

1973

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George J. Rabil

Repository Citation

Rabil, George J., "Disposition of Unwanted Assets" (1973). *William & Mary Annual Tax Conference*. 441.
<https://scholarship.law.wm.edu/tax/441>

DISPOSITION OF UNWANTED ASSETS
GEORGE J. RABIL, ESQUIRE¹

Frequently tax men are confronted with the challenging circumstances of shareholders wanting to dispose of some but not all of the assets held by their controlled corporation. A typical circumstance would be where a shareholder's controlled ABLE Corporation successfully operates two separate and profitable businesses, a trucking business desired by an OUTSIDER Corporation and a garbage business unwanted by the OUTSIDER. The fundamental problem is how to effect the disposition of the wanted trucking business with the most favorable tax consequences to the shareholders and his controlled corporation.

In such situations, the shareholder's ABLE stock is highly appreciated and ABLE's assets in both trucking and garbage businesses are also highly appreciated and ABLE has substantial earnings and profits. Also, assume that the OUTSIDER Corporation does not want ABLE's garbage business nor its garbage business assets for various reasons, such as prohibitions under state law. This basic fact circumstance will be followed throughout my discussions.

The simple fact circumstance unfortunately leads us into some of the most complex and intricate provisions of the entire Internal Revenue Code.

Generally, realized gain upon corporate divisions and unifications at the shareholder level is not required to be recognized for Federal income tax purposes provided there is compliance with the applicable statutory and judicial rules. Here we will discuss § 355,² dealing with nonrecognition at the shareholder level of gain from certain distributions and exchanges in divisive reorganizations; § 346, which provides for capital gains treatment of distributions in partial liquidation to shareholders; and

¹ The opinions expressed are those of the writer and do not necessarily represent the position of the Treasury Department or the Internal Revenue Service. The branch office that he heads has submitted cases to the United States Tax Court in which positions have been taken under some of the Code sections discussed and therefore his opinions may not be completely unbiased.

² All code references are to the *Int. Rev. Code* of 1954 (hereinafter sometimes referred to as *Code* of 1954) unless otherwise indicated.

some of the requirements of these two sections which may be considered interlacing statutes insofar as there are common definitional requirements.

§ 355 of the Internal Revenue Code of 1954 is frequently used to implement a hoped-for tax-free separation of unwanted assets into either an existing or newly created controlled corporation, which we will call BAKER Corporation. This corporate division may be a preliminary step to a unifying reorganization. Although § 355 recognized that corporate divisions are desirable in the American economic system when used to achieve proper business purposes, such divisions are subject to abuse. Therefore, while providing for nonrecognition of gain upon the distribution of stock of a controlled corporation, certain safeguards, both legislative and judicial, have been imposed against use of the provision to distribute corporate earnings to shareholders.

The three most frequently used methods by which a true divisive reorganization is consummated have acquired the labels, (1) "split-up", (2) "split-off", and (3) "spin-off".

(1) A "split-up" occurs when ABLE transfers all of its assets to two or more new corporations (BAKER and CHARLIE) in exchange for the BAKER's and CHARLIE's stock or securities. Thereafter, ABLE transfers its BAKER and CHARLIE stock or securities to shareholders or security holders in exchange for retirement of its own stock or securities, and then dissolves. The result is the disappearance of ABLE and its shareholders or security holders become separate shareholders or security holders of the new BAKER and CHARLIE corporation.

(2) In a "split-off" ABLE transfers part of its assets to BAKER and ABLE's stockholders exchange part of their ABLE securities for BAKER's stock or securities. Thereafter, both ABLE and BAKER continue operations.

(3) In a "spin-off", as with the split-off, ABLE similarly transfers only part of its assets to BAKER. However, in a spin-off, ABLE's stockholders or security holders, while receiving BAKER stock, do not relinquish any of their ABLE stock.

Hereafter, reference to any of the divisive reorganizations shall sometimes be referred to as a "spin-off", since under present law the technical difference between the various forms

are not prejudicial to the outcome and do not warrant elaboration.

§ 355 permits tax-free distribution by the corporation of stock or securities in another corporation if certain conditions are met:

1. *Control*

ABLE must, immediately before the distribution of BAKER stock, control BAKER.³ Control is defined in Code § 368(c) as 80 percent of the total combined voting power of the transferee's stock and 80 percent of the total number of other shares outstanding.

