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Post-TEFRA Holding Company Strategies

David Randall Jenkins

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POST-TEFRA HOLDING COMPANY STRATEGIES

by

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PREFACE

The motivation for this report is derived in part from the regular business practice of JNC Business Planning Corporation. Moreover, this paper also initiates my personal statement objecting to the continuing attack on the closely-held business by the Internal Revenue Service and its parent organization, the Department of the Treasury. To this end, I extend to the reader the opportunity to utilize whatever business planning ideas that may be prompted by this writing.

I particularly want to thank two people on the staff of JNC Business Planning Corporation, Steven J. Moddelmog and Richard B. Slansky, for their patience and effort that contributed to the compilation of this memorandum. Further, I appreciate the patience and understanding extended to me by my partners, Timothy L. Shaftel and Renee M. Jenkins, while I have devoted so much of our firm's resources to producing this book.

D. Randall Jenkins, Ph.D.
JNC Business Planning Corporation
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May 23, 1983
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CHAPTER ONE
INTRODUCTION

The goal of this paper is to review the consequences of certain provisions of Subchapter C of the Internal Revenue Code (IRC) of 1954, as amended. Specifically, it will discuss:

1) The conflict between IRC Sections 304 and 351 prior to the enactment of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA),

2) The inapplicability of IRC Section 304 to newly-formed holding companies created prior to the effective date of certain provisions included in TEFRA,

3) The implications of TEFRA Act Section 226 on the IRC Section 304/351 conflict and the use of newly formed holding companies, and

4) The impact of Post-TEFRA IRC Section 304 on holding company strategies.

In covering these objectives, the paper deals, first, with the historical development of IRC Section 351(a). This tax provision, in general, covers the tax-free exchange of property for the stock and securities of certain controlled corporations. Second, this paper reviews the historical development of IRC Section 304, which provides that certain transactions between related corporations be treated as distributions taxable as dividends. Third, this paper discusses the controversy that has surrounded the concomitant application of IRC Sections 304 and 351. This
issue deals with the question of which taxing provision controls a transaction that falls within the purview of both. Fourth, the paper outlines the tax issues involved, including any concern relevant to an IRC Section 304/351 conflict, in transfers of corporate stock to newly formed holding companies. Next, the paper reviews the precedents and rationale for legitimate corporate existence and the tax provisions added to the Internal Revenue Code by TEFRA that involve the IRC Section 304/351 controversy and transfers to newly-formed holding companies in general. Finally, this paper investigates the implications of these new tax provisions for businesses attempting to achieve the same ends as they did when they used newly-formed holding company strategies under pre-TEFRA tax law.
CHAPTER TWO
APPLICATION OF IRC SECTION 351

The goal of this chapter is to review the historical development of IRC Section 351. The meaning of the terms "property," "stock and securities" and "control" under IRC Section 351 are reviewed to set the foundation for a later discussion of their application. Case law, Internal Revenue Code Sections and Federal Treasury Regulations are used to support and develop the meaning of the non-recognition purpose Congress intended for IRC Section 351.

Historical Development of Section 351

The transfer of property to a corporation was first made tax-free (i.e. the gain or loss is not recognized) in the Revenue Act of 1921. Under prior law the recognized gain or loss was the fair market value minus the basis of the property. However, this created uncertainty and litigation and seriously interfered with business readjustments which the Congress viewed as necessary under the existing conditions.\(^1\) Under this law the presumption was in favor of taxation, but the new bill modified that presumption by providing that on an exchange of property for

\(^1\) Fortney from Comm. on Way & Means, August 16, 1921, Report (to accompany H.R. 8245) p. 10.
property, no gain or loss would be recognized unless the property received had a definite and readily realizable market value. In addition, it specified certain classes of exchanges, including property transferred to a corporation for stock and securities, on which no gain or loss would be recognized notwithstanding the fact that the property received in the exchange had a readily realizable market value.

The original statute in the Revenue Act of 1921 read as follows:

For the purposes of this title, on an exchange of property, real, personal or mixed, for any other such property, no gain or loss shall be recognized unless the property received in exchange has a readily realizable market value; but even if the property received in exchange has a readily realizable market value, no gain or loss shall be recognized . . . when (A) a person transfers any property, real, personal, or mixed, to a corporation, and immediately after the transfer is in control of such corporation, or (B) two or more persons transfer any such property to a corporation, and immediately after the transferors are in control of such corporation, and the amounts of stock, securities, or both, received by such persons are in substantially the same proportion as their interests in the property before such transfer. For the purpose of this paragraph, a person is, or two persons are, 'in control' of a corporation when owning at least 80% of the voting stock and at least 80% of the total number of shares of all other classes of stock of the corporation.2

2 Section 202(c) of the Revenue Act of 1921.
With only minor differences in language, a similar provision has been included in every revenue statute between 1921 and 1954. The Internal Revenue Code of 1954 reenacted Section 112(b)(5) of the 1939 Code, renumbering it IRC Section 351 and making a few changes.

Because of the difficulty in ascertaining the value of the property transferred to a corporation and the disagreement among the courts with regard to the application of the rule, the 1954 Code also eliminated the proportionate interest test. This test had required that the transferors receive stock or securities in substantially the same proportion as their interests in the property transferred.

To avoid abuse, the Senate Committee Report stated that to the extent a "disproportion between the value of the property transferred and the amount of the stock or securities received by each of the transferors results in an event taxable under other provisions of the Code . . . such distribution will be taxed in accordance with its true nature."\(^3\) Thus, in disproportionate situations, a transaction may be treated as if the stock or securities had first been received in proportion to property transferred and then used by the transferor to make gifts or to pay compensation or other obligations to the transferor.\(^4\)

\(^4\) Treasury Regulation Section 1.351-1(b)(1).
this case, the transferor, upon the satisfaction of the obligation, may realize gain or loss in an amount equal to the difference between the transferor's basis in the stock or securities and their fair market value. The 1954 Code also added a provision requiring that gain be recognized to the extent liabilities assumed by the transferee corporation exceed the basis of property transferred.

In 1966, IRC Section 351 was amended to exclude transfers to investment companies made after June 30, 1967. The "grandfather clause" of that provision was eliminated by the Tax Reform Act of 1976. Prior to these amendments, persons would avoid recognizing the gain on appreciated stock by exchanging such stock for shares in an investment fund. Immediately after the exchange, and in order to otherwise qualify for tax-free treatment, the person who transferred the stock to the corporation had to also satisfy the control requirements. Investment funds organized in this way were known as "swap funds."

The Bankruptcy Tax Act of 1980 amended IRC Section 351 to ensure that creditors who hold debt not evidenced by a security and who exchange their claims against a debtor corporation for stock of the corporation must recognize the gain or loss on the exchange. The Bankruptcy Tax Act further revised IRC Section 351 so that it would exclude a debtor's transfer of property in a bankruptcy or similar
case so long as he used the stock or security he received to satisfy his debts. This rule is designed to prevent a debtor from incorporating high-basis, low value assets, since a transfer of the assets directly to the creditors followed by a transfer by the creditors to a controlled corporation would result in a fair market value basis to the corporation.5

IRC Section 351 Definitions

Satisfying the definitions of key terms in applying IRC Section 351 is critical to its non-recognition of gain effect. IRC Section 351 requires that a taxpayer must exchange property for stock or securities of a corporation in order to qualify for non-recognition treatment when he immediately controls the corporation after the exchange. Obviously, the definitions of "property" and "stock or securities" are critical since the property and stock limitations must be satisfied for IRC Section 351 to apply.

Property

A definition of property is set forth under IRC Section 317(a), but it is directly applicable to Part One of Subchapter C and, therefore, does not cover IRC Section 351 which is in Part Three of Subchapter C.

Consequently, the explanation of "property" has been determined by regulations and judicial decisions. The following are considered "property" under Section 351:

a. Money is an acceptable form of property.6

b. Intangible rights created by personal services may qualify as property for IRC Section 351 purposes. Intangible property created by the transferor is "property," if the right to the intangible property is transferred and it is not the transfer of services.7

c. A creditor's transfer of a debtor's obligation to the debtor in exchange for stock or securities is a generally accepted transfer of property. The form of the transferred obligation may be a note or other tangible documentation.8

d. The assignment of accounts receivable of the transferor including those represented by installment obligations derived from either the performance of services or the sale of goods constitute property for IRC Section 351.9

e. Stock of the transferor qualifies as property.10

f. The assignment of equitable interest, the legal title to which is vested in another, constitutes property.11

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6 Portland Company v. Commissioner, 109 F.2d 479 (1st Cir. 1940).

7 For example, patents, trademarks, know-how, trade secrets and secret formulas.

8 Duncan v. Commissioner, 9 TC 468 (1947).

9 Hempt Brothers, Inc. v. U.S., 490 F.2d 1172 (3rd Cir. 1934).

10 Revenue Ruling 74-503, 1974-2 CB 117.

11 The Roberts Company v. Commissioner, 5 TC 1 (1945).
g. A leasehold interest is considered property.12

h. A transfer of a valuable contract right is property.13

and,

i. Inventory is also included in the definition of property.14

Thus, the definition of property under IRC Section 351 includes real and personal property and also money. The definition does not involve services to the corporation or, with respect to transactions after 1980, unsecured debts and claims for unpaid interest accrued on or after the transferor began holding the debt. IRC Section 351 states that stock and securities exchanged for —

(1) services,

(2) indebtedness of the transferee corporation which is not evidenced by a security, or

(3) interest on indebtedness of the transferee corporation which accrued on or after the beginning of the transferor's holding period of the debt

shall not be considered as issued in return for property.

The Internal Revenue Service announced clear guidelines and criteria for qualified property under IRC


Section 351 in Revenue Ruling 64-56.\textsuperscript{15} Any factor dealing with the inherent nature of the consideration transferred affects the qualification of property. Revenue Ruling 64-56 states that:

The term "property" for purposes of Section 351 of the Code will be held to include anything qualifying as "secret processes and formulas" within the meaning of Sections 861(a)(4) and 862(a)(4) of the Code and any other secret information as to a device, process, etc., in the general nature of a patentable invention without regard to whether a patent has been applied for ... and without regard to whether it is patentable in the patent law sense. Other information which is secret will be given consideration as "property" on a case-by-case basis.\textsuperscript{16}

The ruling also maintains that property cannot be qualified by whether information is in written or physical form. Further, "if the information is developed for use in the transferor's own business, it may qualify as property under IRC Section 351 even though services were used to produce or develop the information." This is distinguishable from the case in which information is developed especially for a particular transferee and may be considered services rendered. The Internal Revenue Service will issue advance rulings as to the qualification of property under IRC Section 351.

\textsuperscript{15} 1964-1 CB (Part 1) 133.

\textsuperscript{16} Ibid.
Stock or Securities

A transferor will avoid recognition of any gain under IRC Section 351(a) only if the transfer of property is solely in exchange for the "stock or securities" of the transferee corporation. If the transferor receives money or other property in addition to "stock or securities" of the transferee corporation, then IRC Section 351(b) states:

(1) gain (if any) to such recipient shall be recognized, but not in excess of

(a) the amount of money received, plus

(b) the fair market value of such other property received; and,

(2) no loss to such recipient shall be recognized.

So if in addition to stock or securities of the transferee corporation, the taxpayer receives other property or money, called "boot," then taxable gain is recognized, but not above the total of the amount of money plus the fair market value of the other property. The receipt of boot does not, however, result in the recognition of any loss on the exchange.

In general, the term stock or securities includes shares of stock and various long-term obligations, but it also means stock and securities in the common usage of the terms. In any case an exact definition is not available in the Code or Treasury Regulations. The courts have sought to
provide a definition; however, the judicial interpretations have not been consistent.

The term "stock" generally includes any equity interest in the corporation, either common or preferred stock, voting or nonvoting. Stock rights and warrants, for the purposes of IRC Section 351, are excluded from "stock or securities" by regulation. However, the courts have not yet considered whether stock rights or stock warrants constitute "securities" under IRC Section 351.

The term "securities" generally includes an obligation of the issuing corporation. To avoid recognition of a gain when transferring property to a controlled corporation, a transferor must distinguish a "security" from a general debt. The judicial rule-of-thumb in determining if a debt will be treated as a "security" relies partly on the maturity of the obligation. Generally, the longer the term to maturity, the longer the debt will be subject to the risk of the business and the more likely it will be viewed as a "security" under the meaning of IRC Section 351. Thus, the trend has been to treat, for example, 60-day trade accounts receivables as non-securities and a 30-year debenture as a security.


18 Treasury Regulation 1.351-1(a)(1).
Camp Wolters v. Commissioner is the leading case involving the treatment of debt obligations as securities for purposes of IRC Section 351. In Camp Wolters, notes which were scheduled to mature in installments over a five to nine year period were held to be securities, even though they were actually retired within two years of the date of issuance. One of the major reasons for the ruling was that the notes were subordinated to bank loans which thereby placed the noteholder in a position similar to a shareholder. The time to maturity, in other words, was not the determining factor.

The Tax Court, discussing the question of when obligations are securities, in Camp Wolters stated:

The test as to whether notes are securities is not a mechanical determination of the time period of the note. Though time is an important factor, the controlling consideration is an overall evaluation of the nature of the debt, degree of participation and continuing interest in the business, the extent of proprietary interest compared with the similarity of the note to a cash payment, the purpose of the advances, etc. It is not necessary for the debt obligation to be the equivalent of stock since Section 351 specifically includes both "stock" and "securities".19

The Tax Court applied this test in Dennis v. Commissioner,\textsuperscript{20} determining that notes payable in monthly installments to a stockholder having a proprietary interest in the corporation were securities. The corporation issued twelve and one-half year promissory notes in exchange for property (i.e., patents and patent obligations). The court decided that the taxpayer who received the notes assumed the economic risk because it was taking a note of a new corporation whose major source of funds for repaying the note would be derived from payments from another business which was controlled by the taxpayer and another person.\textsuperscript{21}

In Baker Commodities, Inc. v. Commissioner,\textsuperscript{22} a corporation issued 15-year promissory notes to three brothers who had transferred their business to the corporation because the corporation agreed to assume partnership indebtedness. The court concluded that the note constituted a "security" under IRC Section 351 since the noteholders had participated in the business in a characteristic manner, similar to the actions of a security

\textsuperscript{20} 57 TC 352 (1971), aff'd 473 F2d 274 (5th CIR 1973).
\textsuperscript{21} IBID.
\textsuperscript{22} 48 TC 374 (1967).
holder's interests. For example, until the note was paid, the corporation could not, without the noteholder's consent:

(1) alter the officer's compensation;
(2) declare dividends;
(3) place substantial mortgages on the corporation's property;
(4) amend the certificate of incorporation;
(5) issue additional stock;
(6) incur new indebtedness over certain amounts; or,
(7) enter into certain other agreements.23

The term of the debt, although not the sole or controlling factor in determining if the obligation is a security, is the one question which has received the most attention and consideration by the courts. The length of the term of the obligation may support a judicial conclusion that the risk to the holder of the obligation is approximately the same as the risk incurred by the shareholders. The IRS recognized the importance of debt's maturity in determining its status as a security in Revenue Ruling 56-303,24 which held that short-term notes, notes for terms up to five years, were not securities. The IRS later issued rulings announcing that it would not ordinarily

23 IBID.
24 1956-2 CB 193. See also Rev.Rul. 59-98, 1959-1 CB 76.
publish advance rulings dealing with tax effects of transfers to controlled corporations when part of the consideration received by the transferor consisted of bonds, debentures, or other evidences of indebtedness of the transferee.\(^{25}\) Therefore, although a minimum or maximum length of time has not been set before a debt obligation can be regarded as a security, the courts have generally ruled that a term of five years or more to maturity is sufficient for such consideration. The probability of the obligation's treatment as a security increases as the maturity rises above the five year level (Exhibit A) and decreases as the maturity falls below this level (Exhibit B).

