Spin-Off Spins in Two Directions

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A SPIN-OFF SPINS IN TWO DIRECTIONS

I. Introduction: Facts

Before July 1, 1961, the Pacific Telephone and Telegraph Company [hereinafter referred to as "Pacific"], a subsidiary of American Telephone and Telegraph Company, provided service for the four-state area of California, Oregon, Washington, and Idaho. Because of the tremendous economic expansion in this area and for other business reasons, the Pacific management decided to divide the corporation. To this end a new corporation, Pacific Northwest Bell Telephone Company [hereinafter referred to as "Northwest"], was created. All the non-California assets of Pacific were transferred to Northwest pursuant to the following plan: the non-California assets and liabilities plus $110,000 in cash went to Northwest in return for the issuance of 30,460,000 shares of Northwest common stock and an interest-bearing demand note in the amount of $200,000,000. These transfers left Northwest with a capital structure similar to that of Pacific. The plan further required that Pacific offer to its shareholders the right to purchase, pro rata, all of the Northwest stock held by Pacific. The price of the stock and the number of offerings, however, were matters solely within the discretion of Pacific's management. The plan provided generally that these distributions and price decisions were to be made in response to the capital requirements of Pacific. It was anticipated that all of the Northwest stock would be distributed within three years.

Exercising its discretion, the Pacific management on September 20, 1961, issued one transferable stock right for each outstanding share of Pacific stock. In order to subscribe to one share of Northwest stock, each Pacific shareholder was required to submit six of these rights and sixteen dollars. This initial distribution transferred about 57% of the Northwest stock held by Pacific. This percentage was chosen by Pacific's management to enable American Telephone and Telegraph Company to gain control of Northwest immediately following the first phase of the distribution. On June 12, 1963, almost two years after the initial distribution, Pacific made the second and final offering of the remaining 43% of the Northwest stock. The terms of this offering required eight stock rights and sixteen dollars for one share of Northwest stock. Pacific adopted this rather complicated distribution scheme in order to divide its corporate organization along operational lines and simultaneously satisfy its very large requirements for additional capital to finance expansion.

Oscar E. Baan of Sausalito, California, and Irving Gordon of New York City held stock in Pacific prior to the distribution, and both took advantage of the distribution plan by acquiring shares in Northwest. Prior to the first offering, and in response to a request by the Pacific management, the Commissioner of Internal Revenue issued two ruling letters\(^2\) that concluded that the sale of the rights would produce ordinary income and that their exercise would produce taxable dividend income under section 301 of the Internal Revenue Code of

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1 The facts are set out in great detail in Oscar E. Baan, 45 T.C. 71, 72-86 (1965).
He further warned that the requirements for a tax-free stock distribution under section 355 were not met.

(a) Effect on Distributees.—

(A) a corporation (referred to in this section as the “distributing corporation”)—

(i) distributes to a shareholder, with respect to its stock, or

(ii) distributes to a security holder, in exchange for its securities, solely stock or securities of a corporation (referred to in this section as “controlled corporation”) which it controls immediately before the distribution.

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

(C) the requirements of subsection (b) (relating to active businesses) are satisfied, and

(D) as part of the distribution, the distributing corporation distributes—

(i) all of the stock and securities in the controlled corporation held by it immediately before the distribution, or

(ii) 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 or his delegate 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,

then no gain or loss shall be recognized to (and no amount shall be includable in the income of) such shareholder or security holder on the receipt of such stock or securities.

(2) Non Pro Rata Distributions, etc. — Paragraph (1) shall be applied without regard to the following:

(A) whether or not the distribution is pro rata with respect to all of the shareholders of the distributing corporation,

(B) whether or not the shareholder surrenders stock in the distributing corporation, and

(C) whether or not the distribution is in pursuance of a plan of reorganization (within the meaning of section 368 (a) (1) (D)).

(3) Limitation. — Paragraph (1) shall not apply if—

(A) the principal amount of the securities in the controlled corporation which are received exceeds the principal amount of the securities which are surrendered in connection with such distribution, or

(B) securities in the controlled corporation are received and no securities are surrendered in connection with such distribution.

For purposes of this section (other than paragraph (1) (D) of this subsection) and so much of section 356 as relates to this section, stock of a controlled corporation acquired by the distributing corporation by reason of any transaction which occurs within 5 years of the distribution of such stock and 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.

(4) Cross Reference. — For treatment of the distribution if any property is received which is not permitted to be received under this subsection (including an excess principal amount of securities received over securities surrendered), see section 356.

(b) Requirements as to Active Business.—

(1) In General. — Subsection (a) shall apply only if either—

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

(B) immediately before the distribution, the distributing corporation had no assets other than stock or securities in the controlled corporations and each of the controlled corporations is engaged immediately after the distribution in the active conduct of a trade or business.
After taxpayers Gordon and Baan exercised their stock rights, they took the position that their newly acquired stock was not taxable because it fell under the protection of section 355, and therefore neither taxpayer reported gain or loss in connection with his receipt of the Northwest shares. The Commissioner assessed deficiencies against both, restating his opinion letter to the effect that section 355 was inapplicable to this distribution, and because it did not apply, the taxpayers had realized dividend income to the extent that Northwest stock had a fair market value in excess of the subscription price.

In a consolidated case, the Tax Court decided that section 355 did apply and that the distribution to the taxpayers, Gordon and Baan, was tax free. The Commissioner appealed, taking taxpayer Baan, a resident of California, to the Ninth Circuit, and taxpayer Gordon, a resident of New York, to the Second Circuit. In Commissioner v. Gordon the Second Circuit affirmed for the taxpayer, but the Ninth Circuit held for the government in Commissioner v. Baan.

These opposite decisions, spawned by the same "spin-off" transaction, were the result of conflicting interpretations of section 355. However, before analyzing these two results, it is first necessary to study the elements of a spin-off transaction in order to understand the application of section 355 to the Pacific-Northwest arrangement.

