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# Federal Taxation - Reorganization - Spin-Offs - Labor Difficulties As A Valid Business Purpose - Sidney L. Olson, 48 T .C. 855 (1967)

Here, *United States v. Lincoln*[24] extends this doctrine one step further by obliterating the previous distinction between confessions and admissions, thus marking the culmination of the trend begun by *Tempia*, extending the protections of servicemen to include substantially all of the protections accorded to civilians by *Miranda*.[25] Though the contention has been made that such an extension to servicemen would undercut the discipline necessary for the proper functioning of the armed forces,[26] it would appear that in the future, military personnel can be assured of the full scope of protections afforded by the first ten amendments, with the exception of those "privileges under the Bill of Rights which by necessary implication are inapplicable to servicemen." [27]

**Federal Taxation**—REORGANIZATION—SPIN-OFFS—LABOR DIFFICULTIES AS A VALID BUSINESS PURPOSE. During 1961 and prior years taxpayers conducted, in various capacities, the business affairs of several electronics merchandising corporations, known collectively as the Olson Group. One of these corporations, Cleveland, owned all the stock in

States v. Bollons, 17 U.S.C.M.A. 157, 38 C.M.R. 55 (1967); and (2) that the government has the affirmative burden to show conclusively that the accused has waived his right to remain silent. United States v. McCauley, 17 U.S.C.M.A. 81, 37 C.M.R. 345 (1967); United States v. Gustafson, 17 U.S.C.M.A. 150, 37 C.M.R. 414 (1967).

24. 17 U.S.C.M.A. 330, 38 C.M.R. 128 (1967).

25. Thus the accused, either serviceman or civilian, has the right to remain silent. *Compare* Miranda v. Arizona, 384 U.S. 436 (1966) *with* 10 U.S.C. § 831(b). He has the right to counsel, either retained or appointed, from the beginning of the custodial interrogation. *Campare* Miranda v. Arizona, 384 U.S. 436, 472 (1966), *with* United States v. Tempia, 16 U.S.C.M.A. 629, 37 C.M.R. 249 (1967). Should the government contend that the accused waived the above rights, it must prove this waiver conclusively, before the waiver is admitted. For counsel; *compare* Miranda v. Arizona, 384 U.S. 436, 474 (1966), *with* United States v. Tempia, 16 U.S.C.M.A. 629, 638, 640, 37 C.M.R. 249, 258, 260 (1967); and for the right to remain silent; *compare* Miranda v. Arizona, 384 U.S. 436, 474 (1966) *with* United States v. Bollons, 17 U.S.C.M.A. 253, 38 C.M.R. 51 (1967). Admissions have the same incriminating effect as confessions. *Compare* Miranda v. Arizona, 384 U.S. 436, 476, 477 (1966), *with* United States v. Lincoln, 17 U.S.C.M.A. 330, 38 C.M.R. 128 (1967). An affirmative burden is placed upon the government to prove conclusively that the above has transpired, or the statement risks the fate of inadmissibility as evidence. *Compare* Miranda v. Arizona, 384 U.S. 436, 475 (1966) *with* United States v. Gustafson, 17 U.S.C.M.A. 150, 37 C.M.R. 414 (1967) *and* United States v. Solomon, 17 U.S.C.M.A. 262, 38 C.M.R. 60 (1967).

26. Burns v. Wilson, 346 U.S. 137 (1953); United States v. Jacoby, 11 U.S.C.M.A. 428, 441, 29 C.M.R. 244, 257 (1960) (dissenting opinion). *See generally*, Note, 64 COLUM. L. REV. 127, *supra* note 17. *But see* Henderson, *Courts Martial and the Constitution: The original understanding*, 71 HARV. L. REV. 293 (1957).

27. *See* United States v. Tempia, 16 U.S.C.M.A. 629, 633, 37 C.M.R. 249, 253 (1967).

Buffalo, another corporation in the Olson Group. In 1960, as a result of departures by the president of Cleveland from the personnel policies of the Group, there were union organizing activities at Cleveland. Because of the fear that these unionizing activities might spread to the rest of the Group and especially to Buffalo, taxpayers (the officers and stockholders of Cleveland) authorized and had distributed the stock of Buffalo to the stockholders of Cleveland, thereby "spinning-off"[1] Buffalo. The Commissioner of Internal Revenue ruled that the distribution did not qualify for tax-exempt treatment but constituted a taxable dividend.

The Tax Court, however, held for the taxpayers on the ground that a valid business purpose had been shown for the spin-off.[2]

The tax consequences of spin-offs have varied with the successive internal revenue laws. While the spin-off was originally taxable, the Revenue Act of 1924[3] extended to it nonrecognition of gain status.[4] Tax-free treatment continued through the Revenue Act of 1932.[5] Because these provisions did not contain restrictions like those of the present enactment, a literal reading of the statutes made them subject to tax avoidance schemes. A corporation would form a subsidiary whose sole purpose was to hold the liquid assets of the parent corporation. The stock in the subsidiary would be distributed to the existing corporation's shareholders who would then liquidate the new corporation and the gains from the assets thus sold would be taxed at capital gains rates.[6]

1. A spin-off is a distribution by one corporation of the stock of a subsidiary corporation. Under the 1954 Code, the stock of either an existing subsidiary or a newly created one can qualify for a tax-free spin-off. Before 1954, however, the subsidiary had to be created for the purpose or, if an existing subsidiary was used, the distributing corporation was required to transfer additional assets to it as part of a plan of reorganization. B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS § 11.01, at 450 (2d ed. 1966). The spin-off is regulated by INT. REV. CODE OF 1954, § 355.

