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The Real Estate Corporation: What Can Be Done When a Close Corporation's Shareholders Are No Longer Close

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NOTES

THE REAL ESTATE CORPORATION: WHAT CAN BE DONE WHEN A CLOSE CORPORATION'S SHAREHOLDERS ARE NO LONGER CLOSE?*

I. INTRODUCTION

When a close corporation's shareholders[1] wish to end their association they find that there are many alternative methods from which they can choose to accomplish their goal. This Note examines the tax aspects of the possible alternatives in a hypothetical situation involving a cash-poor close corporation which primarily rents and leases commercial and residential real estate. The corporation is named *R.E. Corp* and is owned by two shareholders, *A* and *B*.

A and *B* may select from four basic alternatives to end their present status as shareholders in *R.E. Corp.*[2] First, one share-

*While this Note was being prepared for publication Congress passed the Deficit-Reduction Act of 1984. At this writing, President Reagan has not yet signed the Act into law. A review of the material on the Act reveals no substantive changes to the code sections offered to in this Note. The reader should be aware, however, that some code sections have been relettered or renumbered by the Act. These sections will not correspond with the citations used in this Note if and when the Act becomes law. For more detailed information see "Deficit-Reduction Act of 1984" as agreed to by House - Senate Conferees, June 23, 1984, Special Supplement (BNA)(June 26, 1984).

1. An exact, uniformly-accepted definition of a close corporation does not exist. W. ROTHENBERG, TAX AND ESTATE PLANNING WITH CLOSELY HELD CORPORATIONS § 1:6 (1981). For the purposes of this article, a close corporation is a corporation with a small number of shareholders, which is managed by those shareholders, and whose stock is not traded in public markets or exchanges. For a detailed discussion of the definition of a close corporation see 1 F. O'NEAL, CLOSE CORPORATIONS §§ 1.02-09 (1958 & Supp. 1970).

2. No matter which alternative is selected, a major question is the valuation of *R.E. Corp.* Before any plan of separation can be developed, *R.E. Corp* will have to be valued, as will the separate interests of *A* and *B* in *R.E. Corp.* The valuation of a corporation and the interests of each of its shareholders depends upon the particular facts of each situation and, thus, will vary from case to case. No detailed attempt will be made in this article to discuss the basic principles of enterprise valuation or to apply those principles

holder may purchase the other shareholder's shares of stock. If *A* and *B* have a buy-sell agreement[3] this procedure could be very simple, for these agreements normally fix the amount of consideration necessary to acquire shares.[4] A consequence of this alternative is that the selling shareholder is taxed on the gain which occurs if the amount of consideration he receives exceeds his adjusted basis in the shares of stock he is selling.[5] If the selling shareholder's adjusted basis in the shares exceeds the amount of consideration he receives, he may be able to recognize a loss on the transaction, thus making this an attractive alternative.[6] In this hypothetical, however, it will be assumed that neither *A* nor *B* is in a financial position to buy the other's shares of stock in *R.E. Corp.*[7]

A second alternative available to *A* and *B* is for one of them to sell his shares of stock in *R.E. Corp* to a third party. This transaction has the same potential tax consequences to the selling shareholder as does the first alternative. A further assumption will be made that no third party is willing to buy *R.E. Corp.* shares,[8] so that neither this alternative nor the first will be given further analysis in this Note.

A third alternative is for *R.E. Corp* to redeem the shares of one of the two shareholders. Once again the selling shareholder

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to the hypothetical facts dealing with *A*, *B*, or *R.E. Corp.* For a concise discussion of the basic principles of enterprise valuation, *see* Haynsworth, *Valuation of Business Interests*, 33 MERCER L. REV. 457 (1982). For an in depth look at the valuation of closely held businesses, *see* F. BURKE, VALUATION AND VALUATION PLANNING FOR CLOSELY HELD BUSINESSES (1981).

3. In the context of this article a buy-sell agreement is one which gives one shareholder the right to purchase the other shareholder's interest at a price fixed by a formula in the agreement, if the other shareholder decides to sell his interest. For a discussion of buy-sell agreements *see* W. ROTHENBERG, *supra* note 1, at §§ 16:3-16.17.

4. For a discussion of the various methods which can be used to fix the price in the buy-sell agreement, see 2 O'NEAL, *supra* note 1, at § 7.24.

5. I.R.C. § 1001.

6. *Id. But see, infra* note 9.

7. In many closely-held corporations substantially all of a shareholder's capital is invested in the corporation. The shareholder, therefore, may not have the needed funds to buy out another shareholder, or he may not want to tie up additional money in the corporation.

8. Stock in a close corporation is often hard to sell to outsiders because by definition there is no public market or exchange at which the stock can be traded. *See supra* note 1. Another factor which hinders the stock's marketability is the buyer's need to get along with the remaining shareholders, since they will have to manage the business together. *Id.*

could have a taxable gain or loss on the transaction. If the redemption results in a recognizable loss this transaction might be best for the selling shareholder.[9] However, since it has been assumed that *R.E. Corp* is cash-poor, some of the corporation's real estate would probably have to be used to redeem the shareholder's stock. If the properties used in the redemption were appreciated properties, *R.E. Corp* might have to recognize some gain on the distribution of those properties.[10] It is likely that a real estate corporation will have appreciated property, thus a major disadvantage is built into the redemption alternative.[11]

The fourth alternative is a corporate division. This transaction involves the transfer of some *R.E. Corp* assets to a new corporation in exchange for all of the new corporation's stock, or the transfer of all of its assets to two new corporations in exchange for all of the new corporations' stock. If only one new corporation is formed, *R.E. Corp* will distribute the shares of the new corporation's stock to either *A* or *B* in exchange for his shares of stock in *R.E. Corp*. If two new corporations are formed, *R.E. Corp* will distribute the stock of one corporation to *A* and the stock of the other corporation to *B*, while in the process of being completely liquidated. If the transaction is carried out in the correct manner, it could be tax-free to *A*, *B* and *R.E. Corp*.[12]

If the shareholder would recognize a capital gain on the sale or redemption of his *R.E. Corp* stock, it is unlikely that any of the first three alternatives would offer an attractive solution compared to the no-tax consequences of the fourth. If he would recognize a capital loss on the sale or redemption, the better alternative might well be among the first three discussed. However, since the hypothetical assumes that neither *A* nor *B* has the funds needed to buy out the other, that no third party can be found to purchase the *R.E. Corp* stock of either owner, and

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9. If the shareholder whose stock is being redeemed owned more than fifty percent of the value of the corporation's outstanding stock directly or indirectly, § 267 of the Internal Revenue Code would disallow any deduction of the loss. *See* I.R.C. § 267(a)(1), (b)(2). Members of the same family often own closely-held corporations. The attribution rules of section 267(c) make this fifty percent ownership test a likely problem. *See* I.R.C. § 267(c)(2).

10. I.R.C. § 311(d).

11. *See infra* p. 11-12.

12. A corporate division will also allow both *A* and *B* to remain in the real estate business after they have ended their business relationship.

that *R.E. Corp* would probably have to recognize gain on a redemption of stock even though the shareholder involved might be able to recognize a loss, sound tax planning would rule out all of the first three alternatives. Therefore, the remainder of this Note will discuss the corporate division alternative and its availability to *A* and *B* in ending their association as joint shareholders of *R.E. Corp.*

II. The Corporate Division Alternative

Under section 355 of the Internal Revenue Code, if a corporation distributes to its shareholders stock of a corporation which it controls immediately before the distribution, no gain or loss will be recognized to (and no amount will be includible in the income of) such shareholders upon the receipt of the stock, as long as certain specific requirements are met. Five requirements are contained in section 355, while two others have been developed judicially. For a corporate division to be tax-free to the recipient shareholders, all of these requirements must be met. Each one will be examined separately in light of the hypothetical circumstances created for *R.E. Corp*, and its two shareholders, *A* and *B*.[13]

A. *The Three Types of Section 355 Distributions*

There are three types of distributions which can be made tax-free to the shareholders of the distributing corporation under section 355: a "spin-off," a "split-off" and a "split-up."[14] A spin-off involves a corporation's pro rata distribution to its shareholders of the stock it holds in the controlled corporation.[15] If the attempted spin-off does not meet the requirements of section 355, the transaction will probably be treated as a dividend under section 301 because it is a pro rata distribution and will not qualify for capital gain under section 302.[16] A split-off involves a corporation's *non*-pro rata distribution to some of its shareholders of the stock it holds in the controlled corporation

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13. *See infra* notes 63-160 and accompanying text.
14. 7 Corporate Capital Transactions Coordinator (Research Inst. of Am.) ¶ 35,151 (March 1984).
15. *Id.*
16. *Id.* at ¶ 35,179.

in exchange for part or all of those shareholders' shares of stock in the distributing corporation.[17] A split-off differs from a spin-off in that the shareholders involved in the former distribution will have either partially or fully terminated their interests in the distributing corporation. If the attempted split-off does not meet the requirements of section 355, the transaction will probably be treated as a redemption, thus being taxed as either a capital gain or loss.[18] A split-up involves a corporation's transfer of all of its assets and liabilities into two or more corporations in exchange for the stock of those corporations.[19] The distributing corporation then distributes the shares of stock it holds in the controlled corporations to its shareholders either pro rata, as in a spin-off, or non-pro rata, as in a split-up, while it simultaneously undergoes liquidation.[20] If the attempted split-up does not meet the requirements of section 355, the transaction will probably be treated as a liquidation for tax purposes.[21]

Of these three types of distributions the split-off would be the most appropriate for *R.E. Corp* and its owners. A split-off can be structured so that either *A* or *B* would exchange all of his stock in *R.E. Corp* for all of the stock of the new corporation (*New Corp*). For example, *A* might end up with all the stock in *R.E. Corp* while *B* would become the stockholder in *New Corp*. *A* and *B* may then go their separate ways and any goodwill which was associated with the name *R.E. Corp* would be preserved. The most significant feature of the entire transaction is that it would be tax-free for all the parties involved.

Another advantage of the split-off over the split-up is the more favorable tax treatment which result if the attempted separation does not qualify for tax-free treatment under section 355. A nonqualifying split-off would be treated as a redemption, thus creating tax consequences for the shareholder who exchanged his stock in *R.E. Corp* for all of the stock in *New Corp*. *R.E. Corp* might find itself with a tax liability if it used appreciated property in the exchange of shareholder's stock.[22] A non-

17. *Id.* at ¶ 35,151.
18. *Id.* at ¶ 35,179.
19. *Id.* at ¶ 35,151.
20. *Id.*
21. *Id.* at ¶ 35,179.
22. *See* I.R.C. §§ 302(a), 311(d).

qualifying split-up would be treated as a liquidation, probably taxable to both *A* and *B*.[23] While the liquidation of a corporation is normally tax-free to the corporation,[24] the recapture rules dealing with the early disposition of investment credit property[25] and the disposition of depreciable property[26] could come into play and increase the tax liability of *R.E. Corp* if such property is distributed in the "deemed" liquidation. Thus, the split-off would not only preserve any goodwill associated with the name *R.E. Corp*, it would also provide a more favorable overall tax treatment in the event a mistake is made and the transaction is not structured so that it meets the requirements of section 355.

