Dunn Trust v. Commissioner, 86 T. C. 745 (1986)

Stock distributed in a spin-off is not considered 'other property' under Section 355(a)(3)(B) if it was acquired through a tax-free exchange, even if the underlying assets were previously purchased in a taxable transaction.

Summary

AT&T acquired additional Pacific stock in a taxable transaction, then transferred it to PacTel Group in a tax-free exchange. The IRS argued that part of the PacTel Group stock distributed to AT&T shareholders should be treated as 'other property' under Section 355(a)(3)(B) due to the prior taxable acquisition. The Tax Court held that the distributed PacTel Group stock did not constitute 'other property' because it was acquired through a tax-free exchange, emphasizing the literal interpretation of the statute and the absence of legislative intent to 'look through' to the underlying assets.

Facts

In 1982, AT&T acquired additional stock of Pacific in a taxable merger. Pursuant to a reorganization and divestiture plan, AT&T transferred all of its Pacific stock to PacTel Group, a newly formed holding company, in a nontaxable exchange for PacTel Group stock. On January 1, 1984, AT&T distributed its PacTel Group stock to its shareholders. The IRS argued that a portion of the PacTel Group stock distributed should be treated as 'other property' under Section 355(a)(3)(B) because of the prior taxable acquisition of Pacific stock.

Procedural History

The case was submitted to the U. S. Tax Court under Rule 122, fully stipulated. The court ruled in favor of the petitioner, holding that no portion of the PacTel Group stock distributed to AT&T's shareholders constituted 'other property' under Section 355(a)(3)(B).

Issue(s)

1. Whether a portion of the PacTel Group stock distributed to AT&T's shareholders constitutes 'other property' under Section 355(a)(3)(B) due to AT&T's prior taxable acquisition of Pacific stock?

Holding

1. No, because the PacTel Group stock was acquired by AT&T in a tax-free exchange, and Section 355(a)(3)(B) does not require looking through to the underlying assets acquired in a prior taxable transaction.

Court's Reasoning

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The court focused on the literal interpretation of Section 355(a)(3)(B), which applies to stock acquired in a taxable transaction within five years of distribution. The court noted that the statute's language and legislative history did not support the IRS's argument to treat the distributed PacTel Group stock as 'other property' based on the prior taxable acquisition of Pacific stock. The court rejected the IRS's argument that the statute should be interpreted to 'look through' the holding company structure to the underlying assets, as there was no clear legislative intent to do so. The court also considered the policy behind the statute, which aims to prevent the conversion of liquid assets into stock that can be distributed tax-free, and found that the transaction did not frustrate this purpose because the Pacific stock remained in corporate solution and was not distributed.

Practical Implications

This decision clarifies that for a spin-off to be tax-free under Section 355, the focus is on the stock being distributed, not on any underlying assets that may have been acquired in a prior taxable transaction. Practitioners should ensure that the stock being distributed was acquired through a tax-free exchange to avoid the 'other property' rule. The decision may encourage the use of holding company structures in corporate reorganizations to facilitate tax-free spin-offs. Subsequent cases have followed this ruling, reinforcing the importance of the form of the transaction in determining tax treatment under Section 355.

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