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The Five-Year Pre-Distribution Active Business Test of Section 355 of The Internal Revenue Code of 1954

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TAX NOTES

THE FIVE-YEAR PRE-DISTRIBUTION ACTIVE BUSINESS TEST OF SECTION 355 OF THE INTERNAL REVENUE CODE OF 1954

The L. B. Walker Radio Company of Pueblo, Colorado, was incorporated in 1947 to engage in a wholesale electronics business which had been operated in a non-corporate form since 1921. In 1954, the corporation rented a small branch store and warehouse in Grand Junction, Colorado, better to serve its customers and to expand its business in that area. Over eighty per cent of the merchandise sold in Grand Junction was sold by Pueblo salesmen and was shipped from the Pueblo warehouse. Also, Pueblo handled all accounts receivable, credit matters and collections. A prior customer was hired as the manager of the branch store, and through his efforts the business in that area grew considerably. He desired to invest in the business and offered to contribute land of his own so that the company might build its own store in Grand Junction. To achieve those ends, a new corporation, the L. B. Walker Radio Company of Grand Junction, was formed in Januàry 1957, and the assets of the Puelbo company located at the Grand Junction store were transferred to the new Grand Junction company in exchange for some of its stock, all of which was then distributed pro rata to the Pueblo company shareholders who were the petitioners herein. In April, 1957, pursuant to a prior agreement, the branch manager conveyed his land to the newly formed corporation in exchange for its stock. The Commissioner contended that the creation of the store and warehouse in Grand Junction constituted the establishment of a separate business in 1954 and consequently that business was not operated for five years at the time of the distribution of stock to the petitioners in 1957. Therefore, the petitioners were not entitled to tax-free[1] treatment with respect to the distribution of stock to them, because the five-year active business requirement of Section 355 (b)[2] was not met. The Commissioner alternatively

1. Tax-free treatment for purposes of this paper means that no tax is imposed at the time of the corporate separation or at the distribution of stock. Any gain accruing to the shareholders is not taxed until a subsequent taxable event, such as a sale. In other words tax-free does not mean an escape from taxation, but rather a postponement.

2. INT. REV. CODE OF 1954, § 355(b), provides as follows:

(b) REQUIREMENTS AS TO ACTIVE BUSINESS—

(1) IN GENERAL—Subsection (a) shall apply only if either—

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

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

contended that Section 355 did not apply to the division of a single business.[3] On petition for redetermination of a deficiency assessment, the Tax Court, *held*, for petitioner: Section 355 does apply to a single business and the acquisition of the Grand Junction store and warehouse in 1954 was only a continuation and furtherance of the existing business and not the establishment of a new business. Accordingly, the assets which were spun-off[4] in 1957 were part of a business which was actively conducted throughout the five-year period preceding the distribution, and thereby met the requirements of Section 355(b)(2)(B). Thus, the distribution of stock to the petitioners qualified for tax-free treatment thereunder. *Patricia W. Burke*, 42 T.C. 1021 (1964).

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(2) DEFINITION—For purposes of paragraph (1), a corporation shall be treated as engaged in the active conduct of a trade or business if and only if—

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

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

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

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

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

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

3. This position was enunciated by the Commissioner in TREAS. REG. §1.355-1(a) (1955) which provided in part that "section 355 does not apply to the division of a single business." However, two circuit courts had previously held that this Regulation was invalid. Coady v. Commissioner, 289 F.2d 490 (6th Cir. 1961); United States v. Marett, 325 F.2d 28 (5th Cir. 1963). Apparently because of these decisions, the Commissioner abandoned his contention in the instant case, and subsequent to the submission of briefs announced that he would follow *Coady* and *Marett* "to the extent that they hold that § 1.355-1(a) of the Income Tax Regulations, providing that Section 355 of the Internal Revenue Code does not apply to the division of a single business, is invalid." REV. RUL. 147, 1964-1 CUM. BULL. 136.

4. The meaning of a spin-off and of other forms of tax-free corporate separations was explained in JACOBS, *Spin-Offs: The Pre-Distribution Two Business Rule—Edmund P. Coady and Beyond*, 19 TAX L. REV. 155 n.2 (1964):

> Corporate separations may be divided into three broad categories: spin-offs, split-offs, and split-ups. The spin-off is similar to a dividend, in that each of the share-holders receives a pro rata share of the stock of the distributed corporation while retaining his shares in the distributing corporation. Under the 1954 Code, the stock of either an existing subsidiary or a newly-created corporation can qualify for a tax-free spin-off. A split-off is identical with a spin-off, except that the stockholders of the distributing corporation surrender a portion of their stock in the distributing corporation in exchange for the stock of the distributed corporation. This method of corporate separation involves a stock redemption. The stock of the distributed corporation may be distributed . . . disproportionately. In a split-up the parent corporation distributes the stock of two or more of its subsidiaries to its shareholders as part of a plan of liquidation. As with the split-off, the stock of each corporation may or may not be distributed pro rata. Under the 1954 Code, all three methods of corporate separation are tax-free unless boot is involved or the separation fails to meet the requirements of section 355. In such cases, divergent tax treatment may be accorded the three methods.

