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THE BUSINESS PURPOSE DOCTRINE IN CORPORATE DIVISIONS

STEPHEN RIGSBY*

INTRODUCTION

FOR A VARIETY OF REASONS, shareholders may find it either necessary or desirable to effect a division of their corporation. The division of a corporation may refer to the creation of a subsidiary corporation or to the distribution to the shareholders of the stock of either an existing or a newly created subsidiary corporation. It is in the latter sense that this paper will refer to corporate division.

The usual result of a corporate division is that the shareholders' investment is unliquidated, although it will be in a modified corporate form. In keeping with business needs and realities, the Internal Revenue Code provides that many corporate divisions result in no taxation. Since the investment is continued, taxation is deferred until a more appropriate time.

The corporate division, however, lends itself to schemes for avoidance of tax. These schemes are attempts to convert ordinary income into income taxable at capital gains rates. An elaborate statutory mechanism has been created to prevent this conversion. In addition, the courts have created judicial doctrines which sometimes work by adding to the statutory framework and sometimes overlap. The resulting confusion of statute and judicial doctrine is the subject of this article. The investigation will focus on that part of the statute known as the device clause and its interaction with the judicial doctrines which together are known as the business purpose doctrine.

First will be considered the origins of the problem found in case law and in the legislative response before 1954. Then the statute in its present form and the cases decided since the enactment of Section 355 will be examined in detail. Finally, a new judicial trend will be considered and a modification proposed.

I. REASONS FOR AND MECHANICS OF THE CORPORATE DIVISION

The reasons for a corporate division may be as varied and as complex as the economic life of the country but despite this, certain reasons for corporate divisions are found frequently in the cases and rulings in this area.

One of the reasons which is often advanced for the division of a corporation owned by a single shareholder is to facilitate his estate planning.

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The corporation may have two businesses which the shareholder may desire to leave to different beneficiaries. The shareholder may also want to divide the corporation in such a manner that some beneficiaries actively manage the business while other beneficiaries are excluded from active management but nonetheless are provided with a source of steady income.¹ In addition, a corporation may be engaged in the management of two or more businesses, one of which is considerably less stable than the others. In order to protect the stable businesses from the creditors of the unstable business, it may be desired to separate the businesses by means of a corporate division.² Where a corporation is owned equally by two shareholders, it may become necessary to effect a division of the corporation when the shareholders can no longer agree as to corporate policy and management.³ In the context of a corporation with a larger number of shareholders, the majority shareholders may want to spin-off part of the corporation to eliminate a group of dissident shareholders.⁴

A variety of other reasons may prompt a corporate division as well. In one reported case, a parent corporation was involved in a labor dispute and a spin-off of a subsidiary was regarded as necessary to prevent the spread of labor difficulties.⁵ Some corporations engage in two businesses which are such that the customers of one business are in competition with the other corporate business. In this situation, customer objections to doing business with a competitor may force a division.⁶ A division of the corporation may be necessary in order to facilitate a merger with a company which does not want to acquire the subsidiary.⁷ In some instances, the success or failure of the corporate venture may depend on the presence or absence of a key employee and to retain that employee, it may be necessary to let him participate in the ownership of the corporation. Where the cost of the stock is too great for the key employee or where the owners do not wish the employee to have an interest in the entire corporation, a division will be necessary.⁸ Corporations are organized frequently with two or more businesses. It may become apparent with the passage of time that the businesses cannot be operated efficiently together, and thus a corporate division is

¹ See *Parshelsky's Estate v. Commissioner*, 9 Am. Fed. Tax R. 2d 1382 (2d Cir. 1962).

² This was one of the reasons advanced for separation of real estate consisting of land and a large building from a corporation engaged in the business of operating an automobile dealership in *Bondy v. Commissioner*, 4 Am. Fed. Tax R. 2d (4th Cir. 1959).

³ See *Albert W. Badanes*, 39 T.C. 410 (1962).

⁴ See Rev. Rul. 75-469, 1975-2 CUM. BULL. 126.

⁵ *Sidney L. Olson*, 48 T.C. 855 (1967).

⁶ See *H. Grady Lester, Jr.*, 40 T.C. 947 (1963).

⁷ See Rev. Rul. 72-530, 1972-2 CUM. BULL. 212.

⁸ See Rev. Rul. 69-460, 1969-2 CUM. BULL. 212.

necessary.⁹ Finally, to complete this survey, it should be noted that a corporate division may sometimes be required by a regulatory agency.¹⁰

A. *Methods of Corporate Division*

A corporation may be divided in one of three ways which are known as the spin-off, the split-off and the split-up. The spin-off is accomplished by first creating a new corporation. The parent corporation then transfers assets to the new corporation, in exchange for all of its stock. This stock is distributed to the shareholders of the parent corporation.

The mechanics of the split-off are similar, except that the shareholders of the parent corporation surrender a portion of their stock in the old corporation in exchange for the stock of the new corporation.

In a split-up, the parent corporation creates two new corporations and transfers its assets to them in exchange for their stock. The stock is distributed to the shareholders of the parent, and it is liquidated.

II. ORIGINS OF THE PROBLEM:

GREGORY V. HELVERING AND THE "BAIL-OUT"

When the corporate division complies with the provisions of Section 355,¹¹ there is a deferral of recognition of gain or loss on the transaction. The underlying assumption of the tax-free exchange provisions is presented in the Regulations. It is that "the new property is substantially a continuation of the old investment still unliquidated; and, in the case of reorganizations, that the new enterprise, the new corporate structure, and the new property are substantially continuations of the old still unliquidated."¹²

The elaborate provisions of Section 355 and the judicial business purpose doctrine are safeguards to prevent the use of the corporate division to effect what is known as a bail-out.

The best known example of a bail-out and by far the leading case in this area, is *Gregory v. Helvering*.¹³ This case was decided under statutory language which provided that a reorganization occurred when a corporation transferred all or part of its assets to another corporation and immediately after the transfer, the transferor corporation or its stockholders or both were in control of the corporation to which the assets were transferred. The statute went on to provide that if in pursuance of a plan of reorganization

⁹ Rev. Rul. 56-451, 1956-2 CUM. BULL. 208; Rev. Rul. 56-366, 1956-1 CUM. BULL. 184.

¹⁰ Rev. Rul. 75-406, 1975-2 CUM. BULL. 125.

¹¹ INT. REV. CODE OF 1954, § 355. All subsequent references to sections will be to the Internal Revenue Code of 1954 unless otherwise noted.

¹² Treas. Reg. § 1.1002-1(c).

there were distributed stock or securities in a corporation which was a party to the reorganization, to a shareholder without the surrender by such shareholder of stock or securities in such a corporation, no gain to the shareholder from the receipt of the stock or securities would be recognized.¹⁴

This language gave a sweeping tax exemption to the spin-off and opened the way for tax evasion. According to the letter of the statute, it was possible to transfer cash or liquid assets such as stock or securities to a new corporation and distribute the shares of the new corporation. The shareholders could then liquidate the new corporation and be taxed on the difference between the value of the assets received in the liquidation and the allocated basis of the stock at capital gains rates, thus avoiding the tax on dividend income.¹⁵ It was just this scheme that Evelyn Gregory utilized. Mrs. Gregory owned all of the stock of the United Mortgage Corporation which had among its assets 1,000 shares of Monitor Securities Corporation. Mrs. Gregory had a buyer for the Monitor stock, but she did not want to receive the Monitor stock as a dividend. On September 18, 1928 the Averill Corporation was organized. On September 20 the United Mortgage Corporation transferred to Averill the 1,000 shares of Monitor stock in consideration for which the Averill Corporation issued its shares to Mrs. Gregory. On September 24 Averill liquidated and dissolved after a life of six days, and Mrs. Gregory sold the shares of Monitor.

The Board of Tax Appeals held for the taxpayer, saying, "A statute so meticulously drafted must be interpreted as a literal expression of the taxing policy, and leaves only the small interstices for judicial consideration. The general legislative plan apparently was to recognize the corporate entity and, in view of such recognition, to specify when the gains or losses would be recognized and upon what basis they should be measured. We may not destroy the effectiveness of this statutory plan by denying recognition to the corporation and thus preventing consideration of its transactions."¹⁶

The taxpayer lost in the Second Circuit. The Supreme Court affirmed that decision and stated:

When subdivision (B) speaks of a transfer of assets by one corporation to another, it means a transfer made "in pursuance of a plan of reorganization" . . . of corporate business; and not a transfer of assets by one corporation to another in pursuance of a plan having no relation to the business of either, as plainly is the case here. Putting aside, then, the question of motive in respect of taxation altogether, and fixing the character of the proceeding by what actually occurred, what do we

¹⁴ INT. REV. CODE OF 1924, § 203(c).

¹⁵ See generally 3 MERTENS, LAW OF FEDERAL INCOME TAXATION § 20.55 (1972).

find? Simply an operation having no business or corporate purpose—a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganize a business, but to transfer a parcel of corporate shares to the petitioner. No doubt, a new and valid corporation was created. But that corporation was nothing more than a contrivance to the end last described. It was brought into existence for no other purpose; it performed, as it was intended from the beginning it should perform, no other function. When that limited function had been exercised, it immediately was put to death.

In these circumstances, the facts speak for themselves and are susceptible of but one interpretation. The whole undertaking, though conducted according to the terms of subdivision (B), was in fact an elaborate and devious form of conveyance masquerading as a corporate reorganization, and nothing else. The rule which excludes from consideration the motive of tax avoidance is not pertinent to the situation, because the transaction upon its face lies outside the plain intent of the statute. To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose.¹⁷

Mrs. Gregory's victory before the Board of Tax Appeals was noted with alarm by the Congress. In its report of December 4, 1933, the House Ways and Means Subcommittee discussed the Gregory case and recommended a repeal of the provisions on which it relied.¹⁸ The report of the Ways and Means Committee rejected a complete elimination of the reorganization provisions, but did recommend that the spin-off provision be eliminated. "This paragraph provides that a corporation by means of a reorganization may distribute to its shareholders stock or securities in another corporation, a party to the reorganization, without any tax to the shareholders."¹⁹ This recommendation was adopted by the Congress in the Revenue Act of 1934 despite the fact that the Court of Appeals' reversal came down during the deliberations.²⁰

It is interesting to note that although the 1934 Act removed the basis of Mrs. Gregory's scheme, the reformers failed to take action on either the split-off or the split-up. If a split-off included a pro-rata surrender of stock, it could be used for the distribution of assets in the same manner as the spin-off was used in *Gregory*. Even the split-up could be pressed into service

¹⁷ *Gregory*, *supra* note 13, at 469-70.

