Edna Louise Dunn Trust v. Commissioner: A Movement from the 5 Year Rule to the Device Clause under Section 355

I. INTRODUCTION

Section 355 of the Internal Revenue Code of 1954 provides that if a shareholder receives stock of a controlled corporation from a distributing corporation under certain conditions, then no gain or loss will be recognized on the distributed stock. Nonrecognition facilitates corporate separations as restructuring can occur without an immediate tax consequence. But a tax-free transaction of this nature may be abused without some outer limits. A corporation may reorganize with its primary motivation being to bail-out profits and earnings without

1. Whenever property is sold or disposed of, gain or loss is realized. I.R.C. § 1001(a)(1986). Ordinarily this gain or loss must be recognized; that is, taken into income and have a tax consequence. I.R.C. § 1001(c)(1986). Certain exceptions from this rule of recognition are provided by the Code and § 355 is one such nonrecognition situation.


4. E.g., Clark, The Morphogenesis of Subchapter C: An Essay in Statutory Evolution and Reform, 87 YALE L.J. 90, 105 (1977). Bail-outs defined as "schemes to transform corporate distributions that normally would appear in ordinary income form into proceeds that appear to be capital gains."

For example, corporation X has two stockholders, A and B and $10 in its corporate solution. Corporation X could declare a dividend of $10 and distribute $5 each to A and B. Upon receipt, A and B would include the $5 in their gross income and it should be taxable as ordinary income. See, I.R.C. §§ 301(c)(1), 316(a)(1986). But suppose corporation X takes the $10 and buys all the stock in corporation Y and then distributes this stock to A and B. If this distribution is tax-free, then A and B are better off. Since they can now sell the stock of corporation Y at capital gains rates without sacrificing their interest in corporation X.

Schneider, Internal Revenue Code Before and After The Tax Reform Act of 1986—A Study in the Regulation of Corporate Tax Bailouts, 39 Okla. L. REV. (1986) referring to bail-outs: "The Tax Reform Act of 1986 has altered the meaning of this term, since the preferential capital gains treatment has been eliminated. Bailouts can and still should occur after 1986, but investors now attempt to defer tax on ordinary income, instead of converting ordinary income into capital gain."
any immediate tax consequence.\textsuperscript{5} The purpose of section 355 is to distinguish between bail-outs and legitimate corporate restructurings and only to accord nonrecognition treatment to the latter.\textsuperscript{6}

Basically, section 355 contains two safeguards against sham separations: the device clause and the active business test.\textsuperscript{7} The device clause provides that nonrecognition is not afforded transactions which are used principally as a "device" to distribute profits and earnings.\textsuperscript{8} The active business test provides that both corporations must be engaged in the "active conduct of a trade or business" for five years prior to the distribution and immediately following the distribution.\textsuperscript{9}

Although section 355 provides these limits to prevent corporate tax bail-outs, they often result in the denial of nonrecognition treatment to legitimate corporate restructuring.\textsuperscript{10} The problem is in the statute itself. Although the 5 year period is an arbitrary meas-

\textsuperscript{5} E.g., Whitman, \textit{supra} note 2, at 1195.

\textsuperscript{6} Commissioner v. Gordon, 391 U.S. 83, 92-93 (1968): "The general purpose of the section 355 was to distinguish corporate fission from the distribution of earnings and profits." Spheeris v. Commissioner, 461 F.2d 271, 275 (7th Cir. 1972). "The purpose of the statute is to deter taxpayers from utilizing corporate reorganizations as a means of tax avoidance rather than accomplishment of legitimate business purposes, by transforming corporate earnings normally taxable as ordinary income into earnings qualified for capital gains treatment."

\textsuperscript{7} Lee, \textit{supra} note 3, at 253.

\textsuperscript{8} I.R.C. § 355(a)(1)(B) (1986) This section provides that:
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 a device).

\textsuperscript{9} I.R.C. § 355(a)(1)(C) & (b) (1986). § 355(b)(1) provides that: Requirements as to active business.

urement, it is still a formidable obstacle to nonrecognition distributions. Moreover, the statute does not define the 5 year rule adequately. The 4 year rule requires that the controlled corporation be in the "active conduct of a trade or business," yet defines neither active conduct nor trade or business.

Edna Louise Dunn Trust v. Commissioner is significant as it addresses yet another undefined term of the 5 year rule: the controlled corporation. In this case, the issue was whether the 5 year rule only applied to the controlled corporation as a whole entity or to its underlying holdings as well. The Tax Court held that the controlled corporation, not its subsidiary, must have a five year business history. Moreover, this narrow application of the 5 year rule shifts emphasis to the device clause, the more appropriate provision for evaluating bail-outs.

Since this decision, Congress has enacted the Tax Reform Act of 1986. Section 355 was not changed. However, the preferential tax on capital gains was eliminated. Since capital gains is no longer available to shareholders, perhaps corporations and shareholders will be more inclined to utilize section 355. After 1986, the decision in Dunn Trust may have the potential of affecting a greater number of taxpayers.