As mentioned, the length of time to maturity of a debt obligation may not control the determination of "security" versus "other property." In U.S. v. Mills,\(^ {26}\) a jury found that an unsecured one year promissory note was a "security" for purposes of IRC Section 351. The court concurred with the lower court's finding that the corporation never expected to repay the principal. The taxpayer regarded the note as a long-term obligation and a roll-over of a one year note.

\(^{25}\) Revenue Procedure 81-10 IRB 1981-13 p. 44.  
\(^{26}\) 399 F2d 744 (5th CIR 1968).
An open account indebtedness would not be a "security" when the shareholder transfers property to the corporation. By definition, an open account indebtedness does not restrict the shareholder's ability to withdraw amounts up to the total indebtedness. This position was upheld in Harrison v. Commissioner,27 where the transferors were required to recognize gain on the transfer of property.

An installment sales contract was held by the Tax Court not to be a "security" for purposes of IRC Section 351 when property was "sold" to a controlled corporation. The leading case involved a transfer of property to a controlled corporation with an installment sales contract providing for installment payments over ten years and reserving title to the property until the entire purchase price had been paid.28 In determining that the installment sales contract was not a security, the court said:


The question whether an evidence of indebtedness constitutes a security does not depend for its resolution upon a simple determination of the length of time the obligations is to run, but depends rather upon an overall evaluation of the nature of the debt so as to ascertain whether or not the instrument issued evidences a continuing interest in the affairs of the corporation. 

... The installment contract in question was not intended to insure the partners a continued participation in the business of the transferee corporation, but was intended rather to effect a termination of such a continuing interest. We are aware of no decision in which an installment sales contract reserving title in the seller has been held to qualify as a security within the meaning of Section 351 and respondent has cited none. Although in certain particulars the contract may resemble a bond, essentially it partakes of the nature of a contract of sale, and in our view does not constitute a security within the meaning of Section 351. 29

Coates Trust v. Commissioner 30 was another case involving an installment contract. In that case, the taxpayers did not contend that a ten-year installment obligation issued under an agreement was a "security," and the court, without further discussion, stated that it was not a security.

If, in addition to stock and securities distributed in a IRC Section 351 exchange, the transferor of the

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29 IBID, p. 36; see also Morgan v. Commissioner, 30 TC 881, 272 F2d 936 (9th CIR 1959); and, Brook v. Commissioner, 23 TCM 1730(1964), 360 F2d 1011 (2d CIR 1966).

property receives boot, any gain will be recognized and realized to the extent of the value of boot received. If boot is distributed in a transaction which would otherwise qualify as a tax-free exchange under IRC Section 351, any loss will not be recognized. Thus, whether the exchange is "stock or securities" or "boot" is of major importance in the IRC Section 351 area. For example, debt which is not considered a security under IRC Section 351 would be boot and any gain would be realized to the extent of such boot.

If a debt is deemed to be "boot" rather than a "security" under IRC Section 351, it does not qualify for non-recognition. There is no definition of "boot" in the Code or regulations, other than the normally implied one of "cash or property." In general, boot will not be considered "received" when the corporation does not return to the transferor anything other than stock or securities of the controlled corporation. This is true even when property or accumulated cash is withheld.\(^{31}\) Also, the assumption of a liability of the transferor will not result in the receipt of boot.\(^{32}\) Moreover, a gain may be recognized under IRC Section 351 where a liability is assumed in excess of


a transferor's basis or where the liability is assumed under a tax avoidance purpose (i.e., without a bona fide business purpose).33

In an IRC Section 351 exchange, debt may be characterized as stock for tax purposes. Even though the obligation may be formally debt, there are situations where the debt will be considered non-recognition property and not boot, the most common being when property is exchanged for an installment obligation. In such cases, the issue centers around:

1. whether the corporation can receive an interest deduction;
2. whether the corporation can obtain a stepped-up (cost) basis in the transferred property for purposes of depreciation;
3. whether the shareholder can treat the transaction as a sale, rather than as a tax-free exchange;
4. whether the shareholder-lender can treat subsequent repayments of "principal" as such (rather than dividend distributions); and
5. whether the shareholder-lender can take a bad debt deduction should the debt become worthless.34

Questions of what constitutes debt versus equity (stock) are typically addressed under IRC Section 385 and proposed regulations. Congress inserted IRC Section 385, which gives the Treasury the power to prescribe regulations

33 IRC Section 357(a)&(c).
that determine whether an interest in a corporation is stock or indebtedness, in the Tax Reform Act of 1969. These regulations have been proposed and final regulations are due in 1983. Regardless of the provisions of the new regulations, they do not apply to transactions occurring before their effective date.

In an IRC Section 351 exchange, both the transferor and the transferee corporation benefit if property is exchanged for securities rather than stock. When interest is paid, the corporation gets an interest deduction and when the principal of the loan is repaid to the stockholders, it is simply treated as a nontaxable return of capital or as a capital gain to the extent the maturity value exceeds the adjusted basis of such security. However, if the Commissioner successfully argues that the stockholder indebtedness is actually a second class of stock, the corporation loses the interest deduction since the interest payments would be considered dividends. Moreover, when the corporation repays the loan to the shareholders, that too might be considered a dividend and fully taxable to the shareholder.

The issue of boot under an IRC Section 351 exchange should not arise if the obligation is considered equity. In Reef Corporation v. Commissioner,35 a business was transferred from one corporation to another through a series
of steps. The stockholders of the new corporation received notes and stock. The transaction constituted a tax-free exchange under IRC Section 351 and the notes were treated as equity (i.e., interest deductions were denied). In this type of case, the equity determination would have precluded boot treatment, if any boot had existed, to the shareholder.

In Truschel v. Commissioner, stock was exchanged for notes and bonds pursuant to a merger of the corporations. The Commissioner contended that the transaction was a reorganization and that the notes constituted a boot-dividend. The court, however, held that the transaction was a sale, not a reorganization, despite a high debt-to-equity ratio. The result was capital gains treatment and no boot-dividend.

The tests to distinguish "securities" from "money and other property" are similar to those used to distinguish debt from equity. The difference usually lies in the degree of involvement in the business.

Summary

This chapter has been devoted to the historical development of IRC Section 351 and the basic requirements of IRC Section 351. Specifically, property, control, and stock and securities were defined in order to show how the taxpayer may qualify for non-recognition treatment in an exchange of property for stock or securities of a corporation. IRC Section 351, like other non-recognition provisions of the Code, entitles the taxpayer to defer recognition of realized gain or loss, if the requirements and definitions of the provision are satisfied. Thus, it is essential for taxpayers planning transfers to controlled corporations to understand and adhere to the requisites in order to enjoy the benefits the tax-free transfer can provide.
Exhibit A
Cases Holding an Obligation Determined to Be a Security

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<td>73-646, 473 F2d 274, aff'g</td>
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<td>5249, 398 F2d 452, rev'g</td>
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<td>(DC Ga) 17 APTR2d 1150.</td>
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<td>Parkland Place Co. v. U.S.,</td>
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<td>George A. Nye v. Commr.,</td>
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<td>Burnham v. Commr.,</td>
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<td>230 F2d 555, 49 APTR 283,</td>
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Exhibit B

Cases Holding an Obligation Determined Not to Be a Security
(Term to Maturity: Less Than Five Years)


Turner v. Commr., (4 CIR; 1962), 9 AFTR2d 1528, 303 F2d 94, cert den 12-13-62, aff'g on this point paragraph 61,101 P-H MemoTC.

Cortland Speciality Co. et.al. v. Commr., (2 CIR;1932), 60 F2d 937, 11 AFTR 857, CtD 668, CB June 1933, p. 164, cert den 1-16-33, aff'g 22 BTA 808.

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CHAPTER THREE
HISTORY OF IRC SECTION 304

The goal of this chapter is to describe the historical development and pre-TEFRA application of IRC Section 304, which transforms stock sales by controlling shareholders of related corporations into redemptions within the meaning of IRC Section 302. Specifically, this chapter discusses: 1) the background of IRC Section 304(a)(2), which was preceded in the 1939 Code by IRC Section 115(g)(2); 2) the addition of brother-sister provisions in IRC Section 304(a)(1) of the 1954 Code; 3) the coordination of IRC Section 304 with IRC Sections 302, 301, 312, and 317; 4) the operation of IRC Sections 304(b)(2)(A) and (B) and IRC Section 316 in determining the amount constituting a dividend if the tests of IRC Section 302 are not met; and, 5) the inapplicability of IRC Section 304 to sales by controlling shareholders of stock in subsidiaries to parent corporations.

IRC Sections 304(a)(1) and 304(a)(2) Distinguished

Both IRC Section 304(a)(1) and IRC Section 304(a)(2) deal with redemptions through related corporations. The history of IRC Section 304 has its roots in the 1939 Internal Revenue Code. IRC Section 115(g)(2) of the 1939
Code preceded IRC Section 304(a)(2) of the 1954 Code, but both deal with the "redemption" by a subsidiary of stock in its parent corporation. A controlling shareholder of the parent corporation would achieve such a redemption by selling part of his stock in the parent to the subsidiary. If the transaction was treated as a sale or exchange, capital gain would presumably be recognized, and the remainder of the sale price would be a tax-free return of basis. By combining the shareholder's indirect ownership of the subsidiary (via direct ownership of the parent, taken together with the subsidiary's ownership of some of the parent's stock), the shareholder's control over the parent would not be diluted. Thus, the taxpayer would obtain the same economic result, but at a lower tax cost, as if he had received a dividend from the subsidiary.37

Prior to 1950 the IRS was unable to obtain dividend treatment for the transaction described above.38 However, in 1950 IRC Section 115(g)(2) was added to the Code thereby ensuring that the transaction would be treated as a distribution from the subsidiary to its parent, followed by a redemption by the parent of its own stock. The net result

37 Assuming the subsidiary had a significant amount of earnings and profits.

38 Commissioner v. Wanamaker, 11 TC 365 (1948).
of this treatment is that IRC Section 302 applies to the distribution. As noted above, the shareholder's interest would not be significantly diluted under the constructive ownership provisions of IRC Section 318(a), so it would also not be significantly reduced under IRC Section 302(b)(2). The transaction, in fact, would most likely result in a dividend to the controlling stockholder since the distribution would constitute a dividend equivalent.

Unlike IRC Section 304(a)(2), IRC Section 304(a)(1) has no predecessor in the 1939 Code. IRC Section 304(a)(1) states that:

For purposes of IRC Sections 302 and 303, if--

(A) one or more persons are in control of each of two corporations, and

(B) in return for property, one of the corporations acquires stock in the other corporation from the person (or persons) so in control,

then (unless paragraph (2) applies) such property shall be treated as a distribution in redemption of the stock of the corporation acquiring such stock.

Thus, whereas IRC Section 304(a)(2) deals with redemptions by subsidiaries, IRC Section 304(a)(1) is aimed at redemptions through the use of brother-sister corporations. Congress explicitly considered and rejected such a provision when it enacted IRC Section 115(g)(2) of the 1939 Code in 1950. Nevertheless, the IRS attempted to use IRC Section 115(g)(2) to obtain dividend treatment for a
brother-sister redemption in Trianon Hotel Company. The court held in favor of the taxpayer, stating:

The fact that Congress did not extend the application of section 115(g) to the factual situation before us in the present case, until enactment of the 1954 Code, though it considered the problem twice prior to that, makes it apparent that under prior existing law, section 115(g) does not apply to transactions between brother-sister corporations.39

Congress remedied this perceived deficiency with the enactment of IRC Section 304(a)(1). The tax treatment of brother-sister redemptions under IRC Section 304(a)(1) is determined by IRC Section 302. As in the case of the parent-subsidiary "redemption" described above, the application of IRC Section 302 could result in a dividend to the controlling stockholder whose stock is redeemed. IRC Section 304 is integrally related to other sections in Subchapter C. Next, the coordination of IRC Section 304 with IRC Sections 301, 302, 312, 316, and 317 is discussed.

Related IRC Sections

Should IRC Section 302 characterize a transaction as an exchange then the dividend rules of IRC Section 304 fall by the wayside. IRC Section 302 has several tests to determine whether a transaction is in substance an exchange.

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39 30 TC 156 (1958).
The most general test for exchange status is found in IRC Section 302(b)(1). Generally, IRC Section 302(b)(1) applies exchange treatment to a transaction if the redemption is "not essentially equivalent to a dividend." The vagueness of this paragraph and the intent of IRC Section 304 make it unlikely, however, that a taxpayer could avoid dividend treatment through its application.

Another test that results in exchange treatment rather than the dividend treatment of IRC Section 304 is referred to as the "substantially disproportionate" test. Specifically, IRC Section 302(b)(2) states that "Sub-section (a) [exchange treatment] shall apply if the distribution is substantially disproportionate with respect to the shareholder." Considering the constructive ownership provisions of IRC Section 318(a), IRC Section 302(b)(2) would be inapplicable to both the parent-subsidiary and brother-sister redemptions. Alternatively, IRC Section 302(b)(3) requires exchange treatment when the distribution is in complete liquidation of the shareholder's interest. In all cases, IRC Section 302(c)(2)(A) exempts the transaction from the constructive ownership provisions of IRC Section 318(a), provided that:

(i) immediately after the distribution the distributee has no interest in the corporation (including an interest as officer, director, or employee), other than an interest as a creditor.
(ii) the distributee does not acquire any such interest (other than stock acquired by bequest or inheritance) within 10 years from the date of such distribution, and

(iii) the distributee, at such time and in such manner as the Secretary by regulations prescribes, files an agreement to notify the Secretary of any acquisition described in clause (ii) and to retain such records as may be necessary for the application of this paragraph.