¹⁸ H.R. REP. No. 704, 73d Cong., 2d Sess. (1933).

¹⁹ *Id.*

²⁰ Apparently the decision was not noted by Congress. See Whitman, *Draining the Serbonian Bog: A New Approach to Corporate Separations Under the 1954 Code*, 81 HARV. L. REV. 1194 (1967) [hereinafter cited as Whitman].

as a means of distribution of assets. A corporation could transfer its business assets to one corporation and its liquid assets to another and then distribute the stock of both corporations in complete liquidation. In this manner, the shareholders could carry on the business of the old corporation through one of the new corporations and liquidate the other new corporation to get the assets.²¹

The spin-off provisions were to remain absent from the law until 1951 when they were reinstated as Section 317 of the Revenue Act of 1951.

A. The "Device" Language in *Gregory*

It is important at this point to consider the origin of the "device" language in the Code and what, if any, relation exists between that language and the business purpose doctrine which was developed in the *Gregory* case. The origin of both terms, device and business purpose, was in the same sentence in *Gregory*: "simply an operation having no business or corporate purpose—a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character."²² Although in the opinion in *Gregory* it is likely that the terms were used interchangeably, the question remains whether the legislative use of the "device" language was intended as a codification of the business purpose test or whether the legislature intended to introduce a completely new concept into the area of corporate divisions.

Sometime after the end of World War II, taxpayer groups began to lobby for the restoration of tax exempt spin-offs, giving as reasons the fact that split-ups accomplished the same things in a more complex manner and that Congress should encourage the voluntary division of corporate businesses into smaller units.²³ In 1947 the Special Tax Study Committee reported to the House Committee on Ways and Means, recommending that Section 112(g) (the spin-off provision) be reenacted. The report indicated considerable hostility to judicial innovations in the area, saying:

In the past 15 years, the Supreme Court and lower courts have undertaken through interpretation to add by judicial fiat a number of requirements to this part of the law. In a number of cases, it is quite clear that the Congress did not intend to enact any such qualifications, but rather intended the statutory language to be literally applied

²¹ It has been suggested that the split-up may have been left alone on the assumption that the possible loss of franchises, contracts, and confusion of customers that would attend a liquidation of the original corporation would discourage its use as a substitute for ordinary dividends. See B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS § 13.02 (3d ed. 1971) [hereinafter cited as BITTKER].

²² *Gregory*, *supra* note 13, at 469-70.

²³ Whitman, *supra* note 20, at 1202. <https://doi.org/10.2307/41202> <https://www.akron.edu/akronlawreview/vol11/iss2/3>

Indeed, if courts are to be free to insert additional requirements, no one can undertake a reorganization with assurance, since he cannot know in advance what the judicial requirements will be.²⁴

The "device" language first appeared in legislative form in the Revenue Bill of 1948,²⁵ and the accompanying report provides some insight into the meaning intended by the draftsmen.²⁶ In the committee report, an example of a spin-off was given with facts substantially identical to those in the *Gregory* case. The report went on to state that this sort of spin-off would be allowed tax-free where business reasons existed, unrelated to any desire to make a distribution of earnings and profits to the shareholders for the separation of the assets. The report further stated that "[t]his Section has been included in the bill because your committee believes that it is economically unsound to impede reorganizations which break up businesses into a greater number of enterprises, when undertaken for legitimate business purposes."²⁷ The Section referred to by the Committee (number 128) included an active business requirement and a provision denying nonrecognition of gain or loss where the reorganization was principally a device for the distribution of earnings and profits. From the use of the "device" language in the statute and the use of "business purpose" or "business reason" in the explanation and example, it seems that the terms were used interchangeably.

This bill, however, was not acted upon by the Senate. In 1950, the Senate Finance Committee again proposed the allowance of the spin-off using the same device provision as the House.²⁸ The accompanying report of the Senate Finance Committee²⁹ did not provide any further enlightenment on the use of the "device" language. This proposal passed the Senate, but was eliminated in conference.

In 1951, there was again a proposal to revive the tax-free spin-off. The Senate version which was ultimately adopted was the same as that passed by the House in 1948, and the report of the Senate Finance Committee used the same example, tracing the facts of *Gregory* and the language concerning business reason, business purpose, and device. The language of the new section read as follows:

If there is distributed, in pursuance of a plan of reorganization, to a shareholder of a corporation which is a party to the reorganization,

²⁴ H.R. Doc. No. 523, 80th Cong., 2d Sess. 21 (1948).

²⁵ H.R. 6712, 80th Cong., 2d Sess., § 128 (1948).

²⁶ H.R. REP. No. 2087, 80th Cong., 2d Sess. 17 (1948).

²⁷ *Id.*

²⁸ H.R. 8920, 81st Cong., 2d Sess., § 207 (1950).

²⁹ S. REP. No. 2375, 81st Cong., 2d Sess. 64, at 80-81, reprinted in [1950] U.S. CODE CONG.

stock (other than preferred stock) in another corporation which is a party to the reorganization, without the surrender by such shareholder of stock, no gain to the distributee from the receipt of such stock shall be recognized unless it appears that (A) any corporation which is a party to such reorganization was not intended to continue the active conduct of a trade or business after such reorganization, or (B) the corporation whose stock is distributed was used principally as a device for the distribution of earnings and profits to the shareholders of any party to the reorganization.³⁰

The committee reports give some evidence that the draftsmen considered "device" to be synonymous with "business purpose" and thus, may have meant the "device" language as a codification of the business purpose doctrine, but this is certainly not conclusive. In any event, the new provisions only applied to spin-offs, and it was not until 1954 that split-offs and split-ups were included in the device restrictions.

It is apparent that when the 1954 Code was written, the draftsmen abandoned any idea of providing a general legislative framework within which the Internal Revenue Service and the courts could work to protect the revenues, and instead provided a detailed set of requirements which apply to all corporate divisions whether or not they satisfy the requirements for a corporate reorganization in Section 368. The device language from the 1954 Act was carried into the 1954 Code without comment in the committee reports.³¹

The form of the present statute is to allow a tax-free corporate division by means of a distribution to the shareholders of stock or securities in another corporation. Immediately before the distribution, the distributing corporation must control the corporation, the stock or securities of which are being distributed.³² Further, the distributing corporation must distribute either all of the stock and securities in the controlled corporation held by it immediately before the distribution or an amount of stock in the controlled corporation constituting control, and establish to the satisfaction of the Treasury that the retention of stock or securities in the controlled corporation is not part of a plan having as one of its principal purposes the avoidance of income tax.³³

There is also a requirement relating to active business.³⁴ Either the

³⁰ S. REP. NO. 737, 82d Cong., 1st Sess. 58 (1951).

³¹ S. REP. NO. 1635, 83d Cong., 2d Sess. 39 (1954); H.R. REP. NO. 2543, 83d Cong., 2d Sess. 39 (1954). The report of the House Committee on Ways and Means had suggested a different set of proposals for corporate divisions including a stock taint. This idea was abandoned in conference in favor of the Senate proposals. See H.R. REP. NO. 1337, 83d Cong., 2d Sess. 39, reprinted in [1954] U.S. CODE CONG. & AD. NEWS 4025.

³² INT. REV. CODE OF 1954, § 355(a)(1)(A). Control is defined in § 368.

distributing corporation and the controlled corporation must be engaged immediately after the distribution in the active conduct of a trade or business or, if immediately before the distribution, the assets of the distributing corporation consisted only of the stock or securities in two or more controlled corporations, each of the controlled corporations must be engaged immediately after the distribution in the active conduct of a trade or business. The rule concerning the active conduct of a trade or business is only satisfied if the trade or business was actively conducted throughout the five year period ending on the date of distribution.³⁵

The device restriction is incorporated by the requirement that "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.)"³⁶ These provisions apply independently of the reorganization definitions in Section 368 and apply whether or not the distribution is pro rata with respect to all of the shareholders of the distributing corporation.³⁷

These highly detailed and technical requirements, in order to enjoy a tax-free corporate division, are the present legislative answer to Mrs. Gregory's scheme to bail out the stock held by her corporation. It is clear that Congress, in drafting this section, did not trust the courts to apply judicial doctrines to prevent the abuse of the spin-off provisions. What is not at all clear is whether by the detail of the provisions in Section 355 and by the inclusion of the device language, Congress intended to merely supplement the judicial doctrine of business purpose or to replace it. Although there is some evidence in the legislative history that Congress intended to codify the business purpose doctrine by use of the device language, this is not certain and presently the business purpose doctrine in all its forms co-exists with the device language in Section 355.

At this point, it is interesting to consider some of the aspects of the *Gregory* case and how they are covered by the present statute and judicial doctrines. It is noteworthy that when the three principal weapons against the bail-out are compared with the *Gregory* case, each would be sufficient

³³ *Id.* § 355(a)(1)(D).

³⁴ *Id.* § 355(b)(1).

³⁵ *Id.* § 355(b)(2).

³⁶ *Id.* § 355(a)(1)(B).

³⁷ *Id.* § 355(a)(2).

in itself to prevent Mrs. Gregory's scheme from working. The Averill Corporation, the subsidiary created to receive the 1,000 shares of Monitor Corporation stock, had never engaged in any business and was never intended to. The active business requirement of Section 355 would not be satisfied on this showing. The immediate and prearranged sale of the Monitor stock would fall within the present interpretation of the device clause and thus, the bail-out would again be prevented. Further, in the initial proceedings in the *Gregory case*, it was apparently conceded that the organization of the Averill Corporation was for no purpose other than the avoidance of tax.³⁸ The business purpose doctrine would be used to counteract the effort of those taxpayers whose primary motive was the avoidance of tax.

As is readily apparent from this brief comparison of the legislative and judicial weapons with the targets presented in *Gregory*, the approach to ending bail-outs by Congress, the courts, and the Internal Revenue Service has become excessively fragmented. This specialization of tests has helped create a situation where apparent bail-outs are sometimes allowed tax-free and where legitimate divisions are condemned as bail-outs.

Although the intricacies of the present form of the active business test are beyond the scope of this discussion, it is important to realize that the test does not always function so as to prevent the separation of liquid assets from a corporation.³⁹ Even though it does function to prevent the separation into a corporate shell of cash or securities alone, a corporate entity may be created which carries on some attributes of a business which at the same time drains off highly salable assets from the parent for eventual liquidation. In addition, there is some evidence of a trend to downgrade the active business test in favor of a strengthened device test. The First Circuit in *Rafferty v. Commissioner*⁴⁰ has made the active business test an inquiry into whether a corporation engages in "entrepreneurial endeavors of such a nature and to such an extent as to qualitatively distinguish its operations from mere investments." Given this state of affairs, it is the purpose here to examine in detail the relationship and functioning of the two remaining barriers against the bail-out of earnings and profits: the legislative device test and the judicial business purpose test.

