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When the Party's over: Use of Divisive Reorganizations for a Tax-Free Division of the Professional Service Corporation.

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WHEN THE PARTY'S OVER: USE OF DIVISIVE REORGANIZATIONS FOR A TAX-FREE DIVISION OF THE PROFESSIONAL SERVICE CORPORATION

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I. INTRODUCTION

For over a decade, professionals in Texas have had the opportunity to practice in corporate form under either the Texas Professional Corporation Act (TPCA)[1] or the Texas Professional Association Act (TPAA).[2] As a result, many groups of professionals have incorporated, thereby realizing the substantial income and estate tax benefits derived by operating through a professional service corporation (PSC).[3] One or all of the shareholder-professionals,

1. TEX. REV. CIV. STAT. ANN. art. 1528e (Vernon 1980). The Texas Professional Corporation Act (TPCA), effective January 1, 1970, applies generally to those personal service professions requiring licensing or other legal authorization from the State which are otherwise forbidden corporate status. *Id.* art. 1528e, § 3(a); *see, e.g.*, TEX. ATT'Y GEN. OP. No. MW-99 (1979) (physical therapists); *id.* No. H-422 (1974) (registered public surveyors); *id.* No. M-1185 (1972) (podiatrists). Specifically listed as among the professions covered by the Act are attorneys-at-law, certified public accountants, dentists, public accountants, and veterinarians. TEX. REV. CIV. STAT. ANN. art. 1528e, § 3(a) (Vernon 1980). Despite inclusion under named examples of personal service professions, architects are excluded from operation of the provisions of the TPCA, but may incorporate under the Texas Business Corporation Act. *See* TEX. ATT'Y GEN. OP. No. M-551 (1970) (citing conflict under architecture statute for preclusion of profession from TPCA); *cf. id.* No. M-539 (1969) (professional engineers authorized to incorporate only under the Texas Business Corporation Act). *See generally* TEX. BUS. CORP. ACT ANN. art. 2.01(B)(2) (Vernon 1980) (limitation on incorporation as to licensed professions).

2. TEX. REV. CIV. STAT. ANN. art. 1528f (Vernon 1980). The Texas Professional Association Act applies only to individuals licensed to practice medicine by the Texas Board of Medical Examiners. TEX. ATT'Y GEN. OP. No. M-551 (1970). *See generally* Leighton & Duncan, *Advantages and Pitfalls for Texas Professional Corporations*, 2 ST. MARY'S L.J. 11, 16-17 (1970) (omission of doctors from the TPCA advanced by the Texas Medical Association).

3. *See generally* Levenfeld, *Professional Corporations and Associations*, 8 HOUS. L.

however, may later want to terminate their interest in the original PSC. The most common reasons advanced for a termination are irreconcilable differences of opinion between the shareholders on either business or professional matters, or both; personality conflicts; or simply a desire to re-locate in a different geographical area.

When termination occurs, the disposition of the departing shareholder's interest in the PSC typically is governed by the terms of an employment contract[4] and the buy-sell agreement between the shareholders.[5] If the buy-sell agreement provides for the redemption of the departing shareholder's stock or a sale to the remaining shareholders, the gain, if any, will usually be taxed at capital gain rates.[6] In addition, the employment contract generally will provide for a form of "severance pay" to distribute the balance of the de-

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REV. 47, 49-54 (1970). Except as otherwise provided in this article, the term "Professional Service Corporation" (PSC) shall refer to any entity organized for the purpose of rendering professional services pursuant to the Texas Professional Corporation Act, the Texas Professional Association Act, or the Texas Business Corporation Act.

4. *See generally* Lee, *Termination of Interest in the Professional Corporation,* in 36TH ANN. N.Y.U. INST. ON FEDERAL TAX. 123 (N. Liakas ed. 1978) (discussing tax devices available to a departing shift in context of a PSC).

5. A buy-sell agreement, taking the form of either an entity purchase or cross-purchase agreement, can greatly facilitate resumption of corporate affairs subsequent to an alteration in the corporate structure. *See* Jorrie & Wolf, *Selected Practical Problems With Professional Associations and Professional Corporations,* 10 ST. MARY'S L.J. 247, 271-74 (1978). Suggested provisions for withdrawal include agreed to option to purchase and payment plans regarding the departing shareholder's interest and a pre-split up valuation and distribution of assets stipulation. *See id.* at 272-74; Levenfeld, *Professional Corporations and Associations,* 8 HOUS. L. REV. 47, 59-61 (1970).

6. *See* I.R.C. § 302 (Distributions in Redemption of Stock). Section 302(b)(3) provides for capital gain treatment, "if the redemption is in complete redemption of all of the stock of the corporation owned by the shareholder." *See, e.g.,* Benjamin v. Commissioner, 66 T.C. 1084, 1113 (1976); Niedermeyer v. Commissioner, 62 T.C. 280, 291 (1970); Leleux v. Commissioner, 54 T.C. 408, 418 (1970); *cf.* I.R.C. § 302(c)(2) (waiver-of-attribution rules, applicable in determination of capital gains treatment if remaining and departing shareholder(s) are related parties). If the sale of stock is made to the remaining shareholder(s), any gain should be taxable as capital gain. *See* I.R.C. § 1221. The advantage of capital gains treatment, however, will be lost should the distribution be construed as made by a collapsible corporation. *See id.* § 341. *See generally* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ch. 12 (4th ed. 1979). Additionally, the sale of section 306 stock will generate ordinary income. I.R.C. § 306(c)(1)(B) (stock previously acquired through reorganization, distribution, or exchange); *see* SENATE COMM. ON FINANCE, SENATE COMM. REP. TO ACCOMPANY H.R. 8300 "A BILL TO REVISE THE INTERNAL REVENUE LAWS OF THE UNITED STATES," S. REP. NO. 1622, 83d Cong., 2d Sess. 267, *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS 4621, 4905.

parting shareholder's allocable share of the accounts receivable, which will be subject to the fifty percent (50%) maximum rate on personal service income[7] when received. When a break up of a two-man PSC has been mutually agreed to by the shareholders, the procedure by which the parties would be "cashed out" would not necessarily be governed by a buy-sell agreement. The termination, however, would continue to be complicated by tax consequences. If the PSC is liquidated, both shareholders have a taxable gain,[8] whereas if one shareholder's stock is either redeemed, or purchased by the remaining shareholder, only the departing shareholder has taxable gain,[9] an unfair consequence.

The solution to inequitable or undesirable tax consequences may be found in the use of a "divisive reorganization," pursuant to section 355 of the Internal Revenue Code. A "divisive reorganization"[10] is simply a tax-free division of a single corporation into two or more separate corporations. Under section 355 one or more shareholder-professional(s) may depart from the PSC, or a complete break-up of the PSC could occur, followed by the continuation of the former shareholder's professional practice in a new corporate form.[11]

This article will focus on the applicability of a section 355 di-

7. *See* I.R.C. § 1348. *See also* Lee, *Termination of Interest in the Professional Corporation*, in 36TH ANN. N.Y.U. INST. ON FEDERAL TAX. 123, 124 (N. Liakas ed. 1978) (termination pay).

8. *See* I.R.C. § 331(a)(1). *See generally* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶¶ 11.01-.05 (4th ed. 1979).

9. *See* I.R.C. § 302(b)(3). "A sale of shares merely substitutes one shareholder for another, leaving the corporation's earnings and profits account intact. The result is that the earnings and profits will be taxed as ordinary income when they are distributed to the new shareholder." B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 11.01, at 11-3 (4th ed. 1979).

10. "Divisive reorganization" is a generic term given to a tax-free division of a corporation in accordance with I.R.C. section 355. *See* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶¶ 13.02-.03 (4th ed. 1979). A "reorganization" within the meaning of section 368(a)(1)(D) is not required to effect a tax-free division under section 355. *See* SENATE COMM. ON FINANCE, SENATE COMM. REP. TO ACCOMPANY H.R. 8300 "A BILL TO REVISE THE INTERNAL REVENUE LAWS OF THE UNITED STATES," S. REP. NO. 1622, 83d Cong., 2d Sess. 267, *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS 4621, 4905.

