Section 335 Active Business Management: What Advice to Give Clients Today

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Section 355 active business requirement: What advice to give clients today

by JOHN W. LEE

The IRS in three Rulings has taken the position that services for the distributing corporation performed through independent contractors could not satisfy the active business requirement test of Section 355. Mr. Lee analyzes the Rulings in light of case law and legislative history that have interpreted the Code's active business test. He concludes that further court tests will be necessary before there can be complete reliance upon active conduct by an independent contractor.

Section 355 contains two safeguards against bail-out abuse: the "device" test and the "active business" test. The provision is inapplicable if the transaction was used principally as a "device" for the distribution of the earnings and profits of the distributing corporation, the controlled corporation or both. Moreover, immediately after the distribution both corporations must be engaged in the "active conduct of a trade or business" that has been actively conducted for five years prior to the distribution.

The purpose underlying the active business test is to prohibit a corporation from separating its surplus in the form of liquid assets from its operating assets, incorporating the liquid assets, and then distributing the subsidiary's stock to its shareholders in anticipation of a future stock sale or liquidation. The five-year pre-distribution period keeps the distributing corporation from using liquid assets to acquire, just before the distribution, a new and active business that can be spun-off without any contraction of old operating assets.¹

An unanswered question was whether the active business test was met if an agent or independent contractor carried out the major activities of the distributing corporation or of the controlled corporation whose stock was distributed. Judicial authorities interpreting Sections 355,² 761³ and 921⁴ indicate that an active business may be conducted through an agent or possibly an independent contractor. Furthermore, such a conclusion appears consistent with the purpose of the active business test and the device test as manifested by the legislative history of Section 355. On the other hand, both Section 856(d)(3) (pertaining to REITs) and the Regulations under Section 954(c)(3)(A) (pertaining to U.S. shareholders in "controlled foreign corporations") would seem to deny active business status to rental real estate if management and operational activities are rendered through an independent contractor. In three 1973 Rulings (73-234, 73-236 and 73-237, 1973-1 CB 181, 183, 184) the IRS has provided a clarification to the independent contractor question.

Facts of recent Rulings

In Rev. Rul. 73-234, Y corporation, a wholly owned subsidiary of X corporation, was engaged in a farm operation for more than five years prior to the proposed spin-off of Y corporation. Tenant farmers (independent contractors) undertook the planting, raising, and harvesting of crops and breeding and raising of livestock in Y's farm operation. Y employed a general maintenance man for farm property and equipment and A, who was the president and sole shareholder of X. A, an experienced farmer, negotiated on Y's behalf the annual contracts with the tenant farmers, hired seasonal workers and mechanics, planned all planting and harvesting of crops and all livestock breeding and purchases. Moreover, A was responsible for handling sales of all crops and livestock and for accounting to the tenant farmers for their shares of the proceeds. Y supplied all equipment and arranged for all financing necessary for its farm operations.

Rev. Rul. 73-237, involved X corporation, a general contractor in the construction industry, with a wholly owned subsidiary actively engaged in the manufacture and sale of electrical equipment. The proposed transaction consisted of splitting off that subsidiary. X performed through several of its salaried employees the following activities: submitting bids; negotiating contracts with principals and subcontractors (independent contractors); purchasing or leasing equipment and supplies; and supervising work of subcontractors to determine whether they had completed their work in conformity with contract specifications. The primary responsibility for the completion of each job fell upon X.

In Rev. Rul. 73-236, X was an unincorporated trust taxable as a corporation. For over five years it had been engaged in two businesses: (1) the sale of real estate that it had developed and improved, and (2) the leasing of some of the buildings that it had constructed. In a Section 351 transaction, X transferred all its property held primarily for sale to customers in the ordinary course of business to Y, a wholly owned and newly formed subsidiary, and then spun off the Y stock. As part of one overall plan, X transformed itself into a REIT and thereafter engaged primarily in the leasing of real estate properties, each of which was managed and operated by an independent contractor. X also retained some undeveloped land that it planned to develop in the future into rental property which an independent contractor also would manage and operate.

The three Rulings announced the same rule: "Section 355 of the Code, by requiring that a trade or business be actively conducted connotes substantial management and operational activities directly carried on by the corporation itself, and not the activities of others outside the corporation, including independent contractors. However, the fact that a portion of a corporation's business activities is performed by independent contractors will not preclude the corporation from being engaged in
the active conduct of a trade or business, if the corporation itself directly performs active and substantial management and operational functions."  

In Rev. Ruls. 73-234 and 73-237, the IRS ruled that since the spun-off subsidiary's farm activities in the former and the distributing corporation's general contracting activities in the latter included the direct performance by each of "active and substantial management and operational functions," apart from those performed by the independent contractors, each was engaged in the active conduct of a trade or business. On the other hand, Rev. Rul. 78-236 concluded that because (1) the only business conducted by the REIT before and after the spin-off was leasing real estate, and (2) the conduct of such rental activities as a REIT precluded it from directly performing substantial management and operational activities, the REIT was not engaged in the active trade or business immediately after the spin-off. The conclusion that direct conduct excludes activities of others outside the corporation, including independent contractors and probably uncompensated corporate officers, constitutes the most important and controversial aspect of the Rulings. But the three Rulings also contains implications as to the possible course of the long awaited revision by the Service of the active business provisions of the 355 Regulations.  

