CORPORATIONS

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INTRODUCTION

As the businesses in a family-owned corporation mature, the family often wants to move one or more of the businesses out of the corporate shell. This chapter discusses four alternatives for dividing a corporation into separate entities. It illustrates the alternatives with a C corporation that has outlived its usefulness. For each of the alternatives, the tax consequences for both the corporation and the shareholders are discussed and illustrated.

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CASE STUDY: BASIC FACTS

CSR Enterprises, Inc. is a second-generation family corporation. The founder, George, had been a successful farmer who had incorporated his business in 1960. Over the years, he was lucky and resourceful. In the good years, he improved his farming operations by updating his buildings, equipment, and irrigation systems. During the tough economic times of the late 1970s, he acquired a hardware store in a nearby community. In the 1980s, he acquired a farm implement dealership. George's three children have reached adulthood, and each has taken an active role in one of the businesses.

- Caroline, the oldest, has taken over the hardware store, and has added appliances, kitchenware, and other home furnishings.
- Robert, the oldest son, has shown an aptitude for farming, and has assumed complete control over the farming operations after his father suffered a debilitating stroke.
- Scott, the youngest, has become involved in the farm implement dealership.

George used corporate funds, plus a conservative amount of debt, to acquire each new business. The farming corporation, CRS Enterprises, Inc. (CRS), acquired the assets of the hardware store and the implement company, and never put either business into a separate corporation.

Several years after his stroke, George died. His wife had predeceased him, and he left all of his property to his children, in three equal portions. At the time of his death, George owned all of the stock of CRS.

A condensed balance sheet of CRS at the current time follows. Note that the assets and liabilities are grouped by business segment. There are cash and marketable securities that are not connected to any particular segment. These accounts are shown in more detail later.

Assets	Basis	Value
Cash	$ 265,000	$ 265,000
Marketable securities	2,475,000	1,750,000
Farming operations	382,500	1,175,000
Hardware business	767,000	1,324,000
Implement dealership	2,207,250	4,785,000
Total	$6,096,750	$9,299,000
Liabilities and Shareholders' Equity		
Farm liabilities	$ 375,000	$ 375,000
Hardware liabilities	509,000	509,000
Implement liabilities	3,820,000	3,820,000
Total liabilities	$4,704,000	$4,704,000
Common stock	2,500	4,595,000
Retained earnings	1,390,250	
Total	$6,096,750	$9,299,000

All of the business operations use the accrual method of accounting. The corporation's accumulated earnings and profits are assumed to be $1,600,000, due to the differences between MACRS (modified accelerated cost recovery system) and earnings and profits depreciation rules. See later discussion of earnings and profits.

At the time of George's death, the total fair market value of the stock was $4,500,000. Thus, each shareholder has a basis of $1,500,000 in his or her stock.

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Within two years after George's death, the three siblings are starting to have some serious differences. They want to divide the business so that Caroline has sole control of the hardware business, Robert is in charge of the farm, and Scott takes complete responsibility of the implement dealership. We will assume that the division is instantaneous, and that all values given above are the same at the time of the distribution of the businesses.

The partial balance sheets for each business segment follow.

Farming Operations **Assets**	**Basis**	**Value**
Land	$ 2,500	$ 600,000
Buildings	185,000	250,000
(Depreciation)	(35,000)	
Equipment	550,000	175,000
(Depreciation)	(320,000)	
Unsold crops	0	150,000
Total assets	$382,500	$1,175,000
Liabilities and Equity		
Accounts payable, farm	$175,000	$175,000
Mortgage on farm	200,000	200,000
Total farm liabilities	$375,000	$375,000
Net equity	$ 7,500	$ 800,000

Hardware Store **Assets**	**Basis**	**Value**
Accounts receivable	$ 14,000	$ 14,000
Franchise	56,000	150,000
Inventory	297,000	430,000
Fixtures	347,000	220,000
(Depreciation)	(185,000)	
Building	220,000	285,000
(Depreciation)	(24,000)	
Land	42,000	75,000
Goodwill	0	150,000
Total assets	$767,000	$1,324,000
Liabilities and Equity		
Accounts payable, hardware	$185,000	$ 185,000
Mortgage on hardware store	324,000	324,000
Total hardware liabilities	$ 509,000	$ 509,000
Net equity	$258,000	$ 815,000

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Implement Dealership Assets	Basis	Value
Accounts receivable	$ 275,000	$ 275,000
Inventory (LIFO)	1,420,000	3,500,000
Fixtures	275,000	185,000
(Depreciation)	(172,500)	
Land	125,000	350,000
Building	327,500	475,000
(Depreciation)	(42,750)	
Total assets	$ 2,207,250	$ 4,785,000
Liabilities and Equity		
Accounts payable—inventory	$ 3,320,000	$ 3,320,000
Accrued expenses payable	225,000	225,000
Mortgage on land and building	275,000	275,000
Total implement liabilities	$ 3,820,000	$ 3,820,000
Net equity	($1,612,750)	$ 965,000

Note that the LIFO (last-in, first-out) inventory value of the implement dealership is quite low in comparison to the fair market value of the inventory. As a result of this valuation, this business segment has liabilities in excess of the adjusted basis of its assets, although the fair market value of the assets exceeds the liabilities by nearly $1 million.

NONTAX CONSIDERATIONS

The above case study describes a common problem in the family-owned business. After the founding generation is no longer involved, the younger generations often do not have the desire, ability, or inclination to be in the same business together. There may be family hostility, or just a difference in lifestyle or business philosophy, so the businesses may often be better off in other hands after the founders depart. A business that is plagued with shareholder feuds or incompetence may find that it loses substantial value in a short time if it remains under the power of family members.

If the business is not easily divisible while still treating the surviving family members equitably, the best course of action may be to find an outside buyer, who will make the acquisition before the value has substantially diminished. In this case study, there are three distinct businesses—one for each of the three surviving members of the family. Although the situation is not quite so convenient so that each of the business segments has identical value, there are enough investment assets in the corporation so that it will be possible to make an equitable distribution of the assets of the entire business—at least until the tax variables are considered.

TAX CONSIDERATIONS

In many situations, a controlling shareholder of a closely held corporation fails to distinguish corporate assets from his or her own personal funds. Assets are transferred at will, with little information or regard to the tax consequences. This casual attitude can be very costly in the complex world of taxation in the United States today. In most cases, it is a relatively easy matter to get property into a corporation, due to the tax-free incorporation and other property transfers permitted by I.R.C. §351. However, getting property back out of the corporation can be extremely costly. This chapter illustrates four different methods of getting property back out of the corporation. With each of these methods, there is a tax cost.

The case study used for illustration in this chapter is a C corporation. Thus, there can be a double tax cost to getting property out to the shareholders. The corporation may be liable for the tax on any gains on the appreciation of property it distributes. The shareholders may be subject to dividend or capital gain treatment for some or all of the proceeds. The final alternative discussed serves to defer tax

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by using a tax-free reorganization. However, the corporations that result from this transaction, as well as the shareholders therein, will be subject to some complex regulation and documentation requirements. They will also face certain basis problems. In general, the corporations involved will take a carryover basis in the assets of the business. The shareholders who receive stock in one or more corporations will not be able to boost basis. Finally, the shareholders will not be able to receive any property other than stock in corporations resulting from the transaction, unless they report taxable income or gains.

ALTERNATIVE STRUCTURES

Caroline, Robert, and Scott have several alternatives for splitting up the business. Some alternatives are much more expensive from a tax point of view than others.

1. **Dividend distribution:** Distribute the assets of the businesses out to the three individuals, keeping CRS in existence as a holding company, with all three of the shareholders retaining stock. This is discussed in the Dividend Distribution section of this chapter.
2. **Stock redemption:** Distribute the assets of two of the businesses out to two of the shareholders, who each surrender their CRS stock. CRS remains in existence with one business and one shareholder. See the Stock Redemption section of this chapter.
3. **Complete liquidation of the corporation:** Distribute the assets of each business to the shareholder who wants it. Then terminate CRS's existence. The Complete Liquidation of the Corporation section of this chapter covers this transaction.
4. **Divisive reorganization:** Divide the three businesses into three corporations while still under the CRS umbrella (using at least two new corporations). At this point CRS has three businesses in three corporations. Then distribute out the stock of each business to the shareholder who wants it. (The historic corporation could remain in existence as the owner of either the farm or the hardware operation, so that only two corporations would be distributed.) A brief overview of this complex topic is contained in the Divisive Reorganization section of this chapter.

Each of these alternatives has specific tax consequences. If the parties do not pay careful attention to the requirements of each alternative, they may find themselves with hefty, or even prohibitive, tax burdens. However, if they observe some rules carefully, they may be able to defer a large portion of or even the entire tax cost for the foreseeable future.

In general, the tax consequences of each of the four alternatives can be ranked from the likely to be most expensive to the likely to be least expensive. Of course, these can vary substantially according to the economics of the particular situation at hand. However, the usual expectation will be as follows:

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Ranking	Description	Explanation
Most expensive	Dividend distribution	Corporation must distribute out all (or most) of its assets. Corporation must recognize gain on appreciated assets, but no loss. Shareholders must report ordinary income to the full extent of the fair market value received, limited only to the corporation's accumulated earnings and profits.
Second	Stock redemption (may be less expensive than liquidation, since corporation does not distribute all of its assets)	Corporation does not need to distribute all assets. Corporation must recognize gain, but not loss, on the distribution of noncash assets. Shareholders may report dividend income or capital gain, and perhaps capital loss.
Third	Complete liquidation	Corporation must recognize gains, but may recognize loss, on the distribution of its assets. Corporation must distribute all assets. Shareholders will report capital gain or loss, but not ordinary income.
Least expensive	Divisive reorganization	Corporation does not recognize gain or loss on the distribution of stock in a subsidiary corporation, although it may recognize gain on distribution of boot. Shareholders do not report any gain except for boot. However, this alternative is by far the most complex, and has rigid pretransaction and posttransaction compliance requirements. It also entails a carryover of basis, which may result in gain at a later date.

DIVIDEND DISTRIBUTION ALTERNATIVE

There are several types of distributions, such as dividends, stock redemptions, distributions in complete liquidation of a corporation, or distributions of stock or other property pursuant to a tax-free reorganization. In some cases, a distribution in redemption or a distribution in a reorganization may receive tax treatment as a dividend. Thus, it is important to understand the effects and the definition of a dividend for federal income tax purposes.

