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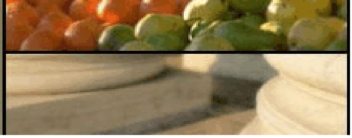

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An Agricultural Law Research Article

Revenue Ruling 76-514: An I.R.S. Hurdle to Corporate Formation for the Agri-Businessman

by

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Originally published in SOUTH DAKOTA LAW REVIEW
24 S. D. L. REV. 681 (1979)

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REVENUE RULING 76-514: AN I.R.S HURDLE TO CORPORATE FORMATION FOR THE AGRI-BUSINESSMAN

by G. MARTIN JOHNSON*

This article examines Revenue Ruling 76-514 as it interprets section 47(b) of the Internal Revenue Code and its impact on the agri-businessman. The author determines that the Regulations are not consistent with the subtle, though admittedly unclear intent of Congress to allow avoidance of investment recapture under I.R.C. section 47. The author concludes that the ruling may create substantial hurdles to structuring of the farming and ranching enterprise and calls for legislative change to correct the problem.

INTRODUCTION

There was a time when the farmer's greatest concern was adequate rainfall and sufficient sunshine. With the proper mix, the farmer could be assured of at least one more year of operation. For assistance, the agri-businessman had only to call upon the Supreme being and hope for the best.

Today, additional and arguably more complicated considerations govern the success or failure of the agricultural industry. Expensive machinery and more efficient methods for tilling the soil have increased dramatically the farmer's ability to handle large numbers of acres. Ever ready to assist the farmer in maximizing his yields are the chemical and fertilizer companies promoting better methods and more sophisticated products to help produce an additional bushel from each acre. One result of this increased sophistication is the evolution of the farmer from a passive tiller of the soil to an educated, sophisticated businessman. No longer is he concerned solely with the elements of nature. No longer does he rely solely on the heavenly forces. Today, the agri-businessman must deal with issues of international trade, commodity markets, and inflation. With these problems have come the need for more sophisticated business planning to reduce the economic cost of operation.

One solution gaining increased acceptance in the farming context is the utilization of the corporate entity. As with any incorporation, however, tough decisions must initially be made. Who will be the shareholders and what percentage will they retain? Will the

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outstanding and issued stock consist solely of common stock or should a class of preferred be issued? What liabilities should be assumed by the corporation and what portion should be retained by the farmer? Should the shareholder receive only stock in exchange for the asserts transferred to the corporation, or should a debt obligation be issued? These are only a few of the issues that are present and must be resolved upon each and every incorporation.

One of the most difficult considerations is what assets should be transferred into the corporation and what should be retained? This pivotal decision has taken on greater significance as a result of the issuance of Revenue Ruling 76-514[1] dealing with Internal Revenue Code section 47(b),[2] and the possible recapture of investment credit upon the transfer of assets into the corporation in an otherwise nontaxable section 351 transfer.[3]

In order to aid in understanding the implications of a potential investment credit recapture in the farming context, two examples will be used through out the article. In the first example, the taxpayer owns two sections of land devoted entirely to the production of grain. Other than the land, the taxpayer owns three center pivot irrigation systems which cost $75,000 and various farm machinery costing $50,000. Because of his advancing age and in order to facilitate the gifting program contained in his estate plan, the taxpayer wishes to incorporate his farming operation. In order, however, to maintain a consistent flow of income for himself, he wishes to retain ownership of the land and lease it to the corporation. The taxpayer will transfer the balance of his assets to the corporation in exchange for stock in a section 351 nontaxable exchange.

In the second example, the taxpayer, along with his sons, manages a 2000 acre grain operation. In addition to his other farm assets, the taxpayer owns two new combines which cost a total of $100,000. The taxpayer wishes to branch out from his grain operation into the custom combining business and proposes to transfer the two combines into a new corporation in exchange for stock in a section 351 nontaxable exchange.

Through the use of the above examples, this article will analyze the investment credit recapture provisions. In addition, this article will analyze the legislative and statutory authority for Revenue Ruling 76-514, outline the problems created, and propose alternative methods to avoid its pitfalls.

SECTION 47: INVESTMENT CREDIT RECAPTURE

Statutory Provisions

The investment credit provisions of the Internal Revenue

1. Rev. Rul. 76-514, 1976-2 C.B. 11.
2. I.R.C. § 47(b).
3. *Id.* § 351.

Code[4] begin with the general rule stated in section 38(a) that "[t]here shall be allowed, as a credit against the tax imposed by this chapter, the amount determined under subpart B[5] of this part."[6] Only the bare bones of this creature called the "Investment Credit" can be located in section 38. To locate the flesh, one must resort to section 46.[7] Section 46(a)(2) states that the amount of the allowable credit under section 38 shall be equal to ten percent of the qualified investment as defined in subsection (c) of section 46.[8] Subsection (c) states that the term "qualified investment" means for any taxable year, the basis of each new section 38 property[9] placed in service having a life of at least three years, subject to a reduction in the basis by 1/3 where the useful life is five years or more but less than seven years, and a reduction by 2/3 where the useful life is three years or more but less than five years.[10] To further narrow the property constituting a "qualified investment", section 48(a)(1)[11] provides generally that "Section 38 Property" means tangible personal property or other tangible property not including a building or its structural components, provided that the property falls within a defined useage set forth in section 48(a).[12]

In the grain operation example above, assuming a ten year useful life for all assets, the total qualified investment would be $125,000[13] which produces a total allowable investment credit of $12,500. In the custom combine example, under the same assumptions, the total qualified investment in combines would be $100,000, and the allowable investment credit would be $10,000.