Active and substantial management  

The performance of "active and substantial management and operational functions" as a test for active conduct set forth in the Rulings appears to be an adoption of one of the tests contained in Reg. 1.956-2 (d)(ii)(a) for determining whether rents are derived in the active conduct of a trade or business. These Rulings, however, despite their seeming abundance of facts which commonly are thought to serve as guideposts to points of emphasis in the Service's analysis, add little flesh to the bare bones of the active and substantial management and operational functions test. Management activities in both the farming (Rev. Rul. 73-234) and general contracting (Rev. Rul. 73-237) operations entailed negotiations of contracts with the independent contractors and overall planning responsibilities. As to operational activities, the principal element in both Rulings was the furnishing (by purchase or lease) of equipment and supplies. It is probable, however, that furnishing equipment and supplies is of secondary importance to rendering management decisions and certainly is not the sine qua non of carrying on active and substantial management and operational activities. Management decisions and participation are essential factors in a similar test contained in an exception to the Section 1402 exclusion of real estate rental income from the term self-employment earnings. In that context, the IRS declared in Rev. Rul. 57-58, 1957-1 CB 270 that physical work and management decisions are the principal factors to be considered and that furnishing equipment and supplies or advancing funds for the expenses of the operation qualify only as additional factors to be considered in borderline cases.  

The "active and substantial management and operational functions" criterion appears closely related, if not identical, to a Section 355 active business definition promulgated in Rafferty, 452 F.2d 767 (CA-1, 1971), cert. den., wherein the First Circuit stated that an active business consisted of entrepreneurial activities quantitatively and distinguishing corporate operations from mere investments. While Rafferty did not further delineate this test, cases decided under Code provisions not containing the qualification "active" but in which the result depended on whether the taxpayer was engaged in a "trade or business" have drawn a distinction between business and investment activities. Such a distinction has turned on whether the taxpayer receives the benefits of his investment as opposed to whether he creates a market or provides services to another; when only the taxpayer stands at the end of the economic chain, he is deemed to be engaged in investment activities. A comparison of a real estate dealer with a trader in securities illustrates this distinction. The trader in securities is not a middleman in the distribution of securities; rather he resells to the same class of persons from whom he buys, i.e., brokers. The fact that the trader does not create a market renders his sales activities passive, and thus he qualifies only as an investor. A dealer in real estate, on the other hand, develops a market and sells to customers, not back to another dealer as a trader would, and thus the dealer engages in a trade or business. Just as trading in securities does not constitute a business, the management of one's own securities is not a business for tax purposes because services to others are not provided; such services are rendered or goods are sold by the business activities of the corporation, a separate entity, whose securities the investor holds; and the corporation's business activities are not attributed to its shareholders. In contrast, the management of improved rental real estate includes the provision of services to the tenant, e.g., renting, maintaining and improving the premises. Comparing ownership of securities with ownership of real estate from the point of view of the owner's activities, it may be noted that nothing further need be done in the case of securities in order to realize income, but further action is required in the case of real estate. The latter will produce no income unless rented, used, or sold; thus, an owner of rental real estate is not a mere passive investor but instead is engaged in a trade or business. In short, the entrepreneurial activities approach focuses on whether the paid. A recurring issue in the case law of Section 355 has been whether the direct conduct criterion is met where corporate officers are not paid.  


1 See, e.g., DuPont, 308 U.S. 488, (1940); Meyers, TCM 1971-265.  

2 See Rafferty, 452 F.2d 767 (CA-1, 1971), cert. den.; second Rafferty, 545 (CA-4, 1972); W. E. Gabriel Fabrication Co., supra.  

3 Rev. Rul. 1.761-1(a) (1956) provides that tenants in common may be partners if they actively carry on a trade or business and divide the profits therefrom. For example, a partnership exists if co-owners of an apartment building lease space and provide services to the occupants alike through an agent. Id. The active business test is satisfied by regular and continuous management and rental activities. Varner, TCM 1973-97; Rothenberg, 48 TC 369 (1967).  

4 See, e.g., Int'l, Canadian Corp., 308 F.2d 520, (CA-9, 1962); United States Oppenham Corp., 504 F.Sup. 627, (DC Ill., 1969), rev'd. on other grounds, 452 F.2d 445 (CA-7, 1971); Barber-Greene Ams., Inc., 35 TC 866 (1960).  


6 While the Rulings do not expressly mention uncompensated corporate officers, they do mention that the corporate officers involved therein were
The non-Section 355 decisions distinguishing between business activities and investment activities also illuminate the problem of whether a business may be actively conducted through an independent contractor. The cited cases involving agent-operated realty implicate the agent's management activities to the owner of the real estate.10

**Direct conduct test**

The true significance of the three Rulings lies in their adoption of the direct conduct test. Support for their application of the direct conduct concept also may be found in the Section 954 model for the active business test. Under that Section the "active business" safe haven of Reg. 1.954-2(d)(1)(ii)(a) is barred if the management and operational functions are performed by a real estate management firm, i.e., an independent contractor. Conversely, Reg. 1.954-2(d)(2)(ii)(c) provides that where a controlled foreign corporation acts as its own rental agent for the leasing of offices in an office building which it has purchased and employs a substantial staff to perform other management and maintenance functions, the rents are derived from the active conduct of a trade or business.

Similarly, the REIT provisions in Section 856(d)(3) exclude amounts received with respect to real property from the term "rents from real property" where the REIT "furnishes or renders services to the tenants of such property or manages or operates such property, other than through an independent contractor." Section 856 does not use the term "active conduct of a trade or business." Nevertheless, as noted by Rev. Rul. 73-236, the legislative history to the Section stated that the REIT restrictions were intended to limit the "pass through" to shareholders of taxable income that was clearly passive income from real estate investments, as contrasted with income from the "active operation of business involving real estate."