For state law purposes, there may be a need to convene the directors and declare, authorize, and record a distribution before it may be classified as a dividend. The tax law, however, requires no such formalities. If a shareholder receives something of value from the corporation, and the receipt does not fall into another category, such as compensation, fringe benefits, or one of the other types of distributions discussed in this material, the treatment will generally be a dividend to the shareholder.

The general rule governing the shareholders who receive a dividend is that the shareholder reports ordinary income to the extent of cash and fair market value of non-cash property received [I.R.C. §§301(c)(1) and 61(a)(7)].

A distribution with no change in ownership of the corporation's stock is generally treated as a dividend. It would be chosen by a well-informed tax practitioner only in rare circumstances. However, it is the default rule governing corporate distributions, and will be the result if the parties do not develop a plan that considers the tax consequences.

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CASE STUDY: ADDITIONAL FACTS FOR DIVIDEND DISTRIBUTION ALTERNATIVE

Assume that CRS distributes the assets and liabilities of the farming business to Robert, those of the hardware operation to Caroline, and the implement dealership to Scott. The results to the shareholders of receiving these assets are as follows:

Shareholder	Value
Robert	
Farming assets	$1,175,000
Farm liabilities	(375,000)
Net dividend	$ 800,000
Caroline	
Hardware	$1,324,000
Hardware liabilities	(509,000)
Net dividend	$ 815,000
Scott	
Implement	$4,785,000
Implement liabilities	(3,820,000)
Net dividend	$ 965,000

CRS also distributes securities to Robert and to Caroline to equate their distributions with the higher business value received by Scott. Thus, every shareholder receives a total of $965,000 assets from the corporation.

BRIEF OVERVIEW OF TAX GOVERNING DIVIDEND DISTRIBUTIONS

A distribution of the assets as described above will be a dividend to each shareholder. Thus, each shareholder will report the fair market value of the assets received as gross income, to the extent of CRS's earnings and profits. CRS will get no deduction for the distribution of any of these assets. Moreover, CRS must recognize gain on each appreciated asset as if it were sold to the shareholder who receives it.

Each of the shareholders will report gross income for the net fair market value of the assets received. Note that there will be very little left in the corporation, especially if the corporation distributes the securities to equate the net fair market value of assets received by each shareholder.

The basis of any shareholder in his or her stock is likewise irrelevant, and stays with the CRS stock. Thus, these shareholders will all have high basis in a corporation that now has very few assets. Liquidation of the corporation at this time would result in a capital loss to each of the shareholders. Thus, they would have gross ordinary income to the extent of a dividend and a capital loss on liquidation.

This is a most unfortunate tax treatment, yet it may happen. If the shareholders decide to save money on tax advice, and merely deed each person his or her "portion" of the corporation's assets, the treatment will be the same as in this portion of the example.

ORGANIZATION OF DISCUSSION

In order to compute the tax consequences of the distribution to the shareholders, the corporation's earnings and profits must be calculated. To calculate earnings and profit, the corporation's gain, loss, and income taxes from the distribution must be calculated. Therefore, the following discussion of the tax consequences of the dividend distribution is organized as follows.

1. The statutory authority for dividend distributions is presented.

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2. The effects of the distribution on the corporation are explained. Gain, loss, and income taxes for the corporation are needed to compute its earnings and profit.
3. The rules for calculating earnings and profits are summarized. The earnings and profits are needed to determine the limit on treating the distribution as a dividend.
4. The tax consequences to the shareholders are discussed and calculated.
5. Each shareholder's basis in the distributed assets is discussed and calculated.

1. Statutory Authority for Dividend Distributions

I.R.C. §301 establishes a priority system for determining the treatment of a distribution to a shareholder. The portion that is deemed to be a dividend as defined in I.R.C. §316 is included in gross income. Under I.R.C. §316(a), the amount distributed is a dividend to the extent that it is out of the corporation's **earnings and profits** (**E&P**). For this purpose, E&P is

- Accumulated E&P (i.e., E&P accumulated **after** February 28, 1913, and before the current taxable year)
- Current E&P (i.e., E&P of the current taxable year) [I.R.C. §316(a)]

The amount of the distribution that is in excess of the corporation's E&P is a nontaxable return of capital to the extent of the shareholder's basis [I.R.C. §301(c)(2)]. The shareholder's basis is reduced by the nontaxable distribution. To the extent that the return of capital portion of the distribution exceeds the shareholder's basis, the amount is treated as gain from the sale or exchange of the underlying stock and thus is usually capital gain [I.R.C. §301(c)(3)].

A corporation that pays a nontaxable distribution must file Form 5452 (Corporate Report on Nontaxable Dividends) not later than two months following the close of the taxable year. The corporation must provide information concerning the distributions made during the tax year, beginning E&P, the portion of the distributions coming from current and accumulated E&P, and schedules supporting the computation of both current E&P and accumulated E&P from prior tax years.

2. Effects of a Dividend on the Corporation

The general rule provides that no gain or loss is recognized by a corporation on a distribution of property to its shareholders [I.R.C. §311(a)]. However, an exception provided in I.R.C. §311(b) makes the general rule true only for losses. I.R.C. §311(b) provides that if a corporation distributes appreciated property, the corporation recognizes gain as if the property were sold for its fair market value.

By virtue of I.R.C. §§311(a) and 311(b), a corporation recognizes gain—but not loss—on the distribution of property to its shareholders. In determining the corporation's gain on the distribution of property along with a related liability, the value of the property is not considered less than the liability [I.R.C. §311(b)(2) and I.R.C. §336(b)].

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Case Study Example 1: Effects of Dividend Distribution on the Corporation

The effects of these distributions on the corporation's taxable income for the year of the distribution would be as follows:

Property Distributed to	FMV Assets	Less Basis	Gain
Robert			
Farm	$1,175,000	(382,500)	$ 792,500
Securities	165,000	233,359	0
Caroline			
Hardware	$1,324,000	(767,000)	$ 557,000
Securities	150,000	212,145	0
Scott			
Implement	$ 4,785,000	(2,207,250)	$ 2,577,750
Gain recognized by CRS			$ 3,927,250

Note that the basis for the securities is 1.4143 times their fair market value. This example uses that ratio for all of the securities distributed. The corporation cannot offset any of the gains with the realized losses on the distribution of the securities. Thus, the corporation has nearly $4 million of gain to recognize. Note that this gain could cause a tax of $1,335,265 ($3,927,250 × .34) to be imposed on the corporation for the year of distribution. The corporation's balance sheet would now be as follows:

Assets	Basis	Value
Cash	$ 265,000	$ 265,000
Securities before distribution	2,475,000	1,750,000
Less distribution to Caroline	(233,359)	(165,000)
Less distribution to Scott	(212,145)	(150,000)
Total assets	$ 2,294,496	$ 1,700,000

3. Rules for Calculating Earnings and Profits

Under statutory authority, a corporation's E&P set the limit on characterization of distributions as dividends. In order to compute current earnings and profits, a corporation must adjust its taxable income in the manner discussed below. Note that the computation does not take into account any dividends paid within the current year. Accumulated earnings and profits are computed in a manner similar to book-retained earnings. In other words, both current earnings and profits and dividends are closed to accumulated earnings and profits.

E&P is not defined in the Internal Revenue Code and it has no counterpart in the area of corporate law or financial accounting. It is not the same as retained earnings or earned surplus. Revenue Procedure 75-17, 1975-1 CB 677, provides a summary of the general information that must be maintained by a corporation, including sample computations and schedules that illustrate a detailed year-by-year analysis of E&P.

As a practical matter, few corporations actually compute earnings and profits regularly. The computation is not necessary in order to file a proper Form 1120. The balance sheet and other schedules on Form 1120 do not even provide a place to show the calculation.

Current E&P is computed by starting with the corporation's current taxable income or loss and making certain adjustments, some of which are prescribed in I.R.C. §312. For purposes of computing E&P, taxable income is computed using the same accounting method normally used by the taxpayer (e.g., the cash or accrual method) [Treas. Reg. §1.312-6(a)].

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There are four adjustments that must be made to taxable income to arrive at current E&P.

1. Taxable income is increased by items of income that are excluded or that may be deferred.
   a. Tax-exempt income, including tax-exempt interest income [Treas. Reg. §1.312-6(b)] and life insurance proceeds, is included in E&P.
   b. Gain deferred under the like-kind exchange provisions of I.R.C. §1031 or involuntary conversion rules of I.R.C. §1033 are **not** included in the adjustments [I.R.C. §312(n)(5) and (f)(1) and Treas. Reg. §1.312-7(b)]. This income is included for E&P purposes at the same time it is included in taxable income [I.R.C. §312(f)(1) and Treas. Reg. §1.312-7(b)].
   c. Losses not recognized under I.R.C. §267 do reduce E&P [Treas. Reg. §1.312-7(b)].
   d. Contributions to capital, gifts, or bequests are not included in the adjustments.
2. Taxable income is increased by certain artificial deductions. Adjustments for deductions that are not permitted in computing E&P include:
   a. Dividend received deduction.
   b. Deductions for depreciable property acquired for tax years beginning after June 30, 1972, and placed in service before 1981, the excess of accelerated depreciation over straight-line depreciation (i.e., only straight-line is allowed, using the same useful life as used for computing taxable income) [I.R.C. §312(k)(1) and Rev. Rul. 76-1].
   c. For recovery property placed in service in tax years beginning after December 31, 1980, and before January 1, 1987 (e.g., 1981–1986), that is depreciated using the original version of ACRS, depreciation is limited to that using the straight-line method using extended recovery periods and the half-year convention.
   d. Post-1986 depreciation for E&P purposes is computed under the alternative depreciation system (ADS, as defined in I.R.C. §168(g)), using the straight-line method and the asset's ADR midpoint life (unless another life is prescribed or if no life is prescribed, 12 years for personal property and 40 years for real property) [I.R.C. §312(k)(3)].
   e. Assets expensed under I.R.C. §179 must be capitalized and deducted ratably over five years [I.R.C. §312(k)(3)(B)].
   f. The gain or loss realized on a disposition of property for E&P purposes normally will differ from that computed in arriving at taxable income, since E&P depreciation for such property differs from tax depreciation [Treas. Reg. §1.312-7(a)].
   g. Only cost depletion is allowed for E&P purposes. Percentage depletion in excess of cost depletion is not allowed.
3. Taxable income is reduced by expenses and losses that are not deductible in computing taxable income but reduce the corporation's ability to pay dividends. Adjustments for items not deductible in computing taxable income but deductible for E&P include
   a. Charitable contributions in excess of the 10% limitation.
   b. Federal income taxes, the corporate alternative minimum tax, penalty taxes, nondeductible assessments, and tax deficiencies.
      i. Cash basis taxpayers may deduct payments of actual and estimated taxes actually paid during the taxable year. Tax refunds paid by the federal government increase E&P in the year received.
      ii. Corporations using the accrual method of accounting reduces its E&P by the federal income taxes shown on the tax return less any credits claimed, including any credit carryovers from preceding taxable years [Rev. Rul. 66-336, 1966-2 C.B. 110]. Carrybacks of credits require an E&P adjustment in the taxable year in which the excess credits were earned and the carryback arose. A tax refund resulting from an NOL carryback increases E&P of the tax year in which the loss is incurred [Rev. Rul. 64-146, 1964-1 C.B. 129]. There is no adjustment to the E&P of the year to which the loss is being carried and for which the accrued taxes are refunded.

