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Proposed Regs. under 355 overhaul device test and single-business divisions

by JOHN W. LEE

Newly issued Proposed Regulations, under Section 355, follow recent decisions allowing horizontal divisions of a single business. In addition, the proposals introduce factors for determining whether a Section 355 transaction is a device for bailing out earnings. Mr. Lee analyzes these and other changes in the Proposed Regulations.

The Service has proposed sweeping amendments to the Regulations under Section 355. The preamble to the amendments describes two major changes: (1) The identification of factors determining whether a transaction is primarily a "device" for the distribution of profits and (2) the introduction of a provision for the separation of a single business consistent with Coady, 289 F.2d 490 (CA-6, 1961) cert. den. and Marett, 325 F.2d 28 (CA-5, 1963). Although the preamble does not acknowledge the fact, the proposed amendments substantially revise the business purpose provisions of the existing Regulations.

In Rev. Rul. 64-147, 1964-1 (Part I) CB 186, the Service announced that it would follow Marett and Coady which had invalidated the Regulations under Section 355 to the extent that they precluded tax-free divisions of a single business. Rev. Rul. 64-147 also stated that consideration was being given to a modification of the Regulations. Then, 11 years later, Rev. Rul. 75-160, 1975-1 CB 112, stated that, pending the issuance of revised Regulations, active trade or business cases under Section 355 would be disposed of in accordance with Rafferty, 452 F.2d 767 (CA-1, 1971), cert. den., which employed a bailout test in its approval of functional divisions. Now, IRS has released Proposed Regs.

Device test

The locus of existing Reg. 1.355-2(b) with respect to the device test is on the effect of post-distribution sales of shares in the distributing or controlled corporation (apparently on the burden of proof) and on whether substantially all of the assets of the post-distribution corporations had been used in the active conduct of the trade or business. Prop. Reg. 1.355-2(c)(1) sets forth a transactional approach: "a tax-free distribution of stock of a controlled corporation presents an extraordinary potential for tax avoidance by placing the shareholders of the distributing corporation in a position whereby, as a consequence of the subsequent sale of stock or the liquidation of either the distributing corporation or the controlled corporation, they can avoid the dividend provisions of the Code ... Whether a transaction which has the potential for the distribution of earnings and profits was used principally as such a device shall be determined from all the facts and circumstances."

Rafferty fashioned the bail-out-potentiality test to the device test in terms of whether the distribution of stock in the controlled corporation would impair the shareholders' residual equity interest in the ongoing corporation's earning power, growth potential or voting control. If a sale of stock in one post-division corporation would impair the common shareholders' equity in the retained corporation, then no dividend-like transaction had occurred due to the meaningful reduction of the shareholders' interest. A substantially disproportionate distribution arguably, almost automatically, would pass a bail-out-potentiality test, while a proportionate distribution would have to run the full-device gauntlet. This is not the same as the statement in Prop. Reg. 1.355-2(c)(1), that a pro rata, or substantially pro rata, distribution presents the greatest potential for withdrawal of earnings and profits and is more likely to be undertaken principally as a device for the distribution of earnings and profits. Field agents are likely to interpret this statement to mean that a proportionate distribution almost automatically fails the device test while a disproportionate distribution will still have to pass the normal device test. Such an approach is contrary to the development of Section 355. Immediately prior to the 1954 Code, the status of non-pro rata split-offs and split-ups was uncertain, and, therefore, Section 355(a) (2)(A) expressly permits non-pro rata corporate divisions. It is almost as if pro rata spin-offs were thought of as the norm. The distinction drawn by Prop. Reg. 1.355-2(c)(1) between pro rata and non-pro rata divisions, so that any stretching of the active business test to permit a particular non-pro rata separation worthy of tax deferral became equally applicable to pro rata divisions. Undoubtedly the drafter of the proposed amendment hoped to avoid this inelasticity in the device test. The goal is perhaps worthy, but the emphasis is wrongly placed. The amendment would have been better worded to provide that a disproportionate distribution presents the least potential for the withdrawal of earnings and profits and is least likely to have been undertaken principally as a device for the distribution of earnings and profits.