Concurrent with the adoption of sections 46 and 48, Congress passed a provision to prevent possible abuse and misuse of the investment credit provision. Section 47 provides generally that if any property upon which the investment credit was taken is disposed of prior to the end of the period on which the credit was based, or otherwise ceases to be section 38 property, then the tax for the year of disposition or cessation will be increased by the difference between the credit as originally taken and the credit as

4. *Id.* §§ 38, 46-48.
5. *Id.* §§ 46-48.
6. *Id.* § 38(a) (footnote added).
7. I.R.C. § 46.
8. *Id.* § 46(a)(2).
9. *See* the text accompanying notes 11 & 12 *infra*.
10. I.R.C. § 46(c).
11. *Id.* § 48(a)(1).
12. Section 38 property includes depreciable tangible personal property or other tangible property (not including a building and its structural components) but only if such property is used as an integral part in the manufacturing, production, or extraction process of a business and storage facilities for fungible commodities. In the farming context, section 38 property includes "single purpose agricultural or horticultural structures," I.R.C. § 48(a)(1)(D), and livestock, *id.* § 48(a)(6). *See generally* J. WHEELER, TAX DESK BOOK FOR FARMING AND RANCHING ¶ 601 (2d ed. 1978).
13. The computations for "qualified investment" and the corresponding investment credit are, of course, determined separately for each asset. For purposes of these examples, the computations have been lumped together.

determined for the period up to the time of the disposition or cessation.[14]

In the above examples, if the irrigation systems and farm machinery were disposed of or otherwise ceased to be section 38 property after only five years, a recapture would result. For the five years in which the property was section 38 property, the applicable percentage would become 33 1/3 percent instead of 100 percent, the qualified investment would only be $41,333, and the allowed investment credit would be $4133. The difference between the credit as taken, and the credit as determined for the period up to the time of disposition or cessation, or $8467, is recaptured. Likewise in the custom combine example, if the combines were disposed of or otherwise ceased being section 38 property after six years, a recapture would result. The recomputation would result in an applicable percentage of 66 2/3 percent, a qualified investment of $66,667, and an investment credit of only $6667. The recaptured credit would increase the current year tax liability by $3333.

In common with most sections in the Internal Revenue Code, this section too contains an exception to the general rule. Section 47(b)[15] sets forth four circumstances in which a disposition or cessation will not result in recapture of the investment credit. The first exception states that a transfer by reason of the death of the taxpayer will be disregarded for purposes of section 47(a).[16] Second, section 47(b)(2)[17] provides that a transfer of property by a corporation to a second corporation in a reorganization to which section 381(a)[18] applies will avoid the recapture provisions. Third, recapture will not occur in a transfer to which section 374(c)[19] applies.[20]

Finally, the fourth exception to the recapture treatment under section 47 arises where there is found to be a "mere change" in the form of conducting a trade or business:

> [P]roperty shall not be treated as ceasing to be section 38 property with respect to the taxpayer by reason of a mere change in the form of conducting the trade or business so long as the property is retained in such trade or business as section 38 property and the taxpayer retains a substantial interest in such trade or business.[21]

At first blush, section 47(b) would appear to require only that (1) the property is retained in such trade or business as section 38 property, and (2) the taxpayer retains a substantial interest in such trade or business. Exactly what was contemplated, however, is not as clear.

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14. I.R.C. § 47(a).
15. *Id.* § 47(b).
16. *Id.* § 47(b)(1).
17. *Id.* § 47(b)(2).
18. *Id.* § 381(a).
19. *Id.* § 374(c), relating to exchanges under the final system plan for Con Rail.
20. *Id.* § 47(b)(3).
21. *Id.* § 47(b).

Regulations

In 1967, the Internal Revenue Service promulgated regulations under Section 47(b). The regulations state that a disposition will *not* occur by reason of a "mere change in the form of conducting the trade or business" provided *four* conditions are met:

> (a) The section 38 property . . . is retained as section 38 property in the same trade or business,
>
> (b) The transferor (or in a case where the transferor is a partnership, estate, trust or electing small business corporation, the partner, beneficiary or the shareholder) of such section 38 property retains a substantial interest in the same trade or business,
>
> (c) Substantially all the assets (whether or not section 38 property) necessary to operate such trade or business are transferred to the transferee to whom such section 38 property is transferred, and
>
> (d) The basis of such section 38 property in the hands of the transferee is determined in whole or in part by reference to the basis of such section 38 property in the hands of the transferor.[22]

Subsections (a) and (b) constitute a restatement of the statute. They correctly carry forward the principal limitations sought necessary to prevent the misuse of the investment credit. Subsection (d) is likewise consistent with section 351 by providing that to fall within the exception, there must be a carry over in basis from transferor to transferee. The object of subsection (d) is to prevent the purchase of an asset and the taking of investment credit thereon by the transferor, and the immediate transfer of that asset to a corporation in a transfer which constitutes a "mere change in the form of conducting the trade or business" but which does not qualify as a nontaxable exchange. If the transfer does not qualify under section 351, the corporation takes its cost for the asset as its basis. In the absence of subsection (d), a transfer of assets may satisfy the tests of subsections (a), (b), and (c), and not result in recapture by the transferor, but yet be claimed as a "purchase" by the corporation if the transaction does not satisfy section 351 control requirements. In such a case, the corporation may attempt to claim an investment credit on this "used section 38 property" resulting in a credit taken twice for the same asset. By requiring the transferee-corporation to take a carryover basis, subsection (d) is designed to prevent this situation by making it necessary to qualify under section 351 to avoid recapture. Arguably, however, subsection (d) is not necessary because of the definition of "purchase" contained in sections 48(c)(3)(A)[23] and 179(d)(2),[24] and the control provisions of sections 351 and 368(c).[25] Subsection