In sharp distinction to the position taken in the three Rulings, Section 856, and the Section 954 Regulations that a trade or business actively conducted means activities directly carried on by the corporation and excludes the activities of others outside the corporation, the Tax Court squarely held in W. E. Gabriel Fabrication Co., 42 TC 545 (1964), acq., that Section 355 does not require the actively conducted business to have been directly conducted by either the distributing corporation or the controlled corporation for purposes of the five year pre-distribution active business requirement. In Gabriel the distributing corporation, Boiler, had operated three lines of businesses: (1) manufacturing boilers, (2) fabricating structural and plate steel, and (3) manufacturing canopy covers for tractors. In addition it owned all the stock in a subsidiary real estate corporation, Engineering. A split-off was contemplated in which the fabricating and canopy businesses would be transferred to Engineering whose stock would then be distributed to one of the Boiler shareholders, Gabriel, in exchange for all of his stock in the latter. About 14 months prior to the actual consummation of the split-off, Boiler transferred all of the fabrication and canopy assets to Gabriel in a transaction denominated by the Tax Court as a loan. Subsequently, as an integral part of the distribution to him of the stock in the subsidiary Engineering, Gabriel transferred these assets to Engineering. The Tax Court held that immediately after the split-off Boiler was engaged in active conduct of the boiler business which it had actively conducted throughout the five-year pre-distribution period. Likewise, Engineering was engaged in the active conduct of the fabrication and canopy businesses immediately after the distribution. However, the court found that Boiler had ceased to engage in the conduct of the fabrication and canopy businesses when it loaned their assets to Gabriel.

The Commissioner asserted that in order to meet the active business requirements, Boiler or Engineering must have conducted the fabricating and canopy businesses or acquired them in a tax-free transaction during the five-year pre-distribution period. Gabriel maintained, on the other hand, that neither the distributing corporation nor the controlled corporation had to have conducted such businesses during that five-year period. It contended "that the trade or business could have been conducted during this period by some third party, such as a corporation not related to either the distributing corporation or the controlled corporation, or even by a sole proprietorship." The Tax Court agreed that Gabriel's operation of the fabricating and canopy businesses in the form of a sole proprietorship during the fourteen months prior to the distribution of the Boiler stock could be added to the period during which Boiler conducted these businesses. Consequently, the court found that the five-year pre-distribution active business requirement of Section 355 had been satisfied.

The pre-distribution requirement of Section 355(b)(2)(B)—"such trade or business had been actively conducted throughout the five-year period ending on the date of the distribution"—does not indicate by whom the business must have been actively conducted. On the other hand, the post-distribution active business requirement of Section 355(b)(1) provides that a non-recognition separation is available only if "the distributing corporation, and the controlled corporation ... is (sic) engaged immediately after the distribution in the active conduct of a trade or business. . ..

Apparently, then, only the post-distribution test requires that both the distributing and controlled corporations themselves engage in the active conduct of a trade or business. Indeed, in Gabriel, the Tax Court acknowledged that at the time when Boiler, the distributing corporation, loaned the fabrication and canopy businesses to Gabriel, it ceased to engage in the conduct of such businesses.

The three Section 355 Rulings do not appear to distinguish between the pre-distribution and post-distribution active business prerequisites in applying their direct conduct requirement. Indeed, Rev. Rul. 73-236, which considers the REIT, would seem to be limited on its facts to the post-distribution active business test. The other two Rulings clearly apply the direct conduct criterion to activities carried on during the five-year pre-distribution period. A blanket application of a direct conduct requirement to both pre-distribution and post-distribution business directly conflicts with the holding of W. E. Gabriel Fabrica-
The post-distribution active business requirement, unlike the pre-distribution active business requirement, apparently does demand that the distributing and controlled corporations directly operate their respective businesses immediately after the distribution. By comparison with Gabriel, the Tax Court in Morgenstern, 56 TC 44 (1971), interpreted a provision of Section 346(b)(1), which is virtually identical with the Section 355 post-distribution active business requirement, since under the former Section a distribution in partial liquidation, in order to be worthy of capital gains treatment, must be attributable to the distributing corporation's ceasing to conduct a trade or business that has been actively conducted throughout the five-year period immediately before the distribution. In Morgenstern, a parent corporation controlled a subsidiary in which it owned 67% of the stock. In a partial liquidation the parent distributed this 67% interest in a pro rata exchange to its shareholders, the taxpayers, for some of their stock. The subsidiary was liquidated shortly thereafter; until that date it had been actively engaged in the conduct of its business for more than five years. The taxpayers contended that since the parent controlled the subsidiary through its 67% stock ownership, it might be said to have actively conducted the subsidiary's business. The Tax Court correctly pointed out that a corporation is a separate and distinct entity from its shareholders and, thus, under fundamental tax principles, a parent corporation does not conduct its subsidiary's business. Furthermore, it concluded that the distribution in partial liquidation must be attributable to cessation of the conduct of an active trade or business by the distributing corporation, and that the terminated business must have been "operated directly" by the parent corporation in order for the liquidation to escape dividend treatment. In reaching its decision, the Morgenstern court relied upon the legislative history of Section 346. Clearly the distributing corporation for purposes of Section 346(b)(1) need not have conducted the active business throughout the entire five-year pre-distribution period, but at the time it ceases to conduct the business it must be engaged in the active conduct of such business. Thus, this Section has an implicit requirement that immediately prior to the termination of the business the distributing corporation must be engaged in the active conduct of the terminated business and the retained business.

Since the Morgenstern-Court interpreted the phrase "engaged in the active conduct" to mean "operated directly," the Section 355 requirement that the post-distribution distributing and controlled corporations must be "engaged" in the active conduct of a trade or business immediately after the distribution by analogy would also appear to demand that such corporations operate directly their respective businesses immediately after the distribution. This conclusion is supported by the finding in Gabriel that the distributing corporation "ceased to engage in the conduct of . . . [the split-off businesses]" 14 months prior to the split-off. Unfortunately, Gabriel and Morgenstern offer little guidance to the meaning of "direct" conduct. Indeed, since the narrow holding in Morgenstern was that a parent corporation does not engage in the active conduct of, i.e., operate directly, the business of its controlled subsidiary, Morgenstern literally requires no more than that the active business be owned by the taxpayer and not by another separate and distinct entity. Similarly, a narrow reading of Gabriel indicates only that a corporation is no longer engaged in the conduct of a business after it has loaned the assets to another.