II. The Spin-off

The spin-off is one of three methods commonly used to accomplish the divisive reorganization of a corporate structure. The other two devices are labeled the "split-up" and the "split-off." Although the methods of separation differ materially, the essential characteristic of all three is the distribution by a parent corporation to its shareholders of stock in a newly created or an existing subsidiary.

The Pacific transaction, illustrative of a typical spin-off, involved: 1) the

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5 Commissioner v. Gordon, 382 F.2d 499, 503 (2d Cir. 1967).
6 Oscar E. Baan, 45 T.C. 71 (1965).
7 Commissioner v. Gordon, 382 F.2d 499 (2d Cir. 1967).
8 Commissioner v. Baan, 382 F.2d 485 (9th Cir. 1967).
9 For purposes of explaining the differences between the three types of divisive reorganizations, we will assume that A, the original corporate party, manages two businesses, the x business and the y business.
creation of a new corporation, Northwest; 2) the transfer of assets representing an existing business to this new corporation in exchange for the newly issued shares of Northwest; 3) the control by Pacific of the Northwest shares immediately prior to distribution; 4) the distribution to Pacific stockholders of Northwest stock, by means of a stock option process, without requiring the return of any Pacific stock. Except for the intervention of the stock rights scheme, the Pacific plan is a classic example of the corporate spin-off.

Pacific rejected the conventional spin-off, partly because of various state law obstacles and, partly because the parent American Telephone and Telegraph corporation had filed a consolidated tax return that eliminated intercorporate dividends, making qualification under section 355 of little importance to the corporate management. To minority stockholders, Gordon and Baan, however, qualification under section 355 would effect substantial tax savings. “It is their position that regardless of what the Pacific management intended, the distribution should be given the preferred tax treatment provided by Section 355.”

III. Section 355

The taxation of divisive reorganizations is covered in the 1954 Code exclusively by section 355. If the requirements of this section are met, a corporate

Split-up: A forms two new corporations, B and C. A transfers the x business to B and the y business to C. In exchange, A receives the new stock of B and C. The stock of B and C in the hands of A is then distributed to A’s shareholders in return for their old A shares and then A liquidates. The old A shareholders thus own the same assets, but through two new corporations, B and C.

Split-off: A forms only one new corporation, B. A transfers the x business to B, but retains the y business. In exchange for the x business, A receives the new stock of B. The stock of B in the hands of A is then distributed to A’s shareholders in return for a portion of their old A shares. After this distribution, the shareholders own the same assets, but now they own the y business through the old corporation (A) and the x business through the new corporation (B).

Spin-off: This device is exactly like the split-off except that the A shareholders do not have to hand in any of their presently held A shares when the new stock (of B) is distributed to them. After this distribution, the shareholders do hold more stock through the two corporate entities, but the actual value of their holdings is not increased.

For a good breakdown of all three types, see B. BITTKE & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS § 11.01, at 450-51 (2 ed. 1966); J. REEVES, TAX ASPECTS OF CORPORATE MERGERS, EXCHANGES, REDEMPTIONS, LIQUIDATIONS AND REORGANIZATIONS 103-06 (1967); Jacobs, The Anatomy of a Spin Off, 1967 DUKE L.J. 1, 2-3 (1967).

11 Commissioner v. Gordon, 382 F.2d 499, 501-02 (2d Cir. 1967).
12 Id. at 502-03.
13 For the text of § 355, see note 4 supra. An examination of subchapter C, Part III, of the 1954 Code indicates a congressional intent to bring all divisive reorganizations under the purview of section 355. In order to prevent a tax-free division under the general reorganization section of the Code (§ 368), Congress added a clause at the end of section 368(a)(1) (D). The additional clause requires that a corporation forming a controlled subsidiary must distribute stock of the subsidiary to its shareholders in a transaction that qualifies under section 354, 355, or 356, in order to have a reorganization which qualifies under section 368. Section 368(a)(2)(A) requires that a transfer of assets that could qualify as a reorganization under both section 368(a)(1)(C) and (D) must be treated as falling under subparagraph (D) only.
All such transfers then must qualify under section 354 or 355. Section 354 applies to a reorganization under section 368(a)(1)(D) only if the transferee corporation acquires “substantially all of the assets” of the transferor corporation, and the transferor then distributes all its assets pursuant to a plan of reorganization. If only some of the assets are transferred or if the transferor does not liquidate then section 354 is inapplicable. A corporate division is not present if “substantially all” the assets of the transferor are turned over to
division with its resulting stock distribution can be effectuated with no recognition of gain, loss, or income attributed to the distributee shareholders. The section has been of little benefit to taxpayers, however, because of the restrictive attitude taken by the Commissioner of Internal Revenue. The Commissioner has consistently demanded that the facts of the transaction conform strictly to both the statute and the regulations.\textsuperscript{14} Thirteen years of cases and rulings on this section have produced seven basic requirements that must be satisfied if a corporate division is to be carried out with full tax benefit to the shareholders. These requirements are:

1) The subsidiary, whose stock is distributed to the parent stockholders, must be controlled by the distributing parent at the time of (immediately before) the distribution.\textsuperscript{15}

2) The controlling corporation must distribute all (or at least 80%) of the stock of the controlled subsidiary which it owns immediately before the distribution.\textsuperscript{16}

3) The distribution must not be used as a "device" for the distribution of earnings and profits of the distributing or controlled corporations.\textsuperscript{17}

4) Immediately after the distribution, both the distributing corporation and the controlled corporation must be engaged in the active conduct of a trade or business; or, if the assets of the distributing corporation consist solely of stock or securities in two or more controlled corporations (split-up), each of the controlled corporations must be so engaged.\textsuperscript{18}

5) The above requirement relating to the active conduct of a trade or business is satisfied only if the trade or business was conducted over the five-year period ending on the distribution date.\textsuperscript{19}

6) There must be a continuity of shareholder interest between the transferor parent company and the transferee controlled subsidiary.\textsuperscript{20}

7) There must be a valid business purpose behind the divisive reorganization.\textsuperscript{21} With these basic requirements in mind, we can now look to the conflict the transferee subsidiary, thus section 354 by its terms excludes what section 355 specifically includes. \textit{See} S. Rep. No. 1622, 83rd Cong., 2d Sess. 50-51 (1954); Simon, \textit{Tax-free Corporate Divisions: They Are Still a Danger Area After Ten Years}, J. TAXATION, vol. 23, July 1965, at 24.