B. Effecting the Split-Off

The first step taken in effecting a split-off is the determination of *R.E. Corp*'s value. The valuation of a corporation and of the various shareholders' interests in that corporation depend upon the specific facts and circumstances of the situation.[27] Once the value for *R.E. Corp* is established, it is divided into two groups. One group is equal to the value of *A*'s interest in *R.E. Corp* (Group A) and the other group is equal to the value of *B*'s interest (Group B).[28] It is assumed in this hypothetical situation that A and B each own fifty percent of *R.E. Corp*. Because of this assumption, no independent valuation of the interests of *A* and *B* is be necessary; the value of *R.E. Corp* would simply be divided in half. If *A* and *B* were not equal shareholders, the valuation of each shareholder's interest could not be determined by simply multiplying his percentage of stock ownership in *R.E. Corp* by the value placed on *R.E. Corp*. Adjustments would have to be made to the respective interests of *A* and *B* for the control premiums and minority discounts commonly associated with

23. *See* I.R.C. § 331(a).
24. I.R.C. § 336(a).
25. I.R.C. § 47(a)(1).
26. I.R.C. §§ 1245, 1250.
27. *See supra* note 2.
28. Because of the "active business" requirement of § 355, *see infra* notes 83-145 and accompanying text, the determination of which assets will be placed into Groups A and B will not be based solely on the assets' values.

close corporation stock.[29]

Once the values of Group A and Group B are determined, the assets and liabilities of *R.E. Corp* must be separated into the two groups.[30] One of the assets that must be considered is goodwill associated with the name *R.E. Corp.* If goodwill exists, it would obviously be placed in the group of assets and liabilities which will stay in *R.E. Corp.* For the balance of this Note, it is assumed that an agreement was reached whereby *A* will continue owning stock in *R.E. Corp* and *B* will exchange his stock of *R.E. Corp* for stock in the new corporation, *New Corp.* Thus, the assets, including good will in *R.E. Corp,* and liabilities in Group A will stay in *R.E. Corp* and the assets and liabilities in Group B will be transferred to *New Corp.*

The second step in the proposed split-off is made up of three parts, all of which are carried out almost simultaneously. First, *New Corp* would be formed. Second, *R.E. Corp* would transfer the assets and liabilities in Group B to *New Corp* in exchange for all of *New Corp*'s stock. Third, *R.E. Corp* would distribute all of the stock it holds in *New Corp* to *B* in exchange for all of *B*'s stock in *R.E. Corp.*

C. *The Taxability of the R.E. Corp—New Corp Exchange*

1. *Taxability to New Corp*

Of the tax questions involved in this hypothetical split-off, the easiest to answer is the taxability to *New Corp* of its receipt of the Group B assets and liabilities in exchange for *New Corp*'s stock. In this exchange section 1032 of the Internal Revenue Code is the operative nonrecognition provision for *New Corp.* Section 1032(a) provides, "No gain or loss shall be recognized to a corporation on the receipt of money or other property in exchange for stock (including treasury stock) of such corpora-

29. *See* Haynsworth, *supra* note 2, at 492-96.

30. One of the requirements associated with a tax-free corporate division is that each corporation involved must be engaged in the active conduct of a trade or business after the division takes place. *See infra* text accompanying notes 83-145. Thus, the assets in Groups A and B must constitute active businesses. The tax-free status of a corporate division will not be destroyed, however, solely because a substantial amount of cash is transfered with the assets constituting a business. Rev. Rul. 64-102, 1964-1 C.B. 136, *see infra* notes 80-81 and accompanying text.

tion."[31] The Internal Revenue Service (IRS) has interpreted this provision as applying to all dispositions that a corporation makes of its own stock for money or other property. The transaction will not give rise to a taxable gain or deductible loss to the corporation regardless of the nature of the disposition or the facts and circumstances involved.[32] This provision makes the *R.E. Corp—New Corp* exchange tax-free to *New Corp*.

2. *Taxability to R.E. Corp*

The nonrecognition provision applicable to *R.E. Corp* in its exchange with *New Corp* is found in section 361 of the Internal Revenue Code. Section 361(a) provides that no gain or loss shall be recognized if a corporation which is a party to a reorganization exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation which is also a party to the reorganization. The assets and liabilites in Group B which *R.E. Corp* is transferring to *New Corp* constitute "property" under section 361, and that property is being exchanged solely for stock in *New Corp*. If the exchange is made pursuant to a plan of reorganization and if both *R.E. Corp* and *New Corp* are considered parties to that reorganization, *R.E. Corp* will not recognize any gain or loss on the exchange. It must, therefore, be determined whether the exchange is being made pursuant to a plan of reorganization and if *R.E. Corp* and *New Corp* are parties to that reorganization.

The definitions relating to corporate reorganizations are found in section 368 of the Internal Revenue Code. Section 368(a)(1)(D) defines reorganization as:

> a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor, or one or more of its shareholders (including persons who were shareholders immediately before the transfer), or any combination thereof, is in control of the corporation to which the assets are transferred; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies

31. I.R.C. § 1032(a).
32. Treas. Reg. § 1.1032-1(a).

under sections 354, 355, or 356. . . .[33]

In the hypothetical therefore, a plan of reorganization would be drafted. Pursuant to that plan, *R.E. Corp* would transfer its Group B assets and liabilities to *New Corp* in exchange for *New Corp* stock, and then *R.E. Corp* would distribute the *New Corp* stock to *B* in exchange for *B*'s *R.E. Corp* stock. Since the exchange between *R.E. Corp* and *New Corp* complies with the statutory language of section 368(a)(1)(D), a reorganization will have been accomplished if the *New Corp* stock that *R.E. Corp* received was distributed to *B* in a transaction qualifying under section 355.

For these exchanges to qualify under section 361 and permit *R.E. Corp* to avoid recognition of gain on the transaction, *R.E. Corp* and *New Corp* must be considered parties to the reorganization. Section 368(b)(2) defines a party to a reorganization as including "both corporations, in the case of a reorganization resulting from the acquisition by one corporation of stock or properties of another."[34] Since a reorganization will exist if the section 355 requirements are met, and since the reorganization will result from *R.E. Corp*'s acquisition of *New Corp* stock, both *R.E. Corp* and *New Corp* will be considered parties to a reorganization. Accordingly, if the exchanges qualify under section 355, *R.E. Corp*, by virtue of section 361, will not have to recognize gain on its exchange with *New Corp*.

There is, however, one instance in which *R.E. Corp* may have to recognize gain on the exchange. Section 357(c)(1) of the Internal Revenue Code provides that, in the case of an exchange to which section 351 of the Internal Revenue Code applies or to which section 361 applies by reason of a plan of reorganization within the meaning of section 368(a)(1)(D), if the sum of the total amount of liabilities assumed plus the total amount of the liabilities to which the property is subject exceed the total of the adjusted basis of *all* the property transferred pursuant to the exchange, then such excess shall be considered as a gain from the sale or exchange of a capital asset or of property which is not a capital asset, as the case may be.[35] If *R.E. Corp* has any highly

33. I.R.C. § 368(a)(1)(D).
34. I.R.C. § 368(b)(2).
35. I.R.C. § 357(c)(1).

appreciated property that has a recently refinanced mortgage, then the liability to which that property is subject could very likely exceed *R.E. Corp*'s adjusted basis in the property.[36] The exchange transaction must be carefully structured so that the property in Group B is not subject to liabilities that exceed *R.E. Corp*'s adjusted basis in all the property transferred to it. Otherwise, *R.E. Corp* will recognize some gain on the exchange.

If the exchanges do not qualify as a reorganization, the exchange between *R.E. Corp* and *B* will probably be treated as a taxable redemption.[37] The exchange between *R.E. Corp* and *New Corp* can be tax-free to *R.E. Corp* even if both exchanges fail to qualify as a reorganization, so long as it meets the requirements of section 351. Since a considerable overlap between section 368(a)(1)(D) and section 351 exists,[38] there should be little difficulty in structuring the exchange between *R.E. Corp* and *New Corp* as a tax-free exchange to *R.E. Corp* under both section 351 and section 361.

Section 351(a) provides that no gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation provided that, immediately after the exchange, such person or persons are in control of the corporation. The exchange between *R.E. Corp* and *New Corp* should be tax-free to *R.E. Corp* under section 351 because (1) The assets and liabilities in Group B should constitute "property" under section 351;[39] (2) *R.E. Corp* would be considered a "person" under section 351; (3) the transaction should be considered an "exchange," and not a sale, under section 351;[40] (4) the transaction would be one "solely in exchange for stock" of *New Corp*; and (5) immediately

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36. Property with a high mortgage and a low basis is not uncommon given the rapid depreciation deductions available for real estate. Z. CAVITCH, TAX PLANNING FOR CORPORATIONS AND SHAREHOLDERS § 4.03[2][c][iii] (1984).

Transferring highly mortgaged property whose value has declined below the amount of the mortgage to the new corporation might result in a problem under § 357(b) if the transfer is viewed as having as its principal purpose the avoidance of Federal income tax. See I.R.C. § 357(b).

37. *See Corporate Capital Transactions Coordinator, supra* note 14 at ¶ 35,179. *See also supra* text accompanying note 18.

38. *Compare* I.R.C. § 368(a)(1)(D) with § 351. *See also* Rev. Rul. 62-138, 1962-2 C.B. 95.

39. *See* I.R.C. § 351(b).