In contrast to the premise of the three Rulings that it is the term "active conduct" which connotes direct operation by the corporation, Gabriel and Morgenstern clearly establish that it is the verb "engaged" and not the phrase "active conduct" which mandates direct operation. Sections 355(b)(2)(B) and 346(b)(1) both set forth a pre-distribution active business requirement that speaks of a trade or business which "has been actively conducted throughout the five-year period." On the other hand, Section 355(b)(1)(A) requires that the distributing and controlled corporations be "engaged immediately after the distribution in the active conduct of a trade or business;" and the court in Morgenstern read into Section 346(b)(1) a requirement that immediately prior to the distribution in partial liquidation the distributing corporation must be engaged in the active conduct of at least two businesses. In both Section 355 and 346 the pre-distribution active business requirement does not demand direct operation by the distributing corporation. Conversely, the post-distribution requirement of Section 355(b)(1)(A) and the requirement of ceasing to conduct a trade or business immediately before distribution under Section 346(b)(1) do appear to require direct operation. The apparent reason for the requirement of direct conduct in these latter instances is that only here does the statutory language mandate that the distributing corporation be "engaged" in the active conduct of a trade or business.

While the various trade or business Code sections including active business provisions use a variety of verbs, the cases generally use the terminology of engaging in a trade or business without regard to the precise wording of the statute. The most common examples are cases in which a court in considering the term "trade" or "business" in conjunction with one verb interchangeably cites a case in which the term, taken from another Code provision, is used with another verb. For instance, in Schwarcz, 24 TC 733 (1955), the Tax Court in applying the net operating loss provisions of the 1939 Code, cited Gilford, 201 F.2d 735 (CA-2, 1953) for the principle that operation of rental property by a taxpayer through an agent does not prevent the taxpayer from being regularly engaged in the business. Accordingly, while "engaged immediately after the distribution in the active conduct of a trade or business" probably requires direct conduct by the corporation, the case law content of the verb "engaged" teaches that such conduct through an agent should not prevent the corporation from being directly engaged in the active conduct of that trade or business. A reading of "direct conduct" as requiring only that the economic risk of loss in the actively conducted business in question must rest with the corporation that seeks to qualify as engaged in the active conduct of such business (so that the active business is its own and not that of another entity) would preserve the viability of the Gabriel and Morgenstern precedents without conflicting with the earlier authorities which accept engaging in a trade or business through an agent. For while Gabriel and Morgenstern would appear to require that the post-distribu-

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11 Reg. 1.346-1(e) provides that the term "active conduct of a trade or business" has the same meaning as in Reg. 1.355-1(e).
13 W. E. Gabriel Fabrication Co., supra note 1 (Section 355); S. Rep't. No. 1622, supra (Section 346).
tion active businesses be directly operated by the distributing and, in the case of Section 355, controlled corporations, neither case speaks to the question of whether conduct through an independent contractor constitutes direct conduct. Rather, Gabriel held that the distributing corporation ceased to conduct the split-off business when the distributing corporation loaned the assets to one of its shareholders, and Morgenstern held that the distributing corporation did not engage in the active conduct of its 67%-owned subsidiary's business. In both cases the economic risks of the business in question obviously did not rest with the distributing corporation.

**Direct conduct, independent contractors**

The conclusion in the three Rulings that active conduct for purposes of Section 355 connotes activities directly carried on by the corporation itself and not the activities of others outside the corporation (i.e., independent contractors) appears to be based on an overt analogy to Section 856(d) and a covert analogy to Reg. 1.954-2(d)(ii)(a). These analogies, however, may be less than perfect. For example, neither of the latter provisions accords active business status to rental transactions with related parties. Yet in King, 458 F.2d 245 (CA-6, 1972), the Sixth Circuit implicitly rejected the position, adopted by the Tax Court below, that relatedness precludes active business. Similarly, Rafferty contains dicta resting on the premise that a spun-off corporation dealing only with related entities can be engaged in the active conduct of a trade or business. Furthermore, in applying its two-part definition of the active business test (“entrepreneurial endeavors” and “objective indicia”), the Rafferty-Court noted that the spun-off corporation did not pay salaries and did not employ independent contractors. The inescapable inference is that employment of independent contractors would have constituted objective indicia of corporate operations from mere investments.

The legislative history of the active business rule, as interpreted by the Tax Court in Coady, 33 TC 771 (1960), aff’d per cur. 289 F.2d 490 (CA-6, 1961), reveals that its function is to prevent the tax-free separation of active and inactive assets into active and inactive corporate entities. Coady involved a split-off in which a single construction business was horizontally divided; that is to say, part of its construction contracts, equipment, and cash was dropped down into a subsidiary, the stock of which was then distributed to one of the parent’s shareholders in exchange for all of his stock in the parent. The Commissioner in reliance on Reg. 1.355-1(a) maintained that Section 355 did not apply to the division of a single business. A divided Tax Court invalidated that portion of the Regulations, reasoning that “as long as the trade or business which has been divided has been actively conducted for five years preceding the distribution, and the resulting businesses (each of which in this case, happens to be half of the original whole) are actively conducted after the division, we are of the opinion that the active business requirements of the statute have been complied with.”

Clearly an independent contractor’s performance of the requisite active and substantial management and operational functions would not change active assets into inactive ones. The harder question is whether the status of the performer of the services determines the status of the corporation. Moreover, the test under Section 921(2) for determining if the corporation derives the requisite income from the active conduct of a trade or business where the activities are conducted by a related party for a management fee, i.e., whether the corporation bears the economic risk of the activities, was echoed in Maple, 440 F.2d 1055 (CA-9, 1971).

Congress also seems to have intended that the status of the assets would determine the status of the corporation for purposes of Section 355(b), for the Senate Finance Committee apparently used the terms “assets” and “corporation” interchangeably in the legislative history of that provision.

