The Art of Regulation Drafting: Structured Discretionary Justice Under Section 355

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I. INTRODUCTION

A. Section 355 and a 25-Year Promise Fulfilled

The legislative treatment of corporate divisions has varied. Initially, they were included with the organization provisions, and the predecessor to present section 355 spawned Gregory v. Helvering. Although the government triumphed in the Gregory case, Congress thought Gregory was insufficient to protect the Federal fisc. Corporate divisions offered too great an opportunity for bailing out corporate earnings, and the tax-free blessing was withdrawn from them. This blanket consignment to tax purgatory, however, was argued to be too broad. By 1951, Congress was receptive to the notion that the good and the bad could be effectively distinguished, and corporate divisions were revived, but tax deferral was denied to transactions used principally as devices for the distribution of earnings and profits to shareholders.

In regulations issued in 1955, the Internal Revenue Service (IRS) drew the line mandated by Congress primarily by restricting corporate divisions to distributions of an entire business. Under these regulations, a corporate division also could effect a business division only by surrendering its tax-free status. In practice, the IRS relied on this active business requirement, but supplemented it with the argument that some distributions essentially were equivalent to a dividend and were, therefore, devices for a distribution of earnings and profits. The first prong of this two-part test did not fare well in the courts, and in 1964, after the courts had determined that a single business could be divided, the IRS announced that it would revise the regulations to permit the division of a single business.

The promise of revision was hailed by the tax bar, and advice that it be a complete overhaul of the existing regulations soon was abundant. Recognizing that any distribution necessarily produced a distribution of earnings, many commentators argued that the presence of a good business purpose should be sufficient to pass the tax deferral test. They also thought that less reliance should be placed on the definitional aspects of an active business. In short, they wanted less formality and more inquiry into the question of whether a given distribution could be supported by reasons other than the desire to reduce the barriers between the shareholder and realization of the corporate earnings.

Many commentators thought that less reliance should be placed on the definitional aspects of an active business.

Revision finally arrived a quarter of a century later, and the final regulations recently promulgated under section 355 largely accomplish these goals. These regulations give substantial guidance to the practitioner about whether a transaction complies with them. More importantly, they deal with the underlying policy and provide
A 'rule'... is ideally capable of generating precise and predictable answers.

A "rule," by contrast, is definitional. It is ideally capable of generating precise and predictable answers. The "active business" requirement of sections 355(a)(1)(C) and (b) is a rule, albeit vague. The underlying policy of the rule was prevention of a bailout, but the narrow definitions used in the 1955 regulations and amplifying rulings (particularly the long-discredited two-business requirement) were both under- and overinclusive, as rules are wont. For instance, pro rata divisions of two readily saleable active business entities easily could meet the Service's 1955 device and business purpose test. However, vertical and functional divisions failed the test that there be two active pre-distribution businesses. This was a failure of policy, at least in the case of non pro rata separations. In general, Professor Kennedy believes that the advantages of rules are (1) the restraint of arbitrariness by the decision maker, and (2) the attainment of certainty or predictability. A cost, however, is the inability to prescribe rules which will accurately achieve the underlying policy objectives. Standards are more adaptable to policy goals. Standards also differ from rules in that the former's greater generality is an attempt to deal with as many different potential fact patterns as practicable. According to jurisprudential thinking, generality increase the number of occasions of lawmaking by the administrative agency, rather than the legislature. The irony, as Whitman's classic article reveals, is that the probable legislative goal of the device restriction (originally enacted in 1951 as part of the 1939 Code predecessor of section 355) was to decrease judicial intervention and possibly administrative discretion as well.

Conversely, jurisprudential scholarship observes that generally, detailed legislation decreases the discretion of the decision maker. This theory may be accurate when applied to judges who follow the rules in deciding tax cases (but not so much as to courts that fashion new standards to overcome the rules as witnessed, for instance, by the cases forcing ways around the no deduction of start-up costs rule). However, detailed regulations promulgated by an administrative agency increase the principled discretion of the agency as a decision maker, according to Professor Davis and subsequent administrative law scholarship. "Structured discretion" serves public policy where rulemaking by the agency (here in the form of IRS private letter rulings) is routinely, if not commonly, sought by the citizen. Empirical knowledge about the proportion of corporate divisions in which private letter rulings are sought, and the proportion

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1Id. at 1689.
2Id. at 1689.
4Kennedy, supra note 1, at 1690. See Gregory v. Commissioner, 27 B.T.A. 223, 225 (1932), rev'd, 68 F.2d 809 (2d Cir. 1934), aff'd, 293 U.S. 465 (1935) ("A statute so meticulously drafted must be interpreted as a literal expression of tax policy, and leaves only the small interstices for judicial consideration"). The Second Circuit formulated the opposing force to literalism of a broad, free-standing judicial standard—business purpose.
7Whitman, supra, note 8, at 1249 ("the practice generally is to get advance rulings" as to corporate separations). In a telephone conversation shortly after the 1989 revisions, an attorney in one of the corporate divisions of the Office of Chief Counsel informed me that currently over 50 percent of the "inventory" of private letter rulings in the corporate reorganization area involved proposed corporate divisions. According to the attorney, a substantial number of these ruling requests involve public companies, which I suspect are positioning themselves after a two- to three-year wait to unwind the results of '60s diversification without triggering inside taxation as to appreciation. The attorney also suspected that many of the section 355 transactions undertaken to shrink companies in order to elect subchapter S during the pre-1987 and 1987-88 transition periods did not request advance private letter rulings.
Behavior modification goals also may influence the policymaker choice between standards and rules. Rules may encourage the risk-taker to walk the line, while standards may discourage risk-taking by creating gray areas. In a world where a very low percentage of income tax returns are audited, however, gray areas apparently encourage more aggressive or perhaps just more ignorant behavior. Uncertainty encourages playing the audit lottery and also creates traps for the unwary. The policy choice may not have to be between rules and standards. Rules may be combined with standards, as in cases where “safe harbors” are allowed despite the use of a facts-and-circumstances test as the underlying standard. Some tax commentators advocated this format as providing certainty for generalists who could read the Code, combined with “an area for those who want to venture into it where, if you really understand the cases, you can advise your client intelligently.”

Conventional jurisprudential wisdom, especially according to Professor Kennedy, also holds that rules and standards tend to shade into each other. For instance, a standard may be implemented by a number of per se regulations is inculcated. The resulting statute and implementing regulations can be handled only by specialists. Such statutes and regulations may be appropriate where high bracket taxpayers have knowingly entered the “thicket.” see “Hearings on Tax Shelters, Accounting Abuses, and Corporate and Securities Reform,” before the House Ways and Means Comm., 98th Cong., 2d Sess. 32-33 (1984) (colloquy between Rep. Don Pease and Assistant Secretary for Tax Policy John (“Buck”) Chapoton), reprinted in 6 “A Legislative History of the Tax Reform Act of 1984” (Bernard D. Reams, Jr., J.D., Ph.D., Ed. 1985) (“Tax Reform 1984”).

Mr. Chapoton. Unquestionably...they will tend to complicate...That is why every attempt has been made particularly in the time value of money changes to provide exceptions so they do not apply to the everyday taxpayer in normal transactions and apply principally to large tax transactions, tax shelters, and otherwise, where very sophisticated planning is involved.

Mr. Pease. So in an effort to close off abusive tax shelters, we are going to further complicate a tax code many people feel is already too complicated.

Mr. Chapoton. I do not think we need to apologize when we complicate the tax code for very complicated transactions, and that is the intent here.

But I also believe that they are impractical where small taxpayers and less sophisticated advisers frequently dwell. As my colleague Alan Gunn observes, the divorce rules should not be overly detailed. See also Berman, “The Alimony Deduction: Time to Slaughter the Sacred Cow,” S. Amer. J. of Tax Policy 49, 59 (1986). See also note 18, infra.

“Again such overly complex, detailed provisions (whether statutory or regulatory, should not be used in the case of everyday transactions unless a two-tier tax regime (simple/complex) can be implemented. Alan Gunn points to the fiduciary income provisions, subchapter J. Similarly, the ill-fated 1964 House corporate provisions (subchapter C) and the equally ill-fated 1960 House-passed revised subchapter K distinguished between little and big taxpayers subject to their regimes. The 1980 Installment Sales Revision Act and accompanying regulations also more subtly distinguished between simple and complex provisions. Even the Subchapter S Revision Act in effect distinguishes sharply between “virgin” S corporations and S corporation converts (formerly C corporation or inheritor of C & P). My guess is none of the two-tier systems really work well or would have worked well. But the technique merits more thought.


rules, either in the statute or accompanying regulations or case law adjudication. Conversely, desiring to avoid injustice, decision makers may create so many exceptions that the rule becomes a standard in effect. Administrative law scholars, on the other hand, believe that agencies using structured discretion—for example, by issuing regulations (rule making) setting forth specific factors to be used in balancing tests implementing the desired standards and policies—can implement standards effectively while maintaining the bureaucrat’s discretion judgment in application. They believe that detailed rules useful in channeling agency exercise of discretion can be developed by first considering one problem at a time, then announcing the hypothetical cases as rulings and refraining from generalizing. General principles or standards can be divined from this experience. Later, the agency can formulate regulations to implement the standards in the form of structured discretion. In the tax law, rules and standards often conflict, both in the context of judicial review of agency discretion and especially in doctrinal areas.