40. Treas. Reg. § 1.351-1(a)(1).

after the exchange, *R.E. Corp* would be in control of *New Corp*.[41] As previously noted, the rule in section 357(c)(1), pertaining to the recognition of gain on the transfer of property subject to liabilities in excess of the transferor's adjusted basis in the property, also applies to section 351 transactions.[42]

D. The Taxability of the R.E. Corp—B Exchange

1. Taxability to R.E. Corp

The operative nonrecognition provision for *R.E. Corp* concerning the exchange between it and *B* is found in section 311(a) of the Internal Revenue Code. This subsection provides, in part, that no gain or loss shall be recognized by a corporation on the distribution, with respect to its stock, of property.[43] One exception to this rule is found in section 311(d) which provides that if a corporation distributes property to a shareholder in redemption of his stock in such corporation and the fair market value of that property exceeds the corporation's adjusted basis in that property, then a gain will be recognized to the corporation in an amount equal to the excess, as if the property distributed had been sold at the time of the distribution.[44] Fortunately, this provision has been interpreted by the IRS as applying only to actual redemptions, and not to transactions which have substantially the same effect as a redemption, such as distributions pursuant to reorganizations or section 355 distributions.[45] However, the Service has also determined that if a distribution is in substance a redemption, section 311(d) will apply.[46] When section 311(d) does not apply, section 311(a) provides for nonrecognition of any gain to the distributing corporation on the distribution. On facts very similar to the ones in the *A—B—R.E. Corp* hypothetical, the IRS has ruled that section 311(a) provides for the nonrecognition of gain or loss by the distributing corporation on a distribution to its shareholders of a controlled corporation's

41. *Id.*
42. *See supra* note 35 and accompanying text.
43. I.R.C. § 311(a).
44. I.R.C. § 311(d)(1).
45. Treas. Reg. § 1.311-2(a)(2).
46. *Id.*

stock.[47] Thus, if the transaction is structured correctly, *R.E. Corp* should not have to recognize any gain on the exchange between itself and *B*.[48]

2. *Taxability to B*

Section 355 is the operative nonrecognition provision concerning the taxability to *B* on the exchange of his *R.E. Corp* stock for *New Corp* stock. *B* will recognize neither gain nor loss on the exchange[49] if it satisfies the statutory and judicial requirements of section 355.[50]

E. Tax Effects of the Split-Off On the Parties Involved After the Exchanges

A split-off creates other tax related issues in addition to the question of recognition of gain or loss. One issue is the tax treatment that *R.E. Corp* might have applied to any of the assets in Group B. Normally when a corporation disposes of depreciated personal property or real property, there is the possibility that the recapture rules of Internal Revenue Code sections 1245 and 1250 would require the corporation to recognize some gain. However, as previously discussed, if the proposed split-off is structured so that it meets the requirements of sections 355, 361 and 368 (and, in case it fails to meet those requirements of section 351), *R.E. Corp* will not have to recognize gain on the disposition of the assets in Group B when transferred to *New Corp*, unless

47. *See, e.g.*, I.R.S. Letter Ruling (CCH) 8304103 (Oct. 27, 1982); I.R.S. Letter Ruling (CCH) 8202061 (Oct. 15, 1981); I.R.S. Letter Ruling (CCH) 7901024 (Oct. 6, 1978).

48. *See generally* B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 13.11 n.133 (4th ed. & 1984 Cum. Supp. No. 1).

49. I.R.C. § 355(a)(1). Since a real estate corporation is involved in this hypothetical, some comment should be made about possible application of the collapsible corporation rules, I.R.C. § 341. These rules were partially designed with real estate corporations in mind. *See* Liebau & Knudsen, *How to Divide a Real Estate Corporation When the Shareholders Start to Disagree*, 7 Tax'n Law. 238, 242-43 (1979). If the rules applied to *B* in this hypothetical the results could be disasterous. Fortunately, the IRS has determined that § 341 does not apply to tax-free transactions. *See* Treas. Reg. § 1.341-4(a); Rev. Rul. 73-378, 1973-2 C.B. 113. *See also* T. Ness & E. Vogel, Taxation of the Closely Held Corporation § 12.1 (1976); Bittker and Eustice, *supra* note 48, at ¶ 12.09(7).

50. *See infra* notes 63-160 and accompanying text.

the provisions in section 357 apply.[51] While a distributing corporation is allowed to escape the recapture rules of sections 1245 and 1250, Congress has not allowed such a corporation to escape all of the recapture rules in a tax-free split-off.

Section 47 of the Internal Revenue Code[52] provides, in part, for the recapture of a portion of the investment tax credit taken on any property if such property is disposed of, or otherwise ceases to be section 38 property, with respect to the taxpayer before the close of the useful life which was taken into account in computing the credit under section 38 of the Internal Revenue Code. This recapture provision requires an adjustment of the federal income tax liability of the taxpayer for the year of disposition or cessation.[53] There is an exception to this recapture provision if the disposition is part of a transaction to which section 381(a) of the Internal Revenue Code applies.[54] However, the IRS has ruled that section 381 does not apply to a divisive reorganization under section 368(a)(1)(D).[55] Since the transfer of section 38 property from a distributing corporation to a controlled corporation is an early disposition of such property if the transfer is made before the close of the useful life taken into account in computing the credit under section 38, the recapture rule of section 47 could apply to a split-off.[56] Therefore, it would be important to structure the *R.E. Corp—New Corp* exchange to avoid, if possible, transferring any section 38 property from *R.E. Corp* to *New Corp*, unless *R.E. Corp* has held the property for its "useful life."

Another tax adjustment which would have to be made as a result of the proposed split-off involves an allocation of *R.E. Corp*'s earnings and profits between *R.E. Corp* and *New Corp*. Section 312(h) of the Internal Revenue Code provides:

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51. These provisions deal with the partial recognition of gain on § 351 or § 361 transfers of assets subject to liabilities that exceed their adjusted basis in the transferor's hands. *See supra* note 35 and accompanying text.

52. I.R.C. § 47(a)(1).

53. *Id.*

54. I.R.C. § 47(b)(2).

55. *See* Rev. Rul. 74-101, 1974-1 C.B. 7.

56. *See, e.g.*, I.R.S. Letter Ruling (CCH) 8304103 (Oct. 27, 1982); I.R.S. Letter Ruling (CCH) 8202061 (Oct. 15, 1981); I.R.S. Letter Ruling (CCH) 8304096 (Oct. 27, 1982); I.R.S. Letter Ruling (CCH) 8050050 (Sept. 18, 1980); I.R.S. Letter Ruling (CCH) 7916017 (Jan. 16, 1979).

> In the case of a distribution or exchange to which section 355 (or so much of section 356 as relates to section 355) applies, proper allocation with respect to the earnings and profits of the distributing corporation and the controlled corporation (or corporations) shall be made under regulations prescribed by the Secretary.[57]

Section 1.312-10 of the Federal Treasury Regulations provides that the allocation of the earnings and profits of the distributing corporation between itself and the controlled corporation is normally based on the fair market value of each corporation after the division.

> In the case of a newly created controlled corporation, such allocation generally shall be made in proportion to the fair market value of the business or businesses (and interests in any other properties) retained by the distributing corporation and the business or businesses (and interests in any other properties) of the controlled corporation immediately after the transaction. In a proper case, allocation shall be made between the distributing corporation and the controlled corporation in proportion to the net basis of the assets transferred and of the assets retained or by such other method as may be appropriate under the facts and circumstances of the case. The term "net basis" means the basis of the assets less the liabilities assumed or liabilities to which such assets are subject. The part of the earnings and profits of the taxable year of the distributing corporation in which the transaction occurs allocable to the controlled corporation shall be included in the computation of the earnings and profits of the first taxable year of the controlled corporation ending after the date of the transaction.[58]

If *R.E. Corp* had earnings and profits at the time of the exchange, and the split-off qualified under sections 368(a)(1)(D) and 355, those earnings and profits would have to be allocated between *R.E. Corp* and *New Corp.*[59] The regulation is flexible as to the factors that may be used to determine the allocation. But, with the regulation's specific reference to the general method that is used with newly created controlled corporations, the fair

57. I.R.C. § 312(h).

58. Treas. Reg. § 1.312-10(a).

59. *See, e.g.*, I.R.S. Letting Ruling (CCH) 8304096 (Oct. 27, 1982); I.R.S. Letter Ruling (CCH) 8304103 (Oct. 27, 1982); I.R.S. Letter Ruling (CCH) 8202061 (Oct. 15, 1981); I.R.S. Letter Ruling (CCH) 7916017 (Jan. 16, 1979).

market value approach would probably be appropriate.[60] If *R.E. Corp* had a deficit, as opposed to positive earnings and profits, at the time of the exchange, the entire deficit would remain with *R.E. Corp*, and none of it would be allocated to *New Corp*.[61] In addition, in Revenue Ruling 77-133,[62] the IRS ruled that none of a distributing corporation's net operating loss should be distributed to a newly created corporation that was split-off in a transaction and to which section 355 applied. Thus, any net operating loss which *R.E. Corp* might have at the time of the exchange with *New Corp* would remain entirely with *R.E. Corp*.

Another tax-related issue arising from the *A—B—R.E. Corp* split-off concerns the tax concept of basis. The assets and liabilities in Group A that *R.E. Corp* retains after the split-off would have the same basis to *R.E. Corp* as before the split-off.

Section 358 of the Internal Revenue Code provides that in the case of an exchange to which section 355 applies, the basis of the property permitted to be received under section 355 without the recognition of gain or loss, will be the same as the basis of the property exchanged. Under section 358, if the hypothetical split-off qualified under section 355, the stock of *New Corp* which *B* receives in the exchange, would have a basis to *B* equal to *B*'s basis in the old *R.E. Corp* stock.

Section 362(b) of the Internal Revenue Code provides that if a corporation acquires property in connection with a reorganization, the basis of such property will be the same as it would be in the hands of the transferor. If the hypothetical split-off qualified as a section 368(a)(1)(D) reorganization, under section 362, *New Corp*'s basis in the property transferred to it from *R.E. Corp* would be the same as *R.E. Corp*'s basis in the property before the exchange. If the split-off did not qualify as a reorganization, but the exchange between *R.E. Corp* and *New Corp* did qualify for the nonrecognition of gain or loss under section 351, *New Corp*'s basis in the transferred property would also remain the same as *R.E. Corp*'s basis in the property before the exchange. This is true because section 362(a) provides for the same type of carryover basis for property that a corporation acquired in a transaction to which section 351 applies.

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60. *See* Treas. Reg. § 1.312-10(a).
61. Treas. Reg. § 1.312-10(c).
62. 1977-1 C.B. 96.

The final tax-related issue in the *A—B—R.E. Corp* split-off transaction deals with the tax concept of "holding period." The split-off would not affect *R.E. Corp*'s holding period in the assets it retained. Section 1223(1) of the Internal Revenue Code provides, in part, that the holding period of property which was received in a distribution to which section 355 applies shall include the holding period of the property exchanged. Thus, *B*'s holding period in his *New Corp* stock would include the period during which he held the *R.E. Corp* stock. For transferred property whose basis is determined by the basis of the previous owner, section 1223(2) provides that the holding period will include the transferor's holding period of the property. Thus, *New Corp*'s holding period in the assets transferred to it will include the period during which *R.E. Corp* held those assets.

III. THE REQUIREMENTS OF A TAX-FREE SPLIT-OFF

(a) The Statutory Requirements

The statutory requirements that must be met for a distribution of stock to qualify under section 355 are as follows: (1) The distributing corporation may distribute only stock or securities of a corporation it controls immediately before the distribution;[63] (2) the stock being distributed must have been acquired by the distributing corporation either (a) at least five years before the distribution to the shareholder[64] or (b) in a transaction in which neither gain nor loss was recognized in whole or in part;[65] (3) the distribution cannot be used principally as a device for the distribution of earnings and profits of the distributing corporation or the controlled corporation or both;[66] (4) the requirements relating to active trades or businesses must be satisfied;[67] and (5) as part of the distribution, the distributing corporation, with one exception, must distribute all of the stock and securities it holds in the controlled corporation.[68]

63. I.R.C. § 355(a)(1)(A).
64. I.R.C. § 355(a)(3)(B)(i).
65. I.R.C. § 355(a)(3)(B)(ii).
66. I.R.C. § 355(a)(1)(B).
67. I.R.S. § 355(a)(1)(C).
68. I.R.C. § 355(a)(1)(D).

