

# Consequences of Divisive, Type D, Reorganizations for S Corporations

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The draconian income tax outcomes for corporate liquidations, especially for C corporations, have boosted the popularity of corporate reorganizations<sup>1</sup> as an alternative planning strategy.<sup>2</sup> Indeed, it is about the only strategy that can be accomplished with little or no income tax liability to separate warring factions in C or S corporations or to simply address the reality that shareholders in a corporation would prefer to be in sole charge of the management of their shares of the assets.

A recent letter ruling<sup>3</sup> has addressed the problems involved, including potential built-in gains tax liability,<sup>4</sup> of a reorganization involving an S corporation.

## Brief review of corporate liquidations

The income tax consequences of corporate dissolution and liquidation differ depending upon whether it is a C or S corporation.

*C corporation liquidations.* In general, gain or loss is recognized to a liquidating C corporation at the corporate level on the distribution of property in complete liquidation as if the property were sold to the shareholders at its fair market value.<sup>5</sup> Moreover, in addition to recapture consequences, *the gain involved even on capital assets<sup>6</sup> and assets used in the trade or business, such as farmland,<sup>7</sup> is taxable as ordinary income, not capital gain.<sup>8</sup>* The preferential rates for long-term capital gains *have not been extended to C corporations.*

In addition, each shareholder of a C corporation recognizes gain or loss on the distribution in exchange for the stock given up to the extent of the difference between the value of property (and cash) received and the income tax basis of the stock involved.<sup>9</sup>

The two tax events often result in a 30 percent to 40 percent (or more) loss in value of the corporate assets in a liquidating C corporation where the income tax basis of the corporate assets is relatively low, as is often the case with farm and ranch C corporations.

*S corporation liquidations.* For S corporations, no gain or loss is normally recognized at the corporate level unless the built-in gains tax applies.<sup>10</sup>

Income tax is imposed at the shareholder level as with C corporations,<sup>11</sup> on the difference between the income tax basis of the stock relinquished and the value of the cash and assets distributed to the particular shareholder.<sup>12</sup> If an S corporate liquidation is carried out shortly after death of shareholders holding a substantial amount of stock, the income tax consequences of a complete liquidation may be modest because of the new basis at death for the stock held by the decedent-shareholder.<sup>13</sup>

## Divisive reorganization as an alternative

A divisive, type D corporate reorganization<sup>14</sup> involves three major steps – (1) formation of a new corporation, initially functioning as a subsidiary; (2) transfer of part of the parent corporation's assets to the subsidiary; and (3) distribution of the stock in the subsidiary to some of the parent corporation's shareholders in exchange for their stock in the parent corporation.<sup>15</sup> If carried out properly, the reorganization can be executed with no or very little income tax liability.

*Consequences of an S corporation reorganization.* In a recently published letter ruling,<sup>16</sup> two shareholders owned all of the stock of a C corporation. The plan was for the original corporation to form a new subsidiary. An agreement was reached to transfer some of the original corporation's assets to the new subsidiary in a tax-free exchange along with some cash<sup>17</sup> to make the transaction fair to both shareholders. Then one of the shareholders of the original corporation would give up the stock held in that corporation for all of the stock in the newly formed corporation. The newly formed corporation would elect to be an S corporation immediately following the distribution.<sup>18</sup> The original corporation would elect to be taxed as an S corporation as of January 1, 2011.<sup>19</sup>

One of the features of the reorganization was that a major asset passing to the newly-formed corporation was to be rented to the surviving shareholder of the original corporation. Interestingly, the letter ruling does not discuss the rental agreement although the reorganization rules specify that immediately after the distribution of assets to the newly-formed corporation, both the parent corporation (the "original" corporation) and the subsidiary must be engaged in the active conduct of a trade or business, or immediately before the distribution the distributing corporation had no assets other than stock or securities in the controlled corporation and each of the corporations is engaged immediately after the distribution in the active conduct of a trade or business.<sup>20</sup> Although there is no discussion in the ruling about the nature of the lease or the type of rental (cash rent or share rent) there is firm authority that cash rented assets do not meet trade or business test, at least in a farm or ranch context.<sup>21</sup> Land that is share-rented does meet the "trade or business" test.<sup>22</sup> It is surprising that this issue was not addressed in the 2010 letter ruling.