The best policy usually is “to legislate broad frameworks for administrative policymaking.”

Tax theoreticians, including Harvard’s Professors Brown and Surrey, have debated for some time the advantages of generalized tax statutes, that is, standards, versus detailed, rule-oriented tax statutes. Writing under Professor Brown’s tutelage, Whittman called for a focus on the underlying policy (device) and would have diminished the role of the additional mechanical statutory detail of the active business test. Recently, the majority of students of taxation follow the Surrey school calling for a general tax statute that is implemented and amplified through indubitably detailed Treasury regulations. They prefer the greater flexibility of administratively amending regulations in light of developing administrative and judicial experience under the statute. Professor Davis agrees that the best policy usually is “to legislate broad frameworks for administrative policymaking.”

Under the Surrey approach, the role of courts in resolving the substance and form dichotomy in tax law is lessened. Section 355 does not fit this model. The First Circuit’s landmark opinion in Rafferty, incorporating Whitman’s vision, forms both the skeleton and much of the flesh of the “device” and “active business” portions of the long-awaited 1989 revisions. The general statute cum detailed regulations model closely parallels Professor Davis’ thinking about “discretionary justice” in administrative law and in particular his concept of “structured discretion.”

II. SECTION 355: FROM THERE TO HERE

A. The Statute

The history of section 355 itself, as ably traced by Whitman, plays out in microcosm the debates between standards and rules and about who is the proper actor for the development of the criteria—Congress, the courts, or the administrators. The reorganization provisions through the Revenue Act of 1921 followed the philosophy of general statutory principles with Treasury formulating specific rules. However, the first provisions explicitly

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27 See note 11, supra.
29 A rule may provide that at the right end the answer is always yes, and that at the left end the answer is always no; when it does that it confines discretion to the middle territory. But the rule may also structure the discretion in that middle territory. For instance, it may provide that in exercising discretion the agency must conform to the criteria. That much is a partial structuring of discretion. The rule also may state the result when the three factors pull together, but provide that the result will be worked out from case to case when the three pull against each other. Such a rule structures discretion, leaving many questions open. A rule which does not generalize but which gives illustrations may help structure discretion.
30 Davis, supra note 11, at 103.
32 See Davis, supra note 11, at 38.
33 Brown, supra note 11, at 38.
permitting tax-free corporate divisions, enacted in the Revenue Act of 1924, showed a reversed course under new tax statutes in Treasury. The advisers preferred minute articulation of the reorganization provisions with the avowed intention of providing predictability in all conceivable situations. 32

Nevertheless, Congress predictably 33 failed to anticipate the avoidance techniques or "mere devices" such as those employed by Mrs. Gregory to avoid dividend treatment on a distribution by her wholly owned corporation. Relying upon the corporate spin-off provisions introduced in 1924, she caused her wholly owned holding company to transfer shares in a publicly owned "target" subsidiary to a newly-formed wholly owned subsidiary which the holding company spun off to her three days later. Three days later, she liquidated the new subsidiary, obtaining a stepped-up basis at a capital gain rate in the shares, which she then sold to the buyer at no further gain. In 1932, the Board of Tax Appeals upheld Mrs. Gregory's scheme as a transaction clearly within the confines of the statutory language. 34

The Democratic Congress of 1933, generally unsympathetic to business problems, was "acutely hostile to tax avoidance schemes." 35 Resisting its first inclination to repeal the reorganization provisions in toto, 36 Congress in 1934 repealed only the spin-off provision and tightened up the definition of reorganizations in general.37 Split-ups still were permitted under that general reorganization definition.38 The Second Circuit in Helvering v. Gregory 39 contemporaneously reversed the Board's decision. The Supreme Court affirmed this reversal, finding no "business or corporate purpose" in the transaction, which was a "mere device," "a contrivance," and "an elaborate and devious form of conveyance masquerading as a corporate reorganization." 40 Thus, the courts had fashioned the "business purpose" standard which came to be applied in all reorganizations.

According to Whitman, during the years 1947 to 1951, manifest congressional antipathy to judicial innovations in the reorganization area was the impetus for the divisive reorganization provision's specific detailed rules. Congress acted with a view that courts would not add new conditions to the statute. 41 on the theory that detailed rules lessen the decision maker's discretion. Consequently, the 1951 predecessor of section 355 contained an active business requirement and a device restriction. The requirement of continued active conduct of a trade or business was designed to preclude a transitory business from qualifying for tax deferral. Arguably, the device clause was intended by Congress in 1951 (or at least by the House in 1948) to supersede judicial business purpose and continuity of interest doctrines, but this original intent was not to be fulfilled. 42

Manifest congressional antipathy to judicial innovations in the reorganization area was the impetus for the divisive reorganization provision's specific detailed rules.

The House draft of the 1954 Code proposed an exclusive asset characterization test for tax-free corporate separations. A 10-year ordinary income "taint" would be placed upon separated stock in an "inactive" corporation. To avoid this characterization, a separated corporation had (1) to have been engaged in an "active business" for five years prior to the separation, (2) to have maintained separate books from the retained business, and (3) to have passed an active business income test (not more than 20 percent passive income). 43 Because cautious Republicans still were in control of both Houses of Congress, 44 the Senate and Conference bills retained the 1951 format of not permitting tax-free separations of an existing corporation into active and inactive entities. The Senate criticized a 10-year taint as permitting "a person in a position to afford a 10-year delay in receiving income to do so at capital gain rather than dividend rates." 45

Section 355 of the 1954 Code requires (a) that the resulting corporations engage in the active conduct of a

32 Whitman, supra note 9, at 1198. See Hearings on H.R. 6715 before the Sen. Comm. on Finance, 68th Cong., 1st Sess. 7, 57 (1924) (statement of A.W. Gregg, Special Ass't to Treasury, "complications come primarily from a complicated policy," including reorganizations. "[T]he bill will cover a given case definitely and certainly. Under the existing law there are hundreds of cases where nobody knows the effect of the transaction upon the tax. This law is definite enough so that the taxpayers will be able to tell the effect of a given transaction. . . .") , reprinted in 2 1909-1950 Legislative Histories.

33 Brown, supra note 24, at 1619; Whitman, supra note 8, at 1198k and note 11, at 1200.


35 Whitman, supra note 9, at 1200.


38 See Treas. reg. 86, art. 112(g)-3 (1935), reprinted in 140 1909-1950 Legislative Histories; Spangler v. Commissioner, 18 T.C. 976 (1952).

39 69 F.2d 809 (2d Cir. 1934).

40 293 U.S. 465, 469-70 (1935).

41 Whitman, supra note 8, at 1203-03.

42 The business purpose and continuity of interest requirement have appeared in every version of the corporate division regulations from 1953 through 1989. Compare Treas. reg. 118, section 39.112(b)(11)-1(b) (1953), with revised Treas. reg. sections 1.355-2(b) and (c) (1989).


44 Former Commissioner Sheldon Cohen, who served as staff in the drafting of the 1954 Code, once told me that the Republican-controlled Senate Finance Committee rejected innovative and, hence, controversial approaches in 1954 because it feared they could drag the bill to the next term when the Democrats might gain control of the Senate and the Committee. See also Darrell, "Internal Revenue Code of 1954—A Striking Example of the Legislative Process in Action," 1955 So. Cal. Tax Inst. 1, 12-15. They did and the Republicans have never controlled both Houses of Congress since.

trade or business immediately after the division which business had not been acquired in a recognition transaction during a five-year lookback, and (b) that the transaction not have been used principally as a device for the distribution of earnings and profits. (The two other statutory requirements are not relevant to this article.) Congress enacted general requirements, but the active business clause was more definitional and the device clause more policy oriented.