III. THE PROBLEM SINCE 1954: SECTION 355

A. The Legislative Device Test

Section 355 requires that in order for a distribution of stock or secur-

³⁸ 27 B.T.A. 223, 225 (1933).

³⁹ See, e.g., *Hanson v. United States*, 29 Am. Fed. Tax R. 2d 72-514 (D. Mont. 1971). See also *Whitman*, *supra* note 20, wherein the author criticized the active business test as essentially unworkable.

⁴⁰ 452 F.2d 767 (1st Cir. 1971).

ities in a corporate division to be tax-free, the transaction must not have been used principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both. The statute also provides that except pursuant to an arrangement negotiated or agreed upon prior to the distribution, 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, shall not be construed to mean that the transaction was used principally as such a device.

The Regulations construe the language in the statute on post distribution sales as narrowly as possible.⁴¹ They provide that if pursuant to an arrangement negotiated or agreed upon prior to the distribution of stock or securities of the controlled corporation, part or all of the stock or securities of either corporation is sold or exchanged after the distribution, the sale or exchange will be evidence that the transaction was used principally as a device. If a sale of stock or securities is made after the distribution and is not pursuant to an arrangement, this fact will not be determinative that the transaction was a device, but it will be *evidence* of a device. The effect of these Regulations is that any post distribution sale of stock will be suspect. However, in an effort to strengthen even further the restrictions on post distribution sales, the Regulations state that if the rules respecting continuity of interest are not met, Section 355 will not apply.⁴²

The Regulations further state that continuity of interest consists of two parts: continuity of the entire business enterprise under modified corporate forms and a continuity of interest in all or part of those persons who, directly or indirectly, were the owners of the enterprise prior to the distribution or exchange.⁴³ The logic of this requirement of continuity of interest on part of the owners is certainly open to question. The statute clearly contemplates that at least some sales which are not prearranged will be allowed. Continuity of interest as put forth in the Regulations would not allow any post distribution sales.

In an early revenue ruling,⁴⁴ the Service was faced with a situation where the shareholders of a corporation wanted to sell their corporation, but the prospective purchaser was not interested in acquiring all the assets. In order to make the corporation salable, it was proposed to distribute the stock of the unwanted subsidiary. The Service ruled against the stockholders, equating the device restrictions with continuity of interest in the following language: "The purpose of the requirement that the transaction not be used

⁴¹ Treas. Reg. § 1.355-2(b).

⁴² *Id.* § 1.355-2(b)(1).

⁴³ *Id.* § 1.355-2(c).

principally as a device for the distribution of earnings and profits is to limit the application of Section 355 of such code to those cases in which the distribution of stock of the controlled corporation effects only a readjustment of continuing interests in property under modified corporate forms."⁴⁵ In this ruling, the Service seems to equate the continuity of interest doctrine with the limitation on post distribution sales.

In a 1958 revenue ruling,⁴⁶ the Service again equated continuity of interest with post distribution sales. The ruling involved the distribution of the stock of a subsidiary followed by the merger of the subsidiary with another corporation. The fact that the Service found a device under these circumstances seems unusual since all three companies involved were owned by a taxpayer or a taxpayer and his wife. However, by 1959, the Service had retreated from this extreme position. In a ruling issued that year,⁴⁷ it was held that the sale of stock immediately before the transaction in order to allow a buyer to participate had the same effect as a contract to sell immediately after the transaction. Despite this holding, where the sale was made to allow a key employee to buy an eighteen percent stock interest, no device was found.

One question which has arisen is whether a spin-off followed by a tax-free reorganization violates the device clause because a sale or exchange has taken place. This situation frequently arises when two corporations wish to effect a merger, but the acquiring corporation does not wish to acquire all the assets of the other corporation. It does not seem that a spin-off followed by a merger of the parent corporation without more is a distribution of earnings and profits. The assets of the former parent corporation are now locked into the merged corporation and the assets of the spin-off are also in a corporation. The spin-off and merger combination does not lend itself more readily to a bail-out than does any spin-off. The circuits have been in conflict on this question,⁴⁸ but the Service has indicated that it will allow a contemporaneous merger and spin-off where there was otherwise no indication of a device.⁴⁹

In 1972, the Internal Revenue Service extended its rulings in this area to allow a spin-off from the acquiring company in a merger in order to allow the stockholders of the acquired company to receive a larger percentage of

⁴⁵ *Id.* at 32.

⁴⁶ Rev. Rul. 58-68, 1958-1 CUM. BULL. 183.

⁴⁷ Rev. Rul. 59-197, 1959-1 CUM. BULL. 77.

⁴⁸ See *Morris Trust v. Commissioner*, 18 Am. Fed. Tax R. 2d 5843 (4th Cir. 1966); *Curtis v. United States*, 14 Am. Fed. Tax R. 2d 5685 (6th Cir. 1964).

⁴⁹ Rev. Rul. 68-603, 1968-2 CUM. BULL. 148.

stock of the acquiring corporation.⁵⁰ In a recent ruling, the Service approved a spin-off of an existing subsidiary prior to a merger of that subsidiary into another corporation.⁵¹

There is a further aspect of the device clause which should be considered at this time. The Service has made it clear that it considers the device clause as a test for dividend equivalency.⁵² That is, a device consists of the conversion of dividend income into capital gains.⁵³

The Service has determined that if in the absence of Section 355, another provision would be available to render the transaction taxable at capital gains rates, there is no device since there is no conversion of ordinary income into capital gains. Therefore, even if there is a post distribution sale, if it can be shown that in the absence of Section 355 there would be capital gains treatment for the stock received in the spin-off, there is no device.

In Revenue Ruling 64-102,⁵⁴ the Service faced a situation where the shareholders of a parent corporation with a wholly owned subsidiary had divided the management of the corporations between two groups. Approximately one third of the shareholders were engaged in managing the subsidiary. A conflict in management policy arose between the two groups, and it was decided to spin off the subsidiary to the shareholders of the parent who had been managing the subsidiary. In order to equalize the value of the stock given up by the minority with that received by them, the parent made a capital contribution to the subsidiary. The Service, on examination, found that there was no device for the distribution of earnings and profits. In the absence of Section 355, Section 302(b)(3)⁵⁵ would be available to provide for taxation at capital gains rates.

The Service distinguished Revenue Ruling 58-68⁵⁶ involving a similar capital contribution on the grounds that in the absence of Section 355, a dividend might well be realized. In a 1971 ruling, the Service found no device in a spin-off of a wholly owned subsidiary where immediately prior to the spin-off there had been a substantial capital contribution to the subsidiary.

⁵⁰ Rev. Rul. 72-530, 1972-2 CUM. BULL. 212.

⁵¹ Rev. Rul. 75-406, 1975-2 CUM. BULL. 125.

⁵² Rev. Rul. 71-384, 1971-2 CUM. BULL. 181.

⁵³ See Rev. Rul. 64-102, 1964-1 CUM. BULL. 136.

⁵⁴ *Id.*

⁵⁵ INT. REV. CODE of 1954, § 302 provides rules for stock redemptions. If the redemption falls within any one of the safe harbors of Section 302(b), the shareholder is treated as having sold or exchanged his stock. Section 302(b)(3) concerns a complete redemption of all of the stock of the corporation owned by the shareholder.

⁵⁶ Rev. Rul. 58-68, 1958-1 CUM. BULL. 183.

The Service reasoned that in the absence of Section 355, Section 302(b)(2)⁵⁷ would be available.

This approach has been criticized on two separate grounds.⁵⁸ First, Congress did not intend to provide that stock redemptions were to escape taxation altogether, but only that taxation was to be at the lower capital gains rates. By the reasoning of the Internal Revenue Service, a transaction which qualifies under Section 302(b)(3) as a complete redemption of a shareholder's interest, if effected through a split-off which otherwise qualifies under Section 355, will escape taxation entirely. Secondly, other than extending the Congressional grant of favorable tax treatment, when the reasoning of the Service is applied to Section 346,⁵⁹ there is an even more surprising result.⁶⁰ The spin-off transaction that satisfies the active business rules of both Sections 355 and 346 would be taxed at capital gains rates were it not for the language of 355. This transaction would not, therefore, cause a bail-out, and there would be no device. The result is that when a transaction fits both sections, the device clause, which in the statute is given equal rank with the active business rules, is completely eliminated.

A survey of this area of the law reveals the paucity of rulings and cases directly concerned with the device clause. The narrow interpretation of the potentially powerful device clause as a tool to combat only bail-outs which occur by means of post distribution sales has weakened the overall approach of Section 355. Certainly in this sense the device clause is not much of a threat to those shareholders who would like to effect a bail-out of earnings and profits. A subsidiary corporation can be formed and the assets ultimately to be sold can be distributed to it in exchange for all its stock. The stock of the subsidiary can then be distributed to the shareholders. The distribution will be claimed to be tax-free under Section 355, and it is here that the Commissioner will usually step in and challenge. If there has been no sale, then the device clause will not function even though every step but the last to effect a bail-out has been consummated. After the seasoning of the assets is accomplished, the bail-out can be finished without fear of the device clause.

Device has remained little used primarily because the Commissioner has chosen to rely on another weapon against bail-outs, the business purpose test. As will shortly be developed in detail, this test has been used in much the same spirit as Section 355. That is, it has been used to serve

⁵⁷ This subsection contains rules concerning substantially disproportionate redemptions of stock.

⁵⁸ See Whitman, *supra* note 20, at 1239.

⁵⁹ This section concerns distributions in partial liquidation.

⁶⁰ Whitman, *supra* note 20, at 1239.

a limited function, rather than as a focal point for an overall analysis of the transaction in order to determine whether or not a bail-out has occurred, or if not, whether the potential for a bail-out is so great that the transaction should not escape taxation.

It is not readily apparent why this piecemeal approach to the problem of preventing bail-outs has been used for so long. The approach is partly inherent in Section 355 which was drafted in detail to provide a number of specific statutory tests which must be satisfied. It is not clear, however, why the Service and, with one exception, the courts have chosen to use both device and business purpose as specific, narrow tests. The draftsmen's approach to Section 355 may be due to a legislative mistrust of the ability of the courts to fashion a remedy for the abuse of bail-outs which has lingered since the Board of Tax Appeals held for Mrs. Gregory. It may also be possible that the present approach to bail-outs by the Service and the courts is due to the influence of the *Gregory* case. Certainly the taxpayer would have lost under any one of the tests subsequently developed, *i.e.*, active business, business purpose, and device. Taxpayers and their advisors have grown more subtle since the decision in *Gregory*, and today the system of specific and narrow judicial and statutory requirements is not functioning effectively.