22. Treas. Reg. § 1.47-3(f)(1)(ii) (1967).
23. I.R.C. § 48(c)(3)(A): "The term 'purchase' has the meaning assigned to such term by section 179(d)(2)."
24. *Id.* § 179(d)(2).
25. *Id.* § 368(c). Control is defined as "the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock

(d) bolsters these limitations and, in common with subsections (a) and (b), is therefor not an unwarranted extension of the legislative intent to prevent abuses of the investment credit. The problem arises, however, under subsection (c).

The Treasury Department in drafting their regulations, chose to adopt a position that "substantially all" of the properties, both section 38 and non-section 38, of the trade or business must be transferred to avoid recapture. This is a third limitation in addition to the requirement that the section 38 property be retained in the trade or business and that the transferor retain an interest in the business. The Department accomplished this by defining a "mere change" to include a transfer of "substantially all" the properties constituting the business activity. The legislative history does not appear to imply the addition of this "substantially all" requirement.

Legislative History Behind Section 47(b)

The investment credit was first passed in 1961[26] in order to provide an incentive for investment by business in an otherwise sluggish economy. To prevent possible abuses of the credit, Congress also passed the recapture provisions,[27] which were designed to prevent the claiming of multiple credits through a quick turnover of assets.[28] and the claiming of credit by one not eligible to receive such a credit.[29] Section 47(b)[30] provided several exceptions to the recapture tax, one being when there was a "mere change in the form of conducting the trade or business."[31]

Section 47(b) and the House and Senate Reports list only two requirements that must be met to qualify for the exception:

> [P]roperty shall not be treated as ceasing to be section 38 property . . . by reason of a mere change in the form of conducting the trade or business so long as [1] the property is retained in such trade or business as section 38 property and [2] the taxpayer retains a substantial interest in such trade or business.[32]

The Senate Report goes on to say that "[o]n the occurrence of any event which results in a failure to meet *either of the conditions de-*

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entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation."

26. Revenue Act of 1962, Pub. L. No. 87-834, § 2, 76 Stat. 966 (1962).

27. I.R.C. § 47. *See* text accompanying notes 4-21 *supra.*

28. H.R. REP. NO. 1447, 87th Cong., 2d Sess., 1962-3 C.B. 402, 417; S. REP. NO. 1881, 87th Cong., 2d Sess., *reprinted in* [1962] U.S. CODE CONG. & AD. NEWS 3297, 3320.

29. *See* I.R.C. § 48(c)(1):

> Property shall not be treated as "used section 38 property" [*i.e.*, the taxpayer will not be eligible for the investment credit] if, after its acquisition by the taxpayer, it is used by a person who used such property before such acquisition (or by a person who bears a relationship described in section 179(d)(2)(A) or (B) to a person who used such property before such acquisition).

30. *Id.* § 47(b).

31. *Id.*

32. *Id.*

scribed above . . ."[33] the property will cease to be section 38 property. This direct language of the Report and the unambiguous language of section 47(b) indicate that Congress intended only two conditions be met, not four as the Treasury Department's regulations require.[34]

Upon initial analysis, the "mere change" exception would appear to be aimed at permitting the avoidance of investment credit recapture when section 38 properties continue in the same trade or business with the same owners only a slightly altered business structure. Had the legislative history ended here, then those seeking to interpret this section would have only two questions to resolve. First, what is the trade or business in which the section 38 property was being used prior to the change? An answer to this question could be fashioned from sections 162, 165, and 172 of the Internal Revenue Code as possible guides, for unfortunately no where is the term *trade or business* defined in the Code.[35] The second question is what percentage of interest must the transferor retain to fall within the exception? Here some guidelines do exist within the Reports themselves. Congress indicated that at a minimum, the transferor must maintain at least as great an interest in the trade or business after the transfer as before.[36]

In addition to the same trade or business and substantial interest requirements, the Senate Report states that

> in determining whether the property ceases to be section 38 property before the close of its estimated useful life, the period the property was held as section 38 property before the mere change in form of conducting the trade or business will be tacked on to the period beginning with the change in form and ending with the [disposition of the section 38 property.][37]

This limitation requires the transferee in a change of form transfer to hold the asset until the end of its useful life to avoid a recapture. Thus, these three limitations would appear to successfully curb the multiple asset turnover problem so feared by Congress.

