

Business Purpose for a Spinoff: Is Nothing Sacred?

by Robert W. Wood • Bancroft & McAlister

These days, with all the talk about Section 355 (see “Sears’ Spinoff: In the Land of the Giants,” “Marriott Jumps On Spin Bandwagon,” and “Is Counting Spins Like Counting Stars?,” elsewhere in this issue), it is hard not to become blindsided about just when Section 355 can be used

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and when it cannot. Put another way, with all of Section 355's technical requirements, it is sometimes difficult to see the forest for the trees.

One place this is not true, however, is with the business purpose requirement. Everyone knows that there can be no Section 355 transaction without a good business purpose. The IRS will not entertain a ruling request unless there is a really good one, and the courts (heaven forbid that an audited transaction should ever go that far) require one as well.

But is a business purpose *really* needed? Some practitioners are seriously questioning this heretofore sacrosanct area of the law and concluding, albeit tentatively, that maybe all of us devoted (and occasionally creative) business purpose aficionados may have been wrong all of these years.

New Dogma

Like a headline about the repeal of the federal income tax, a sentence about the lack of need for a business purpose to do a spin is likely to generate some level of hysteria. But that is just what two practitioners have done in a recent article. In Agar and Tracy, "Sidestepping the Business Purpose Test for Corporate Spin-Offs," 19 *J. Corp. Tax'n* 4 (Winter 1993), the authors go considerably beyond saying that there *should not* be a business purpose requirement in this context.

Indeed, after a lengthy analysis of the genesis of the business purpose requirement (established in *Gregory v. Helvering*, 293 US 465 (1935)), the authors state that, based on the legislative history to the 1954 Code, the business purpose requirement (of Section 355) is not a requirement at all. They lament the "pervasiveness of the erroneous belief that the business purpose test is a statutory requirement." The authors then go on to analyze at some length more recent iterations of the business purpose notion, the focus, predictably, being on the fact that the courts have not fallen into the trap (or the "pervasive erroneous belief") that the business purpose requirement in this context is really anything more than another look at the rule that a spinoff cannot be a device for the distribution of E&P. The proper test, according to the authors, is: was this a device to distribute E&P or not?

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No Real Support

Naysayers will most likely not be persuaded by the fact that the authors come up with the notion that the Service, but not the courts, still cling to the business purpose doctrine. Indeed, armed with a handful of cases that seem to equate the business purpose doctrine in this context with the device rule, the authors conclude that the business purpose requirement does not really pertain to Section 355. Yet ultimately, only one case discussed by the authors seems to squarely support the principle they are trying to enunciate. In *Estate of Parshelsky*, 303 F.2d 14 (CA-2, 1962), the Second Circuit rejected the relevance of a business purpose.

"Proper" Test?

According to the article, the "proper" test under Section 355 should be "whether the transaction was a device to distribute earnings and profits (*i.e.*, tax avoidance)." However, the authors later admit (reluctantly) that the regulations *do* reflect the business purpose requirement in considerable detail. They sift through the portions of the regulations dealing with this requirement, sprinkling the discussion with a dose of their theory that "business purpose is not a statutory requirement for a valid Section 355 transaction."

Get Real

For those of us in the real transactional world, this argument—even if it had been persuasively made—is unsatisfying. We all know that the business purpose requirement is a critical part of the Service's repertoire in reviewing ruling requests. Likewise, we all assume that if we are ever unfortunate enough to litigate a Section 355

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transaction that has gone awry, the relevance and applicability of the business purpose doctrine will be incontrovertible. It would take a hardy soul indeed to seriously argue that the Section 355 regulations are invalid as beyond the scope of permissible interpretive regulations. If that case ever gets brought, bet that the Service will prevail.

Conclusion

We all know the business purpose doctrine is with us to stay, under Section 355 as in various other contexts. While it might be intriguing to some to speculate whether this was *always* a foregone conclusion, it certainly seems to be one now. Even Agar and Tracy appear to recognize this.

In fact, they conclude their article with hopeful observations about maybe consummating a Section 355 spinoff without (gulp!) a business purpose. If you try it, we will watch. ■

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