B. The Regulatory Factors

1. Introduction

a. The Device Restriction. A common 1954 Code tax planning technique consisted of accumulating income inside a closely held corporation, and then bailing out that accumulation at shareholder-level capital gains rates with no further inside corporate tax on a liquidation governed by the General Utilities rule, or the death of the shareholder.66 This device was motivated by extremely high individual income tax rates, much lower corporate income tax rates, low capital gains rates, and the codified General Utilities rule. A witness at House Ways and Means Committee Chairman Wilbur Mills’ 1958 Hearings on General Revenue Revision stated that use of graduated brackets by close C corporations to retain earnings usually taxed at 30 to 45 percent of the maximum individual marginal rate rendered “[t]he high rates that our tax laws now have for individuals … simply a facade.”67 Treasury had suggested meeting this problem by taxing corporations as pass-through entities more than 40 years before.68

Section 355’s active business test and device restriction were designed to thwart a “bailout” through sale of accumulated assets held in a separate corporation by shareholders who continued to hold interests in the parent corporation with undiminished operating assets. Courts had fashioned the free-floating business purpose requirement in Gregory to thwart just this sort of attempted bailout. The Supreme Court also fashioned the “continuity of interest” doctrine, which requires a substantial continuation of equity interests in the post-reorganization corporation(s) by the historic pre-reorganization shareholders.69 Immediate sale of all of the stock in one of the post-division corporations, as in Gregory, also would violate this doctrine.

b. Evolution of Regulatory Approach. The section 355 regulations promulgated in 1955 relied primarily upon a definitional active business test to police potential bailouts, as manifested by its order in the regulations and comparative development of detail. They placed the device provision next and effectively limited it to (1) divisions of corporations with heavy concentrations of non-five-year active business assets and (2) post-division sales. The backstop to these requirements was the otherwise undefined general reorganization business purpose and continuity of interest requirements. The examples limited discussion to the active business requirement. Furthermore, many of the active business examples went beyond the generalization in text, thus often raising as many questions as they answered.50

The Tax Court in Coady71 invalidated the pre-division separate business requirement of the 1955 regulations as going beyond the purpose of the statute. Two circuits agreed,72 and the Service capitulated, promising to revise the regulations by eliminating the pre-division separate active business requirement.73 Whitman advocated restructuring the regulations by relying primarily on the device standard, without limiting gloses, while diminishing the importance of the active business, business purpose, and continuity of interest tests. He argued for permitting divisions of both functions of an integrated business (functional divisions) and branches or even components of a single business (vertical divisions).74 The First Circuit in Rafferty75 adopted Whitman’s arguments to justify separation of a large hotel chain by functions such as land purchasing, construction, hotel management, and leasing divisions, in dictum.


72289 F.2d 490 (6th Cir. 1961); accord, United States v. Marrett, 325 F.2d 28 (5th Cir. 1963).

73Rev. Rul. 64-147, supra note 51.

74Whitman, supra note 8.

75Rafferty v. Commissioner, 452 F.2d 767 (1st Cir. 1971), cert. denied, 408 U.S. 922 (1972).
In 1977 Treasury and the Service proposed revisions to the section 355 regulations which adopted the core of the Raftery approach, but which lacked some of the finer details. The 1977 proposed amendments rearranged the regulation factors in the following new order: business purpose, continuity of interest, device, and active business. The active business portion of the 1977 proposals dropped the pre-division separate active business requirement and substantially rewrote the accompanying examples, which still extended beyond the generalizations in text in a few instances. The 1977 proposed revisions of the device provision elaborated the principles in text both as to subsequent sales and use of assets and added two examples. There was scant modification of the business purpose test except for a reference to co-extensive shareholder business purpose and four business purpose examples. The 1977 proposals continued the mere reference to the continuity of interest doctrine with no examples. The examples that were provided to explain the device restriction often raised more questions than they answered.

The 1989 final regulations are a paradigmatic fusion of rules and standards implemented through factors that closely relate to the underlying policy or standard.

As the product of long administrative experience with section 355, the 1989 final regulations are a paradigmatic fusion of rules and standards implemented through factors that closely relate to the underlying policy or standard. De-emphasis of the active business test and the predominant weight given to the functional device standard continues from 1977 the proposals. But this time, the regulation drafters implemented the device standard through a balancing of non-per se factors evidencing device with factors evidencing non-device, including business purpose, tested against the underlying standard of preventing bailouts. Additionally, a nondividend equivalence test or “escape hatch” ordinarily trumps any device factors. Moreover, the drafters provided instructions as the weighing process. The active business test has been clarified and simplified in spots. The 1989 regulations rely heavily on a clarified business purpose requirement to deny tax deferral to undeserving transactions that do not otherwise violate the device restriction. The continuity of business interest requirement also has been strengthened in an effort to get at these transactions.

The 1989 final regulations increase the number and quality of examples for every aspect of the regulations and often explain in the “Preamble” the rationale of the further examples. Moreover, the text greatly expands the general principles, particularly as to the business purpose and device provisions, and the accompanying examples often refer to the applicable principle. All in all, this process constitutes major step in the maturity of regulation drafting, through lessening the agency’s unbridled discretion in favor of structured discretion.

2. Active Business Rule

a. 1955 Regulation and Coady Rejection. The 1955 regulations gave priority to the active business requirement. The first sentence of those regulations prohibited tax-free division of a single business. Active business was defined in detail, with 16 examples that often contain cryptic facts without accompanying principles in the text of the regulations, which Professor Davis commends as a first step when an agency is as yet unsure of the most practicable rule or standard to use. It is clear that the regulation drafters chose the active business test, and in particular the requirement of at least two active businesses, as the primary barrier to bail out corporate divisions. This conclusion is confirmed in the eyes of Whitman and others by the Service’s early revenue rulings under section 355, which principally relied on the active business test. The Service’s use of the device provision was limited to finding dividend equivalency with the primary focus on post-separation sales. The Service apparently relied equally on business purpose and continuity of interest.

Probably reflecting the Commissioner’s deliberate litigating stance, the early corporate division case law under

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66Prop. Treas. reg. sections 1.355-2(b) and (c), and -3 (1977).
70Id. section 1.355-2(b)(1).
72Again, the order in the regulations appears to be roughly from greater to lesser importance. Treas. reg. sections 1.355-2(b), (c), and (d), and (2) (1989).
73Id. sections 1.355-2(d)(2) and (3).
the 1939 and 1954 Codes predominantly involved owner-occupied real estate, then as now a likely candidate for a device, but the cases turned on active business. The Treasury’s rule-oriented approach to the active business test generated a functional response. This is a frequent if not inevitable pattern in the tax case law which often produces functional-definitional conflicts, that is, standard-rule conflicts that destroy the certainty and predictability of a definitional test. The Tax Court in Coady v. Commissioner considered a non pro rata vertical division of a single business between feuding equal shareholders. A finding that it was a device for distribution of earnings was implausible because the post-distribution corporations were not under common ownership. Both post-distribution corporations were actively conducting a trade or business. Congress clearly meant to allow tax deferral for this transaction. However, the 1955 regulations’ two-business rule under the active business test prohibited both vertical and functional divisions of a single business.

The early corporate division case law under the 1939 and 1954 Codes predominantly involved owner-occupied real estate.

The Tax Court majority in Coady looked to the standard or policy underlying the active business rule, which is prohibition of tax-free separation of a corporation into active and inactive entities. Skillfully parsing the statute to focus on active entities, each actively conducting a five-year-old trade or business, even if it had been a single trade or business prior to the division, the Coady majority ignored other rule-oriented legislative history which supported the two-business requirement. After finding that the active trade or business requirement was met, the majority readily found no device, since the two feuding shareholders had no interest in the other’s post-distribution entity. The Coady majority probably rejected the separate active business rule because it was overinclusive, encompassing transactions that are not conducive to device.

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The Treasury’s overreliance on the active business test and its limitation of the device restriction to post-distribution sales opened up a gaping loophole arising from the underinclusive nature of the active business test. A Coady-like vertical division of a single actively conducted business which was readily saleable could be accomplished without tax even if the distribution was pro rata. Taxpayers easily could meet the active business, business purpose, and continuity of interest tests and the limited device restriction. This was arguably the result in United States v. Maret, which involved a pro rata vertical division. Possibly recognizing the danger posed by the Maret fact pattern—aft er a three-year wait, a post-division corporation could be sold to effect a bailout—the Service acquiesced in 1964 to Coady and Maret, announcing the future revision of section 355 regulations.

b. Whitan’s Vision and the Rafferty Response. The Service’s delay in this revision invited critical commentary, but permitted further incremental development of rules through letter and public rulings. This process constitutes an inherent advantage to agency “rule making” as contrasted with legislative or even judicial-
line drawing, according to Professor Davis, Whitman, focusing on the rule-standard dichotomy—which he articulated as definitional (active business) versus transactional (device) provisions—advocated diminishing the role of the active business test as well as the business purpose and continuity of interest. Whitman argued that the device restriction should be a standard, to be used for determining whether the transaction was worthy of tax deferral.