\textsuperscript{14} \textit{See}, e.g., U.S. v. Marett, 325 F.2d 28 (5th Cir. 1963) where the Commissioner's attempt to enforce Treas. Reg. \textsection{} 1.355-1 (1955) was characterized as "... more than an attempt to put a 'gloss' on the statutory requirement." \textit{Id.} at 30.

\textsuperscript{15} \textit{Int. Rev. Code} of 1954, \textsection{} 355(a)(1)(A). The parent "controls" a subsidiary if it owns stock in the subsidiary giving it at least 80% of the total combined voting power of all the voting stock and at least 80% of the total of all other classes of the subsidiary's stock. \textit{Int. Rev. Code} of 1954, \textsection{} 368(e). The Treasury understands "all" other classes to mean "each" of the other classes. Rev. Rul. 59-259, 1959—2 Cum. Bull. 115.


\textsuperscript{17} \textit{Int. Rev. Code} of 1954, \textsection{} 355(b)(1)(B); Treas. Reg. \textsection{} 1.355-2(b) (1955).


\textsuperscript{20} Treas. Reg. \textsection{} 1.355-2(b)(1) and (c) (1955). In a split-off, the old shareholders must return at least 80% of the transferee's stock, but there are exceptions. In special situations new stockholders may be permitted to join without detrimental tax consequences, provided the circumstances disclose no intention to use the division as a device to distribute earnings and profits. Rev. Rul. 59-197, 1959—1 Cum. Bull. 77.

\textsuperscript{21} The business purpose rule is not a mandate of the statute itself. It traces its origins to a requirement stated in \textit{Gregory v. Helvering}, 293 U.S. 465 (1935). This requirement is now embodied in the Treasury Regulations at \textsection{} 1.355.2(c) (1955). This requirement is
in the two cases under discussion. Their final resolution will surely redefine and expand these requirements.

In the very beginning, it should be noted that the two appellate courts could not agree on the legislative purpose underlying the enactment of section 355, and this basic rift was responsible for the contrary decisions on the specific determinative issues in the two cases. The best approach in analyzing the two cases is to start with contentions of the Commissioner and the manner in which the Tax Court and each Circuit dealt with them. Four of these contentions framed the determinative issues in both courts. 1) The first and truly decisive question before both courts was the general one: How shall section 355 be construed? The Commissioner contended "... that Section 355 was merely a tax concession granted by Congress to permit certain narrowly defined transactions. He concludes that ... the statute is to be narrowly construed."22 (Emphasis added.) Assuming the validity of this preliminary argument, the Commissioner used it as the basis for his specific contentions. 2) The Commissioner contended in both cases that section 355(a)(1)(A)(i) required that stock of Northwest Telephone be distributed by Pacific with respect to the Pacific stock.23 In breaking this argument down for analysis, it falls into two parts. (A) In the first part of this contention, the Commissioner argued that the thing distributed must be stock, and that stock rights do not satisfy the statutory requirements. (B) Secondly, he contended that the distribution must be with respect to the Pacific stock and that the introduction of the sixteen dollars as a conversion requirement inserted an additional factor in the basis for distribution, and thus disrupted the continuity of shareholder interest, and took the transaction out of section 355. 3) The Commissioner contended further that there is an implied requirement in section 355 that the distribution of stock take place in a single offering. It was his view that because Pacific utilized a plan of distribution that called for two offerings separated by two years, and because the initial distribution did not transfer the 80% "control" required by section 355(a)(1)(D), the distribution failed to qualify under the section.24 4) Finally, he argued that, contrary to the requirement of section 355(b)(2)(C), Northwest acquired its assets from Pacific through a transaction in which gain was "recognized."25 These contentions and their respective answers from the Second and Ninth Circuits will be analyzed below.

IV. Construction

In Gordon and in Baan "... the truly decisive question before this Court
is how Section 355 shall be construed. On the one hand it was the view of Judge Moore in Gordon that corporate divisions are desirable as a matter of policy. While recognizing that corporate divisions represent an excellent way to "bail out" earnings, he seemed to imply that once the court is sure that the spin-off is not being used as such a "device" under section 355(a)(1)(B), judicial policy should lend encouragement to the divisive reorganization.

In contrast, Judge Hanley in Baan sketched the history of the section, emphasizing the restrictive nature of the various additions and amendments. He viewed the section as a congressional concession requiring each transaction to meet "carefully specified conditions."

Historically, congressional treatment of the spin-off transaction has not been consistent. Before 1924, a "split-off" and "split-up" were deemed nontaxable if accomplished as part of a corporate reorganization, but a spin-off did not receive this favorable tax treatment. The spin-off was considered to be a severance of assets of the distributing corporation and was taxable as ordinary dividend income. In the Revenue Act of 1924, Congress first permitted a spin-off division to operate tax free. Similar enactments followed the 1924 statute and continued this policy for the next ten years. But none of these acts placed any restriction as to what could be spun-off, and this created a loophole whereby dividend income could be converted into capital gains. A corporation would form a subsidiary, transfer all its liquid assets to the subsidiary and then place liquid assets in the hands of its shareholders by liquidating the subsidiary, thus enabling the shareholders to report the assets distributed as capital gains rather than ordinary dividends. This "bail out" of earnings and profits produced an unfavorable reaction in Congress, and in 1934, the spin-off section was eliminated from the Revenue Act.