Despite the narrow interpretation of device in the Regulations, the Commissioner has indicated that it is entirely possible that the device test will be used more broadly. The Regulations state that in determining whether a transaction was used principally as a device for the distribution of the earnings and profits of the distributing corporation or of the controlled corporation or both, consideration will be given to all of the facts and circumstances of the transaction.⁶¹ In particular, consideration will be given to the nature, kind, and amount of the assets of both corporations immediately after the transaction. The fact that at the time of the transaction substantially all of the assets of each of the corporations involved are and have been used in the active conduct of trades or businesses which meet the requirements of Section 355(b) will be considered evidence that the transaction was not used principally as such a device.

B. *Judicial Business Purpose Test*

The judicial requirement that a corporate division have a business purpose arose from language in the Supreme Court's opinion in *Gregory*.⁶² The draftsmen of Section 355 may have attempted to codify the requirement by the device clause, but it has continued as a separate test. The Commissioner

⁶¹ Treas. Reg. § 1.355-2(b)(3).

⁶² *Gregory*, *supra* note 13, at 467.

has included it in the Regulations, and it has been a frequent basis for decision in the courts. The Regulations state that the "distribution by a corporation of stock or securities of a controlled corporation to its shareholders with respect to its own stock or to its security holders in exchange for its own securities will not qualify under Section 355 where carried out for purposes not germane to the business of the corporations."⁶³

The business purpose doctrine has, since its inception in the *Gregory* case, encompassed several different approaches to the problem of the examination of motive in corporate divisions where a bail-out is suspected. In the Supreme Court's opinion in *Gregory*, the rule which excludes from consideration the motive of tax avoidance was held not to be pertinent to the situation because the transaction on its face was outside the plain intent of the statute.⁶⁴ Although the use of motive to determine whether or not a transaction is in fact a bail-out has proven extraordinarily difficult, and the cases and rulings are in a state of confusion, it is possible to distinguish three approaches to the problem which have been used with some frequency.

The first approach attempts to distinguish between corporate and shareholder motives for a transaction. If the motive is found to be corporate, then the transaction is not a bail-out. On the other hand, if the motive is one which the court determines to be a shareholder motive, the presence of a bail-out is indicated. The second of these is a definitional approach, wherein the courts have attempted to enumerate or define affirmative business purposes which if they can be shown to be the driving force behind the transaction, probably indicate the absence of a bail-out. The third approach has been named by one commentator⁶⁵ as the step-business purpose doctrine. This approach is used where the alleged reason for the transaction is sufficient to justify the creation of a subsidiary corporation, but does not justify the second step of a distribution of stock.

1. Corporate and Shareholder Motives

Perhaps the most interesting place to begin the consideration of the business purpose doctrine is with the distinction between corporate and shareholder business purpose. While no such distinction was explicitly drawn by the Supreme Court in *Gregory*, there is language suggestive of the difference between a business or corporate purpose and the purpose of Mrs. Gregory, the shareholder. "Putting aside, then, the question of motive in respect of taxation altogether, and fixing the character of the proceeding by what actually occurred, what do we find? Simply an operation having no business

⁶³ Treas. Reg. § 1.355-2(c).

⁶⁴ *Gregory*, *supra* note 13, at 468.

⁶⁵ *Whitman*, *supra* note 20.

or corporate purpose . . . the sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganize a business or any part of a business, but to transfer a parcel of corporate shares to the petitioner."⁶⁶

The Service has not always been consistent in requiring the distinction between corporate and shareholder purposes. Although the Regulations speak in terms of purposes "germane to the business of the corporation" and separations "required by business exigencies,"⁶⁷ early Service rulings ignored the distinction.⁶⁸

The difficulty which can arise from the use of this particular distinction is illustrated by the case of *Perry E. Bondy*.⁶⁹ The taxpayer was the sole stockholder of Market Motors, Inc. which was engaged in carrying on the business of a Ford automobile dealership. The corporation owned the real estate on which the dealership was located which included an unusually large building. The Ford Motor Company considered the building impractical and a threat to the success of the franchise and began to pressure for the removal of the building from the assets of Market Motors. In 1950, Bondy Real Estate, Inc. was formed, and the building was transferred to it in return for all its stock. In 1952, taxpayer's wife filed suit for divorce. As part of her demand for alimony, she wanted a pledge of taxpayer's stock in Market Motors. In order to partially satisfy this demand and at the same time protect the franchise, another corporation, P.E.B., Inc., was formed, and the stock of Bondy Real Estate was transferred to it in exchange for all its stock which was distributed to petitioner. Three-fifths of this stock was placed in escrow, in accordance with the separation agreement between taxpayer and his wife.

Despite the formation of Bondy Real Estate in 1950, the Ford Motor representative had been pressing (since that time) for a more complete alienation of the building. The question for decision was whether or not the distribution of P.E.B. stock was tax-free under Section 355. Both the Tax Court and the Fourth Circuit decided the case on the basis of whether the principal motive for the distribution was personal, or was germane to the business of the corporation. The Tax Court, downgrading the insistence of Ford for further alienation, found that the purpose for the spin-off was personal and that Section 355 was not available. The Fourth Circuit, however,

⁶⁶ Gregory, *supra* note 13, at 467.

⁶⁷ Treas. Reg. § 1.355-2(e).

⁶⁸ See, e.g., Rev. Rul. 57-464, 1957-2 CUM. BULL. 244. Here, a corporation, engaged in the manufacture of heating equipment, also owned an old warehouse used for storage and various residential properties. The corporation spun-off the rental properties. There was no attempt by the Service to distinguish corporate and shareholder motives, but rather the transaction was disallowed on active business grounds.

weighed the factors differently and found that the principal purpose was the preservation of the dealership.⁷⁰ The differing results, depending on which motive is considered predominant, points out the weakness of this type of analysis. Moreover, there was virtually no chance that this transaction was the vehicle for a bail-out. The majority of the real estate stock was entangled in the settlement with Bondy's wife, and he could not sell it. Here, the distinction between corporate and shareholder business purpose merely served to confuse the issue. Analysis of probable motives in a transaction suspected of being a bail-out is not helpful until it has first been determined that a bail-out is possible.

In 1960, the Tax Court decided the case of *Moses L. Parshelsky*.⁷¹ The decision, rendered under the 1951 Act, is important since on appeal the reasoning of the *Bondy* court was rejected. Parshelsky was the sole stockholder of a corporation engaged in the operation of a wholesale lumber and millwork business. The corporation owned valuable real estate on which the business was conducted. In addition, the corporation had a large earned surplus and for some years had been paying a tax for an unreasonable accumulation of earnings. Parshelsky was of advanced age and was concerned about the disposition of the business after his death. It was his wish that the actual business be continued by a favored group of employees, but that the land and building go to different beneficiaries. To this end, Parshelsky caused the creation of a subsidiary corporation to which was transferred the real estate in exchange for all its stock which was then distributed to Parshelsky. The subsidiary corporation leased back the real estate to its parent for \$42,000 per year for five years with an option to renew for five years.

The Service attacked the distribution of stock to Parshelsky, relying principally on the corporate/shareholder distinction. The Tax Court agreed and found no corporate business purpose for the reorganization. The Second Circuit decisively rejected this distinction.⁷² The court said that since most spin-offs occurred in the context of a closely held corporation, the distinction between corporate and shareholder business purpose was purely formalistic.

Certainly here, in the case of a corporation with only one shareholder, the only purposes which could exist were those of Moses Parshelsky. The court, however, then focused its attention on whether there was a business purpose for the transaction, either corporate or shareholder. The shareholder purpose to facilitate estate planning was held, on remand, to bring the spin-off within the area of favorable tax treatment. However, as in *Bondy*, focus

⁷⁰ *Bondy v. Commissioner*, 269 F.2d 463 (4th Cir. 1959).

⁷¹ 34 T.C. 946 (1960).

⁷² *Parshelsky v. Commissioner*, 9 Am. Fed. Tax R. 2d 1382 (1962). The First Circuit had rejected the distinction earlier in *Lewis v. Commissioner*, 176 F.2d 646 (1st Cir. 1949).

on motive alone clouded the issue of whether or not a bail-out had in fact occurred or had a large potential for occurring. Parshelsky managed to spin off valuable and salable real estate. By providing for a long term lease, Parshelsky insured that the original business would not be impaired in the event of a sale of the spun-off corporation, and the high rental⁷³ provided a means to drain further earnings from the original corporation.

One commentator writing in 1968 stated that *Parshelsky* had killed off the no shareholder purpose fiction,⁷⁴ but unfortunately, there are some indications that this happy pronouncement was premature. In a 1965 decision, the Ninth Circuit, although citing *Parshelsky*, indicated that a spin-off, the purpose of which was to satisfy the personal needs of the shareholders, would not have a business reason which would entitle the shareholders to a treatment different from that of shareholders who receive dividends.⁷⁵ The Internal Revenue Service has also continued to rely on this aspect of the business purpose doctrine.

The first indications that the Service would resist *Parshelsky* came in Revenue Ruling 69-460.⁷⁶ This ruling was given in response to a general inquiry concerning the application of the business purpose requirement. The ruling amplified the Regulations which require a business purpose germane to the business of the corporations. "This provision makes it clear that Section 355 of the Code applies only to certain specified distributions or exchanges of the stock or securities of controlled corporations incident to the readjustment of continuing interests in property under modified corporate forms."⁷⁷

A further indication of the Service's continuing emphasis on the shareholder/corporate purpose distinction is found in the first example given in the ruling. The situation involved two equal shareholders who had become antagonists and who wished to divide the corporation into equal parts. The example indicated, however, that a mere dispute at the shareholder level is not enough to justify the division. The example involves the situation where "serious disputes . . . as to expansion, marketing channels, and discount policy have created a situation where the parties are so antagonistic that the normal operations of the business are seriously affected" and further provides that "the non pro rata distribution was undertaken for reasons germane to corporate business problems and was necessary for the future conduct of the

⁷³ Indeed, the Tax Court found that in the years 1953 and 1954, the original corporation had not made enough after tax profit to even pay for the rent. *Moses L. Parshelsky*, 34 T.C. 946, 949 (1960).

⁷⁴ Whitman, *supra* note 20, at 1244.

⁷⁵ *Commissioner v. Wilson*, 16 Am. Fed. Tax R. 2d 6030, 6033 (9th Cir. 1965).