Although in a closely-held setting, the shareholder may manifest a continuing interest by serving as a director, officer, or employee of the issuing corporation, such an interest can be avoided. Indeed, IRC Section 302(b)(3) might afford possible relief from the dividend consequence normally anticipated from the application of IRC Section 304.

Assuming that neither the brother-sister redemption nor the parent-subsidiary redemption could qualify for exchange treatment under IRC Sections 302(b)(1), 302(b)(2), or 302(b)(3), IRC Section 302(d) requires that the transaction be examined in the context of IRC Section 301. To the extent that the distribution to the stockholder on the transaction is a dividend, such distribution is taxed as ordinary income.\(^{40}\) The term "dividend" is defined by IRC Section 316 as a distribution out of current or accumulated

\(^{40}\) IRC Section 302(c)(1).
earnings and profits. IRC Section 304(b)(2) specifies which company's earnings and profits limit the amount of the distribution constituting a dividend. In certain cases, the amount of ordinary income resulting to the shareholder and the concomitant reduction in the corporation's earnings and profits are not the same. This is considered below.

Amount Constituting a Dividend

In a brother-sister redemption, IRC Section 304(b)(2)(A) refers to the earnings and profits of the acquiring corporation in determining the shareholder's dividend income. Indeed, if the acquiring corporation has neither current nor accumulated earnings and profits, none of the distribution to the redeeming shareholder is a dividend. On the other hand, IRC Section 304(b)(2)(B), dealing with a subsidiary's redemption of its parent's stock, refers to the earnings and profits of the issuing (parent) corporation: "The determination of the amount which is a dividend shall be made as if the property were distributed by the acquiring corporation to the issuing corporation and immediately thereafter distributed by the issuing corporation." Thus, the amount constituting a dividend depends on the parent's existing earnings and profits, which are then increased by the amount paid by the subsidiary for the stock.
Since IRC Section 317 defines property for the purpose of IRC Section 304, when the acquiring corporation distributes its own securities in a brother-sister redemption, those securities become "property" in determining the amount distributed. Similarly, when the subsidiary distributes its own securities in a parent-subsidiary redemption, those securities would also constitute property. To the extent of earnings and profits of either the subsidiary or the acquiring corporation, depending on whether the transaction falls under IRC Section 304(a)(2) or 304(a)(1), the fair market value of the securities would be taxable to the shareholder as ordinary income, assuming the tests of IRC Section 302 are not met. However, under IRC Section 312(a)(2), the earnings and profits of the appropriate corporation would be reduced by the principal amount of the securities. Thus, if the fair market value of the securities was less than their face value, the acquiring corporation would achieve a reduction in earnings and profits greater than the amount of ordinary income recognized by the shareholder.

Sales to Parent Corporations

Neither IRC Section 304(a)(1) nor IRC Section 304(a)(2) deals with a third possible redemption through the use of related corporations, i.e., the sale by a controlling shareholder of stock in a subsidiary to its controlling
parent. Because the newly-formed holding company has no earnings and profits, a shareholder's transfer of stock in an operating company to that holding company in exchange for the holding company's stock appears to fall entirely outside the scope of IRC Section 304, even if additional IRC Section 351 "boot" property is distributed. Moreover, even if the constructive ownership provisions of IRC Section 318(a) could apply, allowing the exchange to be treated as a brother-sister redemption, IRC Section 304(b)(2)(A) would preclude dividend treatment since the amount deemed to be a dividend would be determined by reference to the holding company's non-existent earnings and profits. The IRS implies agreement with such an interpretation in Revenue Ruling 73-2, stating:

Section 304 of the Code is specifically directed at distributions in redemptions of stock through use of related corporations meeting the 50 percent stock control requirement of section 304(c) of the Code. Section 351 of the Code, on the other hand, generally applies to the formation of corporations in transactions where assets are transferred by a person or persons who, after the transfer, meet the 80 percent stock control requirement.41

The history and the very nature of IRC Section 304 limit its scope to include transactions between pre-existing corporation bearing non-trivial amounts of earnings and

41 1973-1 C.B. 171.
profits. Specifically, on a pre-TEFRA basis, IRC Section 304 has been inapplicable in the case of transfers to newly-formed holding companies. However, where a transaction includes pre-existing corporations, both having non-trivial amounts of earnings and profits, IRC Sections 304 and 351 may have authority. This apparent conflict between IRC Sections 304 and 351 is discussed in greater detail in Chapter Four.
CHAPTER FOUR

THE SECTION 304/351 CONFLICT

The goal of this chapter is to describe the conflict between IRC Sections 304 and 351 where a transaction falls within the literal meaning of both. The discussion is limited to the conflict on a pre-TEFRA basis. The Tax Equity and Fiscal Responsibility Act substantially altered the relationship between IRC Sections 304 and 351. Specifically, this chapter: 1) identifies when IRC Sections 304 and 351 conflict; 2) examines the Code for guidance as to which IRC Section should prevail; 3) discusses the implications of court cases that have dealt with the issue; and, 4) describes the Internal Revenue Service position on this point.

The Nature of the Conflict

IRC Section 351 of the Internal Revenue Code provides that "no gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such persons are in control (as defined in IRC Section 368(c)) of the corporation." In cases where boot is received by the transferor, IRC Section 351 provides for the recognition of gain, but not in excess of the amount of boot received. The reading of this
provision includes a scenario where a taxpayer transfers the stock of one corporation, having earnings and profits, to another corporation, also having earnings and profits, in exchange for the latter's stock, securities and/or "boot" property. To the extent of the stock and securities the transaction would be tax-free. To the extent of the "boot" property the gain would be taxed as a capital gain, unless otherwise provided elsewhere in the Code (other than in Subchapter C).

IRC Section 304 could also be interpreted to apply to the same scenario. Specifically, IRC Section 304(a)(1) states that:

For purposes of IRC Sections 302 and 303, if—

(A) one or more persons are in control of each of two corporations, and

(B) in return for property, one of the corporations acquires stock in the other corporation from the person (or persons) so in control,

then (unless paragraph (2) applies) such property shall be treated as a distribution in redemption of the stock of the corporation acquiring such stock.

For IRC Section 304 purposes, both securities and "boot" property would be potentially taxable as a dividend.

For the purposes of IRC Section 351, control is defined by IRC Section 368(c) as ownership of at least 80 percent of both voting and nonvoting stock. In contrast,
IRC Section 304(c) defines control as 50 percent of the combined voting power of all voting stock or at least 50 percent of all classes of stock.

The conflict between IRC Sections 304 and 351 arises in situations similar to the scenario outlined above where property, in addition to stock or securities, is distributed to a shareholder who has 80 percent or greater control of the transferor corporation in exchange for the shareholder's stock in a second controlled corporation. If IRC Section 351 were applied, the shareholder's gain on the transaction would be limited to the amount of other property received and would most likely result in the recognized gain being taxed at capital gain rates. Application of IRC Section 304, on the other hand, could result in either a capital gain under IRC Section 302 or a dividend, taxable as ordinary income under IRC Section 301. Moreover, the distributing corporation's own securities would constitute property for the purpose of IRC Section 304 due to the application of IRC Section 317, whereas they would be excluded from the definition of boot property under IRC Section 351, which specifically provides for non-recognition of gain with respect to them.

Where the distributing corporation is 100 percent controlled by the shareholder, dividend treatment would ordinarily prevail if IRC Section 304 applies. Thus, it is
generally in the taxpayer's interest to have the transaction characterized as a IRC Section 351 transfer in its entirety. However, this would not be the case when the distributing corporation had no earnings and profits, since under that condition IRC Section 304 has no effect.

Substantial authority can be cited for the notion that IRC Section 351 prevails in the stock transfer situation described above. This authority includes the Internal Revenue Code itself, as well as court cases, most notably Haserot v. Commissioner. 42

The Code does not explicitly state in either IRC Section 304 or 351 that one IRC Section overrides the other. However, IRC Section 304 refers to IRC Section 302, which contains the wording in IRC Section 302(d), "except as otherwise provided in this subchapter." IRC Section 302(d) calls for dividend treatment under IRC Section 301 in cases where subsection (a) does not apply. Since IRC Section 351 "otherwise provides" for exchange treatment, which would ordinarily result in capital gain, it apparently takes precedence over IRC Section 302 and thus ultimately over IRC Section 304.

The Sixth Circuit, in fact, followed this logic in reviewing Haserot (1966), supra. In Haserot, the taxpayers were in control, within the meaning of both IRC Sections 304 and 351, of three corporations, the Haserot Company, Northport Cherry Factory, Inc., and Gypsum Canning Company (hereafter referred to as H, N, and G, respectively). They transferred their stock in N and G to H in return for H's stock worth $48,640 and $64,850 in cash. The taxpayers argued that the transaction was governed solely by IRC Section 351, while the IRS claimed that IRC Section 304 applied to the cash distribution. The Tax Court ruled in favor of the IRS, but was overruled by the Sixth Circuit, which stated:

(T)he statements in IRC Sections 301(a) and 302(d), "except as otherwise provided in this chapter (or subchapter)" of the Code, indicate that Congress made the policy decision that dividend treatment will result from the application of IRC Section 302 only if no other provision in the relevant parts of the Code requires other treatment. Section 351 has no such limitations. That IRC Section is, by its terms, applicable. That IRC Section provides for tax treatment of the payment in question in a manner other than and different from the distribution treatment provided [for by] IRC Sections 302(d) and 301. Consequently, the very words of the latter IRC Sections preclude dividend treatment in this case.43

Haserot can be distinguished from Rose Ann Coates Trust, et. al., v. Commissioner,\textsuperscript{44} which the IRS won. In Coates the shareholders transferred stock to a controlled corporation in what essentially amounted to an installment sale; no stocks or securities were received in the transaction. Hence the taxpayer's contention that IRC Section 351 applied was contrary to its provisions. The Tax Court noted that "without considering whether IRC Section 351 or IRC Section 304 takes precedence when both apply, it is plain here that IRC Section 351 does not apply."\textsuperscript{45} On appeal, however, the Ninth Circuit held that the conflict was relevant, and that IRC Section 304 took precedence over IRC Section 351.\textsuperscript{46} Seemingly, however, the Ninth Circuit went well beyond what was necessary in determining the applicability of IRC Section 304, since IRC Section 351 is clearly inappropriate in instances where neither stock nor securities are exchanged.

Predictably, the IRS announced in Revenue Ruling 73-2 that it would not follow the decision reached by the Sixth Circuit in Haserot. The facts were similar to those of Haserot. The taxpayer, an individual, was the sole

\textsuperscript{44} 480 F. 2d 468 (1973).
\textsuperscript{45} 55 TC 501 (1972).
\textsuperscript{46} Rose Ann Coates Trust, supra.
shareholder of Corporation Y and owned sixty percent of the outstanding stock of Corporation X. For "good business reasons" the stockholder transferred all of his Y stock for additional X stock and cash. The earnings and profits of X exceeded the amount of cash distributed. In its holding the IRS stated that "[W]e will apply IRC Section 304 of the Code and not IRC Section 351(b) of the Code to that portion of the transaction in which cash was received. Section 351 of the Code will be applied to that portion of the transaction in which stock of the acquiring corporation is received."

Presumably, IRC Section 304 would apply equally to property other than cash, as it did in Coates. This was the same finding as in Revenue Ruling 78-422.47

In this Ruling, IRC Section 304 was applied to the assumption of liabilities in a transaction to which the taxpayer hoped IRC Sections 351 and 357 would govern exclusively. The facts were as follows. The taxpayer, an individual, owned all of the stock of X Corporation and purchased all of the outstanding stock of Y Corporation, borrowing most of the purchase funds from a bank. He subsequently transferred all of the Y stock to X in return for the assumption of his liability for the purchase funds as well as for additional X stock. The earnings and profits

47 1973-1 C.B. 171.
of X exceeded the amount of the liability assumed by X. IRC Section 357(a) provides that, except where tax avoidance is the principal motive or liabilities exceed basis, the assumption of liabilities will not preclude a transaction from falling entirely within the provisions of IRC Section 351. In its holding, however, the IRS stated that "[s]ection 304(a)(1) of the Code is applicable, and not IRC Section 357(a), to that portion of the transaction in which the liability is assumed." Thus the assumption of the liability was treated as a distribution in redemption of the X stock and subjected to the provisions of IRC Section 302. Failing the exchange tests of IRC Sections 302(b)(1), 302(b)(2), and 302(b)(3), the taxpayers incurred dividend treatment on the entire amount of the liability assumed.

The IRC Section 304/351 conflict has its roots in the Haserot and Coates cases discussed above. The IRS has made its position clear in Revenue Rulings 73-2 and 78-422. Prior to TEFRA, taxpayers faced a great deal of uncertainty in formulating corporate planning strategies falling within the purview of both IRC Section 304 and IRC Section 351. The next chapter deals with the pre-TEFRA use of newly-formed holding companies to avoid this conflict.
CHAPTER FIVE
THE PRE-TEFRA RULES APPLYING
TO NEWLY FORMED HOLDING COMPANIES

This chapter distinguishes the conflict arising in the Haserot/Coates Trust issue from the use of newly-formed holding companies. The only bona fide attack on the use of newly-formed holding companies by the IRS is, in fact, limited to the application of one of the substantive theories discussed in Chapter Six and not by IRC Section 304. Revenue Rulings 80-239 and 80-240, along with other administrative procedures, are distinct from those rulings and holdings described in Chapter Four.

Haserot/Coates Distinguished

There is a point in common to all of the cases and revenue rulings discussed in Chapter Four -- the acquiring corporation having earnings and profits in excess of the amount of "property" distributed. This situation can be distinguished from acquisitions by corporations which have no accumulated or current earnings and profits. This would be the case, for example, when a taxpayer contributes operating company stock to a newly-formed holding company in exchange for stock in the latter. The tax consequences under such circumstances are clear unless the holding company distributes property in addition to stock. Then the
question arises: is there an IRC Section 304/351 conflict? Significantly, Revenue Ruling 73-2 implicitly limits the scope of IRC Section 304 to situations in which all of the related corporations exist prior to the transaction in question. It states:

Section 304 of the Code is specifically directed at distributions in redemptions of stock through use of related corporations.... Section 351, on the other hand, generally applies to the formation of corporations in transactions where assets are transferred by a person or persons who, after the transfer, meet the 80 percent stock control requirement.48

Thus, it appears that IRC Section 304 is generally inapplicable to transactions involving the formation of holding companies. This interpretation is supported by the provisions of IRC Section 304(b)(2)(A), which stipulate that "[i]n the case of any acquisition of stock to which paragraph (1) (and not paragraph (2)) of subsection (a) of this section applies, the determination of the amount which is a dividend shall be made solely by reference to the earnings and profits of the acquiring corporation." This provision would preclude the shareholder from recognizing income, ordinary or otherwise, if IRC Section 304 were to apply, since the earnings and profits of the newly organized

48 1973-1 CB 171.
holding company would be zero. The obvious intent of IRC Section 304 is to preclude the purchasing company from extracting cash or property at capital gains rates by disguising a dividend as a sale.