The theory behind the tax deferment permitted by Section 355 is that so long as there is no economic change, a business should be free to change its structure or method of doing business without incurring the incidence of taxation.[5]

In order to insure that only those corporate separations which effect no economic change are granted tax deferment, Congress adopted four requirements necessary to qualify for tax free treatment under Section 355. Thus, a shareholder of a distributing corporation shall not recognize gain or loss upon the receipt of stock if the following conditions are satisfied:

> (1) A corporation distributes to its shareholders, with respect to their stock, securities of a corporation which it controlled immediately before the distribution;[6]
> (2) the transaction was not used principally as a device for distributing the earnings and profits of either corporation;[7]
> (3) the requirements of Section 355(b) relating to the active conduct of a trade or business are satisfied;[8] and
> (4) all of the stock of the controlled corporation held by the distributing corporation is distributed to its shareholders.[9]

The instant case deals with one aspect of Section 355 (b). Specifically, it deals with the provision that permits tax-free treatment only if the business of the distributed corporation and the business of the retained corporation have been actively conducted for a period of five years preceding the distribution.[10]

This five-year pre-distribution active business test was first introduced in the 1954 Code. It was born in the Senate Finance Committee and was designed to retain corporate structural flexibility while protecting against abusive tax avoidance.[11] The Commissioner interpreted this rule as necessitating the active conduct of *two* separate businesses for five years as a requirement for the benefits of Section 355.[12] Thus, the

5. In its broadest sense the purpose of Section 355 is to aid in the growth of our economy. For its increased expansion depends in part upon the ability of business to be flexible to meet challenges in its economic environment. Section 355 provides for that flexibility by authorizing one form of tax-free reorganization, a corporate separation. See generally, JACOBS, *Spin-Offs: The Pre-Distribution Two Business Rule—Edmund P. Coady and Beyond*, 19 TAX L. REV. 155 (1964).

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

7. *Id.* at § 355(a)(1)(B).

8. *Id.* at § 355(b).

9. *Id.* at § 355(a)(1)(D). This section entitles the distributees to its tax-free benefits even if the distributing corporation fails to distribute a small portion of the controlled corporation's stock, so long as the retention of the stock was not in pursuance of "a plan having as one of its principal purposes the avoidance of Federal Income Tax."

10. INT. REV. CODE OF 1954, § 355(b)(2)(B).

11. S. REP. No. 1622, 83d Cong., 2d Sess. 51 (1954).

12. TREAS. REG. § 1.355-1(a) (1955). Hereinafter in the text the Treasury Regulations shall be referred to simply as Regulations.

Treasury Department read in an additional restriction, a pre-distribution *two* business rule, which it apparently believed was implied by the wording of the statute.[13]

The validity of this additional restriction was placed squarely in issue in the Tax Court in 1960, in *Edmund P. Coady*,[14] which involved a distribution of stock in 1954, by the Christopher Construction Co., Inc. The corporation had been engaged in the construction business for more than five years preceding the distribution. However, in 1954 differences developed between the petitioner and the other fifty per cent shareholder and they agreed to divide the company into two separate enterprises. Pursuant to that end, the Coady Corporation was organized and it transferred all of its stock to Christopher Construction Co., Inc. in exchange for one half of that company's equipment and other assets. Immediately thereafter, the Christopher Co. distributed the stock of Coady to the petitioner in exchange for his stock in the Christopher Co. Thus, after the reorganization was completed both shareholders had control of a separate construction business each of which constituted one half of the original business. The Commissioner contended that the petitioner realized gain from the distribution of stock because the Christopher Co. was engaged in only one business prior to the transaction, and Section 355 did not apply to the separation of a single business.

In a decision reviewed by the entire Tax Court with six dissents, the court held that it could find "no language, express or implied, denying tax-free treatment at the shareholder level to a transaction, otherwise qualifying under Section 355, on the grounds that it represents the division or separation of a 'single' trade or business."[15]

From this the court reasoned *a priori* that the Regulations denying application of Section 355 to the division of a single business were invalid. The Sixth Circuit Court of Appeals affirmed.[16]

The Commissioner asserted the identical contention two years later and again lost, this time in the Fifth Circuit. In *Marett v. United States*,[17] the taxpayers were shareholders of a corporation which owned three plants, two of which were devoted entirely to the production of edible pork skins for one purchaser. The other plant was transferred to a newly

13. The following writers agreed that the two business rule was implied by the wording of the statute. CAPLIN, *infra* note 35; JACOBS, *supra* note 5. However, they also agreed that it was unnecessary as a tool to prevent tax abuse.

