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Disposition of Business during the Owner's Lifetime--Sale and Liquidation Versus Sale and Continuation

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(d) A's total basis for his 1,000 shares of the fund (adjusted for capital gains retained by the fund — $100,000, original basis, plus $50,000, capital gain, less $12,500, capital gain tax)	$137,500
Value of 1,000 shares of the fund	$87,500
A's potential loss	$50,000
A's potential tax saving therefrom (if the capital loss may be utilized)	$12,500

Value of 1,000 shares of the fund	$87,500
B's total basis for his 1,000 shares of the fund (adjusted for capital gains retained by the fund — 0, original basis, plus $50,000, capital gain, less $12,500, capital gain tax)	$37,500
B's potential gain	$50,000
B's potential tax thereon	$12,500

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DISPOSITION OF BUSINESS DURING THE OWNER'S LIFETIME — SALE AND LIQUIDATION VERSUS SALE AND CONTINUATION

Howard M. Kohn

SALE OF ASSETS

In some instances the disposition of the family business is going to take the form of a sale of assets of the business. If the sale is made in connection with the liquidation of the corporation, and if certain statutory requirements are met, then no gain or loss will be recognized to the corporation on the sale;[1] but gain or loss will be recognized to the shareholders on the liquidation.[2] One alternative that is frequently overlooked, however, is the possibility of not liquidating the corporation after it has sold its assets, and instead continuing it as an investment company.[3]

Assume, for example, that A owns all the stock of X Corporation, having a basis in his hands of $10,000. The assets of the corporation are about to be sold for $300,000, which is their basis. A, who is sixty-six years old, intends to retire from business and invest his funds in in-

1. INT. REV. CODE OF 1954, § 337 [hereinafter cited as CODE §]. For a discussion, see Colborn, *et al., Buying and Selling a Corporate Business*, 10 WEST. RES. L. REV. 139-43 (1959). See also Garver, Liquidations Under Section 337, p. 245 *supra*.

2. CODE § 331.

3. For another discussion of this general subject, see Calkins, *et al., Tax Problems of Close Corporations: A Survey*, 10 WEST. RES. L. REV. 115-17 (1959).

come-producing securities or other property. If the sale is consummated, there will be no gain to the corporation in any event, because it is selling its assets at their basis. If the corporation is then liquidated, the stockholder will realize $300,000; since his basis for his stock is $10,000, he has a capital gain of $290,000; and his capital gain tax will come to some $72,000. Thus, he will have $228,000 remaining in pocket for investment in income-producing securities or other property.

There is, however, another important choice open to A. He might decide not to liquidate the corporation, but instead to complete the sale of the corporation's assets for $300,000, and then let the corporation invest those sale proceeds in other income-producing assets. Continuing the corporation may afford A several advantages. By not liquidating now, he avoids having to pay out $72,000 in capital gain taxes. As a result, the corporation has $300,000 available for investment, in contrast to the $228,000 that would be available were the corporation liquidated. Thus, he has preserved $72,000 — almost twenty-five per cent of his capital — for investment purposes. Furthermore, if A retains the stock of this investment company for his lifetime, on his death his estate will have a new basis for the stock.[4] His estate or heirs will then be able to liquidate the corporation with little or no capital gain tax. Thus, the $72,000 capital gain tax saved by not liquidating the corporation immediately will have been completely avoided.

Up to this point in this discussion we have assumed that the corporate assets were to be sold at their basis, so that no capital gain tax would be incurred by the corporation on the sale. If the corporation sells its assets at a gain, and is not liquidated, then of course the benefits of non-recognition of gain under section 337 will not be available, and the corporation will incur a capital gain tax on the sale. Whether that capital gain tax will be a deterrent to continuing the corporation will depend in large part upon the figures in the particular case. For example, if the corporation's assets had a basis of only $200,000, so that the sale of such assets for $300,000 would result in a $100,000 capital gain, the corporation would pay a capital gain tax of $25,000 and there would be $275,000 available for investment. If the corporation were liquidated and the corporation tax avoided, as we have seen, A would incur a capital gain tax of $72,000 on the liquidation, and he would have less capital available for investment. Thus, depending upon the facts and figures in the particular case, there may be a substantial saving by not liquidating the corporation, even though the continuance of the corporation will result in a capital gain tax being paid by the corporation on the sale of its assets.

4. CODE § 1014.

TAX RESULTS OF CONTINUING THE CORPORATION

Dividends

The tax results of operating the corporation as an investment company will depend in large part upon the type of investments which are made. If the corporation invests in dividend-paying stock of domestic corporations, it will be entitled to a dividend received deduction of eighty-five per cent of the amount of dividend income received.[5] Thus, if the corporation invests $300,000 in such securities, and realizes $12,000 of dividend income, it will pay a tax on only fifteen per cent of that amount, or $1,800, and the corporate tax will be only $540.[6]

The corporation, however, has $72,000 more capital to invest than would have been available had the corporation been liquidated; if it earns four per cent it will have $2,800 more dividend income; and after paying the corporate tax it will have $2,260 more income available for A than he would have had had the corporation been liquidated.

Thus, if the corporation after selling its assets is continued as an investment company, and its funds are invested in dividend-paying stocks, the shareholder may have increased substantially not only his capital by avoidance of capital gains tax but also have increased his spendable income.

