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Richard J. Albrecht

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RICHARD J. ALBRECHT*

Shareholders have a variety of reasons to divide one corporation into two or more separate corporations. They may wish to segregate a risky or speculative enterprise from a more stable one, or disputing shareholders may wish to split the businesses and go their separate ways.[1] Congress has responded to this need for corporate structural flexibility by granting tax-free treatment to certain corporate separations.[2] Since no viable economic change results from

* B.S. University of Minnesota, 1970; J.D., University of Minnesota, 1973; LL.M. (in Taxation), New York University, 1974. Mr. Albrecht is associated with Michael J. Christianson in Newport Beach, California.

1. Other business reasons for corporate divisions may be to comply with antitrust laws or decrees (e.g., by distributing some of the assets of an integrated business); to comply with state or foreign laws (e.g., a prohibition on combining several business functions in the same corporation); to separate a regulated enterprise from an unregulated one; to allow key employees to share in a corporation's ownership; to prepare for a sale of one or both of the corporations. B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS, ¶ 13.01, at 2 (3d ed. 1971); Z. CAVITCH, TAX PLANNING FOR CORPORATIONS AND SHAREHOLDERS, § 9.02, at 4-7 (1st ed. 1975); Note, *Section 355's Active Business Rule—An Outdated Inefficacy*, 24 VAND. L. REV. 955, 962-63 (1971).

2. *See* Jacobs, *Spin-Offs: The Pre-Distribution Two Business Rule—Edmund P. Coady and Beyond*, 19 TAX L. REV. 155, 156 (1963-64); Note,

a mere change in corporate form, Congress felt the taxation of gain should be deferred.[3]

However, these tax-free separations create the opportunity for tax avoidance. A corporation might transfer readily saleable asssets to a newly created subsidiary in exchange for stock of the subsidiary. The parent corporation could then effect a tax-free distribution or "bail-out"[4] of earnings by distributing the subsidiary's stock to its shareholders. The shareholders would in turn be free to sell the subsidiary's stock for capital gain and convert what would otherwise be ordinary income into capital gain. This could be done without impairing the operating efficiency of the corporation or affecting the equity interest of the shareholders. The weapon used to curb this potential for tax mischief is Section 355 of the Internal Revenue Code of 1954.

Section 355 provides, through elaborate rules, the exclusive means of dividing a single corporation in a tax-free manner.[5] Corporate divisions can be accomplished under this section in one of three ways: a spin-off, a split-off, or a split-up. A "spin-off" is a distribution by the distributing corporation of the stock of its controlled subsidiary to the shareholders of the distributing corporation with no change in the stock interest in the distributing corporation.[6] The "split-off" is identical to the spin-off except the

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Section 355's Active Business Rule—An Outdated Inefficacy, 24 VAND. L. REV. 955 (1971).

3. Note, *Section 355's Active Business Rule—An Outdated Inefficacy*, 24 VAND. L. REV. 955 (1971).

4. A "bail-out" usually refers to the withdrawal of corporate assets without impairing the shareholder's equity interest in his corporation's earning power. Implicit in the bail-out is the shareholder's ability to convert the withdrawn assets into cash at a capital gains rate, whereas a formal dividend distribution would result in ordinary income. B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS, ¶ 13.06, at 28 (3d ed. 1971).

5. Section 355 provides for nonrecognition, at the shareholder level, of gain or loss on stock distributed pursuant to the separation into two or more corporations of one or more businesses formerly operated by a single corporation. Section 355 has four basic requirements: (1) there must be a distribution by a corporation of stock or securities of a controlled corporation, as defined in § 368(c); (2) the transaction cannot be used principally as a device for the distribution of earnings and profits of either the distributing corporation or the controlled corporation; (3) the active business test must be satisfied; and (4) the distributing corporation must normally distribute all of its stock in the controlled corporation, and if it does not, it must distribute enough to constitute control (80%) and establish to the satisfaction of the Commissioner that retention of the stock was not in pursuance of a tax-avoidance plan.

6. The spin-off resembles a stock divided. *See* Jacobs, *Spin-Offs: The Anatomy of a Spin-Off*, 1967 DUKE L.J. 1, 2.

shareholders of the distributing corporation exchange part of their stock in the distributing corporation for stock of the controlled subsidiary.[7] Finally, in a "split-up," the distributing corporation distributes its stock in two controlled subsidiaries to its shareholders in exchange for all of their old stock.[8]

Section 355 contains two safeguards designed to prevent the potential tax abuse inherent in a spin-off: the "device" test and the "active business" test. Under the device test, the transaction must not be used "principally as a device" for the distribution of the earnings of either the distributing or the controlled corporation.[9] The purpose of this limitation is to confine the use of Section 355 to business motivated transactions.[10] As previously indicated, a tax-free corporate division places the shareholders in a position where a bail-out of earnings at a single capital gain tax is made possible. The device limitation attempts to prevent shareholders from extracting from the corporation, at a capital gain rate, a part of the corporation's assets under circumstances where the extraction should properly be taxed as an ordinary dividend distribution.

Under the active business test, both the distributing corporation and the controlled corporation must be engaged in the active con-

7. The split-off resembles a stock redemption. *See* Jacobs, *Spin-Offs: The Anatomy of a Spin-Off*, 1967 DUKE L.J. 1, 2-3.

8. Jacobs, *Spin-Offs: The Anatomy of a Spin-Off*, 1967 DUKE L.J. 1, 3. Even though each of the terms denotes a different transaction, the terms are frequently used interchangeably. The term spin-off is most commonly used to describe all three transactions. This article will also indulge in this short-cut.

9. INT. REV. CODE OF 1954, § 355(a)(1)(B) allows tax-free treatment only if:

> [T]he 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).

10. *See* Whitman, *Draining the Serobian Bog: A New Approach to Corporate Separations Under the 1954 Code*, 81 HARV. L. REV. 1194, 1234 *et seq.* (1968); Lee, *Functional Divisions and Other Corporate Separations Under Section 355 After Rafferty*, 27 TAX L. REV. 453, 474-98 (1972); Cordes, *The Device of Devisive Reorganizations. An Analysis of Section 355(a)(1)(B) and its Relation to Section 368(a)(1)(D) and the Doctrines of "Continuity of Interest" and "Business Purpose"*, 10 KAN. L. REV. 21 (1961).

duct of a trade or business immediately after the stock distribution.[11] Where the distributing corporation has no assets other than stock or securities in controlled corporations, each controlled corporation must be engaged in the active conduct of a trade or business. A corporation is engaged in the active conduct of a trade or business only if the trade or business has been actively conducted throughout the five-year period ending on the date of distribution. Furthermore, the trade or business must not have been acquired within the five-year period in a taxable transaction.[12]

The purpose of the active business requirement is to prohibit a corporation from separating its investment or liquid assets from its operating assets, transferring the former into a new corporation and then distributing the subsidiary's stock to its shareholders in anticipation of a future stock sale or liquidation, both taxed as capital gains.[13] The purpose of the five-year pre-distribution period

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11. INT. REV. CODE OF 1954, §§ 355(a)(1)(C) and 355(b). Section 355(b) provides:

(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.

(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, and

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

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

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

12. The business also must not have been conducted by another corporation, the control of which was acquired during the 5-year period in a taxable transaction. INT. REV. CODE OF 1954, § 355(b)(2)(D).

13. Masse, *Section 355: Disposal of Unwanted Assets in Connection with a Reorganization*, 22 TAX L. REV. 439, 445 (1967); Whitman, *Draining the*

is to prevent the temporary investment of liquid assets in a new and active business that could be spun-off without effecting any contraction of the corporation's original operating assets.[14]

Until recently most courts have focused more attention on the active business test than on the device test. The inquiry has been one of definition—whether a certain business was "active" or not.[15] The application of the test has been most troublesome in the area of rental real estate. This article examines the availability of a tax-free spin-off of rental real estate and the special difficulties that may be encountered in application of the active business test in this area. Three major issues arise:

(1) the degree of activity necessary to elevate the real estate activity to the status of an active trade or business;

(2) whether ownership of real estate occupied by the owner in the operation of its trade or business constitutes the active conduct of a trade or business;[16] and

(3) whether the active business requirement is met if a real estate agent or an independent contractor, commonly a real estate management firm, handles all of the major real estate activities, such as leasing, maintenance and operation.

The spin-off of real estate which has been occupied by its owner as a function of an integrated business[17] might not qualify for

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Serbonian Bog: A New Approach to Corporate Separations Under the 1954 Code, 81 HARV. L. REV. 1194, 1202-9 (1968); Note, *Section 355's Active Business Rule—An Outdated Inefficacy*, 24 VAND L. REV. 955, 957-61 (1971).

