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THE "ACTIVE BUSINESS" TEST OF § 355: IMPLICATIONS OF A TRILOGY OF REVENUE RULINGS

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Section 355 of the Internal Revenue Code of 1954 provides the exclusive tax-free means of distributing stock in a controlled corporation to shareholders of the distributing corporation.¹ Distribution

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¹Section 355 provides that if a "distributing corporation" distributes to a shareholder solely an amount of stock in a "controlled corporation" constituting control within in the meaning of § 368(c) or all of the stock in such corporation, then no gain or loss will be recognized by such shareholder if the following conditions, among others, are met:

(1) the transaction was not used principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both (but the mere fact that subsequent to the distribution stock or securities in one or more of such corporations are sold or exchanged by all or some of the distributees (other than pursuant to an arrangement negotiated or agreed upon prior to such distribution) shall not be construed to mean that the transaction was used principally as such a device),

and (2) the "active business" test of § 355(b) is satisfied. Section 355(b) in turn provides that:

Subsection (a) shall apply only if either—

(A) the distributing corporation, and the controlled corporation (or, if stock of more than one controlled corporation is distributed, each of such corporations) is engaged immediately after the distribution in the active conduct of a trade or business, or

(B) immediately before the distribution, the distributing corporation has no assets other than stock or securities in the controlled corporations and each of the controlled corporations is engaged immediately after the distribution in the active conduct of a trade or business.

(2) *Definition.* For purposes of paragraph (1), a corporation shall

pursuant to that section may be in one of three forms. A § 355 distribution is termed a *spin-off* when, as with a stock dividend, shareholders receive the distributed stock with no change in their stock interest in the distributing corporation.² A *split-off* resembles a redemption since the shareholders turn in some or all of their stock in the distributing corporation in exchange for stock in the controlled corporation.³ Finally, a *split-up* occurs where the distributing corporation liquidates and distributes stock in two controlled corporations to its shareholders in exchange for all of their old stock.⁴ These tax-free separations give rise to a potential for tax abuse: a corporation through a distribution of stock in a subsidiary with readily salable assets might effect a tax-free distribution or "bail-out"⁵ of earnings without affect-

be treated as engaged in the active conduct of a trade or business if and only if—

(A) it is engaged in the active conduct of a trade or business, or substantially all of its assets consist of stock and securities of a corporation controlled by it (immediately after the distribution) which is so engaged,

(B) such trade or business has been actively conducted throughout the 5-year period ending on the date of the distribution,

(C) such trade or business was not acquired within the period described in subparagraph (B) in a transaction in which gain or loss was recognized in whole or in part, and

(D) control of a corporation which (at the time of acquisition of control) was conducting such trade or business—

(i) was not acquired directly (or through one or more corporations) by another corporation within the period described in subparagraph (B), or

(ii) was so acquired by another corporation within such period, but such control was so acquired only by reason of transactions in which gain or loss was not recognized in whole or in part, or only by reason of such transactions combined with acquisitions before the beginning of such period.

²Jacobs, *The Anatomy of a Spin-Off*, 1967 DUKE L.J. 1, 2 (hereinafter cited as Jacobs).

³*Id.* at 2-3. The split-off is identical to the spin-off except that some of the shareholders in the distributing corporation exchange some of their stock in it for stock of the controlled or split-off corporation. Note, *Section 355's Active Business Rule—An Outdated Inefficacy*, 24 VAND. L. REV. 955 (1971) (hereinafter cited as Note, *Section 355*).

⁴Jacobs, *supra* note 2, at 3.

⁵A "bail-out" usually refers to the withdrawal of corporate assets without impairment of a shareholder's interest in his corporation's earning power. Implicit in the bail-out is the shareholder's ability to convert such withdrawn assets into cash with capital gains treatment, whereas a formal dividend distribution would result in ordinary income. B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 13.06, at 28 (3d ed. 1971) (hereinafter cited as BITTKER & EUSTICE).

ing its operating assets. By selling the stock of the subsidiary, the shareholders could then convert the distributed stock into cash at capital gains rates without disturbing their equity interest in the original corporation. Without the safeguards of § 355, such a distribution, although in economic effect a dividend, would not be taxed at the ordinary income rates applicable to a formal dividend.

Section 355 contains two safeguards against bail-out abuse: the "device" test and the "active business" test. Section 355 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.⁶ 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.⁷ The purpose of 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.⁸ The aim of the five year pre-distribution period was to keep the distributing corporation from using liquid assets to acquire, just before the distribution, a new and active business that could be spun-off without any contraction of old operating assets.⁹

Until recently, most courts have placed more emphasis on the active business test than on the device test. Thus, the focus has been on "questions of definition—whether a certain business was 'active' or not—rather than on transactional analysis—whether any particular separation should be allowed tax-free treatment."¹⁰ Two pre-

⁶INT. REV. CODE OF 1954, § 355(a)(1)(B).

⁷*Id.* §§ 355(a)(1)(C) and 355(b).

⁸Massee, *Section 355: Disposal of Unwanted Assets in Connection with a Reorganization*, 22 TAX. L. REV. 439, 445 (1967) (hereinafter cited as Massee). Cf. 97 Cong. Rec. 12213 (1954). Indeed, the leading corporate tax commentators concluded that "the decisions seem to sanction § 355 treatment if the divisive transaction involves a separation of one group of *operating* assets from another, as distinguished from the separation of passive or investment assets from operating assets." BITTKER & EUSTICE, *supra* note 5, ¶ 13.04, at 15.

⁹W. E. Gabriel Fabrication Co., 42 T.C. 545, 557 (1964), *acq.* 1965-1 CUM. BULL. 4; Massee, *supra* note 8 at 449; BITTKER & EUSTICE, *supra* note 5, ¶ 13.05.

¹⁰Whitman, *Draining the Serbonian Bog: A New Approach to Corporate Separations Under the 1954 Code*, 81 HARV. L. REV. 1194, 1211 (1968) (hereinafter cited as Whitman). Whitman's criticism of the definitional approach has been adopted by the First Circuit in *Rafferty v. Comm'r*, 452 F.2d 767, 770 (1st Cir. 1971), *cert. denied*, 408 U.S. 922 (1972), which follows an approach centering on the potentiality of a bail-out in contrast to reliance on the overbroad terms in "business purpose" and "active business."

viously unanswered definitional questions were whether the § 355 active business test was met (1) if an agent or independent contractor carried out the major activities of the distributing corporation or of the controlled corporation whose stock was distributed; or (2) if one of the two corporations had no paid employees or compensated officers, and most of its activities were performed by the other corporation for a management fee.¹¹ While the active business concept recurs in a number of Code provisions and regulations, such sources and their accompanying case law unfortunately offer conflicting answers to these questions. On one side, judicial authorities interpreting §§ 355,¹² 761,¹³ and 921¹⁴ indicate that an active business may be conducted through an agent or possibly an independent contractor and that an active corporation could exist without salaried employees. 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 § 355.¹⁵ On the other hand, both

¹¹See, e.g., BITTKER & EUSTICE, *supra* note 5, ¶ 13.04, at 20; Cohen, *Corporate Separations-Active Business Requirements*, BNA TAX MGT. PORTFOLIO NO. 224, at A-5 to A-6 (1969); Jacobs, *supra* note 2, at 15.

¹²See *Rafferty v. Comm'r*, 452 F.2d 767 (1st Cir. 1971), *cert. denied*, 408 U.S. 922 (1972); *accord*, *King v. Comm'r*, 458 F.2d 245 (6th Cir. 1972); *W.E. Gabriel Fabrication Co.*, 42 T.C. 545, 557 (1964), *acq.* 1965-1 CUM. BULL. 4.