In fact, the IRS has not openly challenged transfers to newly-formed holding companies with IRC Section 304 arguments. Instead, the IRS attack on the use of newly-formed holding companies has come from other directions. As early as 1968, the Treasury attacked, with proposed regulations under IRC Sections 531-535 and 1502, the use of holding companies to bail out the earnings of profitable subsidiaries. Admitting there were successful income tax consequences which did not result in a taxable ordinary distribution, the Treasury focused on the accumulated earnings tax. These regulations, which were later unexpectedly withdrawn, would have forced the operating company to justify its accumulation of earnings and profits for the purpose of determining the accumulated earnings tax under IRC Section 531. Proposed Treasury Regulation 1.533-1 stated:

49 33 F.R. 9830.
50 36 F.R. 16661.
In some cases the parent may rely on the underlying value of its investment in the subsidiary to obtain funds for distribution to its shareholders, rather than cause the subsidiary to distribute its earnings and profits. If this occurs, the subsidiary will be deemed to have been availed of for the purpose of avoiding the income tax with respect to shareholders of the parent,... if-

(a) Part or all of the distribution by the parent is treated by its shareholders in the manner provided in section 301(c)(2) or (3), and

(b) Such distribution would have been treated as provided in section 301(c)(1) if the subsidiary had distributed its earnings and profits to the parent.31

The regulations proposed under IRC Section 535 would have determined that the amount of distribution treated by the shareholders under IRC Section 301(c)(2) or (3) was not a reasonable need of the business, absent clear evidence to the contrary. In other words, the IRS would have been able to impose an accumulated earnings tax on the subsidiary to the extent that its value was used to obtain funds for a non-dividend distribution to the shareholders of the parent. What is most noteworthy about the proposed regulations, however, is that they corroborate the notion that the formation of the holding company is otherwise without income tax consequences.

51 Treasury Regulation 1.533-1.
More recently the IRS has attacked the formation of holding companies on grounds apart from either IRC Section 304 or the accumulated earnings tax. Revenue Ruling 80-239, for instance, is directed at the use of the newly-formed holding company to bail out the earnings of the operating company whose stock it has acquired.\textsuperscript{52} The case in Revenue Ruling 80-239 involved the following situation. An individual owned all of the stock of X, an operating company. He transferred this stock to a newly-formed holding company, Y, in exchange for the latter's stock and cash, which Y had borrowed from a bank using the X stock as collateral. In addition, the bank loan was guaranteed by X. Y presumably had a business purpose apart from the avoidance of taxes. The taxpayer hoped IRC Section 351 would apply to the transaction in its entirety. Without disputing the business purpose of Y, the IRS stated that the cash distribution was in substance a dividend from the operating company, X, and that Y was a mere conduit through which the dividend flowed. The IRS based its argument on general doctrines of business purpose and substance over form. Moreover, it claimed that IRC Section 304 was inapplicable to the transaction. In essence, the IRS viewed the transaction as two separate transactions: the formation

\textsuperscript{52} 1980-36 I.R.B. 7 (Sept 8).
of the holding company under IRC Section 351 and the payment of a dividend by X through Y. What appears to be important is not the business purpose of the holding company itself, but rather that of the distribution.

Revenue Ruling 80-239 can be distinguished from Revenue Ruling 80-240,\textsuperscript{53} which demonstrates the consequences of a holding company assuming liabilities upon its formation when no bail-out potential is apparent. The facts of Revenue Ruling 80-240 are as follows. The taxpayer, an individual, borrowed funds from a bank in order to acquire the stock of X, a corporation engaged in the banking business. He then formed Y, a holding company, and transferred all of his X stock to Y in exchange for all of its stock and its assumption of the acquisition indebtedness. In its holding, the IRS found that IRC Section 357(a) applied to the transaction, making it fall entirely within the scope of IRC Section 351. Thus the exchange was completely tax-free.

The results of Revenue Ruling 80-240 contrast sharply, however, with those of Revenue Ruling 78-422,\textsuperscript{54} where the IRS argued that IRC Section 304 precluded the application of IRC Section 357(a). The condition that

\textsuperscript{53} 1980-36 I.R.B. 8 (Sept 8).
\textsuperscript{54} 1978-2 CB 129.
apparently distinguishes the two situations is the existence of earnings and profits by the acquiring corporation in Revenue Ruling 78-422. This is consistent with the interpretation of IRC Section 304(a)(1) above, that the lack of earnings and profits in a newly-formed holding company makes IRC Section 304 irrelevant.

Thus, the IRS has never challenged the use of newly-formed holding companies with an IRC Section 304 argument. One unsuccessful attack was attempted through the accumulated earnings tax regulations. A more recent assault by the IRS is couched in the substantive theories of Subchapter C. As Blanchard points out, the IRS attack, as outlined in Revenue Ruling 80-239, ignores the legitimate tax existence of a corporation in order that the attack be successful. In other words, the IRS will overlook the tax existence of a corporation under certain circumstances, which Chapter six addresses.

CHAPTER SIX
LEGITIMATE CORPORATE TAX EXISTENCE

Chapter 5 identified that the major IRS threat to a newly-formed holding company is couched in terms of the legitimate tax existence of that corporation. Certain substantive Subchapter C issues may threaten that existence. Therefore, this chapter reviews the judicial theories affecting multiple corporations, including:

(1) The Business Purpose Theory,
(2) The Step-Transactions Theory,
(3) The Conduit Theory,
(4) The Sham Transactions Theory, and
(5) The Form versus Substance Theory.

However, before a discussion of these judicial doctrines is presented, the historical relationship between the taxpayer and the legitimate corporate existence is established.

Legitimate Corporate Tax Existence

In general, the Internal Revenue Code of 1954 treats the corporation as an independent taxpayer. The Code imposes an income tax, an accumulated earnings tax, and a personal holding company tax on corporations regardless of the characteristics of its shareholders or changes in the corporate structure, particularly as a result of transfers of stock and securities. In questions of corporate
existence, Federal tax law prevails over state corporate law, notwithstanding the fact that, in general, only the several states authorize the formation of corporations. According to Federal tax law, the creation of a corporate body, if in accordance with state statutory provisions, may produce a separate taxable entity. Its existence is not to be ignored for Federal tax purposes, by the Government and taxpayers alike, except under unusual circumstances.

The IRS taxes the corporation primarily because it recognizes the business as an entity separate and apart from its shareholders. The decision to tax corporations independently was established before the adoption of the Sixteenth Amendment. Prior to 1913, the Courts supported the taxation of corporations separate and apart from the individuals owning them. The same notion has continued even after the enactment of the Sixteenth Amendment. In one case, the Tax Court stated, "The stockholder is, in the ordinary case, a different entity from the corporation."56 In addition, other court cases continue to support the position that the corporate entity is not to be disregarded simply because the sole stockholder of the corporation dominated or controlled it.57 Although some court cases

have held that the corporate entity may be disregarded as a sham, generally a corporation must be considered as a separate taxable entity.

A corporate entity is unaffected by changes in the ownership of the stock, the name of the business, the business situs, or the type of business. It is to be recognized even if all the stock is owned by a single individual or corporation.58

The general rule, then, is that corporations and their stockholders are separate and distinct legal entities for purposes of taxation. In special cases and for certain transactions, exceptions may be made. In these instances, the courts have disregarded the corporate entity and held that the stockholders are the parties of interest. Mertens observes, "It has been only in unusual cases where the corporate entity has been disregarded by the courts and the tax imposed in a manner not strictly in accordance with the letter of the statute."59 Thus, situations do arise where the IRS seeks to disregard a corporate entity and to tax shareholders and related corporations for income earned.

58 Webber v. Knox, 97 F2d 921 (CCA 8th 1938).
The Birth of Business Purpose

The corporate entity may not be disregarded either by the Government or the taxpayer unless the corporation fails to meet what is commonly called the business purpose test. For instance, a corporation formed solely as a temporary legal device or mechanism to avoid taxes is apt to be ignored by the IRS. The classic case that illustrates this point is Gregory v. Helvering.60

The Gregory case instigated the business purpose doctrine. Mrs. Gregory, a sole stockholder, spun-off investment assets by following (what was believed to be) the literal interpretation of the law. Stock of a newly formed corporation was transferred to Mrs. Gregory's solely-owned corporation in exchange for the corporation's stock. Mrs. Gregory's solely-owned corporation also owned stock in a third corporation. After the initial transfer, the stock was distributed to Mrs. Gregory, who sold the stock of the third corporation and reported the profit as long-term capital gain. The court's classic statement in Gregory is that it is "the legal right of the taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits ..."61


61 Ibid.
The IRS, however, believed that whereas the transaction's form fell within the literal interpretation of the law, its substance lacked business purpose. The Supreme Court upheld the IRS position but relied on the intent of the law rather than on the literal interpretation:

The question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended ... when the statutory provision speaks of a transfer of assets by one corporation to another, it means a transfer made 'in pursuance of a plan of reorganization' of corporate business; and not a transfer of assets by one corporation to another in pursuance of a plan having no relation to the business of either, as plainly is the case here.

The rule which excludes from consideration the motive of tax avoidance is pertinent to the situation, because the transaction upon its face lies outside the plain intent of the statute. To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose.62

Thus, the birth of the business purpose doctrine forever altered the course of tax planning. In the same way that lawyers and judges attempt to define the "reasonable man," tax planners and tax judges attempt to define "business purpose." If a corporation has "business purpose," the courts have disallowed any attack on its corporate entity. However, if a corporation does not have "business purpose",

62 IBID.
whether it be because of a sham transaction, a tax avoidance motive, or any other reason, the IRS has successfully challenged corporate existence.

Judge Learned Hand's analysis of the meaning of Gregory is considered to be one of the best:

In Gregory v. Helvering . . . the incorporators adopted the usual form for creating business corporations; but their intent, or purpose was merely to draught the papers, in fact not to create corporations as the court understood that word. That was the purpose which defeated their exemption, not the accompanying purpose to escape taxation; that purpose was legally neutral. Had they really meant to conduct a business by means of the two reorganized companies they would have escaped whatever other aim they might have had, whether to avoid taxes, or to regenerate the world.63

Even though this analysis is concise, the "business purpose" has been a matter of judicial interpretation. No absolute definitions have been established for this concept, so the question remains, "what constitutes business purpose?"

A business purpose, other than tax avoidance, generally has been necessary for corporate existence to survive IRS scrutiny. The same criterion is true in order for a transaction to fit under IRC Section 351 or IRC Section 355. An interesting point that illustrates the trend

63 Chrisholm v. Commissioner, 35-2 USTC Paragraph 9493.

56
was raised in Commissioner v. Wilson. The Tax Court found that the transaction was not a "device" for tax avoidance. And even though the Tax Court also concluded that there was no business purpose, it still held in favor of the taxpayer. However, the Ninth Circuit reversed the Tax Court's ruling, maintaining that "business purpose must be present" even when a transaction is not a tax avoidance device. Thus, it seems necessary that some minimal business purpose be present for creating the corporate entity.

Under Treasury Regulation Section 1.355-2(c), the IRS states its position on business purpose and corporate reorganizations in the following way:

The distribution by a corporation of stock or securities of a controlled corporation to its shareholders with respect to its own stock or its security holders in exchange for its own securities will not qualify under Section 355 where carried out for purposes not germane to the business of the corporations.

Treasury Regulation Section 1.368-1(c) elaborates on this theme by providing that a "scheme, which involves an abrupt departure from normal reorganization procedure in connection with a transaction on which the imposition of a tax is imminent, such as a mere device that puts on the form of a corporate reorganization as a disguise for concealing its

64 66-1 USTC Paragraph 9103.
65 IBID.
real character and the object and accomplishment of which is the consummation of a preconceived plan having no business or corporate purpose," is not a plan or reorganization. The business purpose requirement is repeated in Treasury Regulation Section 1.368-2(g), which states that the transactions must be "undertaken for reasons germane to the continuance of the business of a corporation." Therefore, the establishment of any corporation, particularly in an exchange, needs to exhibit some business purpose before the corporation will be considered a distinct entity. A lack of a tax avoidance motive will no longer sufficiently defend a corporation from a challenge of valid corporate entity.

The requirement of corporate business purpose can be expanded to include not only a corporate purpose, but a shareholder business purpose as well. Early court cases gave credence only to nontaxable business purposes which benefited the corporation. For instance, in Bazley v. Commissioner,66 the Third Circuit considered whether or not a recapitalization resulted in a dividend. The Court found that the distribution of debenture bonds was in effect, a distribution to Bazley of the corporation's previous earnings and profits. In fact, the Court entirely ignored the motives and plans of the taxpayer, stating:

66 46-1 USTC Paragraph 9237, aff'd 47-1 USTC Paragraph 9288.
We have long since passed the place in our thinking, where we view the corporation as an 'artificial being, invisible, intangible, and existing only in contemplation of law.' We think of it as a device that shareholders use to carry on their business as a group. A corporation does not have purposes apart from its shareholders . . . we do not find substance in a distinction between a business advantages of the shareholders with respect to the corporation for the business advantages of the corporation itself.

Furthermore, this very thing concerned with here, reorganization, is a matter in which shareholders directly participate. The day to day business of the corporation is done by its officers, directors, employees. But a realignment of the interests in the enterprise through reorganization must come, under every corporation law which we know of, with the vote of the shareholders. In such circumstances it is as a practical matter impossible to separate as to the very transaction involved, a 'shareholder' from a 'corporate' interest.67

The courts applied the business purpose test to reorganizations narrowly, accepting only non-tax related corporate business purposes. The Commissioner was able to distinguish exchange transactions by claiming, "that such purpose was personal and not germane to the conduct of the venture at hand."68

67 IBID.

68 Farr v. Commissioner, CCH Dec. 21,044, 24 TC 350 (1955). Also see, 46-1 USTC Para. 9238, aff'd 47-1 USTC Para. 9288; 47-1 USTC Para. 9295; and 59-1 USTC 9626.
In more recent cases, however, the courts have rejected the narrow approach and evaluated non-tax avoidance motives of the corporation and the shareholder. For instance, in the Estate of Moses L. Parshelsky case,69 the Second Circuit Court validated shareholder's business purpose as the only requisite business purpose. In this case, the corporation engaged in the wholesale lumber and millwork business. The real estate holdings were spun-off into a separate corporation and all the stock of the new corporation was distributed to Parshelsky. The reason for the transfer involved estate planning. Parshelsky was concerned with the disposition of the business after his death, particularly because of his worries about the scarcity of materials, the decline in volume net profits after the Korean War, and his age.

