King v. Commissioner, 55 T. C. 677 (1971)

A subsidiary's activities do not constitute the 'active conduct of a trade or business' under section 355 if it merely holds and leases property to its parent on a net lease basis.

Summary

Mason & Dixon Lines, Inc. , distributed the stock of its subsidiaries, Interstate, Motorways, and Regal, to its shareholders. These subsidiaries solely leased motor freight terminals to Mason & Dixon on a net lease basis. The IRS determined that this distribution was a taxable dividend because the subsidiaries were not engaged in the active conduct of a trade or business during the five years prior to the distribution, as required by section 355. The Tax Court upheld this determination, ruling that the subsidiaries' passive leasing activities, lack of employees, and complete dependence on Mason & Dixon did not meet the 'active conduct' requirement.

Facts

Mason & Dixon Lines, Inc. , was a motor freight carrier that owned all the stock of three subsidiaries: Interstate Investment Corp. , Motorways Investment Corp. , and Regal Corp. These subsidiaries were formed to acquire, construct, and lease motor freight terminals to Mason & Dixon on a net lease basis, where Mason & Dixon paid all expenses. The subsidiaries had no employees other than a shared accountant and relied on Mason & Dixon for all operational and decision-making activities. On October 4, 1963, Mason & Dixon distributed the stock of these subsidiaries to its shareholders, who then exchanged the stock for shares in Crown Enterprises, Inc.

Procedural History

The IRS determined deficiencies in the petitioners' 1963 federal income taxes, treating the distribution as a taxable dividend. The petitioners contested this in the U. S. Tax Court, arguing that the distribution qualified for nonrecognition of gain under section 355 of the Internal Revenue Code. The Tax Court consolidated multiple cases involving various shareholders of Mason & Dixon and ruled in favor of the Commissioner.

Issue(s)

1. Whether the distribution of the stock of Interstate, Motorways, and Regal by Mason & Dixon to its shareholders qualified for nonrecognition of gain under section 355 of the Internal Revenue Code.

Holding

1. No, because Interstate, Motorways, and Regal were not engaged in the active

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conduct of a trade or business during the five-year period prior to the distribution as required by section 355(b).

Court’s Reasoning

The court applied the requirement under section 355(b) that both the distributing and controlled corporations must have been engaged in the active conduct of a trade or business immediately after and for the five years prior to the distribution. The court found that the subsidiaries’ activities did not meet this requirement because:

- They had no employees of their own and relied on Mason & Dixon for all operational activities.
- Their income was solely from net leases to Mason & Dixon, which is considered passive income.
- They did not seek tenants other than Mason & Dixon.
- Property acquisition, construction, and financing were handled by Mason & Dixon employees.

The court emphasized that the subsidiaries’ dependence on Mason & Dixon for all business functions and the passive nature of their income did not constitute the active conduct of a trade or business. The court distinguished this case from others where subsidiaries had additional income sources or were actively involved in the management of their assets.

Practical Implications

This decision impacts how corporate distributions involving subsidiary companies are analyzed for tax purposes:

- It clarifies that merely holding and leasing property to a parent company on a net lease basis does not qualify as the active conduct of a trade or business under section 355.
- Corporate planners must ensure that subsidiaries have independent operations and employees to meet the active conduct requirement if they wish to qualify for nonrecognition of gain under section 355.
- Businesses must carefully consider the operational independence of subsidiaries when planning corporate restructurings to avoid unintended tax consequences.
- Subsequent cases have cited King v. Commissioner to distinguish situations where subsidiaries engage in more active business activities, such as managing properties or engaging in other business operations beyond passive leasing.

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