¹³Treas. Reg. § 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 thereof. For example, a partnership exists if co-owners of an apartment building lease space and provide services to the occupants albeit *through an agent*. *Id.* The active business test is satisfied by regular and continuous management and rental activities. *Roy P. Varner*, 32 CCH TAX CT. MEM. DEC. 97, 100 (1973); *George Rothenberg*, 48 T.C. 369, 373 (1967).

¹⁴A domestic corporation which transacts its entire business, other than incidental purchases, in the Western Hemisphere may obtain favorable tax treatment under § 921 if it derives 95% or more of its gross income for the 3-year period immediately preceding the close of the taxable year from the "active conduct of a trade or business" and from sources from outside the United States. Sales by an export subsidiary of a United States manufacturing corporation qualify under this provision, despite the absence of any staff in the subsidiary, where the subsidiary pays a management fee to the parent for all its managerial services and bears the economic risk of resale of the items exported. See, e.g., *Frank v. Int'l Canadian Corp.*, 308 F.2d 520, 525 (9th Cir. 1962); *United States Gypsum Co. v. United States*, 304 F. Supp. 627, 642 (N.D. Ill. 1969), *rev'd on other grounds*, 452 F.2d 445 (7th Cir. 1971); *Barber-Greene Americas, Inc.*, 35 T.C. 365, 387-88 (1960).

¹⁵See text accompanying notes 8 and 9, *supra*. In essence, the active business test was intended to prevent the tax-free separation of active and inactive assets into active and inactive corporations. Similarly, the goal of the device clause is to prevent a bail-out of earnings and profits through the separation of surplus corporate assets or properties acquired with the surplus from the operating assets that had generated the surplus. *Massee*, *supra* note 8, at 444-45. It is submitted that where business assets are used in

§ 856(d)(3)¹⁶ and the regulations under § 954(c)(3)(A)¹⁷ would seem to deny active business status to rental real estate if management and operational activities are rendered through an independent contractor. In a recent trilogy of pronouncements, Revenue Rulings 73-234,¹⁸ 73-236¹⁹ and 73-237,²⁰ the Internal Revenue Service has provided a

an active business, albeit operated by an independent contractor, the assets are neither inactive nor corporate surplus, but constitute operating assets.

¹⁶INT. REV. CODE OF 1954, §§ 856-58 provide for conduit tax treatment of a Real Estate Investment Trust (REIT) by which a REIT meeting certain statutory provisions as to beneficial ownership and source of income becomes virtually tax free by distributing its earnings to its beneficial owners. Kahn, *Taxation of Real Estate Investment Trusts*, 48 VA. L. REV. 1011, 1015 (1962). A key provision of this statutory scheme is that specified portions of the REIT's gross income must be derived from traditionally passive sources of income, including "rents from real property." INT. REV. CODE OF 1954, § 856(c). Such rents are in turn defined by § 856(d)(3) as including rents from interests in real property, but not including "any amount received or accrued, directly or indirectly, with respect to any real property, if the real estate investment trust furnishes or renders services to the tenants of such property, or manages or operates such property, other than through an independent contractor from whom the trust itself does not derive or receive any income." These income restrictions were intended to assure that the bulk of a REIT's income was "from passive income sources and not from the active conduct of a trade or business." H.R. REP. NO. 2020, 86th Cong., 2d Sess. (1960), reprinted in 1960-2 CUM. BULL. 822-23.

¹⁷INT. REV. CODE OF 1954, §§ 951-964 provide for the direct taxation of United States shareholders on certain types of income of their "controlled foreign corporations." The goal of these provisions was to end the so-called "deferral privilege," i.e., the taxing of shareholders on the foreign source earnings of their foreign corporations only when the earnings were repatriated to the United States. B. BITTKER & L. EBB, UNITED STATES TAXATION OF FOREIGN INCOME AND FOREIGN PERSONS 338-39 (2d ed. 1968). One of the types of income taxed directly to the United States shareholders is "foreign personal holding company income." INT. REV. CODE OF 1954, § 954(c). However, for purposes of this provision foreign personal holding company income does not include "rents and royalties which are derived in the active conduct of a trade or business and which are received from a person other than a related person. . . ." *Id.* § 954(c)(3)(A). Congress recognized "the need to maintain active American business operations abroad on an equal competitive footing with other operating businesses in the same countries; nevertheless . . . [it saw] no need to maintain the deferral of U.S. tax where the investments are portfolio types of investments, or where the company is merely passively receiving investment income." S. REP. NO. 1881, 87th Cong., 2d Sess. (1962), reprinted in 1962-3 CUM. BULL. 789. Congress viewed "foreign personal holding company income" as generally speaking passive in character. 1962-3 CUM. BULL. 788. However, Congress modified the term "foreign personal holding company income" by excluding certain income "when it arises in connection with certain actual business activities. Specifically, it is provided that rents and royalties received from an unrelated person and derived from the active conduct of a trade or business will not be considered foreign personal holding company income." 1962-3 CUM. BULL. 789.

¹⁸1973 INT. REV. BULL. No. 22, at 7.

¹⁹*Id.* at 8.

²⁰*Id.* at 9.

welcome clarification, if not a welcome answer, to the independent contractor question in the context of § 355.

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 the ubiquitous X was this time an unincorporated trust taxable, however, as a corporation.²¹ 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 § 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 Real Estate Investment Trust (REIT)²² and thereafter engaged primarily in the leasing of real estate properties, each of which was managed and operated by an independent

²¹Under Treas. Reg. § 301.7701-2(a)(3), a trust is taxed as a corporation if it displays a majority of certain listed corporate attributes. See generally Fox, *The Maximum Scope of the Association Concept*, 25 TAX L. REV. 311 (1970).

²²See note 16, *supra*.

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 triad of Revenue 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.²³

In Revenue Rulings 73-234 and 73-237 the Service 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 within the meaning of § 355(b). On the other hand, Rev. Rul. 73-236 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 three rulings clearly state that "active conduct" for § 355 connotes "active and substantial management and operational functions"—a not unexpected or unprecedented conclusion.²⁴ Their holding that such functions must in large part be performed *directly* by

²³Notes 18-20, *supra* (emphasis added).

²⁴The term "trade or business" itself connotes continuity, constant repetition and regularity of activities. See, e.g., *Alvary v. United States*, 302 F.2d 790 (2d Cir. 1962); *McDowell v. Ribicoff*, 292 F.2d 174 (3d Cir. 1961). See generally Lee, "Active Conduct" Distinguished from "Conduct" of a Rental Real Estate Business, 25 TAX LAWYER 317, 318 (1972) (hereinafter cited as Lee, "Active Conduct"). Furthermore, in applying the active business test of Treas. Reg. § 1.761-1(a)(1), the Tax Court relied upon trade or business decisions requiring regular and continuous management activities e.g., *Pinchot v. Comm'r*, 113 F.2d 718 (2d Cir. 1940) and looked to the amount and types of income and expenses. *Roy P. Varner*, 32 C.C.H. TAX CT. MEM. DEC. 94, 100 (1973); *George Rothenberg*, 48 T.C. 369, 373 (1967).

the corporation is significant but also not without precedent.²⁵ The further conclusion that direct conduct excludes activities of others outside the corporation, including independent contractors and probably uncompensated corporate officers,²⁶ constitutes the most important and controversial aspect of the rulings. But the trilogy 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.²⁷

The Active and Substantial Management and Operational Functions Test

The performance of "active and substantial management and operational functions" as a test for active conduct set forth in the trilogy of rulings appears to be an adoption of one of the tests contained in the regulations under § 954(c) (3)(A) for determining whether rents are derived in the active conduct of a trade or business.²⁸ 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 revenue rulings was the furnishing (by purchase or lease) of equipment and supplies. It is probable, however, that fur-

²⁵See text accompanying notes 52-60, *infra*.

²⁶While the rulings do not expressly mention uncompensated corporate officers, they do mention that the corporate officers involved therein were paid. See text following notes 18-20, *supra*. Moreover, a recurring issue in the case law of § 355 has been whether the direct conduct criterion is met where corporate officers are not paid. See text accompanying notes 74-82, *infra*.