The Senate and House Reports go on, however, to address themselves specifically to the incorporation process. The Reports state that

> "a mere change in the form of conducting the trade or business" (whether through incorporation, the formation of a partnership, or otherwise) applies only to cases where the *properties of a trade or business* are *transferred*. Thus, the transfer of section 38 assets to a newly formed corporation in a transaction to which section 351 applies will not fall within the scope of the exception unless the transaction involves the *transfer* of the *trade or business* in which

33. S. REP. NO. 1881, *supra* note 28, at 3453 (emphasis added).
34. Treas. Reg. § 1.47-3(f)(1)(ii) (1967). *See* text accompanying note 22 *supra*.
35. Whitman, *Taxing Corporate Separation*, 81 HARV. L.R. 1194, 1211 (1968).
36. S. REP. NO. 1881, *supra* note 28, at 3453-54.
37. *Id.* at 3453.

such assets were used.[38]

The language above has been highlighed because it raises the crucial issue in analyzing section 47(b) and the regulations contained thereunder. As stated above, the House and Senate Reports together with section 47(b) set forth two conditions which must be satisfied to avoid recapture of investment credit. What is unclear, however, is whether the language contained in the Reports to the effect that a section 351 transfer would not fall within the general exception unless the "transaction involves a transfer of the trade or business in which said assets were used" creates a third exception to the operation of section 47(b) or merely serves to reiterate the initial conditions stated. One interpretation would be to place the emphasis in the initial sentence on the phrase "properties of a trade or business" and to interpret it to mean that all assets, not merely the section 38 assets, must be transferred. The latter sentence could then be read to mean that unless "*the* trade or business" is transferred, including both section 38 and non-section 38 assets, the exception does not apply. As will be seen later, this appears to be the approach taken in the regulations adopted by the Treasury.

A second interpretation exists which appears more consistent with section 351, the abuses sought to be curbed by section 47, and the language of the House and Senate Reports. Section 351 provides that no gain or loss should be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock and securities in such corporation if immediately after the exchange, the transferors own eighty percent of the total number of shares of all classes of stock and eighty percent of the combined voting power of all classes of stock entitled to vote.[39] The purpose of section 351 is to permit avoidance of any gain upon the incorporation of a new business or the restructuring of an existing one where the same persons are in substantial control after as before the transfer. The intent is, therefore, quite similar to that permitting avoidance of recapture of investment credit where a mere change in the form of doing business has occurred.

Turning again to the language of the Senate Report set out above,[40] it would appear that emphasis in the initial sentence should be on the word "transferred." Arguably, Congress in 1961 was not concerned with the mere restructuring of the business through a change in form. However, Congress was concerned with a multiple turnover in assets in an attempt to claim multiple credits and an attempt to claim the credit by a party not qualified to receive the investment credit.[41] By permitting the transfer of assets to the corporation without a recapture while, by negative inference, denying the credit upon the purchase of assets by the

38. *Id.*; H.R. REP. No. 1447, *supra* note 28, at 513 (emphasis added).
39. I.R.C. § 351(a).
40. *See* text accompanying note 38 *supra*.
41. *See* note 29 *supra*.

corporation from a person who controls the corporation, the Legislature was being internally consistent with the related provisions of the Code that deny investment credit where the seller and purchaser maintain disqualifying relationships.[42] Using this interpretation, the second sentence, which is prefaced by the use of the coordinate conjunctive "thus", begins to resemble more of a restatement of the general intent and purpose, than the pronouncement of a third criterion that must be met to avoid recapture. Under this reading, the emphasis is upon the "transfer" requirement of the trade or business and, specifically the section 38 properties; the section 38 properties must be transferred to the corporation, not purchased by the corporation. This interpretation is advantageous as it permits a logical continuity to exist between section 47 and section 351. In addition, it is consistent with the congressional intent to permit tax free incorporation with a minimal amount of tax problems. Finally it is consistent with the abuses sought to be eliminated. Unfortunately, the regulations chose not the latter approach, but the former, and its imposition of a quantitative analysis as to the assets retained by the taxpayer and the assets transferred into the corporation.

REVENUE RULING 76-514

Between 1962 and 1976, neither Congress nor the Treasury Department had occasion to amend either the statutory language of section 47(b) or the regulations contained thereunder. No judicial decisions arose to challenge the Service's interpretation of the Senate Report. In 1976, however, in Revenue Ruling 76-514,[43] the Service held that a dentist was subject to recapture of investment credit on all of his section 38 properties when he transferred into a corporation, pursuant to section 351, the personal property of the business while retaining the real property personally outside of the corporation. Revenue Ruling 76-514 set forth for the first time the interpretation of Regulation section 1.47-3(f)(ii)(c) feared by many business planners.

Facts

In Revenue Ruling 76-514, taxpayer A operated a dental practice, owning the dental and office equipment as well as a building devoted *exclusively* to housing the dental practice. In 1973, the taxpayer, for reasons not set out in the Ruling, chose to incorporate the practice. At that time, the dental and office equipment constituted seventy percent of all assets owned by and used in his business and the building thirty percent. Taxpayer A transferred only the dental and office equipment into the corporation in a transaction qualifying for non-tax treatment under section 351 of

42. *See* I.R.C. §§ 48(c)(1), 179(d)(2)(A) or (B) & 267(b). *See also* note 29 *supra*.
43. Rev. Rul. 76-514, 1976-2 C.B. 11.

the Internal Revenue Code. The corporation then leased the building from taxpayer A on an annual basis for its fair rental value. The Ruling points out that taxpayer A was at all times in control of the corporation. Furthermore, the taxpayer retained and used the transferred properties in the incorporated dental practice, some of which constituted section 38 property. The issue presented was whether this transfer constituted a disposition so as to require recapture under section 47(a) as being other than a mere change in the form of doing business.