11. The divisive reorganization is not applicable in the context of the death, disability, or retirement of the shareholder-professional since the newly-formed professional service corporations must satisfy the post-distribution "active conduct of a trade or business" requirement imposed by I.R.C. section 355(a)(1)(C). *See also* Turnier, *Continuity of Interest—Its Application to Shareholders of the Acquiring Corporation*, 64 CAL. L. REV. 902 (1976).

visive reorganization to Texas professional service corporations. From a tax standpoint, if the termination of the professional's interest in the existing PSC may be structured to effect a tax-free divisive reorganization, the taxable gain upon the redemption or sale of the PSC stock may be avoided completely,[12] and the accounts receivable transferred tax-free to the new PSC.[13] Additionally, the use of a divisive reorganization should facilitate the tax-free "roll-over" of the vested interest of the departing shareholder-professional, as well as the other departing employees, to qualified pension and profit sharing plans adopted by the new PSC.[14] Whether or not the PSC is governed by a previously entered into buy-sell agreement regarding the disposition of the assets and procedure for redemption of stock, the beneficial aspects of avoiding tax consequences renders a section 355 divisive reorganization desirable. The divisive reorganization can be utilized not only as a tax planning device, but also as a practical means of breaking a dead-lock on the final distribution plan, thus facilitating an ongoing professional service corporate structure.

II. The Mechanics of a "Divisive Reorganization"

A. *Form of the "Divisive Reorganization"*

The divisive reorganization of a PSC to separate the professional practice into two or more PSCs may be effected through either a "split-off" or a "split-up."[15]

1. *"Split-off."* A "split-off" is a distribution by the original corporation of 100% of the stock of a subsidiary corporation in ex-

12. *See* I.R.C. § 355(a); *cf. id.* § 356 (receipt of boot; recognition of gain).

13. *Cf.* Hempt Bros., Inc. v. United States, 354 F. Supp. 1172, 1175-77 (M.D. Pa. 1973) (accounts receivable encompassed within meaning of "property"; section 351 non-recognition exchange), *aff'd,* 490 F.2d 1172 (3d Cir.), *cert. denied,* 419 U.S. 826 (1974).

14. *See* Lee, *How to Salvage Tax Benefits When a Professional Corporation Disbands,* 45 J. Tax. 14, 16 (1976). A discussion of the effects of a divisive reorganization of a PSC upon qualified pension and profit sharing plans is beyond the scope of this article.

15. *See generally* Jacobs, *The Anatomy of a Spin-off,* 1967 Duke L.J. 1; Mintz, *Divisive Corporate Reorganizations: Split-Ups and Split-Offs,* 6 Tax L. Rev. 365 (1951). A "divisive reorganization" may also take the form of a "spin-off" which is a distribution by one corporation of the stock of a subsidiary corporation on a pro rata basis. *See* B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 13.01, at 13-3 (4th ed. 1979). This, however, would not accomplish the objectives sought in the divisive reorganization of a PSC, since under a "spin-off" the original shareholders would own a pro rata portion of the other shareholder-professional's PSC. *See id.* at 13-3.

change for part of the original corporation's stock.[16] The distribution of the stock of the subsidiary corporation is made to one or more of the shareholders in the original corporation, in exchange for all of the original shareholder's stock. The subsidiary corporation may be newly formed for the "split-off." For example:

> Attorneys, P.C. (the "original" corporation) is owned equally by A and B. A and B want to divide Attorneys, P.C. so that each owns 100% of their respective PSC. Attorneys, P.C. forms Lawyers, P.C. and a distribution of 50% of the assets of Attorneys, P.C. is made to Lawyers, P.C. B exchanges his 50% ownership of Attorneys, P.C. for 100% ownership of Lawyers, P.C. Thereafter, A owns 100% of Attorneys, P.C. and B owns 100% of Lawyers, P.C.

2. *"Split-up."* A "split-up" is a distribution by the original corporation of 100% of the stock of two or more newly-formed corporations to the shareholders of the original corporation in exchange for all of the original corporation's stock in complete liquidation of the original corporation.[17] For example:

> Attorneys, P.C. (the "original" corporation) is owned equally by A and B. A and B want to divide Attorneys, P.C. into two corporations, then liquidate Attorneys, P.C. Attorneys, P.C. forms Lawyers, P.C. and Barristers, P.C., transferring 50% of its assets to each newly-formed subsidiary corporation. Thereafter, Attorneys, P.C. transfers 100% of Lawyers, P.C. stock to A and 100% of Barristers,

16. *See* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 13.03 (4th ed. 1979). The split-off is basically a spin-off together with an exchange: the shareholders turn in a portion of their stock for shares of the distributed corporation. This distribution need not be pro rata, thus allowing the corporation to cash out a shareholder using the corporation's assets. *See* Whitman, *Draining the Serbonian Bog: A New Approach to Corporate Separations Under the 1954 Code*, 81 HARV. L. REV. 1194, 1194 (1968). Split-offs qualify for capital gain distribution under sections 302 and 331 of the Code. *See* SENATE COMM. ON FINANCE, SENATE COMM. REP. TO ACCOMPANY H.R. 8300 "A BILL TO REVISE THE INTERNAL REVENUE LAWS OF THE UNITED STATES, S. REP. No. 1622, 83d Cong., 2d Sess. 266, *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS 4621, 4905. *See generally* Jacobs, *Spin-Offs: The Predistribution Two Business Rule—Edmund P. Coady & Beyond*, 19 TAX L. REV. 155, 165 (1964).

17. *See* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 13.02 (4th ed. 1979). The split-up may be used to divide the assets between a group of dissident shareholders. The shareholders, following the split-up, own the same amount of shares but in different corporate form. *See id.* ¶ 13.03, at 13-8 to -9. A nonqualifying split-up involves an exchange, and would be taxable as a capital gain, but only to the extent of the gain realized. *See* Whitman, *Draining the Serbonian Bog: A New Approach to Corporate Separation Under the 1954 Code*, 81 HARV. L. REV. 1194, 1209 n.75 (1968). *See generally* I.R.C. § 356(a)(1)(B).

P.C. stock to B in liquidation of Attorneys, P.C.

B. *Overview of the Requirements of I.R.C. § 355*

To effect a tax-free corporate division,[18] one must run the gauntlet of the statutory and judicial rules under I.R.C. section 355.[19] Section 355 governs the tax treatment of stock distributions to the recipients.[20] A distribution meeting the section's requirements is

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18. A tax-free "reorganization" under section 368(a)(1)(D) is no longer a condition precedent to treatment under section 355. *See* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 13.09, at 13-49 (4th ed. 1979). *See generally id.* ¶ 13.02 (Divisive Reorganizations Before 1954). Judicial limitations under section 355, however, may have some effect on an attempted tax-free corporate division. *See* Treas. Reg. § 1.355-2(c) (1955) (section 355 contemplates business purpose and continuity of interest of all persons who were owners prior to the distribution or exchange). *See generally* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 13.09 (4th ed. 1979); notes 114-20 *infra* and accompanying text.

19. *See* I.R.C. §§ 355, 368(a)(1)(D). In Commissioner v. Gordon, 391 U.S. 83 (1968), the Supreme Court stated: "The requirements of [section 355] are detailed and specific, and must be applied with precision." *Id.* at 91-92. The *Gordon* Court further recognized Congressional authority to restrict corporate reorganization, stating: "Congress has abundant power to provide that a corporation wishing to spin off a subsidiary must, however bona fide its intentions, conform the details of a distribution to a particular set of rules." *Id.* at 93-94. *See generally* Treas. Reg. § 1.355-2(c) (1955).

20. I.R.C. section 355 provides:

Distribution of stock and securities of a controlled corporation

(a) Effect on distributees. —

(1) General rule. — if —

(A) a corporation (referred to in this section as the "distributing corporation") —

(i) distributes to a shareholder, with respect to its stock, or

(ii) distributes to a security holder, in exchange for its securities, solely stock or securities of a corporation (referred to in this section as "controlled corporation") which it controls immediately before the distribution,

(B) the transaction was not used principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both (but the mere fact that subsequent to the distribution stock or securities in one or more of such corporations are sold or exchanged by all or some of the distributees (other than pursuant to an arrangement negotiated or agreed upon prior to such distribution) shall not be construed to mean that the transaction was used principally as such a device),

(C) the requirements of subsection (b) (relating to active businesses) are satisfied, and

(D) as part of the distribution, the distributing corporation distributes —

(i) all of the stock and securities in the controlled corporation received tax-free.[21] If, however, the distribution fails to qualify

held by it immediately before the distribution, or

(ii) an amount of stock in the controlled corporation constituting control within the meaning of section 368(c), and it is established to the satisfaction of the Secretary that the retention by the distributing corporation of stock (or stock and securities) in the controlled corporation was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax,

then no gain or loss shall be recognized to (and no amount shall be includible in the income of) such shareholder or security holder on the receipt of such stock or securities.

(2) Non pro rata distributions, etc. — Paragraph (1) shall be applied without regard to the following:

(A) whether or not the distribution is pro rata with respect to all of the shareholders of the distributing corporation,

(B) whether or not the shareholder surrenders stock in the distributing corporation, and

(C) whether or not the distribution is in pursuance of a plan or reorganization (within the meaning of section 368(a)(1)(D)).

