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# Taxation--Corporate Spin-Offs--Reorganization Plan Must Distribute Eighty Percent Control To Qualify for Section 355 Nonrecognition Provision (Commissioner v. Gordon, U.S. 1968)

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to be determined and thus, introduces a degree of consistency and predictability of result into this area of law.

The essence of *Miller,* however, is not to be overlooked. The Court is not merely formulating an exact rule or standard to be procedurely applied but, instead, views interest analysis as merely representing a consideration to be employed in the establishment of a modern rule of law. Illustrative of this attitude is the Court's recognition of the significance of countervailing considerations which in its collective judgment should concern the disposition of justice in a modern court. *Miller,* therefore, does not, as contended by the dissent, adopt domicile per se as the controlling consideration. Rather, the Court establishes a flexible approach which seems to reduce the danger of such parochialism by qualitatively examining all relevant factors before a determination is reached.

## TAXATION — CORPORATE SPIN-OFFS — REORGANIZATION PLAN MUST DISTRIBUTE EIGHTY PERCENT CONTROL TO QUALIFY FOR SECTION 355 NONRECOGNITION PROVISION.

In 1961, Pacific Telephone and Telegraph Company (Pacific) established the Pacific Northwest Bell Telephone Company (Northwest) and transferred all of its non-California assets and $100,000 to Northwest in exchange for all the Northwest stock and a $2,000,000 demand note. In the same year Pacific distributed to its shareholders transferable rights to purchase fifty-seven percent of the Northwest stock at a price substantially less than its fair market value. The remaining forty-three percent was disposed of twenty-one months later through a similar offering. Taxpayers exercised almost all of their rights to acquire the Northwest stock, but failed to report the difference between the fair market value of the stock and the option price paid as income from stock dividends on their federal income tax returns. The Courts of Appeals for the Second and Ninth Circuits disagreed on the qualification of the Pacific spin-off for the nonrecognition of gain treatment that Section 355 of the Internal Revenue Code, under certain circumstances, affords to stockholders of a controlling corporation who receive shares of the controlled subsidiary. On certiorari, the United States Supreme Court *held* that the fifty-seven percent distribution in 1961 was not protected by the corporate spin-off exemption since section 355(a)(1)(D) requires that the distribution divest the controlling corporation of at least eghty percent control of the controlled corporation. This prerequisite could not be satisfied by the Pacific step-transaction plan which was too indefinite to unite the two separate distributions. *Commissioner v. Gordon,* 391 U.S. 83 (1968).

Congress first permitted tax-free treatment of corporate spin-offs[1] in Section 203(c) of the Revenue Act of 1924.[2] This Act expressly provided for such treatment since Congress believed that spin-offs were economically indistinguishable from split-offs[3] and split-ups,[4] which at that time could be effected without the recognition of gain.[5]

It soon became apparent, however, that the form of tax-free spin-off permitted by section 203(c) would lead to widespread tax avoidance. A corporation, instead of declaring a taxable dividend, could transfer cash or other liquid assets to a newly-formed corporation, and distribute the stock of this spun-off corporation to its own stockholders. The spun-off corporation, holding only liquid assets, could be liquidated a short time thereafter at capital gains rates. *Gregory v. Helvering*[6] was the classic case in which such a scheme was utilized. The Supreme Court held that mere compliance with the pertinent reorganization sections would not insure nonrecognition of gain if a bona-fide business purpose was not the motivating factor in the reorganization.

This decision necessitated drawing the sometimes difficult distinction between spin-offs serving a legitimate business purpose and those serving as a tax-avoidance device.[7] Congress reacted by repealing the provision,[8] and, after the passage of the Revenue Act of 1934, any stock received by a stockholder in a spin-off was taxable as a dividend to the extent that the fair market value of the stock reflected the profits of the parent corporation.[9] This was

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1 "A spin-off occurs when a part of the assets of a corporation is transferred to a new corporation and the stock in the latter is distributed to the shareholders of the original corporation without a surrender by the shareholders of stock in the distributing corporation." S. REP. No. 781, 82d Cong., 1st Sess. 57 (1951). *See generally* B. BITTKER, FEDERAL INCOME, ESTATE & GIFT TAXATION 705 (3d ed. 1964).

2 Revenue Act of 1924, ch. 234, 43 Stat. 253, 256-58.

3 In a split-off the stock of a corporate subsidiary is distributed to the parent's stockholders who in turn surrender part of their stock in the parent corporation. S. REP. No. 1622, 83d Cong., 2d Sess. 266-67 (1954). *See generally* B. BITTKER, FEDERAL INCOME, ESTATE & GIFT TAXATION 705 (3d ed. 1964).