In 1951, Congress reinstated the spin-off provision by adding section 112(b)(11) to the 1939 Code. This spin-off provision drew much tighter restrictions around the tax-free status accorded the spin-off transaction than

26 Commissioner v. Gordon, 382 F.2d 499, 503-04 (2d Cir. 1967).
27 Id. at 504.
29 For a thorough survey of the history of § 355, see B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders, § 11.02 (2d ed. 1966). For a case which discusses this history, see Parshelsky’s Estate v. Commissioner, 303 F.2d 14 (2d Cir. 1962).
33 Gregory v. Helvering, 293 U.S. 465 (1935), held that full compliance with the letter of the spin-off statute was not enough if the transaction was otherwise indistinguishable from an ordinary dividend.
The section provided that tax-free status was not to be extended to a spin-off if it appeared (1) that the transaction was used principally as a "device" for distributing earnings and profits to the shareholders of any corporation that was a party to the reorganization; and (2) that any corporation which was a party to such reorganization was not intended to continue in the active conduct of a trade or business after such reorganization. The 1951 enactment also provided that no tax-free distributions could be effected unless they were made pursuant to a reorganization under section 112(g)(1)(D).

The 1954 Code did not change the basic thrust of the 1951 law, but it did produce some substantial alterations. While setting out more intricate restrictions and generally providing a more extensive treatment of the spin-off transaction, the 1954 enactment nonetheless liberalized the 1951 law in many important respects. For example, the new law abolished the requirement that the distribution be made pursuant to a reorganization. Also, the distributing corporation is now permitted to retain stock and security of the previously controlled corporation, providing stock constituting "control" is distributed, and it can be established to the satisfaction of the Secretary that it is not pursuant to a plan having as one of its principle purposes the avoidance of federal income tax liability. The old law, however, was tightened by subsection 355(b) which introduced more elaborate restrictions and definitions into the "active business" requirement.

The Commissioner contends that section 355, as first enacted in 1951 and as it now appears in the 1954 Code, was only a concession by Congress to the business community, and, therefore, that its provisions should be tightly construed. As already noted, this is the view taken by Judge Hamley in Baan. This attitude, however, is not evident in the Senate Report which merely points out, "Section 355 corresponds to that portion of Section 112(b)(3) of the 1939 Code which relates to divisive reorganizations of corporations including 'split-ups' and 'split-offs' and to Section 112(b)(11) of such code relating to corporate 'spin-offs.'"

Because the question posed by the Commissioner's contention concerns the original intent of Congress in reinstating the spin-off provision, the answer lies in the legislative history of the 1951 enactment. The House committee report on the 1951 law sheds some interesting light on the problem. After describing the operation of a "spin-off" and its new tax-free status under the proposed provision, the committee report explained:

36 Id.
37 Id.
43 S. REP. No. 781, 82d Cong., 1st Sess. 57-58 (1951); also found in 1951-1 CUM. BULL. 499 (1951).
This section has been included in the bill because your committee believes that it is economically unsound to impede spin-offs which break-up businesses into a greater number of enterprises, when undertaken for legitimate business purposes.\textsuperscript{44}

This language seems to suggest that the encouragement of spin-offs is a good economic policy and, if made for a legitimate business purpose, they ought to be facilitated by means of favorable tax treatment. Of the two conflicting opinions, the one in \textit{Gordon} seems closer to the spirit of the committee report. It reads in part:

\begin{quote}
Congress recognized, of course, that corporate divisions are a perfect vehicle for bail-outs of earnings and profits and, therefore, hedged in the use of Section 355 with a number of conditions which must be met. But when the division presents no opportunity for a bail out, these conditions should not be so construed as to frustrate the basic congressional purpose.\textsuperscript{45}
\end{quote}

In accordance with this view, the \textit{Gordon} court looked at the transaction and, after determining that it was not a bail out or tax evasion "device," felt obliged to apply a liberal interpretation of section 355 to that transaction. This contrast between the two courts in their general approach to the section itself is further illustrated by the way they dealt with the three specific issues.

V. "Distributes... with respect to its stock... solely stock or securities"

Subsection 355(a)(1)(A) of the 1954 Code states one of the conditions with which a distribution must comply in order for a shareholder or security holder to claim the tax benefits of the section.

(a) Effect on Distributees.

(1) General Rule. If —

(A) a corporation (referred to in this section as the "distributing corporation") —

(i) distributes to a shareholder, with respect to its stock, or

(ii) distributes to a security holder, in exchange for its securities,

solely stock or securities of a corporation (referred to in this section as "controlled corporation") which it controls immediately before the distribution,

then no gain or loss shall be recognized ....

The Commissioner contended that subsection (a)(1)(A)(i) required that solely stock or securities of Northwest be distributed by Pacific with respect to the Pacific stock. Upon analysis, this contention has two parts: (1) that stock rights do not qualify as solely stock or securities under subsection (a)(1)(A)(i), and (2) that "distribution... with respect to its stock" means only stock or securities held by the shareholder and excludes the use of cash consideration or contribution as a basis for distribution.\textsuperscript{46}

The Commissioner took the position in the Tax Court that stock rights

\textsuperscript{44} Id.
\textsuperscript{45} Commissioner v. Gordon, 382 F.2d 499, 504 (2d Cir. 1967).
\textsuperscript{46} Oscar E. Baan, 45 T.C. 71, 90 (1965); Commissioner v. Gordon, 382 F.2d 499, 505 (2d Cir. 1967); Commissioner v. Baan, 382 F.2d 485, 492-93 (9th Cir. 1967).
do not come within the definition of "solely stock or securities" which words are used to define and limit the things that may be distributed under the section. Support for this view is found in the Income Tax Regulations at section 1.355-1(a). 47

Judge Raum in the Tax Court opinion labeled this interpretation "highly technical and inhospitable." 48 He pointed out that the Commissioner's argument assumes that the stock rights themselves, rather than the stock obtained by exercising those rights, were the subject of that distribution. It is clear that the distribution of rights or warrants on corporate equity may not be considered a distribution of corporate earnings and profit. 49 The only way that any income can be charged to the distributees and taxed under section 301 is by recognizing a distribution upon the exercise of the stock rights. When the rights are exercised the stock itself is distributed, and this distribution is clearly within the statutory language. According to Judge Raum's reasoning, we must look for the distribution only when the rights are exercised because it is the only distribution that could possibly be subject to taxation.