The Tax Court in Rafferty had found no active business. The First Circuit agreed, but took the opportunity to attack, in dictum, the 1955 regulations’ prohibition of functional divisions of an integrated business. The court adopted a functional standard for defining active business. The “corporation must engage in entrepreneurial endeavors of such a nature and to such an extent as to qualitatively distinguish its operations from mere investments. Moreover, there should be objective indicia of such corporate operations.” In 1975, the Service announced that it would follow Rafferty, and approved functional divisions of an integrated business.

c. The 1977 Proposed Amendments. In 1977 Treasury proposed extensive revisions to the section 355 regulations. The 1977 proposed regulations were a major step in the evolution from rules to structured discretion through standards implemented with a rule-standard fusion. The Preamble announced two major changes from 1955 regulations: (1) revision of the device provision “to describe factors which are to be taken into account in making the determination of whether a transaction was a ‘device’,” and (2) revision of the active business rule to provide for the separation of a single business consistent with Coady and Marrott, eliminating their overinclusive feature. The revisions adopted much of the spirit of the Rafferty-Whitman approach, albeit not the letter of the cases. For instance, the proposed revisions reordered the rules, placing business purpose and continuity of interest first and device second ahead of the active business rules in the regulations. (This order is maintained in the 1989 final revisions of the section 355 regulations.)

This implicit downgrading of the active business test in the ordering of the regulation provisions is born out by the liberalization regarding functional divisions under the active business test. The drafters explicitly relied on the related function test of an enhanced device restriction. This shift from active business to device was not extended to owner-occupied realty, where the drafters’ chief worry was “net-leasing.” The active business test also implicitly adopted a Rafferty-derived functional definition of “significant operational and management services.” While the 1977 proposals provided numerous active business examples, sometimes reversing the 1955 examples, all too often the examples gave cryptic signals without generalizations in the text.

d. The Active Business Test: 1989 Version. The 1989 revised regulations’ treatment of the active business test essentially follow the basic thrust of the 1977 proposals. The final regulations permit both vertical and horizontal divisions, subjecting the latter to the related function rule of the device provisions.

The new regulations also address the troublesome issue of corporate expansion upon which the case law had split.

Fortunately, the final revised regulations address a number of active business issues which the 1977 proposals failed to consider. For example, in accordance with earlier rulings, the 1989 revisions require the corporation itself generally to perform active and substantial management and operational functions. The new regula-
tions also address the troublesome issue of corporate expansion upon which the case law had split. The regulation drafters chose the more liberal and administrable approach, as explained in the Preamble.

The drafters chose the rule that purchase, creation, or other acquisition of another trade or business in the same line as an existing trade or business is treated as an expansion of the original business unless this purchase, creation, or other acquisition affects such a change of character as to constitute the acquisition of a new or different business. The active business examples were revised to reflect this change and to flesh out the generalization in text. Moreover, the excellent preamble to the revised regulations spells out the reasoning underlying the examples, a welcome development in regulation drafting.

Following the structured discretion shown in the revised regulations, the 1989 regulations also properly point out that the separation of owner-occupied real estate will be subject to careful scrutiny under the active business requirements because this separation, although it could satisfy the active business requirement, presents significant tax avoidance opportunities. Even if this separation survives special scrutiny under the active business test, the preamble and the regulations point out that it may be subject to close examination under the related function device test where the real estate continues to be occupied by the previous owner. The Preamble also mentions, but does not resolve, other longstanding problems raised by the distribution of an entity holding owner-occupied real estate.

The active business provisions of the 1955 regulations, the 1977 proposed amendments, and the 1989 revised regulations all have made commendable and progressively more sophisticated use of examples in illustrating the general principles. There has been a welcome evolution in explanation of the general principles behind the examples; factual patterns are distinguished, and unanswered questions are noted.

3. Device Restriction

a. The 1955 Version and Criticism. The 1955 regulations focused the search for device on post-distribution sales, articulating confusing distinctions based on whether the sale was arranged prior to the corporate separation. While they stated that particular consideration would be given in applying a facts-and-circumstances device test to the nature, kind, and amount of assets, the only guidance that the 1955 regulations provided was a positive implication of no device where substantially all the assets of the post-division corporations had been used in a five-year active business. The Service interpreted the device test as a dividend equivalency test, providing a safe harbor for substantially non pro rata divisions.

In Rafferty v. Commissioner, the transaction clearly was not worthy of tax deferral.

Whitman criticized this diminution of device. He advocated that the device restriction be raised to a standard, asking whether the transaction was worthy of tax deferral. In Rafferty v. Commissioner, the First Circuit seized the opportunity to approve Whitman's proposals in a transaction clearly not worthy of tax deferral. There, the pro rata division was motivated by the sole shareholder's estate planning motives at best, and placed readily saleable real estate (held in a corporation) in the shareholder's hands. This real estate was not leased to a related corporation, so the transaction failed the active business test as well. The First Circuit may have felt provoked by the Tax Court's opinion, which in part exactly paralleled the Treasury approach criticized by Whitman. For the Tax Court in Rafferty, like the Service in general at that time, had devalued the device test by finding it satisfied by an adequate (shareholder-level) business purpose for the


107 In reexamining the active business requirement, Treasury and the Internal Revenue Service recognized that it is often difficult to determine whether a corporation is conducting a single business, which may be separated under section 355 if it has been actively conducted for five years, or multiple businesses, which may be separated from each other under section 355 only if each has been actively conducted for five years. Correlatively, they recognized that it is difficult to determine whether a corporate expenditure for a new activity constitutes a new business or the expansion of an existing business. Accordingly, it is considered appropriate to simplify these determinations. Preamble, supra, 54 Fed. Reg. at 288.


109 Id. sec. 1.355-3(c)(c) Exs. (7) and (6).

110 Preamble, supra, 54 Fed. Reg. at 288 ("same business principle applies regardless of whether (a) old and new components operated as single unit, and (b) new component resulted from internal expansion or purchase as a going concern.") See Lee, supra, 46 J. Tax. at 199, for implications of 1977 examples.

111 Id. at 286; see Schneider, supra note 37, at 592, n. 141.


113 Id. at 289; Treas. reg. section 1.355-3(c) (Ex. (13) (1989) (last sentence)).

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corporate separation. Instead, the Tax Court relied on the active business test, properly finding no active business. The First Circuit cited "the rule that the taxpayer has the burden of proving that the transaction was not used principally as device"—Whitman's catch phrase for elevating the device restriction to a standard. In implementing this standard, the court formulated a balancing framework for determining whether the transaction is worthy of tax deferral: if (1) a transaction has considerable potential for use as a device by placing readily saleable assets in an entity, and (2) sale of this entity or its assets would not impair the shareholder's control over the other continuing business entity, then (3) the taxpayer must show either that the shareholder's motives were germane to the continuance of the corporate business, or were a direct benefit to the business of the original corporation. The 1977 proposals. 5

potential and shareholder or business purposes out- weighing this potential (by requiring retention of the assets) is more standard-oriented than rule-oriented. In effect, Rafferty provided framework for structured justice.

b. The 1977 Device Proposals. The device provisions in the 1977 proposed regulations used a mixture of per se and balancing factors. Prearranged subsequent sales of more than a specified percentage of the distributed stock constituted a device per se. 118 Apparently, either a pro rata distribution or the presence of assets used in a related function constituted evidence of device. 119 Two examples accompanied the 1977 device proposals. One was a simple prearranged sale of a 50 percent interest. The other featured a sale preceded by a distribution of excess cash that outweighed a corporate business purpose. These examples appeared without applicable generalizations in text. 120

The 1977 proposed amendments neither considered the standard of impairment of equity called for in Rafferty nor addressed several other troublesome areas. From the perspective of structured discretion, the failure to rank the various factors relating to device was the most grievous defect of the 1977 proposals. Nevertheless, they were a commendable first step. At the time, however, commentators were irritated by the 13-year delay between the promise first of revision and the arrival of revision of the 1955 active business regulation and the 1977 proposed revisions. 124

C. Device: 1989 Style

The new regulations adopt an "all of the facts and circumstances" test for the device standard. This is augmented by the required balancing of "device factors" with "non-device factors," which in turn is subject to an overriding, detailed exception for nondividend equivalent transactions. There is an exception to the exception if bailout is still facilitated. This is structured discretion. Furthermore, each set of factors and the nondividend equivalent exception contains internal balancing tests that relate back to the device standard. 126 Additionally, the new regulations instruct the decisionmaker to give shifting weight to certain factors according to variations in factual patterns within the particular category of factors and to shift the balance between the factors themselves. 127 Particular "hot buttons," like owner-occupied real estate, are isolated for particular scrutiny, instead of being the overarching concerns that had impaired the efficacy of earlier regulations. 129