Indeed, no reference to proportionality or disproportionality is necessary because the proposed amendment, following the lead of Rev. Rul. 64-102, 1964-1 CB 186, and Rev. Rul. 71-598, 1971-2 CB 181, provides that any case in which a distribution would be treated, if tax¬able, as a redemption to which Section 302(a) would apply, the transaction ordinarily is not to be considered a device for the distribution of earnings and profits. In other words, if the transaction is one which is substantially dis-
proportionate as to a shareholder under Section 302(b)(2), one which would qualify as a complete termination of interest under Section 302(b)(3), or which, presumably, would result in a meaningful reduction under Section 302(b)(1), it would pass the device test. Although the attribution rules under Section 318 are applicable only where expressly made so and Section 355 does not refer to Section 318, Rev. Rul. 64-102 did apply Section 318 indirectly by comparing the Section 355 distribution to a hypothetical Section 302 redemption (to which Section 318 is expressly applicable) in order to determine whether the transaction was capable of being used to bail-out earnings. Prop. Reg. 1.355-2(c)(1) expressly states that in testing to see whether Section 302(a) would apply, Section 302(c)(2)(A) which determines whether there is a complete termination of interest under the attribution rules, is to apply, except for the ten-year look-forward rule for post-redemption reacquisitions. Additionally, under the proposed amendment, a transaction will ordinarily not be considered a device if neither the controlled nor the distributing corporations have earnings and profits.

Bail-out factors

Both existing Reg. 1.355-2(b)(3) and Prop. Reg. 1.355-2(c)(3) give consideration in applying the device test to the nature, kind and amount of the assets of both corporations immediately after the transaction. The existing Regulations, however, downgraded considerably the device test by stating that the fact that at the time of the transaction substantially all of the assets of the corporations involved had been used in the active conduct of trades or businesses meeting the requirements of Section 355(d) would be considered evidence that the transaction was not used principally as a device. The proposed amendments abandon this approach as they set forth with some detail factors which are to be taken into account in making the determination of whether a transaction constitutes a device. Three major categories of factors are set forth: new trade or business, liquid assets, and related function. Unfortunately, the proposal does not consider the impairment of equity defense to a transaction with bail-out potential adopted by Rafferty.

New business. Unofficial rules of thumb had been originally setup by the Service under the active-business test, rather than the device test, as to the effect of new business assets in the post-distribution corporation. Under the early test, at least 50% of the assets to be separated had to be more than five years old, had to constitute more than 50% of the fair market value of the new corporation, and had to be projected to produce more than 50% of the future income. In Rev. Rul. 73-44, 1973-1 CB 182, the Service specifically repudiated the concept that there was any requirement in Section 355(b) that a specific percentage of the corporation's assets be devoted to the active conduct of a trade or business, but announced that the percentage of assets in the spin-off corporation in the Ruling that would be devoted to the active conduct of a trade or business was a relevant factor in determining whether the transaction was used principally as a device. Similarly, the fact that more than 50% of the value of the assets consisted of a trade or business acquired within the five-year period ending on the date of the distribution in a transaction in which gain or loss was recognized was evidence that the transaction was principally a device for distribution of earnings and profits. On the facts of the Ruling, however, the Service concluded that the pro rata distribution was not a device since the stock of the distributing corporation was widely held and publicly traded, investment assets were not involved, the transaction was compelled by a valid business purpose, and the assets included in the controlled corporation represented operating businesses and not assets which could be used to facilitate the distribution of the earnings and profits of the distributing or controlled corporation or both. The Proposed Regulations pick up this theme: the fact that a substantial portion of the assets of any post-distribution corporation consists of a trade or business acquired within the five-year look-back period in a transaction in which the basis was not determined in whole or part by reference to the transferee's basis constitutes evidence that the transaction was used principally as a device. As Rev. Rul. 73-44 indicates, however, when the device approach is used, other factors can outweigh the negative inference arising from an acquired trade or business. Thus, the transactional approach is more flexible than an all-or-nothing definitional approach, such as the active-business test.

Liquid assets. Prop. Reg. 1.355-2(c)(3)(ii) provides that the transfer or retention of cash or liquid assets, such as securities or accounts receivable, which are not related to reasonable business needs of either corporation will be considered as evidence that the transaction was used principally as a device. In contrast, in Rev. Rul. 56-655, 1956-2 CB 214, no device was found when cash which was previously used in the furniture branch of a corporation was transferred to the new appliance corporation in order to equalize the value of the two businesses. It is not without significance that the form of the transaction was a non-pro rata split-up. More recently in Rev. Rul. 71-583, 1971-2 CB 180, the Service expressly ruled that a substantial capital contribution to the controlled corporation (to equalize values) may be evidence of a device, but on the facts before it no device was present because the split-off if taxable would have been substantially disproportionate redemption.

Related function. The Service had indicated previously that the device test encompassed acquisition of a new business or liquid assets. Only commentators, however, had previously suggested that the distribution of a related function of a vertically integrated enterprise should have to pass the device test. Rather, the existing Regulations and the Service had denied tax-free separation to the corporate separation of a function of a vertically integrated enterprise.

1 See Meyer, Active business requirement of 355 caption, but see &P bail-out provision tightened, 43 JTAX 879 (November, 1975).