4 In a split-up, those stockholders receiving stock in the subsidiary corporation surrender all of their stock in the parent corporation. B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 450-51 (2d ed. 1966).

5 H. R. REP. No. 179, 68th Cong., 1st Sess. 14 (1924).

6 293 U.S. 465 (1935).

7 Commissioner v. Wilson, 353 F.2d 184 (9th Cir. 1965); Parshelesky's Estate v. Commissioner, 303 F.2d 14 (2d Cir. 1962); 3 J. MERTENS, LAW OF FEDERAL INCOME TAXATION §§ 20.55, 20.101 (1965).

8 S. REP. No. 558, 73d Cong., 2d Sess. 16 (1934).

9 Revenue Act of 1934, ch. 277, 48 Stat. 680, 712.

true even when no tax avoidance scheme was present and the spin-off was serving a legitimate business interest.

In 1951, Congress once again examined its policy regarding spin-offs and was persuaded that business reasons could exist which would justify granting tax-free status to such reorganizations. Thus, nonrecognition of gain was once again restored in this area, but both corporations had to intend to continue to actively conduct business after the reorganization, and the spin-off could not be used principally as a device for the distribution of dividends.

With the enactment of the present Code, Congress decided to liberalize wherever possible the law concerning the nonrecognition of gain in cases which involved mere rearrangement of the corporate structure, and to remove unwarranted restrictions on necessary or desirable business transactions.[10] Congress undoubtedly intended to encourage divisive reorganizations effected for legitimate business purposes,[11] but it also had another purpose in revising the 1951 amendment. It also tightened the requirements of prior law, so that transactions which were in substance, though not in form, dividend distributions, would be taxable under the new Code at ordinary income rates.[12] As a result, the conditions which Section 355 of the Internal Revenue Code of 1954[13]

[10] S. REP. No. 1622, 83d Cong., 2d Sess. 42, 50, 266-67 (1954); H. R. REP. No. 1337, 83d Cong., 2d Sess. 34, 40, App. 120-22 (1954).

[11] This congressional determination to remove unnecessary impediments to tax-free reorganizations is apparent from the revisions made to the prior law. By section 355(a)(2)(A), pro rata distributions of stock are no longer necessary and subsection (a)(2)(B) has eliminated the necessity of surrendering stock in the parent corporation.

The rationale behind the nonrecognition of gain or loss that section 355 provides is the congressional belief that no tax should be imposed when the same people own the same exact business, the only change being in its form and structure. Treas. Reg. § 1.355-2(c) (1955).

[12] S. REP. No. 1622, 83d Cong., 2d Sess. 42 (1954); H. R. REP. No. 1337, 83d Cong., 2d Sess. 34 (1954).

This in part explains why the phrase "with respect to its stock" in section 355(a)(1)(A) replaced the more flexible clause "in pursuance of a plan of reorganization," and the addition of the word "solely" before "stock or securities." *See* Section 355(a)(2)(C) of the 1954 Code and Section 112(b)(11) of the 1939 Code. Also, the requirement of section 355(a)(1)(D) that at least 80 percent control be distributed eliminated the provisions which permitted post-spin-off control of the spun-off corporation to be shared by both the parent corporation and its stockholders. *See* Section 112(g)(1)(D) of the 1939 Code.

[13] Internal Revenue Code of 1954, § 355, provides in relevant parts:

(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 . . . solely stock or securities of a corporation (referred to in this section as "controlled corporation") which it controls immediately before the distribution, sets up are detailed and specific. The fact that it is an exemption section alone would require that its terms be strictly construed.[14] In addition, the extreme length and complexity of the section, imposing cumulative prerequisites to any nonrecognition of any gain or loss, reflect congressional wariness in dealing with an exemption which has previously been utilized in various tax avoidance schemes.

Section 355 requires that the distributing corporation distribute all of the stock and securities in the controlled corporation, or an amount constituting eighty percent control.[15] In light of the step-transactions utilized in the Pacific plan, it becomes relevant to examine previous judicial treatment of corporate reorganizations when control was divested in a series of steps. The courts have utilized the "step-transaction" theory to grant nonrecognition treatment to such divestitures. The rule is well established that all the steps which are an integral part of a plan of reorganization are to be considered as parts of a single transaction.[16] For example, the Ninth Circuit, examining a reorganization under Section 113(a)(7) of the 1928 Code in *Commissioner v. Schumacher Wall Board Corp.*,[17] held that the question of con-

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

(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 includible in the income of) such shareholder or security holder on the receipt of such stock or securities.

[14] Helvering v. Northwest Steel Mills, 311 U.S. 46, 49 (1940). For a criticism of this policy, however, see Griswold, *An Argument Against the Doctrine that Deductions Should Be Narrowly Construed as a Matter of Legislative Grace*, 56 HARV. L. REV. 1142 (1943).