1. Device Factors. The 1989 regulations contain three device factors: (a) pro rata distribution, (b) a subsequent sale or exchange of stock, and (c) the nature and use of assets. 130 These factors were present in the 1977 proposed revisions, but the taint of a pro rata distribution was not clearly stated. However, the 1977 proposed regulations had a 20 percent ceiling on the percentage of distributed stock that could be sold in a prearranged sale

116 Compare Rafferty, 452 F.2d at 789, with Whitman, supra note 8, at 1253.
118 Compare Rafferty, 452 F.2d at 770.
119 See Lee, supra, 27 Tax L. Rev. at 480-86.
120 Prop. Treas. reg. section 1.355-2(c)(2) (1977) (if prearranged sale of 20 percent or more of stock distributed "will be considered to have been used principally as a device").
without automatically invoking the device restriction. A prearranged sale of less than 20 percent of the stock or of securities was "substantial evidence" of use as a device. Sales that were not prearranged were to be taken into account with other evidence in determining whether the transaction was used principally as a device. The final regulations delete this per se rule, treating any prearranged sale as substantial evidence of a device. In a quantum improvement in regulation drafting, the regulations vary the weight of evidence of device attributable to a subsequent sale as follows:

Generally, the greater the percentage of the stock sold or exchanged after the distribution, the stronger the evidence of device. In addition, the shorter the period of time between the distribution and the sale or exchange, the stronger the evidence of device.

On a technical level, the drafters of the 1989 regulations devoted more careful attention to post-distribution sales of securities and "boot" dividends. They except these sales from treatment as evidence of a device, since neither is amenable to a bailout due to the ordinary income treatment under section 356.

The final regulations . . . treat . . . any prearranged sale as substantial evidence of a device.

The 1989 revisions increase the sophistication of the nature and use of assets factors from the 1977 proposals and the 1955 regulations by taking account of the Service's ruling experience and the advice of commentators. The "nature, kind, and amount of the assets" test for a device in the 1955 regulations focused on satisfaction of the active business test as evidence that the transaction was not used principally as a device. The 1977 proposed regulations focused on the presence of recently purchased assets or liquid assets. A device was indicated if a substantial portion of the assets of any post-distribution corporation consisted of trade or business assets acquired in a cost basis transaction within the preceding five-year period, or there was a transfer or retention of cash or liquid assets unrelated to the reasonable needs of the business. The 1989 revisions coalesce these two tests into one device factor. The presence of assets that are not used in a trade or business that satisfies the five-year predistribution active conduct requirement of section 355(d)—including cash and other liquid assets not related to the reasonable needs of the business—is evidence of device.

Illustrating more sophisticated balancing, the 1989 regulations provide that the strength of the evidence of device depends on all facts and circumstances, including each postdistribution corporation's ratio of value of assets not used in any trade or business to the value of assets that meet the five-year active business requirement.

Drawing upon ruling experience, as advocated by Professor Davis as to administrative rules in general, the 1989 regulations state that a difference in this ratio ordinarily is not evidence of device if the distribution is not pro rata and this difference is attributable to a need to equalize the value of the stock distributed and the stock surrendered by the distributees.

The 1977 proposals and the 1989 revised regulations both include under the nature and use of assets factor the presence of a continuing "related function" between the distributed corporation and the parent corporation. The new regulations use the term "secondary business" for a post-distribution business with a continuing principal function of serving the other post-division business or an affiliate. This approach was Treasury's answer to the problems it saw in functional divisions previously barred by the now-abandoned separate active business requirement. The related function test, particularly as revised in the final regulations, is closely related to the bailout problem. The new version of the related function test properly provides that there is no device if sale of the "secondary business" would adversely affect the business of the other corporation. This, of course, is the impairment of equity test dictated by Rafferty.

2. Non-Device Factors. Following the suggestion of commenters on the 1977 proposed revisions, the government agreed that the corporate business purpose for a transaction could outweigh the evidence of device presented by the transaction. Rafferty mandated this approach. The 1989 regulations guide the decisionmaker's discretion in an innovative way.

The final regulations adopt a sliding scale approach. Thus, the greater the evidence of device, the stronger the corporate business purpose necessary to outweigh that evidence.

Further examples of the structured discretion employed throughout the 1989 revisions are contained in the non-

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143Id. section 1.355-2(d)(2)(iv)(C) (clause (i) of the first sentence).
144Preamble, supra, 54 Fed. Reg. at 286. In theory, the same impairment of equity defense should apply to the other two device factors: post-distribution sales and non-section 355(b) assets, except excess liquid assets. See Lee, supra, 46 J. Tax. at 197, 200; Lee, supra, 27 Tax L. Rev. at 481-86.
exclusive list of factors provided for assessing the strength of a corporate business purpose. They establish "that not just any cooked up, last minute business purpose is enough." The revised regulations also include as a nondevice factor the fact that the distributing corporation is publicly traded with no shareholder owning more than five percent of any class of stock. This per se rule avoids the difficulty, exposed in Golconda Mining, of determining whether a shareholder or group of shareholders in a publicly traded corporation controls it. This is the apparent standard under the accumulated earnings tax for determining whether the shareholders in a public corporation caused it to accumulate income rather than paying dividends.

Commentators on the proposed 1977 revisions pointed out that due to the dividends received deduction applicable to intercorporate dividends, a distribution of stock in the controlled corporation to one or more domestic corporations would not pose a bailout opportunity (at least to the extent of the deduction). The government apparently agreed by treating corporate ownership as not evidence of a device.

The device portion of the 1989 regulations provides four much more helpful examples than the 1977 proposals. The examples weigh various device factors against varying degrees of the corporate business purpose as a nondevice factor, illustrating various aspects of the business purpose factor. Moreover, each example refers to subsections in the text of the regulation containing the relevant generalizations. The Preamble culls and explains the determinative facts of each example and the weighing process. No more cryptic examples here. Incidentally, some of the most commonly asserted business purposes are properly blown away, for example, sales to "valued" employees of a smaller post-division corporation. Under the nontaxable alternative rule, other means of compensation, such as stock appreciation rights or perhaps compensatory alphabet stock of the parent, theoretically might even preclude a tax-free division based upon separating out the company employing the key employee in order to issue her new stock.

3. Safe and Relatively Safe Harbors. The Service indicated in early rulings that it considered the device restriction merely a dividend equivalency test. If, in the absence of section 355, the transaction would have been taxable as capital gain to the distributee shareholder under section 302(a), the distribution did not violate the device restriction. The Service extended the same reasoning to transactions in which the distributing corporation and the controlled or separated corporation did not have earnings and profits. Whitman criticized the Service for abdicating its power to police bailouts by so limiting the device test. He reasoned that the Service diminished the importance of device in order to rely on the familiar reorganization judicial doctrines like business purpose and, implicitly, the active business test. It is more likely that the Service wanted to limit section 355 deferral to non pro rata distributions and separations in which the shareholders in each post-distribution corporation had no interest in the other corporation. A section 302(b)(3) dividend equivalency test seemed to do that nicely.

The Service indicated in early rulings that it considered the device restriction merely a dividend equivalency test.

The 1977 proposed regulations incorporated the described ruling experience of the Service, providing that if a distribution to each distributee would have been treated...
The exception which arises when there are no earnings and profits... is not available to a distributing corporation with built-in gains.

The 1989 final regulations make nondividend equivalency a superfactor that ordinarily outweighs—as suggested by commentators164—any device factors in a per se manner. The rationale is that the three specified nondividend equivalent distributions ordinarily do not present a potential for tax avoidance.165 The favored three consist of (1) no earnings and profits in the distributing or controlled corporations, (2) a transaction to which section 302(a) would apply if the transaction were taxable, and (3) a transaction to which section 303(a) would apply if taxable.166 The new regulations properly lift the protection of the hypothetical section 302(a) and section 303 redemption exceptions if (a) stock in more than one controlled corporation is distributed, and (b) the transaction “facilitates the avoidance of the dividend provisions of the Code through the subsequent sale or exchange of stock of one corporation and the retention of the stock of another corporation.”167 This distribution of a sister corporation exception to the stock exception is a sound innovation. The regulations also soundly limit the exception which arises when there are no earnings and profits. It is not available to a distributing corporation with built-in gains.168

As a matter of substantive policy, however, the government may still have been too permissive regarding the hypothetical redemption transactions. Certainty comes at a price. The addition of section 303 indicates that the drafters’ attention was focused on capital gains treatment and not on any continuing ability of a shareholder to withdraw income without impairing her equity in the retained business. In a hypothetical section 302(b)(3) “complete termination of interest” distribution of stock in a single controlled corporation, a bailout without impairment of equity by definition cannot arise. However, the hypothetical redemption could qualify as a “substantially disproportionate” redemption under section 302(b)(2). A less-than-50-percent shareholder in the post-distribution corporation could retain an interest in the distributing corporation which was reduced only 20 percent (say from 50 percent to 40 percent) and receive a 100 percent interest in the controlled corporation which could even continue to do business with the distributing corporation. A section 303(a) transaction presents an even greater bailout opportunity since the distribution could be completely pro rata and involve a related function. In short, section 303 is an unsuitable gauge of dividend equivalency.