II. BACKGROUND

Section 355 of the Internal Revenue Code provides nonrecognition treatment for stock distributions to shareholders during corporate
separations. There are three types of corporate separations: spin-offs, split-offs and split-ups. In a spin-off shareholders receive stock of a subsidiary while still retaining their stock interest in the distributing corporation. In a split-off, shareholders of a corporation exchange some or all of their stock in the distributing corporation for the stock of the subsidiary. Finally, in a split-up, shareholders of a corporation exchange all of their stock in that corporation for the stock of its subsidiaries, and the distributing corporation dissolves. Each separation effectuates the same ends: to divide the original corporate solution into two or more corporations with the original shareholders owning stock in one or all the corporations.

By 1924, all three of these corporate separations had been made exempt from immediate taxation. Congress decided that corporate readjustment did not result in a taxable transaction to the individual shareholders. The shareholders still had the same equity Interest in the corporate assets after the separation as before. As a group, the shareholders owned the same amount of assets as before, just the corporate form had changed. This exemption from immediate taxation facilitated readjustments which were necessary for the efficient use of corporate assets. For example, the original corporation could be divided into functional units which presumably could produce more income individually than as a group.

While promoting corporate efficiency and genuine reorganizations, the nonrecognition status of separations was also an attractive

25. Revenue Act of 1918, ch. 18, § 202(b), 40 Stat. 1057, 1060 (1918); split-ups and split-offs qualified for nonrecognition treatment. Revenue Act of 1924, ch. 234, § 203(c), 43 Stat. 253, 256-57 (1924); nonrecognition was extended to spin-offs.
26. E.g., Young, Corporate Separations: Some Revenue Rulings Under Section 355, 71 HARV. L. REV. 843, 844 (1967); “Congress, believing that such readjustments behind the corporate walls did not mark an appropriate time to tax the shareholder, added the reorganization provisions to the law in order to postpone the recognition of gain or loss in such cases.”
27. E.g., Commissioner v. Baan, 382 F.2d 485, 495 (9th Cir. 1967), aff’d 391 U.S. 83 (1968). “The fundamental basis of nonrecognition of gain or loss under section 355 is that no tax should be imposed when the same people continue to own the same businesses with only formal changes in the business organization.”
means for avoiding taxes. Separations could be used to bail-out dividends. Historically in a bail-out, the parent corporation indirectly distributes earnings and profits to its shareholders with the distribution ultimately receiving capital gains treatment. For example, the parent corporation could incorporate a subsidiary. With its earnings, the parent corporation could buy all the stock of the subsidiary and distribute this stock to its shareholders. Ordinarily, a direct distribution would be deemed a dividend and taxed as ordinary income immediately. If the corporation and stock purchase are tax-free, then the distribution would not be recognized for tax purposes. Subsequently, the shareholders could sell the subsidiary’s stock and receive capital gains treatment without sacrificing any of their interest in the parent corporation.

The classic case of bail-out by separation is Gregory v. Helvering. Mrs. Evelyn F. Gregory owned the United Mortgage Corporation which held stock in the Monitor Corporation. Mrs. Gregory had found a buyer for the Monitor stock and wished to sell the stock herself. If United Mortgage distributed the Monitor stock to her this would be a stock dividend taxable as ordinary income. To avoid this tax consequence, Mrs. Gregory formed a new corporation, Averill

29. E.g., Whitman, supra note 2, at 1195.
30. See supra note 4.
31. Through 1968, a taxpayer other than a corporation could deduct from gross income 60 percent of the amount of his/her net capital gains. I.R.C. § 1202(a) (1986). See, Clark, The Morphogenesis of Subchapter C: An Essay in Statutory Evolution and Reform, 87 YALE L.J. 90, 104-05 (1977): “Capital gains was first given preferential treatment by the Revenue Act of 1921. The purpose was to increase tax revenues by encouraging the sale of capital assets. Previously, the sale of capital assets was retarded by the overwhelming tax consequences of gains accrued over a series of years.” See also supra note 19.
32. E.g., B. BITTKER & J. EUSTICE, supra note 26, at 7.01: “(A) corporate distribution is a ‘dividend’ that must be included in the recipient’s gross income under §§ 301(c)(1) and 61(a)(7) if, and to the extent that, it comes out of the earnings and profits of the corporation accumulated after February 28, 1913 or out of earnings and profits of the taxable year. Most distributions of most corporations fall well within this category of taxable ‘dividends’ and hence are taxed as ordinary income to the shareholder.”
35. Capital gains are afforded on the sale of a capital asset. Here, the shareholders still own their original capital investment.
36. 69 F.2d 809 (2d Cir. 1934), aff’d 293 U.S. 465 (1935).
Corporation. She persuaded United Mortgage to exchange the Monitor stock for the new Averill stock and then distribute the Averill stock to her, as a tax-free reorganization under the Revenue Act of 1928. Three days later, Mrs. Gregory dissolved Averill and had all its assets, namely the Monitor stock, distributed to herself. Mrs. Gregory then sold the Monitor stock, reporting no gain. The Commissioner assessed a deficiency in income tax. The Board of Tax Appeals set aside the deficiency since the transaction was within the letter of the law.\textsuperscript{37} The Second Circuit reversed, finding that Mrs. Gregory's scheme was not within the exemptions intended by Congress.\textsuperscript{38} The Supreme Court affirmed. Justice Sutherland found no "business purpose" in the transaction and characterized it as "an elaborate and devious form of conveyance masquerading as a reorganization."\textsuperscript{39} Mrs. Gregory was denied nonrecognition treatment, but only because of judicial gloss.\textsuperscript{40}