[15] *Supra* note 13.

[16] Helvering v. Alabama Asphaltic Limestone Co., 315 U.S. 179, 184-85 (1942); *accord*, Dobson v. Commissioner, 320 U.S. 489 (1943).

[17] 93 F.2d 79, 81 (1937); *accord*, Transport Prod. Corp., 25 T.C. 853 (1956), *aff'd mem.*, 239 F.2d 859 (6th Cir. 1956); Portland Oil Co. v. Commissioner, 109 F.2d 479 (1st Cir. 1940); Case v. Commissioner, 103

trol is to be determined by the situation existing at the time of the plan's completion rather than at the termination of an intermediate step. This rule applies generally to all types of reorganizations which are treated in Subchapter C of the 1954 Code, including those under section 355.[18]

Tax-free reorganizations are frequently effected over a period of as many as several years.[19] This is permissible only because the transitory steps of a legitimate plan can be disregarded under the revenue acts when they add nothing of substance to the completed affair.[20] The Supreme Court, in *Helvering v. Alabama Asphaltic Limestone Co.,* characterized such steps as ". . . no more than intermediate procedural devices utilized to enable the new corporation to acquire all the assets of the old one pursuant to a single reorganization plan." [21] Thus, mere lapse of time between the various steps necessary to consummate a plan or reorganization has never been considered a basis for loss of the reorganization exemption status.

It is also recognized that the existence of a "formal plan" is not required to bring the "step-transaction" theory into play when one can be discovered from the circumstances surrounding the reorganization.[22] A review of the cases adopting this view, however, exhibits the presence of a firm commitment to complete the distribution.[23] In *Halliburton v. Commissioner,*[24] for ex-

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F.2d 283 (9th Cir. 1939); Von's Inv. Co. v. Commissioner, 92 F.2d 861 (9th Cir. 1937).

[18] Rev. Rul. 57-311, 1957-2 Cum. Bull. 243; *cf.* W. E. Gabriel Fabrication Co., 42 T.C. 545, 552 (1964), *acquiescence* 1965-1 Cum. Bull. 4.

[19] Moffatt v. Commissioner, 363 F.2d 262 (9th Cir. 1966), *cert. denied,* 386 U.S. 1016 (1967) (over two years between distributions); Pearson Hotel, Inc. v. United States, 199 F. Supp. 33 (N.D. Ill. 1959) (fifteen years between distributions); Roosevelt Hotel Co., 13 T.C. 399 (1949) (four years between distributions); D. W. Douglas, 37 B.T.A. 1122 (1938) (five years between distributions).

[20] Helvering v. Alabama Asphaltic Limestone Co., 315 U.S. 179, 184 (1942); *accord,* Helvering v. Bashford, 302 U.S. 454 (1938); United States v. Phellis, 257 U.S. 156 (1921).

[21] Helvering v. Alabama Asphaltic Limestone Co., 315 U.S. 179, 185 (1942).

[22] Transport Prod. Corp., 25 T.C. 853 (1956), *aff'd mem.,* 239 F.2d 859 (6th Cir. 1956) (finding plan in various discussions and negotiations); *accord,* Fowler Hosiery Co., 36 T.C. 201 (1961); International Inv. Corp., 11 T. C. 678 (1948), *aff'd mem.,* 175 F.2d 772 (3rd Cir. 1949).

[23] Burnside Veneer Co. v. Commissioner, 167 F.2d 214 (6th Cir. 1948) (board of directors' resolution directing corporation's officers to take all necessary and proper steps to immediately dissolve the corporation under North Carolina law); Commissioner v. Schumacher Wall Board Corp., 93 F.2d 79 (9th Cir. 1937) (a pre-existing contract binding the parties to so distribute found a sufficient commitment); Rinkel v. Knox, 196 F. Supp. 21 (D. Minn. 1961) (independent corporation bound by contract to acquire and distribute the stock of newly-formed corporation to its shareholders).

[24] 78 F.2d 265, 267 (9th Cir. 1935).

ample, the Ninth Circuit decided that a twenty-two day delay was immaterial when a pre-existing contract set out in detail the entire plan of transfer.

In the reorganization effected in the instant case, Pacific,[25] in order to achieve its own unique business objectives, strayed from the explicit directives of section 355 and constructed a rather unique stock distribution plan. It provided that only about fifty-seven percent of the Northwest stock would be offered to Pacific's stockholders immediately after the creation of Northwest, intending that the balance would be disposed of by Pacific in one or two subsequent offerings timed to meet its needs for additional capital. The plan also provided that, instead of distributing Northwest stock pro rata to the shareholders, Pacific would distribute to its stockholders transferable rights entitling the holders to purchase Northwest stock at an amount to be specified by Pacific's Board of Directors.[26] Under section 301,[27] however, any such distribution of property by a corporation to its stockholders out of accumulated earnings and profits is a dividend taxable as ordinary income unless some specific exemption section is applicable.[28] The Commissioner contended that the 1961 distribution of Northwest stock failed to qualify under

[25] Pacific, a subsidiary of the American Telephone and Telegraph Company, provided communications services in the far West. American at all times controlled approximately 90% of Pacific's stock.