In the second part of his contention, the Commissioner shifted his emphasis from the thing distributed to the basis for the distribution. Here he urged that the phrase "with respect to its stock" means that the introduction of another basis of distribution, in this case the sixteen dollars of additional capital, violated the purpose of the subsection. That purpose, according to the Commissioner, is continuity of shareholder interest. The fundamental reason why no gain or loss is recognized under section 355 is that no tax should be imposed on the continuous ownership of the same assets by the same people when the only change is a formal, organizational one. 50 If a stock option method of distribution is coupled with a money payment plan, argued the Commissioner, the distributee stockholders may choose to sell their stock rights to outsiders rather than to make the cash payments required to convert the rights into stock. Thus, the door would be opened to "control" of the spun-off stock by new interests.

This argument was considered and rejected by the Tax Court. If Congress had intended that a distribution of the Northwest stock be treated as tax free when made without consideration it is inconceivable that it could have intended the transaction to result in taxable income to the distributees where they paid out money in connection with receiving such stock. 51

In the view of the Tax Court, the requirement that the distribution be made with respect to stock did not exclude an additional basis. Continuity of interest was not threatened because more than 80% of the shares were in fact finally distributed to Pacific stockholders, thus satisfying the control requirement of section 355 (a) (1) (D) (i) or (ii). Judge Raum apparently felt that because

47 Treas. Reg. § 1.355-1(a) (1955): "For the purpose of Section 355, stock rights or stock warrants are not included in the term 'stock and securities.' " For a good discussion of the phrase, "stock and securities," see 3 MERTENS, LAW OF FEDERAL INCOME TAXATION, § 20.67 (rev. 1965).
51 Oscar E. Baan, 45 T.C. 71, 90 (1965).
the crucial distribution took place when the rights were executed and because "control" did in fact pass to Pacific stockholders at that time, there was no problem with continuity of interest.\footnote{52}

In \textit{Gordon} the Second Circuit agreed with the Tax Court that the distribution of the warrants could not be taxed as such until executed and, when so executed, there was a distribution of "stock" within the meaning of section 355(a)(1)(A), and that continuity of interest was preserved since the distribution did \textit{in fact} pass control of the new company to the Pacific stockholders. On the issue of the significance of the sixteen dollars, however, the Second Circuit seemed to go further than the Tax Court. The Tax Court opinion seems to say that the addition of a consideration requirement does not violate the basis for distribution requirement in section 355(a)(1)(A), it just \textit{adds} another factor. The Second Circuit also discounted the sixteen dollar requirement but from a slightly different approach. Rather than characterizing the addition of consideration to the basis as a factor comprehended by the section, the Second Circuit reasoned that the money paid out by the shareholders and the distribution of stock were \textit{separate transactions}. Judge Moore argued that the two transactions should be re-separated for income tax purposes.\footnote{53} Pointing to instances when the Commissioner had used this step-transaction approach himself,\footnote{54} the judge asserted that this type of separation should be employed whenever necessary to accomplish the economic purposes of the statute.\footnote{55} But he was careful to add that such a separation of transactions should never be used when "... the coupling itself is promotive of the evils which the taxing statute was designed to prevent ...."\footnote{56} By taking this approach rather than the simpler Tax Court rationale, the Second Circuit seems to hold by implication that if the consideration is not so separated from the distribution, the distribution would fail. Separation saves the transaction. Thus, in \textit{Gordon} the emphasis shifts from the distribution itself to the question of whether or not the taxpayer can take advantage of the "step-transaction" approach. The Commissioner is generally privileged to disregard form and separate steps in favor of overall substance,\footnote{57} but the taxpayer, on his part, has had a difficult time obtaining the benefit of this reasoning.\footnote{58}

\textit{Notes}

\footnote{52}{Oscar E. Baan, 45 T.C. 71, 94 n.9 (1965). \textit{See also} Commissioner v. Baan, 382 F.2d 495 n.17 (9th Cir. 1967).}

\footnote{53}{Commissioner v. Gordon, 382 F.2d 499, 506 (2d Cir. 1967).}


\footnote{55}{Commissioner v. Gordon, 382 F.2d 499, 506 (2d Cir. 1967).}

\footnote{56}{\textit{Id.} at 506.}

\footnote{57}{American Bantam Car Co. v. Commissioner, 11 T.C. 397 (1948); Rev. Rul. 61-156, 1961-2 CUM. BULL. 63 (1962).}

\footnote{58}{The step approach was denied the taxpayer in Heller v. Commissioner, 2 T.C. 371 (1943). "A given result at the end of a straight path is not made a different result because reached by following a devious path." Minnesota Tea Co. v. Helvering, 302 U.S. 609, 613 (1938). \textit{But see,} Mintz & Plumb, \textit{Step Transactions in Corporate Reorganizations}, 12 N.Y.U. 12TH INST. ON FED. TAX. 247, 248 (1954).}

There was a tendency in the earlier cases to apply the doctrine only in favor of the Government, while holding the taxpayer to the form he adopted and giving tax effect to each step. That may still be the situation where the form is adopted as a tax avoidance device, but in other situations it is no longer the rule. (Footnotes omitted.)
In *Baan* the Commissioner’s reasoning on the distribution argument prevailed where it had failed in the Tax Court and the Second Circuit. At the outset, the Ninth Circuit sidestepped the question of which distribution was crucial — the distribution of rights or the distribution of stock upon their execution. As Judge Hamley said:

> For present purposes we may assume that intercession of a stock rights scheme would not, standing alone, prevent a transfer of Northwest stock from Pacific to taxpayers from constituting a distribution with respect to taxpayers’ ownership of Pacific’s stock.59