Responding to the \textit{Gregory} scheme, Congress set out to reform the separation provisions.\textsuperscript{41} In 1934, spin-offs were removed from nonrecognition treatment while split-offs and split-ups retained nonrecognition status.\textsuperscript{42} In 1951, Congress revived the spin-offs as tax-free transactions.\textsuperscript{43} It was not until 1954 that massive reforms were enacted.\textsuperscript{44}

In an effort to distinguish between genuine and sham corporate readjustments, Congress drafted Section 355 of the Code. Section 355 contained two safeguards against sham separations: the device clause and the active business test.\textsuperscript{45} The device clause provides that nonrecognition is not afforded transactions which are primarily used to

\begin{footnotesize}
\begin{enumerate}
\item Evenly F. Gregory, 27 B.T.A. 223 (1932).
\item Helvering \textit{v.} Gregory, 69 F.2d 809 (2d Cir. 1934).
\item Gregory \textit{v.} Helvering, 293 U.S. 465, 470 (1935).
\item Schneider, \textit{supra} note 4, at ____.
\item See \textit{e.g.}, Whitman, \textit{supra} note 2, at 1196 n.9, referring to Gregory \textit{v.} Helvering: "This case, well known for originating the 'business purpose' doctrine, is also the inspiration for the 'device' clause in \S\ 355 of the 1954 Code."
\item Revenue Act of 1934, ch. 277, 48 Stat. 680 (1934).
\item Revenue Act of 1951, ch. 521, \S\ 317, 65 Stat. 452, 493 (1951) allowed one corporation to spin-off the stock of another corporation if: (i) the distributed stock was not preferred stock (ii) both the distributing and controlled corporations "continued the active conduct of a trade or business" after reorganization; and (iii) the controlled corporation was not "used principally as a device for the distribution of earnings and profits" to its shareholders or to shareholders of the distributing corporation.
\item I.R.C. \S\ 355 (1954).
\item See \textit{supra} note 3.
\end{enumerate}
\end{footnotesize}
distribute profits and earnings. The separation must be furthering some legitimate business purpose. The active business test requires that both the distributing corporation and the controlled corporation be engaged in the “active conduct of a trade or business” for five years prior to the distribution (the 5-year rule) and immediately following the distribution. Further, the stock of the controlled corporation must not have been acquired by the distributing corporation in a transaction in which it recognized gain or loss within five years of its distribution. In this situation, the stock of the controlled corporation would be treated as “other property,” thereby forcing gain recognition.

Although the device clause seems to attack bail-outs in a straightforward fashion, past litigation has centered on the active business test. The active conduct of a trade or business for a period of five years prior to distribution is an inescapable hurdle for any separation. As a result, the focus has been on “questions of definition - whether a certain business has been ‘active’ or not - rather than on transactional analysis - whether any particular separation should be allowed tax-free treatment.”

Moreover, there has been much uncertainty under section 355. In Isabel A. Elliott v. Commissioner, the Eighth Circuit noted “(w)hat constitutes a trade or business is not defined in section 355 or anywhere else in the Internal Revenue Code.” In Estate of Thorval J. Lockwood, the Tax Court noted “what is meant by the ‘active conduct of a trade or business’ is nowhere explained in the Code.”

The Service helped to fill this void by issuing regulations. These regulations were often more restrictive than the statute and some

46. See supra note 8.
47. See supra note 41.
48. See supra note 9.
  stock of the controlled corporation acquired by the distributing corporation by reason of any transaction which occurs within 5 years of the distribution of such stock and in which gain or loss was recognized in whole or in part, shall not be treated as stock of such controlled corporation, but as other property.
50. See, e.g., Lee, supra note 3, at 253.
51. E.g., Whitman, supra note 2, at 1211.
52. Id.
54. 33 T.C.M. (P-H) 1350, 1357 (1964), rev’d, 350 F.2d 712 (8th Cir. 1965).
56. E.g., Lyons supra note 13, at 21, referring to Treas. Reg. § 1.355-1(c)
courts have refused to follow them.\textsuperscript{57} For example in \textit{King v. Commissioner}, the Sixth Circuit stated, "We decline to rest our determination upon these imprecise regulations, and instead rely upon the language of the statute itself and its legislative history."

Thus the undefined terms of section 355 have largely gained their meaning from court decisions. In \textit{Bonsall v. Commissioner},\textsuperscript{59} the Second Circuit found "(o)nly long application may completely clarify the difficult terminology of section 355."\textsuperscript{60}

This emphasis on judicial interpretation is the direct result of legislative inactivity.\textsuperscript{61} Since section 355 was enacted in 1954, no changes have been made by Congress.\textsuperscript{62} Thus the \textit{Dunn Trust} decision will take its place along with other judicial definitions of section 355 terminology.

(1955): "The regulations define a trade or business as consisting 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.' The language of the statute does not appear to require so strict a construction."

\textsuperscript{57} See, \textit{e.g.}, Edmond P. Coady, 33 T.C. 771 (1960), \textit{aff'd per curiam}, 289 F.2d 490 (6th Cir. 1961) (the Tax Court held that Treas. Reg. 1.355(a) (1955) was invalid).

\textsuperscript{58} 458 F.2d 245 (1972).

