32 T.C. 283 (1959)

For a corporate division to be tax-free under Section 355 of the Internal Revenue Code, the active conduct of a trade or business must have been maintained for a minimum of five years prior to the distribution.

Summary

The *Elliott v. Commissioner* case concerns whether a corporate distribution qualifies as a tax-free "split-off" under Section 355 of the Internal Revenue Code. Centrifix Corporation distributed the stock of its wholly-owned subsidiary, Centrifix Management Corporation, to its principal shareholder, Elliott, in exchange for Centrifix's preferred stock. The central issue was whether the real estate rental business conducted by Management satisfied the five-year active business requirement of Section 355(b). The Tax Court held that it did not, as Centrifix's prior rental activities were not sufficiently active and Management's own operations had not existed for five years. Therefore, the distribution was taxable to Elliott.

Facts

Centrifix Corporation, an engineering firm, acquired a property in 1946. It used part of the property for its business and rented the remainder. In 1950, Centrifix sold this property and acquired a new one, which it transferred to a newly formed subsidiary, Centrifix Management Corporation. Management then leased a portion of the property to Centrifix and rented the rest to third parties. On December 15, 1954, Centrifix distributed all Management's stock to Elliott, its principal stockholder, in exchange for Centrifix's preferred stock. The IRS determined that the distribution was taxable, leading to a dispute over whether the five-year active business requirement of Section 355 was met.

Procedural History

The case was heard in the United States Tax Court. The IRS determined a tax deficiency against the Elliotts for the year 1954, arguing that the stock distribution was taxable. The Elliotts disputed this, claiming the distribution qualified for non-recognition under Section 355. The Tax Court upheld the IRS's determination.

Issue(s)

1. Whether the distribution of Management stock to Elliott qualified as a tax-free "split-off" under I.R.C. § 355(a).
2. Whether Centrifix's pre-1950 rental activities, combined with Management's rental activities, met the five-year active conduct of a trade or business requirement under I.R.C. § 355(b).

Holding

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1. No, because the active conduct of a trade or business requirement was not satisfied.
2. No, because Centrifix's prior rental activities were not sufficiently active, and the subsidiary corporation was not in existence for five years prior to the distribution.

Court's Reasoning

The court focused on whether the rental activities of Centrifix and Management met the requirements for the "active conduct of a trade or business" under I.R.C. § 355(b). The court acknowledged that for the purposes of section 355, the active conduct of a trade or business must be examined in light of the purpose for which it is used in this particular section of the Code. It examined whether the rental activities constituted a separate, active business apart from Centrifix's primary engineering business. The court cited the IRS's definition of "trade or business" in 26 C.F.R. § 1.355-1(c), which requires a "specific existing group of activities being carried on for the purpose of earning income or profit from only such group of activities". The court found Centrifix's rental activities to be merely incidental to its primary business and not a separate, actively conducted rental business. It specifically stated: "We do not think a mere passive receipt of income from the use of property which is used in the principal trade or business and which is only incidental to, or an incidental use of a part of property used primarily in, the principal business would constitute the active conduct of a trade or business within the meaning of section 355(b)." Because Management was not incorporated until 1950, it could not have met the five-year requirement, and since Centrifix's prior activity did not meet the active conduct requirement, the court concluded the distribution was taxable.

Practical Implications

This case highlights the importance of meeting all the requirements of Section 355, especially the active conduct of a trade or business. Attorneys and business planners must carefully analyze the nature and duration of the business activities to determine whether a distribution will qualify for non-recognition. The case illustrates that the incidental rental of property used in a principal business does not satisfy the active conduct requirement. The business must be a distinct operation with its own activities, including the collection of income and payment of expenses. A corporate division may not be tax-free if the active business requirement has not been met for the requisite period. Later cases have followed this standard by requiring the subsidiary to actively conduct a trade or business for five years prior to the distribution.

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