Holding

The Ruling initially sets forth the general provisions of section 47(a) to the effect that where section 38 property is disposed of or ceases to be section 38 property with respect to the taxpayer before the close of the useful life on which the credit was computed, recapture of the excess investment credit will result. The Ruling then points out and enumerates the exceptions under section 47(b) and cites the regulations[44] as authority for what constitutes a mere change in the form of conducting the trade or business.

The Service then attempts to determine what "trade or business" is being conducted prior to the transfer. The Ruling states:

> Before these criteria may be applied to a particular transaction, it is necessary to determine what trade or business, or trades or businesses, the taxpayer is conducting. In the present case, the taxpayer is conducting a single trade or business relating to the practice of dentistry. The building in which that business is housed is part of the dental practice and not part of a separate trade or business. *Compare* examples (2), (3), and (4) of section 1.355(1)(d) of the regulations.[45]

After determining that only one trade or business existed prior to the transfer, the Ruling discusses whether "substantially all of the assets . . . necessary to operate the trade or business" have been transferred to the controlled corporation. The Ruling cites *R. & J. Furniture Co.*,[46] *Dixie Portland Flour Co.*,[47] and *Daily Telegram Co.*[48] as authority for the fact that the term "substantially all" is basically a case by case determination. The Ruling points out that the particular situation must be reviewed before and after the transfer to determine whether all of the assets necessary to operate the trade or business have been transferred. Had the taxpayer not owned the building or operated under a long term lease, the Ruling postulates that the transfer of only the dental and office equipment would have constituted "substantially all of the assets" of the trade or business. However, the Ruling quickly states that

44. Treas. Reg. § 1-47-3(f)(1)(ii) (1967).
45. Rev. Rul. 76-514, *supra* note 43, at 12.
46. 20 T.C. 857 (1953), *rev'd on other grounds*, 221 F.2d 795 (6th Cir. 1955).
47. 31 T.C. 641 (1958).
48. 34 B.T.A. 101 (1936).

the taxpayer did in fact own the building; therefore, the building was part of the individual's dental practice and necessary to operate "the incorporated dental practice *in the same manner* as before the transfer".[49] The Service then points out that the value of the building in the present situation represented thirty percent of the total value of the dental practice prior to incorporation and therefore from a quantitative approach, the transfer could not constitute substantially *all* of the assets necessary to operate the dental practice.[50] The Ruling concludes by finding that subparagraph (c) of Regulation section 1.47-3(f)(1)(ii) had not been met and therefore recapture of investment credit would result upon all of the section 38 property transferred to the corporation.[51]

SECTION 355 v. REVENUE RULING 76-514

Initially, one might ask why the dentist pursued this course of planning and thus placed himself in this unenviable position. He may have been attempting to pull earnings out of the corporation by having the corporation lease the building from him at a minimal tax cost to himself and the corporation. While the rent would constitute income to himself, the payment would nevertheless be deductible to the corporation as a trade or business expense under section 162.[52] Had the building gone into the corporation, distributions out of the corporation would be taxable as a dividend or redemption until such time as all earnings and profits had been exhausted.[53] Only after this point had been reached, would distributions be nontaxable as a return of invested capital.

A second reason why he may have desired to retain the building personally would be a desire to dispose of the dental practice at some future point but continue to own and rent the physical structure. Rental income would have no adverse affect at that time on any social security payments as they would not constitute earned income for self-employment purposes.[54] Additionally, the taxpayer may have been unsure as to whether or not to incorporate. To place the building into the corporation at its tax basis, followed by a liquidation at its fair market value, would have been very costly.[55] As a general rule, most forms of liquidations result in some tax exposure.[56]

Many income and estate considerations beyond the scope of this article may have had some influence on the decision whether to transfer or retain the building. Setting aside the motives behind the taxpayer's action, the issue unanswered is whether the Service

49. Rev. Rul. 76-514, *supra* note 43, at 12.
50. *Id.*
51. *Id.*
52. I.R.C. § 162.
53. *See id.* §§ 301, 302.
54. *Id.* § 1402(a)(1).
55. *Id.* §§ 331, 1001.
56. *See id.* § 333, as an exception to this general rule.

was correct in determining that the transfer constituted a cessation or disposition of section 38 property so as to fall outside the protection of section 47(b).

At the outset, it should be pointed out that it is pivotal to the Service's position in Revenue Ruling 76-514 that a single trade or business exist. As discussed above,[57] whether or not Congress intended one hundred percent transfer of the assets in the trade or business to avoid the recapture provisions, is questionable. However, assuming the validity of the Service's interpretation of the Senate and House Reports and the statute, it becomes crucial to determine those assets constituting "the trade or business" being transferred. The Service, at this point, chose to define "trade or business" by reference to section 355,[58] a section concerned not with the general treatment of that phrase, but rather with the distribution of corporate assets to its shareholders.

Section 355 states that if a corporation, referred to as the distributing corporation, distributes to a shareholder or to a security holder, stock or securities of a controlled corporation, then no gain or loss will be recognized to the shareholder or security holder upon receipt of the stock or securities provided two tests are met. First, no tax avoidance intent must be present. In other words, corporation A which owns asset X may transfer asset X into a wholly owned subsidiary of corporation A and distribute the stock of the subsidiary to a shareholder of corporation A. The shareholder would report no gain or loss on the transfer provided the transaction is not used principally as a device for pulling earnings out of the corporation. Such a tainted purpose would be found, however, if an arrangement or an agreement existed prior to the distribution of the stock of the subsidiary whereby the stock of the distributed corporation would be sold or exchanged immediately following the distribution.[59] The absence of any tax avoidance motive, then, becomes the first element under section 355.

