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DIVISIVE CORPORATE REORGANIZATIONS

— by Neil E. Harl

Repeal of the more favorable corporate liquidation options in 1986\(^1\) and the expiration of the phase-out for small corporations at the end of 1988\(^2\) have narrowed the range of workable choices for dealing with corporations that have outlived their usefulness.\(^3\) One possibility, for those motivated by a desire to separate shareholders who prefer not to be associated together any longer in the same corporation, is a divisive, type D, corporate reorganization.\(^4\)

Steps in the reorganization. A type D reorganization involves three steps—(1) a new corporation is formed as a subsidiary to the old corporation, (2) assets are transferred from the old corporation to the new corporation in a tax-free exchange and (3) a designated shareholder exchanges stock in the old corporation for stock in the new corporation. If handled properly, the process should be tax-free except for any boot involved.\(^6\)

Example: In 1978 parents and two farming sons formed a C corporation to carry on the farming operation. The parents died in 1990. Thereafter, the sons agreed that they would vastly prefer to operate separately because of serious disagreements in management style. A type D reorganization in early 1991 resulted in the youngest son ending up with about 40 percent of the land and roughly half of the machinery, equipment and livestock in a newly formed corporation. The rest of the property remained in the original corporation owned by the oldest son.

Tests for reorganization to be tax-free. For a divisive reorganization to be tax-free, five tests must be met—

- The subsidiary corporation must be controlled immediately before the distribution by the parent corporation.\(^7\) The parent corporation must own stock of the subsidiary possessing at least 80 percent of the total combined voting power and at least 80 percent of the total number of shares of all other classes of stock of the subsidiary.\(^8\)
- Immediately after the distribution, both the parent corporation and the subsidiary must be engaged in the "active conduct of a trade or business or immediately before the distribution the parent corporation had no assets other than stock or securities in the subsidiary."\(^9\) Moreover, the trade or business must have been actively conducted for five or more years prior to the distribution by the parent corporation.\(^10\)

For many farm or ranch corporations, a major question is whether land ownership alone is a business. Particularly where one of the shareholders merely wants to end up with land ownership, the issue may be the most critical in the entire reorganization. The IRS position has been that mere land ownership is not a business.\(^11\) Some courts have agreed with the IRS position\(^12\) while other courts have found the necessary trade or business status in cash rental assets.\(^13\) In proposed regulations, the Department of the Treasury has specified that the leasing of land would be a business if the subsidiary performs "active and substantial management and operational functions."\(^14\) However, in a 1986 ruling IRS held that the active business requirement was not met where a corporation cash rented farmland with some sharing of expenses to a tenant who planted, raised, harvested and sold crops using the tenant’s equipment.\(^15\) The activities of the corporate officers in leasing the land, providing advice and reviewing accounts were not substantial enough to meet the active business requirement.

Crop share or livestock share leases with substantial involvement in management are believed to meet the test.

- The distribution must be of "solely stock or securities."\(^16\) Boot, in limited amounts, can be distributed without jeopardizing the tax-free treatment of stock and securities but boot received is generally taxable income.\(^17\)
- The parent corporation must distribute all of its stock and securities in the subsidiary or enough stock to constitute control and establish to the satisfaction of IRS that the retention of stock and securities in the subsidiary was not part of a plan of tax avoidance.\(^18\)
- The distribution must not be used "principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both..."\(^19\)

Two additional tests are imposed— the reorganization must have a business purpose\(^20\) and a "continuity of interest" test must be met with shareholders of the parent corporation retaining at least 50 percent of the stock in the subsidiary.\(^21\)

Tax effects on the corporation. The mere formation of a subsidiary, of course, poses no tax problems and no gain or loss is ordinarily recognized on the transfer of assets to the subsidiary so long as the transfer is solely for stock and securities in the subsidiary.\(^22\) Moreover, no gain

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\(^1\) Charles F. Curtiss Distinguished Professor in Agriculture and Professor of Economics, Iowa State University; member of the Iowa Bar.
or loss is ordinarily recognized to the subsidiary on receipt of assets from the parent corporation in exchange for stock or securities of the subsidiary.\(^{23}\)

As for the various recapture possibilities —

- The rules for recapture of depreciation on real and personal property are not activated.\(^{24}\)
- Soil and water conservation and land clearing expense deductions are not ordinarily recaptured.\(^{25}\)
- Government cost sharing payments excluded from income are apparently not recaptured.\(^{26}\)
- In the few instances in which investment tax credit is still subject to recapture,\(^{27}\) recapture occurs as to the transferred assets.\(^{28}\)
- The rule disallowing a deduction for production expenses for unharvested crops would appear to apply.\(^{29}\)

The earnings and profits of the parent corporation must be allocated between the parent corporation and the subsidiary, usually in proportion to the fair market value of the "business" retained by the parent corporation.\(^{30}\)

Ordinarily, no gain or loss is recognized to the parent corporation on transfer of an installment obligation to the subsidiary.\(^{31}\)

**Tax effects on shareholders.** Ordinarily, no gain or loss is recognized to the shareholders involved.\(^{32}\) The income tax basis of the stock and securities in the subsidiary is derived from the income tax basis of the stock in the parent corporation that was surrendered.\(^{33}\) The available income tax basis is allocated on the basis of fair market values.\(^{34}\) The holding periods are tacked on.\(^{35}\) And a determination should be made as to whether a tax-free corporate division would terminate the right to pay federal estate tax in installments if such an election is outstanding.\(^{36}\)

In general, a reorganization would lead to recapture of special use valuation benefits unless any new shareholders acquiring interests in land under a special use valuation election were members of the family and consented to personal liability for any recapture tax.\(^{37}\)

**FOOTNOTES**

2. Id., Sec. 633(d)(1).
4. I.R.C. § 368(a)(1)(D). See, e.g., Ltr. Rul. 9123027, March 8, 1991 (cattle ranch corporation reorganized into two corporations in order to avoid disputes between shareholders); Ltr. Rul. 9122058, March 5, 1991 (same); Ltr. Rul. 9008078, Nov. 30, 1989 (division of corporation into one corporation for farming and one for manufacturing); Ltr. Rul. 8942031, July 24, 1989 (reorganization of farming corporation into four corporations); Ltr. Rul. 8921093, Mar. 2, 1989 (division of corporation’s cattle raising, crop farming and produce farming businesses into two corporations); Ltr. Rul. 8913047, Jan. 4, 1989 (division of corporation’s two cattle businesses into two corporations).
5. I.R.C. § 59.07[2].
8. I.R.C. § 368(c).
17. See I.R.C. § 356(b).
22. I.R.C. § 361(a).
25. See I.R.C. § 1255(b).
26. See 4 Harl, supra note 3, § 32.05.
32. I.R.C. § 358(a).
34. I.R.C. § 1223(1).
35. I.R.C. § 6166(g)(1). See Ltr. Rul. 792955, April 19, 1979 (reorganization of closely-held corporation did not involve "disposition").

**CASES, REGULATIONS AND STATUTES**

by Robert P. Achenbach, Jr.

**BANKRUPTCY**

**GENERAL**

**AVOIDABLE LIENS.** After the court had closed the Chapter 7 case, the debtor moved to reopen the case to avoid the unsecured portion of a claim against the debtor’s residence under Section 506(d). The court held that because the closing of the case resulted in abandonment of the residence and, therefore, reversion of title to the debtor, the bankruptcy estate no longer had any interest in the residence and avoidance of the lien under Section 506(d) was not available. *In re Sills*, 126 B.R. 974 (Bankr. S.D. Ohio 1991).