FEDERAL TAXATION: MULTI-STEP STOCK PURCHASE RIGHT DISTRIBUTION DISQUALIFIED AS TAX-FREE SPIN-OFF

In *Commissioner v. Gordon*[1] the Supreme Court held that a multi-step distribution of stock purchase rights did not qualify under section 355 of the Internal Revenue Code as a valid distribution pursuant to a tax-free spin-off.[2] Therefore the difference between the sum paid in by minority shareholders exercising stock purchase rights and the fair market value of the stock received in a new subsidiary was held taxable as ordinary income.[3] In 1961 Pacific Telephone and Telegraph Company transferred a portion of its assets to newly-incorporated Northwest Bell in return for all of Northwest's common stock and debt paper.[4] Pursuant to a shareholder-approved plan to distribute all its Northwest stock, Pacific issued stock purchase rights equivalent to 57.3% of the Northwest stock in 1961 and the rest in 1963.[5] The Gordons and Baans, respondents, each exercised or sold the rights received, but neither reported this as income.[6] The Commissioner asserted deficiencies against, not only both sets of taxpayers on the basis of the difference between the price respondent paid for stock through use of his stock purchase rights and the market value of the Northwest stock at the time the rights were exercised, but also against the Gordons for a cash sale of those rights.[7] The Tax Court found the profit realized from the exercise of stock rights not taxable, while holding taxable the proceeds from the sale of the rights.[8] The Commissioner appealed to the Court of Appeals of each taxpayer's residence with the result that the Ninth Circuit reversed on the first point and concurred on the second,[9] while the

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[1] 391 U.S. 83 (1968).
[2] INT. REV. CODE OF 1954, § 355.
[3] 391 U.S. at 98.
[4] *Id.* at 85.
[5] *Id.* at 86-87.
[6] *Id.* at 87.
[7] *Id.* at 87-88.
[8] Baan v. Commissioner, 45 T.C. 71 (1965).
[9] Commissioner v. Baan, 382 F.2d 485 (1967).

Second Circuit concurred in the Tax Court's holding as to the stock rights, but found the sale for cash not taxable.[10] The Supreme Court followed the Ninth Circuit, holding both the exercise and sale of the stock rights taxable on grounds that the spin-off did not meet the distribution requirements of section 355.[11]

Section 355 provides for tax-free treatment of stock distributed pursuant to a corporate division in the nature of a spin-off.[12] A Code spin-off requires a distribution by one corporation of the stock of an existing or newly created subsidiary corporation, the shareholder retaining his shares in the distributing corporation while obtaining the new shares.[13] Although the 1924 Revenue Act accorded tax-free treatment to the spin-off,[14] this was eliminated by the 1934 Revenue Act.[15] While restoring the tax-free spin-off, the 1951 amendments[16] provided that it must not be used principally as a device for distributing the earnings or profits of the distributing or the controlled corporation,[17] and additionally required that immediately after the distribution both the distributing and controlled corporations be engaged in the active conduct of a trade or business.[18] The 1954 Code added requirements that the spun-off business must have been actively controlled by the distributing corporation throughout the five-year period ending on the date of distribution,[19] and that the distributing corporation must distribute to its shareholders all or a controlling amount of the controlled company's stock held immediately before distribution.[20] Although Committee reports on the 1954 Code show congressional reasoning behind the five-year pre-distribution control requirement, no insight is

[10] Commissioner v. Gordon, 382 F.2d 499 (1967).

[11] 391 U.S. at 98.

[12] INT. REV. CODE OF 1954, § 355. *See generally* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS § 11.01 (2d ed. 1966) [hereinafter cited as BITTKER].

[13] INT. REV. CODE OF 1954, § 355(a)(1)(D).

[14] Revenue Act of 1924, ch. 234, § 203(c), 43 Stat. 256-57.

[15] BITTKER at § 11.02.

[16] Int. Rev. Code of 1939, § 112(b)(11), *added by* ch. 521, § 317(a)(11), 65 Stat. 493 (1951).

[17] *Id.*

[18] *Id.*

[19] INT. REV. CODE OF 1954, § 355(b)(2)(B).

[20] *Id.* § 355(a)(1)(D)(i) & (ii). *See also id.* at § 368(c) (defining "control" as 80 percent of total combined voting power and 80 percent of the total number of shares).

given into the necessity for the limitation on multiple distributions.[21]

Thus *Gordon* was a case of first impression in an area devoid of case law and congressional explanation. However, useful analogy can be drawn to Code sections which prior to 1954 were included with the spin-off provisions in a general section dealing with corporate reorganization.[22] Multiple transfers have been allowed under section 351(a), which deals with recognition of gain or loss in transfers of property to corporations by individuals,[23] and under section 368(a)(1)(B), which applies to corporate reorganizations through transfers to stock in exchange for stock or securities in the transferee corporation.[24] Although language similar to that of section 355 is used by the above sections in providing that "immediately after" the exchange of property for stock or securities the transferor must be in control of the transferee corporation,[25] that requirement has never been so strictly construed as in *Gordon.* Thus in *Portland Oil Co. v. Commissioner*[26] it was held that the transfer of property was valid as a tax-free spin-off even though it was made over an interval of three weeks,[27] since the transfers were executed under an antecedent plan of reorganization which did not state when or in how many steps the transfer of property would be made.[28] Relying upon the 1928 equivalent of section 351(a),[29] the court indicated that transfers "need not be effected simultaneously where executed in pursuance of an antecedent agreement."[30] Moreover, in reference to corporate reorganization section 368(a)(1)(B), the Commissioner himself has indicated that the control "immediately after" acquisition requirement will be satisfied if the acquisition takes place in a series of transactions occurring over a relatively short period of time, such as twelve months.[31] His interpretation requires neither that the

[21] BITTKER at § 11.07.

