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DIVIDING CORPORATE BUSINESSES IN ORDER TO FACILITATE PLANNING

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Thus far we have dealt with some of the considerations that will be relevant in deciding whether gifts should be made, choosing the subject matter of the gifts, and choosing the form in which gifts should be made.

We turn now to various possible rearrangments we might wish to make in the family business picture for family tax planning reasons. We consider first some of the opportunities and problems involved in dividing or separating the family's corporate business interests.[1]

It may be desirable to divide the corporate business for any one of a number of reasons. There may be sons or sons-in-law who do not get along with each other in business, and the father may wish if at all possible to give each one a separate business. Or, the father himself may own only one-half of the corporate business, the other one-half being owned by an unrelated associate. It may be desired if possible to divide the enterprise into two corporations, one owned by each of the two associates, so that each can plan the disposition of his own business to his family.

A division of a corporation can be effected tax-free, if the requirements of section 355 of the Internal Revenue Code of 1954 are met.[2] Those requirements have been discussed previously[3] and will not be detailed again here.

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1. If the business is a proprietorship, division of the assets owned by the proprietor presents no particular tax problems. If the business is a partnership, a division may be effected by a distribution of assets to a partner or partners. In general, gain on such a distribution will be taxable only to the extent that money distributed to the distributee partner exceeds the adjusted basis of his interest in the partnership; and such gain will be capital gain. Exceptions apply in the case of certain payments to a retiring partner or to a deceased partner's successor in interest, and in the case of certain payments for unrealized receivables and inventory items. See INT. REV. CODE OF 1954, §§ 731, 736, 751 [hereinafter cited as CODE §].

2. A transaction may be in effect a division of the corporate business, even though it does not qualify as a tax-free division under section 355 and is therefore taxable. For example, a distribution in redemption of the shares of one shareholder, or a partial liquidation of the corporation, may be a means of distributing corporate assets and, in that sense, of dividing the corporate business. For discussions of the tax effects of such redemptions and partial liquidations, see Calkins, *et al*, *Tax Problems of Close Corporations: A Survey*, 10 WEST. RES. L. REV. 89-98, 109-10 (1959); Hacker, *et al.*, *Tax Clinic on Capital Gains*, 12 WEST. RES. L. REV. 310-16, 331-36 (1961).

3. See Calkins, *et al.*, *Tax Problems of Close Corporations: A Survey*, 10 WEST. RES. L. REV. 79-83 (1959).

Two points respecting such tax-free divisions should be considered in particular, however, in connection with family tax planning.

First, to effect a tax-free division of a corporation, it is necessary that after the division there be two corporations, each of which is actively engaged in a trade or business[4] which has been actively conducted for five years preceding the division. It is not clear from the statute whether the two businesses must have been *separate* during that five-year period, but the Internal Revenue Service in its Regulations interprets the statute to mean that the two businesses must have been separate for five years. The Regulations provide that the tax-free separation provisions of the law do not apply to the division of a single business.[5] The validity of those Regulations was directly challenged in *Commissioner v. Coady*,[6] which involved the question whether a division of a single business into two corporations could qualify as tax-free. The Tax Court held the division tax-free and held the portion of the Regulations barring a tax-free division of a single business to be invalid. That decision was affirmed by the Court of Appeals for the Sixth Circuit.

The Internal Revenue Service has announced that it will not follow the decision of the courts in *Coady* pending further judicial test of the Regulations.[7] Accordingly, the practitioner cannot yet proceed in reliance upon *Coady* without being in danger of litigation. Further developments in this area should be watched, however, since if the *Coady* decision is correct, it may be possible to effect tax-free divisions of corporations in many situations where heretofore such divisions were thought to be barred.

The second point requiring discussion in connection with family tax planning is that in order for a division of a corporation to be tax-free, not only must the literal requirements of the statute be satisfied, but also the division must have a business purpose, and there must be a continuity of interest in the enterprise in the persons who are the owners before and after the transaction.[8] Thus, if a family gift is being considered in connection with a division of a corporate business, care must be taken to insure that the gift and the corporate division do not become one transaction. If in the corporate division the new corporation were given to persons who had no interest in the old, the continuity of interest requirement probably would not be satisfied. Thus, the division of the corporation should involve only persons who were owners of the old

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4. The Regulations contain a number of examples indicating what the Internal Revenue Service will and what it will not recognize as the active conduct of a trade or business. See Treas. Reg. § 1.355-1 (1955) [hereinafter cited as Reg. §].

5. Reg. § 1.355-1(a) (1955).

6. 33 T.C. 771 (1960), *aff'd*, 289 F.2d 490 (6th Cir. 1961).