14. W.E. Gabriel Fabrication Co., 42 T.C. 545, 557 (1964), *acquiesced in* 1965-1 CUM. BULL. 4; Masse, *Section 355: Disposal of Unwanted Assets in Connection with a Reorganization*, 22 TAX L. REV. 439, 449 (1967); B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS, ¶ 13.04 at 5 (3d 1971); Cohen, Silverman, Tarleau & Warren, *The Internal Revenue Code of 1954, Corporate Distribution, Organizations and Reorganizations*, 68 HARV. L. REV. 393, 427 n. 255 (1955).

15. Whitman, *Draining the Serobian Bog: A New Approach to Corporate Separations Under the 1954 Code*, 81 HARV. L. REV. 1194, 1211 (1968).

16. This article will assume that real estate owned by a subsidiary and rented to the parent corporation constitutes owner-occupied real estate. The analysis should be no different merely because two parts of the business are owned by separate corporations. R. Cohen, *Corporate Separations—Active Business Requirement*, BNA TAX MANAGEMENT PORTFOLIO No. 224-2nd, at A-18 (1975).

17. The typical corporation is composed of different activities or functions which although part of the same business are designed to perform

tax-free treatment even though the real estate activities may have been sufficient to constitute an active trade or business had the property been rented solely to outsiders.[18] Similarly, tax-free treatment might be unavailable where the major rental activities have been conducted by an agent or independent contractor even though the activities may have been sufficient had they been performed directly by the controlled or the distributing corporation. Consequently, this article will first consider the degree of rental activity necessary to constitute an active trade or business where the rental is conducted solely by the controlled or distributing corporation and is to a party other than one of the related corporations. This article will thereafter proceed to examine the effect of owner-occupied real estate and the use of an agent or independent contractor on the availability of a tax-free spin-off of corporate real estate.

Necessary Degree of Activity

If a corporation, or a parent-subsidiary group of corporations, is conducting separate trades or businesses, one of which is the rental of real estate to outsiders (i.e., to parties other than one of the related corporations), the spin-off of the real estate should qualify under Section 355. If the quantity and duration of the real estate activity is such that the corporation is actively conducting a trade or business, the tax-free division of those activities into two or more corporations should be available. Clearly, a corporation is engaged in the active conduct of a trade or business if it owns an office or apartment building and operates the real estate through its employees.[19] The question is what lesser degree of activity will still satisfy the active business requirement.

In contrast to securities investment,[20] it is difficult to characterize real estate as non-business since real estate generally necessitates some degree of activity in order to realize income.[21] The

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a specific duty. For example, a manufacturing business may have its own research department, dining room for executives or financing services for its customers. Real estate is an integral part of most corporations. Its function is generally to provide the shell or foundation for a corporation's operating activities. Reference to a real estate function in this article is intended to represent situations where the real estate is a part of a business and not a business itself.

18. The term "outsiders" as used in this article refers to third or unrelated parties, i.e., a party other than the distributing and controlled corporations.

19. Treas. Reg. § 1.355-1(c), Example (3) (1960).

20. Rev. Rul. 66-204, 1962-1 Cum. Bull. 113; *cf.* Higgins v. Comm'r, 312 U.S. 212 (1941); Whipple v. Comm'r, 373 U.S. 193 (1963).

21. With the ownership of securities, nothing further need be done in

ownership of improved realty typically involves the rendering of services, such as renting, maintaining and improving the premises. It is true, however, that the leasing of vacant land under a lease which requires no services to be performed by the lessor will not constitute the active conduct of a trade or business.[22]

Unfortunately, there is little authority as to the degree of rental activity necessary to constitute the active conduct of a trade or business. The term "active conduct of a trade or business" is not defined in Section 355 nor anywhere else in the Internal Revenue Code. Extensive regulations have been promulgated, but their validity has been so questioned that they are now more of a trap for the unwary than a useful interpretative tool.[23]

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order to realize income. There are no services provided to anyone else; any services rendered or goods sold are a result of the business activities of the particular corporation whose securities the investor owns. The corporation is a separate entity; its business activities cannot be attributed to its shareholders. *See* Moline Properties v. Comm'r, 319 U.S. 436 (1943); New Colonial Co. v. Helvering, 292 U.S. 435 (1934); Whipple v. Comm'r, 373 U.S. 193 (1963); Lee, *The "Active Business" Test of § 355: Implications of a Trilogy of Revenue Rulings*, WASH. & LEE L. REV. 251, 260-61 (1974); Lee, *"Active Conduct" Distinguished from "Conduct" of a Rental Real Estate Business*, 25 TAX LAW. 317, 323 (1972).

22. Such leases are usually referred to as "net" leases. Under such a lease, the lessor is under no obligation to maintain and operate the property. No basic management duties are required other than the mere collection of rent. *See* Rev. Rul. 68-284, 1968-1 CUM. BULL. 143, where the Internal Revenue Service held that a corporation which leased vacant land to a parking lot operator and did not provide any services to the lessee was not engaged in the active conduct of a trade or business. *See also* Rev. Rul. 56-512, 1956-2 CUM. BULL. 173, where the Service held that mining property leased under terms requiring minimal activity on the part of the owner-lessor was an investment asset for purposes of the partial liquidation provisions of §346 of INT. REV. CODE OF 1954; *cf.* Treas. Reg. § 1.355-1(d), Example (6) (1960).

23. Treas. Reg. § 1.355-1(c) provides in relevant part as follows:

> [F]or purposes of §355, a trade or business consists of a specific existing group of activities being carried on for the purpose of earning income or profit from only such group of activities, and the activities included in such group must include every operation which forms a part of, or a step in, the process of earning income or profit from such group. Such group of activities ordinarily must include the collection of income and the payment of expenses. It does not include—
>
> (1) The holding for investment purposes of stock, securities, land or other property, including casual sales thereof (whether or not the proceeds of such sales are reinvested),
>
> (2) The ownership and operation of land or buildings all or substantially all of which are used and occupied by the owner in

There are no cases where improved real estate, fully operated and rented, has failed the active business test because of minimal activities. Cases have been decided where the issue might have been raised but those cases were decided against the taxpayer either because the property was wholly or primarily used in another corporate business or because significant services were not performed by the owner but by an independent contractor.[24] Due to the absence of case law, it is necessary to draw from other sources to determine the requisite degree of activity.

The term "trade or business" appears frequently throughout the Internal Revenue Code.[25] The cases interpreting the term appear relevant, even though they do not deal with Section 355.[26] In the context of real estate, the term has generally come to require regular and continuous management and rental activities.[27] Although the Tax Court traditionally required only the rental of a single piece of residential property,[28] most courts required more extensive activities to support the status of a trade or business.[29]

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the operation of a trade or business, or

(3) A group of activities which, while a part of a business operated for profit, are not themselves independently producing income even though such activities would produce income with the addition of other activities or with large increases in activities previously incidental or insubstantial.

The authority of these regulations has been questioned on the ground that they are based on the rejected separate business requirement, an issue to be discussed *infra*. Rafferty v. Comm'r, 452 F.2d 767 (1st Cir. 1971), *aff'g* 55 T.C. 490 (1970), United States v. Marett, 325 F.2d 28 (5th Cir. 1963), *aff'g* 63-2 U.S. Tax Cas. 9567 (N.D. Ga. 1962); Edmund P. Coady, 35 T.C. 771 (1960). *See* Lee, *Functional Division and Other Corporate Separation Under Section 355 After Rafferty*, 27 TAX L. REV. 453, 456-57 (1972).

24. Rafferty v. Comm'r, 452 F.2d 767 (1st Cir. 1971), *aff'g* 55 T.C. 490 (1970); King v. Comm'r, 458 F.2d 245 (6th Cir. 1972), *rev'g* 55 T.C. 677 (1971). These issues will be covered later in this article.

25. The term "trade or business" is used in at least sixty different sections of the Internal Revenue Code of 1954. Saunders, *Trade or Business, It's Meaning Under the Internal Revenue Code*, SO. CAL. 12TH INST. ON FED. TAX. 693 (1960); A. Spada & R. Ruge, *Partnerships—Statutory Outline and Definition*, BNA TAX MANAGEMENT PORTFOLIO No. 161-2nd, A-13 (1975). The most familiar examples of the term trade or business are found at §§ 162, 165, 167, 172, 1221(2) and 1231.

26. *See generally* Lee, *"Active Conduct" Distinguished from "Conduct" of a Rental Real Estate Business*, 25 TAX LAW. 217, 323 (1972).

27. *See* George Rothenberg, 48 T.C. 369 (1967); Inez de Amodio, 34 T.C. 894 (1960), *aff'd* 299 F.2d 623 (3d Cir. 1962); Elizabeth Herbert, 30 T.C. 26 (1958), *acquiesced in* 1958-2 CUM. BULL. 6; Jan Casimir Lewenhaupt, 20 T.C. 151 (1953), *aff'd per curiam* 221 F.2d 227 (9th Cir. 1955).