(3) Limitation — Paragraph (1) shall not apply if —

(A) the principal amount of the securities in the controlled corporation which are received exceeds the principal amount of the securities which are surrendered in connection with such distribution, or

(B) securities in the controlled corporation are received and no securities are surrendered in connection with such distribution.

For purposes of this section (other than paragraph (1)(D) of this subsection) and so much of section 356 as relates to this section, stock of a controlled corporation acquired by the distributing corporation by reason of any transaction which occurs within 5 years of the distribution of such stock and in which gain or loss was recognized in whole or in part, shall not be treated as stock of such controlled corporation, but as other property.

. . . .

(b) Requirements as to active business. —

(1) In general. — Subsection (a) shall apply only if either —

(A) the distributing corporation, and the controlled corporation (or, if stock of more than one controlled corporation is distributed, each of such corporations), is engaged immediately after the distribution in the active conduct of a trade or business, or

(B) immediately before the distribution, the distributing corporation had no assets other than stock or securities in the controlled corporations and each of the controlled corporations is engaged immediately after the distribution in the active conduct of a trade or business.

(2) Definition — For purposes of paragraph (1), a corporation shall be treated as engaged in the active conduct of a trade or business if and only if —

(A) it is engaged in the active conduct of a trade or business, or substantially all of its assets consist of stock and securities of a corporation controlled by it (immediately after the distribution) which is so engaged,

(B) such trade or business has been actively conducted throughout the 5-year period ending on the date of distribution,

(C) such trade or business was not acquired within the period deunder section 355, the distribution, in the context of a "split-up," would be treated as a liquidation under I.R.C. section 331(a)(1).[22] In the context of a "split-off," the non-qualifying distribution would be treated as a redemption under section 302(b).[23] The recipient's gain, if any, under either approach would be taxable at capital gain rates.[24]

1. *The Statutory Requirements of I.R.C. § 355.* Section 355 provides for a tax-free distribution by the "distributing corporation"[25] of stock or securities in a "controlled corporation"[26] to a shareholder or securities holder, if the following five conditions are satisfied:

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scribed in subparagraph (B) in a transaction in which gain or loss was recognized in whole or in part, and

(D) control of a corporation which (at the time of acquisition of control) was conducting such trade or business —

(i) was not acquired directly (or through one or more corporations) by another corporation within the period described in subparagraph (B), or

(ii) was so acquired by another corporation within such period, but such control was so acquired only by reason of transactions in which gain or loss was not recognized in whole or in part, or only by reason of such transactions combined with acquisitions before the beginning of such period.

21. *Id.* § 355(a)(1). *See generally* Comment, *Internal Revenue Code Section 355: Recent Trends,* 31 Sw. L.J. 523 (1977); *see also* I.R.C. §§ 355(a)(3), 356(a)(b) (denying tax-free treatment to distributions or exchanges to the extent boot is received).

22. *See* B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 13.14, at 13-65 to -67 (4th ed. 1979). Application of I.R.C. section 331(a)(1) will result in capital gains treatment, to the extent the liquidating distribution value exceeds the adjusted basis of the stock given up. *See* I.R.C. § 331(a)(1) (complete liquidation treated as exchange for stock).

23. *See* B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 13.14, at 13-67 to -68 (4th ed. 1979). Section 302(a) allows redemption, within the meaning of section 317(b), to receive capital gains treatment. Under section 302(b) redemptions are treated as exchanges. Of particular applicability to an unqualified "split-off" distribution is section 302(b)(3), which classifies the distribution as a termination of the shareholder's interest, subject to the provisions of section 302(a). *But see* I.R.C. § 301 (distribution treated as dividend; taxed as ordinary income). *See generally* House Comm. on Ways and Means, House Comm. Rep. to Accompany H.R. 8300 "A Bill to Revise the Internal Revenue Laws of the United States," H.R. Rep. No. 1337, 83d Cong., 2d Sess. 287, *reprinted in* [1954] U.S. Code Cong. & Ad. News 4017, 4259 ("In the case of a distribution of stock which does not qualify under section [355], such distribution will be taxed under section 302 or 301 depending on the nature of the transaction.").

24. *See* I.R.C. §§ 302(b), 331(a)(1); notes 23-24 *supra* and accompanying text.

25. I.R.C. § 355(a)(1)(A).

26. *Id.*

a. *Control.* The "distributing corporation" must be deemed to "control" the "controlled corporation" immediately prior to distribution.[27] "Control" means ownership of at least eighty percent of the total of all voting and non-voting stock[28] of the controlled corporation.

b. *Transaction Not a "Device" for Distribution of Earnings and Profits.* The transaction must not be used "principally as a device"[29] for the distribution of earnings and profits of either the distributing corporation or the controlled corporation, or both.[30]

c. *Post-Distribution "Active Conduct of a Trade or Business."* Both the distributing corporation and the controlled corporation(s) must be engaged in the "active conduct of a trade or business" immediately after the distribution.[31]

d. *5-Year Pre-Distribution History of the "Active Conduct of a Trade or Business."* The definition of "active conduct of a trade or business" for purposes of satisfying the *post*-distribution of an "active trade or business" requirement is dependent upon the active conduct of such trade or business throughout a five-year period ending on the date of the distributing corporation's distribution of the controlled corporation's stock.[32]

e. *Distribution of at Least 80% of the Controlled Corporation's Stock.* The distributing corporation must distribute all of the stock and securities in the controlled corporation held immedi-

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27. *Id.*

28. *See id.* § 368(c). " '[C]ontrol' means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation." *Id.* § 368(c). *See generally* Rev. Rul. 77-11, 1977-1 C.B. 93 (no gain or loss is recognized to shareholder on exchange of all his stock in corporation for stock of another corporation, as his corporation owned more than 80% of another corporation immediately before distribution).

29. I.R.C. § 355(a)(1)(B).

30. *See* Comment, *Internal Revenue Code Section 355: Recent Trends,* 31 Sw. L.J. 523, 527 (1977). "The device test [of section 355(a)(1)(B) is] designed to prevent bail-out of corporate earnings and profits." *Id.* at 550. A bail-out occurs when earnings and profits are distributed to the shareholders in such a way that capital gain or loss can be realized upon disposition of the stock or securities by the shareholder, instead of a distribution taxed at ordinary rates under I.R.C. section 301. *Id.* at 527. *See generally* Gregory v. Helvering, 293 U.S. 465, 469-70 (1935).

31. *See* I.R.C. §§ 355(a)(1)(C), 355(b)(1)(A).

32. *Id.* § 355(b)(2)(B). *See generally* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 13.05 (4th ed. 1979).

ately prior to distribution,[33] or at least eighty percent of the voting and non-voting stock in the controlled corporation.[34] In the latter case, the recipient must establish that the retention of stock by the distributing corporation was not to avoid federal income tax.[35]

2. *The Judicial Requirements of I.R.C. § 355.* In addition to the five statutory tests, the "judicial-gloss" on section 355 requires the following tests be satisfied:

a. *Business Purpose.* The corporate division must be carried out for real and substantial non-tax reasons germane to the business of the corporations.[36]

b. *Continuity of Interest.* The "Continuity of Interest" test requires that part or all of the shareholders of the distributing corporation prior to the distribution must be shareholders of the controlled corporations after the distribution of stock.[37]

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33. I.R.C. § 355(a)(1)(D)(i).

34. *Id.* § 355(a)(1)(D)(ii). The distributed stock of the subsidiary may consist of either common or preferred stock; there is a risk, however, that preferred stock may be deemed section 306 stock. *See id.* § 306(c)(1)(B); Treas. Reg. § 1.355-3(b) (1955); SENATE COMM. ON FINANCE, SENATE COMM. REP. TO ACCOMPANY H.R. 8300 "A BILL TO REVISE THE INTERNAL REVENUE LAWS OF THE UNITED STATES," S. REP. No. 1622, 83d Cong., 2d Sess. 267, *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS 4621, 4905.

35. I.R.C. § 355(a)(1)(D)(ii). *See generally* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 13.07 (4th ed. 1979).

36. *See, e.g.*, Rafferty v. Commissioner, 452 F.2d 767, 769-73 (1st Cir. 1971), *cert. denied*, 408 U.S. 922 (1972); Olson v. Commissioner, 48 T.C. 855, 866-68 (1967); Rev. Rul. 69-460, 1969-2 C.B. 51. As stated in the preface to proposed regulation section 1.355: "Section 355 provides nonrecognition of gain or loss . . . only if the distribution is carried out for real and substantial nontax reasons germane to the business of the corporation . . . ." Prop. Reg. § 1.355, 42 Fed. Reg. 3867 (1977). *Cf.* Treas. Reg. § 1.355-2(2) (1955) (business purpose).

