Rafferty v. Commissioner, 49 T. C. 144 (1967)

A corporate spin-off under Section 355 of the Internal Revenue Code requires both the distributing and controlled corporations to be engaged in the active conduct of a trade or business for the five years preceding the distribution.

Summary

In Rafferty v. Commissioner, the Tax Court ruled that a corporate spin-off did not qualify for tax-free treatment under Section 355 of the Internal Revenue Code because the controlled corporation, Teragram Realty Co. , was not engaged in the active conduct of a trade or business for the required five-year period prior to the distribution of its stock. The court found that Teragram's activities were limited to leasing property to its parent company and did not meet the statutory requirements for an active business. Despite a valid business purpose for the spin-off related to estate planning, the court held that the transaction was a device for distributing earnings and profits, and thus taxable.

Facts

Joseph and Margaret Rafferty owned Rafferty Brown Steel Co. , Inc. (RBS), which transferred its real property to Teragram Realty Co. , Inc. (Teragram) in exchange for all of Teragram's stock in 1960. RBS then leased the property back from Teragram. In 1965, RBS distributed all of Teragram's stock to the Raffertys, who treated it as a tax-free spin-off under Section 355. The IRS challenged this treatment, asserting that Teragram was not engaged in an active business and that the distribution was a device for distributing earnings and profits.

Procedural History

The Raffertys filed a petition with the Tax Court challenging the IRS's determination of a tax deficiency for 1965. The Tax Court heard the case and issued its opinion in 1967, ruling in favor of the Commissioner and against the tax-free treatment of the distribution.

Issue(s)

1. Whether the distribution of Teragram stock by RBS to the Raffertys qualified as a tax-free spin-off under Section 355 of the Internal Revenue Code?

Holding

1. No, because Teragram was not engaged in the active conduct of a trade or business for the five years preceding the distribution, as required by Section 355(b).

Court's Reasoning

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The court applied Section 355 of the Internal Revenue Code, which requires that both the distributing and controlled corporations be engaged in the active conduct of a trade or business for the five years preceding the distribution. The court found that Teragram's activities were limited to leasing property to RBS and did not meet the statutory definition of an active business. The court noted that Teragram had no employees, did not claim deductions for compensation, and its sole source of income was rent from RBS. The court rejected the argument that Teragram's later acquisition of property and construction of a facility in 1965 satisfied the five-year requirement. The court also found that the transaction was a device for distributing earnings and profits, despite the valid business purpose related to the Raffertys' estate planning. The court cited cases such as Henry H. Bonsall, Jr. , Theodore F. Appleby, and Isabel A. Elliott in support of its conclusion that Teragram's activities did not constitute an active business.

Practical Implications

This case clarifies that for a corporate spin-off to qualify for tax-free treatment under Section 355, the controlled corporation must be engaged in an active trade or business for the entire five-year period preceding the distribution. Merely holding and leasing property to a related party does not satisfy this requirement. Tax practitioners must carefully analyze the activities of the controlled corporation to ensure compliance with Section 355(b). The case also highlights the importance of distinguishing between a valid business purpose and a device for distributing earnings and profits. Later cases, such as Rev. Rul. 73-234 and Rev. Rul. 75-253, have provided further guidance on what constitutes an active trade or business for purposes of Section 355.

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