Since this legislative history doesn’t mention the status of the performer of the services and refers to the corporation and its assets synonymously, it may be inferred that Congress did not intend that the corporate utilization of an independent contractor to conduct an active business should render either the corporate entity or its business assets inactive. Furthermore, the exclusion of independent contractor activities from direct active conduct is not mandated by the legislative history of the “device” clause. Under Section 355(a)(1)(B) the shareholder must show that the distribution of stock in the controlled corporation was not used principally as a “device” for the distribution of earnings and profits of the distributing corporation or of the controlled corporation or both. This clause is derived from 1939 Code Section 112(b)(11) which also introduced the post-distribution active business test. In that Section, the device clause was designed to prevent the bail-out of earnings and profits through the separation of surplus corporation assets, or properties acquired with such surplus, from the operating assets that had generated such surplus.

The active business test was intended to supplement the device clause by precluding (1) tax-free status of a spin-off in which a corporation was intended to be liquidated, and (2) a drop down of liquid assets into a subsidiary in anticipation of a delayed future stock sale or redemption. The 1954 Code added the five-year pre-distribution active conduct requirement to assure that such surplus was not used during the five years prior to the distribution to acquire the spun-off business. The Tax Court in Gabriel had surmised that the predistribution active business rule seemed to be a legislative rule of thumb designed to provide some assurance that the spun-off or split-off corporation would not be liquidated or sold shortly after the distribution. Such assurance apparently arose from the belief that if the business were continuously conducted for five years it would be profitable and, therefore, not lightly abandoned. The Gabriel-Court concluded that a business conducted actively by someone other than the distributing or controlled corporation would still fulfill this purpose.

Conduct of an active business through an independent contractor would not open the door to a drop down of liquid assets; nor would such conduct lend itself to a siphoning off of surplus without contraction of operating assets. It is possible, however, that an active business so conducted might be more readily salable after the corporate separation, since continuity of management, often a significant factor in acquisitions of going concerns, could be preserved more easily than where the key management employees were selling stockholders or employees of the retained corporation. Such analysis would appear more properly a part of the device test than the active business test. The device test, however, does not stop with a consideration of the salability of assets but goes on to consider whether their retention is necessary to the other corporation or
their disposition would thwart shareholder or corporate business purposes. Thus, the presence of independent contractors is not determinative under the device test.

In summation, the scant Section 355 precedent and the purpose of the active business and device tests indicate that conduct of an active business through an independent contractor should not be a factor under the active business prerequisite but should be among the factors to be considered under the device test. Since the 1973 Rulings reach a contrary conclusion, a definitive answer must await litigation.

Validity of the Rulings

The active conduct requirements of the performance of substantial management and operational functions and the prerequisite of direct operation as to the post-distribution active business which the 1973 Rulings set forth would in general seem to be sound. The difficult issue however, is whether such direct conduct for purposes of Section 355 precludes performance by others outside the corporation, particularly independent contractors. The Section 954 and REIT analogies would answer this question affirmatively. However, the following considerations militate against such a conclusion: (1) the analogies of the Section 761 Regulations, the Section 921 authorities, and the construction of the verb “engaged” in the trade or business cases; (2) the implications of several Section 355 decisions; and, most significantly, (3) the purpose of the active business and device tests of Section 355. The analogies arising from a consideration of Sections 761, 921 and cases construing the phrase “engaging in a trade or business” focus on a distinction between business and investment activities.18

Especially significant, is the fact that trade (or business) and investment activities have long constituted under the case law mutually exclusive terms as to individual taxpayers, so that an individual could not deduct the expenses of his investment activities under Section 162 since they were not incurred “in carrying on any trade or business.” Instead Section 212, applicable only to individuals, was enacted to permit the deduction by individuals of non-business or investment expenses. However, Section 212 was not extended to corporations because the phrase “trade or business” in their case was apparently thought broad enough to encompass investment activities, permitting such expenses to be deducted under Section 162. Accordingly, it is most probable that wherever Congress has imposed an “active” business test upon corporations, it intended no more than to distinguish activities that in the case of individuals would give rise to the deduction of trade or business expenses under Section 162 from those that would give rise to non-business expenses deductible only under Section 212. In short, since “trade or business” in the case of a corporation encompasses both business activities and investment activities, a qualifying phrase beyond just “trade or business” had to be used when Congress meant to preclude favorable tax treatment to corporations with only investment activities. Therefore, an “active” trade or business as applied to a corporation would be equivalent to a “trade or business” as applied to an individual, but would be a narrower term than “trade or business” as applied to a corporation since the latter application also encompasses investment activities.

The foregoing analysis contradicts the position of the Tax Court that cases which are decided under “trade or business” provisions not containing the qualification “active” are not authority upon the question of what constitutes the active conduct of a trade or business; and that to hold otherwise would be to divest the word “active” of all meaning.10 The non-Tax Court Section 355 decisions28 and even Tax Court decisions under active business provisions other than Section 35529 do not hesitate to rely upon cases decided under Code sections not containing the qualification “active.” Certainly, the function of the active business term in Section 921—to disqualify corporations that receive investment income rather than business income—supports the conclusion that the term “active” refers to business, as distinguished from investment.