⁷⁶ Rev. Rul. 69-460, 1969-2 CUM. BULL. 51. See generally Bales, *The Business Purpose of Corporate Separations*, 56 VA. L. REV. 1242 (1970).

⁷⁷ Rev. Rul. 69-460, 1969-2 CUM. BULL. 51, 52.

business."⁷⁸ It seems apparent from this ruling that the shareholder/corporate business purpose distinction is still viable.

The Service enforced its position in Revenue Ruling 72-530,⁷⁹ where it considered a spin-off as a necessary preliminary to a merger of the parent corporation to improve its competitive position. "The improvement of X's position with its competitors in the warehouse business is germane to its corporate business and the acquisition of Z will accomplish this purpose."⁸⁰

In a recent and important revenue ruling, the Service apparently regressed to the reasoning followed by both courts in the *Bondy* case. Revenue Ruling 75-337⁸¹ presented the Service with a situation like *Bondy*, involving an automobile dealership and a taxpayer with dual motives. Here, X Corporation operated an automobile dealership and Y Corporation, a wholly owned subsidiary, was engaged in the business of renting automobiles. A, the holder of the franchise and owner of 53% of the stock of X, was 70 years old at the time. He had five daughters who owned in equal portions the remainder of the stock of X. Three daughters were actively employed in the business of X. The manufacturer's franchise policy was such that to continue the franchise after the death of the present holder, all stockholders of X would have to be active in the business. To this end, the stock of Y was distributed, three-fourths to the two inactive shareholders of X in exchange for all of their stock, and the remainder to A in exchange for X stock of equal value. The distribution to the inactive daughters furthered the plans to continue the franchise. The distribution to A was made to increase the percentage of ownership in X on the part of the active daughters and to provide A with Y stock which he could leave to the inactive daughters.

The ordinary definition of a bail-out has been given to mean that "earnings and profits have been drawn off without impairing the shareholder's residual equity interest in the corporation's earning power, growth potential, or voting control."⁸² None of the daughters at the end of the transaction had stock in more than one corporation and as to them, there was no bail-out potential. A had stock in both Y and X and if the Y stock were salable, he might realize a bail-out of earnings and profits. However, his percent of ownership was reduced and if he also relinquished his majority position, he impaired his equity in X and could not effect a bail-out. The Service concluded that this transaction did not serve as the basis for a bail-out

⁷⁸ *Id.*

⁷⁹ Rev. Rul. 72-530, 1972-2 CUM. BULL. 212.

⁸⁰ *Id.*

⁸¹ Rev. Rul. 75-337, 1975-2 CUM. BULL. 124.

because the "distribution of Y stock is germane to the continuation of the X business in the reasonably foreseeable future."⁸³ The problem was immediate due to the advanced age of A and was directly related to the retention of a franchise vital to the business of the distributing corporation. The primary purpose did not involve a personal motive and did not have merely a conjectural effect on the business.

It is apparent from this ruling that despite the rejection of the corporate/shareholder business purpose distinction in *Parshelsky*, the Service will continue to apply it in suitable cases.⁸⁴ This ruling also illustrates the futility of trying to detect bail-outs on the basis of motive. If analysis of the transaction reveals that it is structured in such a way that no bail-out is possible, then there is no reason to consider the subtle and confusing distinctions encountered in an analysis of motive.

2. Affirmative Business Purpose

The second aspect of the business purpose doctrine is a definitional approach wherein the courts and the Service have sought proof of certain affirmative business purposes which, if present, make a bail-out unlikely. This has obscured analysis of the actual transaction and has been unsatisfactory both in allowing legitimate corporate divisions and in preventing bail-outs.

A motive for corporate division approved by the Service in two early rulings is the separation of unrelated business activities in order to allow more efficient operation. In Revenue Ruling 56-451,⁸⁵ a corporation was engaged in the business of publishing trade magazines. The division of the corporation was made to separate the publication of a magazine on the metal working industry from the publication of magazines on electronics. Another revenue ruling allowed the spinoff of a bakery and creamery from a retail grocery chain.⁸⁶ Although in neither of these rulings was a complete statement of facts given, it seems unlikely that corporate divisions of this type would lend themselves to bail-outs.

A series of rulings in 1956 concerns banks which have accumulated various real estate holdings by reason of defaults on loans.⁸⁷ In each case,

⁸³ Rev. Rul. 75-337, 1975-2 CUM. BULL. 124.

⁸⁴ Interestingly, the Service discusses *Rafferty v. Commissioner*, 28 Am. Fed. Tax R. 2d 71-6110 (1st Cir. 1971), *cert. denied*, 408 U.S. 922 (1972), which presents a different and superior approach to the bail-out problem, and distinguishes it as a balancing of corporate versus shareholder purposes in which the shareholder purpose predominated.

⁸⁵ Rev. Rul. 56-451, 1956-2 CUM. BULL. 208.

⁸⁶ Rev. Rul. 56-266, 1956-1 CUM. BULL. 184.

⁸⁷ Rev. Rul. 56-557, 1956-2 CUM. BULL. 199; Rev. Rul. 56-555, 1956-2 CUM. BULL. 210; Rev. Rul. 56-554, 1956-2 CUM. BULL. 198.

the bank spun off a subsidiary corporation which contained the highly liquid assets and, in each case, the Service approved the spin-off, apparently finding the desire to separate these assets from the bank to be a sufficient business purpose. The potential for a bail-out is significant here because the assets were highly liquid, and it seems unlikely that these rulings have any application outside the banking business. Apparently, the spin-offs were allowed because of the specialized and highly regulated nature of the banking industry.

An affirmative business purpose which has met with approval both in revenue rulings and in court decisions is that of dividing a corporation to resolve shareholder differences. There is, however, some uncertainty as to the degree of shareholder difference which will be required to support a valid business purpose. In a 1956 ruling, the Service allowed a corporate division where two equal shareholders, one of whom managed one corporate business while the other managed another business, had "fundamental differences in policy."⁸⁸ The Tax Court, in the case of *Albert W. Badanes*,⁸⁹ allowed a corporate division where two businessmen could no longer agree as to the proper means of conducting their joint business interests and where there was continuous conflict over a period of years arising out of personality differences and differing ideas regarding the corporation's management and operations.

To this point, neither the Tax Court nor the Service had attempted to define the degree of shareholder difference necessary, beyond the statement that it must be a "fundamental" disagreement. In Revenue Ruling 69-460, however, the Service indicated that the dispute must have "created a situation where the parties are so antagonistic that the normal operations of the business are seriously affected."⁹⁰ This requirement (which has already been discussed in connection with the corporate/shareholder business purpose distinction) seems to disallow a spin-off unless the business itself is suffering, although there is no indication as to when normal business operations are seriously affected.⁹¹

⁸⁸ Rev. Rul. 56-655, 1956-2 CUM. BULL. 214.

⁸⁹ 39 T.C. 410 (1962).

⁹⁰ Rev. Rul. 69-460, 1969-2 CUM. BULL. 51, 52.

⁹¹ It is apparent from this ruling that the requirement that the normal operations of the business be affected before a shareholder dispute can satisfy the business purpose doctrine will shift the analysis from bail-out potential to a close examination of the impact of the shareholder dispute.

If shareholder interest in the success of the business can overcome these policy differences or if one or more of the shareholders are out of control and are thus not in a position to affect management, then sufficient business justification for separate ownership would not exist... If the tax burden arising from a stock redemption in termination of interest is unacceptable, the quarreling shareholders of a corporation not yet clearly damaged by their differences may be left with two alternative courses to follow. The shareholders could attempt to modify their existing corporate structure

A business purpose which has been argued and approved several times is that of pressure from customers. Frequently, it happens that a corporation engages in two or more related businesses which are linked in a manufacturing, production, or service chain. In these corporations, it is also common for each business to have customers apart from the other business of the corporation. The customers may in fact be customers of one business and in competition with the other corporate business, an arrangement which may work to retard the growth of the corporation. Examples of situations where customer demands have formed the basis for the business purpose requirement include a printing corporation, the wholly owned subsidiary of which was a typesetting corporation,⁹² and a corporation which engaged in both a manufacturing and a brokerage business.⁹³

In a case decided by the Tax Court, *H. Grady Lester, Jr.*,⁹⁴ a corporation was engaged in business as a distributor of auto parts in a dual capacity as a warehouse distributor and as a jobber.⁹⁵ Since jobbers who bought from the corporation objected to its dual activities, it was decided to spin off the warehouse activities. The court found the business purpose doctrine satisfied.⁹⁶ Although the original corporation had a large earned surplus, the spin-off of the assets of the warehouse business did not lend itself to a bail-out. Sale of such an important part of the original business would not constitute removal of liquid assets from the business and would cause an impairment of equity.

Another business purpose which is sometimes advanced is that a corporate division is required by law or has been ordered by a regulatory authority. In Revenue Ruling 62-138,⁹⁷ a banking corporation was found to own all the stock of a realty company which had among its assets certain residential apartment buildings. The banking regulatory authorities advised

short of separation, perhaps by creating autonomous branches, and the disputing shareholders could assent to elaborate contractual arrangements regulating management authority, profit and loss allocation, liquidation rights and the like. However, these efforts to minimize differences may be no more than stop-gap measures, merely precursors foreboding the certain corporate deteriorations that will guarantee the necessary impact on the business for Section 355 qualification. . . . The other alternative would be to separate the business in reliance upon Section 355 and await the Commissioner's challenge.

Bales, *The Business Purpose of Corporate Separations*, 56 VA. L. REV. 1242, 1260-61 (1970).

⁹² Rev. Rul. 56-450, 1956-2 CUM. BULL. 201.

⁹³ Rev. Rul. 59-197, 1959-1 CUM. BULL. 77.

⁹⁴ 40 T.C. 947 (1963).

⁹⁵ In this business, a jobber buys supplies from a warehouse distributor and sells to retail outlets. Manufacturers sell to warehouse distributors and to jobbers at different rates. Jobbers who bought from the corporation objected to its dual practice.

⁹⁶ Concern about possible violations of the Robinson-Patman Act also provided a motive for the division. See *Grady Lester, Jr.*, *supra* note 6.

the bank to divest itself of these holdings, and this provided a business purpose for the corporate division.⁹⁸ A bank was also involved in a 1964 case⁹⁹ where a state bank and a national bank planned to consolidate and, after consolidation, to operate under the charter of the national bank. To comply with federal law, it was necessary for the state bank to divest itself of its insurance business which it chose to do by means of a spin-off in conjunction with the consolidation. The Tax Court found this to be a valid business purpose.