[26] Pacific issued to its common stockholders one right for each share of Pacific. Six rights plus a payment of $16 were required to purchase one share of Northwest. The second distribution was similar in form to its 1961 counterpart, with the one exception that eight rights plus $16 were required to purchase one share of Northwest.

[27] Section 301(a) of the Internal Revenue Code of 1954 provides: "Except as otherwise provided in this chapter, a distribution of property (as defined in section 317(a)) made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c)."

Section 317(a) provides that "the term 'property' means money, securities, and any other property. . . ." Section 301(c)(1) provides that the "portion of the distribution which is a dividend (as defined in section 316) shall be included in gross income."

Section 316 provides that "the term 'dividend' means any distribution of property made of a corporation to its shareholders—(1) out of its earnings and profits. . . ."

Section 316(a) provides in part: "Except as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof. . . ."

[28] The fair market value of the Northwest stock on the date taxpayer Gordon exercised his rights was $26, while its value was $26.94 on the date taxpayer Baan exercised his rights. The Commissioner of Internal Revenue, regarding the differences between the market value and option price as a taxable dividend, subsequently determined that there was a deficiency owed by taxpayers for the year 1961.

section 355 in several different respects.[29] However, the Supreme Court, in remanding the cases to the Tax Court for further consideration,[30] rested its decision only on section 355(a)(1)(D).

It was in the Court of Appeals[31] that the Commissioner first contended that section 355(a)(1)(D) required that the stock of the controlled corporation be distributed in a single distribution. While the Supreme Court did not reach the issue in this case, both circuit courts considered this question of law on the merits and both rejected it.[23] The Commissioner argued alternatively that even if the "step-transaction" theory could be applied to spin-offs under section 355, Pacific's plan was too indefinite to be afforded such treatment. This is the precise issue on which the Supreme Court based its decision. It is obvious that Pacific's initial distribution in 1961 of fifty-seven percent of the Northwest stock transferred neither all of the Northwest stock held by Pacific prior to the spin-off, nor "control" as that term is defined in section 368(c).[33] Thus, unless Pacific's two separate distributions can be regarded as one under the "step-transaction" theory, the spin-off involved can not qualify for nonrecognition under section 355.

However, as the *Gordon* Court pointed out: "Clearly, if an initial transfer of less than a controlling interest in the controlled corporation is to be treated for tax purposes as a mere first step in the divestiture of control, it must at least be identifiable as

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[29] Commissioner v. Gordon, 391 U.S. 83, 94 n.7 (1968).

[30] The issue the Tax Court now must consider is whether the distribution of Northwest stock by Pacific met the requirements for nonrecognition stated in either section 354 or section 346(b) of the Code. *Id.* at 90-91.

[31] The two taxpayers had successfully contested the Commissioner's assessment of a deficiency against them in a consolidated action before the Tax Court, the court holding that the distribution qualified for the exemption treatment provided by section 355. Oscar E. Baan, 45 T.C. 71 (1965).

[32] The Second Circuit rejected this contention completely. Commissioner v. Gordon, 382 F.2d 499, 509 (2d Cir. 1967). The Ninth Circuit, however, while also rejecting the requirement of a single distribution, held that "such distributions must not extend over any greater period of time than is reasonably necessary . . .," and rejected the twenty-one month period which elapsed during Pacific's distribution as unreasonably long under the circumstances. Commissioner v. Baan, 382 F.2d 485, 498 (9th Cir. 1967). The Supreme Court did not reach the precise issue of whether (a)(1)(D) would prohibit or limit a divestiture of control committed from the outset but spread over a series of steps. Commissioner v. Gordon, 391 U.S. 83, 96-97 n.11 (1968).