Simply in attempting to separate its unwanted garbage business into BAKER, ABLE must control at least 80 percent of BAKER's stock at the time of the transfer. If in creating BAKER ABLE joined other unrelated incorporators in excess of 20 percent, ABLE would not be in "control" of the newly created subsidiary and ABLE's shareholder would be ineligible for nonrecognition in the gain resulting from their eventual receipt of BAKER stock. ABLE's stockholder's gain may be recognizable as a redemption essentially equivalent to a dividend. Even worse, under § 311(d) it would seem that ABLE would also be required to recognize gain on the distribution in redemption of its appreciated BAKER stock.

Suppose the BAKER subsidiary was already in existence and already separately operating the garbage business, but only 70 percent owned by ABLE. Can we still use a § 355 spin-off? If valid business reasons justify a recapitalization whereby prior to the BAKER spin-off ABLE becomes an 80 percent stockholder of BAKER under appropriate circumstances where the recapitalization is a permanent realignment and not merely transitory or illusory, ABLE's newly acquired "control" may be honored for the purpose of satisfying § 355 control requirements.⁴

2. *Objective requirement that "all" stock and securities in the controlled corporation be distributed.*

As a general rule a qualifying distribution must include

³ Code of 1954, Sec. 355(a)(1)(A).

⁴ Rev. Rul. 69-407, 1969-2 C.B. 51. *But see* Rev. Rul. 63-260, 1963-2 C.B., 147 where it was held that Sec. 355 of the Code cannot be made to apply to a capital contribution made solely in attempting to qualify the transaction as nontaxable.

“all” of the stock and securities owned by the ABLE Corporation in the BAKER Corporation. This objective-type requirement was undoubtedly designed to disqualify piecemeal distributions.⁵

While §355 permits a distribution of less than all of ABLE’s stock and securities in BAKER Corporation upon proof that the distribution was “not in pursuance of a plan having as one of its principle purposes the avoidance of Federal income tax . . .”, ABLE must, nevertheless, distribute at least an amount of stock equal to “control” over BAKER.⁶ Permission to retain stock in excess of the amount required for “control”, upon proof of what is essentially equivalent to business need, was probably dictated by a desire to accommodate situations where, for example, some stock had to be retained to meet outstanding stock options or stock conversion rights. If ABLE owned only the amount of BAKER stock required by the requisite control test of §368(c), then, of course, the entire amount must be distributed even under the so-called exception.

Many years before so many detailed safeguards were expressly incorporated in the *Code*, the Supreme Court in the *Gregory* case⁷ considered the tax effect of an alleged divisive “reorganization” involving a sole stockholder who, desiring to obtain the investment portfolio of ABLE, arranged for ABLE to transfer just its stock investments to BAKER in return for BAKER’s stock. ABLE—as a second step—immediately distributed the stock of BAKER to its sole stockholder who, in a third step, immediately liquidated BAKER, thereby obtaining the portfolio in which he was interested. Today, of course, the “active-trades-or-businesses” requirement in §355 (a)(1)(c) would have prevented the second step from qualifying under §355. But in that earlier day the first two steps did literally satisfy the earlier statutory counterpart of the present day “D-type” reorganization. The Supreme Court, however, denied the taxpayer’s claim for nonrecognition of the second step and the complementary argument that only the third step constituted a taxable event at capital gain rates (complete liquidation), saying:⁸

⁵ *Code* of 1954, Sec. 355(a)(1)(D).

⁶ *Code* of 1954, Sec. 355(a)(1)(D)(ii)

⁷ *Gregory v. Helvering*, 293 U.S. 465 (1935)

⁸ *Id* at 469.

“ . . . Putting aside, then, the question of motive in respect of taxation altogether, and fixing the character of the proceeding by what actually occurred, what do we find? Simply an operation having no business or corporate purpose—a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganize a business or any part of a business, but to transfer a parcel of corporate shares to the petitioner. No doubt, a new and valid corporation was created. But that corporation was nothing more than a contrivance to the end last described. It was brought into existence for no other purpose; it was performed, as it was intended from the beginning it should perform, no other function. When that limited function had been exercised, it immediately was put to death.”

In *Commissioner v. Marine S. Wilson*, 353 F.2d 184 (9th Cir., 1965),⁹ the Circuit Court accepted the Tax Court's findings that a spin-off was not motivated by tax avoidance purposes. However, it held that the provisions of § 355 were not satisfied since there was no valid business purpose for the transaction.