2. Sidney L. Olson, 48 T.C. 855 (1967).

3. Revenue Act of 1924, ch. 234, § 203(c), 43 Stat. 256. This was done in order to facilitate the separation of a business into units without eliminating the original corporation. 3 MERTENS, FEDERAL INCOME TAXATION § 20.100 (rev. ed. 1966); S. REP. No. 398, 68th Cong., 1st Sess., pt. 1, at 15 (1924).

4. For the history of tax-free spin-offs, *see generally* Estate of Parshelsky v. Commissioner, 303 F.2d 14, 17 (1962); Spangler v. Commissioner, 18 T.C. 976, 987 (1952); 3 MERTENS, *supra* note 3, § 20.100.

5. Revenue Act of 1926, ch. 27, § 203(c), 44 Stat. 13; Revenue Act of 1928, ch. 852, § 112(g), 45 Stat. 818; Revenue Act of 1932, ch. 209, § 112(g), 47 Stat. 197.

6. 3 MERTENS, *supra* note 3, § 20.101.

In *Gregory v. Helvering*,[7] the Supreme Court, in an effort to eliminate these abuses, laid down the general principle that not only must there be literal compliance with the requirements of the Code provisions but there must also be a "business purpose" that reflects the spirit of the section.[8] While *Gregory* was on appeal, and before the Supreme Court had enunciated the "business purpose doctrine," [9] Congress, due to a demand for the repeal of the provision granting nonrecognition treatment to spin-offs, omitted the provision from the Revenue Act of 1934[10] and spin-offs again became taxable.

Thereafter Congress came to believe that it was "economically unsound to impede spin-offs which break up businesses into a greater number of enterprises, when undertaken for legitimate business purposes." [11] Thus in 1951 the nonrecognition provisions pertaining to spin-offs were reinstated in section 112(b)(11) of the 1939 Code.[12] This section partially enacted the "business purpose doctrine" of *Gregory*[13] and included a general prohibition against distribution of earnings and profits to share-

7. 293 U.S. 465 (1935).

8. *See* Michaelson, *"Business Purpose" and Tax-Free Reorganization*, 61 YALE L.J. 14, 25 (1952); Rice, *Judicial Techniques in Combatting Tax Avoidance*, 51 MICH. L. REV. 1021, 1043 (1953). This has been called the "pervasive business doctrine". 3 MERTENS, *supra* note 3, § 20.101, at 498.

9. For a discussion of the *Gregory* doctrine, *see* 3 MERTENS, *supra* note 3, §§ 20.55 and 20.56. This doctrine is now applicable to areas of tax law not at all connected with the spin-off provisions. *See, e.g.*, Commissioner v. Court Holding Co., 324 U.S. 331 (1945); Commissioner v. Wilson, 353 F.2d 184 (9th Cir. 1965); Bondy v. Commissioner, 269 F.2d 463 (4th Cir. 1959). *See also* Michaelson, *"Business Purpose" and Tax Free Reorganization*, 61 YALE L.J. 14, 25 (1952).

10. 3 MERTENS, *supra* note 3, § 20.101, at 498.

11. S. REP. No. 781, 82d Cong., 1st Sess., 58 (1951).

12. Int. Rev. Code of 1939, § 112(b)(11), added by ch. 521, § 317(a), 65 Stat. 493 (1951). For the history of this provision, *see* 96 CONG. REC. 1980 (1950); Estate of Parshelsky v. Commissioner, 303 F.2d 14 (1962). This section read as follows:

> (11) DISTRIBUTION OF STOCK NOT IN LIQUIDATION.—If there is distributed, in pursuance of a plan of reorganization, to a shareholder of a corporation, which is a party to the reorganization, stock (other than preferred stock) in another corporation which is a party to the reorganization, without the surrender by such shareholder of stock, no gain to the distributee from the receipt of such stock shall be recognized unless it appears (A) any corporation which is a party to such reorganization was not intended to continue the active conduct of a trade or business after such reorganization, or (B) the corporation whose stock is distributed was used principally as a device for the distribution of earnings and profits to the shareholders of any corporation a party to the reorganization.