The second crucial test relates to the active business requirement. Section 355(b)[60] states that the non-recognition treatment will be available only if the distributing corporation and the controlled corporation are engaged in the active conduct of a trade or business throughout a five year period ending on the date of distribution and each is engaged immediately after the distribution in the active conduct of a trade or business. Neither the term "active business" nor the phrase the "active conduct of a trade or business" is defined by the Internal Revenue Code.[61] However, the intent of the active business requirement is to prevent the spin-off of passive or investment related assets which would subsequently be passed down to the shareholders of the controlled corporation pur-

57. *See* the text accompanying notes 26-42 *supra*.
58. I.R.C. § 355.
59. Treas. Reg. § 1.355-2(b) (1960).
60. I.R.C. § 355(b).
61. MERTENS, LAW OF FEDERAL INCOME TAXATION § 20.103 (1972).

suant to a liquidation, thereby converting ordinary dividend income into capital gains.[62]

Section 355, therefore, is a specific statute aimed at accomplishing a specific purpose, namely, to prevent the bail out of corporate assets and thus corporate earnings *without* taxation. To assist its purpose, the term "trade or business" as used in that context is extremely narrowly defined. The regulations state that:

> *for 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. It does not include—
>
> (1) The holding for investment purposes of stock, securities, land or other property, . . . ,
>
> (2) The ownership and operation of land or building all or substantially all of which are used and occupied by the owner in the operation of a trade or business, or
>
> (3) A group of activities which, while a part of a business operated for profit, are not themselves independently producing income even though such activities would produce income with the addition of other activities or with large increases in activities previously incidental or insubstantial.[63]

When such a definition of a "trade or business" is paired against the examples contained in that section, the point sought to be illustrated becomes clear. In example two, the regulations state:

> Corporation B is engaged in the business of manufacturing and selling hats in its own factory building. It proposes to transfer the factory building to a new corporation and distribute the stock of such new corporation to its shareholders. The activities in connection with the manufacturing of hats constitute a trade or business; but the operations of the factory building does not.[64]

If the factory building does not have an independent, viable income producing activity of its own, the distribution of the factory building, totally dependent upon the manufacturing corporation for its rental income, begins to look like a passive investment and thus a vehicle for pulling out earnings of the manufacturing corporation.

Example three in the regulations[65] concerns a bank owning an eleven story office building, the ground floor of which is occupied by the bank in its banking related activities. The remaining ten floors were rented to various tenants. The ten remaining floors are rented, managed and maintained by the real estate department of the bank. The transfer by the bank of the building to a new corpo-

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62. *Id.*
63. Treas. Reg. § 1-355-1(c) (1960).
64. *Id.* Example (2).
65. *Id.* Example (3).

ration with a subsequent distribution of the stock to the bank shareholders, would result in nonrecognition treatment upon receipt of the stock by the shareholders for the reason that the banking activities and the rental activities constitute separate trades or businesses. This can be compared to example four of the regulations[66] in which a bank owned a two story building using one and one half floors for its banking activities and renting out the remaining half to a neighboring retail merchant. The proposal to transfer the building to a new corporation and to distribute the stock to the bank's shareholders would not result in nonrecognition treatment because the rental activity was incidental to the operation of the bank and as such did not constitute a separate active trade or business.

The purpose of these illustrations are not, as asserted by Revenue Ruling 76-514, to define the existence of a single versus a multiple business activity nor to make a general statement as to what constitutes a trade or business. Rather, the examples under section 355 are aimed at illustrating what constitutes an "active" trade or business as opposed to a passive trade or business, the latter of which Congress felt prone to abuse by those seeking to spin-off investment-related assets from a corporate entity and later liquidate them at capital gains rates, thus avoiding taxation at the corporate level and later as dividends. The injection therefore of the "active business" test of section 355, as set forth in the illustrations, is both without basis in either the statute or the legislative history to section 47(b) and only serves to confuse the Service's reasoning.

QUANTITATIVE APPROACH UNDER REVENUE RULING 76-514

If it is accepted for the moment that the building, office and dental equipment constituted the entire parameters of the "trade or business," the Ruling proceeds to define whether "substantially all" of the assets constituting the trade or business and necessary to operate the trade or business have been transferred. Two cases are cited in the Ruling for the proposition that the determination of what constitutes substantially all of the property is a case by case determination. In *R. & J. Furniture Co.*,[67] an Ohio partnership was organized in 1932 to operate a furniture business. Initially, the partnership rented the physical facilities; it appears, however, that sometime prior to May 1940, the partnership acquired a fee interest in the land and building. On May 29, 1940, the partnership transferred to R. & J. Furniture Co., a corporation, assets having a value on the books of the corporation of $334,692 and liabilities of $118,692. The real estate, having a book value at the time of incorporation of $59,457, was retained by the partnership.