28. Anders I. Lagreide, 23 T.C. 508 (1954); Leland Hazard, 7 T.C. 372 (1946), *acquiesced in* 1946-2 CUM. BULL. 3.

29. Fackler v. Comm'r, 133 F.2d 509 (6th Cir. 1943); Bauer v. United States, 168 F. Supp. 539 (Ct. Cl. 1958); Grier v. United States, 120 F. Supp. 395 (D. Conn. 1954), *aff'd mem.* 218 F.2d 603 (2d Cir. 1955). *See generally*

It is submitted that the usual trade or business test of regular and continuous management and rental activities ought to be applied to spin-offs of corporate real estate.

A question under Section 355 is whether the addition of the word "active" implies a greater degree of activity than that required under the usual trade or business test. There is consequently disagreement as to whether the cases decided under the "trade or business" sections of the Code can be relied on as authority under Section 355. The Tax Court has held that the usual trade or business standard is not to be used.[30] On the other hand, other decisions[31] and even the Tax Court decisions decided under other active business provisions[32] do not hesitate to rely upon cases decided under Code sections not containing the qualification "active." An analysis of these decisions indicates that the word "active" is intended to do no more than facilitate the distinction between investment and business activities in the corporate area.

Business and investment activities have long constituted mutually exclusive terms as to individual taxpayers.[33] An individual cannot deduct investment expenses under Section 162; he is limited to Section 212.[34] There is no provision comparable to Section 212 for corporations since essentially all activities carried on by a corporation are business.[35] Since it was important in the corporate area to distinguish between investment and business income, the word "active" appears to have been added.[36]

The leading case, not decided by the Tax Court, which appears

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Comment, *The Single Rental as a "Trade or Business" under the Internal Revenue Code*, 23 U. CHI. L. REV. 111 (1955).

30. E. Ward King, 55 T.C. 700 (1972), *rev'd* 458 F.2d 245 (6th Cir. 1972); *see also* Isabel A. Elliot, 32 T.C. 283, 290 (1959).

31. Estate of Parshelsky v. Comm'r, 303 F.2d 14 (2d Cir. 1962) (dealing with the predecessor to § 355 in INT. REV. CODE OF 1939); Hanson v. United States, 338 F. Supp. 602 (D. Mont. 1971).

32. *See e.g.*, George Rothenberg, 48 T.C. 369 (1967); Roy P. Varner, 32 CCH Tax Ct. Mem. 101 (1973).

33. *See* Higgins v. Comm'r, 312 U.S. 212 (1941).

34. McDonald v. Comm'r, 323 U.S. 57, 62 (1944).

35. B. BITTKER & L. STONE, FEDERAL INCOME, ESTATE AND GIFT TAXATION 232 (4th ed. 1972); B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS, ¶ 5.03, at 7 (3d ed. 1971).

36. *See* S. REP. No. 1622, 83rd Cong., 2nd Sess. 50-1 (1954).

to do away with the distinction is *Rafferty v. Commissioner.*[37] Active business was defined in *Rafferty* as entrepreneurial activities quantitatively and qualitatively distinguishing corporate operations from mere investments.[38] The case involved a corporation engaged in the steel processing business. The corporation transferred the real estate on which its business activities were conducted to its wholly owned subsidiary. The subsidiary then leased the real estate to the parent corporation, which was the subsidiary's only activity for five years. After four years the subsidiary acquired additional land, constructed a plant thereon and leased the plant to another corporation owned by the sole shareholder of the parent corporation, Mr. Rafferty. Shortly thereafter, the parent spun off the stock of the subsidiary to Mr. Rafferty for the primary purpose of facilitating his estate plan. He wanted his sons, but not his daughters or their husbands, to enter the family business. Through the spin-off Mr. Rafferty was able to exclude the latter from the management of the steel business and at the same time provide them with investment assets insulated from the fluctuations of the steel market. The Tax Court held the subsidiary's real estate activities insufficient to constitute the active conduct of a trade or business.

On appeal, the First Circuit affirmed the Tax Court but did so on the alternative ground that a sufficient business purpose had not been shown for the separation and distribution of the subsidiary's stock. It concluded that Mr. Rafferty had not demonstrated sufficient evidence to overcome the Commissioner's determination that the distribution was principally a device to distribute earnings and profits. The court felt the real estate corporation could easily be sold, thereby providing Mr. Rafferty with cash without impairing the conduct of the principal business of the parent.

The First Circuit proceeded, however, to discuss whether the subsidiary was an active business. The court stated:

> It is our view that in order to be an active trade or business under § 355, a corporation must engage in an entrepreneurial endeavors of such a nature and to such an extent as to qualitatively distingish its operations from mere investments. Moreover, there should be objective indicia of such corporate operations.[39]

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37. 452 F.2d 767 (1st Cir. 1971), *aff'g* 55 T.C. 490 (1970), *cert. denied* 408 U.S. 922 (1972).

38. *Id.* at 772.

39. 452 F.2d 767, 772 (1st Cir. 1971), *cert. denied* 408 U.S. 922 (1972). It is also interesting to note that while liberalizing the active business test, the *Rafferty* decision placed greater emphasis on the device test to curb the potential for bail-out of corporate earnings. The device test, as formulated by *Rafferty*, requires a showing of business purpose germane to the

The spun-off subsidiary in *Rafferty* failed the court's test. The court felt that the lease was "an activity, in economic terms, almost indistinguishable from an investment in securities" because during the first four years of the predistribution period the subsidiary had leased back to its parent the business premises used by the parent.[40] The subsidiary had no other assets, and the lease was on a near net lease basis. Furthermore, the "objective indicia" were lacking in that the subsidiary's sole activity consisted of collecting rent, paying taxes and maintaining separate books. It paid no salaries or rent, nor did it employ any independent contractors. The court suggested the subsidiary's activities in the fifth year, when it purchased raw land, and financed and constructed a plant, might constitute an active separate trade or business.

The test set forth in *Rafferty* parallels the usual trade or business test applied to rental real estate by most courts in other areas of tax law. A leading commentator has suggested that *Rafferty* is perhaps the first strong step toward elimination of the distinction between the terms "active conduct" and "conduct" of rental real estate.[41]

A recent trilogy of revenue rulings dealing with Section 355 also seem to indicate the distinction is dying.[42] All three rulings, two of which involved real estate, announced that to constitute the active conduct of a trade or business, there must be "substantial

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continuance of the corporate business where the spin-off has considerable bail-out potential. It is suggested by commentators that the proper approach is to de-emphasize the active-business requirement, but to insist upon an adequate business purpose, and to require a showing that the division is not likely to be used as a device for the distribution of earnings. *See* Lee, *Functional Divisions and Other Corporate Separations Under Section 355 After Rafferty*, 27 TAX L. REV. 453, 495-97 (1972); Note, *Section 355's "Active Business" Rule—An Outdated Inefficacy*, 24 VAND. L. REV. 955, 986 (1971).

40. 452 F.2d at 772.

41. *See* Lee, *Functional Divisions and Other Corporate Separations Under Section 355 After Rafferty*, 27 TAX. L. REV. 453, 463 (1972); Note, *Section 355's Active Business Rule—An Outdated Inefficacy*, 24 VAND. L. REV., 986 (1971).

42. Rev. Rul. 73-234, 1973-1 CUM. BULL. 180; Rev. Rul. 73-237, 1973-1 CUM. BULL. 184; Rev. Rul. 73-236, 1972-1 CUM. BULL. 183. All three rulings were devoted primarily to an analysis of the effect on the active business requirement of an agent or independent contractor performing the major activities, a problem discussed in greater detail *infra*.

management and operational activities." This test conforms more to the normal trade or business test than it does to the Tax Court's test in the Section 355 area.[43] In Rev. Rul. 72-234, the corporation was engaged in farming. The actual farm work was performed by tenants who were independent contractors, but the corporation employed a maintenance man to care for the equipment. The sole shareholder of the parent corporation, an experienced farmer, negotiated the agreements with the tenant farmers, studied federal price support programs, planned all planting and harvesting of crops, and purchased all livestock and performed other managerial duties. The corporation was considered to have been engaged in the active conduct of a trade or business.

Similarly, in Rev. Rul. 72-237, the Service ruled that a general contractor was engaged in the active conduct of a trade or business where the corporation's own employees submitted bids, negotiated with subcontractors, and purchased and leased equipment, even though the actual construction work was performed by subcontractors. In Rev. Rul. 72-236, a Real Estate Investment Trust (REIT) which leased real estate was held not to be engaged in the active conduct of a trade or business where each property was managed by an independent contractor. Since the trust in order to qualify as a tax-favored REIT, was precluded from directly performing substantial management and operational activities, the Internal Revenue Service concluded the REIT could not be engaged in an active trade or business.[44]

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43. The Tax Court generally does not consider the usual rental trade or business test of continuous and regular management and rental activities applicable. Theodore F. Appleby, 35 T.C. 755, 764 (1961), *aff'd mem.* 296 F.2d 925 (3d Cir. 1962), *cert. denied* 370 U.S. 910 (1962); E. Ward King, 55 T.C. 677, 700 (1971), *rev'd* 458 F.2d 245 (6th Cir. 1972).