A safe harbor for a partial liquidation under section 302(b)(4) is not available here because it requires distribution of either five-year active business assets that are not in corporate form or the proceeds from sale of these assets. Distribution of stock in a controlled corporation, therefore, cannot qualify as a partial liquidation under section 302(b)(4) and, hence, cannot qualify under section 302(a). Congress must have intended this result because in a partial liquidating distribution (which may be pro rata) of five-year active business assets or the proceeds of their sale automatically satisfies the special dividend equivalency test under sections 302(e)(1)(A) and (2)(A). Thus, the hypothetical redemption exception should not be available to a hypothetical partial liquidation. A published ruling to that effect would be helpful.

Section 303 is an unsuitable gauge of dividend equivalency.

The 1989 regulations accompany this new provision with only two examples. The first is a balancing example from the device-nondevice factor portion of the regulations (with excessive cash in a pro rata division tipping the scale to device) with the additional determinative factor of no earnings and profits.170 The second example illustrates the exception to the hypothetical section 302(a) redemption for distributions of two (or more) corporations which could facilitate a subsequent bailout. The sparseness of examples in the regulations might represent some relative discomfort on the part of Treasury or the Service with these safe harbors rather than their newness, since dividend equivalency had long been a favored Service test for device.

4. Business Purpose. The three major business purpose section 355 issues since Whitman wrote have been whether (a) in a tax-free division a business purpose could outweigh device factors, for example, ready salability; (b) a business purpose test must be met independently whether device potential exists, for example, a completely non pro rata division due to hostility between equal shareholders; and (c) shareholder business purpose alone could suffice.171 The 1989 version of the business purpose requirement for purposes of section 355 addresses all of these questions as well as a number of


162Id.

163See Helfand & Lafving, Part 3, supra note 96.

164Preamble, supra, 54 Fed. Reg. at 287.


166Id. sections 1.355-2(d)(5)(ii), (iii), and (iv).

167Id. section 1.355-2(d)(5)(l) (last sentence).

168Id. section 1.355-2(d)(5)(ii)(C).


171See, e.g., Whitman, supra note 9, at 1245-51.
other troubling issues not dealt with in the 1955 regulations or the 1977 proposals.

The introduction into the 1989 regulations of business purpose as a counterbalancing nondevice factor is discussed above. Turning to business purpose as an independent requirement, Whitman showed that the congressional purpose in adding the device language to the 1939 Code was to head off judicial glosses on the revenue statute. Business purpose and continuity of interest had arisen in just this fashion. Whitman also opposed the government's reliance on the business purpose and continuity of interest doctrines under section 355 as well as its even heavier reliance on the active business test. He saw this reliance as the result of the Service's equation of device with dividend equivalency.\(^{172}\) The First Circuit in Rafferty found Whitman's argument convincing. The Ninth Circuit's holding in Commissioner v. Wilson seemed to require the retention of the 1955 business purpose criterion as an independent test in subsequent versions of the regulations.\(^{173}\) The reasoning and examples in the 1989 revised regulations and Professor Davis' concept of "structured discretion" establish that the business purpose requirement should be independent of the device test. This result seems proper.

Business purpose does, indeed, provide more discretion to the courts and the Service in applying the regulations in ruling requests as well as on audits. But Congress was wrong in fearing that discretion in the context of section 355. Congress is slow to fine-tune tax laws unless major revenue loss or administrative irritants are involved, and the administering agency needs tools to meet unanticipated developments. A broader standard is more likely to provide those tools—business purpose here—than are detailed rules. For instance, the Service apparently used the business purpose test to thwart the use of section 355 to pare down a corporation with too many assets, shareholders, or controlled subsidiaries, which could not be readily liquidated into the parent, in order to satisfy one or more of the 1986-1988 General Utilities' transition rules, the section 355 number of shareholders ceiling, or the affiliated group prohibition for S corporation elections.\(^{174}\)

As illustrated by an example in the 1989 regulations, an independent business purpose test requires a corporate business purpose other than saving Federal income taxes (for example, by an S corporation election) or state taxes arising out of the same transaction amounting to less than the Federal income taxes.\(^{175}\) Such broader discretion is needed in addition to the more structured discretion under the device portion of the regulations. Even here, however, the discretion is not totally unstructured. Unfortunately, many taxpayers apparently made distributions in order to elect S corporation status without requesting rulings.\(^{176}\)

Following the 1955 regulations' bare bones business purpose (and continuity of interest) requirements, the 1977 proposed regulations provided for tax-free separation only if the distribution was carried out for purposes "germane to the business of the corporations," but added that "a shareholder purpose may be so nearly coextensive with corporate business purpose as to preclude any distinction."\(^{177}\) Furthermore, the 1977 proposals contained four examples dealing with corporate business purpose or its absence. Responding to comments, the government explained in the Preamble\(^{178}\) that a coextensive business purpose is acceptable, and the new regulations provide an example. A non pro rata division along business lines of a two-business corporation between equal shareholders was made so that each could devote full-time attention to one business, a move which was expected to enhance the operations of both businesses. This transaction was carried out for a corporate business purpose (presumably enhancement of operations) "notwithstanding that it is also carried out in part for shareholder purposes."\(^{179}\) Presumably, shareholder disagreement about corporate operations also gives rise to a corporate business purpose.

\[\text{An independent business purpose test requires a corporate business purpose other than saving Federal income taxes...}\]

The First Circuit's reasoning in Rafferty regarding shareholder business purpose had not proceeded along the lines of coextensiveness, but instead required that the shareholder purposes be "germane to the continuance of the corporate business."\(^{180}\) The court made an oblique reference to Whitman's example of a corporation's dividing its automobile dealership and its real estate premises to protect the dealership from the sole shareholder's ex-spouse. The sole shareholder pledged the stock in the spun-off real estate corporation as security for alimony payments and thus could not sell the spun-off corporation to outsiders, nor would he, in Whitman's view, default in effect selling the spun-off stock to the ex-spouse since she then would become his operating corporation's lessor.\(^{181}\) Whitman found no device potential there, but the reasoning of the 1989 regulation example would suggest that the shareholder purpose of keeping the ex-spouse away from the automobile dealership also served the corporate purpose of avoidance of dissenion. The 1977 proposals used an example to explain the requirement of a business purpose for the distribution of the controlling stock interest in a distributed subsidiary as well as a business purpose for the formation of the

\(^{172}\) Whitman, supra note 9, at 1235, 1239, 1241; accord, Lee, supra, 27 Tax L. Rev. at 477.

\(^{173}\) 353 F.2d 184 (9th Cir. 1965); see Lee, supra, 46 J. Tax. at 200; Preamble, 54 Fed. Reg. at 283.


\(^{176}\) I was so informed in a telephone conversation with a National Office reorganizations specialist.


\(^{180}\) Rafferty, 452 F.2d at 770.

\(^{181}\) Whitman, supra note 9, at 1242-43.
The 1989 revised regulations continued that example but added a further clarifying example. A transaction in which the distribution served a business purpose still does not qualify for tax deferral if it can be accomplished by another tax-free transaction, as explained in the Preamble. The regulations state:

If a corporate business purpose can be achieved through a nontaxable transaction that does not involve the distribution of stock of a controlled subsidiary and which is neither impractical nor unduly expensive, then...the separation is not carried out for that corporate business purpose.

The 1989 regulations illustrate this principle at several points. This formulation of nontaxable alternatives to the corporation division in assessing business purpose is preferable to the Rafferty approach of rejecting the taxpayer’s preferred business purpose (shareholder estate planning) because this purpose “could be fully satisfied by a bailout of dividends.” This could lead to a test of whether the same result could be obtained by a taxable alternative.

The reworking of the business purpose provisions contained in the 1989 regulations is a major accomplishment.

The reworking of the business purpose provisions contained in the 1989 regulations is a major accomplishment. Like the earlier versions, the final regulations preserve independent business purpose requirement as a standard to disqualify transactions that, though not bailouts, still do not merit tax deferral due to broader tax policies. Examples of these policies include protecting General Utilities repeal and its transition rule or preventing abuse in C to S conversions. Fortunately, the final regulations address various issues raised by comments on the 1977 proposals, other commentators, and the Service’s own ruling experience. They do so through generalizations about policy, followed by carefully crafted examples relating to the generalizations. Regulation drafting has been raised to an art form.