At the first meeting of the Board of Directors on May 31, 1940,

66. *Id.* Example (4).
67. 20 T.C. 857 (1953), *rev'd on other grounds*, 221 F.2d 795 (6th Cir. 1955).

the corporation authorized its officers to enter into a lease with the fee owners of the property for such terms and upon such conditions as the parties may mutually agree upon. Subsequently, on June 1, 1940, R. & J. Furniture Co. acquired possession as a lessee of all of the real estate owned by the partnership. The terms of the net lease required R. & J. Furniture to make monthly payments of $1000, the payment of all water, gas and electric bills, payment of all expenses incurred in repairing and maintaining the property, payment of all special assessments levied against the property, and the insuring at all times the buildings and its contents. The lease was for an initial period of five years with the right on the part of the lessee to extend the lease for ten successive renewal periods of five years each. The opinion states that the useful physical life of the building as of June 1, 1940, was less than the fifty-five years, the term of the lease plus extensions. It appears that at all times material, R. & J. continued to occupy the physical structure and make the payments required under the terms of the lease.

This particular litigation dealt with the computation of the excess profits credit.[68] This credit was based partially upon a percentage of the average base period net income for the corporation. However, a related section[69] permitted the corporation, in determining average base period net income, to tack on the earnings of a partnership, the assets of which were acquired by the corporation if "substantially all of the properties of the partnership" had been acquired pursuant to an exchange under section 112(b)(5).[70] One of the issues, therefore, was whether the retention of the fee interest by the partnership resulted in less than "substantially all of the assets" being acquired by R. & J.

The tax court pointed out in its opinion that the only asset of the partnership not so transferred was the fee interest in the real estate owned and occupied by the partnership. The court stated, however, that:

> [t]he real estate, the fee to which was thus retained by the partnership, was leased to petitioner [R. & J. Furniture Co.] and used by it in its business. Under this lease, petitioner had the right to possess, occupy, and use such real estate for a period of 55 years, or for a longer period than the useful physical and economic life thereof. Leaseholds for such an extended period of time have been administratively classified in Regulations 111, section 29.112(b)(1)—1, and the predecessors thereof, as property of a like kind with and the equivalent of a fee in real estate within the

68. Excess Profits Tax Act of 1940, ch. 757, title II, § 201, 54 Stat. 975 (1940) (codified at Int. Rev. Code of 1939, ch. 2, §§ 710-36) (repealed, Revenue Act of 1945, ch. 453, title I, § 122, 59 Stat. 568 (1945)). The excess profits tax under the 1939 Code in the present case was applicable for tax years beginning after December 31, 1939 and before January 1, 1946 and was a limitation on excess corporate profits during World War II. The computation, however, permitted a credit against the tax computed based either on the average earnings for the base period 1936-1939 or the invested capital of the corporation.

69. Int. Rev. Code of 1939, ch. 2, § 742, 54 Stat. 975.

70. Int. Rev. Code of 1939, ch. 1, § 112(b)(5), 52 Stat. 485 (now I.R.C. § 351).

> purview of the taxing statute. . . . Thus, it appears that petitioner acquired a leasehold interest in the property, the bare fee of which was retained, and, which, if not the equivalent of a fee, constitutes substantially all of the partnership's interest therein.[71]

This case was followed by and subsequently cited by *Dixie Portland Flour Co.*[72] Here, too, the tax court was concerned with whether a corporation would be permitted to include within its average base period income, for purpose of the excess profits credit, the earnings of the partnership for which it acquired the assets. In *Dixie*, the factual situation was a bit more involved.

Majestic Flour Mill, hereinafter referred to as Majestic, was a Tennessee partnership owning shares of stock in the petitioner, Dixie Portland Flour Company. On May 29, 1942, Majestic agreed to sell to petitioner all current assets and to lease certain fixed assets for various lengths of time. On May 31, 1942, Majestic transferred to petitioner all current assets having a value of $391,557 consisting of cash, receivables, inventories, bonds and expense funds. In addition, the petitioner assumed liabilities of approximately $124,075 and issued back to Majestic a ten year debenture note in the amount of $267,482. Majestic retained, however, certain physical assets having an adjusted book basis of $166,623 consisting of land, buildings, machinery and equipment, office equipment, automobiles and trucks. Majestic then leased these fixed assets to the petitioner for periods ranging from five years for the real property and ten years for the personal property. It appears that in 1942, Majestic sold a portion of the buildings, machinery, and equipment then under lease to petitioner to an outside party for cash. Subsequently, the remaining real property and additional parts of the buildings, machinery and equipment under lease were sold to a fourth party. Petitioner itself in 1942 and 1943 also acquired ownership of certain machinery and equipment. Finally, the remaining buildings and equipment under lease were sold to a fifth party in November of 1944.

The petitioner initially asserted that the transactions commencing May 31, 1942, and continuing through November, 1944, constituted a single acquisition and that therefore "substantially all" of the assets had been acquired. The tax court was unable to find that the multiple transactions were in any way related or constituted integrated steps in an indivisible transaction. Rather, the court noted that approximately thirty percent of the total assets were retained by Majestic originally. In addition, the effective life of the two leases after the ultimate disposition of all of the assets owned by Majestic was less than two years. Finally, the court stated that even if all of the various transactions were assumed to fall under an overall plan, petitioner failed to demonstrate that it had acquired "substantially all of the properties" for the reason

71. R. & J. Furniture Co., 20 T.C. 857, 865 (1953).
72. 31 T.C. 640 (1958).

that most of the fixed assets were ultimately sold to outside parties and only the cash was transferred to petitioner by Majestic. The debentures ultimately received back by Majestic, then, were more in the nature of a loan rather than an exchange of securities. The court simply refused to find that this rather complex series of transactions resulted in the acquisition by the petitioner of "substantially all" of the assets.