The Tax Court found no business purpose for the exchange and thus concluded that it was used principally as a device for the distribution of Parshelsky's estate. The Second Circuit Court of Appeals reversed and remanded the case to the Tax Court for an evaluation of the shareholder's purpose. The Court of Appeals thought that the Tax Court's inquiry into business purpose was too narrow since it evaluated only those reasons for the spin-off which

69 62-1 USTC Para. 9460, 303 F2d 14 (CA-2).
benefited the corporation and ignored any valid shareholder non-tax reasons which might have been present (e.g., the shareholder wished the real estate to be a separate asset of his estate).

The intent of Congress, in the case of reorganizations, was to limit tax-free treatment to situations in which there were valid and reasonable corporate and shareholder purposes other than tax avoidance. The Court stated, in the case of Parshelsky, with emphasis, "Congress intended to limit tax exemption to those spin-offs where the taxpayer had corporate or shareholder purposes such as would motivate a reasonable businessman to effect a spin-off."\(^{70}\) Thus, a spin-off reorganization was held to be tax-free even though its only business purpose was that of the sole shareholder and not of the transferor corporation. The shareholder purpose vis-a-vis estate planning validated the existence of the corporation. Shareholder business purpose is often the rationale for the creation of holding companies.

Cases Involving The Corporate Entity

The business purpose doctrine applies to corporate entity arguments whether initiated by the taxpayer or the IRS. However, to succeed in having a corporate entity

\(^{70}\) IBID.
ignored for purposes of taxation requires great skill. If a corporation engages in the slightest business activity, the courts have often held that the corporate entity must be regarded, regardless of whether the taxpayer or the Commissioner benefited from the recognition.

If either the Government or the taxpayer contends that the separate entity of a corporation should be ignored, they usually hope to argue that (1) the income of the corporation should be taxed to the shareholders or (2) a transaction between the corporation and the stockholders should be disregarded for tax purposes. Generally, the corporate entity will not be ignored; but, the principal exception, in tax cases, is when the corporation, instead of having a business purpose or carrying on business activity, is a sham or only wishes to avoid Federal taxes.\textsuperscript{71}

The leading decision of the Supreme Court on corporate business purpose is Moline Properties, Inc. v. Commissioner, in which the majority stated:

\begin{footnote}
\textsuperscript{71} Prentice-Hall Federal Taxes, 1982.
\end{footnote}
The doctrine of corporate entity fills a useful purpose in business life. Whether the purpose be to gain an advantage under the law of the State of incorporation or to avoid or to comply with the demands of creditors or to serve the creditor's personal or undisclosed convenience, so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity.\(^\text{72}\)

In Moline Properties, the taxpayer corporation was organized by an individual, its sole shareholder, to be used as a security device in connection with certain real estate. After the loan which had occasioned the creation of the holding company was paid, the corporation sold part of its real estate at a gain. The Court rejected the contentions that the corporation's separate entity should be ignored and that the gain should be taxed to its sole shareholder.

In Higgins v. Smith,\(^\text{73}\) the Courts stated deliberately and authoritatively that whatever the purpose of organizing the corporation, "so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate entity."\(^\text{74}\)

\(^\text{72}\) 319 US 436, (1943).

\(^\text{73}\) Higgins v. Commissioner, 312 US 212, 25 AFTR 1160.

\(^\text{74}\) IBID.
Other cases have held that the corporate entity was availed of for legitimate business reasons, although one of such reasons may have been to gain substantial tax savings. In Kobacker v. Commissioner, the taxpayer wanted to buy X corporation. He had $175,000, but the asking price was $475,000. He formed Y corporation, and swapped the $175,000 for all the Y stock, which in turn borrowed the additional funds needed and purchased X corporation. This form of the transaction resulted in substantial tax savings to the taxpayer because if he had bought X himself and had borrowed the additional funds, X would have had to distribute its earnings to him in order to pay back the loan. And these would have been taxable dividends. This transaction was, in fact, upheld as a legal business entity formed for a legitimate purpose. In its opinion, the Court stated, "... it is well settled that a taxpayer had the legal right to so conduct his business transactions as to minimize the incidence of taxation, or altogether avoid the amount of what would otherwise be his taxes, by whatever means the law permits."75 The corporation had complied with all the requirements of the corporate laws in its organization and subsequent operations, and had engaged in substantive

75 Arthur J. Kobacker and Sara Jo Kobacker, et. al. v. Commissioner, 37 TC 882.
business activity, therefore, it had established a legitimate business purpose.

In George M. & Jean H. Jones, et.al. v. Commissioner,76 separate corporate and partnership entities were upheld. Partners (sole shareholders) who formed a corporation which would construct and operate an apartment complex were denied a partnership loss deduction relating to the complex because the income and expenses of the complex belonged to the corporation. The business purpose test was satisfied since the corporation was formed to obtain financing and to avoid usury laws. The business activity test was also fulfilled since the corporation negotiated a construction contract in order to make numerous changes in the design and size of the complex.

The Court had previously ruled that the avoidance of restrictions under state law constituted a valid business purpose which required the recognition of the corporate

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76 1978 P-H TC Memo, paragraph 78,446. entity. The Court also believed that the petitioners chose
the advantages of doing business in the corporate form and consequently, they had to accept the tax disadvantages. 77

Another business purpose case was recently highlighted in The Mortgage and Real Estate Executives Report (July 15, 1982). In that situation the central issue dealt with forming a corporation and passing through taxable losses to its shareholders/investors. Because the Tax Court found sufficient business purpose and minimal business activity and could not prove an agency relationship, the corporation was recognized for Federal income tax purposes. Factually, two partners in a real estate company formed a partnership with a number of other investors to build a commercial development under an urban renewal program. After the investors chose to get out of the program, the two partners formed a closely-held corporation in order to obtain a mortgage loan and to avoid violating a state usury law limiting the interest which

77 In Burnet v. Commonwealth Import Company, the Court appraised the relation between a corporation and its sole shareholder and held taxable to the corporation a profit on a sale to its stockholder. This was because the taxpayer had adopted the corporate form for business purposes of his own. The choice of the advantages of incorporation to the business required the acceptance of the tax disadvantages/287 US 415, 3 USTC Para. 1009.
could be paid on loans to individuals. Despite the fact that the corporation was incorporated under state law, it did none of the following:

1. Issue stock;
2. Maintain corporate records;
3. Obtain a bank account; and
4. Observe other corporate formalities.

In fact, the real estate company, rather than the corporation, actually carried out the management and operation of the property. The IRS took the position that the net operating losses of the property were properly attributable to the corporation.

The United States Tax Court agreed with the IRS and held that the corporate entity could not be ignored for tax purposes. In the view of the Tax Court, the following elements were critical:

Since the corporation was organized to circumvent state usury laws, it had sufficient business purpose to require its recognition as a taxable entity.

Despite the fact that the business activity of the corporation was minimal, the corporation did hold title to and lease property, did borrow money, and did accept rent.

The shareholder-partners made no effort to liquidate the corporation after the loan was granted. To the contrary, measures were taken to prevent its dissolution, since franchise tax returns were filed.
There was no proof that a principal-agency relationship existed between partners and the corporation. There was no written agency agreement.

For these basic reasons, the Tax Court decided the corporation was a taxable entity.\textsuperscript{78}

In Paymer v. Commissioner,\textsuperscript{79} Westrich Corporation, a corporation formed by the taxpayers to hold title to real estate, served no business purpose in connection with the property and was created only as a blind to deter the creditors of one of the taxpayers. Westrich was at all times a passive dummy which did nothing but take hold of the title to the real estate. The Court held that Westrich was a sham corporation and its tax existence was, therefore, disregarded.

On the other hand, Raymep Realty Corporation, a corporation formed with the same dummy motive, having no books or officers and holding no corporate meetings, was held to be a taxable entity. The Court ruled that Raymep was active enough to be a legitimate taxable entity because in 1938 it floated a loan and gave, as part security, the rights in two leases on the property held by it.

\textsuperscript{78} Sarkisian v. Commissioner, TC Memo. 1982-199 (4/14/82).
\textsuperscript{79} Paymer v. Commissioner, 150 F2d 334, 33 AFTR 1536 (USCA2).
Related Concepts and Cases

The business purpose doctrine is related to sham transactions, the conduit theory, step transactions, and substance versus form transactions. Each of these concepts is a potential weapon in the government's arsenal for attacking the organization of a business. As Bittker and Eustice point out, a transaction entailing tax-avoidance motives may be disregarded as a "sham, or its form may be recast so as to reflect its economic substance, or interdependent steps in a single transaction may be collapsed in order to prevent overreaching taxpayers from doing indirectly what they cannot do directly."80 In other words, the taxpayer's success in litigation may depend on the existence of business purpose.

A basic decision that came out of Bolger v. Commissioner81 was that ownership of income between a corporation and its stockholders was to be determined by the facts in each case. The corporation was found to be an entity distinct from its shareholders. The Court stated:

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81 59 TC 760, Para. 59.75 P-H TC (A).
there is no question that they organized and utilized in the initial stages for business purpose, namely, to enable the contemplated transactions to produce maximum financing by avoiding state law restrictions on loans to individuals rather than to borrowers, to provide a mechanism for limiting personal liability and to facilitate multiple-lender financing. In furtherance of these purposes, the corporations purchased the properties, entered into the leases, issued their corporate obligations, and executed mortgages and assignments of the leases as security for the payment of those obligations. At that point of time, the corporations were undoubtedly separate viable entities whose separate existence could not be ignored for tax purposes. 82

Thus, the judicial decisions seem to turn on the facts of each particular case.

In Harrison Property Management Company, Inc. v. U.S., 83 profits from oil leases on property were taxable to the corporation that held legal title to the property. The profits were, therefore, not attributed to the corporation's three shareholders, who had transferred, without consideration, the property's title from their partnership while using an agency agreement to retain beneficial ownership for themselves. The corporate entity could not be ignored since it was set up for the acceptable

82 IBID.
83 31 AFTR2d 73-946, 201 Ct. Cl. 77, 475 F2d 623(3-16-73).
business purpose of providing efficient management of the property if one of the former partners died and of decreasing the need for signatures of all three owners in routine operations.

The agency agreement between the corporation and the shareholders did not support a true agency relationship. The facts indicated that the corporation's relations with these three beneficial owners were wholly dependent on the fact that they were the sole shareholders. Further, permitting the shareholders to be taxed in a case such as this, where a true agency relationship did not exist, would thwart Congressional intent because the result would be the same as if the shareholders had elected tax-option corporation status (in spite of the fact that the corporation's passive investment income was more than 20 percent).

In Tomlinson v. Miles,\textsuperscript{84} the Tax Court held that the taxpayer corporation was organized for a bona fide business purpose and must be recognized as a separate corporate entity. In Britt v. U.S.,\textsuperscript{85} the Court of Appeals ruled that three corporations, to which two brothers who owned a citrus grove business as equal partners transferred their

\textsuperscript{84} Tomlinson Fleet Corporation, 25 TCM 59, Dec. 27,816.
\textsuperscript{85} 14 AFTR2d 5482, 335 F2d 907 (USCA 5).
interests, were separate entities apart from the partnership and that the lower court had improperly attributed income from the business to the brothers. The income, the Court claimed, belonged to the corporation. The Court of Appeals also stated that corporate recognition does not depend upon the amount of business conducted: business activity may be minimal. This decision evolved from the fruit and tree doctrine — income from property must be taxed to the individual who, in substance, is the owner of the property generating the income. In this case the district court found that the level of business activity was not sufficient to require recognition of the corporations as business entities. On the evidence, the Court of Appeals reversed the decision.

In Strong v. Commissioner,86 a corporation formed by the partners of a real estate development venture to hold the properties involved as the title owner for the purpose of obtaining financing and circumventing state usury laws applicable to individuals was a separate taxable entity. In fulfilling this purpose, it was, in effect, carrying on a business activity. Therefore, the corporation, not the partners themselves, was the proper party to report the net operating losses generated by the project.

Finally, Commissioner v. State-Adams Corporation was a case involving the general principles of substance v. form, "dummy" real estate corporations, and income to the corporation. The taxpayer-corporation was held taxable on income from real property to which it held title. It maintained that corporate entity should be disregarded because it had no purpose except to hold title and, therefore, income from rental property should be taxed directly to shareholders. (Unlike other cases, the taxpayer, in this instance, wanted to be taxed individually rather than as a corporation.) The Tax Court agreed with the corporation, saying, "under the peculiar facts of this case we conclude that the corporate entity of petitioner should be disregarded for Federal tax purposes and that the income, which is in form the income of the petitioner, is in reality the income of its stockholders and should be taxable to them rather than to petitioner."

But the Court of Appeals held that the functions for which the taxpayer was created were performed and that sufficient business activity existed for purposes of taxation. Upon IRS appeal, State-Adams Corporation argued that the corporation was a mere dummy for the holding of title and, therefore, its separate corporate existence

87 32 TC 365, para. 32.36 P-H TC 1959 (NA).
should be disregarded for Federal tax purposes; however, the Court of Appeals concluded that the corporation had performed the functions for which it had been created, functions which were sufficient to constitute a business activity for purposes of taxation. Thus, the Court seems to be consistent in recognizing a corporate entity for tax purposes where corporate or shareholder business purpose is present, regardless of the degree of business benefits.

The court asserted that the respondent had full beneficial ownership of the land from which it collected rent and engaged in other business. This was not a case where the corporation was a mere nominee, powerless to act with respect to the land except with the consent of the beneficial owners. Had the corporate officers and directors decided to sell the land or to reinvest in other property, the shareholders who had been receiving the rent could not have complained. This was not a case where income belonging to the shareholders was received in form by the corporation. The income belonged to the corporation and was paid directly to the shareholders only because this suited the reason for which the corporation had been established. The corporation, therefore, was organized for a specific purpose which required for its fulfillment a separate legal entity, more than a sham or "shell"; over the years it carefully satisfied every legal requirement to achieve that purpose.
Step Transactions Doctrine

According to Bittker and Eustice, "Like the business purpose doctrine, the judicial requirement that all integrated steps in a single transaction must be amalgamated in determining the true nature of a transaction is applied in every nook and cranny of the tax law." The step transaction doctrine has been used both to create and to deny reorganization status. The basic idea of this doctrine is to treat a series of formally separate steps as a single transaction, "if they are in substance intergrated, interdependent and focused toward a particular end result." The step transaction doctrine is applied on a case-by-case basis, so no universally accepted test exists. Some courts emphasize the "interdependence" aspect of the steps. In other words, would one or more of the steps have been fruitless without completion of the rest? Other courts have interpreted the transaction in terms of the "expected results."