\textsuperscript{59} For example, in Rafferty v. Commissioner, 452 F.2d 767 (1st Cir. 1960), \textit{cert denied}, 408 U.S. 922 (1972), the First Circuit held: "It is our view that in order to be an active trade or business under Section 355 a corporation must engage in entrepreneurial endeavors of such a nature and to such an extent as to qualitatively distinguish its operations from mere investments."; Parshelsky's Estate v. Commissioner, 303 F.2d 14, 22 (2d Cir. 1962) (There must be a valid business purpose to support both the division of the corporate entity and the distribution of the new corporate stock to the shareholders). Commissioner v. Wilson, 353 F.2d 184, 187 (9th Cir. 1965) (Even if there is no tax avoidance motive, a separation having no business purpose does not qualify under § 355).

\textsuperscript{60} 317 F.2d 61, 65 (1963).


\textsuperscript{62} No changes were made in the Tax Reform Act of 1986.
III. EDNA LOUISE DUNN TRUST v. COMMISSIONER

A. FACTS OF THE CASE

On August 24, 1982, a longstanding antitrust suit against American Telephone and Telegraph Company (AT&T) was settled. Under the terms of the decision AT&T was to break up its operations through an agreed plan of reorganization and divestiture.

Prior to this break up, the AT&T infrastructure was composed of a network of holding companies and operating companies with many parent-subsidiary relationships. For simplicity and the purposes of this case, AT&T corporate structure can be divided into seven regional holding companies (RHCs) and twenty-two Bell operating companies (BOCs).

Pursuant to the plan of reorganization and divestiture, the BOCs were placed in the control of the seven RHCs. Thus, AT&T, which owned the RHC stock, gave each RHC the stock of the BOCs in its geographic region. In return, each RHC gave AT&T its stock.

In January of 1984, AT&T stockholders received a distribution of the newly acquired stock of each of the seven RHCs in an amount reflecting their investment in AT&T. A trust in the name of Edna Louise Dunn (Dunn Trust) held 400 shares of AT&T and thus received 40 shares of each of the seven RHCs.

At issue in Dunn Trust is the characterization, for purposes of section 355, of the 40 shares of one of the RHCs, Pacific Telesis Group (PacTel Group). AT&T received the PacTel stock (here, the

64. United States v. AT&T, 552 F. Supp. at 138. The reorganization involved the division of AT&T into regions. AT&T was to divest itself from a group of subsidiaries known as the Bell System, whose principal business was furnishing communication services and equipment.
65. The Bell System included 22 Bell operating companies (BOCs) which were direct or indirect subsidiaries of AT&T, Western Electric Co., Inc., Bell Telephone Laboratories, Inc., and other companies. AT&T's seven regional holding companies (RHCs) were American Information Technologies Corp., Bell Atlantic Corp., Bell South Corp., NYNEX Corp., Pacific Telesis Group, Southwestern Bell Corp. and U.S. West, Inc. See, Dunn Trust v. Commissioner, 86 T.C. (P-H) 86.46, at 378 (April 17, 1986).
66. Id. at 379-80.
67. Id. at 378. See AT&T, INFORMATION STATEMENT AND PROSPECTUS 20 (November 8, 1983); Each AT&T shareholder received one share of stock in each of the seven RHCs for every ten shares of AT&T common stock held.
68. Id. at 380.
ROTC) in exchange for Pacific stock (here, the BOC).⁶⁹ The Pacific stock had been acquired within the last 5 years in a transaction recognizing gain or loss.⁷⁰ According to the literal terms of section 355, the distribution of this stock would lead to a recognition of gain or loss to the recipient.⁷¹ However, Dunn Trust argued that it did not receive the Pacific stock but rather they received the PacTel stock.⁷² The controversy was whether the 5 year rule applies to PacTel only as a whole entity or also to the underlying activities of PacTel, namely the Pacific stock.⁷³

The history of the Pacific stock is as follows. Prior to the antitrust reorganization, the Federal Communications Commission (FCC) ordered AT&T to restructure and separate the functions of the BOCs.⁷⁴

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⁶⁹. Id.
⁷⁰. Id. at 379. The Pacific shareholders recognized gain or loss because AT&T did not acquire control of Pacific within the meaning of I.R.C. § 368(c) (1986). AT&T did not acquire any of Pacific’s nonvoting preferred stock.
⁷¹. See supra note 49 and accompanying text. The Pacific stock would be “other property.”
⁷². Dunn Trust, 86 T.C. (P-H) 86.46, at 380 (April 17, 1986).
⁷³. Id.
⁷⁴. Id. at 379 (citing Amendment of Section 64.702 of the Commissioner’s Rules and Regulations (Second Computer Inquiry), 77 F.C.C. 2d 384 (1980), as modified on reconsideration, 88 F.C.C. 2d 512 (1981), aff’d sub nom., Computer & Communications Indus. Ass’n v. FCC, 693 F.2d 198 (D.C. Cir. 1982), cert. denied sub nom., Louisiana Public Serv. Comm’n v. Federal Communications Comm’n, 461 U.S. 938 (1983)).
Pursuant to the FCC mandate, AT&T entered into a merger agreement in November of 1981.\textsuperscript{75} The corporations involved were AT&T, Pacific and Pacific Transition Corporation (Transition), a newly formed, wholly owned subsidiary of AT&T.\textsuperscript{76} Transition merged into Pacific exchanging AT&T stock and money for Pacific stock.\textsuperscript{77} AT&T did not acquire control over Pacific, thus the Pacific stockholders recognized gain or loss in the merger.\textsuperscript{78}