In at least one instance, labor difficulties provided a valid business purpose for a corporate division. In the case of *Sidney L. Olson*,¹⁰⁰ the parent corporation was engaged in business in Cleveland, Ohio while its subsidiary did a similar business in Buffalo, New York. The parent corporation had experienced labor problems in the Cleveland store, and there had been an attempt to unionize the employees of the store. There was a threat of the spread of the labor difficulties to the store operated by the subsidiary and to better isolate the stores, the subsidiaries' stock was distributed to the parent.

In some corporations, more frequently in small ones, there are one or two key employees whose services are essential to the success of the corporate business. To induce such key employees to stay, it may be necessary to allow the employees to purchase an interest in the corporation. In order to allow the key employee to buy in, a corporate division may be required. Sometimes the assets of the corporation are such that the value of the stock is too great to allow the employee to buy a meaningful percentage, and a spin-off is necessary to reduce the assets, or there may be more than one corporate business and stockholders want the employee to have an interest in only one business.¹⁰¹

A recent and interesting case in which the business purpose advanced was to allow key employees to buy in is *Hanson v. United States*.¹⁰² The old corporation, H-M Corporation, had four stockholders and was engaged in the retail sale of new and used cars. It also provided financing and owned the real property on which its business operations were located. The new company, Hanson-Mersen Motors, Inc., was incorporated December 30,

⁹⁸ More recently, in Rev. Rul. 75-406, 1975-38 INT. REV. BULL. 7, the Service found no device where X corporation, a publicly held corporation which had a wholly owned subsidiary, had to divest itself of the subsidiary pursuant to a government order. The Service apparently only considered the possibility of a bail-out, because there were negotiations for the merger of a subsidiary with a third corporation soon after the distribution of Y stock.

⁹⁹ *Mary Archer Morris Trust*, 42 T.C. 769 (1964).

¹⁰⁰ 48 T.C. 855 (1967).

¹⁰¹ See Rev. Rul. 69-460, 1969-2 CUM. BULL. 51.

¹⁰² 29 Am. Fed. Tax R. 2d 72-514 (D. Mont. 1972).

1954 and shortly thereafter, it exchanged its stock for the old company's new car business, including its Ford Motor Company franchise. The stock was distributed, and two employees purchased interests in the new company. The old company liquidated its used car inventory, and thereafter continued its existence as landlord of the new company. In addition, the old company, although in competition with Ford and with local banks, provided some financing for the new corporation. In the five years following the spin-off, this financing operation varied between seven and eleven percent of the total combined profit of the old and new corporations.

It was this activity which the court found to satisfy the active business requirement of Section 355. The court found that two valid business purposes were advanced: to provide a new franchise agreement with Ford and to permit employees to buy an interest in the business. The court also found that tax avoidance was not among the motives prompting the spin-off.

Despite these findings, the court listed the assets transferred to the new company and those retained by the old company, a listing which presents a vivid picture of a bail-out. The old corporation functioned only as landlord and sometimes financing company to the new corporation, which had no telephone or separate business address and which was not even held out to third persons as a separate entity, nevertheless had very substantial assets. It retained cash, notes and receivables, securities, inventory, land and buildings representing a total investment in excess of \$146,000, over twice the value of the assets transferred to the new corporation. Motive aside, the assets retained by the old corporation could easily be disposed of without interruption to the business of the new corporation with the exception of the land and building. It is quite possible that, however necessary these were to the business, they could be easily replaced, leaving the stockholders in a position to effect a bail-out at any moment. Even if the court's conclusion that no tax avoidance motive existed¹⁰³ is accepted, it may be questioned whether a transaction such as is presented here comes within the overall rationale for the tax deferral sections.

In the general area of corporate reorganizations, the investment remains in assets which are in corporate solution, although the form of the corporation may change. Here, however, the old corporation has become a mere shell and should not be recognized as an entity for tax purposes. When the investments have become so liquid and where the corporation containing them functions only as an easily discarded appendage to another corporation, this

¹⁰³ This conclusion may be somewhat in question by reason of the court's footnote 22, where Hanson was quoted as saying that the division was made so that it would "make it possible to sell out easier if we wanted to." *Id.* at 72-522.

does not satisfy the rationale behind the reorganization provisions and regardless of motive, the transaction should be subject to taxation.

To return now to the consideration of business purposes acceptable to the Service or to the courts, Revenue Ruling 72-530¹⁰⁴ presented a situation where it was permissible to spin off a subsidiary in order to facilitate a merger. X corporation, a warehousing business, desired to effect a merger with Z corporation, another warehousing business, in order to strengthen the competitive position of both firms. It was not practical to transfer the X and Z warehousing businesses to a new corporation, because the new corporation would have to apply for a new state warehousing license and to comply with conditions applicable to new but not existing warehousing businesses. In order to secure the agreement of Z shareholders to the merger, it was necessary that they receive a one-half equity interest in X, which was not possible unless X distributed the stock of its wholly owned subsidiary, Y. Accordingly, this distribution met the business purpose requirement.

Finally, in two recent rulings,¹⁰⁵ the Service has allowed corporate divisions in order to reduce state taxes and to increase the availability of commercial loans.

In the cases which have been discussed, the existence of an acceptable business purpose has not been explicitly stated to be in addition to and separate from the lack of a device. However, in the *Wilson* case,¹⁰⁶ the Ninth Circuit so held in what has been called by one commentator a "sorry regression."¹⁰⁷ This case involved a corporation, wholly owned by two brothers, which operated a furniture store business. The corporation sometimes sold furniture on the basis of deferred payments, and as a result, had on hand conditional sales contracts. A new corporation was formed, and in exchange for its stock which was distributed to the brothers, the conditional sales contracts were transferred to it. The Tax Court adopted the unusual position of requiring the taxpayers to assume the burden of proving that the transaction did not constitute a device.¹⁰⁸ The reasons advanced by the taxpayers as business purposes for the spin-off were rejected as insufficient to carry the burden of proof. The Tax Court did, however, find that overall the taxpayers had demonstrated that the transaction was not a device and found the burden of proof satisfied.

The Ninth Circuit, misconstruing the Tax Court opinion, found itself

¹⁰⁴ Rev. Rul. 72-530, 1972-2 CUM. BULL. 212.

¹⁰⁵ Rev. Rul. 76-187, 1976-1 CUM. BULL. 97; Rev. Rul. 77-22, 1977-4 INT. REV. BULL. 7.

¹⁰⁶ *Commissioner v. Wilson*, 16 Am. Fed. Tax R. 2d 6030 (9th Cir. 1965).

¹⁰⁷ *Whitman*, *supra* note 20, at 1244.

¹⁰⁸ *Marne S. Wilson*, 42 T.C. 914 (1964).

confronted with a unique situation. Here was a case with no business purpose for what had been done and yet no tax avoidance motive. The court concluded, however, "that even if there is no tax avoidance motive, a reorganization having no business reason does not result in the tax advantages which Section 355 confers upon those who satisfy the legal requirements for its benefits."¹⁰⁹ This is a startling conclusion. The court found that even if there is no device to distribute earnings and profits and all the requirements of the statute are satisfied, there still must be fulfilled an additional judicially imposed requirement before the statutory benefits are granted. If there is no bail-out, as the absence of a device shows, there is no reason for the addition of the business purpose test. Predictably, the Service has endorsed the *Wilson* case and the requirement that there be a business purpose even in the absence of a device.¹¹⁰

3. Step-Business Purpose

The final thread running through the business purpose doctrine which must be examined is that of the step-business purpose doctrine. This aspect of business purpose is referred to as the "step" doctrine because the spin-off transaction occurs in two stages or steps: first, a subsidiary is created and assets are transferred to it in exchange for stock, and second, the stock is distributed. Using the step-business purpose doctrine, the courts examine a motive or business purpose advanced in support of a transaction to see whether it can be satisfied by the creation of the subsidiary without necessitating a distribution of stock. If the business purpose can be satisfied by creation of a subsidiary without the stock distribution, then there is no business purpose for the completed transaction, and the stock distribution is taxed as a dividend. Of course, Section 355 allows distribution of the stock of an existing subsidiary, and in this case, the step-business purpose doctrine will not apply.¹¹¹

While this doctrine is clearly required now by Revenue Ruling 69-460,¹¹² the Service has not always been consistent in this regard. In Revenue Ruling 56-266¹¹³ the taxpayers wanted to spin-off a bakery and creamery from a retail grocery chain. The purpose for the spin-off was to separate unrelated business activities in order to operate more efficiently. In allowing the spin-off, the Service overlooked the fact that separation of the businesses could have been accomplished equally well without the distribution of stock.

¹⁰⁹ *Supra* note 75.

¹¹⁰ See Rev. Rul. 69-460, 1969-2 CUM. BULL. 51.

¹¹¹ INT. REV. CODE OF 1954, § 355(2)(c).

¹¹² Rev. Rul. 69-460, 1969-2 CUM. BULL. 51.

¹¹³ Rev. Rul. 56-266, 1956-1 CUM. BULL. 184.

In Revenue Ruling 56-451,¹¹⁴ the Service again overlooked the same distinction. This ruling involved the separation of components of a corporation which publishes trade magazines. One magazine concerned the metal working industry, while the others were in the field of electronics. The purpose of separating the magazines was due to different problems in publishing, to isolate the assets, and to secure high level management. In another 1956 ruling, although the Service did not use the step doctrine to disallow a transaction, it did examine both the business purposes for the formation of the new corporation and that for the distribution of the stock.¹¹⁵

Although the cases and rulings applying this doctrine are few, the Service indicated in Revenue Ruling 69-460 that it would continue to apply the step doctrine. "The fact that there is a valid business reason for the creation of a new corporation does not necessarily satisfy the business purpose requirement for the distribution of the stock pursuant to Section 355 of the Code."¹¹⁶

Revenue Ruling 69-460 discusses two situations which although not directly concerned with the step-business purpose doctrine, do have interesting implications for it. In the first situation,¹¹⁷ X corporation is a closely held corporation engaged in the manufacture of precision scientific equipment and has a wholly owned subsidiary corporation, Y, engaged in the tool and die business. To retain certain key employees of X, it is necessary to allow them to buy an interest in X. This would be too expensive due to the inclusion of the Y stock in the assets of X. X, therefore, proposed to distribute Y stock to its shareholders who would then sell X stock to the key employees. This distribution was found to have a valid business purpose.

In the second situation, X corporation was in the shoe business and owned eighty-five percent of the stock of Y corporation which was engaged in the sale of skiing equipment. A key employee of Y desired to buy an interest in that corporation. X distributed its stock in Y to its shareholder. Since the employee could have purchased a stock interest in Y directly from X without the distribution of stock, there was a taxable distribution to the stockholder of X.