88 Bittker and Eustice, id., Corporate Reorg. p. 130, e.g. whether a transferor has control "immediately after the exchange" under Section 351; whether a purchase of stock coupled with a liquidation is equivalent to a purchase of assets; and whether assets of a partially owned corporation can be acquired in a tax-free exchange.

89 IBID, p. 131.
Within the context of IRC Section 351 transactions, the step transaction doctrine can be applied to the IRC Section 368(c) "control" test. Even if the 80 percent stock interest is satisfied at the time of the exchange, the transferor's stock may be reduced by transferring of shares or issuing of shares at a later date. If the step transaction doctrine is not applied where the stock interest is subsequently reduced, the IRC Section 368(c) control test will have been satisfied. If the doctrine is invoked, the transaction will be amalgamated and the net effect will be disqualifying the transaction for IRC Section 351 purposes out of not meeting the IRC Section 368(c) control test.

The step transaction doctrine has been used to review whether several transactions will be considered independent and separate or whether they will be considered as one transaction. Although there is no single set of factors for ascertaining the status of a set of transactions, the Courts

have generally looked at the intention of the parties,\textsuperscript{91} time interval between the transactions,\textsuperscript{92} and the interdependency of the transactions.\textsuperscript{93}

American Bantam Car Company v. Commissioner\textsuperscript{94} is the landmark case applying the step transaction doctrine to IRC Section 351. In American Bantam, individuals exchanged assets for all the common stock of a corporation. Fifteen months after the transfer, the individuals paid an underwriter for selling preferred stock. Payment was in the form of one-third the outstanding common stock. The stock

\begin{itemize}
\item \textsuperscript{91}Ericsson Screw Machinery Products Company v. Commissioner, 14 TC 757(1950). But see Survant v. Commissioner, 162 F2d 753 (8th CIR 1947)... held that the intent that certain tax provisions would apply to a transaction is not important. Vest v. Commissioner, 57 TC 128, 146(1971), aff'd 481 F2d 238(5th CIR 1973).
\item \textsuperscript{92}H.B. Zachary Co. v. Commissioner, 49 TC 73, 82(1967), wherein the Court noted that the three day interval between the date of the property for stock exchange and the transfer of the stock received in the exchange was not by itself a controlling factor. Commissioner v. Ashland Oil and Refining Company, 99 F2d 588 (6th CIR 1938), cert. den., 306 US 661(1939), steps in one transaction occurred more than six years apart. Hendricksen v. Braicks, 137 F2d 632 (9th CIR 1943), separate transactions occurring one-half hour apart.
\item \textsuperscript{93}Stephans, Inc. v. US, 464 F2d 53(8th CIR 1972); Vest v. Commissioner, supra.; Zachery, supra.; South Bay Company v. Commissioner, 345 F2d 698 (2d CIR 1965); American Wire Fabrics Corporation v. Commissioner, 16 TC 607(1951); American Bantam Car Company v. Commissioner, supra.
\item \textsuperscript{94}11 TC 397 (1948), aff'd 177 F2d 513(3d CIR 1949), cert. den., 339 US 920 (1950).
\end{itemize}
transfer to the underwriter occurred over the fifteen month period. On the basis of these facts, the court rejected the application of the step transaction doctrine, reasoning that the transfer was not an interdependent part of the initial transaction. The Court stated:

In determining whether a series of steps are to be treated as a single indivisible transaction or should retain their separate entity, the Courts use a variety of tests.... Among the factors considered are the intent of the parties, the time element, and the pragmatic test of the ultimate result. An important test is that of mutual interdependence. Were the steps so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series?95

In a more recent test of the step transaction doctrine, the Tax Court rejected its application stating:

A determination of 'ownership' as a term is used in Section 368(c) and for purposes of control under Section 351, depends upon the obligations and freedom of action of the transferee with respect to the stock when he acquired it from the corporation. Such traditional ownership attributes as legal title, voting rights, and possession of stock certificates are not conclusive. If the transferee, as part of the transaction by which the shares were acquired, has irrevocably foregone or relinquished the legal right to determine whether to keep the shares, ownership in such shares is lacking for purposes of Section 351. By contrast, if there are no restrictions upon freedom of action at the time he acquired the shares, it is immaterial how soon thereafter the

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95 Ibid.
transferee elects to dispose of his stock or whether such disposition is in accord with a preconceived plan not amounting to a binding commitment.

The IRS will readily apply the step transaction doctrine, often more readily than the courts. Its position is stated in Revenue Ruling 54-96 where the step transaction doctrine was applied to a transfer of a corporation's assets to a newly-formed corporation in exchange for the new corporation's stock and a subsequent exchange of that acquired stock for 20 percent of the voting stock of another corporation. Integrating the two steps, the IRS determined that neither an IRC Section 351 transaction nor a reorganization under IRC Section 368(a)(l)(B) had occurred. The IRS stated:

The two steps of the transaction described above were part of a prearranged integrated plan, and may not be considered interdependently of each other for Federal income tax purposes.

Thus, according to the IRS position, the step transaction doctrine will be applied even though there is no binding commitment or obligation to consummate the subsequent steps

of the transaction, so long as there is a prearranged plan
to carry out the steps.97

Conduit Theory

The Supreme Court has disregarded the existence of a
corporate entity where the corporation was a mere agent for
its stockholders or where their businesses were so
commingled as to constitute a single business enterprise for
all practical purposes.98 For example, where a
subsidiary acted as an agent of the parent (the subsidiary
kept no bank account and the parent deposited the
subsidiary's funds in its own bank account), the
subsidiary's corporate entity was disregarded.99 In
general, before an agency argument will be accepted, there
must be proof that an agency relationship existed.100

On the other hand, the Supreme Court stated that
whether the purpose was 1) to gain an advantage under state
law; 2) to avoid or to comply with the demands of creditors;
or, 3) to serve the stockholder's personal or undisclosed

97 Rothmans, "Transfers to Controlled Corporations; in
98 Mertens, supra, Section 38-08 p. 13.
99 Shoenberg v. Commissioner, 77 F2d 446 (CCA 8th 1935).
100 Estate of Van Hersden v. Commissioner, 66-2 USTC Para.
9751 (CA 5th, 1966).
convenience, the corporate entity will be recognized for tax purposes, provided the purpose is the equivalent of business activity or is followed by the carrying on of corporate business. The Supreme Court refused to infer an agency relationship from the mere fact that one stockholder owned all of the stock. Thus, it seems a contract of agency, or at the least the usual incidences of an agency contract, is required for the Court to infer an agency relationship.

Furthermore, according to the Supreme Court, the question of agency will not be determined solely from the fact that the taxpayer owns the agent. To qualify as an agent, the corporation must act like an agent and perform the duties of an agent. In National Carbide Corporation v. Commissioner, the Supreme Court overruled its previous decision in Southern Pacific Company v. Lowe, and held

103 IBID.
that the corporate entity should be disregarded only where a true agency is involved. Thus, when a corporation carries on business activity, the mere fact that the owner retains complete control does not exonerate the corporation from paying the income tax on its income.

Sham Doctrine

The separate existence of a corporation may be disregarded if the corporation lacks economic reality or is a sham. In order for the corporation to lack this reality, it must be created for the purpose of avoiding taxation and lack substantial business activity (i.e., business purpose). However, the opposite notion is also true and is the defense of the corporate entity (i.e., business activity creates economic reality and legitimizes corporate existence).

In Aldon Homes, Inc.,107 a group of builders and real estate operators took title to a tract of land. Sixteen additional corporations were formed by the principals of Aldon to take title to 15 lots each. Homes were built on the land by another corporation and the entire tract was sold as a single development. The Tax Court held the corporations were mere shams because they "carried on no separate independent income-producing activities and served

no function except as corporate devices to split the income and reduce taxes." The Court stated that "[the corporations] were mere corporate shells acting as conduits" for Aldon and that "every material step in the production of the income was taken by Aldon or those who controlled it." The IRS was successful in its endeavor to disregard the separate corporate entities because the corporations were "not tax-worthy entities in that they were not formed for any business purpose, did not function in income-producing capacities and lacked substance and reality."

As a defense, the taxpayer, Aldon, argued limited liability, facilitation in handling mechanic's liens, and facilitation in raising investment capital by reducing corporate taxes, and by increasing investor return. To this the Court replied that "escaping taxation is not a business in the ordinary sense." Although the corporations carried out traditional corporate activities (e.g., holding corporate meetings, adopting by-laws, keeping separate accounting records), the Court was not convinced that the functions were related to the production of income. In addition, the financial actions of the controlling stockholder did not prove to the Court that his conception of the corporations was of them as separate entities.
A case closely related to Aldon was Shaw Construction Company.\textsuperscript{108} Shaw Construction was a general contractor owned solely by H. Shaw and his wife. Mr. Shaw bought property and transferred it to 88 corporations owned or controlled by him. Each corporation then entered into a construction contract for the construction of small homes. The houses were advertised as "Shaw built" with no reference to the owning corporations.\textsuperscript{109} The Court found no "real business purpose . . . for the organization of the multiple corporations or that they actually conducted any business activity which gave rise to the income from the development and sale of these properties. The evidence is clear that the multiple corporations were mere paper corporations that existed in form only for the purpose of obtaining the tax benefits available by splitting the income realized in these projects."\textsuperscript{110} The sham theory was sufficient for the Court to deny the corporations their entities and attributes for tax purposes.

Although this case centers around the sham doctrine, it is interesting to note that the form versus substance

\footnotesize{
\begin{enumerate}
  \item[108] CCH Dec. 24,745, 35 TC 1102, aff'd 63-2 USTC Para. 9726, 323 F2d 316 (CA-9).
  \item[109] Kauffman, Joel, "The Concept of the Corporation as a Taxable Entity in the Multiple Corporate Area", Taxes, November 1968, p. 693.
  \item[110] IBID, See Footnote 54.
\end{enumerate}
}
theory, and the business purpose doctrine became woven in
with the sham doctrine. The Court ruled that the
corporations clearly lacked any substance and were of form
only. Because of this and because the corporations lacked
business purpose, they were considered shams. So,
evidently, some or all of the IRS's arsenal can be used in a
given situation in an attempt to have the corporate entity
ignored.

Substance-versus-Form Doctrine

The substance-versus-form doctrine is a vague but
vital doctrine in the law. The problem with the doctrine is
that it fails to specify the extent to which legal and tax
issues turn on the substance of a transaction rather than on
its form. In theory substance should control, but in
reality the form often has substantive consequences.

In regard to the corporate entity question,
recognition or non-recognition often rests on the substance
and form of the transaction. The other doctrines reviewed
in this Chapter directly relate to substance versus form and
clarify the procedure for non-recognition. In cases of tax
avoidance, fraud, sham or other types of non-bona fide
transactions and in cases involving no real business
purpose, the courts have not hesitated to disregard the
corporate entity by looking through the form to the
substance of the transaction.111

In Higgins v. Smith,112 for example, the Court
addressed the substance versus form doctrine:

... the Government may not be required to
acquiesce in the taxpayer's election of that
form for doing business which is most
advantageous to him. The Government may look
at actualities and upon determination that
the form employed for doing business or
carrying out the challenged tax event is
unreal or a sham may sustain or disregard the
effect of the function as best serves the
purpose of the tax statute.113

The Court further stated that the taxpayer does have the
right to look through the form of a transaction to its
substance in order to relieve itself from its tax burdens
but only the Commissioner can exercise such a right.114 And
in Bailey v. U.S., the Court stated, "But the Government may
not look to the substance of a transaction for purposes
beneficial to its interest and disregard the substance for
purposes beneficial to the taxpayer's interests."115

111 National Investors Corporation v. Hoey, 144 F2d 466 (CCA
2d 1944), rev'g 52 F.Supp. 556 (DSCDNY, 1943).
112 308 US 473, 84 LED 406, 60 S.Ct. 355, 358 (1940), rev'g
102 F2d 456 (CCA 2d, 1939).
113 IBID.
(DCMD Tenn., 1955).
CHAPTER SEVEN
THE NEW TEFRA RULES

This chapter reviews the specific changes in the tax law with respect to IRC Sections 304, 306, and 351 brought about by the enactment of The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA). The goal of these changes are twofold: first, to settle disputes over the controlling application of IRC Section 304 versus IRC Section 351 and, second, to curtail the use of newly-formed holding companies to achieve results that have heretofore been superior, tax-wise, than consummating similar transactions with existing corporations. Hence, this chapter discusses the Congressional intent behind these changes and how these new provisions actually affect IRC Sections 304(b)(2)(A), 304(b)(3), 304(c)(2), 306(c)(3), 306(c)(4) and 351(f)(5).

The Two-Pronged Treasury Attack

TEFRA affects the interaction of IRC Sections 304, 306 and 351 in two important ways. First, its changes attempt to clear up the confusion brought to light by the Haserot and Coates Trust cases. That is, the new law

116 TEFRA Act Section 226 is the primary basis for discussion in this chapter.

117 See Chapter Five for discussion of cases & implications.
attempts to avoid conflict between the IRS and taxpayers when both IRC Sections 304 and 351 apply. Specifically, Congress is seeking to apply IRC Section 304 rather than IRC Section 351 where a transaction meets the literal interpretation of both.

The other purpose for the Treasury attack results from the use of newly-formed holding companies. Taxpayers have frequently resorted to using holding companies, in preference to transferring to or recapitalizing existing subsidiaries, to avoid IRC Section 306 or the taxation of distributions of property as dividends. The Treasury's attack focuses, then, on the act of a holding company issuing what otherwise might be defined as IRC Section 306 stock, securities within the meaning of IRC Section 351, or other non-stock, non-securities types of property. As pointed out in the previous chapter, transfers of stock to a newly-formed holding company in exchange for that company's stock and securities (given that the holding company's legitimate tax status survives scrutiny of the substantive issues of subchapter C) have not been subject to IRC Section 304(a)(1). Further, IRC Section 306 has been ineffective in the case of such transactions, and IRS

118 These substantive issues include: 1) The Business Purpose Doctrine; 2) The Conduit Theory; 3) The Step Transactions Doctrine; and 4) The Sham Transactions Doctrine. These issues are discussed in Chapter Six.
Revenue Ruling 80-239 has allowed capital gain treatment to the receipt of other property subject to the bifurcation argument of that Ruling. Here, the Congress intends to equalize the tax treatment between the use of newly-formed holding companies and the recapitalization of an existing subsidiary.