It is noted that a “business purpose” requirement was imposed as a matter of judicial gloss wholly apart from § 355 on what is now § 368(a)(1)(D)'s definition of a “D-type” reorganization and that in the *Wilson* case there was an absence of a business purpose which was proved by the fact that the new corporation was created solely for the purpose of being liquidated, not for the purpose of carrying on business.

As applied in the *Wilson* case, the business purpose requirement of a reorganization actually overlapped a second judicially conceived component attributed to the definition of a “reorganization” itself, namely, that the old stockholders must have intended to retain a “substantial” proprietary stock interest in the new corporation. This rule, generally characterized in part as the “continuity-of-interest” requirement, would have been violated in the previous case, because the principal stockholder

⁹ 353 F.2d 184 (9th Cir., 1965) *rev'g* *Marne S. Wilson* 42 T.C. 914 (1964).

did not intend to retain any such substantial interest.

Of course if the division is effected for a business purpose and if the shareholders did intend to retain a substantial proprietary stake, the fact that—in the years following the reorganization—they decided to sell their interest in one of the corporations will not void the nonrecognition enjoyed earlier at the point of the reorganization. But see *May B. Kass*,¹⁰ where failure to satisfy the judicial continuity of interest doctrine spoils the nonrecognition effect of even a statutory merger in form. Even if all other requirements of §355 are met, failure to meet the business purpose and continuity of interest tests may deprive the shareholder of nonrecognition benefits.

Both of the two previously described doctrines are presently reflected in the interpretation accorded by the regulations to the meaning of the word “reorganization”.

§ 1.368-1(b) and (c), Treas. Regs. (1954) provides that:¹¹

(b) . . . The purpose of the reorganization provisions of the Internal Revenue Code is to except from the General rule certain specifically described exchanges incident to such readjustments of corporate structures made in one of the particular ways specified in the Code, as are required by business exigencies and which effect only a readjustment of continuing interest in property under modified corporate forms. Requisite to a reorganization under the Code are a continuity of the business enterprise under the modified corporate form, and . . . a continuity of interest therein on the part of those persons who, directly or indirectly, were the owners of the enterprise prior to the reorganization . . . In order to exclude transactions not intended to be included, the specifications of the reorganization provisions of the law are precise. Both the terms of the specifications and their underlying assumptions and purposes must be satisfied in order to entitle the taxpayer to the benefit of the exception from the general rule . . .

(c) . . . Such transaction and such acts must be an

¹⁰ 60 T.C. 218 (1973).

¹¹ Treas. Reg. Sec. 1.368-1(b) and (c).

ordinary and necessary incident of the conduct of the enterprise and must provide for a continuation of the enterprise. A scheme, which involves an abrupt departure from normal reorganization procedure in connection with a transaction on which the imposition of tax is imminent, such as a mere device that puts on the form of a corporate reorganization as a disguise for concealing its real character, and the object and accomplishment of which is the consummation of a preconceived plan having no business or corporate purpose, is not a plan of reorganization.

3. *Postdistribution requirements as to active business.*

In the case of spin-off or split-off, both ABLE and BAKER must be engaged in the active conduct of a trade or business immediately after the distribution. In the case of a split-up, (where both of ABLE's businesses are transferred to two separate corporations, BAKER and CHARLIE) BAKER and CHARLIE must be engaged in the active conduct of a trade or business immediately after the distribution.¹²

The first question to be determined under the active business requirement is whether the activities separated and the activities retained will each constitute an active business. In resolving this question, the following general rules are applicable:

Treas. Regs. §1.355-1(c), provides: a trade or business consists of a specific existing group of activities being carried on for the purpose of earning income or profit from only such group of activities, and the activities included in such group must include every operation which forms a part of, or a step in, the process of earning income or profit from such group. Such group of activities ordinarily must include the collection of income and the payment of expenses. It does not include—

1. The holding for investment purposes of stock, securities, land . . . ,
2. The ownership . . . of land . . . occupied by the owner in the operation of a trade or . . .
3. A group of activities which, while a part of a

¹² Code of 1954, Sec. 355(b)(1).

business operated for profit, are not themselves independently producing income . . .

The regulations include a host of examples implementing the foregoing rules. Some of these are reflected in the following examples.