44. INT. REV. CODE OF 1954, §§ 856-58 provide a conduit for a Real Estate Investment Trust (REIT) through which income from equity and mortgage investments in real estate can be distributed to investors without being subject to tax at the trust level. Kahn, *Taxation of Real Estate Investment Trusts*, 48 VA. L. REV. 1011, 1015 (1962); T. Allen & W. Derrick, Jr., *Real Estate Investment Trusts*, BNA TAX MANAGEMENT PORTFOLIO No. 107-3rd, at A-9 (1974). An important provision of this statutory scheme requires that specified portions of a REIT's gross income for a taxable year be from traditionally passive sources of income, including "rents from real property." INT. REV. CODE OF 1954, § 856(c). However § 856(d)(3) excludes from such rents any amount received (or accrued) with respect to real property if the trust furnishes or renders services to the tenants of the property, or manages or operates the property, other than through an independent contractor from whom the trust does not derive or receive any income. Congress' intent when it enacted the income restrictions was to assure that the bulk of a REIT's income was "from passive income sources and not from the active conduct of a trade or business." H.R. REP. No. 2020, 86th Cong., 2d Sess. (1960), *reprinted* in 1960-2 CUM. BULL. 822-23.

These rulings do not elaborate on what the active and substantial management and operational activities test means. The management activities in both Rev. Rul. 73-234 and Rev. Rul. 72-237 consisted principally of negotiating contracts with independent contractors and overall planning responsibilities. As to the operational activities, the primary element was the furnishing of equipment and supplies. It would appear, however, that the furnishing of equipment and supplies is not as significant as the rendering of management decisions.[45]

Analogies arising from consideration of other Code provisions containing the terms "active conduct of a trade or business," and cases construing the term, also indicate that the word "active" is only to serve to distinguish between business and investment activities. The business versus investment distinction arises under the excess investment interest provisions.[46] The distinction is crucial, since only "investment interest" can be subject to the provisions while "business income" escapes completely unscathed.[47] Thus, only interest "connected" with investment property is exposed to detrimental treatment.

The tax preference regulations as originally proposed stated "[p]roperty is not held for investment if it is *actively* used in the conduct of a trade or business. Where it can reasonably be expected that a property will generate passive income, such prop-

45. *See* Lee, *The Active Business Test of §355: Implications of a Trilogy of Revenue Rulings*, WASH. & LEE L. REV. 251, 258-59 (1974).

46. INT. REV. CODE OF 1954, §§ 57(a)(1), 57(b), 57(c) and 163(d). For 1970 and 1971, "excess investment interest" constituted a tax preference subject to the 10 percent minimum tax in the case of individuals, fiduciaries, Subchapter S corporations and personal holding companies. After 1971, excess investment interest is no longer subject to the minimum tax; instead limits are placed on the extent to which investment interest is currently deductible. Noncorporate taxpayers are subject to a special limitation on deducting excess investment interest over $25,000. *See* Josephs, Tiller & Greenberg, *The Excess Investment Interest Limitation: How it Works and How to Avoid It*, 39 J. OF TAX. 214 (October, 1973); Lewis, *Investment Interest (Sec. 163(d))*, BNA TAX MANAGEMENT PORTFOLIO No. 297 (1974).

47. The limitation on deduction of investment interest applies only to "interest paid or accrued on indebtedness incurred or continued to purchase or carry property held for investment." INT. REV. CODE OF 1954, § 163(d)(3)(D). Thus, interest on funds borrowed for such purposes as home mortgage, consumer goods, and personal loans are not affected by the limitation. Nor is interest on funds borrowed in connection with a trade or business affected. H.R. REP. No. 91-272, 91st Cong., 1st Sess. 73 (1969).

erty shall ordinarily be considered investment property . . ."[48] The proposed regulation was criticized on the basis that the Internal Revenue Service could presume that all interest connected with rental real estate was investment interest.[49]

In response to this criticism, revised proposed regulations were issued stating ". . . [p]roperty is not held for investment if the expenses paid or incurred by the taxpayer in connection with his use thereof are allowable as deductions under Section 162. For example, real property held in the conduct of the business of renting real property is property actively used in the conduct of a trade or business . . ."[50] It is important to note that Section 162 is one of the provisions which led to the development of the real estate rental business test of regular and continuous management and rental activities.

Although no regulations on this subject have been proposed under the excess investment interest limitation, it would seem that the same Section 162 test would apply.[51] In fact, in enacting the provision Congress stated that "[r]ental income is to be considered as trade or business income, unless it is derived from property which is rented under a net lease arrangement."[52] The controlling Committee Report does not detail the degree of rental activity necessary to elevate rental real estate to the level of a trade or business, but the Section 162 test contained in the revised proposed preference regulations appears applicable to the excess investment interest limitation.

The regulations under Section 954 use a similar test for purposes of an exception to the term "foreign personal holding company income."[53] They provide that rents are to be considered as being

48. Proposed Treas. Reg. § 1.57-2(b)(2), 35 Fed. Reg. 19767 (1970) (Emphasis added).

49. *See* Comments (No. 13) submitted to the Internal Revenue Service on March 22, 1971 by AICPA's Division of Federal Taxation; McKee, *The Real Estate Tax Shelter: A Computerized Expose*, 57 VA. L. REV. 521, 560 n. 101 (1971).

50. Proposed Treas. Reg. § 1.57-2(b)(2)(i), 36 Fed. Reg. 12023 (1971).

51. Josephs, Tiller & Greenberg, *The Excess Investment Limitation: How it Works and How to Avoid it*, 39 J. OF TAX. 214, 214-15 (1973).

52. H.R. REP. No. 91-413 (Part I), 91st Cong., 1st Sess. 300 (1969). The Senate rejected the limitation on the deduction of investment interest but it was reinstated by the Conference Committee. H.R. REP. No. 91-782, 91st Cong., 1st Sess. 300 (1969).

53. INT. REV. CODE OF 1954, §§ 951-64 provide for the direct taxation of United States shareholders on certain kinds of income earned by their "controlled foreign corporation." As a general rule, foreign source income is insulated from U.S. tax until it is actually brought back into the U.S. via distribution to the U.S. shareholders. The goal of the controlled foreign

derived from the active conduct of a trade or business if generated by the leasing of "[r]eal property with respect to which the lessor performs active and substantial management and operational functions while the property is being leased."[54] The regulations cite the example of an owner of an office building who acts as rental agent for the leasing of the offices and employs a substantial staff to perform other management and maintenance functions.[55] The rents received from the property are considered derived from the active conduct of a trade or business. On the other hand, where an owner purchases an apartment complex and engages a real estate management firm to lease and manage the apartments, the rental income is not considered derived from the active conduct of a trade or business.[56]

The active trade or business problem also arises under Section 761 in determining the existence of a partnership. The regulations, in defining a partnership, provide the following:

> Tenants in common, however, may be partners if they *actively* carry on a trade, business . . . and divide the profits thereof. For example, a partnership exists if co-owners of an apartment building lease space and in addition provide services to the occupants either directly or through an agent.[57]

Since co-owners who conduct an "active" trade or business are treated as partners, the decisions defining what constitutes an active trade or business for purposes of the partnership definition appear relevant for Section 355 purposes. The Tax Court in *George Rothenberg*,[58] held that the operation of apartment houses by co-

corporations provision was to end this tax deferral. B. BITTKER & L. EBB, UNITED STATES TAXATION OF FOREIGN INCOME AND FOREIGN PERSONS 338-39 (2d ed. 1968). United States shareholders are now taxed on certain types of foreign source income as earned, even though the income is not distributed. One of the types of income taxed directly to the U.S. shareholder is "foreign personal holding company income." INT. REV. CODE OF 1954, § 954(c). Congress intended to end the deferral privilege with respect to passive investments, such as dividends, interest, royalties and rents. S. REP. No. 1881, 87th Cong., 2d Sess. (1962), *reprinted in* 1962-3 CUM. BULL. 789. However, rents will not constitute foreign personal holding company income if they are derived from the active conduct of a trade or business. INT. REV. CODE OF 1954, § 954(c)(3)(A).

54. Treas. Reg. § 1.954-2(d)(ii)(a) (1964).
55. Treas. Reg. § 1.954-2(d)(ii), Example (5) (1964).
56. Treas. Reg. § 1.954-2(d)(ii), Example (4) (1964).
57. Treas. Reg. § 1.761-1(a) (1956) (Emphasis added).
58. 48 T.C. 369 (1967).

owners constituted a partnership. The co-owners, under the name R&R Realty Co., leased the apartments, collected the rents and paid bills for such items as taxes and insurance. They provided no hotel-like services. The court drew a distinction between the active conduct of a rental business and the mere holding of property for investment and supported this distinction by citing cases requiring regular and continuous management and rental activities for trade or business status.[59] Similarly, in *Roy P. Varner*,[60] the Tax Court relied on the usual trade or business test to support its holding that co-owners providing less than substantial services were nevertheless partners.