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c. Expenses related to tax-exempt income including premium payments on key man life insurance policies where the corporation is the beneficiary.

d. Capital losses in excess of capital gains.

e. Losses and expenses nondeductible because they were incurred in transactions with a related party [I.R.C. §267].

f. Fines and penalties.

g. NOL carryovers. A positive adjustment is required because the loss was taken into account for E&P in the prior year.

4. For years beginning after September 30, 1984, each corporation must adjust its taxable income to reflect "economic income" pursuant to I.R.C. §312(n).

a. Construction period interest and taxes must be capitalized as part of the asset to which they relate, and amortized over the asset's recovery period that is used for E&P purposes [I.R.C. §312(n)(1)].

b. Intangible drilling costs must be capitalized and amortized ratably over 60 months beginning with the month in which the amount was paid or incurred [I.R.C. §312(n)(2)(A)].

c. Mineral exploration and development costs must be capitalized and amortized ratably over 120 months beginning with the later of the month in which production begins or the month in which the costs were paid or incurred [I.R.C. §312(n)(2)(B)].

d. Organization (I.R.C. §248) and circulation expenditures (I.R.C. §173) may not be amortized, but must be capitalized (I.R.C. §312(n)(3)).

e. E&P must be increased or decreased by changes in the LIFO recapture amount, which is generally the excess of FIFO (first-in, first-out) over LIFO [I.R.C. §312(n)(4)]. There is no change in earnings and profits for a reduction in the LIFO reserve, to the extent the reserve had accumulated in a year beginning before September 30, 1984.

f. The corporation may not use the installment method in computing earnings and profits [I.R.C. §312(n)(5)]. This requires an upward adjustment in the year of an installment sale and downward adjustments in years of collection. Note that this rule applies to the few installment sales permitted under post-1986 law. It also covers installment sales of dealer property in years when the installment method was allowed.

Special Rule of Distributions to Parent Corporations

When a corporation makes a distribution to a corporate shareholder that owns at least 20% of the distributing corporation, I.R.C. §301(e) provides that the adjustments normally made in computing E&P that are required under I.R.C. §312(n) are not made. Examples include the adjustments for LIFO inventory, organization expenses, installment sales, and the completed contract method. This rule generally decreases the E&P of the distributing corporation and consequently makes it more difficult for distributions to qualify for dividend treatment and escape tax completely. This rule is beyond the scope of this material and receives no further discussion.

Effect of Property Distributions on the Corporation's E&P

Generally, E&P is reduced by the adjusted basis of any property distributed [I.R.C. §312(a)(3)]. When a corporation distributes appreciated property, however, a special rule applies [I.R.C. §312(b)]. Since the corporation recognizes gain on the distribution, current E&P first must be increased by the amount of the gain. Accumulated E&P is subsequently decreased by the value of the property distributed. The net result of the increase and the decrease is the same as reducing the E&P by the basis of the property.

If the property distributed is subject to a liability, or the shareholder assumes corporate liabilities, the reduction to E&P is decreased by the liability [I.R.C. §312(c)]. In other words, a distribution of liabilities increases E&P.

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Case Study Example 2: Calculation of Earnings and Profits

The above information can be used to compute CRS's accumulated earnings and profits at the time of the distribution and after the distribution.

Accumulated E&P before distribution		$1,600,000
Gains recognized on distribution of property		3,927,250
Loss on distribution, not recognized for income tax purposes		(130,504)
Income tax payable		(1,335,265)
Accumulated earnings and profits at time of distribution		**$4,061,481**
Fair market value of businesses distributed		
Farm	$1,175,000	
Hardware	1,324,000	
Implement	4,785,000	
Less liabilities distributed		
Farm liabilities	(375,000)	
Hardware liabilities	(509,000)	
Implement liabilities	(3,820,000)	
Basis of securities distributed (233,359 + 212,145)	445,504	
Total distribution		(3,025,504)
E&P after distribution		**$1,035,977**

When a corporation distributes its own debt, E&P is decreased by the principal amount of those securities unless the obligations have original issue discount. If the obligations have original issue discount, E&P is reduced by the fair market value of the securities [I.R.C. §312(a)(2)].

4. Income Tax Consequences to the Shareholders

The statutory authority discussed above requires taxpayers to treat the distribution as a dividend to the extent of the corporation's earnings, and the corporation's earnings and profits can be computed after the corporation's gain, loss, and income taxes resulting from the distribution have been calculated. The corporation's earnings and profits can then be compared with the total distribution to determine the dividends that must be reported by the shareholders. The income taxes on those dividends can then be computed.

Case Study Example 3: Calculation of Shareholders' Income Taxes

In the case study, the shareholders have each received a $965,000 distribution for a total distribution of $965,000 × 3 = $2,895,000. Since that total is less than the corporation's $4,061,481 earnings and profits at the time of the distribution, all of the distribution is treated as a dividend. Therefore, each shareholder must report his or her $965,000 distribution as dividend income. Assuming an approximate 40% tax rate for shareholders on ordinary income, each shareholder would pay a tax of $965,000 × 40% = $386,000.

The total tax cost of the dividend distribution is

Tax on corporate income		$1,335,265
Tax on each shareholder	$ 386,000	
Number of shareholders	× 3	1,158,000
Total tax liability		$ 2,493,265

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5. Basis of Property Received by Shareholders

The distribution of noncash property to the shareholder is a completely taxable transaction. Accordingly, the basis of the property received by each shareholder is its fair market value at the date of distribution [I.R.C. §301(d)].

Case Study Example 4: Calculation of Basis of Property

Each one of the shareholders takes a basis in the assets received that is equal to the asset's fair market value. This rule is equitable to all parties for property on which the corporation recognized gain on the distribution. However, the securities, which had declined in value, receive a step down in basis to the shareholders. There is no corresponding tax benefit to the corporation or to any shareholder.

Practitioner Note. In this case study, each distribution includes the assets of an entire business. Thus, the parties must follow the rules of I.R.C. §1060 to determine the valuation of each asset received.

STOCK REDEMPTION ALTERNATIVE

A "stock redemption" is simply a purchase by the corporation of its own stock from its shareholders [I.R.C. §317(b)]. From the shareholder's view, a redemption of his or her stock is simply a sale of the corporation's own stock back to the corporation. When the shareholder wants to dispose of part or all of his or her interest in the business, a stock redemption may be useful as a financing technique.

The tax consequences of the stock redemption depend on whether it is treated as an exchange of the shareholder's stock for corporate assets or as a dividend.

- **Exchange.** If the redemption is treated as an exchange, the shareholders must report gain and may be allowed to report loss from the "sale" of the stock to the corporation. The gain or loss may be treated as capital gain or loss.
- **Dividend.** If the redemption is treated as a dividend, the shareholders must report ordinary income to the extent of the corporation's earnings and profits.

CASE STUDY: ADDITIONAL FACTS FOR STOCK REDEMPTION ALTERNATIVE

Assume that the parties decide to distribute the operating assets of two of the businesses to the shareholders who want them. The other business will stay with CRS. The two shareholders who received the businesses will surrender all of their CRS shares. The other shareholder will retain his or her CRS shares. After the transactions, CRS will have one business with one shareholder. Each of the other two businesses will have one owner who will then be free to operate the business in any manner that he or she may choose. The newly acquired business can stay a proprietorship, become a limited liability company, or it may be incorporated.

The corporation should retain the business that would cause the greatest gain recognition, and distribute the other two businesses. In this case, assume that CRS retains the implement dealership,

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and distributes the farm operations to Robert and the hardware business to Caroline. In order to cash out all of Robert and Caroline's interests, CRS will also distribute cash and securities.

In order to plan this separation, the parties must determine the value of each member's interest. Therefore, they must first determine the total value of the corporation, after recording the liability for any income tax on the distribution of the assets in redemption.

Corporation's Gain or Loss on Distribution of Property

As discussed above, a corporation recognizes gain—but not loss—on the distribution of property to its shareholders in a dividend distribution [I.R.C. §311(a), (b)]. This rule applies to redemptions as well. In determining the corporation's gain on the distribution of property along with a related liability, the value of the property is not considered less than the liability [I.R.C. §311(b)(2) and I.R.C. §336(b)].

Thus it makes no difference whether the redemption is treated as an exchange or as a dividend when it comes to gain recognition and loss nonrecognition by the corporation.

The tax liability of CRS as a result of the redemption is as follows:

Property Distributed to	FMV Assets	Less Basis	Gain
Robert			
Farm	$1,175,000	(382,500)	$ 792,500
Caroline			
Hardware	$1,324,000	(767,000)	$ 557,000
Gain recognized by CRS			$1,349,500
Tax liability of CRS			$ 458,830

Now the parties can roughly determine the fair market value of what they will each receive.

Fair market value of corporation before tax	$4,595,000
Less corporate income tax on distribution	(458,830)
Net fair market value after corporate tax	$4,136,170
Value per shareholder	$1,378,723

In order to equate the values, the shareholders should compare the above figure with the net value of each business. Since the value of each of the businesses is less than 1/3 of the total stock value, CRS will also distribute securities to Robert and Caroline to bring their total distribution up to their 1/3 share.