(1) Distributing Only Stock or Securities

Section 355(a)(1)(A) contains the requirement that the distributing corporation in a tax-free split-off must distribute *solely* stock or securities of a corporation which it *controls* immediately before the distribution. After the exchange between *R.E. Corp* and *New Corp*, *R.E. Corp* would own 100 percent of the stock in *New Corp* and thus would control *New Corp*. In the exchange between *R.E. Corp* and *B*, *R.E. Corp* would be distributing to *B* only the stock of *New Corp*. Since *R.E. Corp*'s distribution would consist solely of stock of a corporation which it controlled immediately before the distribution, the proposed split-off would satisfy the first statutory requirement.

Throughout this Note, it has been assumed that *R.E. Corp* will distribute only stock of *New Corp* to *B*. If *R.E. Corp* also distributes cash and/or other property to *B*, that cash or other property will constitute "boot." Section 356(a)(1) will require *B* to recognize any gain he may have on the exchange to the extent of the fair market value of such boot. Securities are normally considered to be boot,[69] but an exception is made in the case of securities of the controlled corporation.[70] When securities of the controlled corporation are distributed in a corporate division, they only constitute boot if their principal amount exceeds the principal amount of any securities surrendered in the exchange and the amount of boot is limited to the fair market value of the excess.[71] Thus, if no securities are surrendered in the exchange, the receipt of the controlled corporation's securities will be boot to the extent of their fair market value.[72] Section 356(a)(2) provides that a shareholder's gain on the receipt of boot in a corporate division will be taxed as a dividend if the exchange has the effect of a dividend distribution; otherwise the gain will be treated as a gain from the exchange of property.[73] Careful consideration must be given to the tax treatment of boot when anything in addition to the controlled corporation's stock is being distributed in a corporate division.

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69. I.R.C. § 356(d)(1).
70. I.R.C. § 356(d)(2).
71. I.R.C. § 356(d)(2)(C).
72. *Id.*
73. I.R.C. § 356(a)(2).

(2) The Stock Being Distributed

Section 355(a)(3)(B) states in part:

> stock of a controlled corporation acquired by the distributing corporation by reason of any transaction—
>
> (i) which occurs within 5 years of the distribution of such stock, *and*(ii) in which gain or loss was recognized in whole or in part,
>
> shall not be treated as stock of such controlled corporation, but as other property.[74]

The designation of stock as other property would cause section 356(a)(1) to apply, and would require a shareholder receiving the "other property" in a section 355 exchange to recognize gain, if any, but in an amount not in excess of the fair market value of the other property.[75] Therefore, if a shareholder receives only stock designated as other property in a section 355 distribution, he would be required to recognize his full gain on the exchange. In addition, section 356(c) would prohibit the shareholder from recognizing any loss which he may have incurred on the exchange.

Anytime a *new corporation* is formed for a split-off, the section 355(a)(3)(B) requirement can be met if the exchange between the distributing corporation and the new controlled corporation is structured to avoid the recognition of gain or loss. In addition, when the stock of an *existing subsidiary* is going to be split-off to a shareholder, the section 355(a)(3)(B) requirement can still be met, even though the distributing corporation acquired that stock in a transaction in which gain or loss was recognized, if the distributing corporation acquired that stock at least five years before its distribution to the shareholder.

The proposed *R.E. Corp—New Corp* and *R.E. Corp—B* exchanges ought to satisfy this requirement. Since *R.E. Corp* would not have acquired the *New Corp* stock at least five years before the distribution to *B*, the requirement in section 355(a)(3)(B)(i) would not be met. If the exchange between *R.E. Corp* and *New Corp* were structured correctly, however, *R.E. Corp* would have acquired the stock in a transaction in which

74. I.R.C. § 355(a)(3)(B) (emphasis added).

75. *See supra* notes 69-73 and accompanying text.

neither gain nor loss was recognized in whole or in part, and thus the requirement in section 355(a)(3)(B)(ii) would be satisfied. Since section 355(a)(3)(B)(i) and (ii) are in the alternative,[76] the proposed split-off would satisfy the statutory requirement.[77]

(3) *The "Not a Device" Requirement*

Section 355(a)(1)(B) requires that the distribution in a tax-free split-off not be used principally as a device for the distribution of earnings and profits of the distributing corporation or the controlled corporation or both. The "not a device" requirement is aimed primarily at the spin-off situation. If a distributing corporation could spin off stock of a subsidiary to its shareholders in a tax-free transaction and those shareholders immediately sold the subsidiary stock to third parties, the shareholders of the distributing corporation would receive capital gains treat-ment on dividend income. Section 1.355-2(b) of the Federal Tax Regulations gives some general guidelines on the device limitation.[78]

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76. *See* I.R.C. § 355(a)(3)(B). Since § 355(a)(3)(B) deals with stock which will not be treated as controlled corporation stock, distributed stock not acquired by the distributing corporation in a transaction which falls under *both* section 355(a)(3)(B)(i) *and* (ii) will be treated as stock of the controlled corporation.

77. What about the distribution of stock of a newly created corporation acquired by the distributing corporation in a transaction in which the controlled corporation assumed liabilities which exceeded the distributing corporation's adjusted basis in the assets transferred to the controlled corporation? Clearly the transaction in which the controlled corporation's stock was acquired would fall under § 355(a)(3)(B)(i). If it also fell under § 355(a)(3)(B)(ii), the stock distributed to the distributing corporation's shareholders would not be treated as stock of the controlled corporation and would be taxed as boot. Since § 357(C)(1)(B) requires the distributing corporation to recognize gain on the transaction with the controlled corporation to the extent that the liabilities assumed by the controlled corporation exceed the distributing corporation's adjusted basis in the assets which were transferred to the controlled corporation, would the controlled corporation's stock which was distributed to the distributing corporation's shareholders be treated as other property and taxed by § 356 as boot? The answer appears to be "yes" if the Code is read literally. In Revenue Ruling 78-442, 1978-2 C.B. 143, however, the IRS answered this question in the taxpayer's favor. The Service ruled that Congress did not intend § 355(a)(3)(B)(ii) to apply to controlled corporation stock which is distributed in a corporate division when the gain recognized by the distributing corporation on its acquisition of such stock occurred in a transaction between the distributing and controlled corporations. Therefore, in the hypothetical situation proposed in this footnote, the distributed stock should be treated as controlled corporation stock.

78. Treas. Reg. § 1.355-2(b). In Revenue Ruling 64-147, 1964-1 C.B. 136, the IRS announced it would promulgate revised regulations to § 355. On January 21, 1977, the

If the purpose of the "not a device" requirement is to prevent shareholders from being taxed on distributions from the distributing corporation at capital gains rates when the distributions should be taxed as dividends, the requirement should not apply to a split-off. A corporation's distribution of its subsidiary's stock to one of its shareholders in exchange for all of the shareholder's stock in the distributing corporation would probably be treated as a redemption of the shareholder's interest in the distributing corporation if it did not qualify as a tax-free split-off under section 355.[79] Since the receipt of the subsidiary stock by the shareholder would not be taxed as a dividend to him, the tax-free split-off should not be viewed as a device for the distribution of earnings and profits.

Revenue Ruling 64-102 is the most comprehensive ruling that has dealt with the device question in a section 355 split-off.[80] The distributing corporation had acquired all of the stock of another corporation more than five years before the distribution. Each corporations had been actively engaged in business for more than five years. Management policy differences arose between a minority and a majority group of shareholders. All of the stock of the subsidiary corporation was distributed to the minority shareholders in exchange for all of their stock in the distributing corporation. The problem with the plan was that the minority group of shareholders owned one-third of the stock of the distributing corporation, but the value of the subsidiary

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Service issued Proposed Regulations to § 355. *See* 42 Fed. Reg. 2694 (1977). Congress has never approved the proposed regulations and thus the current regulations to § 355 have been in effect since 1960.

The proposed regulations substantially revised the current regulations on certain matters. One example of this is the abandonment of the geographical location test as the critical factor in determining separate business status. *See* BITTKER AND EUSTICE, *supra* note 48, at ¶ 13.05 n.72. For an in depth analysis of the changes made by the proposed regulations see Helfand, *Filling the Serbonian Bog With Quicksand—Proposed Section 355 Regulations Further Obscure Corporate Separations* (Part I) 5 J. CORP. TAX'N 345 (1978-79); (Part 2) 6 J. CORP. TAX'N 53 (1979-80); (Part 3); 6 J. CORP. TAX'N 133 (1979-80).

The proposed regulations reflect the Service's current position on § 355 issues and can be used as a guideline to the practitioner when dealing with § 355. *Id.* (Part 1) at 347. *But cf.* Rev. Proc. 81-41, 1981-2 C.B. 605 (checklist to follow when requesting a ruling under § 355 makes no reference to the proposed regulations).

79. *See* CORPORATE CAPITAL TRANSACTIONS COORDINATOR, *supra* note 14 at ¶ 35,179. *See also supra* text accompanying note 18. *But see infra* note 82.

80. 1964-1 C.B. 136.

corporation was less than one-third of the value of the distributing corporation. To remedy this problem, the distributing corporation made a capital contribution of 13x dollars to the subsidiary corporation. After the capital contribution, but before the distribution of the subsidiary stock to the minority group shareholders, the stock of the distributing corporation had a value of 72x dollars and the stock of the subsidiary corporation had a value of 24x dollars. The minority shareholders' one-third of the distributing corporation's stock was then surrendered in exchange for all of the subsidiary's stock. The IRS noted that a section 355 transaction must not be used principally as a device for the distribution of earnings and profits and recognized that the distributing corporation's large contribution to the capital of the subsidiary immediately before the distribution of the subsidiary's stock to the minority group shareholders could be a problem. The IRS determined, however, that since the minority group shareholders were giving up all of their stock in the distributing corporation, the distribution, if considered taxable, would not result in dividend income to the minority group shareholders because the exchange would qualify as a complete redemption of their interest in the distributing corporation under section 302(b)(3). The Service went on to rule that "there [could] be no device to distribute earnings and profits (that is, to convert dividend income into capital gains) because of the non-pro rata distribution."[81]

81. *Id.* at 138. For a similar ruling by the IRS see Revenue Ruling 56-655, 1956-2 C.B. 214 (no device problems found when cash was transferred from a corporation's furniture business to its appliance business in order to equalize the values of the businesses).