[33] Section 368(c) of the Internal Revenue Code of 1954 provides in part that "the term 'control' means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation."

such at the time it is made."[34] It is this requirement which the Pacific plan failed to satisfy. The Second Circuit erroneously adopted the taxpayers' contention that the requirements of subsection (a)(1)(D) were met when Pacific distributed the remaining forty-three percent of the Northwest stock in 1963. That court had held that as long as the parent corporation has in fact distributed all the stock of the subsidiary at the time the issue arises, the requirements of this subsection have been fulfilled.[35] This, however, was an improper application of the *Halliburton* "formal plan" rule, for Pacific's plan clearly lacked the prerequisite firm commitment to distribute the remaining stock. The Second Circuit's holding was explicitly overruled by the Supreme Court in the instant case, observing that ". . . if one transaction is to be characterized as a 'first step' there must be a binding commitment to take the later steps."[36] The Court found that in the Northwest reorganization at no time prior to the second distribution did the Pacific stockholders have any enforceable rights to the remaining forty-three percent of the Northwest stock. Although its proxy statement stated that Pacific would offer fifty-seven percent of the Northwest stock promptly after acquiring its securities, as far as future distributions were concerned, Pacific's "Plan for Reorganization" only indicated that the balance of the stock would be offered for sale on one or more occasions within the next few years.[37] The prices were to be determined ". . . by the Board . . . [of Pacific] at the time of each offering."[38]

This plan left all the options to Pacific and no legal right to the balance of the stock to the stockholders. All the terms of the plan were left to the sole discretion of Pacific's Board of Directors, the only possible restraint being "the capital requirements of Pacific." As Judge Friendly pointed out in his *Gordon* dissent, a variety of events might have postponed Pacific's need for cash and as a result, precluded the further distribution of the remaining stock for many years.[39]

The Court did not reach the Commissioner's other contentions regarding Pacific's reorganization. However, with a view towards determining what requirements a corporation must fulfill in order to be granted nonrecognition treatment under subsection (a)(1)(D), it is interesting to examine their validity.[40] The Com-

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[34] Commissioner v. Gordon, 391 U.S. 83, 96 (1968).
[35] Commissioner v. Gordon, 382 F.2d. 499, 509 (2d Cir. 1967).
[36] Commissioner v. Gordon, 391 U.S. 83, 96 (1968).
[37] *Id.* at 97.
[38] *Id.*
[39] Commissioner v. Gordon, 382 F.2d 499, 511 (2d Cir. 1967).
[40] *See generally* Comment, *Corporate Tax: Spin-offs Under Section 355: Commissioner v. Baan and Commissioner v. Gordon*, 54 VA. L. REV.

missioner's contention that section 355 required a single distribution of stock was prompted by the frequent references in the section to things being done "immediately before," or "immediately after" the distribution, reasoning that this indicated a congressional intent that a single distribution be required. More likely, however, this section is simply the embodiment of the congressional decision that only complete and not partial divisions were to receive tax-free status.[41] For example, similar language is used in section 351, and is interpreted by Income Tax Regulations section 1.351-1(a)(1) as follows:

The phrase 'immediately after the exchange' does not necessarily require simultaneous exchanges by two or more persons, but comprehends a situation where the rights of the parties have been previously defined and the execution of the agreement proceeds with an expedition consistent with orderly procedure.[42]

The Commissioner contended that the principal purpose of subsection (a)(1)(D) was to prevent a parent corporation from making periodic distributions of small amounts of stock in a subsidiary as a substitute for ordinary dividends.[43] However, even Professor Bittker admits that such an abuse would clearly be prohibited by subsection (a)(1)(B).[44] The Commission is also free to draft appropriate regulations outlining time limits, specifying the number of steps permitted as part of a general plan, or defining any of the statutory language.

Strangest of all the Commissioner's contentions was the spectre of administrative chaos he raised as the probable result if reorganizations under section 355 were permitted to encompass different tax years. No administrative difficulties have previously been encountered in applying exemption provisions to such reorganizations.[45] Various procedures are available to the Com-

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295 (1968); Note, *Income Tax: Plans and Periodic Distributions under Section 355; Circuits Split on a New Judicial Gloss*, 56 CALIF. L. REV. 220 (1968); 81 HARV. L. REV. 482 (1967).

[41] 3 J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 20.102, at 512 (1965).

[42] Income Tax Regulations section 1.368-2(c) similarly interprets the phrase "immediately after the acquisition" in section 368(a)(1)(B) of the 1954 Code as permitting a series of acquisitions. And lastly, section 393(b)(1) of the 1954 Code clearly indicates that a section 355 spin-off be made pursuant to a plan: "a plan to make an exchange or distribution which is described in section 355...shall be treated as a plan of reorganization."

[43] B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS & SHAREHOLDERS 479 (2d ed. 1966).

[44] *Id.*

[45] Moffatt v. Commissioner, 363 F.2d 262 (9th Cir. 1966), *cert. denied*, 386 U.S. 1016 (1967) (over two years between distributions); Pearson

missioner to protect the revenue in the event a reorganization is not carried out according to plan. For instance, the Second Circuit pointed out that the Commissioner was free to draft reasonable revenue regulations to ameliorate any administrative problems which might occur.[46] In addition, by waiver of the statute of limitations, or by the assessment of taxes and the filing of claims for refunds, tax returns may be held open for final computation until the reorganization is completed. In view of the congressional intent to encourage business-motivated spin-offs whenever possible, it would be inconsistent to allow surmountable administrative problems to further complicate the already complex requirement of section 355.