The ruling does note that the newly-formed corporation (the "subsidiary") would be subject to the built-in gains provision applicable to S corporations<sup>23</sup> *with respect to assets transferred to the newly-formed corporation.*<sup>24</sup> Moreover, upon becoming an S corporation, the original corporation, now shrunken by the transfer of assets to the newly-formed corporation, will also be subject to

the built-in gains provision<sup>25</sup> *with respect to its retained assets*.<sup>26</sup> This feature of the ruling has great significance and could discourage some from using the reorganization strategy to solve problems in farm and ranch corporations.

#### ENDNOTES

<sup>1</sup> See I.R.C. § 368(a)(1)(D).

<sup>2</sup> See generally 8 Harl, *Agricultural Law* §§ 59.07 (2010) (corporate divisions and reorganizations), 59.03 (corporate liquidations); Harl, *Agricultural Law Manual* §§ 7.02[6][c] (2010) (corporate divisions and reorganizations), 7.02[6][b] (2010) (corporate liquidations); 2 Harl, *Farm Income Tax Manual* §§ 7.05 (Matthew Bender 2010 ed.) (corporate liquidations and dissolutions), 7.06 (corporate reorganizations).

<sup>3</sup> Ltr. Rul. 201102046, Sept. 28, 2010.

<sup>4</sup> I.R.C. § 1374.

<sup>5</sup> I.R.C. § 336(a). See, e.g., *Al Zuni of Arizona, Inc. v. Comm’r*, T.C. Memo. 1999-74.

<sup>6</sup> I.R.C. § 1221.

<sup>7</sup> I.R.C. § 1231.

<sup>8</sup> I.R.C. §§ 1(h), 11(b).

<sup>9</sup> I.R.C. § 331(a).

<sup>10</sup> I.R.C. § 1374. See Ltr. Rul. 9218019, Jan. 23, 1992 (no recognition of gain or loss on distribution of cash in complete liquidation of S corporation; any gain or loss would be recognized by the shareholders of the S corporation; no built-in gains tax due).

<sup>11</sup> I.R.C. § 331(a).

<sup>12</sup> Complete liquidations are governed by I.R.C. § 331(a) rather than by the rules for S corporation distributions. I.R.C. § 1368(c). See Treas. Reg. § 1.1368-1(d).

<sup>13</sup> I.R.C. § 1014(a).

<sup>14</sup> I.R.C. § 368(a)(1)(D).

<sup>15</sup> See 2 Harl, *Farm Income Tax Manual* § 7.06[2][a] (Matthew Bender 2010 ed.).

<sup>16</sup> Ltr. Rul. 201102046, Sept. 28, 2010.

<sup>17</sup> See I.R.C. § 351.

<sup>18</sup> I.R.C. § 1362(a).

<sup>19</sup> *Id.*

<sup>20</sup> I.R.C. § 355(b)(1)(A), (B).

<sup>21</sup> Rev. Rul. 86-126, 1986-2 C.B. 58 (active business requirement not met where corporation cash rented farmland to tenant).

<sup>22</sup> Rev. Rul. 73-234, 1973-2 C.B. 180 (livestock share lease with active involvement in management satisfied the “trade or business” requirement).

<sup>23</sup> I.R.C. § 1374.

<sup>24</sup> Ltr. Rul. 201102046, Sept. 28, 2010.

<sup>25</sup> I.R.C. § 1374.

<sup>26</sup> Ltr. Rul. 201102046, Sept. 28, 2010.