Instead of being in the trucking and garbage business, ABLE is engaged in the business of manufacturing and selling hats in its own factory building. ABLE proposes to transfer the factory building to BAKER and distribute BAKER stock to ABLE's shareholders. ABLE's activities in connection with the manufacturing of hats constitute a trade or business, but BAKER's operation of the factory building does not.¹³

ABLE, a bank, owns an eleven-story downtown office building, the ground floor of which is occupied by it in the conduct of its banking business and the remaining ten floors are rented, managed and maintained by ABLE's real estate department. ABLE proposes to transfer its building to BAKER and distribute BAKER's stock to the shareholders. ABLE's activities in connection with banking, constitute a trade or business as do also BAKER's activities in connection with the rental of the building.¹⁴

On the other hand, if ABLE held investment securities, mineral rights, vacant land, or research and selling departments, the activities would not constitute separate trades or businesses.¹⁵

In *Isabel A. Elliott*,¹⁶ ABLE owned a two-story house with caretakers' quarters and a carriage house, one half of which it occupied and the balance it "made available for rent to various tenants". The Tax Court held ABLE was not actively conducting a rental real estate business where its gross income from rentals was merely incidental to its principal business. There was no evidence from which a conclusion could be drawn that ABLE would have operated rental property had it not also been used for the main business. There was no evidence of any specific activity on the part of ABLE's management in renting the unoccupied portion of the property, or of any other rental

¹³ Treas. Reg. Sec. 1.355-1(d), Example (2).

¹⁴ *Id.*, Example (3).

¹⁵ Treas. Reg. Sec. 1.355-1(c)(1).

¹⁶ 32 T.C. 283 (1959).

activity. Consequently, before partially owner-occupied real estate, or possible even other rental real estate, may be spun-off successfully, it must be established that the holding of the property and activities associated with it was more than incidental to the principal corporate business—that such holding was a corporate business activity in itself.

The Second Circuit has noted the particularly “careful scrutiny” that must be anticipated when the property sought to be spun-off is real estate. It observed: “The possibility of the shareholders abstracting accumulated earnings at capital gains rates is present whenever a corporation owns its own factory or office building.”¹⁷

In Rev. Rul. 58-54,¹⁸ it was stated that “the operation of the same type business in different states and localities is considered a separate business in each area only if they are independent of each other.” But the Tax Court, in *H. Grady Lester, Jr.*, held that ABLE was engaged in two separate businesses—the warehouse distribution business and the business of selling to dealers as a jobber—where the only essential difference between the two was the matter of who the customers were. BAKER was incorporated for the specific purpose of carrying on the active business which had theretofore been carried on for more than five years as a division of ABLE, and the respondent’s regulations indicate that in such circumstance, BAKER is entitled to have the benefit of the 5-year active business experience of the pre-existing division.

As previously mentioned, § 355(b)(1)(A) requires that both be engaged “immediately after” the distribution in the “active conduct of a trade or business . . .” However, an exception was made to this rule in § 355(b)(1)(B) to accommodate a “split-up”. In this circumstance, ABLE may transfer both active businesses to two newly created subsidiaries, BAKER and CHARLIE, and ABLE will be excused from being required to further carry on an active trade or business. Typically, in this circumstance, ABLE would dissolve.

4. *Predistribution requirements as to active business.*

¹⁷ *Bonsall v. Comm.*, 317 F.2d 61 (2d Cir., 1963) *aff'g* Henry H. Bonsall, Jr., 21 CCH T.C. Mem. Sec. 820 (1962).

¹⁸ 1958 - 1 C.B. 181.

¹⁹ 40 T.C. 947 (1963) *acq.* 1964-2 C.B. 3.

It is not enough that ABLE was engaged in operating two separate trades or businesses, but ABLE is required to have operated its separate businesses—or as explained below its single business—for at least five years prior to the spin-off or have acquired the businesses in a non-taxable transaction which did not involve ABLE's acquiring control of another corporation in a taxable transaction during the five-year period.²⁰ The purpose of this mechanical five-year rule was designed to prevent the use of corporate divisions as a device for paying out disguised dividends in the form of artificially created stock distributions.