One writer presented an excellent argument for the proposition that the two business rule was not implied by the statute. SHAIMAN, *Corporate Divisions—Does Section 355 Require the Existence of More Than One Separate Active Business Prior to the Distribution of Stock?*, 42 TAXES 279 (1964).

14. 33 T.C. 771 (1960) *aff'd*, 289 F.2d 490 (6th Cir. 1961); 47 CORNELL L.Q. 108 (1961).

15. *Id.* at 775.

16. 289 F.2d 490 (6th Cir. 1961).

17. 325 F.2d 28 (5th Cir. 1963).

formed corporation, the stock of which was then distributed to the shareholders. Even though the plants were in different locations, it was stipulated that the entire operation constituted a single trade or business.

The question of whether the division of a single business could qualify for tax free treatment under Section 355 thus was once again squarely in issue. The district court cited *Coady*, and held that a single business did qualify; and the court of appeals affirmed. In doing so, it also relied on *Coady*, and noted that there was no language in the Code or the Congressional Committee reports that precluded the tax-free division of a single business under Section 355.

Now with two Circuits, the Fifth and Sixth, against him the Commissioner announced that he would follow *Coady* and *Marett* "to the extent that they hold that Section 1.355-1(a) of the Income Tax Regulations, providing that Section 355 of the Internal Revenue Code does not apply to the division of a single business, is invalid."[18]

In the instant case the Tax Court, in effect, extended the *Coady* doctrine one step further. It did so by its determination that the operation of the branch store in Grand Junction did *not* constitute a separate business under Section 355. Indeed, this determination may have imposed one more limitation on the five-year pre-distribution active business rule and it may have nullified the separate business Regulations under Section 355. However it should be noted that the Regulations were completely geared to the two-business requirement and have yet to be amended to reflect the Service's acceptance of the single business concept. Those Regulations provided in part that

> a trade or business consists of a specific existing group of activities being carried on for the purpose of earning income or profit from only such group of activities, and the activities included in such group must include every operation which forms a part of, or a step in, the process of earning income or profits from such group. Such group of activities ordinarily must include the collection of income and the payment of expenses.[19]

The court reasoned that the branch store "did not carry on every operation which forms a part of, or a step in, the process of earning income or profit from such group."[20] Thus, it was not a separate business, but rather "a continuation and furtherance of the existing business."[21] Since the branch store was opened in 1954, and was spun-off only three years later in 1957, this determination was crucial. For after separation the branch store was the business of the controlled corporation, the L. B. Walker Radio Company of Grand Junction.

18. REV. RUL. 147, 1964-1 CUM. BULL. 136.
19. TREAS. REG. § 1.355-1(c) (1955).
20. Patricia W. Burke, 42 T.C. 1021 (1964).
21. *Ibid.*

So if the the branch store was a separate business, then the business of the controlled corporation was not a business which was actively conducted for a period of five years preceding the distribution. Accordingly, tax-free treatment under Section 355 would have been denied.

There is a serious question as to whether denial of separate business status to the branch store was based on a correct interpretation of the Regulations. For the meaning of the Regulation relied upon in the instant case, as construed by the Treasury Department and the Tax Court, seems to indicate that separate business status should have been granted.

Indeed, in one example contained in the Regulations, separate business status was granted to each of two department stores served by a common warehouse, one located downtown and one in the suburbs.[22] Another example provided the same for a grocery store at one location and a hardware store at another.[23] Furthermore, a Revenue Ruling granted separate business status to and permitted the tax-free separation of a grocery business, a bakery business and a creamery products business, all at separate locations.[24] The Treasury Department thus considers physical separation an important factor, in determining whether an activity constitutes a separate business.

The courts have been even more generous, and have granted separate business status in cases where the two activities were not even physically separated. In *H. Grady Lester*,[25] a corporation that was engaged in the warehouse distribution and jobbing of auto parts at the same location, spunoff the warehousing activity. The court held that notwithstanding the almost complete integration of operating facilities and personnel, each activity constituted a separate business. And, in *Marne S. Wilson*,[26] the court held that the finance activities of a retail furniture store were of a sufficient magnitude and character to be an actively conducted business.

These interpretations indicate that the branch store in *Burke* was a separate business within the meaning of the Regulations. For the factor of physical separation emphasized by the Treasury Department was present, and the branch store and main store were not nearly as "amalgamated into one integrated business"[27] as the separate businesses were

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22. TREAS. REG. § 1.377-2(d) (example 2) (1955). All the examples in this Regulation were incorporated into Section 355 by § 1.355-1(e) (1955).