Capital Gains

Capital gains realized by the investment company will be subject to somewhat different treatment. They will be taxed to the corporation;[7] and the corporation will have no eighty-five per cent deduction to offset such gains. Capital gains, however, do not have to be paid out so far as personal holding company status is concerned; the personal holding company penalty tax will not be imposed on retained capital gains.[8]

Thus capital gains retained and reinvested in the corporation will not detract from the advantage of continuing the corporation as an investment company.

Interest Income

If the investment company realizes interest income, it has no eighty-five per cent deduction with respect thereto. Interest is fully taxed to the corporation. Moreover, interest is personal holding company income

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5. CODE §§ 243, 244, 246.

6. The corporation probably would be a personal holding company, but assuming it distributed all its personal holding company income as dividends, it would incur no personal holding company tax. CODE §§ 541-46.

7. CODE § 1201.

8. CODE § 545(b)(5).

which would have to be distributed as dividends to the shareholder to avoid the personal holding company penalty tax.[9] Thus it would not be advantageous to have interest income in the investment company.

Rental Income

If a substantial portion of the continuing corporation's funds are invested in real estate, then the complexion of the corporation will be changed entirely. If more than fifty per cent of the corporation's gross income is from rentals, then such rental income will not be personal holding company income, and the corporation will not be a personal holding company.[10] Rental income will of course be fully taxed to the corporation (there is no eighty-five per cent deduction corresponding to the deduction for dividends received). Expenses of managing the real estate, however, including a reasonable salary for the shareholder-officer of the corporation, may be taken as deductions. If the income remaining after salary and other expenses can be accumulated in the corporation (assuming the corporation is not a personal holding company), then such rental income will be subject only to a single tax at the corporate level. If the net income is less than $25,000 the tax rate will be thirty per cent. In addition there may be a recurring annual tax saving on top of the capital gain tax saved by not liquidating the corporation originally. This annual tax saving would be available if the corporation's tax is less than the tax which the shareholder would pay had he realized the rents directly.

If the corporation is accumulating income, thought must be given to the accumulated earnings tax.[11] If mortgage financing is used in acquiring the property, however, and if accumulated income is then needed to amortize the mortgage indebtedness, it is unlikely that the corporation would have any accumulated earnings tax problem.[12]

Possible Disadvantages of Continuing the Corporation

There may, however, be two important disadvantages to continuing the corporation as an investment company. First, because there is no liquidation of the corporation there may be no funds which can be used for gifts, and it may therefore be more difficult to carry out a sensible family gift program.

The shareholder can, however, make gifts of shares in the investment company. Such gifts may be as effective as gifts of money, to shift income within the family group and reduce the donor's taxable estate.

9. Code § 543.
10. Code §§ 542(a)(1), 543(a)(7).
11. Code § 531.
12. Code §§ 533(a), 537.

If gifts of stock are made, then the donee will take the donor's basis for such shares;[13] and if the corporation is liquidated after the donor's death, the donee will pay a capital gain tax on the gift shares. But the capital gain tax is deferred; it will be incurred only on the shares transferred by gift. Further, the donees may be children with a relatively small income and who will therefore pay tax on the gain at less than twenty-five per cent. Those facts may mitigate the effect of the capital gain tax on the gift shares, and make a gift of stock of the investment company a satisfactory substitute for a gift of cash in the family gift program.

A more serious disadvantage of leaving the proceeds of sale of the business in the corporation may be the shareholder's inability to use the funds for his own purposes. If the shareholder is likely to desire substantial dividends, other than out of dividend income of the corporation on which the corporation has received an eighty-five per cent dividends received deduction, such dividends may be very costly.[14] It should be noted, however, that modest annual dividends in excess of the dividend income of the investment company may not be disadvantageous.

For example, it was pointed out above that if Mr. A's corporation is continued as an investment company, the $72,000 capital gain tax saved by not liquidating would be available for investment. If the funds are invested in stock of domestic corporations, the additional dividends on the added capital would give a $2,260 more income each year, in pocket, than had he not continued the corporation. Thus, in addition to distributing all dividend income currently, the corporation could pay additional dividends each year out of surplus, provided they did not increase A's income tax more than $2,260 a year (if A's top income tax bracket is forty per cent, additional dividends of up to $5,000 a year could be paid) — and A would not be out-of-pocket because the $2,260 of income gained each year by continuing the corporation as an investment company would cover the income tax on the additional dividends.

CONCLUSION

In brief, when the family business is to be sold, the possible advantages of not liquidating the corporation, but instead of continuing it as a

13. CODE § 1015.

14. If the corporation distributes only its dividend income on which it has received an eighty-five per cent dividends received deduction, that dividend income will have been subject to a tax at the corporate level of only 4.5 per cent or 7.8 per cent (depending on whether the corporation was in a thirty per cent or a fifty-two per cent bracket). The dividend income will, of course, be subject to ordinary income tax in the hands of the shareholder. By contrast, if the corporation distributes an additional dividend out of its income other than dividend income (for example rental income or interest) or out of accumulated earnings from prior years, such income will have been subject to ordinary income tax at the corporate level without any eighty-five per cent deduction and the income will still be subject to ordinary income tax in the hands of the shareholder.