S Corporation Dissolution – Part Two; Divisive Reorganization Alternative

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Overview

In Part One earlier this week, the focus was on the tax issues associated with liquidating an S corporation. In Part One, I noted that the same general liquidation rules apply to an S corporation as to a C corporation. However, the tax cost is significantly smaller unless the S corporation is subject to built-in gains taxation. One other point to note is that an S corporation *must* be liquidated in the same tax year as the sale/distribution of assets to produce the desired tax result. If a sale/distribution of assets is accomplished in one tax year and the liquidation of the corporation in the following year, the capital loss produced upon liquidation would not offset the capital gain generated by the sale of assets. In such a case, the capital loss produced upon liquidation would only offset other long-term capital gains for the tax year of the liquidation, plus $3,000 of ordinary income. The remaining long-term capital loss would be carried forward to subsequent tax years.

An alternative to liquidating an S corporation is a divisive reorganization – and it's the topic of today's post.

Alternative to Liquidation – Divisive Reorganization

An alternative to liquidating an S corporation at the death of the surviving spouse is a divisive reorganization under I.R.C. §355. This can be an option where heirs exist that are interested in continuing the farming/ranching business. In a divisive reorganization, part of the assets of a parent corporation are split-off to one or more (former) shareholders through a new corporation. A divisive reorganization typically involves three major steps:

- Formation of a new subsidiary corporation;
- Transfer of part of the parent corporation's assets to the subsidiary (usually tax-free); and
- Distribution of the stock in the subsidiary to some of the parent corporation's shareholders in exchange for their stock in the parent corporation.

A divisive reorganization can be used to divide a single, functionally integrated business (e.g. farming operation) into two separate businesses and will allow surviving shareholders to postpone income recognition that would otherwise occur through corporate liquidation at the death of the first generation shareholders. *Treas. Regs. §§1.355-1(b) & 1.355-3(c), Examples 4 & 5. See also, Rev. Rul. 75-160, 1975-1 CB 112; Coady v. Com'r., 33 T.C. 771 (1960), acq., 1965-2 C.B. 4, non. acq., 1960-2 C.B. 8 (withdrawn), aff'd., 289 F.2d 490 (6th Cir. 1961); United States v. Marett, 325 F.2d 28 (5th Cir. 1963).*

For a divisive reorganization to be tax-free, five tests under IRC §355 must be met:

- Control test;
- Active conduct of a business" test;

- Distribution of "solely stock or securities";
- Parent corporation must distribute all of the stock in the subsidiary (or enough for control); and
- Reorganization must not be used "primarily as a device for distribution of earnings and profits."

While, technically, these five tests must be satisfied for a divisive reorganization to be tax-free, in reality, only two of the tests generally create issues that could prevent a reorganization from being utilized. The two problematic requisites/tests are the active conduct of trade or business requirement and the trade or business requirement.

Active conduct of trade or business. For purposes of I.R.C. §355, a trade or business must have been actively conducted by the distributing parent corporation throughout the five-year period ending on the date of distribution. The regulations under I.R.C. §355 expand this requirement and require continued operation of the business or businesses existing before the implementation of the divisive reorganization. Accordingly, a transitory continuation of one of the active businesses would not satisfy the active trade or business test provided by these regulations. *I.R.C. §355(b)(1)(A); Treas. Reg. §1.355-3(a)(1).*

Guidance on the active trade or business requirement:

- The holding of stock and securities for investment purposes will not constitute the active conduct of a trade or business. Also, the ownership and rental of real or personal property (e.g., farm real estate) will not constitute the active conduct of a trade or business unless the owner performs significant services with respect to the operation and management of the property*. Treas. Reg. §1.355-3(b)(2)(iv).*
- Rul. 73-234, 1973-1 CB 180 involved a corporate farming operation where the active conduct of a trade or business test was satisfied. The facts involved a livestock share lease with active involvement. The IRS states, "the fact that a portion of a corporation's business activities is performed by independent contractors will not preclude the corporation from being engaged in the active conduct of a trade or business if the corporation itself directly performs active and substantial management and operational functions."
- The active conduct of a trade or business test was not met in Rev. Rul. 86-126,1896-2 CB 158. The facts involved a corporation that cash rented farmland. There was a sharing of expenses. The tenant planted, raised, harvested and sold the crops using the tenant's equipment. The activities of the corporate officers in leasing the land, providing advice and reviewing accounts were determined to not be substantial enough to meet the active trade or business requirement.