Property Distributed to	Total Entitlement	FMV Assets of Business	Total Received
Robert	$1,378,723		
Farm (net equity)		$800,000	
Securities		$578,723	$1,378,723
Caroline	$1,378,723		
Hardware (net equity)		$815,000	
Securities		$563,723	$1,378,723

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STATUTORY AUTHORITY: RULES FOR QUALIFYING AS AN EXCHANGE

There are four tests listed in I.R.C. §302 for a distribution to be treated as an exchange and to therefore allow the shareholder to get capital gain treatment. A fifth test is found in I.R.C. §303. If a redemption passes any one of these tests, it is treated as an exchange. Otherwise, it will be a dividend (to the extent of the corporation's accumulated earnings and profits as of the close of the taxable year of the redemption). The five tests are as follows:

1. Not essentially equivalent to a dividend [I.R.C. §302(b)(1)]
2. Substantially disproportionate (non-prorata) [I.R.C. §302(b)(2)]
3. Complete termination of the shareholder's interest in the corporation [I.R.C. §302(b)(3)]
4. Redemption from noncorporate shareholder in distribution qualifying as a partial liquidation [I.R.C. §302(b)(4)]
5. Redemptions due to the death of a shareholder (I.R.C. §303).

1. Not Essentially Equivalent to a Dividend

The first test, "not essentially equivalent to a dividend," is a backstop provision used only on rare occasions. The fourth provision, the partial liquidation, is also an unusual transaction.

Therefore, the transactions most likely to be useful are the substantially disproportionate redemption [I.R.C. §302(b)(2)] and the complete termination of a shareholder's interest [I.R.C. §302(b)(3)].

2. Substantially Disproportionate Redemption

The substantially disproportionate redemption is a strictly mechanical test. In brief, it requires that the shareholder meet **all** of the following tests:

1. Immediately after the redemption, the shareholder **owns less than 50%** of total combined voting power of all classes of stock entitled to vote. For this purpose, the percentage of stock ownership after the redemption must take into account the reduced number of shares outstanding.
2. The percentage of voting stock owned by the shareholder after the redemption is **less than 80% of the percentage of voting stock** owned by the shareholder before the redemption. For this purpose, the percentage of stock ownership after the redemption must take into account the reduced number of shares outstanding.
3. Percentage of common (voting and nonvoting) stock owned by the shareholder after the redemption is **less than 80% of the percentage of common stock** owned by the shareholder before the redemption.

Constructive Ownership of Stock

One of the problems in dealing with the substantially disproportionate redemption is that it uses the constructive ownership rules of I.R.C. §318. Thus, an individual is treated as owning stock that certain family members own, as well as stock owned by other businesses, trusts, or estates in which the individual has an interest. An individual also is treated as the owner of any stock on which he or she holds an option to buy.

Four basic types of constructive ownership are found in I.R.C. §318. They are

1. One family member to another
2. Entity to an owner (e.g., from a partnership, corporation, estate, or trust to the shareholder
3. Owner to an entity (e.g., from a shareholder to a corporation, partnership, trust, or estate)
4. To a person who has an option to acquire stock

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The family attribution rules are rather narrow. An individual's family includes only the following:

- Spouse
- Children
- Grandchildren
- Parents

No reattribution is allowed. Stock deemed owned by virtue of family rule cannot be reattributed to another family member since to do so would extend the definition of family [I.R.C. § 318(a)(5)(B)].

Case Study Example 5: Constructive Ownership Rule

In our situation, the parties are two brothers and their sister. Note that these parties are **not** treated as family members by I.R.C. §318. Thus if the corporation were to redeem all of the stock of any two of the shareholders, the redemption would qualify as an exchange. The shareholders would be entitled to recover basis, and then report capital gain (or perhaps loss) on the distribution.

3. Complete Termination of a Shareholder's Interest

The complete termination of a shareholder's interest has a significant advantage over the substantially disproportionate redemption. In testing for an individual's ownership after the redemption, there is **no constructive** ownership from **family** members.

Thus, an individual can retire from a family corporation and allow his or her children to retain ownership. However, this waiver of constructive ownership **does not apply** to any stock held through estates, trusts, other business entities, or options.

The individual must completely retire and resign from any directorship, as well as **any** active employment. There are also some 10-year tests.

He or she may not reacquire any interest for 10 years, unless the reacquisition is due to the death of another shareholder. The individual must agree to hold the statute of limitations open for the redemption year, and must agree to notify the IRS of any reacquisition of stock.

If the shareholder has received or given away any stock within the last 10 years, he or she may want to request a ruling from the IRS that the transfer was not tax motivated. Often, the IRS rules that a gift of stock to family members within the last 10 years is not tax motivated if the family member who receives the gift continues an active association with the corporation.

Finally, the individual must not have acquired the stock as a gift from any person who continued to be a shareholder within the past 10 years. Thus, parents cannot give their stock to their children, then have the corporation require the children's stock and treat the transaction as a capital gain to the children.

Case Study Example 6: Complete Termination Test

In the case study, the redemption of all of the stock of two shareholders qualifies under the substantially disproportionate rule of I.R.C. §302(b)(2). Thus, the extra overhead of the complete termination of interest rule will be unnecessary. However, if the facts were different, and the mother or father were still living, and the parent also owned stock in the corporation, the complete termination of interest rule could be used to qualify the redemption as an exchange and avoid dividend treatment.

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4. Redemptions in Partial Liquidation

A partial liquidation focuses on activity at the corporate level, as opposed to the shareholder level. General requirements for a partial liquidation to qualify as an exchange are as follows:

a. A distribution is treated as a partial liquidation and therefore qualifies for sale treatment if it is to a noncorporate shareholder and is not essentially equivalent to a dividend [I.R.C. §302(b)(4)].
b. Only distributions to noncorporate shareholders can qualify for partial liquidation treatment. For this purpose, an S corporation is considered a noncorporate shareholder [I.R.C. §302(e)(5)].
c. A partial liquidation must be attributable to a genuine contraction of the corporation's business. To qualify under this criterion, the distribution must be either

- Attributable to the corporation's ceasing to conduct a qualified business, or
- Consist of the assets of a qualified business

Immediately after the exchange, the corporation must still be actively engaged in a qualified business. Activities in which the corporation is engaged must constitute an active business and not an investment.

Case Study Example 7: Partial Liquidation Test

In our scenario, the distribution of the businesses would likely qualify as a partial liquidation, and give the shareholders the desired exchange treatment. However, there may be a problem with distribution of the securities that would be necessary to equalize values. This part of the distribution might not qualify as a partial liquidation. Therefore, the disproportionate distribution rule is probably an easier fit in this situation. However, a partial liquidation could be quite useful in similar cases.

5. Redemption to Pay Estate Tax

Another provision that allows a shareholder to get capital gain treatment on a redemption is found in I.R.C. §303. This provision applies only to stock that has been received through a deceased shareholder's estate. The estate or other holder can have enough stock redeemed to pay the federal and state estate taxes attributable to the decedent's stock in the business. In this situation, the redemption need not pass any of the other redemption tests listed above.

Case Study Example 8: Redemption to Pay Estate Taxes Test

The I.R.C. §303 redemption is useful if the parties need to get liquid assets out of the corporation to pay estate taxes. However, in this situation, the objective is to get business assets out of the corporation so that each shareholder can operate his or her own operations. Thus the I.R.C. §303 rule is not helpful to our parties.

EFFECTS OF A STOCK REDEMPTION ON THE SHAREHOLDERS

Each shareholder needs to be concerned with the nature of gain (or possible loss) realized on the stock redemption. The shareholder also needs to be concerned about the effects on basis of any shares retained, as well as the basis of the property received from the corporation.

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Tax Consequences if the Stock Redemption is Treated as an Exchange

When the redemption qualifies as a sale or exchange, the shareholder should report gain or loss as would be the case if he or she had sold the stock to the corporation. Under normal circumstances any gain or loss would be capital gain. It might also qualify for installment treatment if there were a note from the corporation given as part of the consideration.

If the sale results in a realized loss, the loss would normally be capital. However, the related party rules might serve to disallow the loss. It is important to note that the related party rules dealing with loss recognition are **not** the same as the related party rules dealing with the exchange tests. Under I.R.C. §318, which tests for constructive ownership in the context of redemptions, **brothers and sisters are not** related parties, although certain other family members are related parties. However, I.R.C. §267, which disallows losses on the sale of property to certain related parties provides that **brothers and sisters are** related parties.

Case Study Example 9: Calculation of Gain or Loss of a Stock Redemption Treated as an Exchange

In the case study Robert and Caroline each receive a distribution of $1,378,723 of assets and they each have a $1,500,000 basis in their shares of stock. Therefore they would each realize a loss of $121,277 ($1,500,000 – $1,378,723) on the exchange of the stock for the business assets of CRS. However, since CRS is completely owned by their brother, the loss is disallowed under I.R.C. §267(a)(1). Thus, they would report no gain and no loss on the stock redemption.

The loss disallowance rule of I.R.C. §267 permits the buyer of the loss property to use the seller's disallowed loss on a later sale of the property acquired. However, this rule has no relevance to a corporation that has redeemed its own stock, since I.R.C. §1032 prevents a corporation from recognizing any gain or loss on a sale of its own stock. Thus the excess basis of both Robert and Caroline disappears, and will never result in any tax benefit to any party.

Tax Consequences if the Stock Redemption is Treated as a Dividend

If the shareholder does not pass one of the five tests that allow the stock redemption to be treated as an exchange, the total fair market value received is dividend income.

Case Study Example 10: Tax Consequences of a Stock Redemption Treated as a Dividend

If the redemption could not pass one of the five tests, Robert and Caroline would each report $1,378,723 of dividend income. Stock basis would remain at $1,500,000 for each shareholder. Assuming an approximate 40% income tax rate, they would each pay $1,378,723 × 40% = $551,489.20 of income tax.

Basis of Assets Received by Shareholders

If the stock redemption is not treated as an exchange, the basis of assets is the same as it would be with any other dividend distribution. The Internal Revenue Code specifies fair market value is the basis for property received in a dividend [I.R.C. §301(d)].

If the redemption is treated as an exchange of property, there are no special rules defining shareholder basis in property received. However, since the property received by the shareholder in the stock redemption is received in a taxable exchange, the general basis rules in the code specify that the basis is its fair market value [I.R.C. §1001(b)].

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Case Study Example 11: Shareholder's Basis in Assets

Each one of the shareholders takes a basis in the assets received equal to their fair market value. This rule is equitable to all parties for property on which the corporation recognized gain on the distribution. However, the securities, which had declined in value, receive a step down in basis to the shareholders. There is no corresponding tax benefit to the corporation or to any shareholder.

Practitioner Note. In this case study, each distribution includes the assets of an entire business. Thus, the parties must follow the rules of I.R.C. §1060 to determine the valuation of each asset received.