In *Coady*,²¹ ABLE operated a construction business involving two major construction contracts. Because of the five year rule, the government argued that only one business pre-existed for five years and not two businesses. The Tax Court and the Sixth Circuit ruled in favor of the taxpayer. The Internal Revenue Service first nonacquiesced in the *Coady* decision, but it will now follow *Coady* and the similar *Marett*²² case "to the extent that they hold that § 1.355-1(a) of the Income Tax Regulations, providing that § 355 of the Code does not apply to the division of a single business, is invalid".²³

In *Joseph V. Rafferty*,²⁴ BAKER leased business property to ABLE (its parent) for the requisite five year period. However, the Tax Court held the spin-off of BAKER did not qualify under § 355 because the leasing operation was not an active business in spite of the five year seasoning. On appeal, the First Circuit relied on the Tax Court's reasoning as alternative grounds, but principally determined the spin-off was potentially a device to siphon off ABLE's earnings through the distribution of BAKER stock, and therefore, the transaction was not entitled to § 355 nonrecognition.

As spelled out in current regulations,²⁵ § 355(b) was designed to prevent use of the section to make a tax-free disposition of so-called passive assets, or as the Tax Court

²⁰ Code of 1954, Secs. 355(b)(1)(A), (B), (C), & (D).

²¹ 33 T.C. 771 (1960) *aff'd* 289 F.2d 490 (6th Cir., 1961).

²² 63-2 U.S. Tax Cas. ¶9567 (N.D. Ga., 1962), *aff'd* F.2d 28 (5th Cir., 1963).

²³ Rev. Rul. 64-147, 1964-1 C.B. 136.

²⁴ 55 T.C. 490 (1970) *aff'd* 452 F.2d 767 (1st Cir., 1971).

²⁵ Treas. Reg. 1.355-1(c).

in *Coady* observed in dicta, "to prevent the tax-free separation of active and inactive assets into active and inactive corporate entities". Consequently, if the unwanted assets are investment properties, § 355 will not be available to provide nonrecognition.

The previously discussed examples in the regulations still have vitality in holding investment securities, dormant mineral rights, and vacant land as not constituting a business or the active conduct of a business. Nothing in *Coady*, *Rafferty*, or *Marett* offset these underlying principles.

5. *Device for distributing earnings and profits.* The previously discussed *Rafferty* opinion introduced the final requirement of § 355; namely, that the spin-off not be a device for distributing earnings and profits. § 355(a)(1)(B) contains two general notions:

- (1) That the transaction must not have been used principally as a device for the distribution of ABLE's and BAKER's earnings and profits, or both; and
- (2) That there may be a negative inference that the transaction is used as a device where the subsequent sale or exchange was either "agreed to", or "negotiated" in advance of the spin-off.

Before discussing the intricacies of the impermissible § 355 dividend bail-out device, it is meaningful to interrelate the companion provisions arising under § 346 partial liquidations.

To understand partial liquidations, suppose a shareholder desired directly to exchange a proportion of his ABLE stock for the wanted business assets and pay capital gains tax on the resulting gain. This circumstance may be motivated by OUTSIDER's desire to avoid acquiring the headaches and tax problems of someone else's corporation. § 346 generally provides for capital gains treatment but with many of the same problems appearing under our previous § 355 discussions.

Before the adoption of the 1954 *Code*, the conceptual difference, for tax purposes, between an ordinary redemption and a partial liquidation was obscured by the fact that, in determining the tax effects of the two arrangements to shareholders, one looked to the same statutory provision, indeed, to

a common statutory formula. In general, relinquishment of stock either by way of mere redemption or in connection with a partial liquidation was deemed an "exchange", thus qualifying the typical shareholder for capital gain or loss treatment provided that the transaction—which was then, as it is today, a distribution—was not essentially equivalent to a dividend, insofar as the shareholder was concerned, or did not involve a contraction of operations at the corporate level. But these tests, which were developed by the judiciary with scant legislative direction, were somewhat blurred in actual application and it became apparent that there was need for clarity as to whether the tests for exchange treatment would turn on what had occurred at the corporate level, or what had occurred at the shareholder level.

In 1954, Congress classified the two concepts under separate provisions of the Code and sought simultaneously to sharpen the distinction between the two ideas. The question of whether a stockholder would obtain true "exchange" treatment on relinquishing stock for corporate assets turned on the effect of that transaction at the shareholder level.²⁶

When a distribution meets the requirements of both § 302(b) (redemption) and § 346(b) (partial liquidation), partial liquidation is controlling.²⁷ The 1969 Amendments to § 311(d) imposing gain on ABLE's distribution of appreciated assets in redemption of its stock but not in partial or complete liquidation or in a § 355²⁸ spin-off, adds new tax stakes to these transactions.