3 See Lee, "Functional Divisions and Other Corporate Separations Under Section 355 After Rafferty," supra note 2 at 482.
enterprise apparently on the grounds that the components of a vertically or functionally integrated business previously conducted by a single corporation would not constitute an active business or were not continuing the active conduct of a trade or business formerly conducted by the predivision single corporation. As foreshadowed in Rev. Rul. 75-160, the proposed amendment abandons the former rigid active business barrier to functional divisions. Rather, the relationship between the nature and use of assets of the distributing corporation and the controlled corporation will be considered as evidence that the transaction was used principally as a device. “For example, where the principal function of one corporation before the transaction is to perform services for or supply technical or operating assets to acquire, retain its stock of which is readily salable assets (or leave the distributing corporation with readily salable assets) and thus “bail-out” earnings and profits without affecting the operating assets or earning power of the corporation the stock of which is retained by the shareholders. The shareholders would then sell the distributed stock at capital gains without disturbing their equity interest in the original corporation.

Section 355 provides the exclusive tax-free means of distributing stock in a “controlled corporation” to shareholders of the “distributing corporation.” Such a distribution may create a potential for tax abuse by enabling a corporation to distribute stock in a subsidiary with readily salable assets (or leave the distributing corporation with readily salable assets) and thus “bail-out” earnings and profits without affecting the operating assets or earning power of the corporation the stock of which is retained by the shareholders. The shareholders would then sell the distributed stock at capital gains without disturbing their equity interest in the original corporation.

Section 355 raises two barriers against such a bail-out: the “device” test and the “active business” test. A transaction cannot be used principally as a “device” for the distribution of the earnings and profits of the distributing corporation, the controlled corporation, or both under Section 355(a)(1)(B). In addition, Sections 355(a)(1)(C) and 355(b) require that, immediately after the distribution, both corporations be engaged in the “active conduct of a trade or business” which has been actively conducted for five years prior to the distribution. The purpose of the active business test is to preclude a corporation from separating its retained earnings in the form of liquid assets from its operating assets, and incorporating such liquid assets, and then distributing the subsidiary’s stock to its shareholders in anticipation of a future sale of such stock or liquidation of the spun-off subsidiary. The five-year holding period was designed to keep the distributing corporation from using liquid assets to acquire, shortly before the distribution, a new active business that could be spun-off without any contraction of the old operating assets.

In addition to the device and active business tests, Reg. 1.355-2(c) imposes on Section 355 the business purpose and continuity of interest requirements applicable to reorganizations in general.

BACKGROUND: DEVICE AND ACTIVE BUSINESS TESTS

Section 355 provides the exclusive tax-free means of distributing stock in a “controlled corporation” to shareholders of the “distributing corporation.” Such a distribution may create a potential for tax abuse by enabling a corporation to distribute stock in a subsidiary with readily salable assets (or leave the distributing corporation with readily salable assets) and thus “bail-out” earnings and profits without affecting the operating assets or earning power of the corporation the stock of which is retained by the shareholders. The shareholders would then sell the distributed stock at capital gains without disturbing their equity interest in the original corporation.

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Post-distribution sales. In order to preclude the Service from taking the position that every corporate division followed by a sale of stock violated the device test, Congress expressly stated in Section 355(a)(1)(B) that the mere fact of a post-distribution sale, other than one pursuant to a predistribution arrangement, would not be construed as a transaction that was used principally as a device. Existing Reg. 1.355-2(b)(1) interpreted this to include a non-prearranged sale as evidence of a device, but it was not determinative. Prearranged sales in turn were described simply as evidence of a device without the qualification of not being determinative evidence, but the Service added that qualification as well in Rev. Rul. 59-157, 1959-1 CB 77. Prop. Reg. 1.355-2(c)(2) takes a more sensible approach, setting forth explicit levels of weight to be given to various categories of sales in determining whether the transaction is a device. If a post-distribution sale of 20% or more of stock of either the distributing or controlled corporation is arranged prior to the distribution, the distribution is deemed to have been used principally as a device. If such prearranged sale was of less than 20% of the stock of either corporation, the sale is still considered substantial evidence that the transaction was used principally as a device. If a post-distribution sale of any amount of stock of either corpora-
tion was not negotiated or agreed upon prior to the distribution, then the fact of such sale is taken into account with other evidence in determining whether the transaction was used principally as a device for the distribution of earnings and profits. In Example 2 of Prop. Reg. 1.355-2(c)(2) where, after a pro rata distribution, the distributee shareholders agree to sell to an unrelated third party 90% of the distributed stock of X corporation and prior to the distribution cash was transferred to X corporation which substantially exceeded its reasonable needs, the transaction will be considered to have been used principally as a device "because of the transfer of cash to X and the subsequent sale of X stock by A and B." Implicitly, had the transfer of cash not exceeded the reasonable business needs, the distribution followed by a non-prearranged sale would not have been a device.