EFFECTS OF A STOCK REDEMPTION ON THE CORPORATION

The corporation must determine whether any gain or loss is recognized on the distribution of property to the shareholders in the redemption as shown on page 644. The corporation must also be able to calculate the effects of a redemption on its E&P.

Effect on the Corporation's E&P

Effect on the corporation's E&P depends on whether the stock redemption qualifies to be treated as an exchange. If the redemption qualifies as an exchange, the charge to E&P equals the proportion of E&P attributable to the stock redeemed but not to exceed the amount of redemption distribution [I.R.C. §312(n)(7)]. If the redemption does not qualify as an exchange, the distribution is treated under the normal rules applying to dividend-type distributions under I.R.C. §301.

If the corporation makes both redemption and ordinary dividend distributions during the year, special rules must be followed. Current E&P is first allocated to dividend type distributions. Redemptions are charged against total E&P available at the date of the redemption. Dividends and redemptions distributions that come out of accumulated E&P are charged against E&P in chronological order [Rev. Rul. 74-338, 1974-2 CB 101, and 74-339, 1974-2 CB 103].

COMPARISON OF REDEMPTION AND DIVIDEND DISTRIBUTION

In general, shareholders will prefer the Stock Redemption Alternative over the Dividend Distribution Alternative. The tax cost of the business rearrangement with the Dividend Distribution Alternative or Stock Redemption Alternative are compared in the following table.

Comparison of Tax Consequences for Each Alternative

	1. Dividend Distribution	2. Stock Redemption
Tax on corporation	$1,335,265	$458,830
Tax on shareholders	1,158,000	-0-
Total tax	$2,493,265	$458,830

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COMPLETE LIQUIDATION OF THE CORPORATION ALTERNATIVE

If the shareholders decide to terminate the corporation's existence and distribute all of its assets to the shareholders, the tax law defines it as a complete liquidation.

INTRODUCTION

In general, the liquidation of a corporation is a completely taxable event, at both the corporation and shareholder levels. Thus, while it may be very inexpensive to get property into the corporation, it may be prohibitively expensive to get it back out.

When a corporation completely liquidates, it ceases to be a separate entity for tax purposes. Usually, the corporation rids itself of all of its assets and is dissolved under state law, although a liquidated corporation may retain some limited assets in order to pay any outstanding claims. For income tax purposes, a liquidation is a taxable event, to both the corporation that distributes its property and to the shareholder who receives the corporate property in exchange for his or her stock.

Practitioner Note. Different rules govern the treatment of a parent corporation and a subsidiary corporation [I.R.C. §§332, 337]. In general, these liquidations are tax-free. They are not relevant to the case study at hand and are not covered in this workbook.

EFFECTS ON THE CORPORATION

The liquidating corporation recognizes all gains and losses on distribution of property in liquidation [I.R.C. §336]. In general, the property distributed to the shareholders is treated by the corporation as if it were sold to the shareholders at fair market value on the date of liquidation. There are some special rules to be observed.

In general, the related party loss disallowance rules of I.R.C. §267 do not apply. Thus, a corporation can distribute depreciated property to a person who owns more than 50% of the corporation's stock, in many cases, and the corporation is still allowed to deduct the loss. However, losses are disallowed if property is distributed to the controlling shareholder or a related party, and

1. The property was received as a contribution to capital or received in an I.R.C. §351 exchange within five years, **or**
2. The distribution of loss property is not pro rata [I.R.C. §336(d)(1)]. (Note that **either** of these conditions causes the corporation to be unable to deduct the loss.)

The special gain recharacterization rule of I.R.C. §1239 applies to property distributed to an actual or constructive majority shareholder. Under this rule, any gain recognized by the corporation is ordinary income if the property is depreciable by the receiving party. Thus, the corporation could not use gain on a building to offset capital losses.

Losses may be limited on recently acquired property if not related to the corporation's business [I.R.C. §336(d)(2)]. This disallowance rule applies to any property contributed to the corporation within the past two years prior to the liquidation if

- The corporation's basis exceeded the fair market value of the property at the time of contribution, **and**
- The property is unrelated to the corporation's trade or business activities. (Note that both tests must apply. Also this may be a partial rather than a complete disallowance of the loss.)

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CASE STUDY: ADDITIONAL FACTS FOR COMPLETE LIQUIDATION OF THE CORPORATION ALTERNATIVE

Assume that the three siblings each take the desired business, along with cash and securities, out of CRS. However, the parties realize that the corporation cannot report a loss on the distribution of securities since the distribution is not pro rata and each shareholder is considered a related party under I.R.C. §267. Accordingly, the corporation sells all of the securities, uses the cash to pay its taxes, and distributes the remaining cash to the shareholders. (This assumes that the securities were not recently contributed.)

After the distributions, CRS has no assets, carries on no business, and may be considered liquidated for tax purposes. The corporation would recognize gains and losses on distribution of all of its properties. The loss on the securities would be a capital loss, and could not be deducted by the corporation except to the extent of its capital gains in the current and three preceding years. Fortunately, the corporation has sufficient I.R.C. §1231 gains to allow offset for the capital loss on the sale of securities.

Property Distributed to	FMV Assets	Less Basis	Gain (Loss)
Cash	$ 265,000	$ 265,000	$ 0
Securities	1,750,000	(2,475,000)	(725,000)
Farm	1,175,000	(382,500)	792,500
Hardware	1,324,000	(767,000)	557,000
Implement	4,785,000	(2,207,250)	2,577,750
Net gain recognized by CRS			$3,202,250
Tax payable			$1,088,765

Now the parties can roughly determine the fair market value of what they will each receive.

Fair market value of corporation before tax (from)	4,595,000
Less income tax on distribution	(1,088,765)
Net fair market value after corporate tax	3,506,235
Value per shareholder	1,168,745

EFFECTS ON THE SHAREHOLDERS

The shareholders who receive liquidating distributions from the corporation must be concerned about the taxability of the gain or loss on the receipt of property in exchange for their shares. In addition, there is a need to determine the basis of the property they receive from the defunct corporation.

Gain or Loss on Disposition of Stock

The shareholders report all gains and losses on the disposition of their shares in a complete liquidation [I.R.C. §331]. Under almost all circumstances, the gain would be capital. A loss is generally capital, although I.R.C. §1244 may cause some or all of the gain to be ordinary. Another noteworthy point is that the related party loss disallowance rule does not apply to shareholders who receive property in complete liquidation of a corporation.

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Case Study Example 12: Calculation of Gain or Loss from Complete Liquidation

Each of the three shareholders would report the following gain or loss on disposition of his or her stock in CRS in complete liquidation.

Fair market value of net property received in liquidation	$1,168,745
Adjusted basis of stock	(1,500,000)
Loss	$ 331,255

Note that none of this loss would qualify for ordinary loss treatment under I.R.C. §1244, since these persons were not the original holders of the stock. Thus, it would all be capital. If they are fortunate, they will either have substantial capital gains in the future or live extremely long lives. For purposes of discussion and comparison, assume that each of the three shareholders receives a tax benefit of $3,000 ordinary loss against ordinary income for a tax savings of $1,200 per person. The tax cost to this course of action is as follows

Tax on Complete Liquidation If Corporation Is C Corporation

Tax on corporation	$1,088,765
Tax on shareholders	(3,600)
Total tax	$1,085,165

Basis of Assets Received by Shareholders

The basis of the property received in the liquidation is its fair market value at the date of the distribution [I.R.C. §334(a)]. Again, the allocation rules of I.R.C. §1060 would apply to these distributions, since each group of assets constitutes a going business.

Case Study Example 13: Calculation of Basis in Assets Received by Shareholders

All of the assets distributed to the shareholders would take a new basis. The basis of each asset would be the fair market value at the date of the distribution.

COMPARISON OF DIVIDEND, REDEMPTION AND COMPLETE LIQUIDATION

Finally, it is possible to compare the tax costs of the three alternatives discussed so far.

Comparison of Tax Consequences for Each Alternative

	1. Dividend Distribution	2. Stock Redemption	3. Complete Liquidation
Tax on corporation	$1,335,265	$458,830	$1,088,765
Tax on shareholders	1,158,000	-0-	(3,600)
Total tax	$2,493,265	$458,830	$1,085,165

Under these circumstances, the redemption is the best course of action. The principal reason behind this result is that the corporation does not need to distribute all of its appreciated assets, but is

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able to keep one of the businesses inside the historic corporation. It is unlikely that an informed tax professional would advise his or her client to use the dividend or the complete liquidation. However, if the shareholders informally decide to divide the business, they are likely to find out that they have undertaken one of these transactions.

The tax law is complicated, and the complexity is likely to increase with legislation in process in 2001. When a business is incorporated, the tax and legal complexity increases. A client who skimps on tax and legal advice may be inviting a host of financial problems. A tax advisor who does not understand the rules concerning corporations should turn over the problems to someone who does. Otherwise, the tax professional is likely to face IRS sanctions, as well as the cost and unpleasantness of errors and omissions.

DIVISIVE REORGANIZATION ALTERNATIVE

Practitioner Note. The materials that follow are brief descriptions of provisions of the tax law that may be quite subjective. The reader is advised to consult expert counsel before attempting to engage in a tax-free corporate division. In order to complete one of these transactions, the corporations must observe all of the formalities of the federal tax law and the corporate and property law of the local jurisdictions. A client who tries to do the whole deal on the cheap may be conversing with IRS special agents after failure to produce a properly executed deed, valid stock certificate, or some other evidence of a formality. The compliance rules for taxable liquidations are considerably more relaxed than those of the nontaxable exchanges described in this chapter. The parties involved with a corporation that has outlived its usefulness must weigh the considerable tax compliance costs of a tax-free division with the tax paid on the relatively simple liquidation.

INTRODUCTION

A corporation may find itself at a disadvantage by having too many operations conducted by a single entity or controlled group. It may face antitrust (domestic or foreign) restrictions, regulatory problems, or differences among shareholder factions, such as those discussed earlier in this material. When business issues such as these are present, the corporation may be able to find some avenues for relief from taxation of the distribution of property to the shareholders. The earlier sections have demonstrated the tax consequences of a division using the dividend distribution, the stock redemption, and the complete liquidation. This portion introduces the rules that may allow a corporation and its shareholders to avoid some or all of the current tax liability when it separates its business functions.

