

Letters to the Editor

JUNE 5, 89

SECTION 355 AND BUSINESS PURPOSE.

---

To the Editor:

I enjoyed Lee Sheppard's article ("Section 355 and Business Purpose") in the May 15, 1989 issue of Tax Notes. I was gratified that Ms. Sheppard no longer argues that her views on business purpose and available alternatives are the law under the current regulations. Instead, she now argues -- very persuasively -- that because of transactions she considers abusive, the rules should be changed to make sure that asserted business purposes are scrutinized even more heavily. She also suggests the more draconian solution that ruling activity be suspended altogether in an effort to avoid the admittedly difficult task of separating a good business purpose from a bad one.

The suggestion that businesses routinely gin up a business purpose is troubling. Doubtless, this sometimes occurs, hopefully less frequently than the article suggests. The traditional business purpose to which Ms. Sheppard responds with most vehemence is the desire of employees to purchase an interest in one part of the company.

In my experience, there are often good reasons why an employee may want to purchase only an interest in one of the spun-off entities rather than an interest in the whole, or an interest in a company with a controlling corporate parent. It may be appropriate for the IRS to inquire into these reasons rather than to accept at face value the statement by an employee that he or she only wants to purchase an interest in one entity, and will not accept shares in a company owned by a controlling corporate parent. In my experience over the last several months, the IRS is now scrutinizing precisely this issue in ruling on section 355. Perhaps if the employee does not have a credible answer to the inquiry, it is appropriate to deny a favorable ruling.

Apart from the question of the corporation in which the employee may want or be able to purchase an interest, the notion that stock and nonstock alternatives are really the same should also be dispelled. Admittedly, nonstock compensation devices may put employees in virtually the same economic position that they would be in were they actual shareholders. But believe it or not, some people still prefer true stock ownership. The question of equating nonstock and real stock should not be taken lightly, and may have ramifications well beyond the section 355 context. Many section 355 transactions involve smaller companies in which the distinction between real and nonstock is particularly important.

The least attractive point made by Ms. Sheppard is that the IRS might want to stop ruling on the business purpose question altogether. However closely the IRS scrutinizes business purpose -- and I believe they are currently doing a good job of it -- this alternative makes no sense.

Very truly yours,

Robert W. Wood  
Steeffel, Levitt & Weiss  
San Francisco, Calif.  
May 26, 1989