23. *Id.* at (example 1).

24. REV. RUL. 266, 1956-1 CUM. BULL. 184.

25. 40 T.C. 947 (1963).

26. 42 T.C. 914 (1964).

27. REV. RUL. 190, 1957-1 CUM. BULL. 121. This was the wording used in denying separate business status to each of two automobile franchises as the two businesses had been "amalgamated into one integrated business" when the assets were moved to the same location.

in *H. Grady Lester*[28] and *Marne S. Wilson*.[29] In other words, though the branch store in *Burke* was denied separate business status it had more incidents of separateness than the separate businesses of *Lester* and *Wilson*.

The implication of the *Burke* rationale seems to be that if labeling an activity a separate business would be the only reason for denying the tax-free treatment in view of the five-year requirement of Section 355, then the court might not attach that label, and instead might call the activity a "continuation and furtherance of the existing business and not the establishment of a new business."[30]

Though this result-centered approach may not increase tax avoidance possibilities, it is clear that carried to its logical conclusion, it directly conflicts with the Code requirement that both the business of the distributing corporation and that of the controlled corporation must have been actively conducted for the five-year period prior to the date of distribution.[31]

For even though Section 355 permits the separation of a single business, if two pre-existing businesses are involved in the separation, then the Code requires that both must have been actively conducted for a five year period prior to the date of distribution to qualify for tax-free treatment.[32] So *Burke* by having treated two businesses as one, in effect, presented an attack against the five-year pre-disposition active business test, and impliedly questioned its usefulness as a safeguard against taxpayer abuse.

Perhaps such an attack should have been mounted, but what the future holds with respect to this area is uncertain. The pre-disposition two business rule is no longer available as a safeguard against taxpayer abuse, as the Commissioner now agrees that Section 355 does apply to the division of a single business. But it is questionable whether Congress would want to tamper with the five year active business test at this time. However, a few more cases like *Burke* might cause it to at least restate its position.

It would appear that the test has hindered corporate separations motivated by genuine business reasons and has not helped to prevent tax avoidance. Moreover, there are reasonable alternatives which could serve as suitable substitutes. A report[33] of the American Law Institute

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28. H. Grady Lester, *supra* note 25.
29. Marne S. Wilson, *supra* note 26.
30. Patricia W. Burke, *supra* note 20.
31. INT. REV. CODE OF 1954, § 355(b)(2)(B).
32. *Ibid.*
33. See, SURREY, *Income Tax Problems of Corporations and Shareholders: American Law Institute Tax Project*—American Bar Association Committee Study On *Legislative Revision*, 14 TAX L. REV. 1, 9 (1959).

and American Bar Association criticized the test and urged that it be dropped from Section 355. They would permit the five-year active business test to be simply one factor in determining the reason for the division. It would be considered along with the business purpose for the separation and the determination by the Commissioner that it was not used principally as a device for distributing the earnings and profits of either corporation. Furthermore, the active conduct of a trade or business after the corporate separation by both corporations would be an additional safeguard, as it is inconsistent with a device to distribute retained earnings at other than ordinary income tax rates.[34]

Another important critic of the five-year active business test was ex-Internal Revenue Commissioner Caplin. Prior to his appointment as Commissioner, he wrote that the five-year rule should be abandoned in favor of "the broad malleable standard of the *device* terminology—buttressed by a requirement that both corporations continue the active conduct of a trade of business."[35]

He further indicated that if the five-year rule should be retained to provide a measure of certainty in the statute, "then there should also be included a general catch-all provision, comparable to the *essentially equivalent* standard of Code section 346(a)(2) which would allow corporate separation for legitimate transactions ineligible under the strict *active business* test."[36]

In *Burke*, the court was presented with one of the problems generated by the five-year active business test; the necessity of having to determine whether the two activities carried on by the distributing corporation prior to separation were conducted as two businesses or as one. It was a problem because the *wrong* classification would have been the only reason for denying tax-free treatment to the distribution of stock resulting from the corporate separation. And if this was the one and only reason, then the benefits of Section 355 would have been denied to a corporate separation in which there was no economic change. This of course would have been contrary to the manifest purpose of that section.[37] Both the American Law Institute and ex-Commissioner Caplin have presented satisfactory alternatives to the five-year active business test. It is submitted that these alternatives should be accorded serious Congressional consideration.

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34. This requirement was imposed by INT. REV. CODE OF 1954 § 355(b)(2)(A).

35. CAPLIN, *Corporate Division Under the 1954 Code: A New Approach to the Five-Year "Active Business" Rule*, 43 VA. L. REV. 397, 407 (1957).

36. *Ibid.*

37. See note 5 *supra* and accompanying text.