Settlement of the 304/351 Conflict

Congress has clearly chosen to override the non-recognition provision of IRC Section 351 in cases when IRC Section 304 also applies as a new paragraph (3) added to IRC Section 304(b) manifests. Subparagraph (A) of paragraph (3) reads as follows:

Property Treated as Received in Redemption — Except as otherwise provided in this paragraph, subsection (a) (and not Part III) shall apply to any property received in a distribution described in subsection (a).

The exceptions referred to in this subparagraph include the assumption of liabilities in the acquisition of stock and certain distributions incident to the formation of bank holding companies.\(^{119}\) In sum, the implication of the newly-legislated IRC Section 304(b)(3)(A) is that the dividend treatment of IRC Section 304 is to prevail over the

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119 IRC Section 304(b)(3)(B) deals with the exception relating to the assumption of liabilities in the acquisition of stock. IRC Section 304(b)(3)(C) covers with the exception relating to the formation of bank holding companies.
potential capital gain treatment of IRC Section 351 in that this new provision identifies that IRC Section 304(a) is to govern over those Sections contained in Part III of Subchapter C. It seems the Haserot/Coates Trust issue is dead. The IRS has, in the final analysis, won on this point.

Holding Company Strategies - Avoiding IRC Section 306

Exchanges resulting in the distribution of stock by a newly-formed holding company that might otherwise satisfy IRC Section 306 had such stock been distributed by an existing subsidiary have not, in the past, fallen prey to the IRC Section 306 snare. This treatment had resulted from definitions contained in two sources. First, the application of IRC Section 306 had been limited to transactions defined in IRC Section 305; and transactions governed by IRC Section 355 and had not, by definition, included stock issued in a transfer to which IRC Section 351 applied unless such stock had been exchanged for IRC Section 306 stock. Second, IRC Section 306(c)(2) had limited the application of IRC Section 306 so as to exclude the

120 Part III of Subchapter C includes IRC Sections 351-368.
121 IRC Section 306(c)(1)(A).
122 IRC Section 306(c)(1)(B)(i).
123 IRC Section 306(c)(1)(B)(ii).
distribution of stock which would not have been a dividend at the time of the distribution if money had been paid in lieu of the stock. Thus, transfers of non-IRC Section 306 subsidiary stock to a newly-formed holding company in exchange for stock that may otherwise have satisfied the definitional provisions of IRC Section 306 since 1) the issuance of such stock would have been governed by IRC Section 351 and/or 2) the distributing company had no earnings and profits at the time of the distribution.

That TEFRA was introduced partly to stop corporations from avoiding IRC Section 306 on transfers to newly-formed holding companies is apparent upon reading two of its provisions. First, new paragraph (3) of IRC Section 306(c) maintains that if money received in lieu of stock (in an exchange usually governed by IRC Section 351) would have resulted in a dividend to any extent, then such stock is IRC Section 306 stock. This new provision ties IRC Section 306 to the new reading of IRC Section 304(b)(2)(A). This new reading assumes that the issuing corporation first distributes property, thereby transferring its earnings and profits to the acquiring corporation which then makes a distribution to its shareholders. That is, the combined earnings and profits of the issuing (subsidiary) and acquiring (parent) corporations determine the amount of earnings and profits which may ultimately play a part in
deciding the amount of dividend income recognized on the redemption of IRC Section 306 stock. Thus, the interaction of the amended IRC Section 304(b)(2)(A) and the new IRC Section 306(c)(3) means that when a subsidiary's stock (when such subsidiary has non-zero earnings and profits) is transferred to a newly-formed holding company, it will be treated as IRC Section 306 stock. However, those classes of stock which may potentially be IRC Section 306 stock will not differ from those classes generally regarded as such under pre-TEFRA rules.

Holding Company Strategies - Distributions of Securities

Pre-TEFRA tax provisions treated transfers of a subsidiary's stock to a newly-formed holding company in exchange for the latter's stock and securities as a non-recognition event governed by the provisions of IRC Section 351 and by the substantive issues that generally plague multiple corporate transactions under Subchapter C of the Code. IRC Section 304(b)(2)(A) under pre-TEFRA law provided that the dividend result of a related-corporation redemption defined under IRC Section 304(a)(1) was limited by the earnings and profits of the acquiring corporation. Since the acquiring corporation was the newly-formed holding company, which had no earnings and profits, IRC Section 304(a)(1) was ineffective in capturing transfers to these companies in transactions which included the distribution of
securities by the holding company. The Joint Conference Report recognized the effect of this type of transaction in stating that:

Even if the redemption rule applies (referring to IRC Section 304) and dividend treatment results, dividend consequences would be determined by reference to the earnings and profits of the purchasing corporation. If it is a newly-formed holding company, it would have no earnings.\textsuperscript{124}

To remedy this perceived abuse, Congress altered the reading of IRC Section 304(b)(2)(A) so that the amount determined to be a dividend would be so done by assuming the property\textsuperscript{125} was first distributed by the issuing corporation to the acquiring corporation and immediately thereafter distributed by the acquiring corporation to its shareholders. The result is that, to the extent of the fair market value of the property, the subsidiary's (the issuing corporation) earnings and profits are shifted to the parent (the acquiring corporation); then the distribution exposure is increased by the incremental earnings and profits of the parent so that ultimately, the dividend consequences are a function of both the subsidiary's and the parent's earnings.

\textsuperscript{124} Conference Report 97-760, p. 541.

\textsuperscript{125} Property in this context is defined in IRC Section 317 and is discussed in Chapter Four.
and profits. In brief, the taxpayer must pay close attention to any transaction involving the use of a newly-formed holding company.

Holding Company Strategies - Distribution of Other Property

Another age-old opportunity has succumbed to changes in the tax law. Under pre-TEFRA rules when a taxpayer transferred a subsidiary's stock to a newly-formed holding company (or one absent of earnings and profits) in exchange for that company's stock, and the holding company subsequently borrowed money (using the acquired subsidiary's stock as collateral) and distributed such borrowed funds to the holding company's shareholders, the distribution would receive capital gain and/or return of capital treatment. Such transactions did not result in dividend treatment. The Treasury and the IRS previously attempted to attack this type of transaction by proposing accumulated earnings tax regulations,¹²⁶ which were subsequently rescinded, and by effecting IRS Revenue Ruling 80-239. The Government has not challenged any such transactions in the courts. Their only means of attack, before TEFRA, would have been on the basis of one of the substantive Subchapter C multiple corporate

¹²⁶ Proposed Regulations Sections 1.533-1(a)(3) and 1.535-3(b)(iii), published July 9, 1968, 33 F.R. 9830. A discussion of these proposed Treasury Regulations is contained in Chapter Five.
issues reviewed in Chapter Six. As previously indicated, such an attack, when valid business purpose exists, probably still would not succeed.\textsuperscript{127} Rather than risk failure, and a subsequent deluge of such transactions, the IRS waited for the opportunity to prevent this perceived abuse by other means. That opportunity presented itself in the form of TEFRA.

Post-TEFRA transactions, similar to the one described in this subsection, must be approached with much caution. The new reading of IRC Section 304(b)(2)(A), as previously discussed, assumes that the subsidiary (issuing) corporation first distributes property to the parent (acquiring) corporation and that the latter then distributes it to its shareholders. Thus, in order to avoid dividend treatment, the parent may do its borrowing and distributing after its initial acquisition of the subsidiary's stock is an "old and cold" transaction.

Miscellaneous TEFRA Provisions

One pre-TEFRA question that has been resolved by one of the new provisions is whether IRC Section 304 applies

\textsuperscript{127} For further discussion on this point see "The Service's Recent Attack: Taxation of Section 351 Exchanges Between Shareholders and Newly Formed Holding Companies," (Jerred G. Blanchard, Jr.), \textit{Tax Lawyer}, Volume 35, 1982, Number 1, pp. 163-198.
only when both the issuing corporation and the acquiring corporation exist prior to the transaction in question. In other words, IRC Section 304 applied to the a newly-formed holding company since it was not in existence immediately prior to the transaction. New IRC Section 304(c)(2)(A) provides, however, that stock acquired from the new holding company be taken into account.

A mention of one other minor provision concludes the discussion on the new TEFRA rules. Paragraph (5) has been added to IRC Section 351(f) in order to coordinate the clear relationship between IRC Sections 304 and 351.

The overall implication of these new TEFRA provisions is that corporate shareholders must do considerable thinking in order to achieve the objectives that prompted them to use newly-formed holding companies under pre-TEFRA rules. New strategies, considerations, and trade-offs are the subject of Chapter Eight.
CHAPTER EIGHT

IMPLICATIONS OF NEW TEFRA RULES FOR HOLDING COMPANY TYPES OF STRATEGIES

This chapter explores the aftermath of the new TEFRA rules concerning the use of holding company strategies. Specifically, this chapter emphasizes the importance of managing the location, in a multiple corporation setting, where earnings and profits are to be accumulated; and, to show that in managing such location, in general, it seems advisable to maintain such accumulation away from appreciating wealth, as far as is practical. Further, this chapter proves that TEFRA did not end the use of newly-formed holding companies; instead, it created at least two opportunities. The first possibility deals with evaluating the risks and returns of the new rules, whereas the second one involves avoiding the new rules, or at least casting the issue back into the context of bona fide corporate tax existence. The final holding company strategy reviewed in this Chapter is referred to as "Bottom Freezing."

Locale of Earnings and Profits

The enactment of TEFRA emphasizes how important it is that a corporation be constantly aware of its earnings and profits. The new TEFRA provisions discussed in this paper especially have an implication for transactions falling
within the scope of IRC Sections 304, 306, and 351. At a minimum, in a multiple corporate setting, the corporations must be aware of where earnings and profits are accumulating so that they can plan meaningfully for their current and future planning needs. For example, failure to carefully document earnings and profits might mean that one corporation would accumulate large amounts of earnings and profits at a time when the taxpayer/shareholder wanted to use corporate strategies that would result in taxable dividend consequences rather than in capital gain or tax-free treatment.

Such an accumulation would, however, make it impossible for the taxpayer to fulfill this objective. Since the parent corporation, in a chain of corporations, may ultimately become the issuing corporation in an IRC 304 context, the locale of the accumulation of earnings and profits in that corporate chain is important. Specifically, for what would finally be a transaction needing to withstand IRC Section 304 consequences, it would be best to have earnings and profits aggregate in lower-tier subsidiaries rather than in the parent. In that way, when the parent corporation ultimately becomes an IRC Section 304 issuing corporation, it has little or no earnings and profits.

Affiliated multi-corporate income tax filing status may affect where earnings accumulate. That is, one
implication of the new TEFRA rules is that, in an affiliated multiple-corporate group, it has become more important to weigh the decision to have that group elect to file consolidated returns versus continuing to file separate returns. Different rules, of course, apply to the accounting for earnings and profits given the status of consolidated or separate returns. But, more important, the relative ease of electing to file consolidated returns, and the relative difficulty of breaking that election, subjects the initial choice to file consolidated returns to careful evaluation.

Managing Earnings & Profits Away from Appreciating Wealth

One strategy that becomes more important since the enactment of TEFRA is to keep the accumulation of wealth away from the accumulation of earnings and profits until such time as strategic objectives are clear. By accomplishing this dichotomy through multiple corporate relationships, a taxpayer/shareholder remains flexible for implementing planning choices that facilitate strategic objectives.

There are several ways to manage earnings and profits so as not to taint appreciating wealth with the associated earnings and profits problems. One way is to use personal
service management companies. Another way is to retain the fundamental wealth outside of corporate entities and to enter into leasing arrangements.

Implications for the Use of Holding Companies

The previous discussion in this paper dealing with changes brought about by TEFRA may seem to indicate that the use of holding companies to achieve strategic objectives has been squashed. This is not true. Given the typical types of transactions involving the use of holding companies, as described in Chapter Seven, it is fair to say that in one sense TEFRA simply has imposed a higher transaction cost. For example, assume an individual owns a corporation valued at $2,000,000 whose earnings and profits are $150,000. Assume also that it is consistent with the individual's strategic objectives to establish a holding company and to transfer the subsidiary's stock, worth $2,000,000, to the holding-company in exchange for $1,500,000, face value, holding-company debentures, $400,000 of holding-company preferred shares and $100,000 of holding-company common shares.

The new provisions introduced by TEFRA would treat the bonds as property for IRC Section 304 purposes and would further assume that they were first distributed by the subsidiary to the holding company and then by the holding company to the individual. Moreover, since IRC Section 304
now clearly prevails over IRC Section 351, such a
distribution would be taxable as a dividend to the extent of
the earnings and profits of the subsidiary (recall the
discussion earlier in this paper about the fact that the
earnings and profits are reduced by the face value of the
bonds while the amount of the taxable dividend is a function
of the fair market value of the bonds). The trade-off that
the individual must evaluate, in a present-value sense, is
whether the recognition of a dividend, and paying the
appropriate tax, is advantageous. The other side of the
trade-off would provide the individual the ability to
ultimately distribute $1,500,000 from the corporation to
himself in an amount taxable as either a capital gain, a
return of basis, or both. Further, since the distribution
of the bonds would absorb all of the earnings and profits
between the subsidiary and the parent, the preferred shares
should not, upon issue, constitute IRC Section 306 stock.
Thus, in one sense, TEFRA has not eliminated the use of
holding companies in the pursuit of strategic objectives,
but has, merely complicated the evaluation of the implicit
trade-offs.

What seems to be a more interesting observation is
that the TEFRA provisions discussed in this paper only
superficially attack the legitimate use of holding
companies. That is, IRC Section 304(b)(2)(A) has been

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amended to take into account the earnings and profits of a subsidiary, as well as of a holding company, in taxing distributions of holding-company property as a dividend if transfers of that property do not satisfy the IRC 302 redemption tests. But, if neither the subsidiary nor the holding company has earnings and profits, there is no taxable dividend. Further, the new IRC Section 304 provisions deal only with the issuing corporation (the subsidiary) and the acquiring corporation (the parent) and not with any third-tier or lower subsidiaries. Situations may, therefore, exist where all the earnings and profits of an affiliated group may be in third-tier and below subsidiaries (because of the appropriate accounting provided by either separate or consolidated return status) and not in either the issuing corporation or the acquiring corporation, meaning that holding companies are still viable strategies.

