138] Indeed, in a recent section 355 decision where the Government argued that "assuming that there was a business purpose for the creation of the new company there was no business purpose for the distribution of its stock since the same objective could have been accomplished by operating the new company as a subsidiary," the district court countered with the observation that "it does not follow that a spin-off, prompted by valid business motives, can be taxed merely by showing that the same business purposes could have been served by some other form of reorganization."[139] Thus, it is not advisable to hold that a spin off which in other respects is not a device does not possess an adequate business purpose merely because the same result could be obtained by a payment of cash dividends. Rather, under section 355, as under section 269, the rule should be that the taxpayer must show that the choice of the more favorable tax route was motivated by business reasons at least equal to the opportunity to obtain the potential tax benefits in the method selected, viz., a bail-out of earnings and profits.

A further business purpose question not directly answered by *Rafferty* is whether such a purpose must be evidenced for application of section 355 even though the distributed stock cannot be potentially converted into cash without impairing the distributee's equity interest in the continuing corporation. The Ninth Circuit in *Commissioner v. Wilson*[140] has held that business purpose was an independent test which must be met even after the device clause had been satisfied. It is significant, therefore, that the *Rafferty* court appears to use business purpose as a threshold question which is triggered only by the presence of bail-out potential:

> [*I*]*f, in other respects the transaction was a "device,"* that purpose could not satisfy the taxpayers' burden of proving that it was not being used "principally as a device" . . . .

[137] Electrical Securities Corp. v. Comm'r, 92 F.2d 593, 595 (2d Cir. 1937).

[138] BITTKER & EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 16–38 (3d ed. 1971).

[139] Hanson v. United States, 338 F. Supp. 602, 613 (D. Mont. 1971).

[140] 353 F.2d 184, 187 (9th Cir. 1965).

. . . .

Accordingly, once the stock was distributed, *if it could potentially be converted into cash without thereby impairing taxpayers' equity interest* in RBS, the transaction could easily be used to avoid taxes. The business purpose here alleged, which could be fully satisfied by a bail-out of dividends, is not sufficient to prove that the transaction was not being principally so used.

. . . . .

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,* . . . the distribution was principally a device to distribute earnings and profits.[141]

Furthermore, the court stated that it preferred this application of the device test to reliance upon formulations such as business purpose or active business, citing Whitman, who in this context was quite critical of the appellate opinion in *Wilson,* pointing out it downgraded the device concept to a mere formality.[142] Thus, it may be concluded that under the *Rafferty* approach, business purpose is merely an element that the taxpayer must prove if the transaction offers bail-out potentiality, but has no independent significance beyond this limited role.

Consequently, where the taxpayer shows that the transaction displays no real potential for a bail-out and the reformulated active business test is met, he should prevail even in the absence of a business purpose, *Wilson* notwithstanding, since he has satisfied his burden that it was not being used "principally as a device." This approach corresponds nicely to an analysis of the reference to earnings and profits as suggesting a dividend equivalence focus and the use of device as implying a tax avoidance concept (which invokes a *business purpose* defense). It may be significant that the assets (conditional sales contracts) of the spun-off corporation in *Wilson* were highly liquid and that a sale of its stock would not appear to adversely affect the shareholders of the ongoing retail furniture company, so that the result reached would not vary under the *Rafferty* device test, only the reasoning. Indeed, the central weakness of the *Wilson* approach is high-

141 Rafferty v. Comm'r, 452 F.2d 767, 770-71 (1st Cir. 1971) (emphasis added).

142 *Rafferty's* bail-out potentiality approach is better suited to policing spin-offs of active businesses than an independent business purpose test. Thus, the apprehension by some commentators that without the *Wilson* rule a bail-out of earnings could be accomplished by a three or five year "holding period" should be allayed.

lighted by the recent *Hanson* decision.[143] There, the court found adequate business purposes for the separation of a financing business that also satisfied the active business requirement. The Commissioner having conceded that the transaction was not a device, the taxpayer prevailed.