As stated earlier, these two rather obscure cases are cited in Revenue Ruling 76-514 only for the proposition that it is a case by case determination of whether or not "substantially all" of the assets have been transferred. The Ruling provides no guidelines to follow nor does it make any comparisons with comparable provisions in the Internal Revenue Code. For example, the Service could have looked at Regulation section 1.337-2(b)[73] that states that a plan of complete liquidation may be informally adopted when "substantially all" of the assets are sold. Likewise, the Service could have analyzed the requirement in section 354(b)(1)(A)[74] that the transferee corporation must acquire "substantially all" of the assets of the transferor corporation as part of a section 368(a)(1)(D)[75] reorganization. In addition, "substantially all" of the assets of another corporation must be acquired in a Type C reorganization.[76] In short, these provisions, and others that contain "substantially all" language,[77] could have been analyzed in order to establish guidelines in the Revenue Ruling.

PLANNING AFTER REVENUE RULING 76-514

The analysis of the legislative background to section 47(b) as interpreted by the Internal Revenue Service reveals that major hurdles do exist to the transferring of less than all of the assets constituting the trade or business into a corporation pursuant to section 351. The Senate and House Reports reflect an intent of Congress, however subtly stated, to permit incorporation pursuant to section 351 without recapture of investment credit. This is not the position accepted by Revenue Ruling 76-514. However, the Ruling does offer at least two courses of conduct that may continue to make the retention of the property outside the corporation a viable alternative.

In Revenue Ruling 76-514, reliance is placed on *R. & J. Furniture Co.* and its discussion regarding what constitutes "substantially all" of the properties needed to be transferred. In *R. & J.*, the corporation, through the use of a long term lease, successfully maintained that, in effect, all of the assets continued to be used in the trade or business both before and after the transfer. In that particular case, the leases with their attendant options extended

73. Treas. Reg. § 1.337-2(b) (1960).
74. I.R.C. § 354(b)(1)(A).
75. *Id.* § 368(a)(1)(D).
76. *Id.* § 368(a)(1)(C).
77. *See e.g.*, Treas. Reg. § 1.381b-1(b) (1960).

the lease for a period in excess of the useful life of the real property. *R. & J.* cites *Century Electric Co.*[78] as authority for its proposition that a long term lease can constitute a fee interest in real property. *Century Electric* similarily involved a long term lease. The court cited as authority Regulation section 1.1031(a)-1(c) for the proposition that the tax laws construe a thirty year or longer leasehold to be the equivalent of a fee interest at least for purposes of like kind exchange treatment.[79] In the grain operation example above,[80]a long term lease would very easily be utilized to give the corporation, in effect, a fee interest in the land that would also give it "substantially all" of the farm assets. If in fact, therefore, the fatal aspect of the dentist in Revenue Ruling 76-514 was the entering into an annual lease as opposed to a long term lease with options, the Service is remiss in failing to provide some guideline in the ruling itself.

If the use of a long term lease is not feasible or desirable, a second alternative remains available to avoid the recapture threat. As alluded to above, the pivotal consideration under the ruling and under the statute is the parameters of the "trade or business" being transferred into the corporation. If multiple activities can be shown to exist, then the incorporation of one activity would have no bearing for investment credit recapture purposes on the retention of the second activity. The Senate and House Reports themselves set forth the example of a manufacturing firm concurrently engaged in a personal service business and seem by implication to recognize multiple activities being conducted by the same general entity.[81] In the farming context, multiple activities can generally be shown where there exists grain related activities in conjunction with livestock activities. The incorporation of the livestock activities while retaining the grain related activities should clearly be permissible because they represent individual and not necessarily related businesses. A grey area arises however where as part of the livestock operation, the agri-businessman attempts to transfer into the corporation bins, tractors, and other field machinery that arguably are tied more closely to the grain activities than the livestock activities. The obvious risk is that once the grain related activities have been defined, the transfer of the first asset related to these activities into the corporation will generate recapture if less than substantially all of the assets of that activity are similarily transferred. So also in the custom combine example above,[82] the taxpayer might possibly show that his combining activities are separate from his grain operation and thus qualify by transferring "substantially all" the assets, *i.e.*, the combines, to the corporation.

78. 15 T.C. 581, 192 F.2d 155 (8th Cir. 1951).
79. I.R.C. § 1031.
80. *See* the text following note 3 *supra*.
81. S. REP. NO. 1881, *supra* note 28, at 3454, Example 2.
82. *See* the text following note 3 *supra*.

CONCLUSION

If the intent of Congress is to avoid quick turnover of assets simply to obtain the investment credit or circumvention of the investment credit rules to permit a nonqualified party from obtaining an interest in the assets, the language of section 47(b) with related provisions would have been adequate. The confusion created by Congress' failure to delineate the applicability of section 47(b) in a situation involving section 351 has created an unnecessary trap and restriction in this area. The Service has further impeded planning in the area through their interpretation of congressional intent and the imposition of a "substantially all" test in their regulations. In this author's opinion, congressional action is required to clarify section 47(b) to make it clear that certain assets may be retained outside of the corporation without running afoul of section 47(a). The log jam now being created by Revenue Ruling 76-514 must be cleared.