Subsequently, through the Plan of Reorganization resulting from the antitrust suit, AT&T was allowed to amend Pacific’s Articles of Incorporation and thereby acquire control of Pacific.\textsuperscript{79} In October of 1983, the Internal Revenue Service ruled that this amendment qualified as a reorganization and no gain or loss was to be recognized by AT&T or Pacific stockholders.\textsuperscript{80}

In Dunn Trust, the taxpayer and the Service agreed that AT&T did not have control over Pacific until 1983, so this stock was improperly aged.\textsuperscript{81} What was being disputed was the Service’s determination that the portion of the PacTel stock attributed to the Pacific stock-swap should be recognized and taxable.\textsuperscript{82} On this basis, the Service found a deficiency in Dunn Trust’s federal income tax return of $29.64.\textsuperscript{83} Dunn Trust asserted that this was an erroneous interpretation of section 355 and the 5 year rule.\textsuperscript{84} Dunn Trust filed this suit

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  \item \textsuperscript{75} Dunn Trust, 86 T.C. (P-H) (qar) 86.46, at 379 (April 17, 1986).
  \item \textsuperscript{76} Id.
  \item \textsuperscript{77} Id. Pacific stockholders received .35 shares of AT&T common stock in exchange for each share of Pacific common stock and $60 in cash for each share of Pacific 6 percent voting preferred stock.
  \item \textsuperscript{78} See supra note 70.
  \item \textsuperscript{79} Dunn Trust, 86 T.C. (P-H) (qar) 86.46, at 379 (April 17, 1986): “The Plan of Reorganization provided that the Articles of Incorporation of Pacific would be amended to convert the one outstanding share of Pacific voting common stock into 224,504,982 shares of voting common stock (the number of common shares outstanding prior to the merger), and to modify the rights of the nonvoting preferred stock to entitle each share to one vote per share with cumulative voting for directors as authorized by California law.”
  \item \textsuperscript{80} Id. On October 6, 1983, the Service ruled the amendment to Pacific’s Articles of Incorporation qualified as a reorganization within the meaning of I.R.C. § 368(a)(1)(E) and therefore no gain or loss would be recognized.
  \item \textsuperscript{81} Id. at 380. See supra text accompanying not 49. The stock was “improperly aged” as it was acquired within 5 years of the PacTel stock distribution.
  \item \textsuperscript{82} See supra note 49. The Service determined the Pacific stock was “other property.”
  \item \textsuperscript{83} Dunn Trust, 86 T.C. (P-H) (qar) 86.46, at 378 (April 17, 1986).
  \item \textsuperscript{84} Id. at 380.
\end{itemize}
to eliminate the deficiency.

B. DECISION & RATIONALE:

In a majority opinion by Judge Tannenwald, the Tax Court held that no portion of the PacTel stock distributed to AT&T's stockholders constituted "other property."85 In the five years prior to the distribution, none of the PacTel stock was acquired by AT&T in a transaction recognizing gain or loss.86 Since the PacTel stock met the requirements of Section 355 and no gain or loss was to be recognized on the distribution. Thus, there was no deficiency in federal tax return of Dunn Trust.87

Judge Tannenwald addressed each of the two Service arguments individually. First, the Service argued that Pacific was a "controlled corporation" of AT&T for the purposes of section 355.88 If this was held valid, then the Pacific stock would constitute "other property."89 AT&T acquired all of the Pacific stock through a merger agreement in which gain or loss was recognized.90 Further, the merger agreement occurred within five years of the distribution at issue here.91 Since the Pacific stock is "other property," the distribution of the PacTel stock would not meet the requirements of a § 355 distribution, thus gain or loss must be recognized by the recipient shareholders.92 The court found this argument to be erroneous from two points of view. First, from a literal standpoint, Pacific was not a "controlled corporation" of AT&T since AT&T did not own the Pacific stock prior to the distribution.93 AT&T had exchanged the Pacific stock for the PacTel stock, which was the stock that was ultimately distributed. There could be no distribution, which is a fundamental element of this case, without AT&T first relinquishing the Pacific stock. AT&T could not control a corporation without owning its stock.94 Turning from the

85. Id. at 383. The court held that the PacTel stock was properly aged according to the 5 year rule and AT&T had acquired control of PacTel within the meaning of I.R.C. 368(c) (1954). See supra note 49.
86. Id. at 380.
87. Id. at 384.
88. Id. at 380; I.R.C. § 355(a)(1)(D)(ii).
89. See supra note 49.
90. Dunn Trust, 86 T.C. (P-H) (qar) 86.46, at 379 (April 17, 1986).
91. Id.
92. Id.
93. Id. at 381-82.
94. I.R.C. § 368(c) (1984) 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.
literal meaning of "controlled corporation," the court looked to the legislative history. In 1954, the Senate Finance Committee amended the Senate version of section 355(a)(3) to read:

"stock of a controlled corporation acquired by the distributing corporation within 5 years of its distribution. IN A TRANSACTION in which gain or loss was recognized in whole or in part, shall not be treated as stock of such controlled corporation, but as other property."

