Harry B. Atlee and Colleen Atlee, Petitioners v. Commissioner of Internal Revenue, Respondent, 67 T. C. 395 (1976)

For a corporate division to qualify as tax-free under Section 355, both the distributing and controlled corporations must be engaged in the active conduct of a trade or business immediately after the distribution, with such business having been actively conducted throughout the 5-year period prior to the distribution.

Summary

In Atlee v. Commissioner, the Tax Court ruled that a corporate division between two equal shareholders did not qualify as a tax-free division under Section 355. The Atlees and Hansens owned equal shares in Hansen-Atlee Co. , which they attempted to divide into two new entities. The court found that Hansen-Atlee served merely as a conduit for transferring assets individually owned by the shareholders, rather than distributing an active business. The key issue was whether the division satisfied Section 355's requirement that both resulting corporations be actively engaged in a trade or business for the 5 years prior to the division. The court held that it did not, as the assets transferred to the new corporation, Atlee Enterprises, Inc. , were not part of Hansen-Atlee's active business operations. This decision underscores the necessity for a clear separation of an active business to qualify for tax-free treatment under Section 355.

Facts

Petitioners Harry B. Atlee and Colleen Atlee, along with Leonard M. Hansen and Evelyn S. Hansen, each owned 50% of Hansen-Atlee Co. , a corporation involved in real estate development and rental. In late 1969, they devised a plan to divide the business, creating Atlee Enterprises, Inc. On December 31, 1969, Hansen-Atlee transferred various assets, including undeveloped land, notes, a leasehold interest, and personal property, to Atlee Enterprises in exchange for all its stock. These assets had been transferred to Hansen-Atlee just days before by the shareholders individually. On January 2, 1970, the Atlees exchanged their Hansen-Atlee stock for all the shares of Atlee Enterprises. Hansen-Atlee retained its primary operating assets, such as the Country Club Apartments.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the Atlees' federal income taxes for 1969 and 1970, asserting that the corporate division was a taxable event. The Atlees petitioned the U. S. Tax Court to challenge these deficiencies, arguing that the division qualified as a tax-free reorganization under Section 355. The Tax Court held a trial and subsequently ruled against the Atlees, finding that the reorganization did not meet the requirements of Section 355.

Issue(s)

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1. Whether the corporate division between Hansen-Atlee Co. and Atlee Enterprises, Inc. , qualified as a tax-free division under Section 355.
2. If the division was taxable, what was the fair market value of Atlee Enterprises, Inc. ‘s stock on the date of distribution?

Holding

1. No, because Hansen-Atlee Co. served merely as a conduit for transferring assets individually owned by the shareholders, and the assets transferred to Atlee Enterprises, Inc. , did not constitute an active trade or business conducted by Hansen-Atlee for the required 5-year period.
2. The fair market value of Atlee Enterprises, Inc. ‘s stock on the date of distribution was determined to be $139,168. 74.

Court’s Reasoning

The court applied Section 355, which requires that both the distributing and controlled corporations must be engaged in the active conduct of a trade or business immediately after the distribution, with such business having been actively conducted throughout the 5-year period prior to the distribution. The court found that Hansen-Atlee Co. retained virtually all its operating assets, while the assets transferred to Atlee Enterprises were not part of its active business. The court viewed Hansen-Atlee as a mere conduit for transferring individual assets between shareholders, not as a division of an active business. The court cited Section 355(b)(1) and (b)(2) as the legal basis for its decision, emphasizing the 5-year active business requirement. The court also referenced cases like Portland Mfg. Co. v. Commissioner to support its view of Hansen-Atlee as a conduit. No dissenting opinions were noted.

Practical Implications

This decision reinforces the strict requirements for tax-free corporate divisions under Section 355. Practitioners must ensure that both resulting corporations are actively engaged in a trade or business for the requisite 5-year period before attempting such a division. The ruling underscores the need to avoid using a corporation as a mere conduit for individual asset transfers, which could disqualify the division from tax-free treatment. This case has been cited in subsequent rulings to clarify what constitutes an active trade or business under Section 355. For businesses considering corporate reorganizations, this case highlights the importance of careful planning to ensure compliance with Section 355, potentially affecting how shareholders structure their asset transfers and reorganizations.

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