Another area into which this "not a device" requirement spills is the active business requirement, *supra* text accompanying notes 83-145. After a corporate division, all corporations involved in the division must be engaged in the active conduct of a trade or business. *Id.* While a corporation which is engaged in the active conduct of a trade or business will meet that requirement, if a large portion of its assets are not involved in the active conduct of a trade or business there is the potential for the corporate division to be treated as a device for the distribution of the corporation's earnings and profits. *See* Treas. Reg. § 1.355-2(b)(3). There is no specific percentage of a corporation's assets which must be devoted to the active conduct or a trade or business. Revenue Ruling 73-44, 1973-1 C.B. 182. In Revenue Ruling 64-102, *supra* note 80, the distribution of the stock of the controlled corporation was found not to be such a device, and it appears that over fifty percent of the controlled corporation's assets consisted of cash. *See supra* text accompanying notes 80-81. In Revenue Ruling 73-44, 1973-1 C.B. 182, a pro rata spin-off was found not to be such a device when less than fifty percent of the controlled corpora-

Revenue Ruling 64-102 demonstrates that the "not a device" requirement of section 355(a)(1)(B) should not be a problem in a split-off. Proposed Federal Tax Regulation section 1.355-2(c)(1) further supports this reasoning. It provides that the transaction is ordinarily not considered a device for the distribution of earnings and profits in any case in which a distribution would be treated as a section 302(a) redemption, with respect to each distributee, if not for the application of section 355.[82]

In the *A—B—R.E. Corp* hypothetical a split-off is used to effect the corporate separation, so there is no problem with the exchange between *R.E. Corp* and *B* meeting the "not a device" requirement of section 355.

(4) The Active Business Requirement

a) In General

Section 355(a)(1)(C) contains the provision relating to active trades or businesses, the most critical element of a tax-free split-off. Section 355(b) provides, in part, that the nonrecognition provisions of section 355(a) will apply to a distribution if the distributing corporation and the controlled corporation are engaged in the active conduct of trades or businesses immediately after the distribution. The nonrecognition provisions in section 355(a) also apply if the distributing corporation had no assets other than stock or securities in more than one controlled corporation and each of the controlled corporations is engaged immediately after the distribution in the active conduct of a trade or business.[83] This second method of satisfying the active businesses requirement, involving a holding company as the distributing corporation will not be discussed further.

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tion's assets were used in the active conduct of a trade or business (the majority of the assets were being used in a business which could not meet the five-year requirement).

82. Prop. Treas. Reg. § 1.355-2(c)(1). It should be noted that if a shareholder is having stock redeemed by the corporation and other shareholders in the corporation are in such shareholder's family, an exchange which might ordinarily qualify as a redemption under § 302(a) could fail to qualify because of the attribution rules of § 302(c). Since a split-off involving similar facts would not be treated as a redemption if taxable, the "not a device" requirement could become a problem.

83. I.R.C. § 355(b)(1)(B).

A threshold issue raised by section 355 is what amount of the distributing corporation's and the controlled corporation's assets must be used in an active trade or business.[84] Section 355(b) is silent on the requisite percentage of a corporation's assets which must be used in an active trade or business in order for that corporation to pass the test.[85] Thus, it appears that a corporation with as little as one percent of its assets being used in a qualified business would technically meet this requirement. The active businesses requirement is, however, only one of five statutory and two judicial requirements which must be satisfied in order for a corporate division to be tax-free.

For a corporation that uses a small amount of its assets in its business, the "not a device" requirement[86] is most likely the obstacle it will find preventing it from qualifying under section 355. In a pro rata corporate division the potential for the division to be used principally as a device for the distribution of the distributing corporation's earnings and profits is obvious, if the controlled corporation has mainly liquid assets which are not involved in an active trade or business. The shareholders can either sell the controlled corporation stock or liquidate the controlled corporation, and be taxed at capital gain rates, without giving up significant ownership in the distributing corporation or impairing its operations. In contrast, the "not a device" requirement should not be a problem if such a corporation is involved in a non-pro rata corporate division like the one found in the split-off proposal of the *A—B—R.E. Corp* hypothetical. Under these circumstances the distribution would probably be taxed as a redemption if it failed to qualify under section 355.[87] The standard for non-pro rata divisions is that after the corporate division, each corporation must be engaged in an active trade or business; there is no requirement for a specific percentage of the corporations' assets to be involved in those active businesses. Therefore, *A* and *B* should enjoy a great deal of flexibility in deciding which assets should remain in *R.E. Corp* and which assets should be transferred to *New Corp.*

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84. *See* I.R.C. § 355(b).

85. *Id.*

86. *See supra* text accompanying notes 78-82.

87. *See* CORPORATE CAPITAL TRANSACTIONS COORDINATOR, *supra* note 14 at ¶ 35,179. *See also supra* text accompanying note 18.

b) Active Conduct of a Trade or Business

Section 355(b)(2)(A) provides that a corporation will be treated as being engaged in the active conduct of a trade or business if and only if

> (A) it is engaged in the active conduct of a trade or business, or substantially all of its assets consist of stock and securities of a corporation controlled by it (immediately after the distribution) which is so engaged,
> (B) such trade or business has been actively conducted throughout the 5-year period ending on the date of the distribution,
> (C) such trade or business was not acquired within the period described in subparagraph (B) in a transaction in which gain or loss was recognized in whole or 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.[88]

A corporation must satisfy all four conditions under sections 355(b)(2)(A)-(D) to meet the test for the active conduct of a trade or business.[89] Subparagraph (A) allows a corporation to qualify if substantially all of its assets are the stock of its controlled subsidiary and the subsidiary is engaged in the active conduct of a trade or business.[90] Subparagraph B requires that a corporation's trade or business must have been actively conducted during five-year period ending on the date of distribu-

88. I.R.C. § 355(b)(2)(A)-(D)(emphasis added).

89. The subparagraphs are joined by the conjunctive "and."

90. In Revenue Procedure 77-37 the IRS announced that it will issue letter rulings on a proposed corporate division when § 355(b)(2)(A) is satisfied through a corporation's ownership of stock in another corporation only if ninety percent of the fair market value of the first corporation's *gross* assets are stock or securities of such controlled corporation. 1977-2 C.B. 568, 570.

tion. This requirement prevents the distributing corporation from using non-active business assets to start up a new business immediately before the distribution and then splitting-off either the new business or the distributing corporation's old business.[91] Subparagraph (C) prohibits the corporation's trade or business from qualifying if the business was acquired within the five-year period ending on the date of distribution in a transaction in which gain or loss was recognized. This limitation prevents the distributing corporation from otherwise avoiding the requirement in subparagraph (B) by simply using non-active business assets to buy an existing trade or business from a third party.[92] Finally, subparagraph (D) is intended to prevent a corporation from qualifying under subparagraph (A) if, within the five-year period ending on the date of distribution, the distributing corporation used non-active business assets to acquire control of a corporation which had been actively engaged in the conduct of a trade or business throughout the five-year period ending on the date of distribution, and either gain or loss was recognized on that acquisition.[93]

While section 355(b)(2) provides the requirements for the time period during which a corporation must be involved in an active trade or business,[94] as well as the manner in which the corporation can get involved in the trade or business,[95] nowhere does the Code define the phrase "active conduct of a trade or business." Section 1.355-1(c) of the Federal Treasury Regulations is an attempt by the IRS to define what business activities qualify under the code.[96] The regulation provides, 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 activities included in such group must include every operation which forms a part of, or a step in, the process of earning income or profit from such group. Such group of activities must ordinarily include the collection of income and the payment of expenses.[97]

91. I.R.C. § 355(b)(2)(B).
92. I.R.C. § 355(b)(2)(C).
93. I.R.C. § 355(b)(2)(D).
94. I.R.C. § 355(b)(2)(B).
95. I.R.C. § 355(b)(2)(C), (D).
96. Treas. Reg. § 1.355-(1)(c).
97. *Id.*

In its proposed regulations to section 355, the IRS has expanded this definition by stating that for a corporation to be actively conducting a trade or business, it must perform active and substantial management and operation functions.[98] The proposed regulations explain that the active conduct of a trade or business does not include the ownership and operation (including leasing) of real or personal property used in a trade or business, unless the owner performs significant services with respect to the operation and management of the property.[99] This might be particularly troublesome when rental buildings owned by real estate corporations are also used in part as the corporate offices. If a real estate corporation does not perform significant services with respect to the operation and management of the property, the leasing of space in that building to other tenants will not be treated as an active trade or business.[100] This is a potential problem which exists under both the present and proposed regulations. It is illustrated by two examples. In the first, a bank owned an eleven-story downtown office building. The first floor is occupied by the bank and the other ten floors are leased to tenants. The ten floors are rented, managed and maintained by the bank's real estate department. The activities in connection with the rental of the building qualified as an active trade or business.[101] In the second example, a bank owns a two-story building in a suburban area. The first floor and one-half of the second floor are occupied by the bank while the half of the second floor is rented to a local merchant for storage. The activities in connection with the rental of the storage space on the second floor were considered merely incidental to the banking business and not an active trade or business.[102] From this example it can be seen that a real estate corporation which occupies a substantial part of one of its rental buildings might not be considered engaged in the active conduct of a trade or business in respect to activities involving the rented portion of its building.

98. Prop. Treas. Reg. § 1.355-3(b)(2)(iii), 42 Fed. Reg. 2694 (1977).

99. Prop. Treas. Reg. § 1.355-3(b)(2)(iv)(B).

100. *See id.*

101. Treas. Reg. § 1.355-1(d) example (3) and Prop. Treas. Reg. § 1.355-3(c) example (4).

102. Treas. Reg. § 1.355-1(d) example (4) and Prop. Treas. Reg. § 1.355-3(c) example (5).

In *Rafferty v. Commissioner*,[103] the First Circuit Court of Appeals explained what it considered to be the active conduct of a trade or business. The court stated that "in order to be an active trade or business under section 355 a corporation must engage in entrepreneurial endeavors of such a nature and to such an extent as to qualitatively distinguish its operations from mere investments. Moreover, there should be objective indicia of such corporate operations."[104] The IRS has frequently applied this test in its rulings.[105]

The more precise question of how much corporate activity is needed to meet the active conduct of a trade or business requirement has been dealt with in several IRS rulings. In Revenue Ruling 79-394,[106] the distributing corporation, P, wanted to split-off the stock of one of its subsidiaries, Y, to one of its shareholders in exchange for all of that shareholder's stock in P. Y had been engaged for more than five years in the renting and leasing of commercial and residential real estate to unrelated third parties. Y continually looked for new properties. When a property was located, Y negotiated its purchase and financing, and the renovated the building to reflect its custom floor plan. Through advertising and investigation of tenant applications Y would rent the units in the building. Y negotiated all lease provisions and found new tenants when vacancies occurred. Y provided and paid for gas, water, electricity, sewage, and insurance for the properties, and paid the taxes assessed thereon. Y also provided day-to-day maintenance and repair services which included insect control, janitorial service, trash collection, ground maintenance, and heating, air conditioning and plumbing maintenance. In addition, Y routinely inspected the properties and repainted and refurbished the buildings when needed. The IRS ruled that Y's conduct of its rental activities demonstrated ample day-to-day management and operational activity and was sufficiently distinguishable from a passive investment in real estate. Thus Y was deemed to have been engaged in the active conduct of a trade or business and the split-off qualified for the non-recognition provisions of section 355.