Device and Business Purpose Regulations After *Rafferty*

An evaluation of the section 355 device and busness purpose regulations in light of *Rafferty* does not reveal the broad sweep repudiation evident in the active business regulations. Rather the primary impression is one of a reordering of priorities in the weight and role of their elements. An exception may be found in the postdistribution sales provisions of the device regulations [144] which, though previously the most critical aspect of these regulations, appear for the most part no longer relevant and certainly not conclusive or even presumptive. Although not directly criticized in the opinion, they are not consonant with the rationale supporting the bail-out potential approach. If a sale of one of the postdistribution corporations impairs the taxpayer's equity in the other corporation, the sale has not likely been used as a bail-out; on the other hand, if a sale would not impair such equity and the assets are readily salable, "the substance of the transaction is such as to leave the taxpayer in a position to distribute the earnings and profits of the corporation away from, or out of the business" [145] regardless of whether a sale actually occurs.

Possibly, postdistribution sales could be a factor in the infrequent situations in which the assets do not have a readily realizable value but their actual sale, nevertheless, does not impair the taxpayer's interest in the ongoing corporation or the potential for bail-out is real but shareholder motives germane to the continuance of the corporate business are shown. In both cases, the bail-out which appeared highly unlikely (only because a sale appeared unlikely) has, in fact, occurred through a postdistribution sale.

The focus of these regulations on the proportion of active business or liquid assets [146] is both amplified and narrowed by *Rafferty*. Whether the stock of one of the postdistribution corporations can

143 Hanson v. United States, 338 F. Supp. 602 (D. Mont. 1971).

144 Reg. §§ 1.355-2(b)(1) and (2).

145 452 F.2d at 771.

146 Reg. § 1.355-2(b)(2).

be potentially or readily converted into cash has now become a critical question. It is not determinative, however, since the potential for a bail-out is not real unless such sale would also not impair the taxpayer's equity interest in the other corporation. This limitation, which is nowhere contained in the existing device regulations, is a definite restriction on them.

Business purpose and continuity of interest[147] still play a role since shareholder business purpose and continuity of interest, in the limited sense of continuity of the business enterprise, are in effect melded into a single requirement that retention of the spun-off assets must be needed to accomplish the shareholder's purpose (if the spin-off puts salable assets in the hands of shareholders and their continued retention is not needed to continue the business enterprise—continuity of interest again). Similarly, the need to show a corporate benefit or business purpose where shareholders motives will not meet the above test is triggered by bail-out potential. In summary, the theory of *Rafferty,* though not the express language, indicates that business purpose and the modified continuity of interest requirement do not exist independently of the device test as the regulations imply and the Service asserts.

Conclusion

The First Circuit's election in *Rafferty* to rely primarily on the device clause to police bail-outs offers a new approach to section 355, one long demanded by commentators. Whether that approach, which was accompanied by a deliberate abrogation of most of the elements of the already shaky active business regulations, will mature and introduce predictability to this area will turn on two imponderables: (1) the course taken by the "modification" of the regulations that the Treasury has been considering for eight years, and (2) the degree to which the new formulations of device, active business and business purpose, as well as the radiations of the *Rafferty* reasoning (and dicta) are perceived and followed by subsequent decisions.

The viability of the present active business regulations is no longer debatable; if the Service attempts to resuscitate them as the principal barrier to bail-outs, further taxpayer challenges to their validity can only result. Viewed solely from the vantage point of section 355, *Rafferty* presents a blueprint for regulations that

[147] Reg. § 1.355-2(c).

would maintain a more precise and reliable screen against potential bail-outs but permit other transactions to pass unscathed. If the court's bail-out potentiality approach—(1) where salable assets are placed in the hands of shareholders with interests in both postdistribution corporations, and (2) their retention is not needed to continue the business of the other corporation, then (and only then) (3) the taxpayer must show that either their retention is necessary to accomplish his business purpose, or (4) that the distribution serves a corporate purpose equal to or greater than the bail-out opportunity—is substituted for the present device and business purpose regulations, the active business regulations could be safely reduced to a quantitative and qualitative corporate activities test that distinguishes corporate operations from mere investments. Thus, whatever apprehension the Service may have had that liberalizing the active business regulations would open the floodgates for a deluge of bail-outs should be alleviated by adoption of the *Rafferty* tack in the device regulations along with the revision of the active business regulations. Furthermore, although the purposes of the active business rule and device requirement have always overlapped,[148] this step would restore the active business rule to supplementing, not supplanting, the device clause.