The references in *Rothenberg* and *Varner* to the usual trade or business test are significant. It must be remembered that to be brought within the partnership provisions, the co-owners must have "actively" carried on a venture. Yet, the decisions draw no distinction between the conduct of a trade or business and the narrower "active" conduct of a trade or business. The absence of this type of distinction implies that, at least for purposes of Section 761, the addition of the word "active" is inconsequential.[61]

On the other hand, for purposes of qualifying for Subchapter S status,[62] management and rental activities alone are insufficient to constitute an active trade or business. A Subchapter S election will be terminated if more than 20 percent of the electing corporation's gross receipts result from passive investment income, including rents.[63] Congress intended Subchapter S to be limited only to small businesses "actively engaged in trade or business."[64] Con-

59. *Id.* at 373.

60. 32 CCH Tax Ct. Mem. 101 (1973).

61. *But see* Estate of Edgar S. Appleby, 41 B.T.A. 18 (1940), *nonacquiesced in* 1940-2 CUM. BULL. 9, *aff'd* 123 F.2d 700 (2d Cir. 1941); Gilford v. Comm'r, 201 F.2d 735 (2d Cir. 1953), *aff'g* 11 CCH Tax Ct. Mem. 175 (1952), and Lulu Lung Powell, 26 CCH Tax Ct. Mem. 161 (1967), which seem to require some significant activity beyond the leasing of jointly owned property to bring co-owners within the purview of the partnership provisions. The services performed in *Rothenberg* were not all that different than those in *Appleby*, *Gilford* and *Powell*, but the latter cases involved property acquired by inheritance or gift. In the case of jointly owned property acquired by inheritance or gift, the crucial question does not appear to be the degree of trade or business activity, but whether the co-owners intend to act, and do act as partners. Cohen, *Partnerships—Statutory Outline and Definition*, BNA TAX MANAGEMENT PORTFOLIO No. 161-2nd, at A-9 (1975); Roy P. Varner, 32 CCH Tax Ct. Mem. 101 (1973).

62. INT. REV. CODE OF 1954, §§ 1371-79 provide for conduit tax treatment of a corporation if certain stock ownership and income requirements are met.

63. INT. REV. CODE OF 1954, § 1372(e)(5).

64. S. REP. No. 1007, 89th Cong., 2d Sess. 8 (1966), *reprinted in* 1966-1 CUM. BULL. 532.

gress differentiated operating firms from mere incorporated investment activities.[65] Rents are considered to be derived from an active trade or business only if "significant services" are rendered to the lessee.[66] Such services must be other than those normally rendered, such as furnishing utilities, cleaning public areas, and collecting trash.[67] The regulations state that maid services would be sufficient.[68] Thus, payments received from operating a hotel, motel or parking lot, in all probability do not constitute "rent" for Subchapter S purposes. On the other hand, the rental of mere space, such as leasing apartments or offices, would be considered rental income. In short, in order for rents to be considered active business income for Subchapter S purposes, services more substantial than the normal activities of a landlord must be performed.[69] However, one commentator believes the Subchapter S regulations are an exception to the term rents and thus probably should not be relied upon for purposes of Section 355.[70]

The foregoing analysis indicates that Congress added the word "active" to the term "trade or business" in Section 355 for the purpose of distinguishing passive investment from true business income. It follows that the usual trade or business authorities are permissible guidelines in determining whether the active business requirement is satisfied.[71]

As previously stated, "trade or business" connotes continuous and

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65. H.R. REP. No. 91-1737, 91st Cong., 2d Sess. (1970).
66. Treas. Reg. § 1.1372-4(b)(5)(vi) (1959).
67. *Id.*
68. *Id.*
69. City Markets, Inc. v. Comm'r, 433 F.2d 1240, 1242 (6th Cir. 1970).
70. Lee, *The "Active Business" Test of § 355: Implications of a Trilogy of Revenue Rulings*, 25 Tax Law. 251, at 259 n.31.
71. However, the early Tax Court decisions involving the rental by a noncorporate taxpayer of a single parcel of residential property are no longer valid authorities for what constitutes a trade or business. The Tax Court's position appears to have been adopted in response to the fact that prior to 1942, depreciation and maintenance expenses were deductible only from property used in a trade or business. The Tax Court solved the problem by adopting the theory that all rental property was trade or business property. *See, e.g.*, Anders I. Lagreide, 23 T.C. 508, 511 (1954); Leland Hazard, 7 T.C. 372, 375-76 (1946); John D. Fackler, 45 B.T.A. 708, 713-15 (1941), *aff'd* 133 F.2d 509 (6th Cir. 1943). *See generally* Comment, *The Single Rental as a "Trade or Business" under the Internal Revenue Code*, 23 U. CHI. L. REV. 111 (1959).

regular management and rental activities.[72] Generally, if an owner is required under the terms of the lease to collect rents, supervise repairs, pay expenses, and otherwise exercise constant supervision over the property, the owner is engaged in a trade or business.[73] However, the activities must exceed the scope of mere ownership of real property or the receipt of rents. If the property is rented under a strict net lease, the owner is not engaged in businesses.[74]

The purpose of the active business requirement in Section 355, to preclude the tax free separation of active and inactive assets into active and inactive corporate entities, is achieved through application of the usual trade or business test of continuous and regular management and rental activities. Therefore, the interpretation of the active business test given by the *Rafferty* decision may prove to be correct. However, since the exact degree of management and rental activity required is still unclear, the Section 355 regulations should be revised. The regulations should focus on such issues as the degree and continuity of management and operational activities necessary to satisfy Section 355 and the distinction between business and investment endeavors.[75]

Owner-Occupied Real Estate

The preceeding section of this article analyzed the degree of activity necessary to satisfy the active business requirement where rentals are entirely to outsiders. This section will review the more difficult situation which arises when the real estate activities conducted by a corporation are a function of a business conducted by that corporation or its parent or subsidiary corporation. Difficulty is encountered primarily because the spin-off of owner-occupied real estate presents an effective way to pull earnings and profits out of a corporation since after the spin-off, the corporation is in

72. *See, e.g.*, Fackler v. Comm'r, 133 F.2d 509 (6th Cir. 1943); Bauer v. United States, 168 F. Supp. 539 (Ct. Cl. 1958); Grier v. United States, 120 F. Supp. 395 (D. Conn. 1954), *aff'd mem.* 218 F.2d 603 (2d Cir. 1955).

73. Grier v. United States, 120 F. Supp. 395 (D. Conn. 1954), *aff'd per curiam* 218 F.2d 603 (2d Cir. 1955); Jan Casimir Lewenhaupt, 20 T.C. 151 (1953), *aff'd per curiam* 221 F.2d 623 (3d Cir. 1962); Pinchot v. Comm'r, 113 F.2d 718 (2d Cir. 1940); *see also* Comment *The Single Rental as a "Trade or Business" Under the Internal Revenue Code*, 23 U. Chi. L. Rev. 111 (1955).

74. Evelyn M.L. Neill, 46 T.C. 197 (1942). The net leases involved in *Rafferty* or *King* would thus not meet the test, but presumably the acquisition, financing and construction activities in *King* would.

75. *See* Lee, *The Active Business Test of § 355: Implications of a Trilogy of Revenue Rulings*, Wash. & Lee L. Rev. 251, 284 (1974).

excellent position to utilize its accumulated earnings in the purchase or rental of new real estate. Although the courts have traditionally been very strict in this area, more recent decisions indicate that owner-occupied real estate may be spun-off in limited circumstances. In order to better understand the circumstances in which this type of spin-off will be permitted, it is beneficial to examine the background of the issue.

Background

The regulations have always held that the real estate function of a business cannot be divided tax-free on the basis that the real estate function itself is not a trade or business.[76] For example the regulations provide that where a bank occupies the ground floor and one-half of the second floor of its two-story office building and rents the remaining half of the second floor, it will not be engaged in the active conduct of a trade or business.[77] The rental activity is considered incidental to the banking business.

On the other hand, the regulations provide that if a bank owns an eleven story building and rents the top ten floors to outsiders through its real estate department, the bank will be considered to engage in an active real estate business.[78] Thus, according to the regulations owner-occupied real estate cannot qualify as an active business unless substantial income is derived from outsiders.