> The distribution . . . will not qualify under section 355 where carried out for purposes not germane to the business of the corporations. The principal reason for this requirement is to limit the application of section 355 to certain specified distributions or exchanges with respect to the stock or securities of controlled corporations incident to such readjustment of corporate structures as is required by business exigencies and which, in general, effect only a readjustment of continuing interests in property under modified corporate forms.

Id.

37. *See, e.g.*, LeTulle v. Scofield, 308 U.S. 415, 418-21 (1940); Pinellas Ice & Cold Storage Co. v. Commissioner, 287 U.S. 415, 468-70 (1932); Farr v. Commissioner, 24 T.C. 342, 366-67 (1955). *See generally* Treas. Reg. § 1.355-2(c) (1955). "Section 355 contemplates . . . a continuity of interest in all or part of such business enterprise on the part of those persons who, directly or indirectly, were the owners of the enterprise prior to the distribution or exchange." *Id.*; *cf.* I.R.C. § 368 (reorganization transactions); Treas. Reg. § 1.368 ("business purpose" and "continuity of interest" requirements under section 368).

III. Application of the "Divisive Reorganization" Provisions of I.R.C. § 355 To Professional Service Corporations

A. *Case Study*

Attorneys, P.C., a Texas professional corporation, was formed in 1978 by A and B, licensed attorneys, to "incorporate" the law partnership they have operated since 1970. In 1979, A and B sold stock in Attorneys, P.C. to C, a newly-licensed attorney, for $10,000; thereafter A, B, and C were equal shareholders in Attorneys, P.C.

In 1980, after a big settlement, Attorneys, P.C. purchased three new word-processing systems, a new copying machine, antique desks and chairs for all three attorneys, and a new library.

In 1981, a dispute arose between A, B, and C over the compensation formula to be used by Attorneys, P.C. By mutual agreement between A, B, and C, C will separate from Attorneys, P.C. The fair market value of C's corporate stock is $60,000; if he "sells" his Attorneys, P.C. stock to A and B for cash, pursuant to the buy-sell agreement between the three, C will recognize a $50,000 gain. Attorneys, P.C. is on the cash method of accounting and has accounts receivable of $150,000, of which $50,000 was generated by C. C intends to continue practicing trial law in corporate form and, therefore, forms Barristers, P.C., a Texas professional corporation. To effect a "divisive reorganization" resulting in a tax-free "split-off" of C's interest in Attorneys, P.C. into Barristers, P.C., the requirements of I.R.C. section 355 must be examined. The tax savings to C, if the divisive reorganization may be utilized, would be approximately $10,000.[38]

B. *Meeting the Statutory Requirements of I.R.C. § 355*

1. *Overview of the Applicability of the Statutory Requirements.* Three of the five statutory requirements, the "device"

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38. The $10,000 tax savings to C is computed as follows:

Amounts realized from sale of Attorneys, P.C. stock:	$60,000
Less: Adjusted Basis	10,000
Gain Realized	$50,000

Assume C is in 50% marginal tax bracket. Section 1201 allows a 60% exclusion; 40% of the realized gain of $50,000 is taxable as ordinary income. Thus, a tax liability attributable to $20,000 (40% of $50,000) of $10,000 results.

test,[39] the post-distribution active conduct of a trade or business proviso,[40] and the distribution of stock requirement[41] generally will be met in the division of a professional service corporation. Continuation of business is inherent in the reorganization of a PSC, whether the division be in the nature of a "split-up" or a "split-off," rendering the transaction qualified under the several subsections of section 355.[42] Potential pitfalls, however, are presented by the "control" test[43] and the five-year pre-distribution history requirement;[44] it is in these areas that a professional service corporation may be precluded from the utilization of section 355.

2. *The "Control" Test.* I.R.C. section 355(a)(1)(A) provides that the "distributing corporation," Attorneys, P.C., must "control" the "controlled corporation," Barristers, P.C., immediately before the distribution of the controlled corporation's stock.[45] Thus, under the "control" requirement, the creation of a parent-subsidiary relationship between the distributing and controlled corporations as a condition precedent to a "split-up" or a "split-off" seemingly is mandated. Satisfaction of the control test is usually inherent in the nature of a split-off or split-up since the formation of a parent-subsidiary relationship is a necessary first step in effecting any corporate division.

In Texas, and several other jurisdictions, the formation of a parent-subsidiary relationship among professional service corporations is not allowed. Specifically, under the Texas statutory scheme for the creation and operation of a PSC, a professional service corpo-

39. *See* I.R.C. § 355(a)(1)(B). The "device" test is aimed at preventing the "bail-out" of earnings and profits of the corporation at capital gain rates, as opposed to ordinary income treatment usually accorded such distributions pursuant to I.R.C. section 301. *See* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 13.06, at 13-37 (4th ed. 1979).

40. *See* I.R.C. § 355(a)(1)(C).

41. *See id.* § 355(a)(1)(D)(i). At a minimum, 80% of the controlled corporation's stock must be distributed. *See* notes 33-35 *supra* and accompanying text.

42. *See* TAXES, May 1980, at 349-50 (stipulations on taxpayer rulings on professional service corporation dissolutions). *See generally* Comment, *Internal Revenue Code Section 355: Recent Trends,* 31 SW. L.J. 523 (1977).

43. *See* I.R.C. § 355(a)(1)(A).

44. *See id.* § 355(b)(1).

45. *Id.* § 355(a)(1)(A); *see id.* § 368(c). Control, as relating to corporate reorganization, is defined as, "the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation." *Id.* § 368(c).

ration is prohibited from owning stock in another PSC.[46] This statutory prohibition can be traced to the fundamental public policy considerations which gave rise to the need for the enactment of the TPAA and TPCA.[47] Professional licensing considerations dictated that corporations, as opposed to individuals, not be legally authorized to render professional services. The statutory restriction has as its basis guarding against the likelihood of non-professional employees, acting through the corporate entity, performing tasks that require state licensing.[48] Such policy reasons, however, would not be violated in the instance of one PSC forming another for the limited purpose of effecting a "split-off" or "split-up."[49] Nonetheless, in the absence of legislative change allowing the formation of a parent-subsidiary relationship by a PSC, a qualifying division under section 355 would effectively be precluded; the technical requirement of "control" under subsection (a)(1)(A) could not be satisfied.

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46. *See* TEX. REV. CIV. STAT. ANN. arts. 1528e, 1528f (Vernon 1980). Incorporation of a PSC is allowed by licensed *individuals. See id.* art. 1528e, § 4 (emphasis added). The Texas Professional Corporation Act defines a "professional corporation" as a "corporation . . . which has as its shareholders only individuals who themselves are duly licensed or otherwise duly authorized . . . to render the same professional service as the corporation." *Id.* art. 1528e, § 3(b). Since under article 1528e, individuals are distinguished from the corporation, and both are required to be "licensed or . . . authorized" to render the same professional service, the statute obviates an argument that the term "individual" could be construed to include a "professional corporation." *Compare id.* art. 1528e, § 3(b) (identity of shareholders: licensed individuals) *with id.* art. 1528e, § 4 (creation of corporation). The creation of a parent-subsidiary relationship between PSCs, therefore, appears to be prohibited under local law, inasmuch as formation of the subsidiary would be foreclosed. Likewise, the Texas Professional Association Act provides: "Any one or more *persons* duly licensed to practice a profession . . . may . . . form a professional association." *Id.* art. 1528f, § 2(a) (emphasis added).

47. *See generally* Jorrie & Wolf, *Selected Practical Problems With Professional Associations And Professional Corporations*, 10 ST. MARY'S L.J. 247 (1978); Levenfeld, *Professional Corporations and Associations*, 8 HOUS. L. REV. 47 (1970); *see also* Scallen, *Federal Income Taxation of Professional Associations and Corporations*, 49 MINN. L. REV. 603 (1965).

48. *See* Hexter Title & Abstract Co. v. Grievance Comm., 142 Tex. 506, 520, 179 S.W.2d 946, 953-54 (1944); Rockett v. Texas State Bd. of Medical Examiners, 287 S.W.2d 190, 191-92 (Tex. Civ. App. — San Antonio 1956, writ ref'd n.r.e.).

49. *See* Rockett v. Texas State Bd. of Medical Examiners, 287 S.W.2d 190, 192 (Tex. Civ. App. — San Antonio 1956, writ ref'd n.r.e.). "The practice of medicine . . . is subject to licensing and regulation and . . . may not lawfully be subjected 'to commercialization or exploitation.'" *Id.* at 192 (quoting *United States v. American Medical Ass'n,* 110 F.2d 703, 714 (D.C. Cir.), *cert. denied,* 310 U.S. 644 (1940); *accord,* Hexter Title & Abstract Co. v. Grievance Comm., 142 Tex. 506, 520, 179 S.W.2d 946, 953-54 (1944) (practice of law).