²⁷Rev. Rul. 64-147, 1964-1 CUM. BULL. (Part I) 136.

²⁸Treas. Reg. § 1.954-2(d)(ii)(a) provides in part as follows:

In every case rents will be considered for the purpose of this subparagraph to be derived in the active conduct of a trade or business by a controlled foreign corporation which is a lessor of property if such rents are derived from the leasing of—

.
(2) Real property with respect to which the lessor *performs active and substantial management and operational functions* while the property is leased

(emphasis added). The function of the active business test in § 954(c)(3) is discussed in note 17, *supra*.

nishing 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 § 1402 exclusion of real estate rental income from the term self-employment earnings.²⁹ In that context the Service declared in Rev. Rul. 57-58³⁰ 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. Moreover, the Commissioner subsequently relied upon this ruling in concluding that, for the purposes of § 1372(e) (5),³¹ "the term 'rents' does not include income

²⁹INT. REV. CODE OF 1954, § 1402(a)(1) excludes real estate income from "net earnings from self-employment" which are subject to Old-Age, Survivors, and Disability Insurance taxes (FICA taxes) under § 1401, but then provides that this exclusion shall not apply if an owner or tenant of farm land derives income under a sharecropping arrangement and *materially participates* in the production or management of the production of agricultural commodities under the share-cropping agreement. The apparent reason for the exception appears to be that § 1402 is intended only to cover income from a trade or business and exclude investment income. See Lee, "Active Conduct," *supra* note 24, at 324. Management decisions and participation would take the owner out of an investment status and put him in the trade or business of farming.

³⁰1957-1 CUM. BULL. 270.

³¹INT. REV. CODE OF 1954, §§ 1371-1379 provide for conduit tax treatment of a corporation if certain stock ownership and income requirements are met. Section 1372(e)(5) provides that a Subchapter S election terminates if more than 20% of the electing corporation's gross receipts consists of "passive investment income," which includes *inter alia* gross receipts derived from *rents*. Treas. Reg. § 1.1372-4(b)(5)(vi) (1959) states, however, that the term "rents" as used in § 1372(e)(5) "does not include payments for the use or occupancy of rooms or other space where significant services are also rendered to the occupant, such as for the use or occupancy of rooms or other quarters in hotels Generally, services are considered rendered to the occupant if they are primarily for his convenience and are other than those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only. . . . Payments for the use or occupancy of entire private residences or living quarters in . . . multiple housing units, of offices in an office building, etc., are generally 'rents'"

Congress' goal was to limit Subchapter S treatment to businesses "actively engaged in trades or business," S. REP. NO. 1007, 89th Cong., 2d Sess. 8 (1966), *reprinted in* 1966-1 CUM. BULL. 532, and to distinguish operating companies from mere incorporated investment activities. H.R. REP. NO. 91-1737, 91st Cong., 2d Sess. (1970), *reprinted in* 1970-3 CUM. BULL. — CCH 1970 FED. TAX REP. ¶ 4846(j). Commentators agree that the "significant additional services" test in the regulations represents an attempt by the Service to carve out an "active rental business" exception to § 1372(e)(5). Lee, "Active Conduct," *supra* note 24, at 327; Spada & Ruge, *Partnerships-Statutory Outline and Definition*, BNA TAX MGT. PORTFOLIO NO. 161, at A-13 to A-14 (1969).

realized by a landowner under a sharefarming arrangement where the landowner participates to a material degree in the production of farm commodities through physical work or management decisions, or a combination of both."³² Significantly, commentators agree that the regulations under § 1372(e)(5) carve out an active business exception to the term "rents."³³

The "active and substantial management and operational functions" criterion appears closely related, if not identical, to a § 355 active business definition recently promulgated in *Rafferty v. Commissioner*,³⁴ wherein the First Circuit stated that an active business consisted of entrepreneurial activities quantitatively and qualitatively distinguishing corporate operations from mere investments.³⁵ 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 only the taxpayer receives the benefits of his investment as opposed to whether he creates a market or provides services to another;³⁶ 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.³⁷ 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 are not provided to others; such services are rendered or

³²Rev. Rul. 61-112, 1961-1 CUM. BULL. 399.

³³Note 31, *supra*.

³⁴452 F.2d 767 (1st Cir. 1971), *cert. denied*, 408 U.S. 922 (1972).

³⁵*Id.* at 772.

³⁶*See, e.g.,* *Deputy v. DuPont*, 308 U.S. 488, 499 (1940); *Louis C. Meyers*, 30 C.C.H. TAX CT. MEM. DEC. 1154 (1971).

³⁷*See, e.g.,* *Achille O. Van Suetendael*, 3 C.C.H. TAX CT. MEM. DEC. 987 (1944), *aff'd mem.*, 152 F.2d 654 (2d Cir. 1945). *See also* *Saunders*, "Trade or Business," *Its Meaning Under the Internal Revenue Code*, S. CAL. 12TH INST. ON FED. TAX. 693, 696 (1960) (hereinafter cited as *Saunders*).

goods are sold by the business activities of the corporation, a separate entity,³⁸ whose securities the investor holds; and the corporation's business activities are not attributed to its shareholders.³⁹ In contrast, the management of improved rental real estate involves the provision of services to the tenant, *e.g.*, renting, maintaining and improving the premises.⁴⁰ 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.⁴¹ In short, the entrepreneurial activities approach focuses on whether the corporation creates a market or provides services to another.

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. For example, in Rev. Rul. 73-525 the Service, reviewing court decisions involving non-resident individual owners of real estate in the United States, concluded that such cases hold that

activity of non-resident alien individuals (or their *agents*) in connection with domestic real estate that is beyond the mere receipt of income from rented property, and the payment of expenses incidental to the collection thereof, places the owner in a trade or business within the United States, provided that

³⁸See *Moline Properties v. Comm'r*, 319 U.S. 436 (1943); *New Colonial Co. v. Helvering*, 292 U.S. 435 (1934).

³⁹See *Whipple v. Comm'r*, 373 U.S. 193 (1963). This rationale is clearly exposed by those partnership taxation decisions which distinguish *Whipple* by asserting that the business of a partnership is imputed to a partner. *E.g.*, *A. L. Stanchfield*, 24 C.C.H. TAX CT. MEM. DEC. 1681 (1965). See also *S.E. Maitland Brenhouse*, 37 T.C. 326, 330 (1956). See generally Lee, "Active Conduct," *supra* note 24, at 323.

⁴⁰The Second Circuit in *Pinchot v. Comm'r*, 113 F.2d 718 (2d Cir. 1940), held that a rental agent's activities in executing leases, renting properties, collecting rents, supervising repairs, paying taxes, mortgage interest, insurance premiums, and executing sales were considerable, continuous, and regular and thereby constituted engaging in a business because they went beyond the scope of mere ownership of real property or the receipt of income from real property. The *Pinchot* approach has been widely followed. See Rev. Rul. 73-522, 1973 INT. REV. BULL. No. 48, at 10, and cases cited therein.

⁴¹*Cf.* *Cooper Tire & Rubber Co. Employee's Retirement Fund*, 36 T.C. 96, 101 (1961), *aff'd*, 306 F.2d 20 (6th Cir. 1962), dealing with the leasing of tangible personal property under INT. REV. CODE OF 1954, § 512(a); see also *Louis C. Meyers*, 30 C.C.H. TAX CT. MEM. DEC. 1154 (1971).

such activity is considerable, continuous and regular.⁴²

The cited cases involving agent-operated realty impute the agent's management activities to the owner of the real estate.⁴³ Furthermore, another line of cases cited by the ruling draw no apparent distinction between activities of independent contractors and of employee/agents in determining whether the owner of rental real estate was engaged in a trade or business.⁴⁴ It is submitted that, in view of *Rafferty's* entrepreneurial activities test and the approach taken by trade or business authorities in distinguishing between a business and an investment, the focus of the § 355 active conduct of a trade or business should be on the character of the services rendered rather than on who renders them.