As under the existing Regulations, a sale is considered always to have been made pursuant to an arrangement negotiated or agreed upon prior to the distribution when enforceable rights to buy or sell exist before the distribution. The existing Regulations had provided that where a sale or exchange was discussed but enforceable rights to buy or sell did not exist, the question of whether the arrangement was negotiated within the meaning of Section 355 (a)(1)(B) was to be determined from all the facts and circumstances Prop. Reg. 1.355-2(c)(2) takes a harder position: if a sale was discussed by the buyer and the seller before the distribution and was reasonably to be anticipated by both parties, such sale ordinarily is considered as made pursuant to an arrangement negotiated or agreed upon prior to the distribution.

Neither the existing Regulations nor the proposed amendments speak to a pre-distribution sale of stock in the distributing corporation. In Rev. Rul. 59-197, 1959-1 CB 77, the Service ruled that such a sale has exactly the same effect as a binding contract to sell some of the stock after the transaction. Furthermore, if the 20%-or-more-prearranged-subsequent-sale rule is applicable, it is unclear whether the 20% would be measured against the sale of stock in the distributing corporation, which under the facts of the Ruling was 19.8%, or the interest acquired in the controlled corporation. Under the Ruling's facts, the purchaser acquired, in the reorganization, 18% in value of the stock in the controlled corporation, but 1/2 of the voting rights and half of the stock.

The Service had previously conceded that a divisive reorganization could be combined with an amalgamating reorganization 14 Prop. Reg. 1.355-2(c)(2) acknowledges that concession by stating that for purposes of the subsequent-sales-or-exchanges-of-stock rule, the term "exchange" does not include an exchange of stock or securities in a tax-free transaction in which no gain or loss is recognized "or in which an insubstantial amount of gain is recognized." The question of boot or excess principal amount of securities may lead to litigation in the future.

The proposed amendment does not attempt to address the question whether there is a conflict between the subsequent sale or exchange of stock rule and the rule that transactions to which Section 302(a) would apply if the transaction were taxable are ordinarily not to be considered a device. Due, however, to difference in wording of the two rules, it would appear that the subsequent sale of stock provision would override the disproportionate distribution or complete termination of interest provision. Presumably, the only tax consequence would be the timing of the gain, since it would ordinarily be capital in either event.

In summary, the device provisions of the proposed amendments to the Regulations are an admirable attempt to update and bring the Section 355 Regulations in line with the cases and the underlying policies of the provision. The principal weakness lies in (1) their failure to mesh the business purpose test with the device test and the bail-out-potentiality approach, and (2) their failure to consider the impairment of equity concept.

Active business

According to the preamble to the proposed amendments, the purpose of the changes to the active-business provisions is to provide for the separation of a single business consistent with the holdings of Coady and Marett. But the changes also reflect later developments.

Single business As a starting point, the old references in Regs. 1.355-1(a) to a single business and in 1.355-1(b) to the continued operation of the businesses existing prior to the separation have been deleted. Existing Reg. 1.355-1(c) contained a definition of the term trade or business for purposes of Section 355 and then provided three negative provisos as to activities which the term did not include. Prop. Reg. 1.355-3(b)(2)(ii) by and large keeps the same definition of trade or business: a specific group of activities carried on for the purpose of earning income or profit which 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." Previously, it was this language in part that was thought to be the basis of the prohibition of functional divisions15 together with the rule that Section 355 did not apply to the division of a single business.16 To the extent that this was so, the proposed amendments apparently change the meaning of the above definition by changing most of the questioned examples flowing from the definition. Significantly, the three negative provisos have been radically changed. As before, Prop Reg. 1.355-3(b)(2)(iv)(A) indicates that the holding for investment purposes of stock, land or other property does not constitute the active conduct of a trade or business.17 The prior proviso that a trade or business did not include a group of activities, which while not themselves independently producing income, could do so with the

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16 Raftery, 652 F.2d 767, (CA-1, 1977), cert. den.
18 See Reg. 1.355-1(d) Examples (5), (11), (13) and (14).
19 Compare Reg. 1.355-1(c) Examples (6), (12) and (13) with Prop. Reg. 1.355-3(c) Examples (8), (9) and (11).
21 Lee, "Functional Divisions and Other Corporate Separations Under Section 355 After Raftery," supra note 2 at 480-81.
23 Lee, "Functional Divisions and Other Corporate Separations Under Section 355 After Raftery," supra note 2 at 480-81.
addition of other activities has been deleted in its entirety. Perhaps the most bothersome of the old negative provisions, the denial of active business status to the ownership and operation of owner-occupied land or buildings, has been modified radically. Now, under Prop. Reg. 1.355-3(b)(2)(iv)(B), the active conduct of a trade or business does not include the ownership and operation (including leasing) of real or personal property used in a trade or business, whether or not owner occupied, unless the owner performs significant services as to the operation and management of the property.