“But,” he continued, “this stock rights scheme did not stand alone.”60 The stock rights scheme was coupled with the sixteen dollar consideration requirement and, in the view of Judge Hamley, resembled a sale of corporate assets, which is not a type of “distribution” contemplated by section 355. He thus agreed with the Commissioner that throughout the Code the phrase “distributes . . . with respect to stock” means a distribution without consideration. The taxpayer took exception to this point by referring to section 301 of the Code which also covers distributions made by a corporation to a shareholder “. . . with respect to its stock . . .”61 The taxpayer contended that the Commissioner had taken inconsistent positions on this point. On the one hand, he claimed that money paid by the shareholders in connection with a section 355 distribution is enough to take the transaction out of the section, but the same payment does not take the distribution out of section 301 even though the same language is used.62

Judge Hamley answered by pointing out that section 301 relates to the distribution of property, as defined in section 317 (a), while section 355 relates to “solely stock or securities.”63 Stock rights are property within the coverage of section 301, but not “stock or securities” within the scope of section 355.64 In holding that consideration is not contemplated in the phrase “with respect to stock,” the judge attempted to distinguish section 301 distributions on the basis of what is distributed to the shareholders. Section 301 distributions include stock rights, but section 355 distributions do not.65 What he seems to have done is to decide what he earlier sidestepped. He bypassed the stock rights scheme at first. But in order to hold that the distribution of rights is not within section 355, he could not bypass it.

The Tax Court case and the *Gordon* case had focused on the distribution after the stock rights were executed,66 but Judge Hamley focused on the distribution of the rights themselves. As he saw it, the distribution of rights indirectly represents taxable income because the amount of the dividend, determinable at the time the shareholder of the distributing corporation exercises his rights, is

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59 Commissioner v. *Baan*, 382 F.2d 485, 492 (9th Cir. 1967).
60 Id.
61 INT. REV. CODE OF 1954 § 301(a).
62 The Commissioner’s own regulations authorize the application of section 301 to a case where the distributee gives value. See Treas. Reg. § 1.301-1 (j), (k) (1955).
63 Commissioner v. *Baan*, 382 F.2d 485, 493 (9th Cir. 1967).
64 INT. REV. CODE OF 1954 § 317(a); Treas. Reg. § 1.355-1(a) (1955).
65 Commissioner v. *Baan*, 382 F.2d 485, 493 (9th Cir. 1967).
the difference between the market value of the stock and the purchase price called for by the stock rights. This “spread” can be determined either when the rights are issued or when they are executed, whichever is lower.67

This reasoning is ingenious but it does not satisfactorily answer the holding in the Tax Court that there is no taxable distribution at all until the rights are exercised. The determination of “spread” goes to the amount of the distribution that is taxable, it does not change the time when the distribution becomes taxable. If the Tax Court and Gordon are right about the crucial time for determining distribution, then Judge Hamley’s attempt to distinguish “distribution... with respect to stock” under section 355 cannot stand because it is based on the assumption that the things distributed under section 355 are stock rights.

Judge Hamley also took exception to the Tax Court’s holding that Congress could not want to exempt distributions without consideration and yet tax the same distribution where money was paid out by the distributee.68 He reasoned that it would be perfectly reasonable for Congress to recognize such a distinction because the basic assumption behind the tax concession in section 355 is that the same people continue to own the same assets, changing only the formal structure of their ownership. Congress could well conclude that this assumption would be undermined if distribution were by means of transferable stock rights, the exercise of which may require substantial cash payments that many shareholders will be unwilling to make. Being unwilling to make payment, many stockholders would sell the issued rights and thereby disrupt the continuity of interest.

This argument does make a valid point. Congress may very well have intended that the phrases “solely stock and securities” in section 355(a)(1)(A) act as a safeguard, protecting against schemes which could potentially undermine the continuity of interest provided for in section 355(a)(1)(D). The legislative history, however, does not indicate that Congress had any such intention,69 and the Commissioner himself has permitted new stockholders to join a distribution where the circumstances disclose no intention to use the division as a device to distribute earnings and profits.70

VI. A Single Distribution

The Commissioner argued that there is an implied requirement in section 355 that the distribution take place in a single offering and since Pacific utilized two offerings separated by almost two years, this statutory requirement had not been met. Although conceding the lack of direct authority on this point, he contended that the overall scheme of section 355, in particular subsection (a)(1)(D), demands such an interpretation. The subsection reads:

If —

68 Commissioner v. Baan, 382 F.2d 485, 495 (9th Cir. 1967). See also Oscar E. Baan, 45 T.C. 71, 90 (1965).
as part of the distribution, the distributing corporation distributes—

(i) all of the stock and securities in the controlled corporation held by it immediately before the distribution, or

(ii) 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 or his delegate 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, then no gain or loss shall be recognized to (and no amount shall be includible in the income of) such shareholder or security holder on the receipt of such stock or securities.\(^7\)

These requirements, contended the Commissioner, were designed to prevent periodic distribution of stock in the controlled corporation as a substitute for dividends.\(^7\) Thus, from the Commissioner's point of view, subsection (a)(1)(D) strengthens the anti-tax-avoidance device provision of subsection (a)(1)(B).

We do not have the benefit of Judge Raum's view on this contention because the Commissioner failed to raise the issue in the Tax Court.\(^7\) The two Circuit Courts did deal with the contention and they managed to spawn three points of view. In addition to the two conflicting court opinions, the third view is Judge Friendly's dissent in Gordon\(^7\) which concentrated on the single distribution issue.