The Prerequisite of Direct Conduct

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 § 954 model for the active business test. Under that section the "active business" safe haven of Treas. 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.⁴⁵ Thus, where a controlled foreign corporation purchases an apartment complex and engages a real estate management firm to lease the apartments, manage the buildings and pay over the net rents to it, the rental income is not derived in the active conduct of a trade or business for purposes of § 954.⁴⁶

⁴²1973 INT. REV. BULL. No. 48, at 10 (emphasis added).

⁴³*See* Inez De Amodio, 34 T.C. 894 (1960), *aff'd*, 299 F.2d 623 (3d Cir. 1962); Elizabeth Herbert, 30 T.C. 26 (1958), *acq.* 1958-2 CUM. BULL. 6; Jan Casimir Lewenhaupt, 20 T.C. 151 (1953), *aff'd per curiam*, 221 F.2d 227 (9th Cir. 1955).

⁴⁴*Reiner v. United States*, 222 F.2d 770 (7th Cir. 1955); *accord*, Adolph Schwarcz, 24 T.C. 733 (1955), *acq.* 1956-1 CUM. BULL. 5. *See generally* Lee, "Active Conduct," *supra* note 24, at 321.

⁴⁵*See* note 17, *supra*. The regulations under § 954 specifically exclude consideration of activities performed by an independent contractor in determining whether the corporate-lessor actively conducts a foreign marketing and servicing organization "through its own staff of employees located in a foreign country." Treas. Reg. § 1.954-2(d)(1)(ii)(a)(4) and (d)(1)(ii)(b)(3)(i) (1964). The satisfaction of active conduct under these regulations constitutes a separate safe haven from the "active and substantial management and operational functions" safe haven of Reg. § 1.954-2(d)(ii)(a)(2). *Cf.* note 25, *supra*. However, in the accompanying examples rental income from apartments managed by a real estate management firm is not considered as derived in the active conduct of a trade or business for purposes of § 954(c)(3)(A). Treas. Reg. § 1.954-2(d)(2)(ii)(c) *Example (4)* (1964).

⁴⁶Treas. Reg. § 1.954-2(d)(1)(ii)(c) *Example (4)* (1964). *But cf.* Treas. Reg.

Conversely, the § 954 regulations provide 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.⁴⁷

Similarly, the Real Estate Investment Trust (REIT) provisions in § 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.*" (emphasis added). 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 states 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."⁴⁸

In sharp distinction to the position taken in the three § 355 rulings, § 856, and the § 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.*⁴⁹ that § 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 fourteen months prior to the actual consummation of

§ 1.761-1(a)(1) (1956).

⁴⁷Treas. Reg. § 1.954-2(d)(2)(ii) (c) *Example (5)* (1964). *But cf.* Treas. Reg. § 1.1372-4(b)(5)(iv) (1959). *See generally* Lee, *Functional Divisions and Other Corporate Separations Under Section 355 After Rafferty*, 27 TAX. L. REV. 453, 465-66 (1972) (hereinafter cited as Lee, *Functional Divisions*).

⁴⁸1973 INT. REV. BULL. No. 22, at 9. *See also* note 16, *supra*.

⁴⁹42 T.C. 545 (1964), *acq.* 1965-1 CUM. BULL. 4.

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.⁵⁰ 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 § 355 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. He 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."⁵¹ The Tax Court agreed that Gabriel's operation of the fabrication 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 § 355 had been satisfied.

The pre-distribution requirement of § 355(b)(2)(B)—"such trade or business has 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.⁵² On the other hand, the post-distribution active business requirement of § 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" (emphasis added). Apparently, then, only the post-distribution test requires that both the distributing and controlled corporations themselves engage in the active con-

⁵⁰42 T.C. at 554.

⁵¹*Id.* at 555.

⁵²Mintz, *Corporate Separations*, 36 TAXES 882, 883 n.8 (1958).

duct 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 triad of § 355 rulings does 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 businesses directly conflicts with the holding of *W.E. Gabriel Fabrication Co.* and thus seems erroneous.

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 *H.L. Morgenstern*⁵³ interpreted a provision of § 346(b)(1), which is virtually identical with the § 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.⁵⁴ 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 princi-

⁵³56 T.C. 44 (1971).

⁵⁴Treas. Reg. § 1.346-1(c) (1955) provides that the term "active conduct of a trade or business" has the same meaning as in Treas. Reg. § 1.355-1(c). Indeed, the statutorily mandated two businesses requirement of § 346 may well have inspired the erroneous two businesses restriction contained in the § 355 regulations. See Lee, *Functional Divisions*, *supra* note 47, at 496.

ples a parent corporation does not conduct its subsidiary's business.⁵⁵ 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.⁵⁶

In reaching its decision, the *Morgenstern* court relied upon the following legislative history:

Subsection (b) provides a description of one kind of distribution which will be considered as being in partial liquidation. Paragraphs (1) and (2) contemplate that the distributing corporation must be engaged in the active conduct of at least 2 businesses which have been actively conducted (whether or not by it) for the five year period ending on the date of the distribution⁵⁷

Clearly the distributing corporation for purposes of § 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 § 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" fourteen months prior to the split-off.⁵⁸ 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*

⁵⁵See text accompanying notes 38 and 39, *supra*.

⁵⁶56 T.C. at 47.

⁵⁷S. REP. NO. 1622, 83d Cong. 2d Sess. 262 (1954).

⁵⁸W. E. Gabriel Fabrication Co., 42 T.C. 545, 553 (1964).

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 revenue 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, § 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 § 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 § 355 and § 346 the pre-distribution active business requirement does not demand direct operation by the distributing corporation.⁵⁹ Conversely, the post-distribution requirement of § 355(b)(1)(A) and the requirement of ceasing to conduct a trade or business immediately before distribution under § 346(b)(1) do appear to require direct operation.⁶⁰ 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,⁶¹ the cases generally use the terminology of engaging in a trade or business without regard to the precise wording of the statute.⁶² 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 *Adolph Schwarcz*⁶³ the Tax Court in applying the

⁵⁹*Id.* at 556 (§ 355); S. REP. NO. 1622, 83d Cong., 2d Sess. 262 (1954) (§ 346).

⁶⁰See text accompanying note 58, *supra*.

⁶¹See, e.g., INT. REV. CODE OF 1954, §§ 162, 165(c), 167(a), 274(a)(1) (A), 355(b), 761(a)(1), 864(c)(4)(B)(i), 871(b)(1), 921(2), 954(c), 1221(2), 1372(e)(5)(B)(i), 1402.

⁶²See, e.g., *Gilford v. Comm'r*, 201 F.2d 735, 736 (2d Cir. 1953); *Adolph Schwarcz*, 24 T.C. 733, 739 (1955). See also *Saunders*, *supra* note 37, at 723.

⁶³24 T.C. 733, 739 (1955).

net operating loss provisions of the 1939 Code, cited *Gilford v. Commissioner*,⁶⁴ 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.⁶⁵ As the Second Circuit reasoned in *Gilford v. Commissioner*:

Although it does not appear tht the petitioner did anything herself in connection with the management of these eight buildings, an appreciable amount of time and work was necessarily required on the part of the managing agent. And if such was a "trade or business," the petitioner was so engaged although she acted only through an agent.⁶⁶

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-distribution active businesses be directly operated by the distributing and, in the case of § 355, controlled corporations,⁶⁷ 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,⁶⁸ and

⁶⁴201 F.2d 735 (2d Cir. 1953).