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103. 452 F.2d 767 (1st Cir. 1971), *cert. denied*, 408 U.S. 922 (1972).
104. *Id.* at 772.
105. *See, e.g.*, Rev. Rul. 79-394, 1979-2 C.B. 141.
106. *Id.*

IRS Private Letter Ruling 7916017[107] also dealt with the split-up of a real estate corporation. The distributing corporation was in the business of owning numerous multiple tenant commercial and residential rental buildings. The distributing corporation managed all of the buildings and in most of them it provided the hot water as well as all cleaning and janitorial services. It performed its own rent collections and except for major repairs and renovations its employees made virtually all repairs to the building. Whenever there were vacacies advertisements were placed in newspapers and corporate employees spoke directly with real estate brokers. The distributing corporation had a full-time maintenance man, handyman, carpenter, and bookkeeper. In addition, it employed a part-time clerical worker and a number of resident and nonresident managers. Resident managers in each building accepted applications and showed the vacancies to interested persons. The corporation's employees engaged in supervising its overall operations including receiving complaints, reviewing rental applications, dealing with leasing agents, negotiating leases, collecting rents and dealing with evictions. They also negotiated with outside contractors for repairs and renovations, and supervised contract work, the preparation of vacant apartments, resident janitors, managers, and day-to-day maintenance. The taxpayer represented that over the five-year period before the request for a ruling was made, employment of persons performing the above duties remained relatively constant. Outside janitorial services were used from time to time when qualified janitorial personnel were unavailable. An outside cleaning service was used in the corporation's buildings having twenty or fewer tenants, but even there the corporation's employees still performed all minor repairs. Because of the substantial managerial and operational activities of the distributing corporation, the Service ruled that the corporation was engaged in the active conduct of a trade or business.

In Revenue Ruling 73-236,[108] the active conduct of a trade or business was not found to exist. A trust, which qualified as an association taxable as a corporation, was selling real estate that it developed and improved. The trust also leased some of the buildings which it constructed. To qualify as a real estate invest-

107. I.R.S. Letter Ruling (CCH) 7916017 (Jan. 16, 1979).
108. 1973-1 C.B. 183.

ment trust (REIT),[109] it transferred the business of selling real estate to a newly formed corporation and distributed the stock of the new corporation to its shareholders in a spin-off. The trust retained the real estate leasing properties, but in order to comply with REIT provisions, the business of leasing the real estate properties had to be managed and operated through an independent contractor. The IRS noted that section 355 connotes

> substantial management and operational activities directly carried on by the corporation itself. The activities of others outside the corporation, including independent contractors, may not be considered in determining whether the corporation itself is engaged in the active conduct of a trade or business for purposes of Section 355. However, the fact that a portion of a corporation's business activities is performed by independent contractors will not preclude the corporation from being engaged in the active conduct of a trade or business if the corporation itself directly performs active and substantial management and operational functions.[110]

Since the trust was involved in *no* active and substantial management or operational functions, the IRS ruled that the trust was not engaged in the active conduct of a trade or business, and thus, the spin-off could not qualify for the nonrecognition provision of section 355.

Revenue Ruling 73-236 may pose problems for real estate corporations that own shopping centers and hire unrelated real estate management companies to manage their properties. Since the activities of the unrelated management companies will not be considered in determining whether the corporation is engaged in the active conduct of a trade or business for purposes of section 355,[111] the corporation will probably have trouble meeting the requirement for this particular business. Furthermore, it is unlikely that a corporation that has its shopping centers managed by an unrelated management company would itself be directly performing active and substantial management and operational functions with regard to those shopping centers.[112]

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109. *See* I.R.C. §§ 856-860.
110. 1973-1 C.B. at 184.
111. *See id.*
112. To do so would defeat the purpose of hiring the real estate management

The above rulings lead to the conclusion that a real estate corporation engaged primarily in the leasing of property on a "net lease" basis will probably not be able to transact a tax-free split-off.[113] The difference between the managerial and operational activities of the trust in Revenue Ruling 73-236 and the managerial and operational activities of a corporation leasing property on a net lease basis are probably minimal. For example, in *Rafferty*,[114] a corporation which leased back real estate to its parent on a long-term fixed rental basis and merely collected rents and paid taxes on the property was determined not to have been engaged in the active conduct of a trade or business. A corporation involved in net leasing may increase its chances of having its businesses being considered "active" by carrying out substantial operational activities. These activities would include, for example, advertising vacancies, interviewing prospective tenants, negotiating all financing on the properties as well as negotiating with and securing contractors for repairs. It might also be helpful if the length of the leases were relatively short and required frequent renegotiation.[115]

Finally, one court has considered business practicalities and custom when deciding whether a "net lease" will support a finding of active conduct of a trade or business. In *King v. Commissioner*,[116] a subsidiary's only source of income for the five-year predistribution period was the rent collected on real estate being leased to its parent corporation on a net lease basis. The subsidiary performed activities necessary for the operation of a real estate leasing business. In its opinion, the court noted these activities and emphasized the following factors: (1) the net lease was the most advantageous method of doing business for the subsidiary given the unique factual situation involved; (2) the leases were bona fide and of a type customarily used in the industry in long term situations; and (3) the rentals paid were customary in

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company.

113. In Private Letter Ruling 7916017, *supra* note 107, it was specifically pointed out that none of the buildings of the corporation were leased on a net lease basis.

114. *Rafferty, supra* note 103.

115. Satisfying the requirement will also be made easier if only a portion of the properties are leased on a net lease basis. *See generally* Strobel, *How to Divide a Real Estate Corporation Without Immediate Recognition of Gain*, 11 TAX'N FOR LAWYERS 296, 300 (1983).

116. 458 F.2d 245 (6th Cir. 1972).

the industry. The court also noted that the subsidiary was not a sham corporation and there were valid business reasons for its existance. Because of these factors, the court reasoned, the subsidiary was actively conducting a trade or business and the nonrecognition provisions of section 355 were available to the parent corporation's shareholders.

Corporations like *R.E. Corp*, in the business of leasing commercial or residential real estate, might also own some unimproved land. The unimproved real estate could be held for investment purposes, for future development or for lease in its unimproved condition. For example, a corporation may lease unimproved land for use as a parking lot. When a corporation is engaged in the active conduct of one or more trades or businesses, the determination of whether this unimproved land is a part of an active trade or business may be important in satisfying the "not a device" requirement, particularly if the land constitutes a sizeable percentage of the corporation's assets.

Section 1.355-1(c)(1) of the regulations states that the holding of stock, securities, land or other property does not constitute an active trade or business. Since any stock or securities held by *R.E. Corp* will not be a part of its active business for the purposes of the "not a device" requirement, it follows that any land held for investment purposes by *R.E. Corp* will not be included either. Thus, any vacant land held by *R.E. Corp* for investment will probably not be treated as a part of an active business of *R.E. Corp*.

When considering whether vacant land held by *R.E. Corp* for future development will be a part of its active business, an obvious problem comes to mind: the difficulty distinguishing between vacant land held for future development and vacant land held for investment purposes. Typically, a corporation like *R.E. Corp* will buy vacant land with an eye towards both investment *and* development. It seems logical, however, that land held for future development should be considered part of an active business only when specific development plans have been drawn for that property and which would probably already be underway, if not for the corporate division. In almost any other situation, such land is essentially investment property which, as discussed earlier, will not be treated as a part of a corporation's active business. Thus, any vacant land held by *R.E. Corp* for future development will probably not be treated as part of an active business

either of *R.E. Corp.*

Whether vacant land rented to other parties can be considered part of an active business is a more difficult question. It is clear that renting vacant land will not, by itself, constitute an active trade or business.[117] However, when vacant land is being leased by a corporation also engaged in leasing developed real estate, it is not too difficult to consider that vacant land as being a passive part of the active business, particularly if there is a substantial link between the vacant land and the active business. For example, if the vacant land is adjacent to or near one of the corporation's rental buildings and is leased as a parking lot, the vacant land should be treated as a part of the corporation's active business of leasing space in the building if a substantial amount of the space in the parking lot is leased to people who either lease space in the building[118] or work in the building. The stronger the connection between the vacant land and the active business, the more likely it is the land will be considered a part of that business.

As noted earlier, the "not a device" requirement usually becomes a problem only in pro rata corporate divisions.[119] Then the classification of the vacant land as a part of an active business could be important in keeping the distribution from being labeled a "device." However, in the *A—B—R.E. Corp* hypothetical split-off it is not important whether any vacant land held by *R.E. Corp* is classified as a part of its active business.[120] Any specific application of the active business requirement to the *A—B—R.E. Corp* hypothetical could not be made without knowing specific facts about *R.E. Corp*'s properties and operations.[121]

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117. *See* Rev. Rul. 68-284, 1968-1 C.B. 143.

118. For example, a tenant in a building may rent some parking spaces to reserve for its customers or clients.

119. *See supra* notes 79-82 and accompanying text.

120. *See supra* text accompanying notes 86-87.

121. An attempt to apply the active business requirement to *R.E. Corp* and to *New Corp* would be meaningless without the extensive fabrication of background information. Instead, an effort was made to point out some of the potential problem areas the active business requirement creates for real estate corporations. In each different factual situation, not only will the problem areas mentioned need to be examined and dealt with but others as well. For an in depth look at the active business requirement see Cohen, *Corporate Separations—Active Business Requirements*, BNA TAX MGMT. PORTFOLIO 224 3rd (1981).