Certainly, these situations are not without logic. It makes no sense in the second situation to distribute stock simply in order to sell it, when it could have been as easily sold from the corporation. The problem, however, arises not where there is an existing subsidiary, but where there is a corpora-

¹¹⁴ Rev. Rul. 56-451, 1956-2 CUM. BULL. 208.

¹¹⁵ Rev. Rul. 56-557, 1956-2 CUM. BULL. 199.

¹¹⁶ Rev. Rul. 69-460, 1969-2 CUM. BULL. 51, 52.

¹¹⁷ Actually, these are situations 2 and 3 in the Revenue Ruling.

tion with two or more businesses which does not have a subsidiary. If an employee wants to buy into one business, and either because it is too expensive to buy into the corporation or because the present owners do not want the employee to have an interest in assets of both businesses, a spin-off is desired, the form of that spin-off becomes very important. If a subsidiary corporation is created and the assets of the business in which the employee is not to invest are spun off, then the first situation discussed should make this transaction valid. If, however, the assets of the business in which the employee is to invest are spun off, then by the second situation discussed, there would be no business purpose for the distribution.

It is always possible that the Service will assert that there can never be a business purpose for a spin-off from an integrated corporation for the purpose of allowing an employee to buy into one business, since that business could always be put in a subsidiary and the employee could buy stock at that stage. In *Patricia W. Burke*,¹¹⁸ it was held that a spin-off from an integrated corporation in order to allow a key employee to buy in did have a business purpose, but in light of Revenue Ruling 69-460, the issue had to be regarded as not settled. This question has been considered by one court since the ruling, and the position of the Service was clearly rejected.

In *Hanson v. United States*,¹¹⁹ there was a spin-off, the purpose of which was to allow certain employees to buy in to part of an integrated corporation. The assets spun off were those in which the employees were to have an interest and thus, under the logic of Revenue Ruling 69-460, there was no business purpose for the distribution, since stock in the subsidiary could have been sold. The court rejected the argument of the Service, but in a puzzling manner. The court first cited *Parshelsky* for the proposition that the taxpayer must show a business purpose for both the formation of the subsidiary and the distribution of its stock by the parent. The court then said, "It does not follow that a spin-off, promoted by valid business motives, can be taxed merely by showing that the same business purposes could have been served by some other form of reorganization."¹²⁰

Apparently the court is rejecting the step-business purpose doctrine, since the heart of that doctrine is that if the business purpose could be satisfied by the initial step of the creation of a subsidiary, then absent some other business purpose which compels the stock distribution, Section 355 does not apply. It also seems possible that although the court speaks of this doctrine, the decision was actually based on the court's finding that there

¹¹⁸ 42 T.C. 1021 (1964).

¹¹⁹ 29 Am. Fed. Tax R. 2d 72-514 (D. Mont. 1972).

was no device. In either event, the status of the step-business purpose doctrine cannot be regarded as settled.

4. A Pragmatic View of the Various Approaches

As it has been interpreted and supplemented by both the courts and the Service, Section 355 has not provided an adequate safeguard against bail-out transactions. The overall problem seems to be that the major judicial and statutory tests fashioned to stop the bail-out operate in a piecemeal manner. This type of approach has been generally ineffective for two reasons. First, because certain transactions, which may marginally satisfy each of the tests, seem to provide the setting for a bail-out, and second, because the individual tests are in such a state of confusion. This is particularly well demonstrated by the business purpose doctrine. It is a foregone conclusion that any doctrine which determines the tax effects of a transaction on the basis of taxpayer motive will produce difficult cases, since motives are frequently mixed or unclear. Even acknowledging this difficulty, the various aspects of the business purpose doctrine, as developed by the courts and the Service, have proved unsatisfactory.

The distinction between a corporate purpose and a shareholder purpose for a spin-off was, of course, an attempt to distinguish between motives which lead to a bail-out and those which do not. However, as was pointed out in *Parshelsky*, the bail-out most often occurs in the context of a closely-held corporation. When the number of shareholders becomes small, the entity theory of a corporation is no longer valid. The dividend policy, officers' salaries, and general management policies may be affected more by family and personal needs than by business considerations. Because the distinction between corporate and shareholder motives in the context of a close corporation is so difficult to make, the effect of the business purpose doctrine is to shift the attention of the court away from the inquiry concerning the bail-out.

The affirmative business purpose doctrine has been more useful. Here, the courts have not so much tried to distinguish permissible from impermissible motives by means of a test, as they have tried to define and list motives which will satisfy the business purpose test. Some of these purposes, when they are truly the force behind the corporate division, almost certainly indicate the lack of a bail-out. Examples of such motives include corporate divisions to satisfy legal requirements or to end problems caused by feuding shareholders. This aspect of the business purpose doctrine has several flaws of its own that arise from the fact that the courts are trying to define a range of permissible motives for divisive reorganizations. This creates a problem each time a court is faced with a new situation, as was the case in *Parshelsky*.

Further, in deciding which criteria fit the definition of business purpose without considering which motives lead to a bail-out, the courts in effect substitute their business judgment for that of the taxpayer.

A second problem with this aspect of the business purpose doctrine is that it obscures analysis of a bail-out by looking at reasons for what was done rather than what in fact happened. This allows transactions to occur where the potential for bail-out was very high, although the motive falls within acceptable business purposes. An example of this result is the *Hanson* case discussed earlier.

Finally, this definitional approach to the business purpose doctrine tends to shift the emphasis of Section 355. The statutory provision is written in terms of allowing tax-free treatment of any transaction which satisfies its various tests. Business purpose in general and particularly this aspect of the doctrine, narrows the range of allowable transactions contemplated by the statute, and unfortunately, it does this in a manner which does not guarantee an absence of bail-out.

The step-business purpose doctrine represents an attempt to determine whether a motive advanced by the taxpayer is sufficient to justify both the creation of the subsidiary and the distribution of its stock. If only the creation of the subsidiary is supported, the distribution of stock is held to be part of a bail-out. In the first place, the fact that a motive could be satisfied by the mere creation of a subsidiary does not prove the presence or absence of a bail-out. Further analysis of the transaction itself is necessary to determine what has in fact occurred. In addition, this doctrine leads to the complexities and technicalities discussed in connection with Revenue Ruling 69-460.

IV. A NEW APPROACH TO PREVENT BAIL-OUTS:

RAFFERTY V. COMMISSIONER

It is important to consider in some detail a recent case in which the First Circuit used a different approach to the problem of preventing bail-outs. In *Rafferty v. Commissioner*,¹²¹ the taxpayers owned all the stock of the Rafferty Brown Steel Co. (RBS), a Massachusetts corporation engaged in the processing and distribution of steel. In 1960, Teragram Realty Co. was organized, and the real estate on which RBS engaged in business was transferred to it in exchange for all its stock. The real estate was then leased back to RBS for ten years at an annual rental of \$42,000. In 1962, taxpayers organized Rafferty Brown Steel Co. of Connecticut (RBS Conn.). After three years, Teragram purchased some unimproved real estate and built a plant which it leased to RBS Conn. for fourteen years. In 1965, RBS

had an earned surplus of over \$500,000, while Teragram had an earned surplus of \$46,743. In 1965, the Teragram stock was distributed to taxpayers.

The reason advanced for the distribution was in order to provide for the estate planning of Joseph Rafferty. It was his wish that his sons join him in the active management of the steel business and that his daughters would be provided with property which would produce a steady income. The taxpayers planned to use the Teragram stock for future gifts to the daughters.

The analysis of the court involved three parts. First, the court considered how easily the taxpayer would be able, were he so to choose, to liquidate or sell the spun-off corporation. The court said that the question here was "whether the property transferred to the newly organized corporation had a readily realizable value, so that the distributee-shareholders could, if they ever wished, 'obtain such cash or property or the cash equivalent thereof either by selling the distributed stock or liquidating the corporation, thereby converting what would otherwise be dividends taxable as ordinary income into capital gain.'"¹²²

The second question in this analysis is whether the taxpayers could effect a bail-out without impairing their control over the ongoing business. The court quoted the definition of bail-out given by Bittker and Eustice as the situation where "earnings and profits have been drawn off without impairing the shareholder's residual equity interest in the corporations' earning power, growth potential, or voting control."¹²³ The court did not further define the impairment of equity test, although in the context of this case, the court looked for evidence that the land and buildings at which RBS carried on its steel operations were so distinctive that the sale of Teragram stock would impair the continued operation of RBS or impair Rafferty's control or other equity interests at RBS. This test, of course, refers to impaired equity in the distributing corporation, since any sale will impair equity in the spun-off corporation. One commentator has suggested that the court here implies that the further question of whether the spun-off assets can be replaced, must also be asked.¹²⁴

Thirdly, the court's analysis ties the transactional analysis to an examination of taxpayer motive. It has been said that "in effect, under this approach a taxpayer is given another bite at the apple to show that the likelihood of a bail-out is slight."¹²⁵ The question considered by the court was

¹²² *Id.* at 71-6113.

¹²³ BITTKER, *supra* note 21, § 13.06.

¹²⁴ Lee, *Functional Divisions and Other Corporate Separations Under Section 355 after Rafferty*, 27 TAX L. REV. 453, 483 (1972).

¹²⁵ *Id.* at 489.

whether the taxpayers' desire to distribute the Teragram stock to facilitate their estate planning was a sufficient personal business purpose to prevent the transaction from being a device for the distribution of earnings and profits. The court, however, held that merely any investment purpose of the shareholders was not sufficient. Where a distribution has a considerable potential for use as a device for distributing earnings and profits, it will not qualify for tax-free treatment on the basis of personal motives unless these motives are germane to the continuance of the corporate business.

It is interesting to note that the court does change the language in the Regulations which require "purposes . . . germane to the business of the corporations."¹²⁶ It is possible that the court is trying to get away from the confusion of the business purpose doctrine. However that may be, the language of motives germane to the continuance of the corporate business combined with the court's limitation of the *Lewis* case¹²⁷ to its facts seems to indicate that the court may follow the corporate/shareholder business purpose distinction.

Although the court may be using this aspect of the business purpose doctrine, it is certainly not following the requirement advanced by the Ninth Circuit in *Commissioner v. Wilson*¹²⁸ that business purpose is an affirmative requirement which must be satisfied even in the absence of a device. Here, motive of the taxpayer is not considered at all unless the transaction has a high potential for use as a bail-out. If it does, motives which prove that it is unlikely that the distinction is being used as a device may be used to show non-device. This is a vast improvement over the general use of the business purpose doctrine. Certainly where the transaction has no potential for use as a bail-out, it should be allowed regardless of motive, and the court has no reason to become entangled in the intricacies of business purpose.