⁶⁵INT. REV. CODE OF 1939, § 122(d)(5), under consideration in *Schwarcz*, provided that "Deductions . . . not attributable to the operation of a *trade or business regularly carried on* by the taxpayer shall . . . be allowed only to the extent of . . . gross income not derived from such trade or business" (emphasis added); however, the Tax Court in citing *Gilford* was looking at statutory language that excluded from the definition of capital assets "real property *used in the trade or business* of the taxpayer" (emphasis added). INT. REV. CODE OF 1939, § 117(a)(1).

⁶⁶201 F.2d at 736.

⁶⁷See text accompanying note 58, *supra*.

⁶⁸42 T.C. at 553.

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.⁶⁹

Such an economic risk analysis is paralleled in the case law of § 921, by which a corporation may obtain favorable Western Hemisphere Trade Corporation treatment if 90% of its gross income is "derived from the active conduct of a trade or business."⁷⁰ The district court in *United States Gypsum Co. v. United States*⁷¹ saw as the crux of § 921 the limitation in the statute that the taxpayer be "engaged" in the active conduct of a trade or business. Its analysis centered on whether the taxpayer bore the economic risks of the business and performed any services.⁷² Other § 921 decisions have found that the active business test is met where the business activities are performed by an agent⁷¹ who is not a salaried employee over whom the corporation exercises complete control.⁷³

Direct Conduct and Uncompensated Corporate Officers

The facts and conclusions of the rulings disclose the substance of the Commissioner's views about the concept of direct conduct. For example, all three rulings indicate that performance of activities by independent contractors constitutes, in the eyes of the Service, performance by others outside the corporation rather than directly by the corporation itself and hence does not qualify as active conduct by the corporation.

A question of some frequency in decisions under § 355,⁷⁴ as well as under other provisions⁷⁵ of the Code, has been whether an active trade or business test is satisfied where the requisite activities are performed by uncompensated officers, common joint officers of related corporations, or other (related) parties for a management fee. Rev. Rul. 73-234 noted that the president and sole shareholder of the

⁶⁹56 T.C. at 47.

⁷⁰See note 14, *supra*.

⁷¹304 F. Supp. 627, 642 (N.D. Ill. 1969), *rev'd on other grounds*, 452 F.2d 445 (7th Cir. 1972).

⁷²*Id.* at 642.

⁷³*E.g.*, *Frank v. Int'l Canadian Corp.*, 308 F.2d 520, 525 (9th Cir. 1962). See generally Lee, "Active Conduct," *supra* note 24, at 330-31.

⁷⁴*E.g.*, *King v. Comm'r*, 55 T.C. 677 (1971), *rev'd*, 458 F.2d 245, (6th Cir. 1972); *Hanson v. United States*, 338 F. Supp. 602 (D. Mont. 1971). See generally Lee, *Functional Divisions*, *supra* note 47, at 459-62.

⁷⁵See, e.g., *American Sav. Bank*, 56 T.C. 828, 839 (1971) [§ 61(2)]; *Frank v. Int'l Canadian Corp.*, 308 F.2d 520, 525 (9th Cir. 1962) [§ 921(2)].

parent (distributing) corporation was *employed* by the spun-off subsidiary to participate in the farm operation. Similarly, Rev. Rul. 73-237 pointed out that the activities in question were performed by several salaried employees of the distributing corporation. It may be inferred from these careful references in the rulings to the employment status of the performer of the activities that the Service would take the position that its requirement of direct performance by a corporation *A* is *not* satisfied where *A*'s management and operational functions are carried out by the officers-employees of related corporation *B*, who are also officers of *A* but whose salaries are paid solely by *B*.

The Tax Court opinion in *E. Ward King*⁷⁶ offers perhaps the strongest support for any Service contention that activities by non-compensated joint officers would not satisfy the requirement of direct conduct by the corporation:

It is our holding that Interstate, Motorways and Regal (the spun-off corporations) were not engaged in the active conduct of a trade or business. During the critical 5-year period the books and records and other general accounting services were kept and performed by James Little, who, it appears was their only salaried employee. . . . Beginning in June of 1961, and from then on, for all the record indicates, the real estate corporations had no employees whatsoever. . . . There is no evidence to show that the corporations ever had more than one employee, and objectively we find it quite difficult to perceive the active conduct of a trade or business when no activities are being performed by the corporations in question. In conjunction with the paucity of real estate leasing company employees we also found the lack of office, address and telephone antithetical to the active conduct on a trade or business.

In the instant case, however, the petitioners contend that in addition to renting terminals to the parent corporation the real estate leasing corporations acquired property, arranged financing, and constructed the terminals. After having carefully considered the petitioners' arguments, it is our conclusion that Interstate, Motorways and Regal performed these functions in name only.

As we stated in detail in our Findings of Fact, Mason & Dixon would determine when a new facility was needed.

⁷⁶55 T.C. 677 (1971), *rev'd*, 458 F.2d 245 (6th Cir. 1972).

Mason & Dixon employees would then determine the proper location for a new terminal. E. Ward or John R. King, officers, shareholders and directors of Mason & Dixon, would then acquire property for the leasing corporation involved. *These men were, to be sure, officers of the real estate leasing corporations, but were not compensated for their services.*⁷⁷

However, the Sixth Circuit in reversing disagreed with the view of the Tax Court that the spun-off corporations performed the acquisition, financing and construction activities in name only. It acknowledged that the officers and directors of the spun-off leasing subsidiaries were also officers and directors of the distributing corporation, but concluded that "when they were performing activities in behalf of the leasing corporations they were in fact and in law acting solely for the leasing corporations."⁷⁸ The appellate court noted that these officers were not paid by the spun-off corporation for their substantial acquisition, financing and construction services, but emphasized that it is customary that officers and directors serve without compensation unless special provisions have been made. Accordingly, the Sixth Circuit expressly rejected the Tax Court's conclusion that the spun-off corporations did not perform any activities because they employed only one paid employee, an accountant.

Of similar import is *Hanson v. United States*,⁷⁹ where the facts do not clearly reveal whether the corporation in question had paid employees, but the district court approvingly quoted the following passage from a Tax Court decision not involving § 355:

"Where, as here, business was conducted through agents and an accurate record of income and disbursements was kept primarily with check stubs, the absence of the factors relied upon by respondent [operation without employees, a separate office, a telephone, advertising or a complete set of books and records] does not justify ignoring that business operations were in fact being conducted."⁸⁰

Finally, case law authority under the analogous active business provision of § 921(2) reaches results consistent with the opinions in *King* and *Hanson*.⁸¹

The various authorities herein considered could all be reconciled

⁷⁷55 T.C. at 697-98 (emphasis added).

⁷⁸458 F.2d at 248.

⁷⁹338 F. Supp. 602 (D. Mont. 1971).

⁸⁰Id. at 611 n.16, quoting *American Sav. Bank*, 56 T.C. 828, 839 (1971).

⁸¹See text accompanying notes 70-73, *supra*.

by (1) limiting the "directly carried on" touchstone of Revenue Rulings 73-234, 73-236 and 73-237 to the post-distribution active business requirement of § 355, and (2) distinguishing the performance of active and substantial management and operational activities by independent contractors from such performance by non-compensated joint officers or related corporations for a management fee. In other words, the cases have only gone so far as to hold that the § 355 post-distribution active business test cannot be satisfied where *all* active and substantial management and operational activities are performed by an independent contractor. Despite this possibility of surface harmony, however, the question of whether direct operation by a corporation of an active trade or business should or actually does preclude consideration of the "activities of others outside the corporation, including independent contractors"⁸² must be considered. For this question lies at the core of the three rulings, and the Service's answer to it comprises their most significant holding.