The performance of significant services as to the operation and management of the property is not intended to incorporate the Subchapter S corporation distinctions between active conduct and conduct of a rental real estate business.\(^{18}\) For instance, Example 4 of Prop. Reg. 1.355-3(b)(4)(C) holds that a corporation which manages a building, negotiates leases, seeks new tenants, and repairs and maintains the building is engaged in the active conduct of a trade or business, which would not be the case under the Subchapter S corporation test.\(^{19}\)

With respect to owner occupied real estate, the existing Regulations look to see whether the rental activity is incidental to the main business or, instead, is really a separate business. On the other hand, the proposals proceed from the basis of the activities carried on by the real estate corporation. In Example 4 of Prop. Reg. 1.355-3(b)(4)(C), in which a real estate corporation qualified as actively conducting a trade or business, the distributor banking corporation transferred to such real estate corporation an 11-story commercial building. The bank had occupied only one floor of such building with the other ten floors being rented out to outsiders. In contrast, Example 4 in existing Reg. 1.355-1(d) discusses a bank which owned a two-story building, only 75% of which the bank occupied. The conclusion there was that the 25% (half of the second floor) of which was rented to outsiders was only incidental in the original regulation example. On substantially the same facts, Example 5, of Prop. Reg. 1.355-3(c)(6) also concludes that such rental activities do not constitute the active conduct of a trade or business, but additional facts are added: the lease is a net lease, the distributing corporation will lease the space formerly occupied by it from the new corporation and under the lease will repair and maintain its portion of the building and pay property taxes and insurance. This provision may conflict with King, 458 F.2d 245 (CA-6, 1972), which held that net leasing freight terminals to a patent trucking corporation together with activities in constructing the terminals constituted an active business. Clearly, however, the proposal correctly denies active business status where the only activity is net leasing property.\(^{20}\) In short, under the proposal, the net lease aspect and not the owner occupied aspect precludes active business status. All of the other examples of owner-occupied real estate in the proposed amendment also involve situations in which the principal activities of the lessor consist of the collection of rent from the building and the lessee maintains the rental property.\(^{21}\) Unfortunately, none of the examples posit a situation in which the post-distribution real estate corporation leases the property solely to the distributing corporation, but the lessor-controlled corporation is responsible for maintenance and repair of the building and has negotiated its own lease. While undoubtedly in the Service's eyes, such a transaction is at the very borderline of what is an active business, it is submitted that the proper approach, where the lessor corporation carries on the requisite activities, is to place the emphasis on the related function aspect of the device test. It appears that there is little difference between a sales corporation which merely functions as an exclusive agent for a manufacturing corporation after the distribution and a rental real estate corporation that leases solely to a related manufacturing corporation. If the requisite activities are there, the barrier should be the device test.

**Corporate divisions**

**Functional divisions.** Examples 2, 5, 11 and 12 under existing Reg. 1.355-1(d) indicate that the separate components of an integrated business conducted prior to the separation by a single corporation could not constitute a post-distribution active business or were not continuing the active conduct of the trade or business formerly conducted by the predistribution single corporation. The rationale was either that Section 355 did not apply to the division of a single business or that activities which were not themselves independently producing income could not qualify as an active business. The First Circuit in Ref. 2 approved, in dictum, functional divisions of existing businesses under the Coady rationale. The Service conceded the issue in Rev. Rul. 75-160, 1975-1 CB 112. And now the proposed amendment also accords active business status to functional divisions that were denied such status under the existing Regulations on the ground that they were merely incidental activities. The shift has been, as indicated above, from the active business test to the device test, which is more responsive to the question of bail-out potential.

**Vertical Divisions.** A vertical division consists of a corporate division in which each of the post-distribution businesses carries on all stages or function of the original business.\(^{22}\) This was the type of corporate separation approved in Coady and Marett. New examples in the proposed amendment to the active business Regulations incorporate the facts of these two cases. The pre-Coady prohibition on the division of a single corporation posed certain problems that commentators believed the Service originally sought to resolve in the existing Regulations by fashioning the rule that the factor of geographic separation gave rise to separate businesses, apparently on the premise that widely dispersed businesses could more easily separate.\(^{23}\) Indeed, almost a third of the active business examples under the existing Regulations approved geographic divisions on the grounds that the activities in each state constituted a trade or business. After Coady there tended to be a reversal of roles: the taxpayer often sought to establish that the separated activities inherited a five-year history from a single predistribution business where one of the divisions was less than five years old, while the Government argued that there were two businesses, only one of which was properly "aged."\(^{24}\) The Proposed Regulations delete all of the geographic separation examples, apparently in a concession to the holding in Lockwood, 350 F.2d 712 (CA-8, 1965), that, for purposes of the predistribution five-year active business test, prior business activity of the distributing corporation is to be determined by examining overall operation, and measurement is not limited to the geographical area where the controlled corporation is eventually formed.