Although *Rafferty* did not involve a situation for the application of the step-business purpose doctrine since there was an existing subsidiary, the court did engage in the somewhat similar reasoning of dividend equivalence. The reasoning in the step doctrine is that if the alleged business purpose can be satisfied by the creation of a subsidiary corporation, then the additional step of stock distribution must be for a tax avoidance reason.

¹²⁶ Treas. Reg. § 1.355-2(c).

¹²⁷ *Lewis v. Commissioner*, 176 F.2d 646 (1st Cir. 1949). The court had said, "To seek to differentiate between 'corporate purpose' and 'shareholder purpose' is unrealistic and impractical, particularly with respect to closely held corporations. . . . The separate legal entity of these corporations should not obscure the fact that they are operated by their shareholders in a manner thought best calculated to serve the latter's interests. What is deemed best for the shareholders is deemed best for the corporation, and vice versa."

In *Rafferty*, the court indicated that the business purpose could have been satisfied by a dividend. A stock distribution would probably be deemed a tax avoidance purpose and it would seem that the taxpayer would encounter significant difficulty in overcoming his burden of showing non-device, especially in view of the high bail-out potential.

While *Rafferty* does not answer the questions as to exactly how the business purpose doctrine survives, it is clear that the potential for reviving or continuing much of the confusion in motivational analysis exists. It is considerably downgraded to be sure, since the question does not even arise unless the transaction has much potential for abuse.

Since the *Rafferty* decision, there has been a case and a revenue ruling which give some indication of the influence of that decision. In *King v. Commissioner*,¹²⁹ the Sixth Circuit was concerned with a distribution of stock of subsidiary corporations of Mason and Dixon Lines, Inc., a carrier of freight in interstate commerce. Mason and Dixon had been expanding rapidly since 1945, and after 1950, it was in need of new terminal facilities. In order to borrow substantial funds without prior ICC approval, subsidiary corporations were formed to acquire, improve, and lease real estate to Mason and Dixon. In 1963, in order to facilitate a merger of Mason and Dixon with another company, the stock of the subsidiary corporations was distributed and then exchanged for stock in a holding company. The reason for this exchange was that each of the three subsidiary corporations now enjoyed greater borrowing power by virtue of the fact that the common parent could negotiate for all.

The Tax Court decided the case on the basis of the active business requirement and had not considered the device issue.¹³⁰ The Sixth Circuit reversed and went on to consider the device issue. Although not supported by the record, the court found that a sale of the terminal facilities could not be easily arranged because the terminals were single purpose facilities which required specialized equipment and construction. Further, the terminal facilities could not be sold without impairing the continued operations of Mason and Dixon. At this point, since there was no potential for a bail-out, there was no reason to consider taxpayer motives under the *Rafferty* analysis. The court did, however, discuss motive and found a corporate business purpose for the distribution. "The motive for the distribution was to place all non-carrier corporations in a single group, with a common parent in order to accomplish the maximum concentration of financial strength with which to raise additional capital to enable the subsidiaries to construct the terminals

¹²⁹ 29 Am. Fed. Tax R. 2d 72-869 (6th Cir. 1972).

¹³⁰ *King v. Commissioner*, 55 TC 677 (1971).

needed by Mason and Dixon. The purpose of all transactions was immediate and germane to the continuation of all corporations. If any shareholder purpose was served, it was a normal purpose in that the corporations in which they owned interests were enabled to expand and to become more profitable."¹³¹

It is apparent that the Sixth Circuit did not understand the reduced role of business purpose under the *Rafferty* analysis. By examining motive even in the face of its determination that there was no device, the court seems to follow the requirement in *Wilson* that business purpose is a test independent of device which must be satisfied in order to receive the benefits of Section 355. In addition to using the two part *Rafferty* analysis to find that this transaction had no bail-out potential, the court said that the distribution could not be a device because the plan of distribution required that the stock received be exchanged immediately for the stock of the holding company. Thus, it was felt that the distributed stocks were locked into the holding company after the transaction, as securely as they had been locked into Mason and Dixon. This overlooks the fact that the subsidiary stock and thus, the real estate assets, were no longer locked into Mason and Dixon. If they were salable, a bail-out was possible.

Although the Sixth Circuit has at least partially adopted the analysis of *Rafferty*, the Commissioner has not indicated his willingness to do so as yet. In Revenue Ruling 75-337,¹³² the question was whether the business purpose requirement was satisfied in a distribution of stock of an existing subsidiary to a majority shareholder and two inactive shareholders. The purpose of the distribution was to insure that after the majority shareholder's death, only active shareholders would remain in the dealership to meet the manufacturer's requirement of franchise renewal. The device clause was not discussed at all in the ruling, and business purpose was treated as an independent requirement. *Rafferty* was cited, but only for the purpose of distinguishing it on the grounds that the business purpose there was primarily personal and the effect on the corporate business was conjectural.

The first conclusion which can be drawn from this survey of the post-1954 cases concerning the business purpose doctrine is that the law in this area abounds in conflict and confusion. Depending on the circuit in which the taxpayer resides, he may be faced with the corporate/shareholder purpose distinction, the step-business purpose requirement, the transactional analysis from *Rafferty*, or some combination, and it is quite possible that even if the taxpayer shows that the transaction does not lend itself to a bail-out, he

¹³¹ *Id.* at 873.

will still be required to satisfy some business purpose test. The problem is that this doctrine introduces a huge element of uncertainty into business dealings. In this area of the Code, it is important to be able to forecast accurately the tax effects of a particular transaction. It is a fact, however, that whenever proof of motive becomes the prime factor in determining the tax effects of a given transaction, uncertainty will reign.

The approach used by the First Circuit in *Rafferty* was an improvement. At least in this case, the analysis of taxpayer motivation was eliminated where the possibility of effecting a bail-out was slight. But if the transactional analysis of *Rafferty* indicates bail-out potential, the taxpayer must again take his chance with the wheel of fortune. The business purpose doctrine has not worked well enough in the reported cases either to protect the revenues in the case of a bail-out or to protect the taxpayer where there is no bail-out.

CONCLUSION

This article has examined legislative and judicial efforts to prevent bail-out transactions and at the same time to allow corporate divisions which are not bail-outs. The problem in this area arises from the fact that bail-outs are planned and purposeful attempts to manipulate the tax laws. In attempting to control such manipulation, the courts have examined motives. It is this examination which has led to the complex and confusing doctrines of business purpose. It is at least arguable that in drafting Section 355, Congress attempted to solve the problem of bail-outs by an objective approach. The legislative history, however, is unclear and it is possible that Congress, uncertain that the objective tests provided in Section 355 would solve the problem, intended to include the judicial doctrines as a further safeguard.

The landmark case in this area is *Rafferty*. Its significance is that it uses an objective test to detect bail-outs. Taxpayers attempting to structure bail-outs can be detected by the results of their efforts, not by their motives for those efforts. The great improvement under the *Rafferty* test is that transactions which cannot be bail-outs will no longer be condemned as such. A case in point discussed earlier is *Perry E. Bondy*. Bondy spun off the real estate connected with his business, but there was no possible bail-out because the stock of the spun-off corporation was tied up in escrow in connection with Bondy's divorce. The Tax Court held against Bondy, and the Fourth Circuit, for him. It could easily have been the other way around. The point is that there was no reason to consider motive. Bondy could not bail out, so he had no bad motive; or if he did, it was ineffective

The *Rafferty* court retained the business purpose doctrine as an adjunct to its objective tests to provide a last chance for a taxpayer who without

so intending has engineered a potential bail-out. It can be argued that this is a justifiable safe harbor to prevent unexpected and possibly ruinous taxation. The problem again is that the business purpose doctrine is too complex and unreliable to be allowed to determine taxation even at this stage.

If *Rafferty* is followed, those taxpayers who divide their corporations and who cannot effect a bail-out are safe. Those who can effect a bail-out fall into two categories: those who intended to bail-out and those who did not. Since these groups differ only by their motives, *i.e.*, their subjective intentions, the policy decision remaining seems clear. Either taxation must be the result of satisfying the two objective tests of *Rafferty*, or as in that decision, some form of the business purpose doctrine must be retained in an attempt to distinguish motives.

The proposed Regulations to Section 355,¹³³ released on January 21, 1977, although providing the potential for significant improvement to the approach to bail-out transactions, do not clearly address this policy decision. In the Regulations, the role of the device clause is expanded to include both transactions in which stock is sold and those in which it is retained. Objective criteria have been added to aid in the determination of whether a transaction which has the potential for the distribution of earnings and profits is in fact a bail-out. Indications of a bail-out may come from post-distribution sales of stock, a division in which a substantial portion of the assets of any post-distribution corporation consists of a new trade or business, the transfer or retention of cash or liquid assets (not related to the reasonable needs of the business), and the relationship between the assets of the distributing and the controlled corporations. This last factor is illustrated by the situation where the principal function of one corporation before the transaction is to perform services for or supply technical or research data to the other corporation and after the transaction, that corporation continues to function on the same basis.

Although these factors are characteristic of certain bail-out transactions, the proposed criteria would be most useful if employed to aid in answering the questions posed by the *Rafferty* court: how easily would the taxpayer be able to liquidate or sell the spun-off corporation and would this be done without impairing control over the ongoing business. Unfortunately, the proposed Regulations also expand and clarify the Service's position that business purpose is an equal and additional requirement for a tax-free corporate division. Both the corporate-shareholder distinction and the step-business purpose doctrine are specifically used in the examples.

By adopting both the business purpose doctrine and the objective ap-

proach as separate and co-equal tests to combat bail-outs, the Service is preserving the present complexity and confusion. The proposed regulations should be redrafted to emphasize an objective approach to detecting bail-outs by an expansion of the device clause. The objective criteria now found in the proposed Regulations could be retained to aid in answering the *Rafferty* questions. The business purpose doctrine, however, should be eliminated entirely and taxation imposed whenever objective analysis indicates potential for bail-out.

The advantages of denying Section 355 treatment to a shareholder when the assets spun-off are salable without impairment of equity are several. It would serve to reduce complexity in the tax laws. The business purpose doctrine has added much complexity by appearing in several forms, none of which works satisfactorily or has been universally accepted. It would serve to protect the revenues by requiring immediate taxation every time a bail-out is imminent; and it would help to provide certainty in a most complex area. The determination of whether property transferred to a newly organized corporation has readily realizable value and whether this value could be obtained without impairing control over the ongoing corporation would leave questions in close cases, but it is a much better standard with which to work than the determination of whether the transaction was a "mere device which put on the form of a corporate reorganization as a disguise for concealing its real character."¹³⁴