Boettger v. Commissioner, 51 T. C. 324 (1968)

The 5-year active business requirement for tax-free corporate divisions under Section 355 must be met by the specific business distributed, not by the acquiring corporation's overall business.

Summary

Oak Park Community Hospital, Inc. split into two corporations, distributing stock to shareholders in a 'split-up. ' The IRS challenged the tax-free status of these distributions under Section 355, arguing that the Los Angeles hospital, distributed to some shareholders, had not been actively conducted for the required 5 years. The Tax Court agreed with the IRS, holding that the specific business distributed must meet the 5-year active conduct requirement, not merely the overall business of the distributing corporation. This ruling underscores the importance of the specific business's history in determining tax-free status under Section 355, impacting how corporate divisions are structured to ensure compliance with tax laws.

Facts

Oak Park Community Hospital, Inc. operated hospitals in Stockton and Los Angeles. It acquired the Los Angeles hospital in a taxable transaction in August 1961. In 1964, due to shareholder disputes, Oak Park split into Oak Park North (Stockton hospital) and GERM Hospital, Inc. (Los Angeles hospital). The stock of these new corporations was distributed to shareholders, with petitioners receiving Oak Park North stock. The IRS challenged the tax-free status of these distributions under Section 355, asserting that the Los Angeles hospital did not meet the 5-year active business requirement.

Procedural History

The IRS determined deficiencies in petitioners' 1964 income tax returns due to the taxable nature of the Oak Park North stock distribution. Petitioners appealed to the U. S. Tax Court, which consolidated the cases and ruled in favor of the Commissioner, denying tax-free treatment under Section 355.

Issue(s)

1. Whether the distribution of Oak Park North stock to petitioners qualifies for tax-free treatment under Section 355 of the Internal Revenue Code, given that the Los Angeles hospital business was acquired by Oak Park less than 5 years before the distribution.

Holding

1. No, because the Los Angeles hospital business, which was distributed to shareholders, had not been actively conducted for the required 5-year period ending

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on the date of distribution, as required by Section 355(b)(2)(B) and (C).

Court's Reasoning

The Tax Court focused on the specific business distributed, not the overall business of Oak Park. Section 355(b)(2)(C) requires that the business distributed must not have been acquired within the 5-year period in a taxable transaction. The court rejected the petitioners' argument that Oak Park operated a single business at two locations, emphasizing that the Los Angeles hospital was a separate business acquired in a taxable transaction less than 5 years before the distribution. The court interpreted 'such trade or business' in Section 355(b)(2)(C) to refer specifically to the business conducted by the controlled corporation after the distribution, in this case, the Los Angeles hospital. The court noted that this ruling prevents corporations from acquiring businesses for temporary investment and distributing them tax-free under Section 355.

Practical Implications

This decision clarifies that for a corporate division to qualify for tax-free treatment under Section 355, the specific business being distributed must have been actively conducted for at least 5 years. This ruling affects how corporations structure their divisions, requiring careful consideration of the business history of each segment being distributed. It prevents the use of Section 355 to 'bail out' accumulated earnings through the acquisition and quick distribution of businesses. Subsequent cases have followed this precedent, emphasizing the importance of the 5-year active business requirement for each distributed business segment.

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