Note. It does <u>not</u> appear that the use of a farm manager (agent) to perform these services for the corporation necessarily impairs the active conduct of a trade or business requirement. *Webster Corp. v. Comr., 25 T.C. 55 (1955), acq. 1960-2 C.B. 4,.7, aff'd., Comr. v. Webster Corp., 240 F 2d 164 (2d Cir. 1957).* However, the officers and directors must be active in directing the activities of the agent, not mere spectators.

Caution - Tax Planning: The corporation's officers and directors' activities for the pre-distribution (5 yr.) and post-distribution (suggested as 2 years or more) time frames should be well documented before a divisive reorganization is undertaken. Also, payment of at least nominal officer/director salaries for services performed should be considered.

Trade or business purpose. Treas. Reg. §1.355-2(b)(2) provides that a corporate business purpose must be a real and substantial non-federal tax purpose germane to the business of the distributing corporation*, as well as* the controlled corporation. A shareholder purpose (e.g. accomplishing personal estate planning objectives) by itself, is *not* a corporate business purpose. However, the regulations go on to explain that a shareholder purpose may be so nearly co-extensive with a corporate business purpose as to preclude any distinction between them, in which case the transaction meets the corporate business purpose requirement. A transaction motivated in substantial part by a corporate business purpose will not fail the business purpose requirement merely because it is motivated in part by non-federal tax shareholder purposes.

Note. According to the Treasury Regulation, the whether the business purpose test has been satisfied is generally readily ascertainable (e.g. shareholder disputes or potential therefore, etc.).

Examples. Rev. Rul. 2003-52, 2003-1 C.B. 960 involved a family farming corporation that the parents and their two adult children owned. The children provided active management. One child intended to focus on the livestock side of the business while the other child preferred to operate the grain farming operation. The corporation reorganized into two corporations, with one child receiving the stock of the livestock business and the other child receiving the stock of the grain enterprise. The IRS approved the reorganization on the basis that it was motivated by a substantial non-tax business purpose even though the reorganization advanced the personal estate planning goals of the parents and promoted family harmony.

Private Letter Ruling 200323041 (Mar. 11, 2003) involved the separation of a grain farming business between siblings after their father's death. The IRS concluded that a corporate split-off that is undertaken to avoid shareholder disputes in a family-owned grain farming corporation (engaged in a single line of business) will constitute a divisive reorganization under I.R.C. §368(a)(1)(D) and the stockholders of the split-off corporation would not recognize gain or loss under I.R.C. §355. *See also Priv. Ltr. Rul. 200425033 (Mar. 4, 2004) and Priv. Ltr. Rul. 200422040 (Feb. 13, 2004)(same).*

Note. The IRS has ruled that the post-distribution business purpose requirement of I.R.C. Reg. §1.355-2(b) remained satisfied even though the business purpose could not be achieved due to an unexpected change in circumstances following the divisive reorganization. In so ruling, the IRS noted that the "regulations do not require that the corporation in fact succeed in meeting its corporate business purpose, as long as, at the time of the distribution, such a purpose exists and motivates, in whole or substantial part, the distribution." *Rev. Rul. 2003-55, 2003-1 C.B. 961.*

Other considerations. While I.R.C. §355 requires that the corporation seeking a divisive reorganization be engaged in the active conduct of a trade or business it does not require that all of the assets of the corporation be devoted to or used in an active trade or business. The corporation may hold non-qualifying assets (generally less than 5% of total) as long as it is engaged in the active conduct of a trade or business. *Treas. Reg. §1.355-(3)(a)(ii).*

Planning recommendation. It may be advisable to have all shareholders enter into an agreement providing that any shareholder who violates the post-distribution active trade or business rule agrees to pay <u>all</u> taxes incurred by all shareholders if the divisive reorganization fails to pass IRS scrutiny.

Note: In Rev. Proc. 2003-48, 2003-2 C.B. 86, the IRS stated that, for ruling requests after August 8, 2003, it would no longer rule on whether (1) a distribution of stock of a controlled corporation is carried out for business purposes, (2) the transaction is used principally as a device, or (3) a distribution and an acquisition are part of a plan under IRS §355(e). Rather, taxpayers seeking a ruling under IRS §355 must submit representations on these issues for review and determination by IRS.

Conclusion

Tax issues do arise when an S Corporation is dissolved. Fortunately, certain planning steps can be taken to avoid the heirs being denied the benefit of a basis increase in the corporate assets to fair market value at death. A reorganization is one possible tax-efficient planning step that could be utilized. Other planning options (not discussed in this two-part series) include liquidating the S corporation via a merger, and conversion of the S corporation to a partnership.

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