"Partial liquidation" in § 346 includes three alternative tests which are to be used to determine whether relinquishment of stock for corporate assets qualifies as a true "partial liquidation". § 346 (a) provides that a distribution is a partial liquidation if it is one of a series of distributions in redemption of all of ABLE stock pursuant to a plan. Gain will not be recognized to the shareholder until the amount received exceeds the shareholder's basis in the stock.

In a true partial liquidation, as opposed to a complete liquidation, care must be taken to assure that the true amount of gain

²⁶ S. Rep. No-1622, 83rd Cong. 2d sess., p. 49.

²⁷ Treas. Regs., Sec. 1.346-2.

²⁸ Code of 1954, Sec. 355.

or loss is attributed to each distribution. In other words, the precise number of ABLE's shares which stockholders may choose to turn in at any one time is not the determinative factor.

The second principle under which the shareholder might qualify a redemption as a exchange in partial liquidation provides that the redemption of part of the stock must meet three requirements: (1) it must have been pursuant to a plan,²⁹ (2) it must occur within the taxable year in which the plan was adopted or within the succeeding taxable year,³⁰ and (3) it must not be essentially equivalent to a dividend. With respect to the first requirement it is sufficient if ABLE adopts, formally or informally, a plan which as a matter of fact shows itself to constitute a plan of complete liquidation or redemption of a part of the stock of the corporation if the other criteria of § 346(a)(2) are met.³¹

The third requirement in § 346(a)(2), to the effect that the redemption be not essentially equivalent to a dividend, is understandable only when considered in the context of Pre-1954 Code Developments. § 346(b) contains a five year historical test which is intended to exclude from the benefits of this provision those corporations which engage in an artificially conceived contraction only for tax avoidance purposes. This section permits only the distribution of a five year or older business which was not acquired by ABLE within the five year period by a taxable exchange. Thus, if within five years prior to the partial liquidation ABLE bought an already existing five year old business, partial liquidation treatment would not be available when the business assets are exchanged with shareholders in surrender of a porportion of his ABLE stock.

The five year historical test will give rise to some degree of uncertainty because the character of the business to be terminated may have changed in one way or another during the preceding five years. The change may be in terms of size, such as where cash was used during that five year period to permit an increase in inventories.

²⁹ Code of 1954, Sec. 346(a)(2).

³⁰ *Id.*

³¹ Fowler Hosiery Company, 36 T.C. 201 (1961) *aff'd* 301 F.2d 394 (7th Cir., 1962).

In addition to the five year historical test under § 346(b)(1), § 346(b)(2) requires that ABLE itself continue to be actively engaged in the conduct of a trade or business “immediately after” its partial liquidating distribution. For the purpose of resolving questions relating to the meaning of “active” business, the regulations interpreting § 346(b) interrelate with the previously discussed regulations under § 355.³²

As an alternative to meeting the technical five year requirements, partial liquidation treatment is still available if the distribution is not “essentially equivalent to a dividend”. But this nebulous test is difficult to meet, and failing to meet the more objective tests of § 346 might raise a negative implication that the distribution was essentially equivalent to a dividend and not motivated by innocent business purposes.

In Rev. Rul. 57-33,³³ it was held that ABLE’s distribution of land to shareholders did not qualify as a distribution in partial liquidation under § 346(a)(2). The ruling was based on the fact that the amount realized from the rental of the land was only a nominal portion of ABLE’s gross profits, and ABLE’s activities with respect to the land were only incidental to its food brokerage business. Therefore, the separate trade or business requirement was not satisfied, and the distribution was considered “essentially equivalent to a dividend”.

From the foregoing it can be seen that when OUTSIDER is interested in acquiring some but not all of ABLE’s assets, it is first necessary to ascertain whether ABLE’s assets are of a type which can be separated in a manner that will result in compliance with active business history requirements, either under the capital gain provisions of § 346 or the nonrecognition provisions of § 355.

In Rev. Rul. 55-103³⁴ ABLE operated only its trucking business and its garbage business had already been transferred to BAKER. OUTSIDER wanted ABLE’s trucking business but not BAKER’s stock or BAKER’s garbage business. Accordingly, BAKER’s stock was preliminarily spun-off to shareholder and then shareholder sold his ABLE stock to OUTSIDER. The ruling held the presence of the preliminary negotiation with

³² Treas. Reg., Sec. 1.346-1(c).