The rules explained in this portion of the chapter apply to the giant corporations such as AT&T and to small closely held corporations. However, as the introductory note suggests, there is little leeway when it comes to compliance with the exacting statutes and regulations. There are some extremely subjective problems, for which a general tax practitioner would be well advised to engage a specialist.

CASE STUDY: ADDITIONAL FACTS FOR DIVISIVE REORGANIZATION ALTERNATIVE

CRS forms two subsidiary corporations, Farmco and Harco. CRS transfers the farming assets and liabilities to Farmco and the hardware operations to Harco. CRS then transfers all of its Farmco shares to Robert, who surrenders his CRS stock. CRS trades all of the Harco stock to Caroline, in redemption of her CRS shares. After the transactions, Scott owns all of the CRS stock, and CRS now has only the implement business. Robert is the sole shareholder of Farmco, which only has the farm, and Caroline owns all of the Harco stock, representing the entire interest in the hardware business.

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They decide upon the distribution of assets as follows:

Property Distributed to	Total Entitlement	FMV Assets of Business	Total Received
Robert	$1,531,666		
Farm		$800,000	
Securities		$731,666	$1,531,666
Caroline	$1,531,666		
Hardware	-	$815,000	
Securities		$716,666	$1,531,666

Accordingly, CRS incorporates Farmco and Harco, and transfers the appropriate assets. Assume that each of these corporations has need for $300,000 working capital, which is transferred to the subsidiary along with the operating assets. Thus the final transfer to our shareholders is as follows:

Property Distributed to	Total Entitlement	FMV Assets of Business	Total Received
Robert	$1,531,666		
Farmco stock		$1,100,000	
Excess securities		$ 431,666	$1,531,666
Caroline	$1,531,666		
Harco stock		$1,115,000	
Excess securities		$ 416,666	$1,531,666

THE BASIC TRANSACTIONAL PATTERNS OF TYPE D REORGANIZATIONS

There are three basic patterns of the permitted nontaxable corporate divisions, which are referred to as Type D reorganizations. These patterns are not contained in the Internal Revenue Code or Treasury Regulations, but are terms of the profession.

The Spin-Off

When a parent corporation distributes stock of a subsidiary corporation to its shareholders pro rata, the transaction is a **spin-off**, assuming that the transaction meets all of the I.R.C. §355 requirements, discussed below. Neither the distributing corporation nor the shareholders recognize any gain or loss. Note that this distribution of stock is a dividend if it does not qualify under the tax-free division rules.

The Split-Off

Functionally, a **split-off** resembles a stock redemption. Some shareholders surrender stock in the original corporation in exchange for stock of a subsidiary corporation, whereas other shareholders retain stock in the original corporation. As is the case with the spin-off, the corporations and the shareholders avoid tax on part or all of the immediate gains.

The Split-Up

Functionally, a **split-up** resembles a complete liquidation. At the moment of the split-up, the parent corporation's only assets are stock in two or more subsidiary corporations. The different subsidiaries are dealt out to different shareholders. Then the old corporation, which now has no assets, is terminated.

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Case Study Example 14: Transactional Patterns of Type D Reorganizations

The transactions in the case study constitute two divisive reorganizations and a split-off. Although there are some details to be covered, the transactions may be largely tax-free to CRS and to all of the shareholders. There are some compensating factors, such as carryover basis, and survival of certain tax attributes. However, this method of restructuring the business ownership can avoid substantially all of the taxes mentioned in the earlier parts of the case study.

STATUTORY AUTHORITY

I.R.C. §355 is the only statutory authority for the tax-free division of a corporation. Thus, all of the patterns above must meet all of the qualifications. In brief, the requirements of I.R.C. §355 and its regulations are as follows:

1. Both the distributing parent and the distributed subsidiary (or subsidiaries, in a split-up) must be engaged in the active conduct of a business after the distribution.
2. The businesses must each have a five-year history of operation by the parent. The businesses must not have been acquired in a taxable transaction within the five-year period prior to the distribution.
3. The parent must be in "control" of each subsidiary immediately before the distribution.
4. Persons who were stockholders in the parent corporation must control the new corporation.
5. The transaction must not be a device for distributing the parent corporation's earnings and profits.
6. There must be continuity of interest in ownership of the new corporation(s).

1. The Active Trade or Business Requirement

I.R.C. §355 was designed in order to enable a corporation to separate active business units. Thus, in order to qualify for tax-free treatment under I.R.C. §355, both the distributing parent and the distributed subsidiary (or subsidiaries in a split-up) must be engaged in the **active conduct** of a **trade or business** after the distribution.

An active trade or business must include ". . . every operation that forms a part of, or a step in, the process of earning income or profit. Such group of activities ordinarily must include the collection of income and the payment of expense . . ." [Treas. Reg. §1.355-3(b)(2)(ii)]. The regulations also describe the active conduct of such trade or business. The corporation must have responsibility for "active and substantial management and operational functions" to qualify under the active conduct requirement [Treas. Reg. §1.355-3(b)(2)(iii)].

A corporation that holds only investment assets is not considered to be in a trade or business per se. [see Treas. Reg. §1.355-3(c), Example (1)]. Thus, the other criteria are irrelevant for I.R.C. §355 since the distributed corporation does not have a trade or business. A pro rata distribution of the assets would most likely be a dividend, and a disproportionate distribution in exchange for some shareholders' stock in the distributing corporation would most likely be a stock redemption if there were no active trade or business.

This rule keeps corporations from using the tax-free reorganization and I.R.C. §355 rules to distribute portfolio investments to the shareholders, which are better treated as property dividends. For example, if a corporation has an operating trade or business and excess working capital, it could divide itself into an operating company and a holding company. It could distribute the holding company to its shareholders, who would then be able to liquidate the holding company at capital gain rates.

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Case Study Example 15: Active Trade or Business

In this situation, the corporation really has four activities—the farm, the hardware business, implement sales, and the investment securities. The first three would likely meet the active trade or business test, whereas the investment securities would not qualify unless the corporation had actively conducted a securities trading business—not likely, from the facts as they have been presented.

Certain properties such as real estate may constitute an active trade or business if the corporation provides significant services, receives rent, and operates the real estate as a separate business in and of itself. However, this level of activity must precede the distribution for at least five years. Thus, the I.R.C. §355 division is not a means to distribute portfolio assets and excess working capital.

Case Study Example 16: Separate Business

Assume that the shareholders would like to distribute out the farmland, and rent the land back to the corporation for its farming operations. This distribution would not qualify under I.R.C. §355 unless the corporation had actively operated the land as a separate trade or business for the 5-year period. Again, this situation is most unlikely.

2. Five-Year Holding Period

In order to qualify for I.R.C. §355, the distributing corporation must separate into two or more corporations. Each of the surviving corporations must conduct at least one active trade or business that has not been acquired in a taxable transaction within the past five years [I.R.C. §355(b)(2)]. A business may be acquired by the distributing corporation in a nontaxable transaction at any time before the division without running afoul of the 5-year period. Thus, if an operating business is incorporated in a nontaxable transaction, the entire preincorporation operating period tacks on to the holding period of the stock.

Case Study Example 17: Tax-Free Incorporation in 5-Year Period

Assume that CRS has operated the hardware business for over five years. Two years ago CRS incorporated the hardware business in an I.R.C. §351 transaction. CRS has held 100% of the subsidiary stock since incorporation. The tax-free incorporation is not considered the acquisition of a new business. Thus, CRS meets the 5-year test for the hardware operation.

A corporation may consider acquiring a new business whose functions are complementary with those of the existing business. Such an acquisition might make good business sense. If conditions change after the acquisition, and it now makes sense to distribute the business to the shareholders, then the business should look into the tax rules governing divisions. However, a distribution of a passive portfolio, or acquisition of a new business with a view to distributing the new business to the shareholders in lieu of a dividend, might not make good business sense.

Acquisition of a new business in the same line of business in which the corporation is already engaged is not treated as an acquisition of a **new** trade or business, but is treated as the expansion of an existing business [Treas. Reg. §1.355-3(b)(3)(ii)].

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Case Study Example 18: Expansion of Business in Five-Year Period

Assume that CRS has operated the implement business for over five years. Two years ago, it acquired a competing dealership and moved into the former competitor's facilities. This acquisition would likely be treated as an expansion of a historic business, rather than the acquisition of a new business.

3. Parent Must Control Subsidiary before Distribution

In order to qualify for I.R.C. §355 treatment, a corporation must have control of each corporation that it distributes to its shareholders. Control has a specific statutory definition, and the corporation must not have purchased this control within five years preceding the distribution.

The distributing corporation must be in control of the businesses immediately before the distribution. For this purpose, the term "control" means at least 80% of the voting stock and at least 80% of each class of nonvoting shares [I.R.C. §368(c), Rev. Rul. 59-259, 1959-2 C.B. 115]. In addition, the corporation must not have acquired this control within the last five years (in a taxable transaction), or the entire distribution becomes taxable. Thus, it must own the requisite 80% before the 5-year period starts to run.

The IRS and courts have held that the taxable acquisition of a controlling interest in a business starts the 5-year period. Even when the parent corporation acquires the stock in an ostensibly tax-free transaction, if there is a direct or indirect acquisition of control, a distribution of the subsidiary stock will not qualify under I.R.C. §355 until the subsidiary has been under the parent's control for five years [see Rev. Rul. 57-144, 1957-1 CB 123, Rev. Rul. 89-37, 1989-1 CB 107].

Case Study Example 19: Parent Control of Subsidiary

Change the original facts, and assume that both the hardware and implement operations were held as separate corporations. Harco owned all the hardware operations, and Quipco held the implement dealership. CRS had held 64% of Harco for ten years, and acquired the remaining 36% two years ago. The distribution of Harco stock would not qualify until five years had elapsed from the date that CRS first held the requisite 80% interest in Harco.

Assume that CRS had held 90% of the stock in Quipco for seven years, and had acquired the remaining 10% one year ago. The distribution of Quipco would qualify under I.R.C. §355, since CRS had controlled Quipco for at least five years. However, the distribution of the other 10% would be treated as boot, discussed below.

4. Stockholders Must Control Subsidiary after Distribution

In order to qualify for a tax-free division under I.R.C. §355, the corporation making the distribution must transfer stock in the other corporation, so that the persons who were stockholders in the parent corporation control the former subsidiary. The tax law also permits holders of securities in the distributing corporation to exchange their securities for those issued by the corporation that has been distributed. The stock and securities that can be distributed tax-free are termed "qualifying property." There are special rules dealing with warrants and options that are generally not treated as stock or as securities. If a corporation distributes any property other than qualifying property as part of the division, it will be treated as **boot** to the receiving shareholders. Thus, a division with boot may be a partially taxable transaction.