13. Int. Rev. Code of 1939, § 112(b)(11)(A), added by ch. 521, § 317(a), 65 Stat. 493 (1951) (now INT. REV. CODE OF 1954, § 355(b)(1)(A)).

holders by means of a reorganization.[14] Section 355 of the 1954 Code substantially continues these two basic requirements.[15] The Treasury Regulations even more clearly spell out the necessity of showing a valid business purpose for the reorganization; otherwise the nonrecognition provisions of section 355 are not available.[16]

Here, in *Sidney L. Olson*,[17] the Commissioner contended that the taxpayers had not met the requirements of section 355, because, *inter alia*,[18] they had failed to show a valid business purpose for the distribution of the stock in Buffalo. The Tax Court disagreed, analogizing the differences between Cleveland and its employees to the situation where two stockholders of a corporation, to avoid further differences and conflicts between them as to the conduct of the business, separate the assets of the corporation between themselves, each thereafter operating a separate corporate enterprise. This latter situation has been held to constitute a valid business purpose.[19] Thus the Tax Court concluded that the

14. Int. Rev. Code of 1939, § 112(b)(11)(B), added by ch. 521, § 317(a), 65 Stat. 493 (1951) (now INT. REV. CODE OF 1954, § 355(a)(1)(B)).

15. *See* S. REP. No. 1622, 83d Cong., 2d Sess., 50-51 (1954). It is to be noted that nowhere in section 355 does the phrase "business purpose" appear as a requirement for a tax-free spin-off. The section does require, however, that the distribution 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." INT. REV. CODE OF 1954, § 355(a)(1)(B). Moreover the distribution must not be "in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax." INT. REV. CODE OF 1954, § 355(a)(1)(D)(ii).

16. Treas. Reg. § 1.355-2(c) (1955). Even if there is no tax avoidance motive, a reorganization having no business purpose has been held not to be entitled to the nonrecognition provisions of section 355. Commissioner v. Wilson, 353 F.2d 184 (1965). As examples of business purposes which might support a tax-free distribution under section 355, in B. BITTKER & J. EUSTICE, *supra* note 1, at 484, there are listed the following: (1) Compliance with local law requiring two businesses to be separated. (2) Compliance with federal anti-trust law. (3) Segregation of hazardous activities in a separate corporation. (4) Separation of a business to permit its employees to share in profits or ownership. (5) Settlement of a shareholder dispute, by giving each group of shareholders control or ownership of one business.

17. Sidney L. Olson, 48 T.C. 855 (1967).

18. The Commissioner also argued that the transfer of the Buffalo shares to trusts for the stockholders' wives coupled with the fact that Buffalo first began paying dividends in 1960 indicated this was a plan to avoid tax on the dividends by shifting income to the trusts. The Tax Court disposed of this contention, holding that section 355(a)(1)(B) provides that a subsequent sale of the stock, which is not agreed to before the distribution, does not destroy the tax free nature of the transaction. Besides, the statute contains no such limitation on transfers of stock to a trust. The Court added that, even if these restrictions applied, here the taxpayers would prevail since there was no evidence of a prior agreement. Sidney L. Olson, 48 T.C. 855 (1967).

19. Albert W. Badanes, 39 T.C. 410, 415 (1962), *petition for review dismissed* (6th

avoidance of conflicts between Cleveland and its employees and the possible spread of these difficulties to Buffalo and its employees constituted a valid business purpose for the distribution.[20]

The result would seem to be in accord with the intent of Congress in enacting section 355. As Congress felt it was "economically unsound to impede spin-offs *when undertaken for legitimate business purposes*," [21] tax-exempt treatment should be given when such a "legitimate business purpose" is shown. Furthermore, both Government and business favor the separation of large concerns into smaller units when done for a valid business purpose.[22] True, the Government, as well as most taxpayers for that matter, is opposed to tax avoidance,[23] but conflicts of these interests can best be met by a close scrutiny of the business reasons behind the transaction, provided the literal requirements of the statute are met. Where, as in *Olson*, these requirements are met, regard should be given to congressional intent and the gain should not be recognized.

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Cir. 1963). *Cf.* Edmund P. Coady, 33 T.C. 771 (1960), *aff'd* 289 F.2d 490 (6th Cir. 1961); W.E. Gabriel Fabrication Co., 42 T.C. 545 (1964). *See also* B. BITTKER & J. EUSTICE, *supra* note 1, at 484; Rev. Rul. 59-197, 1959-1 CUM. BULL. 77.

20. Sidney L. Olson, 48 T.C. 855 (1967).

21. S. REP. No. 781, 82d Cong., 1st Sess., 58 (1951) (Emphasis added). It is to be noted that, had this been considered an unfair labor practice, the result could have gone the other way on the basis that it would be against public policy to allow this to constitute a valid business purpose. But this would not necessarily be so since "the federal income tax is a tax on net income, not a sanction against wrongdoing." Commissioner v. Tellier, 383 U.S. 687 (1966). In this regard, *see also* 50 CONG. REC. 3849 (1913) as to congressional intent in the first income tax bill. *But see* 4A MERTENS, *supra* note 3, §§ 25.49ff.

22. Helvering v. Gregory, 69 F.2d 809, 811 (2d Cir. 1934). *See generally* B. BITTKER & J. EUSTICE, *supra* note 1, §§ 11.02, 12.01; 3 MERTENS, *supra* note 3, § 20.101.

23. *See* Gregory v. Helvering, 293 U.S. 465 (1935); INT. REV. CODE OF 1954, § 355(a)(1)(B); 3 MERTENS, *supra* note 3, § 20.103.