7. T.I.R. 339, P-H 1961 FED. TAXES ¶ 54922 (Oct. 3, 1961).

8. Reg. § 1.355-2(c) (1955).

corporation. If gifts of stock are to be made, they should be consummated well in advance of the division of the corporation, or afterwards, as a separate transaction.

Let us turn now to another difficult problem that sometimes arises in family tax planning, that is, the situation where it is desired to separate two associates who have interests in common in two or more corporations. Let us assume that A and B, who are unrelated, own forty and sixty shares respectively of the stock of Corporation X, and forty and sixty shares respectively of the stock of Corporation Y. Assume further that each corporation started with $10,000 of capital and is now worth $100,000, so that A's forty percent of the total net worth of the two companies is $80,000 and B's sixty percent interest is $120,000. Assume further that A wishes to sever his connection with Y Corporation and wind up owning 100 percent of X Corporation; and B wishes to own all of Y Corporation and none of X Corporation.

A and B may regard this change as merely a corporate rearrangement which should be effected tax-free. Indeed, A will receive no money in the exchange. Rather, he may have to pay out $20,000, since his equity is worth only $80,000 and the value of X Corporation which he wishes to own is $100,000.

Our question is: Can the parties be placed where they wish to be through a tax-free exchange? The answer seems clearly to be "No."

We have seen that if the businesses of X Corporation and Y Corporation were in one corporation, and if they qualified as two separate businesses (either as subsidiaries or as divisions of Z Corporation), then we might be able to divide them tax-free under section 355 relating to tax-free divisions.

If business X and business Y are already in two separate corporations, however, with A and B each owning shares in both, there is no provision under which A can now terminate his stock interest in Corporation Y in exchange for B terminating his stock interest in Corporation X, and have the transaction qualify as tax-free.

If A and B contribute all of their stock of X and all of their stock of Y to a new corporation, Z, in order to be in a position to then spin-off all of X Corporation to A and all of Y Corporation to B, this will not be effective. The Regulations expressly state that the tax-free spin-off rules will not apply if the substance of the transaction is merely an exchange of stock or securities in one corporation for stock or securities in another corporation.[9]

We can, of course, have A and B effect an exchange transaction be-

9. Reg. § 1.355-3(a) (1955). Of course, if X Corporation and Y Corporation are now combined into Z Corporation, and any further consideration of a separation is postponed for more than five years, then after that time a tax-free separation may be possible.

tween themselves, A transferring to B the shares that A owns in Y Corporation (worth $40,000) plus $20,000, in exchange for B transferring to A the shares that B owns in X Corporation (valued at $60,000). This, however, will clearly be a taxable exchange, in which each of the parties will realize a capital gain. Yet A has received no funds with which to pay the capital gain tax.

There is, however, a third alternative that may be more attractive. Y Corporation can redeem all of A's shares in Y for $40,000, and X Corporation can redeem all of B's shares in X for $60,000, the price in each case being the fair market value of the shares redeemed. The redemptions will leave A owning all of the stock of X and B owning all of the stock of Y. The redemptions will of course be taxable sales, and each must be tested under the rules relating to redemptions generally, and the attribution rules. If each redemption terminates the redeeming shareholder's interest in the redeeming corporation, then it will result in a capital gain.[10] A and B will, however, receive the dollars with which to pay their tax.

The question arises, however, whether simultaneous redemptions by two separate corporations will be treated as something other than two separate redemptions.

A Tennessee District Court recently had before it two such redemptions.[11] The Commissioner sought to treat the two corporations as one, and the redemptions as redemptions of the stock of one corporation, substantially pro rata, and the equivalent of a dividend. The court, however, refused to disregard the separateness of the corporate entities, and held that each corporation had effected a redemption of its own stock. Therefore, each redemption terminated the redeeming shareholder's interest in the redeeming corporation, and resulted in a capital gain, not an ordinary dividend.

Thus, where the division involves two corporations, a redemption by each corporation may be the most advantageous route. Although taxable, it will give each redeeming shareholder dollars in exchange for the shares he is giving up.

10. For other discussions of the tax effects of redemptions generally, see the authorities cited in footnote 2 *supra*. An important recent decision involving the tax effect of a redemption on the corporation is Mountain State Steel Foundries, Inc. v. Commissioner, 284 F.2d 737 (4th Cir. 1961). It was held that the corporation's redemption of its shares served a proper corporate purpose and furnished no basis for imposition of the accumulated earnings tax on the corporation.

11. Ward v. Rountree, 193 F. Supp. 154 (M.D. Tenn. 1961).