Another objection raised by the Commissioner and left unanswered by the Court in the instant case related to subsection (a)(1)(A). The Commissioner contended that Pacific, by distributing rights rather than the stock itself, failed to distribute "solely stock or securities" as required by that subsection. Both the Tax Court and the Second Circuit correctly rejected this position, relying on the familiar "step-transaction" theory to hold the substance rather than the form of the transaction controlling —that the distribution in reality consisted of the stock itself and not the initial stock rights.[47] The distribution of a stock right has no tax consequences since there is no distribution of corporate property until the right is exercised.[48] It follows then that it was the actual distribution of the Northwest stock that was the taxable event

Hotel, Inc. v. United States, 199 F. Supp. 33 (N.D. Ill. 1959) (fifteen years between distributions); Roosevelt Hotel Co., 13 T.C. 399 (1949) (four years between distributions); D. W. Douglas, 37 B.T.A. 1122 (1938) (five years between distributions).

[46] Commissioner v. Gordon, 382 F.2d 499, 509 (2d Cir. 1967).

[47] Oscar E. Baan, 45 T.C. 71, 91 (1965); Commissioner v. Gordon, 382 F.2d 499, 505 (2d Cir. 1967). *See also* Carlberg v. United States, 281 F.2d 507 (8th Cir. 1960); William H. Bateman, 40 T.C. 408 (1963). The Ninth Circuit limited its holding to an assumption that the mere use of stock rights in Pacific's plan, without the requirement of consideration, would not disqualify it under section 355. Commissioner v. Baan, 382 F.2d 485, 492 (9th Cir. 1967). This is not a very significant holding, however, simply because stock rights are used in such reorganizations almost exclusively as a convenient method to raise capital.

[48] Palmer v. Commissioner, 302 U.S. 63 (1937); Miles v. Safe Deposit & Trust Co., 259 U.S. 247 (1922); Choate v. Commissioner, 129 F.2d 684 (2d Cir. 1942). In *Palmer* the Court held that the mere distribution of stock rights was not a dividend since the sales price represented the reasonable value of the stock at the time of issuance. Here there was a spread between the market value of the stock and its sales price. Thus this spread was a distribution of corporate assets and, upon exercise of the rights, was taxable as a dividend unless some exemption provision was applicable.

here,[49] with the rights serving merely as a transitory step in the final distribution thereof.

Lastly, the Commissioner contended that Pacific violated the subsection (a)(1)(A)(i) requirement of a distribution "to a shareholder, with respect to its stock," since a cash consideration was necessary for the exercise of the rights distributed. While the Court in the instant case did not consider this argument, the Tax Court rejection of it was in order:

Had it [Pacific] distributed the Northwest stock directly to its stockholders without consideration there would clearly have been the type of divisive organization contemplated by the statute, at least as far as subparagraph (A) is concerned. And in our view, the situation is not changed merely because that distribution was conditioned upon payment of $16 a share by distributees. . . . 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.[50]

The Ninth Circuit accepted the Commissioner's contention that the phrase "to a shareholder with respect to its stock" was a term of art, used consistently throughout the Code to describe situations in which a shareholder receives a share in corporate assets solely because of his status as such, and without the payment of any consideration.[51] The Commissioner cited no cases or authorities in support of this position, but did cite several other Code sections in analogy.[52] An examination of these sections,

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[49] There has been some suggestion that the expanded definition of property in section 317 of the 1954 Code has now made it possible to regard the mere issuance of rights as the taxable event. Whiteside, *Income Tax Consequences of Distributions of Stock Rights to Shareholders,* 66 YALE L.J. 1016, 1028-31 (1957); Comment, *Taxation of Stock Rights,* 51 CALIF. L. REV. 146, 151 (1963). But *Palmer* assumed that the rights were valuable at the date of issuance and yet still held they were not dividends. Similarly, stock rights to acquire more stock in the same company have been held to be a mere opportunity for the shareholders, in preference to strangers, to participate in contributing capital to the company. Miles v. Safe Deposit & Trust Co., 259 U.S. 247, 251-52 (1922). Nor is there any evidence that Congress intended to change *Palmer* and treat rights as taxable on issuance rather than exercise. Indeed, section 301 was presented as being a mere restatement of the provisions under section 115 (a, b, d, e, & j) of the 1928 Code. H. R. REP. No. 1377, 83d Cong., 2d Sess. A70 (1954); S. REP. No. 1622, 83d Cong., 2d Sess. 231 (1954). However, the Supreme Court did not reach the question in this case since, the rights having been both issued and exercised, the taxable event had clearly occurred. Commissioner v. Gordon, 391 U.S. 83, 89-90, n.4 (1968).