Common stock is qualifying property for distribution in an I.R.C. §355 division. Securities qualify only if they are received by security holders, although some "excess principal amount" may be treated as boot. Both the debentures and the warrants are securities. Nonqualified preferred stock (NPS) is stock which is likely to be redeemed within the next 20 years and does not significantly participate in

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growth or earnings. This stock qualifies for distribution in an I.R.C. §355 division only if it is exchanged for stock with similar characteristics. Otherwise, it is treated as boot. Cash would also be treated as boot.

Case Study Example 20: Stockholder Control of Subsidiary

CRS must distribute all of its shares in both Farmco and Harco, or it must satisfy the IRS that there is a valid nontax business purpose for retaining any shares. At a minimum, CRS must distribute 80% of the stock in each subsidiary, so that the recipients can be in "control" of each of the new corporations. If CRS distributes any cash or securities, in order to equalize values, the cash and securities will be treated as boot, and the distributed stock will constitute the qualifying property.

Common stock is qualifying property, and it must be distributed in the divisive transaction. Preferred stock with no participation rights and subject to a put option of the holder is nonqualified preferred stock, which is not qualified property unless it is received in exchange for stock with similar characteristics [I.R.C. §351(g)].

Warrants and options are treated as securities with no principal amount. Thus, they may be distributed to a shareholder who surrenders other such securities in the exchange [Treas. Reg. §1.356-3(b)]. Debt securities are qualifying property, but only if they are distributed in exchange for other securities [I.R.C. §355(a)(1)(A)(ii)].

In most cases, a corporation must distribute all of its shares in a subsidiary corporation in order for the division to qualify under I.R.C. §355. However, a corporation may retain some stock in the subsidiary, but only if it secures a favorable ruling from the IRS.

If the distributing corporation retains any shares in the controlled corporation, it must satisfy the IRS that there is a valid business purpose for the retention [I.R.C. §355(a)(1)(D), Rev. Proc. 96-30, 1996-1 CB 696 (Appendix B)]. The IRS will likely require the distributing corporation vote any retained shares in the same proportion as all other outstanding shares. In addition, the IRS will likely require a plan to divest of all remaining shares within five years.

5. Nondevice Requirement

In order for a distribution to qualify under I.R.C. §355, the transaction must not be a "device" for the distribution of the corporation's earnings and profits. Obviously this is a subjective test, in contrast with the control test which is completely objective, and with the distribution requirements, which are primarily objective. The device is even more subjective than the active trade or business requirement; the device test requires a weighing of the evidentiary factors. The most important factor is the valid nontax corporate business purpose criterion, that the regulations elevates to a nearly coequal criterion. The business purpose is evidence that the I.R.C. §355 transfer is not a device for distributing earnings and profits, but it does not replace the device test, per se.

Evidence That the Planned Transaction is a Device to Distribute Earnings and Profits

A valid corporate business purpose is evidence of a nondevice. If the nondevice factors outweigh the evidences of device, the corporation will meet this requirement of an I.R.C. §355 division. There is indication of a device when the business of one of the corporations is the primary customer of a business of the other corporation.

The regulations, at Treas. Reg. §1.355-2(d), list several items that are evidence of a device to distribute the corporation's earnings and profits. They generally point to actions that are likely to get cash out of the existing corporation, especially in a pro rata distribution. Sale of stock in one of the corporations after the transaction is also an important issue. If it is likely to occur, there is evidence of a device. Some of the other factors include

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1. If a corporation transfers a substantial amount of cash or marketable securities to a subsidiary before distributing the subsidiary stock, there is evidence that the distribution would be a device to distribute the corporation's earnings and profits.

Case Study Example 21: Distribution of Securities

The securities are likely to cause some problems with the division of CRS. The parent corporation may transfer reasonable amounts of working capital to each of the subsidiaries. However, any excess might endanger the transfer. If the parties need extra money to compensate for the unequal business values, it is probably best to transfer any securities in excess of reasonable working capital directly to the shareholders. These securities would not be qualifying property, and would be treated as boot. However, a relatively minor amount of boot does not cause any substantial tax problems.

2. When a distributing corporation is widely held, there is evidence that the distribution is not being used as a device to distribute earnings and profits. Thus, the AT&T and other well-known divisions probably had little trouble meeting this requirement.
3. When a distribution would qualify as an exchange under the stock redemption rules of I.R.C. §302 or I.R.C. §303 (if I.R.C. §355 did not apply), there is evidence that the distribution is not being used as a device to distribute earnings and profits.

Case Study Example 22: Nondevice Requirement

A split-off of two of the businesses in complete redemption of two shareholders' interests in CRS would qualify under I.R.C. §302. Thus, there is good evidence that the transaction is not a device for distributing E&P.

Evidence of Valid Nontax Business Purpose

The statute specifically requires that an I.R.C. §355 distribution must not be a device for distributing the corporation's earnings and profits. The regulations adopt the business purpose test, and use it as one of the principal indicators that a distribution is not a device. There are other device and nondevice tests. If the facts and circumstances indicate that nondevice factors, including the corporate business purpose, outweigh the device factors, then the corporation meets this requirement.

The IRS lists several nondevice factors in Treas. Reg. §1.355-2. Among the most important of these is the valid corporate nontax business purpose. Some of the factors include

1. The corporation wants to transfer a division to an ESOP for key employees. This is evidence that there is a valid business purpose.
2. The corporation is ordered to separate its businesses in a federal or state antitrust decision. This is a valid business purpose for a tax-free division.
3. Shareholder differences may be a valid business purpose for a split-off or split-up, but not for a spin-off.

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Case Study Example 23: Valid Nontax Business Purpose

Since the two brothers and their sister have different business interests, there is good evidence of a nontax business purpose. This certainly helps the case for a tax-free division.

The IRS gives several examples of valid business purpose, as well as examples of considerations that do not show a valid business purpose, at Treas. Reg. §1.355-2. There is additional guidance in Rev. Proc. 96-30, Appendix A. In general, a valid business purpose is one that will result in increased wealth to the corporations, not to the shareholders.

1. A corporation plans to distribute one of its businesses in a split-off. After the division, the newly liberated corporation would be eligible for an S election, which would save state income tax. The federal tax savings would likely be higher than the state tax savings. Thus, the tax saving motive dominates the nontax business purpose.
2. One of a corporation's businesses is a competitor to a key customer of another one of the corporation's businesses. The customer has indicated that it will not continue to do business with the corporation unless it divests of its competing division. This is a valid business purpose.
3. A corporation plans a public offering. If it divests of one of its subsidiaries, the public offering will likely yield a higher stock price. The proceeds will go to the corporation to be used to expand its operations. This is a valid business purpose. However, if the major impact would be for existing shareholders to sell stock at a higher price, there would not be a valid corporate business purpose.

Evidence of a Lack of Valid Business Purpose

A purpose of saving taxes, or to add wealth to the shareholders, does not constitute a valid business purpose per se. The parties must be able to demonstrate that the corporations themselves will benefit from the separation, and this benefit would not be possible without using a division. Criteria are more rigorous for a pro rata division, such as a spin-off, than they are for a split-off or a split-up. Examples include

1. A corporation is not an S corporation. A split-off would make one of the corporations eligible to become an S corporation. The tax savings available through an S election do not constitute a valid nontax business purpose.
2. A corporation wants to separate a risky business from a less risky business in order to obtain less expensive insurance. There is no practical reason that the two businesses could not be owned as subsidiaries of a single holding company. Therefore, the less expensive insurance is not a valid nontax business reason for the division.

6. Distributions Preceded or Followed by an Acquisition

There is a nonstatutory continuity of interest requirement in the regulations under I.R.C. §355. The purpose of the law is to allow tax-free treatment of a division only when the owners are reasonably consistent after the division. This requirement has been augmented by two statutory tests. The first of these, enacted in 1990, taxes the distributing corporation on the distribution of "disqualified stock," or stock which was acquired by a person within five years preceding the distribution in a taxable transaction, when the effect is to give this new shareholder a 50% or greater interest in any corporation resulting from the division. The second statutory modification to the continuity of interest doctrine taxes a distributing corporation on the distribution of any stock pursuant to a plan whereby any corporation resulting from a distribution is acquired by persons who were not historic shareholders of the distributing corporation.

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Practitioner Note. The rules governing acquisitions of stock proximate to the division get to be quite complicated. They can cause a tax-free division to backfire, and yield some unpleasant surprises. The material in this part is only a brief introduction to the problems.

The continuity of proprietary interest doctrine applies to several of the reorganization transactions, including the Type D reorganization, which may be a step in an I.R.C. §355 division. There is also a regulatory requirement that there must be continuity of proprietary interest in an I.R.C. §355 division. However, this doctrine has largely been supplanted by the objective tests of I.R.C. §355(d), relating to "disqualified distributions," and I.R.C. §355(e), which governs divisions that are part of a plan to dispose of a business. These topics are covered in the remainder of this module.

A purchase of shares in the distributing corporation followed by a distribution of a subsidiary corporation to the person who purchased the shares has a strong resemblance to a purchase of the target subsidiary business by the new shareholder. Thus, if a new shareholder holds more than 50% of the stock in either corporation (former parent or former subsidiary) after an I.R.C. §355 distribution, the stock held by such person is "disqualified stock." The recipient shareholder does not treat disqualified stock differently from other stock received in an I.R.C. §355 distribution, but the distributing corporation must recognize gain (not loss) when it distributes the stock [I.R.C. §355(d)].

Disqualified stock is stock in the controlling (parent) corporation acquired by purchase by one person within five years before a §355 distribution. If any person who has disqualified stock ends up with at least 50% of the distributing corporation of any controlled corporation after the division, the distributing corporation must recognize gain (but not loss) on the distribution. Note that the gain is not limited to the disqualified stock, per se, or a distribution in respect of such stock, but encompasses the entire distribution. The distribution becomes taxable if the holder of at least 50% of any resulting corporation is a person who acquired the disqualified stock. The disqualified stock must be acquired in a purchase transaction, although certain I.R.C. §351 transfers may meet this definition. The 5-year period is an objective test, and not a presumption. Thus, there is no relief given, even if the parties can prove that there was no intent to effect the division at the time that the shareholder in question acquired the disqualified stock.