14 Regs. 1.954-2(d) (1) (i) (1964) and 1.856-4(h) (2).
15 S. Rep’t. No. 1622, supra note 12 at 50-51.
17 If the business is active, the assets presumably are also active and thus are not prone to be dropped down and liquidated.
18 Varner, supra note 5; Int’l Canadian Corp., supra note 4.
19 King, 55 TC 700 (1972), rev’d, 458 F.2d 245 (CA-6, 1972); see also Elliott, 32 TC 583 (1959).
20 Estate of Parsholby, 303 F.2d 14 (CA-2, 1962) (dealing with the 1939 Code predecessor to Section 355); Hanson, 358 F. Supp. 602 (DC Mont., 1971).
21 See e.g., Rothenberg, supra note 5; Varner, supra note 5.
22 The Second Circuit has indicated that acting as a lessor to a related corporation would constitute a trade or business activity. Estate of Parsholby, supra note 20. Moreover, recent Section 355 case law clearly holds that such activities constitute an active trade or business. Accordingly, one must conclude that in Sections 954(e) (3) and 856(d) (3) Congress was adding a requirement not inherent in the concept of active conduct of a trade or business.
24 See Meyer, Active business requirement of 355 case law clearly holds that such activities constitute an active trade or business. Accordingly, one must conclude that in Sections 954(e) (3) and 856(d) (3) Congress was adding a requirement not inherent in the concept of active conduct of a trade or business.
Tax avoidance is still the ultimate issue in Sec. 531 accumulated earnings disputes

Most 531 cases are fought on the basis of whether a corporation's earnings were accumulated beyond the reasonable needs of the business. However, in order for the penalty tax to be imposed, it also must be shown that such accumulation was for the purpose of avoiding tax on the shareholders. This latter factor was the key to the taxpayer's victory in Starman Investment, Inc., 534 F.2d 834 (CA-9, 1976). In the following paragraphs, Charles P. Duffy, a partner in the Portland, Oregon law firm of Duffy, Georgeson, Dahl & Kekel, and the taxpayer's attorney in Starman, points out the significance of this approach in defending against IRS imposition of the tax.

The principal thrust of The Donruss Company, 395 U.S. 297 (1969), decision was that, in order for a taxpayer to rebut the presumption of unreasonableness contained in Section 533(a), "the taxpayer must establish by the preponderance of the evidence that tax avoidance with respect to shareholders was not 'one of the purposes' for the accumulation of earnings beyond the reasonable needs of the business." The Supreme Court held that tax avoidance need not be the dominant, impelling or controlling purpose for the accumulation and that the taxpayer must show by a preponderance of the evidence that tax avoidance with respect to its shareholders was not "one of the purposes" for the accumulation of earnings beyond the reasonable needs of the business.

It is well to keep in mind the fact that a corporation may accumulate earnings and profits without limitation and not incur the penalty unless one of the purposes of the accumulation was tax avoidance with respect to its shareholders. At the conclusion of its opinion in the Donruss case, the Supreme Court stated:

"It (the Court's holding) still serves to isolate those cases in which tax avoidance motives did not contribute to the decision to accumulate. Obviously, in such a case imposition of the tax would be futile. In addition, 'purpose' means more than mere knowledge, undoubtedly present in nearly every case. It is still open for the taxpayer to show that even though knowledge of the tax consequences was present, that knowledge did not contribute to the decision to accumulate earnings."

In Ivan Allen Co., 422 U.S. 617 (1965), the Supreme Court held that listed and readily marketable securities owned by that corporation (Xerox shares valued at more than ten times cost) were to be taken into account at their net liquidation value rather than at cost in applying Section 533. Appreciation was not taken into account in determining "earnings and profits" but still was considered in determining liquidity for dividend purposes.

The Ivan Allen case had been heard by the trial court on the basis of a stipulation that, if the securities owned by the corporation were valued at cost, the taxpayer's earnings and profits had not been accumulated beyond the reasonable needs of the taxpayer's business. The trial court held for the taxpayer, but this was reversed by the Fifth Circuit. The Supreme Court affirmed the decision of the Fifth Circuit in remanding the case to the trial court "for the additional factual determination (under Section 532(a)) of whether one purpose for the accumulation was to avoid income tax on behalf of the shareholders."

Prior to the enactment of the 1954 Code, the law required a corporation to prove a lack of tax avoidance by a "clear" preponderance of the evidence, but this is no longer required.

Part of the Government's usual defense in this type of case is to offer evidence at the trial that, if all of the corporation's accumulated taxable income had been distributed to the shareholders in that year, their respective individual taxes would have been increased substantially. Of course, this does not necessarily indicate the prohibited purpose of avoiding the income tax on the stockholders, but it is usually possible for the Government to show substantial increases in the taxable incomes of the shareholders even though they are not in the highest brackets. Despite the privacy statutes, courts seem to be willing to allow the Government to put into evidence the individual income tax returns of the shareholders, even though they are not direct parties to the litigation. This can be a dramatic presentation, coupled with the implication that the Section 531 penalty is in lieu of such individual shareholder tax increases. It is necessary to extract from the IRS witness the admission that the excess earnings (less the Section 531 penalty when paid) will remain in the cor-
porate solution and will require the payment of individual taxes in the year of distribution of such earnings.

In Starman Investment, Inc., a family corporation was engaged in manufacturing its own line of products and in distributing the products of a national company. Sometime in 1967, the national company announced its desire to distribute its own products and asked about buying the corporate business. The shareholders decided that it was not feasible to continue in business without distributing the national line. Therefore, in 1968, they decided to sell to the national company all the corporation’s assets except its real estate, life insurance and profit-sharing trust. Most of the shareholders were to be employed by the national company, but only one was to receive an employment contract. The company did not liquidate. It leased the real estate to the national company and merely put the cash proceeds in a savings account. The Service took the position that all of the income of the corporation during the year of sale should have been distributed to the shareholders and, accordingly, imposed the Section 551 penalty.

The district court found as a fact that earnings had not been permitted to accumulate beyond the reasonable needs of the business and also found as a fact that tax avoidance was not one of the motives for allowing the earnings to accumulate.

The Court of Appeals, in affirming the district court, determined that such findings of fact were not “clearly erroneous” and held:

“The government must attack both of these findings in order to prevail on this appeal. For even if the finding that the earnings did not accumulate beyond the reasonable needs of the business is clearly erroneous, the accumulated earnings tax does not apply so long as tax avoidance was not a motive for the accumulation.

“Thus, we start from the premise that even if earnings were accumulated beyond the reasonable needs of the business, the result is only that the corporation must prove by a preponderance of the evidence that there was no tax avoidance purpose for the accumulation. See e.g., Ivan Allen Co. v. United States.”