Under section 355 it used to be unclear whether a corporation that only conducted one business could separate it into two parts, retaining one and distributing the other to a subsidiary. Section 1.355-1(a) of the Federal Treasury Regulations states that section 355 does not apply to the division of a single business.[122] However, in both *Edmund P. Coady*[123] and *United States v. Marrett*[124] the IRS lost with this argument. In Revenue Ruling 64-147,[125] the Service stated it will follow the *Coady* and *Marrett* decisions, both of which allow section 355 to apply to the division of a single business. In addition, proposed regulations to section 355 also provide that a single business may be split-up into two businesses for section 355 purposes.[126]

c) Problems Arising Out of the "Five-Year" Condition

As noted earlier, one of the conditions which must be satisfied before a corporation will be treated as one engaged in the active conduct of a trade or business is the requirement of section 355(b)(2)(B) that the trade or business has been actively conducted throughout the five-year period ending on the date of distribution.[127] This "five-year" condition can be particularly troublesome when the business being divided has undergone changes during the five-year period, or when the distributing corporation conducts horizontally-integrated activities that could be considered either parts of a single business or separate businesses themselves. The problems in these two areas will be discussed separately. According to leading commentators, five factors should be considered in any examination of the "five-year" condition as it affects a specific factual situation. They are:

> (1) Whether the commencement of a business activity is an extension of the old business, or constitutes entry into a new and separate business; (2) whether a change of location constitutes an abandonment of the old business and the start of a new one, or merely the continuation of the old business at a new loca-

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122. Treas. Reg. § 1.355-1(a).
123. 33 T.C. 771 (1960), *aff'd*, Coady v. Commissioner, 299 F.2d 490 (6th Cir. 1961).
124. 325 F.2d 28 (5th Cir. 1963).
125. 1964-1 C.B. 136.
126. Prop. Treas. Reg. § 1.355-1(a).
127. *See supra* notes 88-93 and accompanying text.

tion; (3) whether a cessation of business activity followed by a resumption of activity constitutes a termination of the old business and the start of a new one, or is a continuation of the old business after a temporary lull; (4) whether expansion constitutes an entry into a new business; and (5) whether the source of funds behind an expansion is significant.[128]

A vertical division of a single business occurs when the business is split into two or more parts that are basically identical in make-up and function. After the division there would exist two or more smaller versions of the old single business. The "five-year" condition will not present a problem if the old business itself could have satisfied the condition. Each of the newly created businesses will satisfy the "five-year" condition by "tacking" on the old business' years of operation.[129] A problem may arise with a vertical division of a single business if the nature of the old business changed during the five-year period ending on the date of distribution. This potential obstacle is illustrated by the following example: Suppose in years one through ten X corporation owned multiple-tenant residential buildings and leased units in those buildings. In year eleven X acquired (or converted some of its residential buildings into) multiple-tenant commercial buildings and began leasing units in those buildings. Would X's business have changed enough for it to be considered a new business requiring a new five-year period for section 355(b) purposes? If by year fourteen X owned and leased units in solely multiple tenant commercial buildings, would X's business have become a new business again? Would X's five-year period begin in year one, year eleven or year fourteen? The answers to these questions are unclear.

The Service's position, as stated in the regulations, is that changes will be disregarded for the purposes of the "five-year" condition if they are not of a character as would constitute the acquisition of a new or different business.[130] The determination of whether a change was of such a character is very subjective, and there are few guidelines to follow. One private letter ruling[131] addressing this issue involved a corporation, Insurance,

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128. BITTKER AND EUSTICE, *supra* note 48, at ¶ 13.05, p. 13-33.

129. *Id.*

130. Treas. Reg. § 1.355-4(b)(3).

131. I.R.S. Private Letter Ruling 6107136590A (July 13, 1961)(available on LEXIS,

which was engaged in the insurance business and in the business of renting two adjacent residential apartment buildings. Insurance acquired one of the apartment buildings in 1950 and the other in 1953. In 1959, Insurance formed a subsidiary, Realty, and transferred the rental buildings to it. After the transfer, both buildings were razed and, by 1960, a new commercial building was erected on the property. The new building was rented for use as a restaurant and cocktail lounge. In late 1960, a request for a ruling was made to the IRS on whether Insurance could distribute Realty's stock to its shareholders tax-free under section 355. The Service ruled that given the construction of an entirely new building, different in type and use from the old buildings, the new building's rental constituted conduct of a new business beginning in 1960 rather than the continuation of the rental activities associated with the apartment buildings. The five-year active business requirement of section 355 had not been met and the distribution would not be tax-free.

The shareholders of a real estate corporation which is considering a section 355 corporate division should determine if any changes in the past five years have altered the corporation's business to the extent that it might appear to have discontinued its old business and started a new one. If so, a new five-year period, running from the date of the change, could be required for section 355(b) purposes.

The other area in which problems arise because of the "five-year" condition centers on determining whether the activities which qualified as the active conduct of a business make up a single integrated business or separate businesses. As stated above, in the past the IRS insisted that a single business could not be divided tax-free under section 355.[132] Thus, the Service would often try to argue that a distributing corporation's activities constituted a single business and because a single business could not be divided for the purposes of meeting the active businesses requirement of section 355, the division of the distributing corporation was not tax-free.[133] However, since the IRS has now agreed that a single business can be divided under section

FED TAX LIBRARY, P.R. File).

132. Treas. Reg. § 1.355-1(a).

133. *See supra* notes 123-124 and accompanying text.

355,[134] it will often argue that a distributing corporation's activities before the corporate division constitute more than one business. The significance of this argument rests on the "five-year" condition. If the activities of the distributing corporation truly constitute separate businesses, each business must possess its own five-year operational history. However, if the distributing corporation's activities are merely separable parts of one integrated business, then each part will share in the integrated business' operational history.[135]

The IRS formerly focused on the geographical locations of the corporation's activities in determining whether they constituted single or multiple businesses.[136] If operations were carried on in different states, the IRS often viewed those operations as constituting two different businesses.[137] In one instance, a corporation owned two retail clothing stores, one operated in the downtown area of a city and the other operated in the suburbs. The Service considered the corporation to be conducting two separate businesses.[138]

This view was particularly troublesome for real estate corporations owning different rental buildings in different parts of a city or county. Under the old test each building of the corporation probably had to meet the "five-year" condition individually. No tacking was permitted to the operations history of the corporation as a whole. Considering how often real estate corporations buy, sell and trade properties, it would be surprising if, at any one moment, all of a corporation's property had been operated by that corporation for five years. It would appear that only a very small real estate corporation holding a few properties for an extended period could have avoided this problem.

The primary method used by the IRS today to determine whether a corporation's activities constitute a single business or multiple businesses is to analyze the functional character of the particular activities being examined.[139] The focus is not on the location of the operations, but on whether the operations are re-

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134. *See supra* note 125-126 and accompanying text.

135. Bittker and Eustice, *supra* note 48, at ¶ 13.05, p. 13-32.

136. *Id.* at ¶ 13.04, p. 13-21.

137. *See* Treas. Reg. ¶ 1.355-1(d) Ex. 8, 9, 13-15.

138. Treas. Reg. § 1.355-1(d) Ex. 10.

139. Bittker and Eustice, *supra* note 48, at ¶ 13.04, p. 13-23.

ally doing the same thing, albeit in different locations.[140] In its proposed regulations to section 355, the Service has included an example in which a corporation owned a department store in the city of W for nine years.[141] Three years earlier the corporation built a branch store in the suburbs of W. The stores are located in different parts of the city but they are "operated as a single unit and have common advertising, bank accounts, billing, purchasing and management."[142] The corporation is deemed to have operated a single integrated business for nine years and the branch store is deemed to have been a part of the business for the full nine years for purposes of section 355.

This shift in focus from the geographical location of an operation to the functional character of an operation is obviously advantageous for real estate corporations. If the corporation's rental properties are managed through a central office and all bookkeeping, bank accounts, and advertising take place in that central office, it is likely the corporation will be considered to have only one integrated business. The more centrally run a corporation's operations are, the better the argument that the corporation has a single business.

The more distinctive and independent a corporation's activities the weaker its claim to a unified business history.[143] Thus, problems may exist for a real estate corporation with different types of rental property, such as commercial and residential, or single tenant and multiple tenant. This analysis was used in Revenue Ruling 57-190[144] causing a distribution to fail to qualify under section 355. The distributing corporation had been engaged in the sale and service of brand X automobiles since 1946. For more than five years prior to distribution, the corporation's operations had been carried out in two of its buildings (B and C) located some distance apart in the same city. In 1954 the corporation acquired a franchise for the sale and service of brand Y automobiles. It had been operated by the previous owner in a leased building adjoining building B. The corporation moved all its brand X operations to building C. Thereafter, it operated the

140. *Id.* at ¶ 13.04, pp. 13-23 to -24.

141. Prop. Treas. Reg. § 1.355-3(c) Ex. 12.

142. *Id.*

143. BITTKER AND EUSTICE, *supra* note 48, at ¶ 13.05.

144. 1957-1 C.B. 121.

brand X franchise in building C and the brand Y franchise in building B as well as the leased building adjoining it. In 1956, for valid business reasons, the distributing corporation formed a new corporation, transferring all the assets and liabilities of the brand X franchise to the new corporation in exchange for all the new corporation's stock, and distributed the new corporation's stock to its stockholders pro rata. The IRS ruled that while the new corporation was engaged in the active conduct of a trade or business, the distributing corporation was not. The theory behind the ruling was that the brand Y franchise was so different from the brand X franchise that they constituted two separate businesses, with each operating a singular automobile franchise rather than one integrated business operating two automobile franchises.

It is difficult to imagine two automobile dealerships so different that they could not be considered separate parts of the same business. While the dealerships in the ruling were operated in different parts of the same city, the IRS ruled that the brand X dealership which had formerly operated out of the two buildings was one single integrated business, so it would appear the geographical location test was not the basis for the ruling. The ruling apparently turns entirely on the distinction between the two brands of automobiles.

The analysis in Revenue Ruling 57-190 could create significant hurdles if applied to the split-off of a real estate corporation. If the corporation leased both residential and commercial property or single tenant and multiple tenant buildings, the Service could use Revenue Ruling 57-190 to determine that each kind of building was a separate business, and therefore needs its own five-year operational history. This area is very unclear for there appear to be no objective guidelines to follow; therefore, extreme care should be taken.[145]

(5) Distributing all the Stock and Securities In the Controlled Corporation

Section 355(a)(1)(D)(i) contains the provision which requires the distributing corporation in a tax-free split-off to dis-

145. For a private letter ruling which distinguishes between leasing commercial and residential real estate, *see supra* note 131.

tribute *all* of the stock and securities in the controlled corporation held by it before the distribution. There is an exception in section 355(a)(1)(D)(ii) that allows the distributing corporation to retain a portion of stock in the controlled corporation if the distributing corporation distributes

> an amount of stock in the controlled corporation constituting control within the meaning of Section 368(c), and it is established to the satisfaction of the Secretary that the retention by the distributing corporation of stock (or stock and securities) in the controlled corporation was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax.[146]

Section 368(c) defines "control" as the ownership of stock possessing at least eighty percent of the total combined voting power of all classes of stock entitled to vote and at least eighty percent of the total number of shares of all other classes of stock of the corporation.

In the case of a controlled corporation with only one class of stock, the distributing corporation must distribute at least eighty percent of the total number of shares of that stock to its shareholders to meet the requirement in section 355(a)(1)(D). In addition the distributing corporation must establish that any shares of the controlled corporation stock it does retain was not in pursuance of a plan having as one of its principal purposes the avoidance of federal income tax. The section 355 regulations do not suggest what might constitute a legitimate reason for the distributing corporation to retain a portion of the controlled corporation's stock.[147]

The proposed split-off in the *A—B—R.E. Corp* hypothetical can satisfy the section 355(a)(1)(D) requirement because *R.E. Corp* will distribute all of *New Corp*'s stock to *B*. The problems with this requirement for a tax-free split-off usually arise if the

146. I.R.C. § 355(a)(1)(D)(ii).

147. For examples of published rulings on this point see IRS Letter Ruling (CCH) 8015097 (Jan. 17, 1980)(retention by distributing corporation of five percent of the stock of controlled corporation deemed for a legitimate reason when distributing corporation needed such stock for use as collateral for financing which was necessary for corporation division to be effectuated); I.R.S. Letter Ruling (CCH) 8405017 (Oct. 28, 1983)(retention by distributing corporation of ten percent of the stock of controlled corporation for the purpose of raising needed capitol by selling said stock over the next five years ruled not to be in pursuance of a plan having as one of its purposes the avoidance of income tax).

subsidiary is already in existence at the time the split-off is proposed.[148]

B. *The Judicially Created Requirements for a Tax-Free Split-Off*

The courts have created two requirements in addition to those of section 355, in order to further what they deem to be Congress' intent in allowing tax-free corporate divisions.[149] The first is the "business purpose" rule.