The majority in Gordon felt that the Commissioner had taken an overstrained view of subsection (a)(1)(D) when he read into it the single distribution requirement. Judge Moore saw the subsection simply as the embodiment of the congressional decision that only complete, not partial divisions, were to receive tax-free status. To prevent abuse, the last phrase in subsection (a)(1)(D)(ii) was added not so much to duplicate the "device" provision in subsection (a)(1)(B), but rather to require the taxpayer to come forward with evidence that he had no tax avoidance objective when he partially retained the controlled company stock, instead of requiring the Commissioner to make the first move under subsection (a)(1)(B).\(^7\)

The majority in Gordon viewed the distribution from a transactional approach. If complete distribution is contemplated, then the tax-free provisions of section 355 will not be denied because the actual distributions take place in more than one phase. On this point, Judge Friendly vigorously dissented in Gordon. The main thrust of his dissent seems to be that by looking at the distribution as a transaction, the court has ignored the concept of the taxable year.\(^7\) At the end of 1961, 57% of the Northwest stock had been distributed. Looking at the 1961 return only, Pacific clearly did not pass the control necessary to fall under section 355.\(^7\) Friendly went even further, however, in adopting the

\(^{71}\) INT. REV. CODE OF 1954, § 355(a)(1)(D).

\(^{72}\) Commissioner v. Gordon, 382 F.2d 499, 508 (2d Cir. 1967).

\(^{73}\) Commissioner v. Baan, 382 F.2d 485, 496 n.19 (9th Cir. 1967).

\(^{74}\) Commissioner v. Gordon, 382 F.2d 499, 510 (2d Cir. 1967) (dissenting opinion).

\(^{75}\) Commissioner v. Gordon, 382 F.2d 499, 507 (2d Cir. 1967).


\(^{77}\) Commissioner v. Gordon, 382 F.2d 499, 511-12 (2d Cir. 1967) (dissenting opinion); INT. REV. CODE OF 1954, § 368(c).
Commissioner’s argument that section 355(a)(1)(D) must be interpreted as requiring a single distribution in any case. In his view, the ordinary meaning of subsection (a)(1)(D) is that Congress intended to offer a choice to corporations seeking division. Either they could distribute all the stock in the controlled corporation at one time with no questions asked, or they could distribute not less than 80% of the stock. If they choose the latter alternative, they must satisfy the Commissioner that they did not retain the stock for the purpose of tax evasion. Friendly argued that the words “...immediately before the distribution,” when read against the basic concept of annual tax accounting, can only mean to distribute all at one time.  

The majority in Baan adopted the same position as Judge Friendly’s dissent. Although they conceded that a multi-step corporate reorganization may be treated as a single entity when executed in pursuance of an antecedent agreement, they distinguished the Baan case because Pacific and Northwest had given no definite date on which the remaining shares would be distributed. The date depended on Pacific’s need for additional capital. This factor plus the gap of two taxable years between the phases of distribution led the court to conclude, as did Judge Friendly, that section 355 anticipates a single offering.

The committee reports contain very little mention of subsection (a)(1)(D), even though this provision makes its first appearance in the 1954 Code. The only authority on the question of whether the distribution must be accomplished in a single offering is the scholarship of Professors Bittker and Eustice who note that:

The committee reports on the 1954 Code do not explain this limitation [in Section 355(a)(1)(D)] on the retention of stock or securities by the distributing corporation, but presumably it was to prevent a parent corporation from making periodic distributions of small amounts of stock and securities in a subsidiary as a substitute for ordinary dividends.

After setting up this presumed purpose, however, they expose its weakness:

It is not clear, however, why periodic distributions of small amounts of the controlled corporation’s stock should be treated as a dividend, once

78 Commissioner v. Gordon, 382 F.2d 499, 513 (2d Cir. 1967) (dissenting opinion).
79 Commissioner v. Baan, 382 F.2d 485, 496-97 (9th Cir. 1967). The court did not hold that a single distribution was required, in the literal sense, because of the difficulties of administration. But they did hold that such distributions must not extend over any greater period of time than is reasonably necessary considering the practical problems involved in completing such distributions. Id. at 498.
80 See Portland Oil Co. v. Commissioner, 109 F.2d 479, 488 (1st Cir. 1940). Von’s Investment Co. v. Commissioner, 92 F.2d 861, 863 (9th Cir. 1937).
81 Commissioner v. Baan, 382 F.2d 485, 497-98 (9th Cir. 1967).

Subparagraph (D) of paragraph (1) requires that in order for a transaction to qualify under Section 355, the distributing corporation must distribute either all of the stock and securities of the controlled corporation, or an amount of stock constituting control within the meaning of Section 368(c) (i.e., 80 percent of the voting power and total number of shares), and the Secretary must be satisfied that no avoidance of taxes was intended. This requirement is a change from present law and the House bill.
the basic policy decision to permit a tax-free distribution of all of its stock and securities under § 355 was made. The theory that underlies § 355, if valid at all, seems as applicable to a partial separation of the controlled corporation as to a complete separation. Perhaps the draftsmen of § 355(a)(1)(D) were concerned about a distribution of part of the controlled corporation’s stock or securities in anticipation of a sale by the distributees. But the “device” language of § 355(a)(1)(B) serves as an independent restriction on sales, at least if they are prearranged; . . . and no reason suggests itself for imposing a more severe restriction on sale of all the stock received in a partial separation than on a sale of part of the stock received in a complete separation.84

This attack makes more sense than the presumption that they construct as a target. To contend that section 355(a)(1)(D) requires a single offering in all cases is certainly an extravagant application of judicial gloss.