The Conference Committee further modified the phrase "within 5 years of its distribution, IN A TRANSACTION" to read "BY REASON OF ANY TRANSACTION which occurs within 5 years of the distribution of such stock." The explanation of this modification was to broaden the range of stock purchases which could justifiably constitute "other property." This modification prevented a distributing corporation from acquiring additional controlled corporation stock through a tax-free transaction with a related corporation and then distributing all the stock on a valid nonrecognition basis. The Service argued that Pacific, PacTel and AT&T are related corporations and were meant to be encompassed in this modification. The court pointed out that with or without the modification, section 355(c)(3)(B) required a distribution of the controlled corporation’s stock. Regardless of the close relationship of the three corporations, Pacific’s stock was never distributed. From Section 355’s literal reading or historic development, the Tax Court could not find that the Pacific stock was “other property.” The status of “other property” attaches to stock which is distributed. The Pacific stock was never distributed.

The Service’s second argument is that the overall statutory framework of section 355 requires that the underlying subsidiary have its

95. Dunn Trust, 86 T.C. (P-H) (qar) 86.46, at 381 (April 17, 1986).
96. Id. (quoting H.R. 8300, 83rd Cong., 2d Sess. 1622 CONG. REC. 122 (1954)). (Emphasis in original).
98. Id.
99. Id.
100. Dunn Trust, 86 T.C. (P-H) (qar) 86.46, at 381 (April 17, 1986). The court recognized that the Service might have a valid argument here since the statute and the modification were “sufficiently ambiguous.”
101. Id. at 381-82.
own 5 year business history. Under section 355(b)(2)(A), a controlled
corporation can actually satisfy the 5 year rule through a subsidiary. For
elementary, assume corporation Y is a subsidiary of corporation X
and corporation Y is engaged in the active conduct of a trade or
business. If substantially all of corporation X’s assets consist of the
stock of corporation Y, then corporation X will be treated as engaged
in the active conduct of a trade or business. The Service argued that
since a subsidiary can fulfill the active business requirement of the
distributing or controlled corporation, then the stock of the subsidiary
should be investigated for its potential status as “other property.”
Without such a requirement, the statute would not be symmetrical.
The court found it difficult to make this “analytical jump.” If the
statute is as inconsistent as the Service believed, then Congress must
have been aware of this dichotomy and intended such a result. The
court held that unless this narrow application of other property
“would lead to absurd results . . . or would thwart the obvious
purpose of the statute” it would not adopt a different construction.
The purpose of section 355 is to prevent the conversion of earnings
and profits into a sham stock distribution which receives favorable
nonrecognition treatment. AT&T did not bail-out liquid assets when
it spun-off PacTel. The Pacific stock has still remained in the
 corporate solution. The question to recognize a gain or loss must be
proceeded by an actual distribution. No such distribution has oc-
curred.

Lastly, the court noted future problems which would result if the
Service’s reasoning were adopted. What happens when the Pacific
stock is finally distributed? What value does it have? Should it be
“tainted” in a subsequent 355 distribution? What if more than one
class of stock is involved? If a subsidiary is required to have its own
5 year history, what about a subsidiary of a subsidiary?

102. Id. at 382.
103. I.R.C. § 355(b)(2)(A) (1986). A corporation shall be treated as being
engaged in the active conduct of trade or business if “substantially all its assets”
consist of stock of a controlled subsidiary which is so engaged.
104. Dunn Trust, 86 T.C. (P-H) (qar) 86.46, at 382 (April 17, 1986). See supra
note 49 for the statutory definition of “other property.”
105. Id.
106. Id.
107. Id.
108. Id. (quoting Helvering v. Hammel, 311 U.S. 504, 510-11 (1941)).
109. 86 T.C. (T.C. (P-H) (qar) 86.46 at 383.
110. Id.
111. Id.
Judge Tannenwald concluded that none of the Service's arguments had persuaded him to believe the purpose of the statute was being frustrated by the court's interpretation. If the Service felt that there was a bail-out and that section 355 had not envisioned this sort of transaction, the Service could challenge the transaction as a device. The Service had declined this line of argument conceding that the implementation of the FCC order and the antitrust decree were valid business purposes. Having conceded that AT&T was acting under a valid business purpose, the Service should not be allowed to circumvent the device clause by expanding the 5 year rule.

C. ANALYSIS:

It ordinarily is to the advantage of a corporation and its shareholders to distribute stock to the shareholders on a nonrecognition basis. The recognition of gain or loss can have substantial effects on the fair market value of both the controlled corporation's and the distributing corporation's stock. On the other hand, corporations cannot be allowed to bail-out profits and earnings through tax-free restructuring.

Section 355 curtails the temptation to restructure principally for the tax advantage of nonrecognition distributions. But it should follow that restructuring for other reasons should not be prohibited by section 355. On this basis, the decision in Dunn Trust has put the application of section 355 in its appropriate context.

