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Planning Options for C Corporations

By Neil E. Harl*

One of the most perplexing problems in business planning is in making the decision as to what to do with a C corporation that is no longer serving the interests of the shareholders. The income tax costs of liquidation are often prohibitive, a reorganization may not solve the problem or be unavailable and living with the C corporation may be unacceptable, with the only reasonable alternative remaining being a sale of the C corporation as an entity.

Liquidation of a C corporation

Since 1988, liquidation of C corporations, especially those owning real property, has become very costly. In general, gain or loss is recognized to a liquidating corporation at the corporate level as though the property were sold, with all gain at the corporate level taxed as ordinary income inasmuch as corporations have not, since 1990, been able to use capital gains rates available to individual taxpayers.

In addition, the subsequent distribution of cash and other assets to the shareholders is subject to tax at the shareholder level, measured by the difference between the income tax basis of the stock given up and the value of the distribution. Particularly for C corporations owning a substantial amount of farmland with a relatively low basis (which is typical) which has increased substantially in value, and with shareholders holding stock with a relatively low basis, the total tax cost, both state and federal, can easily exceed 50 percent of the pre-liquidation value of the corporate assets.

Divisive, type D, reorganization

With heavy loss of capital in a corporate liquidation, attention often turns to a divisive, type D, reorganization. Such a reorganization does not result in assets being moved out of the C corporation structure, but instead results in each shareholder ending up with their own corporation holding a proportionate amount of the assets. The problem, frequently, is that the C corporation has been cash renting the assets to others and that type of arrangement is not viewed as constituting a “trade or business” which is required for a divisive, type D reorganization. The IRS position has been that a share-rent lease meets the “trade or business” test, but a cash rent lease of the assets to one or more tenants generally does not meet the trade or business test.

What if the corporation had been cash renting for a year or two before the reorganization and otherwise had been share renting? A 2011 private letter ruling addressed that issue in a setting of a corporation that halted production for one year because of a spike-up

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in raw materials cost in the five year period before the proposed reorganization.12 The Internal Revenue Service overlooked the one year during which the trade or business requirement was not met. Would that outcome be likely for a farm or ranch reorganization in which the lack of trade or business status for a year or two was because of cash rent leasing as the owners moved into retirement? That is unclear but retirement of the owners arguably is less compelling as a reason for failing to meet the trade or business requirement than a solidly business-related reason for failing to meet the test such as a sharp increase in materials costs that made production unprofitable for the corporation.

An entity sale

Another possible alternative would be to engage in an entity sale with the new owner or owners assuming ownership of the C corporation.

Possibility of capital gains treatment. The major advantage, of course, is that if the corporate stock has been held by each shareholder for more than one year, the gain or loss is a long-term capital gain or loss on the stock.13 The income tax basis of the assets within the corporation is unchanged by such a stock sale, of course, but if the purchaser views the acquisition as a long-term investment, that would likely have a minor effect on the selling price. However, it would mean that tile lines, fences, feeding floors, buildings and other depreciable property would not receive a new income tax basis for depreciation purposes.14 The significance of that factor would depend upon whether the assets involved are heavily non-depreciable (such as farmland alone) or the land involved is heavily improved.

Possibility of tax reform. Another point to consider is that there is some chance that tax reform could alter the tax treatment of corporate liquidations and restore the pre-1987 situation of a tax-free or nearly tax-free liquidation of small corporations.15 That provision, Section 333 of the Internal Revenue Code, limited the recognition of gain on a distribution in complete liquidation to the earnings and profits of the distributing corporation and the cash and marketable securities of the corporation before 1989.16 Eligible closely-held corporations were entitled to prior law treatment for liquidating sales and distributions occurring before January 1, 1989, if the liquidation was completed before that date.17 That would alter significantly the preferred strategy in planning for the liquidation of a C corporation.

Possibility of an entity discount. The attractiveness of an entity sale, however, depends heavily upon the discount from fair market value of the land alone demanded by the purchaser. It is doubtful that the discount would reach the level of loss of value because of the income taxes levied on a complete liquidation of the corporation.

May need an audited financial statement. Purchasers would likely insist on an audited financial statement showing the amount of accumulated earnings and profits and the other financial data relevant to the sale.

If it's a sale of a “trade or business.” If the sale is the sale of a “trade or business,” it is deemed to be a sale of individual assets.18 An “applicable asset acquisition” involving a trade or business is considered the sale of individual assets and is any transfer which would be a trade or business in the hands of either the seller or buyer.19 A sale of an entity with machinery, livestock, equipment and farmland would likely be considered sale of a trade or business.

The seller and the buyer of an applicable asset acquisition must each report information concerning the allocation of consideration in the transaction on Form 8594.20

ENDNOTES


2. Eligible closely-held corporations were entitled to prior law treatment for liquidating sales and distributions occurring before January 1, 1989, if the liquidation was completed before that time. Pub. L. No. 99-514, § 633(d)(1), 100 Stat. 2817 (1986).


5. I.R.C. §§ 11(b), 1201(a).


7. See I.R.C. § 368(a)(1)(D).

8. Id.


11. Rev. Rul. 86-126, 1986-2 C.B. 58 (active trade or business requirement not met where corporation cash rented farmland, with sharing of expenses, to tenant who planted, raised, harvested and sold crops using tenant’s equipment; activities of corporation officers in leasing land, providing advice and reviewing accounts, not substantial enough to meet the active trade or business requirement).


17. Id.


19. Id.