Practitioner Note. When a corporation intends to divest itself of one of its businesses, it should determine whether or not there have been any changes in share holdings within the last five years. If so, it should be aware of the maximum stock that can be held by any new owner, or be prepared to wait until the 5-year period has lapsed.

Under I.R.C. §355(e), an acquisition of either the distributing corporation or any controlled corporation may treat the entire distribution of stock as taxable to the distributing corporation. This rule applies when an acquisition of stock of the distributing or controlled corporation are pursuant to a plan. The effect on the distributing corporation is that it recognizes gain (but not loss) on the distribution of stock in one or more controlled corporations. If the rule applies due to the acquisition of stock in a controlled (subsidiary) corporation, the distributing corporation recognizes gain on the distribution of stock of the corporation(s) whose ownership has changed. If the rule applies due to the acquisition of stock in the distributing (parent) corporation, the parent recognizes gains on all of the distribution of stock in every controlled corporation in the transaction. This rule has no effect on any shareholders involved in the I.R.C. §355 transfer. These persons treat any stock received in the same manner as if it were a completely tax-free event. Thus they recognize no gain or loss (except that receipt of boot may cause gain recognition), and assign a substituted basis to qualifying property received.

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> **Practitioner Note.** When a corporation is planning an I.R.C. §355 distribution, it may want to get tax indemnification agreements from any corporation that will survive the division, and all shareholders. It may also be possible to issue stock subject to certain nontransferability agreements. Without these safeguards, the distributing corporation may find out, with hindsight, that it must pay tax on the purportedly nontaxable distribution.

A corporation that plans a division must inform all of its shareholders of the potential for disqualification of the entire distribution. The parties should weigh the freezing of the ownership against the tax benefits of the tax-free division.

EFFECT ON SHAREHOLDER AND DISTRIBUTING CORPORATION

In general, the distributing corporation recognizes no gain or loss on the transfer of property to a subsidiary corporation in a divisive reorganization. Similarly, the distributing corporation recognizes no gain or loss when it distributes stock and securities in the controlled corporation to shareholders, with certain exceptions. Shareholders do not recognize income, gain, or loss on the receipt of qualifying property.

Before a shareholder agrees to a division of a corporation, he or she should be careful to ascertain that the fair market values of the shares received and any shares surrendered are equal. If this equality in the value of the shares is not present, then the shareholder should insist on distribution of other property to compensate.

Shareholder Gain or Loss Recognition

A shareholder may recognize gain on an I.R.C. §355 transaction, but it is limited to the shareholder's gain realized on the transaction, or to the fair market value of the boot received, whichever is less. If gain has the effect of a dividend it is treated as a dividend. A gain recognized in a spin-off, where the recipient shareholder surrenders nothing, is always a dividend to the extent of the distributing corporation's earnings and profits. If the shareholder surrenders shares in a split-off or split-up, the IRS uses the stock redemption tests to determine dividend equivalency. Thus, gain recognized by a shareholder in an I.R.C. §355 transaction may be capital gain or dividend income. A shareholder is not permitted to recognize a loss on an I.R.C. §355 transaction.

In a spin-off, any gain recognized is treated as a dividend, to the extent of the distributing corporation's earnings and profits. In a split-off, the gain may be capital if it would qualify under I.R.C. §302 as an exchange–otherwise it will be a dividend [I.R.C. §356(a), 356(b), Treas. Reg. §1.356-2, Rev. Rul. 74-516, 1974-2 CB 121].

Case Study Example 24: Shareholder Gain

Robert would receive qualifying property worth $1,100,000 and boot of $431,666, whereas Caroline receives qualifying property worth $1,115,000 and boot of $416,666. The gain calculation to each of the shareholders is as follows:

	Robert	Caroline
Total amount realized	$1,531,666	$1,531,666
Less adjusted basis in CRS	(1,500,000)	(1,500,000)
Gain Realized	$ 31,666	$ 31,666
Boot received	$ 431,666	$ 416,666
Gain recognized	$ 31,666	$ 31,666
Tax @ 20%	$ 6,333	$ 6,333

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SHAREHOLDER BASIS

Basis for the qualifying property (stock and securities) is determined by substituting the basis (if any) of the stock and securities given up in the exchange.

If there is no exchange, which is the case with a spin-off, each shareholder is deemed to have exchanged a portion of the stock in the old corporation, based on the relative fair market value. For example, if stock in a controlled corporation is distributed in a spin-off and the controlled stock is 30% of the fair market value of all of the distributing corporation's assets immediately prior to the spin-off, each shareholder will be treated as if he or she exchanged 30% of the controlled corporation stock. Therefore, each shareholder will allocate 30% of his or her prior basis to the new stock received. Boot takes on a basis equal to its fair market value.

Basis in qualifying property (stock and securities) received in a split-off or split-up is the basis of stock and securities exchanged, if there is no boot received. When the shareholder receives boot, the following formula determines the basis of the qualifying property received:

1. Begin with basis of stock and securities surrendered.
2. Add any gain recognized (lesser of gain realized or fair market value of boot).
3. Reduce for fair market value of boot received (this becomes the basis of the boot.)
4. The result is the basis of the qualifying stock and securities.
5. If a person receives more than one class of qualifying property, allocate basis in proportion to the fair market value of each class.

Case Study Example 25: Shareholder Basis

Robert and Caroline would calculate basis as follows:

	Robert	Caroline
Adjusted basis in CRS	$1,500,000	$1,500,000
Less boot received	(431,666)	(416,666)
Add gain recognized	31,666	31,666
Basis in stock received	$1,100,000	$1,115,000
Basis in boot received	$ 431,666	$ 416,666

RECOGNITION OF GAIN OR LOSS BY THE DISTRIBUTING CORPORATION

In many instances, a corporation must create or augment a distribution of stock in an I.R.C. §355 transaction. The parent corporation must contribute property to the subsidiary so that the subsidiary contains at least one active trade or business. The transfer of assets to a corporation, when the stock of the corporation is then distributed under I.R.C. §355, is a divisive Type D reorganization. In general, a corporation recognizes no gain or loss when it transfers property to another corporation in a reorganization transaction. However, there are exceptions for liabilities in excess of basis, and for any boot received by the parent corporation from the subsidiary, unless the boot is also distributed to the parent corporation's shareholders in the reorganization.

When a corporation distributes qualifying stock and securities in an I.R.C. §355 distribution, it recognizes no gain or loss. The corporation recognizes gain, but never loss, on the distribution of boot. The character of gain to the corporation is the same as if the corporation had sold the boot property to the shareholder. Some stock and securities are treated as boot. These include securities with an excess principal amount over any securities surrendered, nonqualified preferred stock, stock acquired by the

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distributing corporation within the past five years, and any stock or securities given to a shareholder in exchange for accrued interest on any security surrendered.

Case Study Example 26: Recognition of Gain or Loss by Distributing Corporation

CRS recognizes no gain or loss on the transfer of the property to the subsidiaries. Note that this nonrecognition extends to any high basis securities transferred to the subsidiaries or working capital purposes. Thus the final tax is only the tax imposed on the shareholders, from Scenario Part 30, as follows:

Taxpayer	Tax
Robert	$ 6,333
Caroline	6,333
Scott	0
Corporation	0
Total	$12,666

The distributing corporation recognizes gain on the distribution of stock in a controlled corporation to the extent that the shares were acquired in the past five years. These shares cannot be qualifying property. I.R.C. §355 does not permit recognition of losses by any party in an I.R.C. §355 transaction.

OTHER TAX ATTRIBUTES

The regulations under I.R.C. §310 deal with the allocation of earnings and profits as a result of an I.R.C. §355 division. The rules are different for divisive reorganization transactions than for distribution of stock of an existing subsidiary. In the case of a divisive reorganization, the original corporation allocates its accumulated earnings and profits between itself and the distributed corporation in proportion to the net fair market value of each business (fair market value of assets less liabilities). In the case of a divisive reorganization, the post-distribution earnings and profits of the subsidiary are those allocated by the parent. When the distribution concerns an existing subsidiary and no transfer of the parent corporation's assets into the subsidiary, the distributing corporation must reduce it s own earnings and profits by the proportionate net fair market values of the businesses, or the net basis of the subsidiary's business, whichever is less. The post-distribution earnings and profits of the subsidiary are its earnings and profits immediately before the distribution, and are increased by the excess (if any) of the decrease to the parent's earnings and profits over the subsidiary's pre-distribution earnings and profits. There is no allocation if the parent's earnings and profits are negative. This balance stays with the parent corporation [Treas. Reg. §1.312-10(a)].

A newly formed corporation in a divisive reorganization does not inherit any of the parent corporation's accounting methods or other elections. Thus, in a spin-off or split-off, any new corporations are free to make their own tax elections, but the parent corporation is not. In a split-up where all of the corporations are new, the parent corporation's accounting methods and other elections disappear. When there is a division using preexisting corporations, each one of the newly liberated subsidiaries keeps it entire tax history, including its accounting methods.

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COMPARISON OF DIVIDEND, REDEMPTION, COMPLETE LIQUIDATION, AND DIVISIVE REORGANIZATION

Finally, it is possible to compare the tax costs of all four alternatives.

Comparison of Tax Consequences for Each Alternative

	1. Dividend Distribution	2. Stock Redemption	3. Complete Liquidation	4. Divisive Reorganization
Tax on corporation	$1,335,265	$458,830	$1,088,765	-0-
Tax on shareholders	1,158,000	-0-	(3,600)	$12,666
Total tax	$2,493,265	$458,830	$1,085,165	$12,666

The tax saving from the divisive reorganization in this scenario is so dramatic as to make it worth the substantial compliance costs that may be incurred. If the corporation and shareholders can qualify for this treatment, the immediate savings are substantial. However, all of the parties are now left with the historical stock and asset basis. In addition, the parties cannot dispose of their stock in the near future without having the original division recast as a taxable transaction to the distributing corporation.

In many cases, the tax cost of handling the transaction in any other manner would be prohibitive. Accordingly, this provision enables separation for many corporations that could not otherwise afford to make the transition. The provisions are extraordinarily complex and several rules are subjective.

CONCLUSION

Various routes can be used to split a corporation into separate parts. In many cases, the tax burden may be extreme. The tax-free division allows a legitimate deferral of taxes at both the corporation and shareholder level. In order to qualify for a tax-free division, the parties must ensure that the documentation is meticulous, and that the procedures are followed precisely. In most cases, it is unwise to proceed with a division without obtaining a letter ruling from the IRS.

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