5. Continuity of Interest. Continuity of interest, like the business purpose doctrine, was judicially fashioned and only contained in bare bones fashion in the 1955 regulations. Whitman and the First Circuit in Rafferty opposed Service reliance on the continuity of interest doctrine since they viewed it as a concomitant of the government’s refusal to give form and substance to the device restriction. The 1977 proposal neither added examples nor amplified the mere statement that the continuity of interest doctrine applies to section 355 divisions.

As a policy matter, the shareholder-level “continuity of interest” doctrine should apply to section 355 if it serves a broader purpose than merely preventing bailouts. The policy of the continuity of proprietary interest doctrine is that reorganization treatment should be limited to historic shareholders who maintain a significant proprietary interest in the continuing corporations.

The 1989 revisions apply the continuity of interest doctrine to corporate divisions by requiring that the historic shareholders maintain continuity in each of the resulting corporations.

The 1989 regulations add four examples illustrating the continuity of interest requirement, “the principles of which are based on previously established revenue rulings.” In contrast to the other section 355 regulation areas, neither the text nor the Preamble spell out the parameters of the continuity of interest requirement itself. Nonetheless, the examples indicate some boundaries. Continuity of interest exists where the prior owners in the aggregate retain at least 50 percent of their equity interest in each of the post-division corporations. Conversely, retention of only a 20 percent interest by a former owner (or owners) in one of the post-division corporations is not sufficient.

The probable reason for the absence of further explanation of continuity of interest doctrine is that the government does not spell out the parameters of the doctrine as to an acquisitive reorganization as defined in section 368, merely requiring a 50 percent continuity for advance ruling purposes. The case law had allowed a consider-

163Treas. reg. section 1.355-2(c) (1955) (included in paragraph captioned “Business Purpose”).
164Whitman, supra note 8, at 1239, 1241; Cf. Rafferty, 452 F.2d at 770 (prefer approach of requiring showing in case of personal motives as to distribution with bailout potential that such motives were "germane to the continuance of the corporate business...overreliance upon formulations such as 'business purpose,' and 'active business'").
165Prop. Treas. reg. section 1.355-2(b)(2) (1977) (next to last sentence) (“continuity of interest” added to caption of paragraph).
166See Sheppard, “Section 355 Regulations,” supra note 148, at 274-75; Faber, supra note 149.
167Treas. reg. section 1.355-2(c)(1) (1989) states:

[Section] 355 requires that one or more persons who, directly or indirectly, were the owners of the enterprise prior to the distribution or exchange own, in the aggregate, an amount of stock establishing a continuity of interest in each of the modified corporate forms in which the enterprise is conducted after the separation.

169Ibid. section 1.355-2(c)(2) Ex. (2).
170Ibid. section 1.355-2(c)(2) Ex. (4).
ably lower level, but not as low as 20 percent. The revised regulations continue the statement in prior versions that "section 355 contemplates the continued operation of the business or businesses existing prior to the separation." The general reorganization regulations historically had used similar language in referring to "continuity of business enterprise" requirement. Treasury recently interpreted this in the acquisitive reorganization context as requiring either continuation of the business or businesses existing prior to the separation. "Significant" here may require business use of one-third of target's historic business assets in a business. "Continuous of business enterprise" requirement is satisfied when as little as five or six percent of the assets are target's "historic business" or use of a significant portion of target's historic business assets in a business. "Significant" is "continuity of business enterprise" requirement.

The 1989 revisions apply the continuity of interest doctrine to corporate divisions.

While the business purpose and continuity of proprietary interest requirements can effectuate policies not met by the statutory requirements, the continuity of business enterprise doctrine's objectives would be covered by the device test. The absence of examples and discussion on the 1989 Preamble indicate that the reference on the new regulations was more a reflex action than thoughtful requirement.

Restoration of the capital gains preference as to selected capital assets, specifically including stock, is much in the news these days. See "Capital Gains Issue," 43 Tax Notes 1009-32 (May 22, 1989) and cites id. at 1029.

Thus, sections 336 and 338 now treat a liquidating distribution and the erstwhile deemed liquidating distribution as a deemed (recognition) sale at the corporate level at fair market value. 1954 Code section 337 providing a corporate level shield as to bulk sales pursuant to a timely liquidation simply has been repealed.

When in early January 1989 I sketched this scenario to the National Office ruling specialist, his response was to the effect that what was done after two years was not relevant.

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SPECIAL REPORTS

III. WHAT IS NEXT?

Ironically, the 1986 repeal of the capital gains preference has in most cases eliminated the traditional advantage of an earnings bailout over a dividend payment in the absence of offsetting capital losses. Shareholder basis recovery is the only remaining issue. But with the 1986 repeal of the General Utilities shelter for corporate asset appreciation in nonliquidating and liquidating distributions, the planning and policy focus now is on deferring recognition of inside gain in a corporate division. Potential abuses include (1) a deferred non pro rata split-off/Esmark transaction in which P purchases a minority interest in T (or at least less than 80 percent), waits a decent interval (say two years), and then exchanges the minority T stock interest for a desired division of T, a section 355 division; and (2) T distributes an incorporated division pro rata to its shareholders anticipating that after a decent interval, they will sell it to P in a transactional carryover basis acquisition. In both cases, T has escaped tax on inside gain.

The continuity of proprietary interest test looks both backward and forward. The 1989 regulations do not address how long before and after the corporate separation this continuity must exist. Practitioners use two years as a rule of thumb (based on the facts of a published ruling) for the continuity of interest lookback period, and presumably, they use the same period to look forward as well. Whether any waiting period clearly establishes continuity of interest where a post-acquisition division is contemplated at acquisition or a post-division...
sale is contemplated at the time of division, is highly problematic.210

In the limited area of a corporate distributee which acquired "control" (80 percent stock interest) of the distributing corporation, Congress imposed in 1987 a five-year holding period requirement.211 Professors Simon and Simmons convincingly argue that a broader five-year holding period requirement going forward should be statutorily extended (while still requiring only 40 to 50 percent aggregate continuity in each post-distribution corporation).212

Practitioners use two years as a rule of thumb . . . for the continuity of interest lookback period . . .

A forward-looking holding period poses many more problems. First, as Professors Simon and Simmons point out,213 unless a floor approach (say five percent or more of all shareholders) is used, section 355 would be unavailable to publicly traded corporations due to the current heavy annual turnover in their stock. Second, post-distribution sales are already the subject of the device standards. Third, distinctions between pro rata and non pro rata separations would have to be drawn. Otherwise, hostile non pro rata divisions would give the shareholders of each post-division corporation a means to trigger at least inside corporate level recognition of gain to the other corporation(s) by selling all of the stock of their post-division corporation shortly after the corporate division. And fourth, the inside gain recognition problem is inextricably tied to the policy of safeguarding the 1986 repeal of the General Utilities doctrine214 and the issue of self-help elective carryover basis acquisitions when only part of target's assets are desired.215 Any further amendments and section 355 should take the form of a one-year (at the shareholder and corporate levels) along the lines of section 302(c)(2)(A) (flush paragraph), if a triggering sale occurs.

210The 1986 repeal of the codified General Utilities doctrine (noncorporate-level recognition upon (a) nonliquidating and liquidating distributions of property, 1954 Code sections 311 and 336, and (b) sales and deemed sales pursuant to liquidations and deemed liquidations, 1954 Code sections 337 and 338) was in large part rationalized as needed to prevent artificial encouragement of mergers.

A corporation acquiring the assets of a liquidating corporation was able to obtain a basis in assets equal to their fair-market value, although the transferor recognized no gain (other than possibly recapture amounts) on the sale. The tax benefits made the assets potentially more valuable in the hands of a transferee than in the hands of the current owner. This might induce corporations with substantial appreciated assets to liquidate and transfer their assets to other corporations for tax reasons, when economic considerations might indicate a different course of action. Staff Joint Comm., General Explanation of the Tax Reform Act of 1986 (H.R. 3838), 386 (1987).