Many Section 531 penalties are suggested or proposed by examining revenue agents (or conferencees) in an attempt to gain the taxpayer’s acceptance of other disputed adjustments. Most revenue agents’ reports proposing Section 531 penalties will include detailed “Bardahl” computations in an effort to show that the earnings of a corporation have been allowed to accumulate unreasonably. It is rare to see any mention of tax avoidance, although it is the ultimate factual issue.

Section 534 allows the taxpayer, in cases which may come before the Tax Court, an opportunity to shift to the Commissioner the burden of proving accumulation beyond the reasonable needs of the business. The Service will send a notice to the taxpayer prior to the issuance of a statutory deficiency notice that it has an opportunity to submit a statement setting forth the ground or grounds on which it relies to justify the reasonableness of its accumulations. Taxpayers responding to such notice with a detailed statement of its reasons for the accumulation will usually find that it achieves only one end—the Service is able to correct any omissions and bolster its case before issuing the deficiency notice. The Tax Court has shown little inclination to shift the burden of proof to the Service, despite the furnishing of such detailed statements. A review of Section 531 cases in the Tax Court and the district courts and Court of Claims indicates that the taxpayer corporation should avoid the Tax Court and proceed by way of the refund route if it is to have any reasonable chance to prevail.

The statutory presumptions are necessary because of the subjective intent factor in the tax avoidance issue, but, keeping in mind the Donnuss principle, the taxpayer corporation still has the opportunity to prove the lack of tax avoidance by a preponderance of the evidence. Although this may be a heavy burden, it should not be shirked in an appropriate case.

Cash for return of escrowed stock okay in C reorg.

The SOLELY-FOR-VOTING stock requirement of Section 368(a)(1)(C) was ruled, in Rev. Rul. 76-334, IRB 1976-36, 8, not to have been violated when a disputed claim against the acquired corporation was settled by the return of escrowed stock of the acquiring corporation in exchange for cash.

In Rev. Rul. 76-334, the acquiring corporation Y, in a C reorganization placed in escrow 10,000 shares of the Y voting stock to be transferred. The escrow account was to secure Y against any breach of warranty or representation by X, the acquired corporation. Y could look only to the escrowed account for compensation and the parties were bound by the valuation given the escrowed stock at the time of the reorganization. A dispute arose between Y and the shareholders of X as to whether 2,000 of the escrowed shares should be returned to Y. Y’s claim of $20,000 contemplated the return of 2,000 shares of the escrowed Y stock, based on the stock valuation set in the agreement. The current fair market value of the Y stock had increased two and one-half fold. Y offered to pay the former X shareholders $25,000 upon the return of the disputed 2,000 shares of stock. They accepted.

The Service ruled that the cash payment was a transaction separate from the reorganization. As such, it did not violate the solely-for-voting-stock requirement. The ruling noted that there was no prearranged scheme for repurchasing the Y stock and that, in fact, the payment arose solely out of Y’s offer to settle the dispute under the escrow agreement. In addition, the number of shares to be returned was fixed by the initial negotiated value and Y could only look to the escrowed stock for compensation.

The shareholders of X would treat the cash received as a redemption subject to Section 302, of a sufficient portion of the escrowed stock with a fair market value equaling $25,000. This result is based on the rationale that the escrow transfer was sufficient to render the former X shareholders the beneficial owners of the stock since they had voting and dividend rights.

The return of the remaining shares requires an adjustment of the reorganization’s original purchase price. No gain or loss is realized by the shareholders of former corporation X. This is consistent with Rev. Rul. 76-42, wherein escrowed stock was returned to the acquiring corporation upon the failure of the acquired corporation’s profits to reach a specified point. The basis of the forfeited shares is picked up by the shares originally acquired in the reorganization exchange.

Settlement of escrowed stock disputes may be effected by taking into consideration a change in value of the escrowed stock. The line between a disputed amount of damages and the amount of stock necessary to satisfy the underlying
was still applying when a corporation entered a new business. The position to allow losses in such a situation was not enough to substantiate a claim is difficult to draw. This could make the stock value established in the escrow agreement useless and make Rev. Rul. 76-334's reorganization protection unavailable. Rev. Rul. 76-42 sounds a similar alarm when it warns that if a shareholder benefits from an increase in value of the escrowed stock, there would be occasion to find a realization of gain or loss on the forfeiture of escrowed stock.

NOLs do not preclude worthlessness deduction

Another court has held that a corporation can be worthless for purposes of Section 165, even though it possesses net operating losses that can offset future income. The latest case, *Textron*, DC R.I., 6/7/76, involved a parent corporation which had a wholly-owned subsidiary which operated a cruise ship, its only asset. The taxpayer-parent eventually repossessed the ship after spending a total of nearly $6 million to make the subsidiary a profitable operation. The taxpayer deducted this amount on its return, including a $1.3 million stock investment, under Section 165(g)(3) which provides for an ordinary loss deduction for the worthless stock of a subsidiary. About a year later, the parent advanced additional funds to the subsidiary and started it on a completely new business venture. This venture proved successful and the subsidiary offset the income with the net operating losses carried over from its ship operating days.

The Service denied the worthless stock loss on grounds that since the corporation had the NOL carryover potential, it could not be said to have had no value whatsoever. However, the court held that the availability of NOL carryovers by themselves was not enough to substantiate a claim that the corporation had some value. The losses did not give the corporation value because they would not have been available had the subsidiary been sold. In addition, at the time of the deduction, there was substantial doubt that the carryovers could be used if the corporation entered a new business. This was because the Service then was still applying *Libson Shops*, Inc., 353 U.S. 382 (1957), to deny carryovers when a corporation entered a new business. The IRS did not change its position to allow losses in such a situation when there was no change of corporate ownership until four years later when it issued *Rev. Rul. 63-40*, 1963-1 CB 46.