³³ 1957-2 C.B. 239.

³⁴ 1955-1 C.B. 31.

OUTSIDER evidenced the existence of the fatal and impermissible device to distribute earnings and profits. The purpose of §355 is to effect readjustments of continuing interest in business under modified corporate forms.

The fatal "device" found under §355 is similar to the dividend equivalence under §346. Suppose shareholder seeks to avoid the §355 device inhibition by causing ABLE to liquidate BAKER under §332 and then partially liquidate by distributing the assets of the garbage business directly to shareholder. This apparent circumvention should offer little comfort to shareholder because of the "not essentially equivalent to a dividend" test under §346.

Moreover, under §311(d)³⁵ ABLE may experience gain on the distribution of its appreciated asset in partial liquidation, as well as dividends on its shareholder, where a sale of the assets to OUTSIDER is prearranged. Support for this may be (1) expectation of sale doctrine, and (2) the Court Holding Company doctrine. The recent *Peeler Realty*³⁶ case discussed the latter doctrine.

If shareholder must sell or desires to sell the assets of the wanted trucking business to OUTSIDER, serious problems exist both under the §355 "dividend device" restriction and the §346 "dividend equivalent" test. Could shareholder find safety in avoiding a subsequent sale of the wanted assets or the stock in the wanted corporation and propose a corporate reorganization? Suppose shareholder, without creating BAKER, proposed to exchange ABLE's trucking business with OUTSIDER solely for common stock. This transaction would fit the classic "C" reorganization pattern, but fail to qualify because less than substantially all of ABLE's assets are being transferred as required.

Again, suppose in order to satisfy the "substantially all" requirements of a "C" reorganization ABLE initially spins off unwanted assets into BAKER so that all remaining assets can be entirely exchanged solely for OUTSIDER's stock. These latter facts are essentially the *Elkhorn Coal*³⁷ case where the court collapsed the steps into one transaction, that is, a non-qualified

³⁵ Code of 1954, Sec. 311(d).

³⁶ 60 T.C. No. 74 (1973).

³⁷ *Helvering v. Elkhorn Coal Co.*, 95 F.2d 732 (4th Cir., 1937).

“C” reorganization. Although *Elkhorn* would seem to prevent the use of preliminary spin-offs as a device to circumvent the “substantially all” “C” reorganization requirement, taxpayers have been partially successful in using a follow-up “A” reorganization after the preliminary spin-off. At this point, the results in decided case lose symmetry. This is because the preliminary spin-off in *Elkhorn* was essential for the “C” reorganization and it also seems to be essential for the “A” reorganization in *Morris Trust*.³⁸ In *Morris Trust* the preliminary spin-off seemed to be essential to making available a statutory merger under Federal banking laws. However, a follow-up “A” reorganization was unsuccessful in the earlier *Curtis v. U.S.* case.³⁹

The *Mary Archer v. Morris Trust* case involved a spin-off which was a preliminary step to an “A” reorganization. In *Morris Trust*, ABLE spun-off its unwanted insurance business, retaining its state banking business, and then consolidated with another OUTSIDER (a national bank). The reorganized bank adopted a new banking name. The Government argued that ABLE’s shareholders failed to retain the requisite control after the integral step which culminated in the consolidation with OUTSIDER and that ABLE’s retained banking business was not engaged in the same business immediately after the intergal steps, due to the conversion of the state bank into a national bank and a change of its business name.

In sustaining the taxpayer, the Tax Court held that under the Banking Act.⁴⁰ both ABLE and BAKER continued in existence. The Fourth Circuit speaking through Judge Haynesworth, in *Morris Trust*, affirmed the Tax Court decision concluding that § 355(b)(1)(A)’s post-distribution of active business requirement should not be read literally and a determination of whether its requirements had been met should be made by viewing the situation existing “immediately after the distribution.” The court then stated, “the limitation so construed will not inhibit continued stockholder conduct of the active business through altered corporate form and with further changes in corporate structure, the very thing the reorganization

³⁸ 42 T.C. 779 (1964) *aff’d* 367 F.2d 794 (4th Cir., 1966).

³⁹ 215 F Supp. 855 (N.D. Ohio, 1963) *aff’d* 336 F.2d 714 (6th Cir., 1969).