The elimination of the old geographi-
and to the troublesome question whether one or two businesses exist for purposes of the five-year test will rely upon integration of management and income producing activities.

Example 10 of the existing Regulations had specifically stated that no common warehouse was maintained for the two men's retail stores. Example 7 of Prop. Reg. 1.355-3(c), to the contrary, has a common warehouse and delivery system for the predistribution stores. This example, however, points out that the post-distribution stores will be operated differently with one corporation retaining the warehouses and the other retaining the delivery trucks and employees. Each store will acquire from outsiders the corresponding functions that the other store retained. It is unclear whether a failure after the distribution to utilize unrelated parties to supply the functions which are not retained would be fatal under the active business test. More likely, the question would be whether the related function aspect of the device test was violated.

**Active Business Requirement.** Prop. Reg. 1.355-3(b)(2)(iii) provides that in general a corporation in order to actively conduct a trade or business must perform active and substantial management and operational functions. There can hardly be any quarrel with this as an accurate statement of the law. The rental property examples which illustrate performance or failure to perform any significant service as to the operation and management of the property are the only illustrations in the proposed amendment of active and substantial operational functions. Quite likely the two tests are not distinguishable. From these examples one may conclude that management of a building, negotiating leases, seeking new tenants and repairing and maintaining the building satisfies both tests, while net leasing property will not satisfy either test. An earlier trilogy of Revenue Rulings, 73-224, 73-236 and 73-237, 1973-1 CB 181, 183 and 184, offer some guidelines as to the active and financial management and operational functions test.

Neither the statement in the proposed amendment to the Regulations of the test nor any of the examples in the proposal address the other holding of these Rulings, namely that such substantial management and operational activities must be directly carried on by the corporation itself and that the test is not satisfied by the activities of others outside the corporation, including independent contractors. The absence of reference to direct conduct in the proposed amendment may signal a withdrawal from the position taken in the Rulings, which had been criticized as inconsistent with the case law and the function of the active business test.

**Business purpose, interest continuity**

The cases and the commentators each display conflicts as to the proper role under Section 355 for the business purpose and continuity of interest tests. One school, long followed by the Service, holds that business purpose is an independent test which must be met even if the taxpayer passes the device and the active business tests. The other school, to the contrary, holds that business purpose and continuity of interest are relevant only as adjuncts to the device test. If the transaction presents a bail-out potential so that it can be used as a device, then the taxpayer must show a business purpose sufficient to outweigh the bail-out potential, which purpose can only be satisfied by the continued retention of

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the post-distribution corporations. Beyond this conflict, there is still another conflict as to whether a shareholder purpose alone can satisfy the business purpose test. The proposals, perhaps not surprisingly, retain the emphasis of the existing Regulations on business purpose and continuity of interest being requirements independent of the device test. Furthermore, the proposals make explicit the prior position of the Service that a transaction motivated solely by personal reasons of a shareholder will not qualify under Section 355. The proposed amendment points out that depending upon the facts of a particular case, a shareholder purpose may be so nearly coextensive with the corporate business purpose as to preclude any distinction between them, in which case the transaction is carried out for purposes germane to the business of a corporation. But, where the transaction is motivated solely by the personal reasons of a shareholder, such as fulfilling the personal [estate or business planning purposes of the shareholder, the distribution will not qualify under Section 355. The prognosis for future development in these two areas is difficult, for the courts themselves cannot agree. In such circumstances the Service may be expected not to yield its position until the conflicts are resolved judicially or legislatively.

As foreshadowed in Rev. Rul. 69-460, 1969-2 CB 51, the Service now makes explicit in the examples in Prop. Reg. 1.355-2(B)(2), that a business purpose must exist for the distribution of the stock of the controlled corporation. Thus, in Example 8, where a business purpose, such as protection of the assets of one activity from the risks of another, can be fulfilled by the transfer of the business to a new corporation without distribution of the stock to the shareholder, the transaction fails the business purpose test. Given the premise of the Regulations that business purpose is an independent test, the position that there must be a business purpose for the distribution follows inexorably. The examples illustrate circumstances in which such purpose for separate ownership may be satisfied. In Example 4 for instance, if a lender requires the separation of the one business from another and distribution of the stock in the controlled corporation based upon its customary business practice, then the corporate business purpose test is satisfied.