A series of early Tax Court decisions supported the approach of the regulations. In *Isabel A. Elliot*,[79] the Tax Court held that a half owner-occupied building was not an active business. The court emphasized the small amount of rental income and the non-segregation of accounts for rental activities. In *Elliot*, the disqualified building had been replaced by a larger building within the five year pre-distribution period. The owner then occupied about half of the new structure and rented the other half to outsiders. The only change was that the new building had been placed in a new subsidiary which "charged" the parent rent and managed the rental to the outsiders. The court disqualified the spin-off because the

76. Treas. Reg. § 1.355-1(c)(2) (1955).
77. Treas. Reg. § 1.355-1(d), Example (4) (1955).
78. Treas. Reg. § 1.355-1(d), Example (3) (1955).
79. 32 T.C. 283 (1959).

parent corporation had not actively conducted a real estate business for the necessary five years prior to the incorporation of the subsidiary. In dictum the court indicated that the second building constituted an active business asset although it did not meet the five-year test.[80]

The Tax Court followed *Elliot* in *Theodore F. Appleby*,[81] holding that a half-owner-occupied building was also not an active business asset. The court again relied on the small amount of activity in respect to rental income. Finally, in *Bonsall v. Commissioner*,[82] owner-occupied real estate was also disqualified on the basis that the rental activity was merely incidental. The Tax Court found that less than one tenth of the usable square footage of the buildings had been rented and that the gross annual rental did not even cover the heating costs, let alone taxes and depreciation. The Second Circuit in affirming the Tax Court warned that:

> It is clear that careful scrutiny of purported "real-estate rental" businesses is necessary to prevent evasion of the purposes of the statute. The possibility of the shareholders abstracting accumulated earnings at capital gains rates is present whenever a corporation owns its own factory or office building. Under taxpayers' interpretation, all that need be done is to transfer the building to a new corporation and distribute the stock received in return. The shareholders would then be free to sell their stock and pay a capital gains rate on the proceeds while the corporation can rent or purchase another building and reduce its accumulated earnings.[83]

The position of the Internal Revenue Service seems to stem from its view that a division of a single business cannot be spun-off tax-free. According to the regulations, there must be at least two separate businesses conducted for the requisite five-year period.[84] The courts, however, have consistently repudiated the regulations in situations where a corporation conducting a single active business has been divided into two separate corporations. In the landmark case of *Edmund P. Coady*,[85] a single construction business, con-

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80. *Id.* at 291. It would seem that mere incorporation cannot help convert an inactive business into an active one. *See* Note, *Section 355's Active Business Rule—An Outdated Inefficacy*, 24 VAND. L. REV. 955, 982 (1971); Whitman, *Draining the Serobian Bog: A New Approach to Corporate Separations Under the 1954 Code*, 91 HARV. L. REV. 1194, 1218 (1968); Cohen, *Partnerships—Statutory Outline and Definition*, BNA TAX MANAGEMENT PORTFOLIO No. 161-2nd, at A-18 to A-19 (1975).

81. 35 T.C. 755 (1961), *aff'd per curiam* 296 F.2d 925 (3d Cir. 1962), *cert. denied* 370 U.S. 910 (1962).

82. 317 F.2d 61 (2d Cir. 1963), *aff'g* 11 CCH Tax Ct. Mem. 820 (1962).

83. 317 F.2d at 65.

84. Treas. Reg. § 1.355-1(a) (1955).

85. 35 T.C. 771 (1960), *aff'd per curiam* 289 F.2d 490 (6th Cir. 1961), *nonacquiesced* Rev. Rul. 61-198, 1961-2 CUM. BULL. 61, *nonacquiesced revoked* Rev. Rul. 64-147, 1964-1 CUM. BULL. (Part 1) 136.

ducted for more than five years, was divided into two businesses. The two shareholders had disagreed on management of the business and decided it would be best to part ways. The corporation transferred half of the construction contracts, some construction equipment and cash of the original corporation to a newly-formed corporation. The stock of the new corporation was spun-off to one of the two shareholders. The Service argued that Section 355 did not apply to the division of a single business. The Tax Court, referring to the statute, stated that the validity of the regulations was questionable. The court felt that the purpose of the active business requirement was to prevent the tax-free separation of inactive assets from active assets. It stated that as long as the division did not result in the splitting-off of inactive assets, the separation of any business into parts was permissible provided all other requirements of the statute have been met.

The Service lost again in *Commissioner v. Marett*,[86] where a corporation which manufactured food products at three factories spun-off one of its factories, opened just eight months before, to a newly formed corporation. The Fifth Circuit held that the active business requirement was satisfied even though the particular spin-off resulted in the vertical division of a single business.

The Service at first indicated its non-acquiescence in *Coady*.[87] However, after the decision in *Marett*, it announced in Rev. Rul. 64-147[88] that it would abide by *Coady* and *Marett* to the extent they held the regulations invalid in providing that Section 355 does not apply to the division of a single business. Although the ruling stated that consideration would be given to modifying the regulations, no modification was made during the following twelve years. Notwithstanding the absence of such modification, the Service has conceded the right to the tax-free spin-off of a single business.[89]

In both *Coady* and *Marett* a single business was divided essentially in half so that after the division each corporation was operating basically the same business but on a smaller scale. However, when different functions of a single business are divided there is

86. 325 F.2d 28 (5th Cir. 1963), *aff'g* 62-3 U.S. Tax Cas. 9567 (N.D. Ga. 1962).
87. Rev. Rul. 61-198, 1961-2 CUM. BULL. 61.
88. Rev. Rul. 64-147, 1964-1 CUM. BULL. (Part 1) 136.
89. Rev. Rul. 75-160, 1975-1 CUM. BULL. 112.

greater opportunity for tax avoidance. It is easier to siphon off earnings when business functions are divided because intercompany transactions are possible. There is added danger with the real estate function, since it can often, unlike other functions, be easily sold without impairing the conduct of the principal business.

The Service has not clearly defined its position on this issue. The regulations contain a number of examples which deny tax-free status to spin-offs of functions of a single business.[90] However, the regulations probably do not reflect the present attitude of the service inasmuch as they have not been amended since the Service's acceptance of *Coady* and *Marett* in 1964.

There have been instances where the Tax Court has accorded tax-free status to the functional division of an integrated business.[91] However, in each case, the Tax Court has carefully avoided any implication that it was extending the *Coady* rationale to the functional division of a corporation by its findings that the separated activities constituted separate businesses before the division. For example, in *Marne S .Wilson*,[92] the credit operations of a furniture store were allowed to be spun-off tax-free. The Tax Court held that the finance activities "were of sufficient magnitude and character throughout the five year period to constitute an actively conducted business."[93]

The anxiety over the Service's resistance to functional divisions of a single corporation is compounded by the Service position that activities which are not independently producing income do not constitute an active trade or business. The regulations specifically exclude a group of activities which, while a part of a profitable business, are not themselves independently producing income.[94] Thus, under these rules, an activity will not qualify as an active business unless it earns income from outsiders.

The merits of the Service position on owner-occupied real estate and the "independent production of income" requirement have been questioned by commentators because the Service position depends in part upon the provision of the regulations which prohibits the tax-free division of a single business. This provision of the regula-

90. Treas. Reg. § 1.355-1(d) (1955).
91. Marne S. Wilson, 42 T.C. 914 (1964), *rev'd* 353 F.2d 184 (9th Cir. 1965); H. Grady Lester, Jr., 40 T.C. 947 (1963), *acquiesced in* 1964-2 CUM. BULL. 6; Hanson v. United States, 338 F. Supp. 602 (D. Mont. 1971).
92. 42 T.C. 914 (1964), *rev'd* 353 F.2d 184 (9th Cir. 1965).
93. *Id.* at 925.
94. Treas. Reg. § 1.355-1(e) (1955).

tions was explicitly rejected in *Coady*.[95] There is admittedly a factual difference between dividing a single business in half as in *Coady* and *Marett* and dividing different functions of a single business. But the purpose of the active business requirement does not seem to require that *Coady* and *Marett*, and their acceptance by the Service, be limited to the vertical division of a single business. The purpose of the requirement, as announced by *Coady*, is "to prevent the tax free separation of *active* and *inactive* assets into *active* and *inactive* corporate entities."[96] Where this is not the case, there is no public policy served by drawing fine distinctions based upon whether the division is vertical (in half) or horizontal (functional).

Current Status

The active business status of owner-occupied real estate was refined in *Rafferty*. The First Circuit in holding that the subsidiary was not engaged in the active conduct of a trade business, rejected the provision in the regulations that owner-occupied real estate is not an active business asset.[97] The court stated that the regulations were questionable in light of the *Coady* rejection of the separate business requirement and the Service's concession in Rev. Rul. 64-147[98] that the regulations need modification. The court in *Rafferty* pointed out that a broad interpretation of the phrase in the regulations requiring the activity being separated to have independently produced income was largely a restatement of the erroneous separate business restriction. Thus the court concluded that the *Coady* rationale was applicable to functional as well as vertical divisions of existing businesses.