⁴⁰ 42 T.C. 799 (1964).

section was intended to facilitate".⁴¹

The Commissioner, in Rev. Rul. 68-603,⁴² agreed to follow the decision in the *Morris* case to the extent that it held that (1) the active business requirements of § 355(b)(1)(A) were satisfied even though the distributing corporation immediately after the spin-off merged into another corporation, (2) the control requirement of § 368(a)(1)(D) implies no limitation upon a reorganization of the transferor corporation after the distribution of stock of the transferee corporation, and (3) there was a business purpose for the spin-off and merger.

The decision in *Morris* and the subsequent issuance of Rev. Rul. 68-603,⁴³ resulted in the rule that a reduction of assets through a spin-off, followed by a stock-for-stock exchange of the ABLE's stock for the OUTSIDER's stock as part of the same plan is held to be reorganization under § 368(a)(1)(B). ABLE had been engaged in the active conduct of two businesses (toy manufacturing and tool manufacturing) for over five years. OUTSIDER desired to acquire ABLE's tool manufacturing business but not the toy business. This was accomplished pursuant to a plan under which ABLE transferred its unwanted toy manufacturing business, representing 23 percent of its assets, to BAKER. BAKER's stock was distributed pro rata to ABLE's shareholders qualifying for non-recognition as a "D" reorganization (split-off) since the distribution of the BAKER stock met all of the requirements of § 355. OUTSIDER then acquired all of the outstanding stock of ABLE in exchange solely for OUTSIDER voting common stock. ABLE remained in existence as a wholly owned subsidiary. The ruling held that the exchange of ABLE's stock for OUTSIDER stock is a valid "B" reorganization. The unwanted BAKER stock previously distributed to the ABLE's shareholders was not considered "boot" received from OUTSIDER in connection with the exchange of ABLE stock for OUTSIDER stock.

Does it make any difference if the wanted trucking business is transferred to the newly created subsidiary BAKER and the

⁴¹ 367 F.2d 794, 799 (4th Cir., 1966).

⁴² 1968-2 C.B. 148.

⁴³ *Id.*

unwanted garbage business retained by ABLE? In either case, gain will not be initially recognized on the transfer of some assets from ABLE to BAKER, in exchange for BAKER stock under either § 351 or § 361, or both.

However, if the wanted trucking business is transferred to BAKER, and then BAKER stock is distributed to shareholder who sells his BAKER stock to OUTSIDER, § 351 may be violated since "immediately after" all of the integral steps, ABLE and its shareholder no longer control BAKER, since BAKER is now owned by OUTSIDER.

If instead of selling his BAKER stock to OUTSIDER, shareholder chooses to exchange his BAKER stock for a less than controlling interest in OUTSIDER, the same problem exists under § 361. After all of the integral steps shareholder and ABLE no longer control BAKER. The integrated steps fail to qualify for either a "B" or "D" reorganization. Rev. Rul. 70-225.⁴⁴ Under this Revenue Ruling, shareholder sustained a dividend from the receipt of BAKER stock.

In addition to failing to meet the control requirements of § 351 and § 361 and then losing the benefits of § 355, "shareholder's nonrecognition," ABLE may be required to recognize gain on the appreciation attributable to its distributed BAKER stock under § 311(d).

There seems to be no clear solution to effect transfer of assets at present from ABLE to OUTSIDER where all of ABLE's assets are not wanted. The elusive concepts of business purpose, continuity of interest and the technical schematic under §§ 355 and 368 have not been fully formulated. Neither *Morris Trust*, Rev. Ruls. 68-603, and 70-434 should be considered applicable to other factual circumstances without first obtaining an advance Revenue Ruling. If a nontaxable transfer is desired, reliance upon taxpayer victories, such as *Peeler Realty*,⁴⁵ is equally hazardous without first obtaining a ruling in advance of the stock sale. Who knows what subsequent significance may be later attributed to the important fact that in *Morris Trust*, the ABLE shareholder retained more than a 50 percent interest in OUTSIDER after the final reorganization? These and other questions must be continuously

⁴⁴ 1970-1 C.B. 80. See also Rev. Rul. 54-96, 1954-1 C.B. 111.

⁴⁵ *Peeler Realty Co., Inc.* 60 T.C. No. 74 (1973).

studied and where advance Revenue Rulings can be obtained, that procedure would seem to be the safest approach to these problems.