McLaulin v. Commissioner, 115 T. C. 255 (2000)

A corporate spinoff under Section 355 must meet the active business requirements, including that control of the controlled corporation was not acquired within the 5-year period in a taxable transaction.

Summary

Ridge Pallets, Inc. , an S corporation, sought to distribute all its stock in Sunbelt Forest Products, Inc. , to its shareholders in a tax-free spinoff under Section 355. However, Sunbelt had redeemed a 50% shareholder's stock for cash just one day before the spinoff, which was funded by a loan from Ridge. The Tax Court held that this redemption constituted a taxable acquisition of control within the 5-year period before the distribution, thus failing to satisfy the active business requirement under Section 355(b)(2)(D)(ii). As a result, the spinoff was taxable, with gain recognized to Ridge and passed through to its shareholders.

Facts

Ridge Pallets, Inc. , an S corporation, owned 50% of Sunbelt Forest Products, Inc. , a C corporation. Sunbelt redeemed the other 50% shareholder's stock for cash and real property on January 14, 1993. The cash for the redemption was borrowed from Ridge the day before. On January 15, 1993, Ridge distributed its 100% interest in Sunbelt to its shareholders, intending it to be a tax-free spinoff under Section 355. Ridge's reasons for the distribution included potential environmental liabilities, avoiding securities law obligations, and maintaining S corporation status.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the petitioners' federal income taxes for 1993, asserting that the distribution did not qualify as a tax-free spinoff. The petitioners challenged these deficiencies in the U. S. Tax Court, which consolidated the cases. The court ruled in favor of the Commissioner, finding that the distribution did not meet the active business requirement under Section 355(b)(2)(D)(ii).

Issue(s)

1. Whether the distribution by Ridge of the Sunbelt stock to its shareholders qualified as a tax-free spinoff under Section 355, specifically meeting the active business requirement under Section 355(b)(2)(D)(ii).

Holding

1. No, because the distribution failed to satisfy the active business requirement under Section 355(b)(2)(D)(ii). The court found that Ridge's acquisition of control over Sunbelt through the redemption was a taxable transaction within the 5-year

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period before the distribution, thus disqualifying the spinoff from tax-free treatment.

Court’s Reasoning

The court applied the statutory language of Section 355, particularly Section 355(b)(2)(D)(ii), which requires that control of the controlled corporation was not acquired within the 5-year period in a taxable transaction. The court reasoned that the redemption of the 50% shareholder’s stock by Sunbelt, funded by Ridge, constituted an acquisition of control by Ridge within the 5-year period. This was because Ridge directly financed the redemption, making it functionally equivalent to Ridge purchasing the stock outright. The court relied on Rev. Rul. 57-144, which treats a redemption as an acquisition of control for Section 355 purposes. The court rejected the petitioners’ arguments that the redemption was not an acquisition and that the accumulated adjustment account’s status should allow for tax-free treatment, emphasizing the policy against using Section 355 to avoid the repeal of the General Utilities doctrine.

Practical Implications

This decision emphasizes the importance of meeting the active business requirement for a tax-free spinoff under Section 355. It highlights that any taxable transaction acquiring control of the controlled corporation within the 5-year period before the distribution can disqualify the spinoff from tax-free treatment. Practitioners must carefully structure transactions to ensure compliance with this rule, particularly when financing is involved. The ruling has significant implications for corporate tax planning, requiring careful consideration of the timing and nature of any control-acquiring transactions. It also affects business practices by discouraging the use of Section 355 to circumvent corporate-level gain recognition. Subsequent cases and IRS guidance have further clarified and applied these principles.

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