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ACTION ON DECISION

Subject: Clark D. and Janis L. Pulliam v. Commissioner
Decision: August 12, 1997
Opinion: T.C. Memo. 1997-274

Issue:

Whether the distribution to a sole shareholder of the stock of a newly formed corporation qualified under I.R.C. § 355.

Discussion:

Clark D. Pulliam ("Pulliam") is the sole shareholder of Pulliam Funeral Homes, P.C. ("Homes"). Prior to January 1, 1992, Homes operated funeral homes in three Illinois towns, including Oblong. Pulliam asserted that in order to induce Earl L. Deckard ("Deckard"), a key employee, to remain at the Oblong location and to dissuade him from opening a competing facility, Pulliam reached an agreement with Deckard. Under the agreement, Homes would "spin off" to Pulliam a newly formed subsidiary, Pulliam-Deckard Funeral Chapel, P.C. ("Chapel"), containing the Oblong assets, and Pulliam would then sell 49% of the Chapel stock to Deckard. The transaction was effective as of January 1, 1992.

On his tax return for 1992, Pulliam did not report any income or gain in connection with the distribution of the Chapel stock to Pulliam. The Service determined that the distribution of the Chapel stock was taxable to Pulliam as a dividend.

In the Tax Court, the Service argued that Homes' distribution of the Chapel stock to Pulliam did not qualify under section 355 because (1) there was no valid corporate business purpose for the distribution and (2) the transaction was used principally as a device for the distribution of earnings and profits ("E&P"). In addition, the Service argued that Homes (rather than Pulliam) should be treated as the seller of the Chapel stock under Commissioner v. Court Holding Co., 324 U.S. 331 (1945), and thus Homes did not have control of Chapel immediately before the distribution as required by section 355(a)(1)(A).

In holding for Pulliam, the Tax Court concluded that protecting Homes against competition from Deckard and retaining Deckard as a key employee were valid corporate business purposes, which were sufficiently compelling to overcome the substantial evidence that the distribution of the Chapel stock was used as a device for distributing E&P. The court rejected the Service's argument that Homes could have achieved the same purposes by

selling 49% of the Chapel stock directly to Deckard instead of distributing the Chapel stock to Pulliam. The court concluded that Pulliam reasonably believed Chapel had to be a professional corporation ("PC"), whose shares were held by licensed individuals, because the practice of funeral directing and embalming required a state license that could only be issued to individuals or a PC. An appeal on this issue was not pursued due to its factual nature.

Even if there were valid corporate business purposes for the distribution of Chapel to Pulliam, we disagree with the court's failure to recognize that there was still no corporate business purpose for Pulliam's post-distribution sale of Chapel stock to Deckard in lieu of a sale of shares by Chapel. Under section 355(a)(1)(B), "the transaction" cannot be used principally as a device for distributing E&P. Although Treas. Reg. § 1.355-2(d)(3)(ii) provides that a corporate business purpose for the transaction (not merely for the distribution) is evidence of nondevice, that purpose must outweigh evidence of device. The Commissioner's position is directly supported by Example 1 of Treas. Reg. § 1.355-2(d)(4), which the court inaccurately distinguished from this case on the ground that the key employee in Example 1 acquired stock in the distributing corporation instead of the controlled corporation. This finding ignores the express rule of Treas. Reg. § 1.355-2(d)(2)(iii)(A) that "a sale or exchange of stock of the distributing or the controlled corporation after the distribution . . . is evidence of device" (emphasis added). Thus, it makes no difference in Example 1 whether the key employee purchased stock of the distributing corporation or stock of the controlled corporation. Accordingly, the difference noted by the court between the facts of this case and those in the example is neither meaningful nor relevant, and, accordingly, the court should have applied Example 1 to Pulliam's sale to Deckard.

Even if the corporate business purposes of protecting against competition and retaining Deckard were sufficiently compelling to warrant the distribution of Chapel stock to Pulliam, those purposes could have been achieved by having Chapel sell stock to Deckard, thereby giving him the desired ownership interest. If Deckard acquired his stock directly from Chapel, the transaction would not have served as a device for distributing the E&P of Homes as capital gain since Pulliam would not have received any proceeds from the sale of the stock. The Service's briefs in this case, however, do not fully articulate this argument and, accordingly, the record would not support an appeal based on this argument.

The court refused to consider the Service's argument under Court Holding on the ground that it was raised untimely. The facts demonstrate, however, that it was prearranged for Pulliam

to make an installment sale of 49% of that stock to Deckard after the spinoff of the Chapel stock. Accordingly, Homes should have been treated as the seller and thus lacked control of Chapel immediately before the distribution. See Court Holding; Rev. Rul. 96-30, 1996-1 C.B. 36, obs. (after § 1012 of Taxpayer Relief Act of 1997), Rev. Rul. 98-27, 1998-22 I.R.B. 4 (June 1, 1998).

Pulliam's pre-planned sale of the Chapel stock represents a classic device for distributing E&P, which the statute and regulations are designed to prevent. The Service will continue to determine that any similar transaction constitutes a device for the distribution of E&P and thus does not qualify under section 355.

Recommendation:

Nonacquiescence.

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Reviewers:

Approved: STUART L. BROWN
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By: _____
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