> The distribution by a corporation of stock or securities of a controlled corporation to its shareholders . . . in exchange for its own securities will not qualify under section 355 where carried out for purposes not germane to the business of the corporation. The principal reason for this requirement is to limit the application of section 355 to certain specified distributions or exchanges with respect to the stock or securities of controlled corporations incident to such readjustment of corporate structures as is required by business exigencies. . . .[150]

Simply put, the "business purpose" rule requires that the reason for the corporate division must be the corporation's and not the shareholders'. Obviously, there may be shared reasons between the corporation and its shareholders in seeking a corporate division. However, as long as there are legitimate business reasons for the corporate division, the existence of shareholder reasons will not be a problem.

One of the more commonly accepted business reasons for the division of a corporation is to settle disputes among share-

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148. If a new corporation is formed for the purposes of a split-off, the exact amount of assets needed to equalize or proportionalize the values of the distributing and controlled corporations will be transfered to the controlled corporation. However, in the case of the split-off of an existing subsidiary, if the value of the controlled corporation exceeds the value of the stock held by the shareholders of the distributing corporation who will receive the controlled corporation stock, a distribution of 100 percent of the controlled corporation stock will not be fair to the remaining stockholders of the distributing corporation. Thus, some of the existing subsidiary's stock might have to be retained by the distributing corporation to remedy this situation. This would not appear to jeopardize § 355 treatment of the transaction.

149. BITTKER AND EUSTICE, *supra* note 48, at ¶ 13.09, *passim*. *See, e.g.*, Badanes v. Comm'r, 39 T.C. 410 (1962).

150. Treas. Reg. § 1.355-2(c).

holders.[151] If two groups of shareholders in a close corporation are involved in a dispute, the business could suffer while the fighting resolves itself. In the *A—B—R.E. Corp* hypothetical, if *A* wants to expand and purchase new properties but *B* does not think it is an advantageous time for real estate purchases and would rather renovate some of the *R.E. Corp*'s existing properties, the corporation could be at a virtual standstill until *A* and *B* come to an agreement. *R.E. Corp* might miss out on several profitable opportunities to either expand or remodel while the deadlock exists. By dividing *R.E. Corp* into two corporations, *A* could take his corporation and expand it by acquiring new properties while *B* could take his corporation and renovate the existing properties. In a closely-held real estate corporation disagreements on the expansion policy of the corporation are entirely understandable, especially in a fluctuating real estate market. Dividing the corporation to settle share-holder disputes, therefore, will normally be a valid business reason for division.

Examples of other valid reasons for dividing a corporation, are complying with a judicial decree or administrative order,[152] saving assets from nationalization by a foreign government,[153] complying with a decree of a foreign government requiring certain ownership percentages to be held by its citizens,[154] and simplifying matters in a public offering of the distributing corporation's stock.[155]

The other judicially created requirement for a tax-free corporate division is the "continuity of interest" rule. "Section 355

151. *See, e.g.*, Badanes v. Commissioner, 39 T.C. 410 (1962) (shareholders could no longer agree as to proper method for advancing their common business interest); Rev. Rul. 64-102, 1964-1 C.B. 136 (managerial policy differences); I.R.S. Letter Ruling (CCH) 8202061 (Oct. 15, 1981)(serious shareholder disputes having adverse impact on the operations of the distributing corporation); I.R.S. Letter Ruling (CCH) 8304103 (Oct. 27, 1982)(severe disputes over the operations and management of distributing corporation); I.R.S. Letter Ruling (CCH) 8050050 (Sept. 18, 1980) (dissension between the shareholders concerning future activities of distributing corporation).

152. Rev. Rul. 83-114, 1982-32 I.R.B. 11; Rev. Rul. 75-406, 1975-2 C.B. 125.

153. Rev. Rul. 78-383, 1978-2 C.B. 142.

154. Rev. Rul. 83-23, 1983-5 I.R.B. 9.

155. Rev. Rul. 82-130, 1982-2 C.B. 83. Another area into which the business purpose of a corporate division has an impact is the requirement of the distribution of all of the controlled corporation's stock, or at least enough to constitute control, found in § 355(a)(1)(D). The business reasons which support the distribution of a controlled corporation's stock will usually require that all of the controlled corporation's stock be distributed. Treas. Reg. § 1.355-2(d)(2).

contemplates a continuity of the entire business enterprise under modified corporate forms and a *continuity* of interest in all or part of such business enterprise on the part of those persons who . . . were the owners of the enterprise prior to the distribution or exchange."[156] The continuity of interest rule arose from cases holding that the tax-free reorganization provisions may not be used to convert what is essentially a sale, into a tax-free transaction.[157] After the corporate division therefore, the two corporations must be owned by essentially the same shareholders who owned the distributing corporation before the distribution. It is not required that *each* shareholder own an interest in *each* corporation following non-pro rata distributions. Additionally, there is no definite time period during which the interests in the corporations must be maintained by the predivision shareholders. The sale of a shareholder's interest in one or both of the corporations, as the case may be, will at some point be deemed not to have violated the "continuity of interest" rule.

The "continuity of interest" rule can also be a subpart of the "not a device" requirement and in fact is referred to in the portion of the section 355 regulations which discuss the "device" requirement.[158] The regulations also provide that if a sale of stock is made after the distribution but not pursuant to an arrangement negotiated or agreed upon prior to the distribution, the mere fact that there was a sale *is not* determinative that the transaction was used principally as a device for the distributions of earnings and profits. However, such a circumstance *will* be evidence that the transaction was used principally as such a device.[159] The regulations infer that when a shareholder's con-

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156. Treas. Reg. § 1.355-2(c)(emphasis added).

157. BITTKER AND EUSTICE, *supra* note 48, at ¶ 13.09, pp. 13-52 to -53.

158. Treas. Reg. § 1.355-2(b).

159. *Id.* Examples of IRS rulings dealing with this issue are Rev. Rul. 83-114, 1983-32 I.R.B. 11 (distribution of controlled corporation's stock followed by a prearranged merger of an unrelated corporation into the controlled corporation was not in itself a sufficient basis for determining that the transaction was a device); Rev. Rul. 75-406, 1975-2 C.B. 125 (distribution of controlled corporation's stock quickly followed by a statutory merger of the controlled corporation into an unrelated corporation did not violate continuity of interest requirement); Rev. Rul. 77-377, 1977-2 C.B. 111 (pro rata split-up in which the estate of a shareholder took part followed by a § 303 redemption by the controlled corporations of some of the stock held by the estate ruled not to be a device when, at the time of the split-up, questions regarding the value of the estate's assets were unresolved); I.R.S. Letter Ruling (CCH) 7743085 (Aug. 1, 1977)(right of the distributing corporation's shareholders to elect to receive up to twenty percent cash from an

tinuity of interest is broken due to the sale of the stock distributed to him, the transaction that involved the distribution to the shareholder can potentially be characterized as principally a device for the distribution of earnings and profits. Thus, when the "break" occurs the IRS will look back to the date of distribution.

In summary, the "continuity of interest" rule has two effects. First, it prevents what is in substance a sale from being treated as a corporate division. This aspect will normally have its effect on the non-pro rata distribution occurring with a split-off or split-up. If a shareholder wants to terminate his interest in a close corporation and no buyer for his stock can be found, a cash-poor corporation might be forced into either redeeming that shareholder's stock in exchange for corporate property or selling some corporate property and redeeming the shareholder's stock with the proceeds of the sale. In either case, if appreciated property was involved, the corporation would probably have to recognize some gain. Without the continuity of interest rule a corporation, having found a buyer for assets which constitute an active business could transfer those assets into a newly formed controlled corporation and then distribute the controlled corporation stock to the terminating shareholder in exchange for his stock in the distributing corporation. The distributing corporation would have no gain on the transactions. The former stockholder could then immediately sell the previously controlled corporation stock to the buyer. The shareholder would be in the same tax position as he would have been under a redemption. The continuity of interest rule plugs this hole if the sale is made too soon after the distribution.

Second, the continuity of interest rule, when used in conjunction with the "not a device" requirement, helps stop some of the creative tax planning associated with attempted spin-offs. If the distributing corporation can transfer assets into a controlled corporation and distribute the controlled corporation stock pro rata to its shareholders, those shareholders could sell the controlled corporation stock, while being taxed at capital gain rates, without any dilution of their interests in the distributing corporation. However, the IRS uses the date of a shareholder's break

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unrelated corporation acquiring the controlled corporation in a merger when the spin-off may have been a device).

in continuity of interest as the time to determine whether the distribution of the controlled corporation stock was used principally as a device for the distribution of the earnings and profits of the distributing corporation. To avoid losing the benefits of the nonrecognition provisions of section 355, the shareholders must wait for a lengthy period before they can safely sell their controlled corporation stock.

The judicially created requirements to a tax-free corporate division must be examined in light of the specific facts surrounding a particular transaction. If, in the *A—B—R.E. Corp* hypothetical, *A* and *B* are having substantial differences of opinion on the managerial policies of *R.E. Corp*, the two judicially created requirements would probably not be a problem in the division of *R.E. Corp*, provided that after the split-off both *A* and *B* hold onto their respective interests for a sufficient interval of time.

IV. CONCLUSION

A split-off is a feasible alternative to redemption or sale of stock when the problem of serious shareholder disagreements arise in a closely-held real estate corporation. This Note attempts to point out advantages of a split-off and the procedures and requirements which must be met to qualify for its special tax treatment. All of the elements discussed should be carefully examined before attempting a split-off. Because of the intracacies of section 355, private letter rulings will, in most cases, be advisable to protect both the lawyer and his client.[160]

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160. Due to the complexities and uncertainties involved with qualifying a corporate division as a tax-free event, it is highly desirable to obtain an advance ruling on the proposed division from the IRS. L. Silton, *Taking Cash Out of the Closely-Held Corporation: Tax Opportunities, Strategies and Techniques* 184 (1980); Z. Cavitch, *Tax Planning for Corporations and Shareholders* § 9.06 (1984). The IRS has issued Revenue Procedure 81-41 to guide practitioners in drafting requests for a ruling under section 355. *See* 1981-2 C.B. 605.