[22] Revenue Act of 1924, ch. 234, § 203(c), 43 Stat. 256; Int. Rev. Code of 1939, ch. 2, § 112(c), 53 Stat. 37.

[23] INT. REV. CODE OF 1954, § 351(a).

[24] *Id.* § 368(a)(1)(B).

[25] *Id.*; *cf.* Turner Constr. Co. v. United States, 364 F.2d 525 (2d Cir. 1966).

[26] 109 F.2d 479 (1st Cir.), *cert. denied,* 310 U.S. 650 (1940).

[27] *Id.* at 484.

[28] 109 F.2d at 483.

[29] Revenue Act of 1924, ch. 234, § 203(c), 43 Stat. 256.

[30] 109 F.2d at 488; *accord,* Von's Inv. Co. Ltd. v. Commissioner, 92 F.2d 861 (9th Cir. 1937); Halliburton v. Commissioner, 78 F.2d 265 (9th Cir. 1935).

[31] INT. REV. CODE OF 1954, § 368(a)(1)(B); Treas. Reg. § 1.368-2(c) (1955).

multi-step acquisition be made pursuant to a plan of reorganization, nor any other indication of when, in what amounts, or at what prices the acquired corporation's stock will be obtained.[32]

In *Commissioner v. Gordon* the Court emphasized that Congress had established detailed and specific requirements in the spin-off section and stressed that, notwithstanding valid business objectives, corporations must comply in order to secure tax-free treatment.[33] To this end, the Court found irrelevant any congressional justification for the multiple distribution limitations[34] by reasoning that, although the general purpose of section 355 is to distinguish corporate fission from distributions of earnings and profits, a court may have reference to this general purpose only when there is "a genuine question as to the meaning of the specific requirements."[35] Without deciding whether section 355(a)(1)(D) allows a multiple distribution,[36] the Court found that the Code requires, if an initial transfer is less than the statutorily required controlling interest, that the transfer be identifiable at the time of transfer as a mere first step in the distribution of control.[37] Emphasizing that the Code provisions must be interpreted so as to conform to the basic premise of annual accounting,[38] the Court held that the tax impact of a transaction may not be left "undeterminable and unfixed for an indefinite and unlimited time, contingent on future uncertain events."[39] Thus, the Court stated that the entire distribution would not have to take place within a single year,[40] but there must be a binding commitment to take later steps to distribute control.[41] Although noting that the written distribution plan in *Gordon* might be interpreted to compel eventual sale of the stock to Pacific shareholders, the Court found that the plan did not qualify as an acceptable commitment under

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[32] *Id.*

[33] 391 U.S. at 91; *see* Commissioner v. Gordon, 382 F.2d 499, 512 (2d Cir. 1967) (Friendly, J., dissenting).

[34] INT. REV. CODE OF 1954, § 355(a)(1)(D).

[35] 391 U.S. at 92.

[36] *Id.* at 96.

[37] *Id.*

[38] *Id.; see* Commissioner v. Gordon, 382 F.2d, 499, 511 (2d Cir. 1967) (Friendly, J., dissenting).

[39] 391 U.S. at 96.

[40] *Id.*

[41] *Id.*

section 355 because there was no promise to sell any specified amount of stock at any specified time or at any specified price.[42] Consequently the Court held that shareholders must recognize ordinary income on the difference between the price paid for the Northwest stock through utilization of the stock purchase rights and the Northwest common stock market price at the time the rights were exercised.[43]

Although *Commissioner v. Gordon* refuses to accord tax-free treatment to plans requiring eventual distribution but leaving the steps of the process contingent on future uncertain events, it is doubtful that this stringent limitation upon section 355 spin-offs would be upheld in a case where the multiple distributions actually take place within a relatively short period of time, such as twelve months. A relaxation of the *Gordon* requirement under these circumstances would not be inconsistent with the basic premise of annual accounting. Furthermore, multi-step transfers made over a relatively short period of time, under reorganization sections of the Code which use language similar to that of section 355, have been held to justify advantageous tax treatment *without* the requirement of a plan outlining when or upon what event the several distributions would take place.[44] If *Gordon* requires a fixed plan of distribution even in those cases where actual distribution of control takes place rather quickly, then it would seem incongruous not to apply the same requirements to corporate reorganizations under the similar provisions of 351(a) and 368(a)(1)(B).[45] Such an interpretation of *Gordon* is unjustified, however, since it may create unnecessary rigidity in spin-offs when there are valid business reasons for not predetermining the plan of distribution. For example, a company may desire to incorporate the distributions into a flexible financial plan designed to respond to company needs for capital or fluctuating market demands for the stock. Because annual accounting would not be frustrated, and because there appears to be no other Congressional policy served by interpreting section 355(a)(1)(D) to require single-distribution,[46] the *Gordon*

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[42] *Id.* at 97.
[43] *Id.* at 98.
[44] *See* text accompanying notes 22-31 *supra*.
[45] INT. REV. CODE OF 1954, §§ 351(a) & 368(a)(1)(B).
[46] BITTKER at § 11.07.

mandate of a fixed commitment should not be applied to cases in which all distributions are actually made within a relatively short period of time.[47]

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[47] *See* Treas. Reg. 1.368-2(c) (1955) (suggesting twelve months as a "relatively short period" of time).