[50] Commissioner v. Baan, 45 T.C. 71, 90 (1965).

[51] Commissioner v. Baan, 382 F.2d 485, 493 (9th Cir. 1967).

[52] The Commissioner cited sections 301, 305, 307, 311, and 312. *Id.* at 493, n.11.

however, reveals that while the term is used to describe such distributions, the payment of consideration is certainly not prohibited. Section 355 itself indicates that consideration may indeed be required in such reorganization plans without their resultant disqualification. Section 355(a)(1)(A)(ii) permits a distribution ". . . to a security holder, in exchange for its securities, [of] solely stock or securities of a corporation. . . ." Subsection (a)(2) also permits an exchange of stock for stock in the distributing corporation. Section 1.301-1(J) of the Internal Revenue Regulations provides that a sale of corporate assets to the shareholders of a corporation at less than fair market value, is taxable as a dividend.[53] Such a sale then is considered a "distribution . . . by a corporation with respect to its stocks" under section 301(a).[54] This is the very section under which the Commissioner sought to tax Pacific's distribution. Thus, he was placed in the position of contending that a distribution for consideration was not a distribution "to a shareholder with respect to its stock," at the same time he was urging that the transaction was a taxable "distribution . . . by a corporation with respect to its stock" under section 301(a). While he admitted that both sections referred to distributions by a corporation with respect to its stock, he attempted to escape this inconsistency by urging that section 355 related this provision to the distribution of "solely stock or securities" while section 301 related it to the distribution of "property as defined in Section 317(a)." Section 317(a) does not limit its definition of property to stock, but includes under it "any other property." The Commissioner concluded then that Pacific's distribution of stock rights requiring a cash consideration was a distribution of property within the meaning of section 301, but not a distribution of solely stock or securities within the meaning of section 355.[55]

It is submitted that the Commissioner's position is erroneous in several respects. There is no justification for refusing to treat a corporation's sale of spun-off assets in a spin-off reorganization to its stockholders as a distribution under section 355. The spread between the option price and the market value of the Northwest stock did not represent a dividend, but was merely the means of effecting the distribution of the Northwest stock. The application

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[53] *See* Timberlake v. Commissioner, 132 F.2d 259 (4th Cir. 1942). *See generally* 1 J. MERTENS, LAW OF FEDERAL INCOME TAXATION, § 9.22 at 58 (1962).

[54] The Senate Finance Committee in its report on the 1954 Code also stated that section 301 had application only to distributions of property to shareholders in their capacity as such. S. REP. No. 1622, 83d Cong., 2d Sess. 231 (1954).

[55] Commissioner v. Baan, 382 F.2d 485 (9th Cir. 1967).

of the "step-transaction" theory transforms Pacific's initial distribution into that of the Northwest stock, with the stock rights serving merely as a mechanism to effect its final distribution. Section 355 was invoked by the taxpayers not in respect to the rights distributed, but to the stock received on their exercise. As stockholders of Pacific, they exercised these rights only to retain the same interest in Pacific which they held before the spin-off occurred.

The Commissioner also contended that the very issuance of transferrable rights was inconsistent with the general rationale behind the Code's reorganization provisions—that a mere change in corporate form has occurred when the shares of the two corporations resulting from the spin-off are owned by the same stockholders of the parent corporation. The Ninth Circuit rejected this contention, but did hold that a distribution "effectuated by means of transferable stock rights, the exercise of which required substantial cash payments"[56] would not qualify for nonrecognition treatment under section 355. The court reasoned that the likely result of such a plan would be that a substantial number of stockholders would sell their rights rather than make the necessary cash payment, thus destroying the continuity of interest required in such reorganizations.[57]

Since American owned approximately ninety percent of Pacific's stock, it was clear from the outset that continuity of interest would be retained. However, this is the exception rather than the rule. For example, of the minority stockholders, over one-third failed to acquire the Northwest stock to which they had received rights, despite the fact that its option price was substantially lower than its fair market value. Usually, it will be more probable that the continuity of interest requirement of subsection (a)(1)(D) will not be fulfilled whenever a corporation without a dominant shareholder effectuates the distribution of its stocks by transferable rights requiring cash consideration for their exercise. It is submitted however that this mere probability is not sufficient justification to declare all such distributions per se violative of section 355 safeguards.

Criticism of section 355 as being too narrow in scope would be manifestly unfair. Pacific simply failed to conform its elaborate reorganization plan, designed to satisfy its own unique business needs, to the requirements of the statute. What basically occurred

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56 Commissioner v. Baan, 382 F.2d 485, 492 (9th Cir. 1967).