Direct Conduct and Independent Contractors

As shown above, the conclusion in the trilogy of rulings that active conduct for purposes of § 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 § 856(d) and a covert analogy to Treas. Reg. § 1.954-2(d)(ii)(a).⁸³ 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.⁸⁴ Yet in *King v. Commissioner*, the Sixth Circuit implicitly rejected the position, adopted by the Tax Court below, that relatedness precludes active business.⁸⁵ Similarly, *Rafferty v. Commissioner* 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.⁸⁶ Furthermore, in applying its two-part definition of the active business test ("entrepreneurial endeavors" and "objective indicia"), the

⁸²Rev. Rul. 73-234, 1973 INT. REV. BULL. No. 22, at 7; Rev. Rul. 73-236, *Id.* at 8; Rev. Rul. 73-237, *Id.* at 9.

⁸³See text accompanying notes 45-48, *supra*.

⁸⁴Treas. Reg. § 1.954-2(d)(1)(i) (1964); Treas. Reg. § 1.856-4(b)(2) (1962).

⁸⁵458 F.2d 245, 248 (6th Cir. 1972). See 2 SURREY, WARREN, MCDANIEL & AULT, FEDERAL INCOME TAXATION 852-53 (1973) (hereinafter cited as SURREY, WARREN, MCDANIEL & AULT).

⁸⁶452 F.2d at 772 n.12.

Rafferty court noted that the spun-off corporation did not pay salaries and did not employ independent contractors.⁸⁷ 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 the landmark decision of *Edmund P. Coady*,⁸⁸ 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 Treas. Reg. § 1.355-1(a) maintained that § 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.⁸⁹

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 § 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, is echoed elsewhere:

Whether or not one is a farmer for tax purposes does not depend on his tilling the soil by his own labor rather than by that of hired hands, tenant farmers, or even professional nurserymen. Where, as here, the taxpayers assume the risk that the

⁸⁷*Id.* at 772-73.

⁸⁸33 T.C. 771, 777 (1960), *aff'd per curiam*, 289 F.2d 490 (6th Cir. 1961), *nonacq.*, Rev. Rul. 61-198, 1961-2 CUM. BULL. 61, *nonacq. revoked*, Rev. Rul. 64-147, 1964-1 CUM. BULL. (Part 1) 136.

⁸⁹33 T.C. at 777.

crop will never be harvested due to unforeseen circumstances and the crop is related to the taxpayer's farming endeavors, the expenses they incur with regard to that crop are farming expenses.⁹¹

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

Present law [the active business provision of section 112(b)(11) of the Internal Revenue Code of 1939] *contemplates that a tax-free separation shall involve only the separation of assets attributable to the carrying on of a active business.* Under the House bill, it is immaterial whether the assets are those used in an active business but if investment assets, for example, are separated into a new corporation, any amount received in respect of such an inactive corporation, whether by a distribution from it or by a sale of its stock, would be treated as ordinary income for a period of 10 years from the date of its creation. Your committee returns to *existing law in not permitting the tax free separation of an existing corporation into active and inactive entities.* It is not believed that the business need for this kind of transaction is sufficiently great to permit a person in a position to afford a 10-year delay in receiving income to do so at capital gain rather than dividend rates. Your committee requires that both the business retained by the distributing company and the business of the corporation the stock of which is distributed must have been actively conducted for the 5 years preceding the distribution, a safeguard against avoidance not contained in existing law.⁹²

Since this legislative history does not 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.

⁹¹Frank v. Int'l Canadian Corp., 308 F.2d 520, 525 (9th Cir. 1962); Babson Bros. Export Co., 22 C.C.H. TAX CT. MEM. DEC. 677 (1963).

⁹²Maple v. Comm'r, 440 F.2d 1055, 1057 (9th Cir. 1971).

⁹³S. REP. No. 1622, 83d Cong., 2d Sess. 50-51 (1954) (emphasis added), *quoting*, Edmund P. Coady, 33 T.C. 771, 778.

Furthermore, the exclusion of independent contractor activities from direct active conduct is not mandated by the legislative history of the "device" clause. Under § 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 § 112(b)(11) of the Internal Revenue Code of 1939, which also introduced the post-distribution active business test. In that section, the device clause was designed to prevent the bail-out⁹³ 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.⁹⁴

The First Circuit in *Rafferty v. Commissioner* finely tuned the device test by formulating an analysis focusing on the potentiality of a bail-out. The court held that (1) where salable assets of one corporation, e.g., a subsidiary, are distributed by another, e.g., a parent, to shareholders with an interest in both post-distribution corporations; and (2) the retention of these assets is not necessary to continue the business of the distributing corporation,⁹⁵ thereby giving rise to a potential bail-out; then (3) the shareholders must show either that the retention of the assets is necessary to accomplish a shareholder business purpose; or (4) that the distribution serves a corporate purpose equal to or greater than the bail-out opportunity.⁹⁶ This bail-out potential analysis may be illustrated by the following hypothetical transaction. Sales company *P* spins off to its sole stockholder *A* the stock in *S*, a subsidiary real estate corporation that owns and leases to *P* the facilities in which *P* conducts its sales business. Assuming that such facilities can be readily rented, the element of "salable assets" in the shareholder's hands is met. If the facilities are not so unique that *P* could not rent comparable facilities elsewhere, the second element is satisfied, and the transaction possesses bail-out potentiality. In such circumstances the holding in *Rafferty* would seem to imply that a shareholder's purpose of facilitating his estate planning by donating the typically stable, fixed-income stock in *S* to nonbusiness oriented members of his family, thereby also excluding them from the management of *P*, would not outweigh the bail-out

⁹³See note 5, *supra*, and accompanying text.

⁹⁴Massee, *supra* note 8, at 449.

⁹⁵Thus, the sale of the assets would not impair the shareholders' equity interest in the distributing corporation.

⁹⁶452 F.2d at 770-71. See SURREY, WARREN, McDANIEL & AULT, *supra* note 85, at 861; Lee, *Functional Divisions*, *supra* note 47, at 496.

potential in the transaction. On the other hand, if the shareholder's business purpose for the spin-off of the real estate had been to pledge the stock in *S* as security for alimony payments, in order to prevent the subjection of *P* to his ex-wife's claims, it has been suggested that such a purpose would preclude any bail-out of earnings goal on *A*'s part.⁹⁷ Presumably the pledged stock would be non-transferable except to the former wife upon a default in alimony payments by *A*.

The taxpayer's other method of avoiding the device stigma is to show that *P* had sufficient business reasons for the spin-off to overcome the bail-out potential. Such business reasons have usually been expressed in terms of purposes for the separation of the assets of the controlled corporation (*e.g.*, to shield a financially solid corporation from the risks of a speculative venture) or for the distribution of the stock itself (*e.g.*, to satisfy an anti-trust consent decree or to allow a key employee to invest in a division which he manages).⁹⁸ Nevertheless, it would appear to be more consistent with the function of this element in the analysis of bail-out potentiality—to assay the likelihood that the potential bail-out will be carried to fruition—to ask whether the corporate business purpose would retard a shareholder stock sale or liquidation of the spun-off corporation.⁹⁹

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.¹⁰⁰ 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.¹⁰¹ The Tax Court in *Gabriel* had surmised that the pre-distribution 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.¹⁰² The *Gabriel* court

⁹⁷Whitman, *supra* note 10, at 1243.

⁹⁸*Id.* at 1254.

⁹⁹Lee, *Functional Divisions*, *supra* note 47, at 493.

¹⁰⁰Massee, *supra* note 8, at 444-45.

¹⁰¹*Id.* at 449; BITTKER & EUSTICE, *supra* note 5, ¶ 13.04, at 22; Cohen, Silverman, Tarleau, & Warren, *The Internal Revenue Code of 1954, Corporate Distributions, Organizations and Reorganizations*, 68 HARV. L. REV. 393, 427 n.255 (1955).