The partial liquidation provisions of section 346 and the active business regulations issued thereunder, which expressly incorporate the active business definition of section 1.355-2(c) of the regulations, contain no counterpart to the device clause of section 355. Thus, this too may be a factor in the Treasury's gestation period for modifications of the section 355 regulations. It should be noted, however, that the chief, though not the sole, conceptual weakness in the present regulations is that they are bottomed on the rejected separate business requirement. Yet, under section 346, that requirement is dictated by the clear language of the statute and, indeed, the section 346 requirement may have been the inspiration for the two business restrictions contained in the section 355 regulations.[149] Thus, portions of these regulations may be salvaged for application to section 346 only. In any event if that

[148] E. Ward King, 55 T.C. 677, 696, n.7 (1971).

[149] Some legislative history also suggested this construction, and with the premises: (1) the reduction in scope that would occur in the division of a single business in halves prevented each from qualifying as the same "such trade or business" as had existed before the distribution and (2) that "such trade or business" in section 355(b)(2)(B) referred to the same predistribution active business required by section 355(b)(1), the statute itself supported the two business requirement. *See* Reg. § 1.355-1(d) Ex. 11.

alternative is not chosen, section 346 would not be the only active business provision unaccompanied by explanatory or definitional regulations.[150] The ultimate resolution of this problem lies perhaps in a congressional exploration of whether a modification of the *Rafferty* device is a suitable substitute under section 346 for the present active business safe harbor.

Case law development will probably follow *Rafferty* with respect to its reformulation of device—*King* is a current example. A possible exception may arise as to the role of business purpose since the Ninth Circuit has held that it must be shown regardless of whether the device clause is satisfied, and the First Circuit did not expressly hold on this question. Rather the latter's juxtaposition of bail-out potentiality and business purpose as well as its preference of device over active business and business purpose to police bail-outs only suggests that it would disagree with *Wilson*. In any event, if the *Rafferty* position on device is followed, it is to be hoped that its deemphasis of active business will also be followed. For the two are but the faces of a single coin—the transactional approach.

As to the First Circuit's view of the active business requirement, *King* also evidences that the express pronouncements (even where dicta) on functional divisions, independent production of income and corporations dealing only with related entities will prevail. Whether other courts will limit the active business test to a requirement of objective indicia of entrepreneurial activities quantitatively and qualitatively, distinguishing corporate operations from mere investments, is a harder question. In addition, the effect the radiations of *Rafferty* will have in the Tax Court on the continuing precedent value of such Tax Court decisions as the *Elliot* trilogy and the more recent cases of *Spheeris* and *King* is not possible to predict at this point. Hopefully, however, the Tax Court will give serious reconsideration to its previous stance on the section 355 active business clause now that a reinterpretation of the device clause is available and the existing active business regulations have been seriously, even fatally, questioned by two circuit opinions. While under the facts of many of these decisions the results would not vary under the new approach, this would not be the case in non pro rata divisions or pro rata separations in which the salable real estate was so distinctive that its sale would impair the ongoing corporation's operations.

Rafferty has signaled a new beginning under section 355; hope-

[150] *See, e.g.*, I.R.C. §§ 274, 921(2), 931(a)(2), 1551, and 1372(e)(5)(B)(i).

fully it will be followed uniformly and administratively without an ensuing decade of taxpayer uncertainty and perplexed commentary, as has been the situation after *Coady*. But if that millenium does not arrive, the bail-out potentiality concept can also serve as a blueprint for Congress to "enable the business community to adjust more freely its methods of conducting business" and at the same time to effectively isolate an attempted bail-out of earnings and profits from a valid corporate readjustment.[151]

[151] Note, *Section 355's Active Business Rule—An Outdated Inefficacy*, 24 VAND. L. REV. 955, 956 (1971).