The reality was that due to the "recapture income" (including statutory depreciation recapture) override to the General Utilities shield, see id. at 333-34, 336, most corporate acquisitions of capital intensive corporations during the late 1954 Code were not cast as cost-basis acquisitions because the impact of the recapture income tax exceeded the present value of the basis step-up—an exception then (and now) arose where target's NOLs would offset the gain recognized upon liquidation. See Lee, supra, 8 Va. Tax Rev. at 116-17 and n. 251. The real tax goal, particularly in leveraged buyouts (other than use of interest deductions to shelter target's income), was to dispose of unwanted target assets (bust-up takeovers) without triggering an inside corporate tax on appreciation. This is where "mirror transactions," "son of mirror," etc., and section 355 come in. See Sheppard, "Mirror Moves: Life Without the General Utilities Rule," 32 Tax Notes 847 (September 1, 1986); Sheppard, "Enforcing General Utilities Repeal," 32 Tax Notes 1217 (September 29, 1986); Sheppard, "The Prodigal Son of Mirror," 34 Tax Notes 444 (February 2, 1987); Axelrod, "Section 304, Excess Loss Accounts and Other Consolidated Return Galla maufy," 36 Tax Notes 729 (August 17, 1987); Sheppard, "Through the Looking Glass," 35 Tax Notes 436 (May 4, 1987); Sheppard, "Spin Cycle," supra note 209; Walter, "Spin-Offs, Split-Offs and Split-Ups in Two-Step Acquisitions and Dispositions," 66 Taxes 970 (1988); Pullman, Warner & Jacobs, "Notice 87-14 and the Section 1503 (e)(3)(A) Regulations," 42 Tax Notes 737 (Feb. 6, 1989). Availability of such techniques to avoid inside recognition would encourage or at least facilitate takeovers or at least acquisitions of non-recently spun-off parts of targets (or acquisitions of part of target to enable a non pro rata division a while later).

214A notion that has been batted about is that "mirror transactions" and other transactional elective carryover basis as to selected lines of business techniques, presumably including predivision acquisition of a minority interest looking forward to non pro rata division and pro rata division looking forward to a later sale, are not inconsistent with the General Utilities repeal because they permit only an outside stock basis step-up and in effect an elective carryover basis. See, e.g., letters by Peter Faber, Esq., 32 Tax Notes 1022 (September 8, 1988), 32 Tax
Very early in the development of section 355 under the 1954 Code, "prestigious groups of commentators," in Whitman's words, recommended that the severity of the section 355 definitional requirements be mitigated by statutorily granting the Service the power to rule favorably on otherwise taxable transactions. Whitman's telling criticism was the lack of standards to guide this discretion. Now that the revised regulations have substantially eased this severity and have provided ample structured discretion for the exercise of this ruling authority, the policy of mandatory advance approval should be reconsidered, not to lighten the impact of section 355 this time, but to implement it. A mandatory advance ruling regime should provide very simple procedures for common, nonabusive transactions, for example, non pro rata divisions of small active businesses between small numbers of historic shareholders. Alternatively, more narrow mechanical rules without an advance ruling requirement could be provided (optional or mandatory) for simple transactions with mandatory structured discretion for more complex transactions.

The Service's recent decision not to give comfort rulings . . . should not prevent adoption of a mandatory advance ruling program for section 355 transactions.

The Service's recent decision not to give comfort rulings to transactions where the legal result is readily ascertainable should not prevent adoption of a mandatory advance ruling program for section 355 transactions. Nor should the recent Service announcement that it will refuse to rule that there is a business purpose for a distribution of controlled corporation stock: where Federal tax savings are greater than state tax savings; where Federal tax reductions coexist with foreign tax reductions; or whether potential Federal tax savings are the substantial motivation of a transaction with a different asserted business purpose. Some inside and outside of government argue, however, that the government has nothing to gain from approving taxpayers' asserted business purposes if the result is to hamstring the Service when it later questions the propriety of the deferral for the transaction.

The regulations could provide more mechanical rules for transactions not seeking advance approval . . . .

What can the government do in the absence of mandatory advance ruling requirements? First, both the corporation and the shareholder could be required to red-flag section 355 transactions in which no advance ruling is sought. This requirement should work somewhat along the lines of section 751(b) transactions. Second, the regulations could provide more mechanical rules for transactions not seeking advance approval, but the litigation experience under section 355 (Coady and Raftery) suggests that this should be implemented only with a statutory foundation. Third, consideration should be given to inducements for seeking a ruling. A ruling has advantages in addition to certainty of result, as illustrated by regulations under section 755 and elsewhere.

IV. CONCLUSION

The evolution of the section 355 regulations from 1955 to 1989 remarkably parallels Professor Davis' thoughts about "Discretionary Justice." Starting with a broad legislative and tax common-law framework—requirements relating to active business, device, business purpose, and continuity of interest—the regulation drafters first employed bare bones tests in all areas, except the active

Notes 1205 (September 22, 1986). Beyond the fact that Congress has not yet enacted elective carryover basis, see letter by Michael Schler, id. at 1204, elective carryover basis under the final 1985 subchapter C proposals would not extend to such partial asset acquisitions. See Staff Sen. Fin. Comm., "The Subchapter C Revision Act of 1985," 99th Cong., 1st Sess. 50 (S. Print 47, 1985) (acquisition of control of target or 70 percent of gross fair market value or 90 percent of net fair market value necessary for elective carryover basis). Furthermore, if as expected "mirror transactions," etc., are stopped by Treasury, use of section 355 to achieve the same "elective" carryover basis without recognition of inside appreciation by the distributing corporation perversely will favor friendly takeovers of desired assets over hostile bust-up takeovers violating the tax policy of horizontal equity or economic efficiency.

Whitman, supra note 8, at 1249 (ALI and the House Ways and Means Committee Advisory Group on subchapter C).

Rev. Proc. 89-34, 1989-20 IRB 145. The Service, however, has decided to "back off" this policy for six months. Rosen, "Comfort Rulings' Stance Will Be Reversed, Scott Tells ABA Tax Section," 44 Tax Notes 629 (Aug. 7, 1989). Moreover, the IRS more recently stated that the "no comfort rulings" policy should not affect section 355 ruling requests. Ann. 89-105, 1989-35 IRB 1, Q&A 12.


The ideas following in text owe much to a brainstorming session with my colleagues Elmer Schaefer and Alan Gunn.

Treas. reg. section 1.751-1(b)(5). Return preparers (and apparently practitioners in general) frequently if not universally "overlook" this requirement or more accurately section 751(b) itself, which has been argued as reason to repeal section 751(b). Hearings on H.R. 1656, H.R. 2571, H.R. 3397, and H.R. 4448 (Issues Relating to Passthrough Entities) before the Subcommittee on Select Revenue Measures of the House Ways and Means Comm., 99th Cong., 2d Sess. 61 (1986) (statement of Joel Rabinovitz, Esq.). I think it is instead grounds to impose return preparer penalties, malpractice sanctions, or fraud penalties depending on the level of understanding of subchapter K practitioner-return preparer. The repeal the provision argument reminds me of Queen Isabella's rationalization for expelling the Spanish Jews in 1492—that they were causing the descendents of the 1391 forced Jewish converts to Christianity to Judaize.

business requirement. The 1955 regulations set forth more detailed principles and accompanied them with numerous examples which were not, however, explicitly related to the rules in the text. With this framework, the Service commenced ruling and litigating, principally focusing on the active business test at first and then after a decade on the device restriction as well.

The 1989 revisions...do provide detailed and...sensible guidelines for discretionary justice as to the device standard.

Acting in an increasingly collaborative mode, courts and commentators attacked the Service's mechanical reliance on the active business test (and particularly the separate business corollary), calling for primary reliance upon a standard instead—the device restriction. The government responded in 1977 with proposed amendments to the section 355 regulations. They embodied a shift in emphasis from active business to device, expanded the device principles, and reflected past ruling experience and criticism in the commentary. The guidance about the meaning of device was raised to about the same level of sophistication as the 1955 active business provisions in the regulations. But the 1977 examples were still not clear, and the proposed regulations failed to provide guidelines for discretionary justice.

The 1989 revisions reflecting further ruling experience in part under changed conditions (the aftermath of repeal of the General Utilities doctrine in the 1986 Code) and the suggestions of commenters, do provide detailed and, I believe, sensible, guidelines for discretionary justice as to the device standard. Furthermore, in all areas except the continuity of interest doctrine, the new regulations provide a detailed framework of principles in text. Careful illustrations often have cross references to text and usually explicitly tie together the principles and examples in the Preamble. (Should this excellent format continue, the Code of Federal Regulations and commercial publishers of tax regulations will need to include the preamble with the regulations as the Federal Register does.)

Although further refinement is possible in the continuity of interest context, the 1989 regulations otherwise take the current section 355 about as far as it can go. Congress should revise section 355 in a more substantial way than the 1987 revision. Now that structured discretionary justice is available, mandatory advance rulings by the Service should be required (with increased costs passed on to the users). A simplified check-the-box form should be provided for garden variety, especially non pro rata, vertical or separate business divisions. A statutory five-year holding period to establish continuity of interest should be enacted. Elective carryover basis, which would excuse corporations from recognition of inside gain, also should be enacted and decoupled from the reorganization provisions. A five-year holding period going forward should be required for pro rata divisions, and bolstered by the threat of reopening year one at the corporate and shareholder levels if post-distribution sales create a bail-out should be considered. But for the present, let us celebrate a job well done in the 1989 revised regulations.