¹⁰²42 T.C. at 556 (1964), *acq.* 1965-1 CUM. BULL. 4. See Palestin, *Tests for Tax-free Distributions on Corporate Division*, 38 TAXES 327, 329-30 (1960).

concluded that a business conducted actively by some one other than the distributing or controlled corporation would still fulfill this purpose.¹⁰³

Conduct of an active business through an independent contractor would not open the door to a drop down of liquid assets;¹⁰⁴ 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 § 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 trilogy of recent rulings reaches 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 triad of § 355 Revenue rulings sets forth would in general seem to be sound. The difficult issue however, is whether such direct conduct for purposes of § 355 precludes performance by others outside the corporation, particularly independent contractors. The § 954 and REIT analogies would answer this question affirmatively. However, the following considerations militate against such a conclusion: (1) the analogies of the § 761 regulations, the § 921 authorities, and the

¹⁰³42 T.C. at 556.

¹⁰⁴If the business is active, the assets presumably are also active and thus are not prone to be dropped down and liquidated.

construction of the verb "engaged" in the trade or business cases; (2) the implications of several § 355 decisions; and, most significantly, (3) the purpose of the active business and device tests of § 355. The analogies arising from a consideration of § 761, § 921 and cases construing the phrase "engaging in a trade or business" focus on a distinction between business activities and investment activities. For example, the Tax Court recently concluded in *Roy P. Varner*¹⁰⁵ that tenants in common were actively carrying on a trade or business and hence were partners within the § 761 definition, on the grounds that the amount and types of their income and expenses indicated a more active rental business than the mere holding of property for investment. Similarly, the term "active conduct" in § 921 is intended to disqualify corporations that are "inactive" in the sense that they receive investment income rather than business income.¹⁰⁶

Finally, and 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 § 162 since they were not incurred "in carrying on any trade or business."¹⁰⁷ Instead, § 212, applicable only to individuals, was enacted to permit the deduction by individuals of non-business or investment expenses.¹⁰⁸ However, § 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 § 162.¹⁰⁹ 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 § 162 from those that would give rise to non-business expenses deductible only under § 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

¹⁰⁵22 C.C.H. TAX CT. MEM. DEC. 97, 100 (1973).

¹⁰⁶*Frank v. Int'l Canadian Corp.*, 308 F.2d 520, 525 (9th Cir. 1962).

¹⁰⁷INT. REV. CODE OF 1954, § 162(a). See *Higgins v. Comm'r*, 312 U.S. 212 (1941); *Comm'r v. Smith*, 203 F.2d 310 (2d Cir.), *cert. denied*, 346 U.S. 816 (1953).

¹⁰⁸*McDonald v. Comm'r*, 323 U.S. 57, 62 (1944).

¹⁰⁹BITTKER & STONE, *FEDERAL INCOME ESTATE AND GIFT TAXATION* 232 (4th ed. 1972); BITTKER & EUSTICE, *supra* note 5, ¶ 5.03, at 7.

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 would also encompass investment activities.

The foregoing analysis contradicts the position of the Tax Court that cases which are decided under "trade or business" sections of the Code 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.¹¹⁰ Of course, it is true that the Tax Court's earlier decisions involving the rental by an individual taxpayer of a single piece of residential property, because of their narrow import, are no longer valid authority for what constitutes a trade or business.¹¹¹ However, it would seem proper to look to those earlier decisions interpreting "trade or business" where the individuals involved were engaged in non-investment activities. In any event, the non-Tax Court § 355 decisions¹¹² and even Tax Court decisions under active business provisions other than § 355¹¹³ 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 § 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, income. Furthermore, the term "passive" (inactive) income is frequently used to refer to investment income in the Code.¹¹⁴ Consequently, it would seem that the function of the active business requirement in § 355—to preclude the tax-free separation of active and inactive assets into active and inactive corporate entities—is consistent with the above analysis.¹¹⁵ Indeed, the *Rafferty* definition

¹¹⁰E. Ward King, 55 T.C. 700 (1972), *rev'd* 458 F.2d 245 (6th Cir. 1972); *see also* Isabel A. Elliot, 32 T.C. 283, 290 (1959).

¹¹¹*See, e.g.*, Anders I. Lagreide, 23 T.C. 508, 511 (1954); Leland Hazard, 7 T.C. 372, 375-76 (1946); John D. Fackler, 45 B.T.A. 708, 713-15 (1941), *aff'd*, 133 F.2d 509 (6th Cir. 1943). *See generally* Lee "Active Conduct," *supra* note 24, at 318-19; Comment, *The Single Rental as a "Trade or Business" under the Internal Revenue Code*, 23 U. Chi. L. Rev. 111 (1959).

¹¹²*Estate of Parshelsky v. Comm'r*, 303 F.2d 14 (2d Cir. 1962) (dealing with the 1939 Code predecessor to § 355); *Hanson v. United States*, 338 F. Supp. 602 (D. Mont. 1971).

¹¹³*See, e.g.*, Roy P. Varner, 32 C.C.H. TAX CT. MEM. DEC. 97, 100 (1973); George Rothenberg, 48 T.C. 369, 373 (1967).

¹¹⁴*See, e.g.*, INT. REV. CODE OF 1954, § 1372(e)(5); S. REP. No. 1881, 87th Cong. 2d Sess. (1962), *reprinted in* 1962-3 CUM. BULL. 788-89.

¹¹⁵Moreover, Congress in speaking of the dichotomy between active business and

of active business under § 355 as entrepreneurial activities quantitatively and qualitatively distinguishing corporate operations from mere investments¹¹⁶ could serve, with the deletion of the word "corporate," as the definition of trade or business in the case of an individual.¹¹⁷

By contrast, the active business elements of §§ 954 and 856, which were apparently utilized as analogies by the drafters of the three § 355 rulings, on the surface conflict with the foregoing analysis since they clearly require more than trade or business in the case of an individual taxpayer;¹¹⁸ yet these two sections are also rooted in the distinction between business income and passive investment income. According to the Senate Finance Committee Report, the foreign personal holding income (FPHC income) test of § 954(c) was utilized because Congress saw "no need to maintain the deferral of U.S. tax where the investments are portfolio types of investments, or where the company is merely passively receiving investment income."¹¹⁹ The Finance Committee described FPHC income as, generally speaking, passive in character. On the other hand, Congress did not want to include income arising in connection with certain actual business activities. Thus it provided in § 954(c)(3) "that rents and royalties received from an unrelated person and derived from the active conduct of a trade or business will not be considered foreign personal holding company income."¹²⁰ Nevertheless, neither this legislative

passive investment income in § 1372(e)(5) has stated that the passive investment income standard was meant to distinguish operating companies from mere incorporated investment activities. H.R. REP. NO. 91-1737, 91st Cong. 2d Sess. (1970), *reprinted in* 1970-3 CUM. BULL. —, CCH 1970 FED. TAX REP. ¶ 4846(j). Thus, passive investment income from "inactive assets" would result in a corporation which is merely an incorporated investment activity or an inactive entity. Moreover, in explanation of § 954(c) Congress has seen the "active conduct of a trade or business" as the antithesis of the passive receipt of investment income. S. REP. NO. 1881, 87th Cong. 2d Sess. (1962), *reprinted in* 1962-3 CUM. BULL. 788-89.

¹¹⁶452 F.2d at 772.

¹¹⁷*See, e.g.,* *Alvary v. United States*, 302 F.2d 790 (2d Cir. 1962); *McDowell v. Ribicoff*, 292 F.2d 174 (3d Cir. 1961). *See generally* Lee, "Active Conduct," *supra* note 24, at 318.

¹¹⁸The Second Circuit has indicated that acting as a lessor to a related corporation would constitute a trade or business activity. *Estate of Parshelsky v. Comm'r*, 303 F.2d 14 (2d Cir. 1962). Moreover, recent § 355 case law clearly holds that such activities constitute an active trade or business. *See* notes 84-87, *supra*, and accompanying text. Accordingly, one must conclude that in §§ 954(c)(3) and 856(d)(3) Congress was adding a requirement not inherent in the concept of active conduct of a trade or business.