Both the courts[50] and the Internal Revenue Service,[51] however, have recognized that the technical requirements of the control test need not be satisfied when the transaction "in substance" otherwise qualifies as a section 355 transaction. A strong argument in favor of waiving the technical requirements of the control test is presented by the divisive reorganization of PSC's meeting the substantive requirements of control; no conflict is presented with tax policy considerations underlying the "control" requirement.

The basis of the control requirement, as presented by section 351, an analogous Code section,[52] is the allowance of tax-free treatment to a transaction in which, instead of effecting a termination or extinguishment of the beneficial interests of the transferors in the transferred property, "the transferors continue to be beneficially interested in the transferred property and have dominion over it by virtue of their control of the new corporate owner" after consummation of the transaction.[53] The same policy considerations, by comparison, apply under section 355.[54] In the context of a section 355 reorganization, part or all of the shareholders in the PSC serving as the distributing corporation exchange that ownership interest for 100% ownership interest in the new corporation, i.e., the "controlled corporation," and thereafter "continue to be beneficially interested" in the underlying assets, which are the subject of the transfer, both before and after the transaction. Therefore, the divisive reorganization of a PSC, although involving an intermediate transfer to satisfy state incorporation requirements, and thus failing to meet the technical requirements of section 355,

50. *See* Stephens, Inc. v. United States, 464 F.2d 53, 65-67 (8th Cir. 1972), *cert. denied*, 409 U.S. 1118 (1973); Commissioner v. Schumacher Wall Bd. Corp., 93 F.2d 79, 81 (9th Cir. 1937); *cf.* Commissioner v. Baan, 382 F.2d 485, 495 (9th Cir. 1967) (policy of tax-free reorganization; identity of business ownership), *aff'd*, 391 U.S. 83 (1968).

51. *See* Rev. Rul. 77-191, 1977-1 C.B. 94; Private Letter Rul. No. 7838134 (June 26, 1978) (Dept. of Treas./IRS); Private Letter Rul. No. 7838131 (June 26, 1978) (Dept. of Treas./IRS).

52. *Compare* I.R.C. § 351 (tax-free exchange on transfer to corporation controlled by transferor) *with id.* § 355 (tax-free corporate reorganization).

53. American Compress & Warehouse Co. v. Bender, 70 F.2d 655, 657 (5th Cir. 1934).

54. *Cf.* Commissioner v. Baan, 382 F.2d 485, 495 (9th Cir. 1967) (policy considerations underlying section 355), *aff'd*, 391 U.S. 83 (1968). "[T]he fundamental basis of non-recognition of gain or loss under section 355 is that no tax should be imposed when the same people continue to own the same business with only formal changes in the business organization." *Id.* at 495. *See generally* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 3.19 (4th ed. 1979).

continues in substance to fulfill statutory and policy considerations of the section 355 (a)(1)(A) control requirement.

The Internal Revenue Service previously has granted favorable tax treatment to reorganizations advancing through intermediate distribution. In Revenue Ruling 77-191, the Service held a distribution qualified under section 355, notwithstanding the failure to satisfy the technical control requirements of subsection (a)(1)(A). A and B, as individuals, owned the stock of Corporation X, an operator of two divisions. The assets of one division were distributed to A and B, in redemption of part of their stock in X. "Immediately following the distribution and pursuant to an integrated plan, A and B transferred all of the assets received to Corporation Y, which was newly organized for that purpose."[55] Called upon to analyze the distribution as constituting a section 346 partial liquidation or a section 355 reorganization, the Service stated that control, as defined in section 368(a)(1)(D), is satisfied if "immediately after the transfer the transferor *or one or more of its shareholders* is in control of the corporation to which the assets are transferred . . . [but only if the subsequent distribution of stock qualifies under section 355]."[56] While recognizing the control test under section 355 does not contemplate a transfer to shareholders,[57] the Service found such matter inconclusive. Instead, the Service held that the substance, rather than the form, of the transaction would determine the tax consequences,[58] citing *Commissioner v. Court Holding Co.*[59] The Service concluded:

> The end result of the planned series of steps was precisely the same as if X [Corporation] had created Y [Corporation] as a wholly-owned subsidiary, transferred the assets of . . . [Corporation X] . . . to Y, and then distributed the stock of Y pro rata to A and B in exchange for part of their X stock. Such a series of steps is a typical corporate split-off described in sections 368(a)(1)(D) *and 355 of the Code.*[60]

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55. Rev. Rul. 77-191, 1977-1 C.B. 94, 95.

56. *Id.* at 95; *accord,* Commissioner v. Morris, 367 F.2d 794, 799-800 (4th Cir. 1966) (control reference determinative as to transferee; no limitations upon subsequent reorganizations of transferor).

57. *See* Rev. Rul. 77-191, 1977-1 C.B. 94, 95 (section 368(a)(1)(D) reorganization upon transfer by one corporation to another corporation).

58. *Id.* at 95.

59. 324 U.S. 331 (1945).

60. Rev. Rul. 77-191, 1977-1 C.B. 94, 95 (emphasis added).

As evidenced by this ruling, the Service, in appropriate cases, may be willing to overlook the taxpayer's failure to satisfy the technical requirements of the control test if the substance of the transaction is in accord with the policy objectives of section 355(a)(1)(A).[61]

In a series of private letter rulings,[62] issued in 1978, the Internal Revenue Service recognized local law constraints on PSC split-off or split-up compliance under section 355(a)(1)(A). When state statutory provisions prohibited technical compliance with the control requirement for a tax-free divisive reorganization, the substance of the transaction was scrutinized to give the taxpayer the benefits of the policy considerations of section 355.

In Private Letter Ruling 7834040, a split-up of an Arkansas medical professional association was ruled upon. The original professional association (Distributing) organized two new corporations (Controlled I and II). Thereafter, Distributing transferred its operating assets to Controlled I and II in exchange for 100% of the stock in each. As a final step, Distributing exchanged 100% of the

61. *See id.* at 95. The issue in Revenue Ruling 77-191 was whether the described transaction was a partial liquidation pursuant to section 331(a)(2), in which a taxable gain or loss would be recognized, or a reorganization pursuant to sections 368(a)(1)(D) and 355. Although not clear from the ruling, the taxpayer may have sought to structure the transaction as a partial liquidation under I.R.C. section 331(a)(2) in order to recognize a loss. The Service referred to Treasury Regulation section 1.331-1(c), which provides that a liquidation, followed by a transfer of all or part of the assets received in liquidation to another corporation "may have the effect of . . . a reorganization in which no loss is recognized." The citation of the treasury regulation, and statement that "[t]he true nature of a transaction cannot be disguised by mere formalisms that exist solely to alter tax liabilities" indicates the Service's position was to effectuate a recharacterization of the transaction as a reorganization, thus preventing the recognition of a loss. *See id.* at 95, *citing* Commissioner v. Court Holding Co., 324 U.S. 331 (1945). Therefore, the policy underlying the Service's willingness to overlook the failure to meet the technical requirements of the control test under section 355(a)(1)(A) must be viewed in light of the role in which the Service was placed.

62. *See* Private Letter Rul. No. 7838134 (June 26, 1978) (Dept. of Treas./IRS); Private Letter Rul. No. 7838131 (June 26, 1978) (Dept. of Treas./IRS); Private Letter Rul. No. 7834840 (May 25, 1978) (Dept. of Treas./IRS). Private letter rulings issued by the Internal Revenue Service "may not be used or cited as precedent." I.R.C. § 6110(j)(3). Such rulings, however, can be used by the practitioner as a guide in determining the probable approach of the Service under an analogous fact situation. For years the Service has issued private letter rulings to taxpayers to give certainty to the tax consequences of a proposed or completed transaction. Any such ruling is useful as precedent only by the taxpayer who requested the ruling. *See* I.R.C. § 6110(j)(3); Treas. Reg. § 301.6110 (1977). Furthermore, a private letter ruling issued to a taxpayer may be revoked if the taxpayer request is found to contain misstatements and omissions of material facts, or if it is discovered that the transaction was not implemented as described in the letter request for the ruling. *See* Reeves v. Commissioner, 71 T.C. 727, 731 (1979).

stock in Controlled I and II to two groups of physician-shareholders in redemption of their stock in Distributing. The Service ruled the transaction qualified under I.R.C. sections 368(a)(1)(D) and 355, "provided it is legal in the State of Arkansas for Controlled I [and II] to engage in the practice of . . . [medicine] . . . and Controlled I [and II] . . . have each been organized and operated in accordance with the Arkansas Professional Corporation Act."[63] Since Arkansas law does not prohibit one PSC from owning stock in another PSC,[64] the section 355(a)(1)(A) control test could be technically satisfied.