57 *See* Helvering v. Minnesota Tea Co., 296 U.S. 378 (1935); Treas. Reg. § 1.355-2(c) (1955); B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS & STOCKHOLDERS 479, 508-16 (2d ed. 1966). If such continuity of interest is not present, the distribution then becomes, in effect, a mere sale to strangers.

was a bargain-sale[58] by Pacific of its assets in Washington, Idaho, and Oregon to its stockholders.[59] Pacific in turn used the proceeds of the sale to repay the funds which it had borrowed from American to finance its previous expansion. However, Pacific wanted only as much capital as it needed at that time, since any excess would only have to be invested temporarily at a low return. This was the underlying reason why only fifty-seven percent of the Northwest stock was distributed in 1961.[60] Accordingly, Pacific also took care to reserve the right to distribute the remaining stock at a time and price to be established at the discretion of its Board. Pacific did not commit itself in 1961 in regard to the future of its reorganization plan since it desired to retain its flexibility and fulfill its needs as they developed. In the very act of accomplishing its own business objectives, Pacific failed to satisfy the requirements of section 355. Such a plan is simply too indefinite to unite under the "step-transaction" theory the eventual second distribution with the initial one.

While disqualification of Pacific's reorganization may seem harsh, it should be clear that Congress did leave Pacific alternative courses of conduct. Pacific could well have distributed "control" immediately. Thus Pacifice could have held the remaining twenty percent indefinitely, retaining at least partially its flexibility to fulfill cash needs as they arose. On the other hand, Pacific could have sacrificed its flexibility somewhat by bringing its plan under the protection of the "step-transaction" doctrine. An initial distribution of fifty-six percent, accompanied by a firm commitment to distribute the remaining forty-four percent in installments at various specified dates, chosen on the basis of a projected study of its future cash needs, would have enabled Pacific to retain a large degree of flexibility and yet avoid any unfavorable investments at low returns. Or perhaps an initial distribution of fifty-

[58] A bargain-sale is a sale of corporate assets to the stockholders of a corporation at less than fair market value. The difference between the fair market value and the sale price is taxable as a dividend. *See generally* 1 J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 9.22, at 58 (1962).

[59] *See* Gibson v. Commissioner, 133 F.2d 308 (2d Cir. 1943).

[60] This percentage was also convenient in the sense that it effectively enabled American to acquire more than 50% control of Northwest. Pacific also feared that a simple distribution of Northwest stock would encounter obstacles under California corporate law. Pacific's attorneys had advised that if the Northwest stock was distributed without the payment of consideration by Pacific's shareholders, the distribution would have to be charged against its earned surplus. This earned surplus, however, would have been insufficient for this purpose unless a reduction surplus of capital was set up. Pacific was further advised that this reduction surplus could not be legally utilized under California law as long as any of its preferred shares remained outstanding. It is admitted that this advice was quite possibly erroneous. *See* Oscar E. Baan, 45 T.C. 79 (1965).

six percent accompanied by a firm commitment to distribute the remaining twenty-four percent needed to fulfill the "control" requirement, at a date chosen after similar studies, would have best suited Pacific's needs. Utilizing such a staggered distribution would have enabled Pacific to retain even more flexibility by holding the remaining twenty percent indefinitely for unexpected capital emergencies. Thus it is clear that subsection (a)(1)(D) does not inhibit in any great degree the type of refinancing program Pacific attempted here. A corporation with similar financial considerations will simply have to choose between the alternative methods of distribution available if nonrecognition treatment under section 355 is to be granted.

While section 355 has been successful in preventing the tax avoidance schemes, it is not yet clear whether its requirements are so complex as to also effectively hinder the type of corporate reorganization Congress wished to encourage. Thus far, each of the circuit courts in these cases has given extreme interpretations of this section. It is vitally important to avoid giving a revenue statute an overtechnical and forced reading. Thus a future rejection of the Commissioner's contentions regarding 355's requirement of a single distribution is in order. Yet a court must also give a statute its plain and rational meaning.[61] The Supreme Court recognized in this case that in addition to the subsection (a)(1)(B) requirement that the spin-off have a valid business objective, Congress saw fit to establish several other detailed and specific requirements which must be satisfied before nonrecognition will be granted.[62] At this point, however, the Supreme Court has limited its interpretation of section 355 to a holding that a plan must present a binding commitment to distribute the remaining shares of stock before two separate transactions made pursuant to it can be considered as one under the "step-transaction" doctrine.

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[61] Crane v. Commissioner, 331 U.S. 1 (1947).
[62] Commissioner v. Gordon, 391 U.S. 83, 91-92 (1968).