To the same effect is Rev. Rul. 77-22, IRB 1977-4, which, though decided under existing Reg. 1.355-2(c), found a valid business purpose in the pro-rata distribution by a parent of its subsidiary stock which enabled both corporations to thus qualify for more total bank credit.

In addition to the question whether the business purpose and continuity of interest criteria constitute an independent test, there is the issue whether a showing of (corporate) business purpose which can only be satisfied by a continued retention by the distributives of control of both post-distribution corporations can outweigh a strong bail-out potentiality of a transaction so that it is not a device. Rafferty indicated that it can, but the proposed amendment is distressingly silent.

Conclusion

With minor adjustments the device and active business provisions of the proposed amendment to the Regulations fully meet the Service's objectives of providing the factors which evidence device and eliminate the existing Regulations' prohibition regarding the separation of a single business. By and large, they satisfy in these two areas, all of the dictates of the recent court decisions and the suggestions from commentators, with the principal exception of the impairment of equity and business purpose defense aspects of the device test. It would appear that it will be primarily in those areas and in the "independent" business purpose section that controversy and uncertainty will continue. Given, however, the conflict between cases and commentators, the Service hardly could have been expected to have chosen any other path as to the independent corporate business purpose requirement than it did. From this vantage point, the 13-year gestation period may well have been worth the final product.

Second Circuit, in Aetna, provides new planning possibilities in F reorgs.

The Second Circuit, in Aetna Casualty and Surety Co., CA-2, 12/15/76, has held that a merger of a corporation's 61%-owned subsidiary into its newly created, wholly-owned subsidiary qualifies as an F reorganization despite the elimination of the 39%-minority interest. Thus, the taxpayer was able to deduct its post-reorganization NOLs against the pre-reorganization income of its predecessor. In its first decision squarely facing this issue, the court followed the lead of the Fifth Circuit, in Reef Corporation, 368 F.2d 125 (CA-5, 1966), in concluding that complete identity of shareholder interests is not an indispensable element of an "F" reorganization.

The transaction in Aetna Casualty involved an attempt by Aetna Life Insurance Company (Aetna Life) to set the stage for a Section 355 distribution of the stock of its 61%- subsidiary, Aetna Casualty and Surety Company (Old Aetna). For various business reasons, Aetna Life wanted identical shareholder groups for the two companies. It also wanted to remove the value of Old Aetna's stock from its asset bases for purposes of computing taxable investment income under Subchapter L.

In order to distribute Old Aetna stock without tax cost, Aetna Life sought to comply with Section 815(f)(3)(B)(ii), which permits insurance companies to make tax-free distributions of stock of a 100% subsidiary if certain requirements are met. Aetna Life first formed New Aetna by contributing its own stock in exchange for all of New Aetna's stock. New Aetna then exchanged the Aetna Life stock (its only asset) for the stock of Old Aetna which was held by Aetna Life and the 99%-minority group. Under state law, Old Aetna was merged into New Aetna. Finally, Aetna Life distributed the stock of New Aetna to a trust for the benefit of Old Aetna's shareholders (which now included the former minority interest in Old Aetna).

As a result, an identical group of shareholders owned both Aetna Life and New Aetna, which continued without interruption the business of its predecessor.

The Service has long held that where an "A," "B" or "C" reorganization also qualifies as an "F," it should be treated as an "F" for purposes of Section 811(b)(3), Rev. Rul. 57-276, 1957-1 CB 126. Further, the IRS has recently acceded to the view of several courts that an "F" reorganization can involve a combination between two or more commonly
controlled corporations, however, the Service's position, stated in Rev. Rul. 75-561, 1975-2 CB 129, is that such a transaction requires complete identity of shareholder interests. In rejecting the IRS' approach, Aetna Casualty and Surety Co. relied heavily upon the ground broken in the Fifth Circuit's *Reef* decision. There, the IRS was the party urging "F" reorganization treatment of an alleged "liquidation." In a complicated transaction conducted through a straw man, former 52% shareholders of the liquidated corporation wound up owning 100% of a newly formed corporation which had acquired all the operating assets of the old corporation. The 48% minority was bought out for cash and notes. *Reef* held that the redemption of the minority interest and the reincorporation of the old business into the new shell were functionally unrelated, the former being governed by Section 302 and the latter by Section 368(a)(1)(F).