The issue of divisive reorganization of professional service corporations faced with statutory restraints on the formation of a subsidiary PSC was squarely presented in Private Letter Rulings 7838131 and 7838134. In Private Letter Ruling 7838131, the applicable state law limited the class of persons eligible to own stock in a professional corporation "to persons . . . duly licensed to practice the profession for which the professional corporation is organized."[65] As a result, the distributing PSC made a distribution of part of its assets directly to the departing shareholder-physician, in exchange for such shareholder's stock in the distributing PSC. This distribution was "expressly conditioned upon the immediate contribution [by the departing shareholder-physician] of all the assets received to a newly-organized professional corporation solely in exchange for all of the stock [of the newly-organized PSC]."[66] The Service ruled that the series of steps "will be treated as a reorganization within the meaning of section 368(a)(1)(D) . . . [citing Revenue Ruling 77-191]."[67] Further, the Service held the distribution qualified under section 355.[68]

63. Private Letter Rul. No. 7834040, at 6 (May 25, 1978) (Dept. of Treas./IRS).

64. *See* ARK. STAT. ANN. §§ 64-2002(a) to -2003 (rev. ed. 1966). The Arkansas Professional Corporation Act provides: "Two or more *persons* duly and properly licensed . . . may associate to form a corporation . . . to own, operate and maintain a professional corporation." *Id.* § 64-2002(a) (emphasis added). The Act further provides: "The Business Corporation Act shall be applicable to such professional corporations, including their organization." *Id.* § 64-2003.

65. Private Letter Rul. No. 7838131, at 3 (June 26, 1978) (Dept. of Treas./IRS) (no reference to state of incorporation); *cf.* TEX. REV. CIV. STAT. ANN. art. 1528e, § 3(b) (Vernon 1980) (eligible shareholders limited to licensed individuals). *See generally* note 46 *supra* and accompanying text.

66. Private Letter Rul. No. 7838131, at 3 (June 26, 1978) (Dept. of Treas./IRS).

67. *Id.* at 5 (§ (1)).

68. *Id.* at 5 (§ (5)).

In Private Letter Ruling 7838134, a distribution of assets was made directly to the departing shareholder-professional as part of an integrated plan to transfer such assets immediately to a newly organized PSC. The Service acknowledged the series of steps was undertaken to "comply with applicable state laws which prohibit professional corporations from owning stock in other professional corporations."[69] The Service went one step further in this ruling, stating the combined steps

> [would] be treated as the creation by Distributing of [the newly organized PSC] as wholly-owned subsidiaries, the transference by Distributing of a portion of its assets and liabilities to [the newly organized PSC], and then the distribution of the stock of [the newly organized PSC] to [the departing professional] in exchange for all of the stock of Distributing held by [the departing professional].[70]

Again, Revenue Ruling 77-191 was cited as authority for the position taken. Accordingly, the transaction qualified as a section 368(a)(1)(D) reorganization followed by a distribution qualifying under section 355.

These private letter rulings recognize that the shareholder-professional who is splitting-off, or the group of shareholder-professionals splitting-up, is merely serving as a conduit through which the assets must pass into the newly-organized PSC, due to state laws prohibiting one PSC from owning stock in another PSC. In addition, the rulings indicate the Service's recognition that the policy considerations underlying the section 355 (a)(1)(A) control requirement are not circumvented by such procedure, and that denial of a tax-free division of PSCs pursuant to section 355 because of state law restrictions precluding satisfaction of pre-and post-distribution control clearly would be an inequitable and unintended result. Due to the potential pitfall which exists, the Texas Legislature should consider amending the applicable provisions of the TPCA and TPAA to remove the technical impediments to qualifying under I.R.C. section 355, consistent with public policy considerations of the state.[71]

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69. Private Letter Rul. No. 7838134, at 2 (June 26, 1978) (Dept. of Treas./IRS).

70. *Id.* at 5-6 (§ (1)).

71. As a planning alternative, it is possible to structure a divisive reorganization of a Texas professional service corporation in such a manner as to avoid the section 355(a)(1)(A) "control" issue completely. The Texas Professional Corporation Act and Texas Professional

3. *The "Active Conduct of a Trade or Business" Requirement.* The most esoteric issue surrounding a tax-free division of a PSC is presented by the "active conduct of a trade or business requirement."[72] I.R.C. section 355(b)(1) requires the "distributing corporation" and each of the "controlled" corporations, in a split-off or split-up, to be "engaged immediately after the distribution in the active conduct of a trade or business."[73] Satisfying this proviso would appear relatively simple for PSCs when the continuation of the professional practice is contemplated, albeit in an altered corporate form. An integral component of the section 355(b)(1) post-distribution test, however, is the pre-distribution requirement that "such trade or business has been actively conducted throughout the 5-year period ending on the date of distribution."[74]

While "active conduct of a trade or business" is not defined by statute,[75] the scope of the term "trade or business" is clarified under the proposed regulations to section 355.[76] Under these regu-

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Association Act each provide that professional service corporations may own stock in a regular corporation. *See* TEX. REV. CIV. STAT. ANN. art. 1528e, § 7 & art. 1528f, § 5(A) (Vernon 1980). These provisions would enable the distributing PSC to form a wholly-owned subsidiary corporation under the Texas Business Corporation Act. Thereafter, the distributing PSC would transfer a portion of its assets and liabilities, attributable to the departing shareholder-professional, in exchange for all of the subsidiary's stock. The departing shareholder-professional subsequently would exchange his stock in the distributing PSC for 100% of the stock of the subsidiary. The departing shareholder-professional, contemporaneous with the exchange, would merge the regular corporation into a newly organized PSC; a reorganization pursuant to section 368(a)(1)(F). *See* I.R.C. § 368(a)(1)(F) ("a mere change in identity, *form*, or place of organization, however effected") (emphasis added). Since the "identity of proprietary interest" and "uninterrupted business continuity" tests of section 355 have been met, the conversion of a regular corporation under the Texas Business Corporation Act to a Texas professional corporation or association could be effected tax-free. *See* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 14.19, at 14-89 to -90 (4th ed. 1979). This approach, however, is certain to be costly and cumbersome as the creation of a new corporation is entailed.

72. *See* I.R.C. § 355(b). *See generally* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 13.04 (4th ed. 1979).

73. I.R.C. § 355(b)(1)(A)-355(b)(1)(B).

74. *Id.* § 355(b)(2)(B); B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 13.04, at 13-14 (4th ed. 1979).

75. B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 13.04, at 13-15 & n.22.

76. Prop. Treas. Reg. § 1.355-2(b)(2)(ii), 42 Fed. Reg. 3870 (1977). The regulation provides:

> A corporation shall be treated as engaged in a trade or business immediately after a distribution of stock if a specific group of activities are being carried on by such corporation for the purpose of earning income or profit from such group of activities,

lations, the key factor to a finding of "trade or business" is the presence of a "specific group of activities," encompassing "every operation which forms a part of, or a step in, the process of earning income . . . from such group."[77] The proposed regulations further specify that "such group of activities ordinarily must include the collection of income and the payment of expenses."[78]

The threshold issue in meeting the "active trade or business" requirement is whether each professional's activities constitute a separate trade or business, or whether the professionals' collective efforts as a group controls as the "trade or business." The matter of construction of single trade or business is decisive: its resolution is determinative of whether each individual professional will have to meet the five-year pre-distribution history test in his own right, or whether the test can be met through the vehicle of corporate pre-distribution history.

Of course, if each of the professionals within the PSC have been in practice together throughout a five year period, the pre-distribution test, as applied at either the individual or corporate level, would be met. The professional in many instances, however, will not have practiced in corporate form for a full five-year period prior to departure. The departing professional, under such circumstances, will have to "piggy-back" the PSC's five-year distribution history.[79]

> and the activities included in such group include every operation which forms a part of, or a step in, the process of earning income or profit from such group. Such group of activities ordinarily must include the collection of income and the payment of expenses.

Id. A similar definition of "trade or business" is contained in Treasury Regulation section 1.355-1 (1955):

> [F]or purposes of section 355, a trade or business consists of a specific existing group of activities being carried on for the purpose of earning income or profit from only such group of activities, and the activities included in such group must include every operation which forms a part of, or a step in, the process of earning income or profit from such group. Such group of activities ordinarily must include the collection of income and the payment of expenses.

Treas. Reg. § 1.355-1 (1955).

77. *See* Prop. Treas. Reg. § 1.355-2(b)(2)(ii), 42 Fed. Reg. 3870 (1977).

78. *Id.*; *cf.* Treas. Reg. § 1.355-1(c) (1955) (source of specification).