In the view of the court, the availability of the subsidiary's net operating loss was dependent on the following three events, all of which occurred after the year of the worthless stock deduction.

1. The parent-taxpayer's willingness and capacity to place new funds at the risk of the subsidiary.
2. Timely generation of profits in the new enterprise by the subsidiary.
3. The decision by the IRS or the courts to permit the carryovers to be used against such profits.

While the third event is no longer applicable, in view of *Rev. Rul. 63-40*, the other two factors still would argue for the allowability of such a loss in similar circumstances.

In *Becker*, 308 F. Supp. 555 (DC Neb., 1970), the taxpayer attempted to deduct the worthlessness of his stock in a corporation that had become a shell. The corporation later started on a profitable business, the income from which was offset by its previous loss carryovers.

The court held that to accept the IRS' position that the availability of such carryovers precluded a finding that the corporation was worthless, would be to conclude that no stock would ever be worthless since it would have potential value because of such losses (at least until the losses expired).

In the *Textron* came to a similar conclusion.

In *Textron*, the IRS also raised the point that to allow the subsidiary to offset income with its losses after the parent took a worthless stock deduction would, in effect, permit a double deduction.

The court held this argument to be without merit since the parent and the subsidiary were two different entities and the losses in question were incurred by separate taxpayers.

Thus, the situation here was different from that, for example, in *Marwais Steel Co.*, 354 F.2d 997 (CA-9, 1965). There, a parent corporation deducted as a bad debt advances to its subsidiary. It then liquidated the sub and tried to deduct the subsidiary's net operating losses against its own income. The court disallowed the deduction on the grounds that there would be a double deduction by the same taxpayer for the same loss. However, in *Textron*, the deductions for worthless stock and net operating loss carryovers were incurred by two different corporations and, therefore, according to the court, both were allowable.

**New decisions**

**DIVIDENDS**

Cash received in merger was capital gain. (DC)

Taxpayer owned 66% of the stock of corporation X. X was subsequently merged into corporation Y, a large publicly held corporation, and as a result of the merger taxpayer received common stock of Y and cash. After the merger, taxpayer owned less than 1% of the common stock of Y. The Commissioner held that the cash received was taxable as ordinary income; taxpayer sought long-term capital gain treatment.

*Held:* For taxpayer. The court, citing the Supreme Court's *Davis* decision, states that the characterization of the boot is to be found by looking to Section 302(b)(1). The boot "is not essentially equivalent to a dividend" because the merger resulted in a radical change and meaningful reduction in the nature of taxpayer's interest in the continuing business. Therefore the cash or boot is taxable as proceeds from the sale of a capital asset. *Shimberg, Jr.*, DC Fla., 7/1/76.

**COLLAPSIBILITY**

Collapsible corporation's gain in Section 337 liquidation was subject to tax. (TC)

Taxpayer purchased farmland and buildings which it held primarily for sale to customers in the ordinary course of its business. In January, 1968, the corporation contracted to sell one parcel of the land and incurred expenses for the construction of an access road thereon, which was completed in 1972. In March, 1968, the taxpayer contemplated liquidation and on August 16, 1968, the corporation adopted a plan of liquidation and sold substantially all of the remaining acreage. The Commissioner determined that gains on the sales were includible in taxpayer's income because the taxpayer was a collapsible corporation.

*Held:* For the Commissioner. The taxpayer was availed of principally for the construction of property with a simultaneous view toward liquidation. Taxpayer realized only an insubstantial...
amount (9.3%) of its total taxable income from the property prior to forming the intent to liquidate. Manassas Airport Industrial Park, Inc., 66 TC No. 55.

**Tax Court finds corporation collapsible. (TCM)**

Taxpayers formed a corporation to acquire land and to construct, own, and operate an apartment development. Commissioner contended that it was a collapsible corporation.

**Held:** For the Commissioner. On the record the court found that various distributions made to the shareholders prior to the corporation’s realization of a substantial amount of the income to be derived from the property, had been contemplated prior to completion of construction. Zorn, TCM 1976-241.

**LIQUIDATIONS**

**Ordinary expense deduction allowed for expenses attributable to sale of assets in a Section 337 corporate liquidation. (DC)**

Citing Mountain States Mixed Feed Co., 565 F.2d 244 (CA-10, 1966), taxpayer contended that it was entitled to an ordinary expense deduction for expenses attributable to the sale of assets in connection with a §337 liquidation.

**Held:** For taxpayer. Benedict Oil Co., DC Okla., 7/1/76.

**Acquiescence announcement.**

**Pre-liquidation income allocated between corporation and shareholders.** A corporation distributed as part of a liquidation two distribution contracts, for a motion picture and a television program. Payments on the contracts attributable to periods prior to the liquidation were taxable to the corporation. The shareholders, as transferees, are liable for the tax thereon but may deduct such taxes as a loss in the year paid. Income from later contract payments, taxable to the shareholders, may not be reported on the cost recovery method. Schneider, 65 TC 18 (1975), acq. IRB 1976-31.5.

**THIN CAPITALIZATION**

**Stockholdings and cash advances are capital investments; losses resulting are capital. (TCM)**

In 1969 D, a computer programming firm, acquired C, which operated computer training schools. During 1969-70 D made cash advances and guarantees of loans to C in order to provide working capital. D had to make good on some guarantees, and in 1970 sold C at a loss. D claimed an ordinary loss, while the Commissioner contended that the loss was capital.

**Held:** For the Commissioner. The stock of C was a capital asset, obtained by D for an investment, not to assure a supply of computer programmers for D’s own operations. The stock did not become wholly worthless prior to the sale in 1970, thus Section 165(g)(3) was unavailable. Advances and payments on guarantees were contributions to capital, added to stock basis, not debts. Thus, all losses are capital, subject to the limitations thereon. Datamation Services, Inc. TCM 1976-252.

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