The Second Circuit in *Aetna* carried this reasoning one step further. Noting that one of the innovations of the 1954 Code was the comprehensive set of rules related to redemptions, the court urged that even if the reorganization aspects of the transaction could not be separated from the redemption features these different parts of the deal should still be treated separately for tax purposes. Since neither a redemption nor a simple reincorporation into a new shell would, if undertaken separately, justify imposing the restrictions of Section 381(b)(3), the fact that both occur simultaneously should not, the court reasoned, change the tax result.

Both *Reef* and *Aetna* explicitly limit their holdings to situations where (1) the new corporation continues the business of the old without interruption, (2) the shareholders of the new corporation hold at least 50% of the old company, and (3) no new shareholders enter. While suggesting that a taxable sale rather than a reorganization might result where the latter two conditions are not met, neither decision attempts to delineate the precise outer limits of reorganization treatment.

The Second Circuit distinguishes the elimination of a minority interest which it approves in *Aetna* from the kind of shift in proprietary interest held to be incompatible with an "F" reorganization in *Southwest Consolidated*, 315 U.S. 194 (1942). That case, the court notes, involved a bankruptcy reorganization where the former creditors of the corporation became the majority shareholders of the reorganized company.

In addition, the Second Circuit, argued in a footnote, that *Southwest Consolidated*, may be of doubtful vitality under the 1954 Code, in view of the enactment of Section 381(b), which greatly enhanced the significance of the definition of an "F" reorganization—a question which *Southwest Consolidated* disposed of in one sentence. The Second Circuit disapproved of the approach taken by the Tax Court in *Casco Products Corp.*, 49 TC 32 (1967), where a reincorporation coupled with the elimination of a 9% minority was held to be simply a redemption. Although agreeing that the redemption should be treated as such, the Second Circuit felt that the reorganization aspects of the transaction could not be ignored, and that the "F" definition is broad enough to embrace such an arrangement.

Underlying the holding in *Aetna* is the court's view that its result is consistent with the purposes of Sections 381(b) and 172. According to the Second Circuit, 381(b)(3) is designed to avoid post-acquisition divisional accounting, and prevents the manipulation which would result if an acquiring corporation were allowed to apportion current losses between the operations of two predecessor corporations. When an "F" reorganization is involved, and a new shell with no business of its own is used to effect the acquisition, no such accounting problems result, since only the acquired company has a business history.

Normally, an acquiring corporation in a transaction covered by Section 381(b)(3) at least has the option of carrying its post-merger losses back to its own pre-merger years, since Section 381 imposes no restrictions on this practice. However, application of 381(b)(3) to the acquiring corporation in an Aetna-type transaction effectively precludes any loss carryback, since the acquiring company has no pre-merger history. The *Aetna-Court* felt that this would be too harsh a result to inflict merely because an "F" reorganization was coupled with the redemption of a minority interest—especially in light of the legislative policy in favor of loss carrybacks evidenced by Section 172.

Although the Second Circuit explicitly reserves the question of whether an "F" reorganization should be defined identically in all circumstances, its decision in *Aetna* effectively holds the IRS to the same definition when challenging reorganization status, as the Service successfully asserted in foiling the attempted liquidation-reincorporation in *Reef*.

**TC prescribes rules for computing E & P**

The Tax Court, in *Anderson*, 67 TC No. 39, announced three rules on computing a corporation's earnings and profits. First, where a corporation with no accumulated earnings and profits makes both ordinary cash distributions and redemption distributions to its shareholders and where the current earnings are insufficient to cover both types of distributions, then the ordinary cash distributions are deemed to be made first from the current earnings and profits to the extent thereof as computed under Section 316(a)(2) before taking into account any Section 302(a) redemption distributions. In addition, the court approved the rule announced originally in *Jarvis*, 43 BTA 439 (1941), which limits the charge to capital under Section 312(c) on account of a redemption distribution to the proportion of paid-in capital represented by the redeemed shares. Finally, the court decided that where an employee of a subsidiary corporation exercises a stock option which had been assumed by the parent's corporation within the meaning of Section 425(a), then the spread between the option price and the fair market value of the stock when the option is exercised is a proper charge to the earnings and profits of the employer (subsidiary) corporation.

The Section 316 definition of a dividend prescribes that the current year's earnings and profits are to be computed as of the end of the tax year and are not to be diminished by any distributions during such tax year. Notwithstanding this provision, the taxpayers in *Anderson* argued that, under Section 312, any portion of a Section 302(a) redemption distribution which is not properly chargeable to capital, should reduce the earnings and profits as of the date of the redemption. The taxpayers pointed to the wording of Section 312(a) which indicates that a corporation's earnings and profits will be reduced on the distribution of property by such corporation. Even assuming that Section 312(a) does provide a timing rule for adjustments of earnings and profits, the Tax Court believed that the special rule in Section 316 which explicitly preserves the full