It would seem that the Pacific transaction fails to qualify for a much more basic reason and that reason is the focal point of Judge Friendly’s dissent. Even if the distribution may be in the form of two or more separate offerings, the taxpayer should not be able to fall under the provisions of section 355(a)(1)(D) when his offerings cover more than one taxable year. At the end of 1961, the first Pacific offering had distributed about 57% of the Northwest stock. At the close of the taxable year, Pacific had not in fact distributed “control” as defined by section 368(c) and as required by section 355(a)(1)(D). The taxpayer argued that the transactional approach should be applied in this situation and pointed to Portland Oil Company v. Commissioner,85 and Von’s Investment Company v. Commissioner,86 both cases involving the taxation of reorganizations and both cases permitted the taxpayer to treat separate distributions as one transaction when they were executed pursuant to an antecedent agreement.87 An examination of both cases, however, reveals that although the distributions pursuant to the agreement were separate, they occurred within the same taxable year.88 It may very well be entirely consistent with the spirit of section 355(a)(1)(D) to permit separate offerings to be treated as one distribution if pursuant to an overall plan to distribute “control” to the shareholders, but the section should not be read so as to permit the distributing corporation the luxury of ignoring the concept of the taxable year.89

VII. Gain or Loss

Finally, the Commissioner argued that contrary to the requirement of section 355(b)(2)(C), Northwest acquired its telephone business from Pacific in a transaction in which gain was “recognized.”90 Subsection (b) provides in part as follows:

84 Id.
85 109 F.2d 479 (1st Cir. 1940).
86 92 F.2d 861 (9th Cir. 1937).
87 Portland Oil Co. v. Commissioner, 109 F.2d 479, 488 (1st Cir. 1940); Von’s Investment Co. v. Commissioner, 92 F.2d 861, 863 (9th Cir. 1937).
88 Portland Oil Co. v. Commissioner, 109 F.2d 479, 484 (1st Cir. 1940); Von’s Investment Co. v. Commissioner, 92 F.2d 861, 863 (9th Cir. 1937).
90 Oscar E. Baan, 45 T.C. 71, 92 (1965); Commissioner v. Gordon, 382 F.2d 499, 506 (2d Cir. 1967).
(b) Requirements as to active business.

(1) In General. Subsection (a) shall apply only if either—
(A) The distributing corporation, and the controlled corporation . . . is engaged immediately after the distribution in the active conduct of a trade or business, or

(2) Definition. For purposes of paragraph (1), a corporation shall be treated as engaged in the active conduct of a trade or business if— and only if—
(A) it is engaged in the active conduct of a trade or business, or substantially all of its assets consist of stock and securities of a corporation controlled by it (immediately after the distribution) which is so engaged,
(B) such trade or business has been actively conducted throughout the 5-year period ending on the date of the distribution,
(C) such trade or business was not acquired within the period described in subparagraph (B) in a transaction in which gain or loss was recognized in whole or in part. . . .

The Commissioner contended that the $200,000,000 note given by Northwest to Pacific was other property not protected by section 351(a), and because it was “boot,” the controlled corporation had acquired its business in a transaction in which gain or loss had been recognized within the prohibited five-year period of section 355.

During 1961, the year in which the asset stock exchange was consummated, both Pacific and Northwest were subsidiaries of American Telephone and Telegraph Company and joined with it in the filing of a consolidated return. Thus, any gain that may have resulted from the transaction had the exchanging companies been independent was eliminated by the consolidated return. The Commissioner, while conceding that no gain was in fact realized, still maintained that a gain was “recognized” within the terms of section 355(b)(2)(C).

The taxpayer’s defense was two-fold; he contended (1) that the note was security which, like stock, can be received without recognition of gain under section 351(a), and (2) that if no gain is realized because of the consolidated return, none is recognized under section 355(b)(2)(C).

The Tax Court never ruled on the taxpayer’s first contention because Judge Raum refused to accept the Commissioner’s distinction between gain that is “realized” and gain that is “recognized” for the purposes of section 351. Once this decision was made, then the elimination of gain or loss under the consolidated return regulations satisfied the no-recognition-of-gain-or-loss requirement of section 355(b)(2)(C).

91 INT. REV. CODE OF 1954, § 355(b).
92 Oscar E. Baan, 45 T.C. 71, 92 (1965).
93 Id. at 83.
94 Id. at 93.
95 Id. at 92.
96 Id. at 93-94.
97 Id. at 93.
98 The consolidated return regulations were changed in 1966 to provide that intercompany exchanges result in a recognition of gain to the exchanging parties, although the gain is deferred until a subsequent event. Treas. Reg. § 1.1502-13 (1966). This would seem to argue for a different result in future cases.
The Second Circuit agreed with the Tax Court, but for different reasons. Judge Moore felt that the purpose of subsections (b) (2) (C) and (D) argued against the Tax Court rationale. The subsections were included to eliminate the possibility that one corporation might purchase another corporation for the purpose of distributing its stock as a dividend, while avoiding the tax on dividends. This danger is not diminished because the corporations involved are affiliated. Looking again at the purpose behind the statute, however, Judge Moore held that section 355(b) (2) (C) was not meant to apply to the present fact situation. The real danger was that one corporation would bring new assets within its shell before or as part of a section 355 division. The draftsmen did not intend the subsection to reach intercorporate transfers where no new assets were brought within the shell of the dividing corporation. Judge Moore's point here is well taken. The active business requirement in section 355(b) seems to be directed at new assets and operations. New assets could be acquired from an affiliated company in violation of the purpose of the section, yet it would never show up on a consolidated return.

On the other hand, there is no danger that new assets will be acquired and distributed in a section 355 division when the transaction involves assets within the same corporate shell during the five years prior to distribution. The Senate committee report indicates that the requirement in subsection (b) (2) (C) applies to acquisition of the trade or business five years prior to the date of distribution. Because this provision is part of the active business requirement, it appears that the drafters were thinking primarily of acquisitions prior to the division, not acquisitions that are part of the division itself and involve only intercorporate property.

VIII. Conclusion

Both the Baan and the Gordon decisions argue well for their respective conclusions. The opinions were well reasoned and carefully written. The divergent results can be traced to the way both courts approached section 355. In Baan the court gave primary consideration to the danger of tax evasion inherent in corporate divisions. This view naturally led to a restrictive interpretation of section 355.

On the other hand, the Gordon court found a legislative intent to encourage legitimate corporate division, and facilitation of these divisions spawned a more liberal approach to the specific provisions of the section. The rationale behind the taxation of reorganizations generally is subject to either the Baan or Gordon analysis, and a resolution of this conflict by the Supreme Court could act as a directive in this unsettled area.

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99 Id. at 507.