In Dunn Trust, the Tax Court held that the Pacific was not the "controlled corporation" to which section 355 was applicable. This

112. Id.
113. Id. at 383-84. See supra note 8 for the statutory definition of a device.
114. 86 T.C. (P-H) (qar) 86.46 at 384. See Schneider, supra note 4, at ___: "(B)usiness purpose should be evidence of whether or not the separation is a 'device' for distributing the profits of any of the participating corporations authority to the contrary notwithstanding." See also, Lester v. Commissioner, 40 T.C. 947 (1963) (business purpose subsumed by device clause); But see Commissioner v. Wilson, 353, F.2d 184 (9th Cir. 1965) (business purpose independent of device clause).
115. Id.
116. Cf. Commissioner v. Wilson, 353 F.2d 184, 187 (9th Cir. 1965). (Court denying tax advantages to corporation which had undertaken such distribution, for reason that underlying reorganization had been for no valid business purpose).
118. E.g., Lyons, supra note 10, at 32. Shareholders receiving a bail-out of profits and earnings "should be made to bear the burden of ordinary income rates."
119. See supra note 8.
120. Dunn Trust, 86 T.C. (P-H) (qar) 86.46, at 381 (April 17, 1986).
statutory interpretation is proper for two reasons. First, AT&T did not control Pacific "immediately before distribution" as required by section 368(c). AT&T did not own any Pacific stock immediately before the distribution, let alone possess a controlling interest. AT&T had already exchanged the Pacific stock for the PacTel stock. If Pacific is not AT&T's controlled corporation under 368(c), inconsistency would arise to find PacTel controlled under section 355. On its face, section 355 stipulates the same requirement, a corporation controlled "immediately before distribution." Second, section 355 distribution is a distribution of stock and securities of a "controlled corporation." AT&T did not distribute the Pacific stock to its shareholders. The Pacific stock remained in PacTel's corporate pool. There was no distribution within the meaning Congress intended for section 355.

In light of this statutory construction, PacTel was the controlled corporation. PacTel was controlled "immediately before the distribution" under both sections 368(c) and 355. Further, the stock actually distributed was the PacTel stock. Having established that PacTel was the controlled corporation, PacTel must have a 5 year history to qualify for nonrecognition treatment.

But does this requirement pertain to the whole corporation or each of its assets, specifically the Pacific stock? This is the heart of the Dunn Trust decision. The Tax Court held that PacTel was an entity which must have a 5 year history. The court's analysis relied almost exclusively on the fact that the Pacific stock remained in PacTel's corporate solution. The court noted future evaluation problems if the Pacific stock was held to be "other property" under section 355. However, the court had a stronger argument available in holding that PacTel must have a 5 year history only as a whole entity. To hold otherwise would result in a conflict between the 5

121. See supra note 93.
125. Dunn Trust, 86 T.C. (P-H) (qar) 86.46, at 383 (April 17, 1986).
126. See, Commissioner v. Levi, 136 F.2d 366, 367 (7th Cir. 1943): "Congress used the word 'distribution' in its usual and commonly accepted sense. Websters (sic) defines 'distribute' as meaning to 'divide among several or many; . . . apportion; a lot.'"
127. Dunn Trust, 86 T.C. (P-H) (qar) 86.46, at 381 (April 17, 1986).
128. See supra note 9.
129. Dunn Trust, 86 T.C. (P-H) (qar) 86.46, at 381-82 (April 17, 1986).
130. Id. at 383.
year rule and the active business rule. Section 355 requires both the distributing corporation and the controlled corporation to be actively conducting a trade or business throughout the 5 years prior to distribution. PacTel was in the business of providing communication services. PacTel was providing these services for 5 years prior to the distribution.

The acquisition of the Pacific stock did not alter PacTel's prior business activities. Following the acquisition, PacTel's communication services were expanded to the Pacific customers but this expansion did not alter the trade or business that PacTel was conducting. PacTel had been in the same business throughout the 5 years prior to distribution. Thus in essence, to hold that the Pacific stock must have its own 5 year history ignores the fact that PacTel has satisfied the active business requirement of the statute. Given either rationale, the result is still the same for the purposes of section 355. PacTel is the controlled corporation requiring a 5 year history.

In Dunn Trust, the Tax Court centered its analysis on the definition of a controlled corporation. This was unavoidable since the Service's argument was that Pacific was the controlled corporation. However, the court did look at the whole transaction itself. The court answered the simple question of whether this was a bail-out. The Pacific stock was still in the corporate solution of PacTel, but then again, AT&T acquired the PacTel stock by giving up the unaged Pacific stock. But for the unaged Pacific stock, the ultimate distribution of the PacTel stock would not have occurred. Was this sufficient grounds to treat the distribution of the PacTel stock as a bail-out? The Tax Court accurately found that it was not.

By definition, a bail-out involves the distribution of earnings and profits to shareholders without a corresponding decrease in their equity interest. First, AT&T did not acquire the Pacific stock, stock it would distribute to its shareholders with its liquid assets. Over 97% of the consideration furnished by AT&T was newly-issued shares of its own stock. Thus, AT&T's earnings would not be distributed to its shareholders when they received the Pacific stock. Second, the

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131. See supra note 9.
133. Id. at 383. See also Whitman, supra note 2, at 1211. Whitman stresses the transactional analysis over the "sterile" definitional approach. The transactional analysis asks the basic question: is this transaction a bail-out?
134. Id. at 383.
135. See supra note 4.
AT&T shareholders experienced a decrease in their percentage ownership in the company. If their original investment diminished because of the Pacific purchase, the receipt of the PacTel stock simply returned them to their original economic status. The court correctly found that AT&T stockholders did not engage in a bail-out. The distribution of the PacTel stock to the AT&T stockholders was not a taxable event.