The overwhelming implication, then, is that the pre-TEFRA and post-TEFRA issues are the same. Under pre-TEFRA rules the IRS's only assault on the use of newly-formed holding companies was through one of the substantive doctrines or theories of Subchapter C. Under post-TEFRA rules, if the IRS wants to impute the earnings and profits of third-tier and lower subsidiaries into the issuing corporation, in order to ultimately tax the holding company shareholder, it seems that the IRS must, once again
disregard the legitimate tax status of the issuing corporation. Thus, it appears that the substantive multiple corporation issues of Subchapter C are still the issue and not IRC Section 304.

Careful planning would require the formation, early on, of the issuing corporation which, in turn, would own the third-tier subsidiary. Management of the issuing corporation's earnings and profits to minimally acceptable levels would also be imperative. Then the subsequent formation of the acquiring corporation would result in a managed exposure to IRC Section 304. Moreover, what is as equally obvious is that should the issuing corporation have been formed in earlier years and have filed at least one or more tax returns, the IRS's ability to ignore the legitimate existence of the issuing corporation would be greatly diminished. Thus, it seems that the new TEFRA rules force taxpayers into planning strategies that, by their very nature, strengthen the taxpayer's factual position relative to the Subchapter C substantive issues.

A similar strategy would involve the management of a parent corporation's earnings and profits to a minimally acceptable level. Then in some subsequent period, the holding company would be recapitalized to create debt securities, to issue IRC Section 306 type of securities, or to distribute other property. The earnings and profits to
be taken into account would then be limited to those of the holding company unless the IRS was successful in ignoring the legitimate tax existence of the holding company. Note, however, that the distribution of debt securities and other property would involve at least the recognition of a capital gain.

Thus, in spite of TEFRA, holding companies can continue to be used for income and transfer tax planning situations. Typically, the goals include one or more of the following:

1) To achieve corporate distributions at capital gains rates;

2) To create multiple corporate tax brackets (which can result in lower taxes by averaging multiple-corporation income); and

3) To initiate a value-freezing strategy so that future multiple-corporate growth can be shifted to younger shareholder-generations.

Achieving corporate distributions at capital gain rates includes holding-company strategies (where neither the issuing nor the acquiring corporation have earnings and profits) involving the distribution of property and or the issuance of securities (securities may be subsequently retired for cash without the scrutiny of IRC Section 302). Creating multiple-corporate tax brackets involves a less than 80% shareholder (less in certain family situations) transferring his stock to a newly formed holding company in exchange for the latter's stock. Should the shareholder be
able to successfully average taxable income between the subsidiary and the parent total multiple-corporate annual income taxes could fall by as much as approximately $20,000. Successful introduction of additional corporate brackets results in additional incremental $20,000 savings.

Value-freezing strategies initially involve either the recapitalization of an existing corporation or the formation of a new holding company in order to create a capital structure which is designed to explain the majority of existing corporate value in the form of fixed-valued securities. The future growth would inure to the growth security which is initially created to reflect a nominal amount of existing corporate value.

An alternative and/or companion strategy to those mentioned in the previous paragraph is to pursue similar goals from the bottom of the multiple corporation structure. This alternative approach is referred to as "Bottom Freezing". The next subsection discusses "Bottom Freezing."

Bottom Freezing

Bottom Freezing may be best explained by an example. Suppose, that, a taxpayer and his wife wholly own a corporation whose taxable income approximates $500,000 per year. The corporation owns and operates four retail establishments, all having equal economic characteristics. Specifically, each retail store has a fair market value of
$400,000. Assume, prior to planning, the corporation does not have any subsidiaries. Further, the taxpayer and his wife have four children, all of whom are over the age of 21.

The Bottom Freeze is initiated by the existing corporation creating four new subsidiary corporations. Subsequently, the holding company transfers one of the retail establishments to each of the newly-formed subsidiaries. In the exchange, which is governed by IRC Section 351 (and not IRC Section 368(a)(1)(D)), the holding company receives each subsidiary's stock and securities. Assume the holding company receives $250,000 in bonds, $100,000 in non-voting preferred stock (preferred in liquidations and dividends), and $50,000 in unrestricted, voting common stock. The Bottom Freeze is consummated by the holding company subsequently selling 50% of its common stock in each subsidiary to one child. That is, the holding company sells 50% of the common stock in subsidiary one to child one, 50% of the common stock in subsidiary two to child two, and so forth.

For income tax purposes, the Bottom Freeze results in the successful creation of four new corporate tax brackets. Assuming the pre-planning $500,000 taxable income is successfully averaged over the holding company and its four subsidiaries, total multiple-corporate annual income taxes would fall by approximately $80,000.
The income tax results described above are achieved since the interrelationship of the holding company and the subsidiaries avoids the controlled group tests of IRC Section 1563. The parent-subsidiary test of IRC Section 1563(a)(1) is not met since the holding company owns less than 80% of any subsidiary and the attribution rules of IRC Section 1563(d) and (e) have no detrimental effect. Further, the IRC Section 1563(a)(2) brother-sister test is avoided since neither the 80% total ownership test nor the 50% identical ownership tests are violated. In part, this results from the Supreme Court's holding in the Vogel Fertilizer Co. case. In that case, the Court held that in order to be included in the 80% total ownership test, on a pairwise comparison, a shareholder would have to own stock in each corporation. Since Child One doesn't own, directly or indirectly, any stock in Subsidiary Two, the 80% test is not met for purposes of comparing Subsidiary One to Subsidiary Two for their brother-sister relationship.

If the group avoids the tests of IRC Section 1563, it may still lose its multiple surtax exemptions and accumulated earnings tax credits under IRC Section 1551. This Section applies to corporations created by transfers from other corporations for the purpose of obtaining the

benefits at issue here (multiple surtax exemptions and accumulated earnings tax credits). The burden is on the taxpayer to prove that achieving such tax advantages was not "a major purpose" of forming the new subsidiaries.

In addition to this subjective test, the same two objective tests of IRC Section 1563 must be met (i.e., the 80% common ownership test and the 50% identical ownership test) in order for IRC Section 1551 to apply.

Constructive ownership for IRC Section 1551 purposes is determined under the rules of IRC Section 1563(e). The general test of IRC Section 1551 is slightly different from those in IRC Section 1563(a) in that IRC Section 1563(c), regarding excluded stock, does not apply. Hence, there is no excluded stock for purposes of IRC Section 1551. However, IRC Section 1563(c) may apply to reduce stock ownership attribution under IRC Section 1563(e), since IRC Section 1563(c) excludes certain stocks from the attribution rules within the meaning of stock for IRC Section 1563(e) purposes. IRC Section 269 is not viewed as posing a problem for obtaining the favored tax benefits since the subjective test in IRC Section 1551 is more stringent than the one imposed by IRC Section 269. Therefore, given a multi-corporate structure survives the scrutiny of the IRC Section 1551 subjective test it ought to enjoy multiple-corporate benefits.
Initiating each subsidiary's capital structure with bonds, preferred stock, and common stock leads to creating a partial freeze in the value of the subsidiary. Once the holding company sells 50% of the subsidiary's stock to a child 50% of the future growth of the subsidiary's value inures to that child. Thus, the subsidiary is half "frozen." The growth in value of the 50% of the common stock retained by the holding company will be indirectly reflected through the holding company stock owned by the taxpayer and his spouse and, thus, is not "frozen." Taken together with the post-TEFRA strategies outlined above, the Bottom Freeze adds a new weapon to the tax planning arsenal for the closely-held business owner. Further, the Bottom Freeze accentuates the value of holding company structures.

In sum, the new TEFRA provisions affecting IRC Sections 304, 306, and 351 and the use of newly-formed holding company strategies imply several things:

1) Corporations must keep track of where their earnings and profits are accumulating;

2) Corporations should manage the location of earnings and profits away from appreciating wealth;

3) Corporations will have to evaluate the trade-offs created by TEFRA for the use of holding-company strategies;

4) The real issues in the use of newly-formed holding companies have not changed; and,

5) Alternative holding company strategies achieve valuable income and transfer tax savings while not having any exposure to IRC Section 304 problems.
CHAPTER NINE
SUMMARY AND CONCLUSION

The goal of this Chapter is to summarize the objectives and conclusions of this report. Specifically, in Chapter 1, the paper's goals were outlined:

1) To identify a conflict between IRC Sections 304 and 351 prior to the enactment of TEFRA;

2) To show that IRC Section 304 is inapplicable to newly-formed holding companies created prior to the effective date of TEFRA;

3) To delineate the implications of TEFRA Act Section 226 on the IRC Section 304/351 conflict and the use of newly-formed holding companies; and

4) To discuss the Post-TEFRA IRC Section 304 implications for holding-company strategies.

Chapter Two of this paper was dedicated to a discussion of IRC Section 351. Its goal was to communicate the intent of Congress in taxing the transfer of property to certain controlled corporations. Specifically, in addition to generally describing the nature of the tax-free exchange covered by IRC Section 351, a brief definition of the terms "property" and "securities." There should be little confusion that the stock of an operating company constitutes "property" for IRC Section 351 purposes. Chapter Three indicates that while IRC Section 351 deals favorably with securities issued by the transferee-holding company, that
IRC Section 304, by definition in IRC Section 317, does not provide the same grace to securities as it does to stock.

Chapter Three also provided an historical perspective on the development of IRC Section 304. This Chapter clearly described the scope of IRC Section 304 (pre-TEFRA) as well as the interaction of IRC Sections 301, 302, 312, 316, and 317. Most important to the pre-TEFRA transfer of subsidiary stock to newly-formed holding companies is the point that IRC Section 304 has not been applicable to such transfers.

Chapter Four reviewed the pre-TEFRA IRC Section 304/351 conflict. While this has been a collateral issue with respect to transfers to newly-formed holding companies, it is essential to reexamine the conflict in order to understand fully its inapplicability, and that of the pre-TEFRA IRC Section 304 provisions, to transactions involving the use of newly-formed holding companies. Moreover, given an understanding of the IRC Section 304/351 conflict and of the IRS's prior attacks on transactions involving these new companies, it seems the changes to IRC Section 304 brought about by TEFRA ought to be more clear.

Chapter Five indicated that, pre-TEFRA, the IRS has attacked the use of newly-formed holding companies on two fronts. The first attack, launched in 1968, recognized that there was a lack of income tax consequences associated with transfers to newly-formed holding companies and developed
further tax consequences through the accumulated earnings tax provisions. This attack was terminated in 1971 when the Treasury withdrew these proposed regulations. The second pre-TEFRA attack on transfers to newly-formed holding companies was Revenue Ruling 80-239 (issued in 1980). The gist of this Ruling was to bifurcate the exchange. The likelihood of this IRS ruling being sustained in court is very doubtful given the history of the judicial doctrines surrounding the legitimate tax existence of corporations.

Chapter Six provided a lengthy discussion of when a corporation is treated as such for Federal income tax purposes. Further, this chapter reviewed the applicable tax doctrines in this area including:

1) The Business Purpose Theory,
2) The Step-Transactions Theory,
3) The Conduit Theory,
4) The Sham Transactions Theory, and
5) The Form versus Substance Theory.

The conclusion reached in Chapter Six was that when a corporation's existence survives the scrutiny of these substantive issues, then the IRS would not succeed in attacking transfers to newly-formed holding companies.

Chapter Seven described the Congressional intent behind TEFRA Act Section 226 as well as the changes this provision has for IRC Sections 304, 306, and 351.
Essentially the Treasury used TEFRA to make two major changes in Subchapter C. First, without doubt the Congress plans to apply IRC Section 304 rather than IRC Section 351. Second, the Congress has changed the reading of IRC Section 304(b)(2)(A) to cause both the issuing and the acquiring corporation's earnings and profits to be taken into account. The implication is that where a newly-formed holding company is the acquiring corporation, the subsidiary (issuing) corporation's earnings and profits are to be considered in order to treat distributions of property (including securities) by the holding company as taxable dividends and to apply IRC Section 306 provisions. Pre-TEFRA holding company strategies have been greatly impaired.

Chapter Eight was specifically dedicated to a review of the implications of TEFRA Act Section 226 and the use of newly-formed holding companies. What is very clear as a result of the enactment of this provision is that it is more important than ever to manage both the amount and the location of the accumulation of earnings and profits. Reckless behavior in either of these areas may result in inflexible situations for future business planning. Nevertheless, continued use of newly-formed holding companies has not been totally prevented. For example, the taxpayer can choose to incur the consequences of the new IRC Section 304 for higher future gain.
Further, Chapter Eight suggested three plans for avoiding the provisions brought about by TEFRA Act Section 226. First, it is important to recognize that the Post-TEFRA issue and the Pre-TEFRA issue surrounding the use of multiple corporations in business planning is the same. That is, situations may be developed to prevent the application of the new IRC Section 304, leaving an IRS attack to the substantive issues of Subchapter C. Two examples of these situations were provided in Chapter Eight, both of which rely on establishing a parent-subsidiary relationship with earnings and profits accumulated in lower-tier subsidiaries. Subsequently, the closely-held shareholder(s) would be able either to recapitalize the existing parent, creating either securities (should the recognition of a capital gain not be an undesirable consequence) or preferred stock, or to transfer the stock of the existing parent to a newly-formed holding company in exchange for the latter's securities and/or preferred stock. The result is that in the first case only IRC Section 306, IRC Section 355 and judicial decisions such as Bazley v. U.S.129 would have any implication for recapitalizing the existing parent corporation. In this case the negative consequences of IRC Section 306 would be limited since the

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parent would have little or no current or accumulated earnings and profits. Gain would be recognized to the extent of the principal amount of the securities. Given the newly-formed holding company has little or no earnings and profits this gain should be a capital gain.

In the case of setting up a newly formed holding company, IRC Section 304 would apply, but its application would be meaningless since neither the acquiring nor the issuing corporation would have a meaningful accumulation of earnings and profits. Thus, the provisions brought to the Code by TEFRA Act Section 226 are not totally destructive to the use of newly formed holding companies, but merely impose a requirement for careful planning and more conscientious corporate management.

Bottom Freezing was identified in Chapter Eight as an alternative to the "Top Freeze" strategies described in the preceding two paragraphs. Bottom Freezing has no IRC Section 304 or IRC Section 306 exposure. Certain income tax advantages can be gained by establishing a careful plan to avoid the application of IRC Sections 1551 and 1563.

All in all, it seems the Treasury, in its hurry to introduce what would become TEFRA Act Section 226 in July of 1982, failed to recognize that the tax planning issues which most pervade Subchapter C of the Code are the multiple corporation issues. Until the Congress takes specific
action to close all opportunities for the uses of multiple corporations, it seems taxpayers and practitioners can expect to deal with the same issues, albeit draped in different clothing.