79. The professional service corporation itself does not have to have been in existence for the five-year period. I.R.C. section 355(b)(2)(c) allows the acquisition of a "trade or business" in a non-taxable transaction, e.g. the incorporation of a sole proprietorship or partnership pursuant to section 351. *See* Private Letter Rul. No. 7810013, at 1-6 (Dec. 1, 1977) (Dept. of Treas./IRS) (tax-free merger of two professional service corporations). The use of

a. *The Professional Employee as a Separate Trade or Business.* The source of analysis of section 355(b) lies in the definition of "trade or business" under the proposed regulations:

> A corporation shall be treated as engaged in a trade or business immediately after a distribution of stock if *a specific group of activities* are being carried on by such corporation for the purpose of earning income or profit from such group of activities, and the activities included in such group *include every operation which forms a part of, or a step in, the process of earning income or profit . . . and from such group.* Such group of activities *ordinarily must include the collection of income and the payment of expenses.*[80]

Whether this definition is broad enough to encompass the professional activities of an individual necessarily depends upon the matter of operation of each practice.

A practice operated with each professional serving a separate group of clients or patients could be construed as constituting several separate trades or businesses. The case of *Lester v. Commissioner*[81] is instructive on this point. In *Lester* the Tax Court found the existence of separate businesses in the corporate sale of products to jobbers through warehouse distributors and the subsequent sale of the same products, with the corporation acting as a jobber, to dealers.[82] The functions of warehouse distribution and jobber sale were construed as separate businesses, even though both activities were conducted at the same location, with the same employees, and without segregation of inventories or separate records of income and expense.[83] By analogy, if one professional of a PSC renders specialized services to a group of clients, e.g., tax-planning

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"boot" may disqualify the transaction; I.R.C. section 355(b)(2)(c) prohibits the recognition of "gain or loss . . . in whole or in part." *See* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 13.05, at 13-30 to -31, 13-31 n.67. The following question is presented when the specific set of circumstances warrant application of the "trade or business" test at the professional individual level: whether a purchase of the professional individual's stock from other shareholder-professionals in the PSC, or from the professional service corporation itself would violate I.R.C. section 355(b)(2)(C), as involving acquisition of the trade or business "in a transaction in which gain or loss was recognized." *See* I.R.C. § 355(b)(2)(C).

80. Prop. Treas. Reg. § 1.355-2(b)(2)(ii), 42 Fed. Reg. 3870 (1977) (emphasis added).

81. 40 T.C. 947 (1963).

82. *Id.* at 956-58.

83. Id. at 957-58; *see* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 13.04, at 13-20 to -24 (4th ed. 1979).

services, with no other members of the PSC offering such service, and the only business generated under the "pool" of clients is tax-planning, then arguably, under the rationale of *Lester,* the Service could find that the tax practitioner's activities constitute a separate trade or business.[84] Factors evidencing the management and operation of the office[85] on a collective basis, while apparently relevant considerations under the definition of "trade or business,"[86] cannot be considered determinative.[87]

Implicit in the application of the "active trade or business" test at the individual professional activity level is recognition of the unique nature of a professional service corporation section 355 reorganization. In the classic divisive reorganization, the tangible operating assets of one corporate entity are transferred to another corporate entity via a tax-free reorganization.[88] The fair market value of such assets is objectively ascertainable; recognition of realized gain on the transfer, likewise ascertainable,[89] is avoided by qualifying the distribution under section 355. By contrast, the real subject matter of the transfer in a professional service corporation reorganization is the professional himself. Notwithstanding the fact that the gain to be avoided under a section 355 reorganization, by definition, is limited to the gain arising on the transfer of tangible assets,[90] the Service feasibly could employ an argument for treating the professional as a separate trade or business on the grounds that the professional himself "is the fount of [the] com-

84. *Cf.* Lester v. Commissioner, 40 T.C. 947, 956-58 (1963) (warehouse distribution and jobber sale functions as separate businesses). *See generally* B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 13.04, at 13-20 to -24 (4th ed. 1979).

85. Common management and operational services, directly impacting on the professional, include shared secretarial services, billing and collection procedures, purchase of supplies, and centralized management and policy decision-making.

86. *See* Prop. Treas. Reg. § 1.355-3(b)(2)(ii), 42 Fed. Reg. 3870 (1977). *See generally* B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 13.04, at 13-17 to -20 (4th ed. 1979).

87. *Cf.* Lester v. Commissioner, 40 T.C. 947, 956-58 (1963) (separate business activities under common management).

88. *See* B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 13.01 (4th ed. 1979).

89. *See* I.R.C. § 1001.

90. *See id.* § 355(a) ("no gain or loss shall be recognized . . . on the receipt of such stock or securities").

pany's income."[91] Utilization of the concept that the ultimate product of the corporation exists in the asset of practitioner skills thus bolsters the assertion of individual activity "trade or business" status.

No cases or revenue rulings have addressed the specific issue of the governing criterion for application of the active business test at the corporate, as opposed to individual practitioner level. Several private letter rulings, while lacking in precedential value, are instructive on the matter.[92]

The Internal Revenue Service applied the "trade or business" test at the corporate level in Private Letter Ruling 7838131, dealing with a professional association engaged in the practice of dentistry.[93] The association's operations were conducted at one location, under a centralized billing, collection, and disbursement system. Furthermore, the PSC shared support staff among its professionals, had centralized management for all professional operations, and presumably shared a pool of patients.[94] Although one of the professionals had practiced with the PSC for less than five years, the position of the Service was that the association "had operating income and expenses representative of the active conduct of a trade or business for the past five years."[95]

The converse position was taken by the Service in Private Letter Ruling 8018084,[96] regarding a professional corporation engaged in the business of providing orthodontic services. Prior to incorporation, each of the five physician-shareholders operated separate practices as sole proprietorships. After the decision to incorporate, each physician-shareholder continued to operate individual offices

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91. Eduardo Catalano, Inc. Pension Trust [1979] TAX CT. MEM. DEC. (P-H) ¶ 79,183 T.C.M.

92. *See* Private Letter Rul. No. 8045046 (Aug. 13, 1980) (Dept. of Treas./IRS); Private Letter Rul. No. 8023030 (March 11, 1980) (Dept. of Treas./IRS); Private Letter Rul. No. 8018084 (Feb. 11, 1980) (Dept. of Treas./IRS); Private Letter Rul. No. 8016036 (Jan. 22, 1980) (Dept. of Treas./IRS); Private Letter Rul. No. 8009039 (Dec. 4, 1979) (Dept. of Treas./IRS); Private Letter Rul. No. 7838134 (June 26, 1979) (Dept. of Treas./IRS); Private Letter Rul. No. 7838131 (June 26, 1978) (Dept. of Treas./IRS); Private Letter Rul. No. 7834040 (May 25, 1978) (Dept. of Treas./IRS); Private Letter Rul. No. 7810013 (Dec. 1, 1977) (Dept. of Treas./IRS); Private Letter Rul. No. 7743001 (June 14, 1977) (Dept. of Treas./IRS). *See also* note 62 *supra* and accompanying text (private letter rulings of no precedential value).

93. *See* Private Letter Rul. No. 7838131, at 1 (June 26, 1978) (Dept. of Treas./IRS).

94. *Id.* at 1-2.

95. *Id.* at 1.

96. *See* Private Letter Rul. No. 8018084 (Feb. 11, 1980) (Dept. of Treas./IRS).

"as separate cash basis profit centers with their own separate employees."[97] The accounting and billing functions were centralized.[98] Under these circumstances, the Internal Revenue Service applied the "active trade or business" five-year pre-distribution history test at the professional level.[99]

The Internal Revenue Service has indicated the "active trade or business" test will be applicable at either the individual professional activity level, or the professional service corporation level, depending upon the manner in which the professional services are rendered.[100] The basic distinction to be drawn is between the functioning of a PSC as separately operated "profit centers," construed as individual businesses, and the operation of an individual practice or specialty, distinguished by service to the same pool of clients, e.g., a full-service law office, and utilization of centralized billing, collection, and expense paying services. At stake in resolution of the issue of whether the "active trade or business" test is applicable at the professional-employee level or the corporate level is the satisfaction of section 355(b)(2)(B)'s five-year pre-distribution history requirement. As observed by one noted authority, "[t]he more distinctive and independently viable the activities are, however, the weaker is their claim to an inherited history."[101]

b. *The Professional Service Corporation as a "Single Busi-*

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97. *Id.* at 1.

98. *Id.* at 1.

99. *Id.* at 1. The original professional association was formed by five doctors. The Service stated: "Financial information has been submitted which indicates that the [five] *offices* . . . have *each* had gross receipts and operating expenses representative of the active conduct of a trade or business for the past five years." *Id.* at 1 (emphasis added); *cf.* Private Letter Rul. No. 7834040, at 1-2 (May 25, 1978) (Dept. of Treas./IRS) (two-department professional medical association; "active trade or business" test applied at corporate level).