IV. IMPLICATIONS:

The 5 year rule and the device clause were drafted as safeguards against sham separations seeking a tax-free treatment. However the 5 year rule, by its concrete nature, has overstepped this purpose. Businesses bought within the statutory period are automatically disqualified from section 355, whether the subsequent separation is a bail-out or not. Commentators have criticized the emphasis of this rule over the transactional analysis, whether the particular separation should be allowed tax-free treatment. The Dunn Trust decision is a welcomed restriction to the overinflated 5 year rule.

Courts cannot ignore mandates of Congress's yet they can temper their practical impact through strict construction of the individual provisions. The Tax Court in Dunn Trust ameliorated the harshness of the 5 year rule by limiting its application. The court would not expand the 5 year rule to include an "indirect distribution" of the Pacific stock. The court reasoned that Congress did not intend to put direct distributions on a par with indirect distributions.

While the Dunn Trust decision decreases potential disqualifications based only on an arbitrary cut-off, it also places more emphasis on the device clause. If more separations can avoid the 5 year rule requirement, then the device clause will be used by courts to snare sham separations. At the same time, more legitimate separations have the potential of qualifying. This would be progressive change. The

137. Id. at 383 n.6. "When a corporation issues new stock in exchange for adequate consideration, existing shareholders realize no increase in the value of their individual holdings, because although the overall net worth of the company rises, so does the number of shares outstanding."
138. Id. at 383.
139. See, Lee, supra note 3, at 253.
140. See, Lyons, supra note 10, at 32.
141. See generally, Whitman, supra note 2.
142. Dunn Trust, 86 T.C. (P-H) (qar) 86.46, at 383 (April 17, 1986).
143. Id. at 384 (emphasis in original).
144. See supra note 18.
device clause gets right to the essence of section 355: is this a bail-
out? 145

Although the device clause sounds like the right tool for the right
job, it may have its drawbacks. As arbitrary as the 5 year rule is, it
does have the attribute of certainty which the device clause lacks. 146
The device clause lacks certainty because of its nature. Whether a
distribution is being used principally as a device to avoid federal taxes
is a factual question and depends on a matter of degree when other
business purposes are present. The device clause also lacks predicta-
bility because it, like any other term under section 355, lacks an
adequate definition. 147 Like any other term under section 355, the
device clause will have to be defined through litigation. Perhaps Dunn
Trust has opened the door for more use of the device clause in section
355 cases and thus more opportunity to refine it. Hopefully, the
refinement will decrease the uncertainty of the device clause yet not
to the extent that it becomes as rigid as the 5 year rule.

Moreover, the decision in Dunn Trust is significant in light of
the Tax Reform Act of 1986. Since the preferential tax on capital
gains has now been eliminated, 148 nonrecognition treatment may be
even more attractive. It is a fair assumption that taxpayers will always
minimize their taxes. 149 If capital gain is no longer a way for share-
holders to minimize their taxes, then other means will be utilized.
Arguably, the potential for bail-outs should increase. Given a choice
between a current or deferred tax, the shareholder would opt for the
deferral. 150 The goal of the bail-out would merely shift from obtaining
capital gains over ordinary income to qualifying for nonrecognition
rather than being currently taxed. 151 In a nonrecognition distribution,
the shareholder would still have control over the timing and amount
of tax. The shareholder could postpone the sale of the distributed
stock to a taxable year in which the sale would result in a lesser tax
consequence. For example, a shareholder could delay the sale until a
year in which he/she incurred a capital loss, then sell the quantity of
§ 355 stock which would off-set the loss. 152 Or, a shareholder could

145. See supra note 133.
146. E.g., Isabel A. Elliott v. Commissioner, 32 T.C. 283, 291 (1959). The
distribution of stock was denied nonrecognition as the control corporation was only
created four years and four months prior to the distribution.
147. See supra note 59 and accompanying text.
148. See supra note 19.
149. E.g., Schneider, supra note 4, at ____
150. Id.
151. Id.
sell in a year in which he/she had little income, thereby having the proceeds taxed at a lower tax rate.

If the tax climate has conceivably created more attempts for §355 distributions and the *Dunn Trust* decision qualifies potentially more separations for nonrecognition treatment, then the use of the device clause is paramount to curb bail-outs. Although the device clause is preferable to strict requirements such as the 5 year rule, it is still a nebulous standard. Only future litigation will tell whether the device clause will be a lamb or a lion. At least the *Dunn Trust* decision has shifted the analysis in the right direction.

V. CONCLUSION:

Section 355 of the Internal Revenue Code of 1954 provides that if a shareholder receives stock of a controlled corporation from a distributing corporation, under certain conditions, no gain or loss will be recognized on such stock. One inescapable requirement is that the controlled subsidiary must have been actively conducting business for 5 years prior to the distribution. This bench-mark is an arbitrary measure meant to distinguish legitimate separations from sham separations seeking tax-free treatment. Unfortunately, some legitimate separations cannot meet this requirement. A better test to distinguish between sham and legitimate separations is the device clause. The device clause asks the question: Is this a sham separation?

Historically, courts have emphasized the 5 year rule over the device clause since the 5 year period is a threshold requirement. In *Dunn Trust*, the court refused to expand the 5 year rule to encompass indirect distributions. By narrowing the application of the 5 year rule, the Tax Court shifted emphasis to the device clause. Perhaps the *Dunn Trust* decision has opened the door for more use of the device clause in §355 cases. Only application will define the true parameters of the device clause. This refinement is paramount as the device clause will ultimately determine the flexibility for future separations under §355.

*Delaine Frangos*