¹¹⁹S. REP. NO. 1881, 87th Cong. 2d Sess. (1962), *reprinted in* 1962-3 CUM. BULL. 789.

¹²⁰*Id.*

history nor § 954(c) itself makes reference to exclusion of the activities of an independent contractor in applying the active business test. Thus, § 954(c) does not conflict with the view that "active" business for a corporation means no more than "trade or business" in the case of an individual. Rather the independent contractor innovation first appears in the regulations¹²¹ and quite possibly is patterned after § 856(d)(3).

Under § 856(d)(3), one of the principal purposes of imposing restrictions on the types of income a qualifying REIT may receive was

to be sure that the bulk of its income is from passive income-sources and not from the active conduct of a trade or business. . . . This interest in restricting the income of the trust to that of a passive nature also accounts for two of the restrictions provided in the definition of "rents from real property."

. . . .

A second restriction, intended to limit the definition of rents from real property to those of a passive nature, excludes from the definition amounts where the trust directly furnishes or renders services to the tenants or manages or operates the property. However, the bill permits these services or management or operation of the property to be provided through an independent contractor.¹²²

While this legislative history might lead to the conclusion that Congress believed that performance of managerial or operational services by an independent contractor rendered the rents from such property passive, it can be read just as easily as supporting the view that where the trust through an independent contractor furnishes services to tenants and manages the property, the rent is still derived from the active conduct of a trade or business, but that Congress has created an exception permitting the use of such an independent contractor in practical recognition of the fact that "ownership of real estate today is hopelessly encumbered with management functions."¹²³ It is submitted, therefore, that the analogies allowing active conduct through independent contractors should be relied upon in § 355 cases and that the three recent rulings are in error. While this conclusion

¹²¹See notes 17, 28 and 45, *supra*.

¹²²H.R. REP. NO. 2020, 86th CONG. 2d Sess. 3 (1960), *reprinted in* 1960-2 CUM. BULL. 822-23.

¹²³Parker, *REIT Trustees and the "Independent Contractor,"* 48 VA. L. REV. 1048, 1051 (1962).

might be doubtful if only the active business analogies are considered, it is buttressed by the implications of the *Rafferty*, *King*, *Hansen* and *Gabriel* cases and the purposes ascribed to the § 355 active business and device tests, as well as the meaning Congress apparently intended to ascribe to the active conduct of a trade or business by a corporation.

Possible Directions of the Modified Regulations

In Rev. Rul. 64-147¹²⁴ the Service announced that it would follow *Coady* to the extent that it ruled invalid Treas. Reg. § 1.355-1(a), which provides that § 355 is inapplicable to the division of a single business. The ruling further stated that consideration was being given to modifications of the regulations.¹²⁵ In light of the holding in *Coady*, such modifications would clearly entail deletion of the requirement of two businesses. However, commentators¹²⁶ have asked whether the two businesses rule did not serve as the conceptual foundation for the further requirement of the regulations that a trade or business for purposes of § 355 must consist of activities including every operation that forms a part of, or a step in, the process of earning income or profit from a specific existing group of activities; and as the basis for the proviso that such a trade or business does not include a group of activities which, while part of a business operated for profit, were not themselves independently producing income.¹²⁷ Furthermore, the implications of examples accompanying the regulations that components of a functionally integrated business do not actively conduct separate businesses appear to be bottomed on the requirement of two businesses and independent production of income by each component.¹²⁸ Beyond the question of whether any modification would approve functional divisions, commentators have begun to question the basic thrust of the regulations, which place emphasis on whether the definitional elements of active conduct of a trade or business are met rather than on whether the transaction gives rise to a potential bail-out of earnings and profits.¹²⁹

¹²⁴1964-1 CUM. BULL. (Part 1) 136.

¹²⁵*Id.*

¹²⁶Whitman, *supra* note 10, at 1222-23. See also BITTKER & EUSTICE, *supra* note 5, ¶ 13.04, at 14; Massee, *supra* note 8, at 462 (suggesting that the requirement of independent production of income is inconsistent with the active-inactive dichotomy in *Coady*).

¹²⁷Treas. Reg. § 1.355-1(c) (1955).

¹²⁸BITTKER & EUSTICE, *supra* note 5, ¶ 13.04, at 15; Massee, *supra* note 8, at 461. Note, *Section 355*, *supra* note 3, at 976.

¹²⁹Lee, *Functional Division*, *supra* note 47, at 495-96; Whitman, *supra* note 10, at

The First Circuit in *Rafferty* recently agreed that the requirement in the regulations of independent production of income by each component of a business was largely a restatement of the erroneous separate business prerequisite and expressed its belief that the *Coady* rationale extended to functional divisions of an existing business.¹³⁰ While each of the three rulings refers to the definition in the regulations of a trade or business as including every step in the process of earning income or profit from the group of activities, no reference is made to the requirement of independent production of income by each division. Moreover, the trilogy states that performance of a portion of a corporation's business by independent contractors, which itself does not constitute the active conduct of the corporation's business, will not alone preclude the corporation from being engaged in the active conduct of a trade or business. This language signals a retreat from the requirement in the regulations that a trade or business must consist of activities (implicitly carried on directly by the corporation) which include every step in the process of earning income or profit from the group. Such a retreat may well foreshadow the Service's ultimate acceptance of functional divisions.

The very fact that the rulings place the independent contractor issue within the definitional context of the active business test rather than under the device test manifests that the Service is not yet willing to abandon the definitional bias of the current § 355 regulations and adopt a transactional approach. Such reluctance is unfortunate, for to the extent that any modification of the regulations does not reflect the emerging transactional preference of the circuit courts, continued taxpayer challenges to their validity and uncertainty may be expected. Of course, the Service's apparent preference for an objective test is understandable from a tax administration viewpoint. However, although the active business requirement would seem to set an objective standard, uncertainty as to its meaning continues to generate litigation. Moreover, it is simply too broad a test as applied by the Service and unresponsive to the issue of whether the transaction is capable of being used as a device to bail-out earnings and profits. On the other hand, the bail-out potentiality approach also has objective elements relating to the liquidity of assets and impairment of equity factors; and although the element of corporate or shareholder business purpose is itself subjective, whether such purpose outweighs the bail-out potential of the transaction again pro-

1234, 1252-53; Note, *Section 355*, *supra* note 3, at 976-78.

¹³⁰452 F.2d at 772 n.10.

vides the opportunity for an objective analysis. Moreover, it is not unusual in other areas of tax law to require proof of subjective intent through substantial objective evidence in addition to the taxpayer's testimony.¹³¹

If the regulations are modified to rely primarily on the device test and its emphasis on the potentiality of a bail-out, then each of the latter's elements—liquidity of assets, impairment of equity, and shareholder and corporate business purpose—should be set forth with specificity and accompanied by examples fashioned with care to include the consideration of the factors of independent contractors and uncompensated corporate officers. The active business test, on the other hand, should be deemphasized and restated as imposing the definition of trade or business under the case law of § 162, pertaining to individuals, upon the distributing and controlled corporations with exception of activities whose expenses would be deductible by individuals only under § 212. In short, the *Rafferty* court's interpretation of the active business test, as well as its reformulation of the device prerequisite, should be adopted. In illustrating such an active business approach, the modified regulations should focus on such questions as the degree and continuity of management and operational activities required, the distinction between business and investment endeavors, and whether the net leasing of real or personal property qualifies as a business

¹³¹*see, e.g.*, Leonard F. Barcus, 32 C.C.H. TAX. CT. MEM. DEC. 660, 644 (1973), *aff'd per curiam*, CCH 1974 STAND. FED. TAX REP. ¶ 9288 (2d Cir. Feb. 19, 1974), 1974-1 U.S.T.C. _____. *But see* Imbesi v. Comm'r, 361 F.2d 640, 645 (3d Cir. 1966).