100. *Compare* Private Letter Rul. No. 8018084, at 1 (Feb. 11, 1980) (Dept. of Treas./IRS) (individual businesses operating under corporate entity) *with* Private Letter Rul. No. 7838131, at 1-2 (June 26, 1978) (corporate business). *But cf.* Private Letter Rul. No. 7834040, at 1-2 (May 25, 1978) (Dept. of Treas./IRS) (business conducted at corporate level; association operated two separate departments). Several private letter rulings have applied the "active trade or business" test at the corporate level. *See, e.g.*, Private Letter Rul. No. 7838134, at 2 (June 26, 1979) (Dept. of Treas./IRS); Private Letter Rul. No. 7810013, at 2 (Dec. 1, 1977) (Dept. of Treas./IRS); Private Letter Rul. No. 7743001, at 2 (June 14, 1977) (Dept. of Treas./IRS). Only in one instance, however, was the departing professional associated with the PSC for less than five years. *See* Private Letter Rul. No. 7838131, at 2 (June 26, 1978) (Dept. of Treas./IRS).

101. B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 13.05, at 13-33 (4th ed. 1979).

ness." Assuming the "active trade or business" test is applicable at the corporate level,[102] i.e., the business activities of the professional service corporation constitute a "single business," each professional corporation formed as a result of the split-up or split-off would share in the prior professional corporation's five-year business history. This is the only manner in which the departing professional who has practiced less than five years can satisfy the five-year pre-distribution history requirement of section 355(b)(2)(B).

The Treasury previously construed the active business requirement as calling for, essentially, the conduct of separate businesses both before and after distribution,[103] a characterization precluding divisive reorganization of a PSC. Such interpretation followed from a literal construction of section 355(b)(2)(B),[104] as reflected in regulation section 1.355-1(a): "Section 355 does not apply to the division of a single business."[105] This provision of the regulations was invalidated by the Tax Court in *Commissioner v. Coady,*[106] a position now reflected in the proposed regulations.[107] In *Coady,* the Tax Court allowed what is commonly known as a "vertical division"[108] of a single business.

The "single business" in *Coady* was a construction business, coowned by two shareholder-employees. The division was accomplished by the transfer of a pro rata share of the assets, consisting of construction contracts, tools, and cash, to a newly-formed subsidiary.[109] The subsidiary was "split-off" by the one shareholder exchanging his stock in the original corporation for 100% of the

102. *E.g.,* Private Letter Rul. No. 8045046, at 1 (Aug. 13, 1980) (Dept. of Treas./IRS); Private Letter Rul. No. 8023030, at 1 (March 11, 1980) (Dept. of Treas./IRS); Private Letter Rul. No. 8009039, at 1 (Dec. 4, 1979).

103. B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 13.04, at 13-16 (4th ed. 1979).

104. *See id.* ¶ 13.04, at 13-16; I.R.C. § 355(b)(2)(B).

105. Treas. Reg. § 1.355-1(a) (1955).

106. 33 T.C. 771 (1960), *aff'd,* 289 F.2d 490 (6th Cir. 1961); *accord,* United States v. Marett, 325 F.2d 28 (5th Cir. 1963); Rev. Rul. 64-147, 1964-1 C.B. 136.

107. *See* Prop. Treas. Reg. § 1.355-1(a), 42 Fed. Reg. 3867 (1977). *See generally id.* § 1.355-3(c), Example 10, 42 Fed. Reg. 3871 (1977).

108. A "vertical division" of a single business occurs when each of the post-distribution businesses carries on all stages or functions of the original business. B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 13.04, at 13-17 (4th ed. 1979).

109. Commissioner v. Coady, 33 T.C. 771, 773 (1960), *aff'd,* 289 F.2d 490 (6th Cir. 1961).

stock in the new subsidiary.[110]

The *Coady* "vertical division" of a single business serves as the conceptual blueprint for the divisive reorganization of a professional service corporation. The Service, in numerous private letter rulings, has allowed the vertical division of a PSC.[111] Illustrative of the position taken is Private Letter Ruling 7743001, in which the Service ruled a "vertical division" of a professional corporation rendering medical and surgical services qualified as a section 368(a)(1)(D) reorganization, with a tax-free distribution pursuant to section 355.[112]

In view of the many favorable private letter rulings issued by the Service on "vertical" devisive reorganization of a professional service corporation,[113] it would appear relatively safe to structure a break-up of a PSC in such manner. The rulings additionally serve as a good guide to planning a divisive reorganization.

C. *Meeting the Judicial Requirements of I.R.C. § 355*

In the same manner in which several of the statutory requirements of section 355 become of negligible concern as applied to reorganization of a PSC,[114] the judicial mandates of business purpose and continuity of interest generally will be met *a fortiori*. The proposed Treasury Regulations incident to section 355 are instructive on the nature of the basis for the business purpose and continuity of interest requirements.[115] The business purpose doctrine, closely related to the "device" test,[116] requires that the transfer of

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110. *See id.* at 773.

111. *See* Private Letter Rul. No. 8045046 (Aug. 13, 1980) (Dept. of Treas./IRS); Private Letter Rul. No. 8023030 (March 11, 1980) (Dept. of Treas./IRS); Private Letter Rul. No. 8016036 (Jan. 22, 1980) (Dept. of Treas./IRS); Private Letter Rul. No. 8009039 (Dec. 4, 1979) (Dept. of Treas./IRS); Private Letter Rul. No. 7838134 (June 26, 1978) (Dept. of Treas./IRS); Private Letter Rul. No. 7838131 (June 26, 1978) (Dept. of Treas./IRS); Private Letter Rul. No. 7834040 (May 25, 1978) (Dept. of Treas./IRS); Private Letter Rul. No. 7810013 (Dec. 1, 1977) (Dept. of Treas./IRS); Private Letter Rul. No. 7743001 (June 14, 1977) (Dept. of Treas./IRS).

112. *See* Private Letter Rul. No. 7743001, at 1-2 (June 14, 1977) (Dept. of Treas./IRS).

113. *See* note 111 *supra* and accompanying text.

114. *See* notes 39-42 *supra* and accompanying text.

115. *See* Prop. Treas. Reg. § 1.355-2(b), 42 Fed Reg. 3867-69.

116. *See* notes 29-30 *supra* and accompanying text. *See generally* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 13.06 (4th ed. 1979); Comment, *Internal Revenue Code Section 355: Recent Trends*, 31 Sw. L.J. 523, 538-58 (1977).

stock be "carried out for real and substantial nontax reasons germane to the business of the corporations."[117] Providing the requisite intent to separate the business structure in readjustment of professional activities is present, the issue of business purpose need not be raised.[118] Inasmuch as the business purpose of PSC dissolution and reorganization presupposes to effect a "readjustment of continuing interests in property under modified corporate forms,"[119] the additional hurdle of continuity of interest should be overcome with ease.[120]

IV. Conclusion

In planning for the formation, as well as dissolution of the professional service corporation the potential tax savings inherent under a tax-free divisive reorganization warrant the planner's attention. In the pre-formation context, a fresh approach to drafting the buy-sell agreement, incorporating the necessary provisions to lay the predicate potentially leading to a subsequent divisive reorganization, should be examined. Alternatively, if dissolution of the professional service corporation is inevitable, the tax planner should review the tax consequences of a divisive reorganization compared with dissolving the PSC in accordance with the buy-sell agreement. If the divisive reorganization yields the greater tax savings, the buy-sell agreement should be amended prior to dissolution, or revoked entirely to facilitate a divisive reorganization.

The tax-free reorganization provisions of I.R.C. section 355 are intricate, but not formidable. As this article suggests, prior road blocks such as the "control" test and the five-year pre-distribution test have been ameliorated in view of the current ruling positions of the Internal Revenue Service. As an additional measure, the threat of a divisive reorganization stumbling on the "control" issue could be eliminated by curative legislation enacted by the Texas Legislature.

Since professionals undergoing the trauma of a split-up only

117. Prop. Treas. Reg. § 1.355-2(b)(i), 42 Fed. Reg. 3867.

118. *See* note 36 *supra* and accompanying text.

119. Treas. Reg. § 1.355-2(c) (1955). "Section 355 contemplates . . . a continuity of interest in all or part of such business enterprise on the part of those persons who, directly or indirectly, were the owners of the enterprise prior to the distribution or exchange." *Id.*

120. *See* Prop. Treas. Reg. § 1.355-2(b)(i), 42 Fed. Reg. 3867.

want to be in the same economic position both before and after a break, without the additional tax burden inherent in the typical buy-sell situation, the divisive reorganization seems like a painless, even natural alternative. Like the old saying goes, "what have you got to lose?"