The court in *Rafferty* further stated that regulations were so broadly drawn that the congressional purpose in enacting Section 355 was sometimes defeated. The court proffered the following

95. *See* Lee, *Functional Divisions and Other Corporate Separations Under Section 355 After Rafferty*, 27 TAX. L. REV. 453, 456 (1972); Cohen, *Current Partial Liquidation and Spin-Off Problems*, 41 TAXES 775, 779-80 (1963).

96. Edmund P. Coady, 33 T.C. 771, 777 (1960).

97. Rafferty v. Comm'r, 452 F.2d 767 (1st Cir. 1971), *aff'g* 55 T.C. 490 (1970).

98. 1964-1 CUM. BULL. (Part 1) 136.

example: "[T]he regulations could be construed to deny § 355 treatment to a large hotel chain which spun-off its land purchasing, hotel construction, and leasing activities from its hotel management operations if the spun-off corporation leased the completed hotels exclusively to the management corporation. We are reluctant to approve such regulations which appear to fly in the face of Congressional intent."[99]

The First Circuit thus gave its approval to a functional separation of previously owner-occupied real estate which is thereafter leased back to the distributing corporation. The court stated that the active business status of real estate is to be tested on the basis of actual activities. As a result, the court laid the groundwork for owner-occupied real estate to qualify as an active business asset.

Just four months after the First Circuit's decision in *Rafferty*, the Sixth Circuit in *King v. Commissioner*[100] held that a spun-off corporation dealing solely with related entities can nevertheless be engaged in an active business. The court ruled that the subsidiaries which rented terminal and other facilities to a parent corporation in the trucking business met the active business test, noting that:

> [T]he subsidiary corporations did far more than merely hold title to the terminal facilities which were leased to Mason & Dixon [the parent corporation]. In short, the record shows that the leasing corporations engaged repeatedly in construction projects of considerable magnitude, created substantial income producing rental properties and conducted all activities essential to the real estate leasing business.[101]

In so stating, the Sixth Circuit reversed a decision of the Tax Court which held that the rental real estate activities of the subsidiaries did not qualify as active businesses since all rentals were to a related entity. The Sixth Circuit said that it agreed with the First Circuit in *Rafferty* that the independent production of income requirement of the regulations was so broadly drawn that it might be used in some cases to defeat the clear legislative intent of the section. The effect of *Rafferty* and *King* is that real estate utilized by the taxpayer or its affiliate will qualify as an active business provided sufficient activities are connected with the leasing and operation of such property.

The Service in a recent ruling has apparently indicated that it may now follow *Rafferty* and permit functional divisions of a single

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99. Rafferty v. Comm'r, 452 F.2d 767, 772-73 (1st Cir. 1971), *aff'g* 55 T.C. 490 (1970).

100. 458 F.2d 245 (6th Cir. 1972), *rev'g* 55 T.C. 677 (1971).

101. *Id.* at 248.

business.[102] The ruling did not involve a real estate function; nevertheless, it represents an important concession on the Service's part and is thus worthy of examination. In Rev. Rul. 75-160, a three tier corporate structure was reduced to two tiers. Corporation A owned all of the stock of corporation B, which in turned owned all of the stock of corporation C and corporation D. Corporation B manufactured and sold furniture. Corporation C manufactured food products and corporation D sold food products but only those manufactured by corporation C. Corporations B, C, and D used substantially all of their assets in the active operation of their respective businesses for more than five years. For unstated, valid business purposes generated by factors beyond control of the parent, corporation A, it was decided that corporation C and corporation D should be owned by corporation A rather than corporation B. Corporation B accordingly distributed all of the stock of corporation C and corporation D to its sole shareholder, corporation A. Thereby all the corporations involved in the realignment became wholly owned first tier subsidiaries of corporation A. Corporation B, corporation C and corporation D were to continue to operate their respective businesses. There were no plans on the part of corporation A to dispose of any of the stock it held in these corporations. On these facts, the Service held that the distribution by corporation B was not a "device" within the meaning of Section 355 for the distribution of earnings. The Service further ruled that in accordance with *Rafferty*, *Marett* and *Coady*, the activities of corporations B, C and D were all sufficient to constitute an active trade or business.

The Service thus appears to have given its approval to the functional separation of a single business. The ruling also appears to abandon the requirement that each business be independently producing income. If the independent production of income were required, then it would appear that the ruling could not have determined that corporation C and corporation D were both engaged in the active conduct of a trade or business.

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102. Rev. Rul. 75-160, 1975-1 CUM. BULL. 112. The ruling also stated that it would follow United States v. Marett, 325 F.2d 28 (5th Cir. 1963) and Comm'r v. Coady, 289 F.2d 490 (6th Cir. 1961), *aff'g* 33 T.C. 771 (1960), as to the vertical division of a single business, but the Service had previously announced ten years prior that it would follow those decisions. Rev. Rul. 64-147, 1964-1 CUM. BULL. (Part 1) 136.

The ruling has application to the spin-off of owner-occupied real estate. Although courts have refused to extend the rule permitting division of a single business to the separation of owner-occupied real estate in cases like *Bonsall, Appleby* and *Elliot,* they have done so principally in reliance upon the independent production of income requirement of the regulations.[103] Now that the Service in Rev. Rul. 75-160 seeems to have abandoned this requirement, the cases holding that owner-occupied real estate does not constitute an active trade or business probably no longer have validity.

In summary, the independent production of income requirement of the regulations has been expressly rejected by the First Circuit in *Rafferty,* a conclusion approved by the Sixth Circuit in *King* and now seemingly by the Service in Rev. Rul. 75-160. The active business status of owner-occupied real estate was implicitly accepted in *Rafferty*; and the *King* decision clearly indicates that a real estate subsidiary can be engaged in an active business where its only tenant is the parent corporation. Accordingly, the separation of functional divisions of a fully integrated business now appears possible.

Independent Contractors

The third major issue in the tax-free spin-off of corporate real estate is whether the active business test can be satisfied if an agent or independent contractor, typically a management real estate firm, performs a substantial part of the activities of the real estate business.[104] The position of the Internal Revenue Service is that the activities of an independent contractor on behalf of a corporation are not to be considered in determining whether the corporation is engaged in the active conduct of a trade or business.[105] The apparent problem with the use of an independent contractor is that it appears to place the corporation more in the position of being a passive investor.

According to Rev. Rul. 73-234, Rev. Rul. 73-236 and Rev. Rul. 73-273, a corporation that uses independent contractors can meet the active business test only if the corporation itself directly per-

103. Marne S. Wilson, 42 T.C. 914 (1964), *rev'd on other grounds* 353 F.2d 184 (9th Cir. 1965); H. Grady Lester, Jr., 40 T.C. 947 (1963), *acquiesced* 1964-3 Cum. Bull. 6; Albert W. Badness, 39 T.C. 410 (1962).

104. A closely analogous inquiry is the determination of whether the active business test is met if the activities are performed by uncompensated officers, joint officers of related corporations or by related parties for a management fee.

105. Rev. Rul. 73-234, 1973-1 Cum. Bull. 180; Rev. Rul. 73-237, 1973-1 Cum. Bull. 184; Rev. Rul. 73-236, 1973-1 Cum. Bull. 183.

forms active and substantial management and operational functions through its own employees. Support for this requirement may be found in the regulations under Section 954.[106] Rents that are derived from the active conduct of a trade or business are excluded from the definition of foreign personal holding company income.[107] The "active business" safe haven, however, is unavailable if the management and operational activities are performed by a real estate management firm, i.e., an independent contractor.[108] Similarly, the Real Estate Investment Trust (REIT) provisions would also seem to deny active business status to rental real estate if the management and operational functions are performed by an independent contractor.[109] Where the REIT furnishes or renders services to the tenants of real property or manages such property, other than through an independent contractor, the amounts received from such property do not constitute "rents."[110]

However, an analysis of the judicial authorities under Section 355 indicates that an active business can be conducted entirely through an agent or possibly an independent contractor. The Tax Court in *W.E. Gabriel Fabrication Co.*[111] held that Section 355 does not require the activity to be conducted directly by either the distributing corporation or the controlled corporation but can be conducted by a third party. The court held that the active business requirement was met, although for a period of fourteen months prior to the division, the shareholder of the distributing corporation had operated the spun-off business through a "loan" of the operating assets to him.

The First Circuit in *Rafferty* touches indirectly on this issue. In its discussion of the "objective indicia" portion of its proposed active

106. INT. REV. CODE OF 1954, § 954. *See supra* note 50.
107. INT. REV. CODE OF 1954, § 954(c)(3)(A).
108. Treas. Reg. 1.954-2(d)(ii) (1964).
109. Although § 856 does not use the term "active conduct of a trade or business" the legislative history to the section states that the REIT restrictions were intended to limit the "pass through" of taxable income that was clearly passive income from real estate investments, as distinguished from income derived from the "active" operation of business involving real estate. H.R. REP. No. 2020, 86th Cong., 2d Sess. (1960), *reprinted* in 1960-2 CUM. BULL. 822-23.
110. INT. REV. CODE OF 1954, § 856(d)(3).
111. 42 T.C. 545, *acquiesced in* 1965-1 CUM. BULL. 4.

business test, it acknowledged that the spun-off subsidiary did not employ independent contractors.[112] The inference is that employment of independent contractors would have constituted the objective indicia required by the court to meet the court's active business test.[113]

A comparison of the manner with which this issue is dealt with under Sections 761 and 921 indicates that use of independent contractors will not always prevent the activity from achieving the status of an active business. The regulations under Section 761 provide that co-owners of an apartment building can be considered partners engaged in the conduct of an active trade or business even though tenant services are provided through an agent.[114] Furthermore, case law under Section 761 indicates that the actions of a real estate agent will be attributed to the owner. For example, in *Gilford v. Commissioner*,[115] the taxpayer and three others inherited eight buildings in Manhattan. The ground floors of all the buildings were rented as stores, while the upper floors were leased as apartments. The properties were managed by real estate agents. The Second Circuit found that the taxpayer held the real estate for use in a trade or business, since the real estate agents employed by the taxpayer and other co-owners maintained the buildings "in rental condition" and expended "an appreciable amount of time and work" in supplying "such services for the tenants as were needed to rent them to good advantage."[116]

Cases interpreting the requirement of Section 921 for the active conduct of a trade or business indicate a similar result. Under Section 921, a corporation may obtain favorable Western Hemisphere Trade Corporation treatment[117] if 90 percent of its gross income is "derived from the active conduct of a trade or business."[118] A common problem is whether sales made by an export subsidiary of a United States manufacturing corporation will constitute an

112. Rafferty v. Comm'r, 452 F.2d 767, 772-73 (1st Cir. 1971), *aff'g* 55 T.C. 409 (1970), *cert. denied* 408 U.S. 922 (1972).

113. Lee, *The "Active Business" Test of §355: Implications of a Trilogy of Revenue Rulings*, WASH. & LEE L. REV. 251, 273 (1974).

114. Treas. Reg. § 1.761-1(a) (1956).

115. 201 F.2d 735 (2d Cir. 1953), *aff'g* 11 CCH Tax Ct. Mem. 175 (1952).

116. *Id.* at 736.

117. INT. REV. CODE OF 1954, § 921. A Western Hemisphere Trade Corporation is a domestic corporation which transacts its entire business, other than incidental purchases, in the Western Hemisphere. This corporation will receive perferential tax treatment as long as 95 percent or more of its gross income for the 3-year period immediately preceding the close of the taxable year is from the "active conduct of a trade or business" and 90 percent or more of its gross income is from sources outside the United States.

118. INT. REV. CODE OF 1954, § 921(2).

active business if the subsidiary relies entirely upon the parent to supply salesmen and other staff. The courts uniformly hold that the active business requirement is satisfied even though the business activities are rendered by an agent.[119] Absence of complete employee organization will not preclude qualification. The significant factor is whether the subsidiary bears the economic risk of the business.[120] With the typical rental real estate arrangement, the economic risk clearly lies with the owner, and not the real estate management company.

It is well established that for purposes of the usual trade or business test, management and rental activities of an independent contractor or an agent on behalf of an owner is imputed to the owner in determining his trade or business status.[121] An owner of real estate is considered to be engaged in a trade or business if the activities performed by the management or rental agent would be sufficient to constitute a trade or business had they been conducted directly by the owner himself.[122] In addition, the cases dealing with non-resident individual owners of real estate within the United States impute the agent's management activities to the owner of the real estate.[123]

In summary, even though the position of the Service, as evidenced by Rev. Rul. 73-234, Rev. Rul. 72-236 and Rev. Rul. 73-273, is that to constitute an active business the management and operational activity must be conducted directly by the corporation, the analogies arising from consideration of Section 761, Section 921, cases construing the phrase "trade or business" and the inferences which

119. *See, e.g.*, Frank v. Int'l Canadian Corp., 308 F.2d 520, 525 (9th Cir. 1962); United States Gypsum Co. v. United States, 304 F. Supp. 627, 642 (N.D. Ill. 1969), *rev'd on other grounds* 452 F.2d 445 (7th Cir. 1971); Barber-Greene Americas, Inc., 35 T.C. 365, 387-88 (1960).

120. United States Gypsum Co. v. United States, 304 F. Supp. 627, 642 (N.D. Ill. 1969), *rev'd on other grounds* 452 F.2d 445 (7th Cir. 1972).

121. Reiner v. United States, 222 F.2d 770 (7th Cir. 1955); Gilford v. Comm'r, 201 F.2d 735 (2d Cir. 1953); Bauer v. United States, 168 F. Supp. 539 (Ct. Cl. 1958) (dictum); Adolph Schwarcz, 24 T.C. 733, 739 (1955).

122. Reiner v. United States, 222 F.2d 770 (7th Cir. 1955); Gilford v. Comm'r, 201 F.2d 735 (2d Cir. 1953); Bauer v. United States, 168 F. Supp. 539 (Ct. Cl. 1958) (dictum); Adolph Schwarcz, 24 T.C. 733 (1955).

123. *See* Inez de Amodio, 34 T.C. 894 (1960), *aff'd* 299 F.2d 623 (3d Cir. 1962); Elizabeth Herbert, 30 T.C. 26 (1958), *acquiesced in* 1958-2 CUM. BULL. 6; Jan Casimir Lewenhaupt, 20 T.C. 151 (1953), *aff'd per curiam* 221 F.2d 227 (9th Cir. 1955).

may be drawn from certain Section 355 decisions indicate that active business status can be achieved by use of agents or independent contractors. Thus the present significance of the performance of activities by independent contractors is uncertain. However, it is difficult to understand how utilization of an independent contractor to conduct an active business can render the business inactive. It is illogical that the identity of the party performing the services should determine the status of the corporation. The fear that allowance of conduct through an independent contractor will open the door to a bail-out of earnings and profits is unfounded. If the business is truly active, presumably the assets are also active and not prone to bail-out. Recognizing this, one commentator has stated that the independent contractor question should not be a factor under the active business test but rather should be among the factors to be considered under the device test.[124] However, since the position of the Service is clearly to the contrary, a final resolution must await litigation.

Conclusion

For the corporate planner, the determination of whether the spin-off of rental real estate will satisfy the active business requirement is not without difficulty. Although there has been recent clarification of the active business requirement, many questions remain unanswered. Where the rental of real estate is to outsiders, the standard to be applied would seem to be the usual trade or business standard of regular and continuous management and rental activity. However, the exact degree of management and rental activity required is still unclear.

With respect to real estate used by a taxpayer or its affiliate in its own business, the *Rafferty* and *King* decisions indicate that the rental real estate will qualify as an active business if substantial activities are rendered in connection with the leasing or operation of the real estate. But again, the exact degree of requisite activity is unclear. The recent pronouncement of the Internal Revenue Service in Rev. Rul. 75-160 that it will follow *Rafferty* and the ruling's apparent rejection of the independent production of income requirement should provide the tax advisor with some assurance in this area.

Revenue Rulings 73-234, 73-236 and 73-237 indicate that the use of a management company to perform the majority of rental activities

124. Lee, *The "Active Business" Test of § 355: Implications of a Trilogy of Revenue Rulings*, Wash. & Lee L. Rev. 251, 277 (1974).

will not automatically disqualify the proposed spin-off. However, the scope of these rulings remains to be fully explored. In light of *Rafferty's* entrepreneurial activities test and the approach taken by the non-section 355 decisions in distinguishing between a business and an investment, the emphasis of the active business requirement should be on the character of the services rendered rather than on the identity of the party rendering them.

It is clear that the present active business regulations are no longer viable. Their principal weakness is that they are based on the rejected separate business requirement. They have been severely criticized for placing emphasis on the definitional elements of an active business rather than on whether the transaction gives rise to a potential bail-out of earnings and profits.[125] The regulations should be modified to place principal reliance on the device test[126] and to redefine the active business test to conform more closely to the normal trade or business standard as, for example, is enunciated in the cases decided under Section 162. Unfortunately, until the regulations are modified, taxpayer uncertainty will continue.

125. Lee, *Functional Divisions and Other Corporate Separations Under Section 355 After Rafferty*, 27 TAX L. REV. 453, 495-96; Whitman, *Draining the Serbonian Bog: A New Approach to Corporate Separations Under the 1954 Code*, 81 HARV. L. REV. 1194, 1252-53 (1968); Note, *Section 355's Active Business Rule—An Outdated Inefficacy*, 24 VAND. L. REV. 955, 976-78 (1971).

126. One commentator has even suggested that in the more difficult area of real estate the taxpayer have the burden of proving that the spin-off has a genuine business purpose and is not intended to effect a bail-out of earnings. Whitman, *Draining the Serbonian Bog: A New Approach to Corporate Separations Under the 1954 Code*, 81 HARV. L. REV. 1194, 1253 (1968).