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Tax Consequences for Corporate Divisions of the Family Farm Corporation

by

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Originally published in JOURNAL OF CORPORATION LAW
4 J. CORP. L. 1 (1978)

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TAX CONSEQUENCES FOR CORPORATE DIVISIONS OF THE FAMILY FARM CORPORATION*

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I.	INTRODUCTION.....	2
II.	THE HYPOTHETICAL CORPORATION OF BAKER FARMS, INC.....	4
III.	TAXABLE CORPORATE DIVISIONS.....	7
	A. <i>Distribution of Corporate Assets</i>	8
	B. <i>Redemption of Stock</i>	10
	1. <i>Nontax Factors</i>	10
	2. <i>Tax Factors of Proposed Redemption</i>	13
	3. <i>Application to Baker Farms</i>	17
	4. <i>Potential Use of Stock Redemptions in Other Situations</i>	22
	5. <i>Summary of Stock Redemptions</i>	24
	C. <i>A Complete Liquidation As a Division Technique</i>	24
IV.	NONTAXABLE CORPORATE DIVISIONS.....	35
	A. <i>Only a "Controlled" Subsidiary Can Be Separated Tax Free</i>	36
	B. <i>Only Stock or Securities Can Be Distributed Tax Free</i>	37
	C. <i>Extent of Distribution</i>	37
	D. <i>The "Device Test"</i>	38
	E. <i>The Active Business Requirement</i>	43
	1. <i>Vertical Division of a Single Business</i>	44
	2. <i>Ownership of Real Estate as an Active Business</i>	45
	3. <i>The Use of Independent Contractors to Satisfy Active Business Test</i>	47

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The authors wish to express their appreciation to University of Missouri-Kansas City law students: Linda Chalmstrom, Thomas Stewart and Donald Wallace.

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4. <i>The Five Year Rule-Changes in the Business During the Critical Period</i>	48
F. <i>NonStatutory Requirements</i>	49
1. <i>Business Purpose</i>	49
2. <i>Continuity of Interest</i>	54
G. <i>Tax Impact to the Corporation and Shareholders Upon a § 355 Transaction</i>	55
1. <i>Tax Consequences to the Corporations</i>	55
2. <i>Taxation of a Shareholder Upon the Distribution of Stock</i>	60
V. CONCLUSION	61

I. INTRODUCTION

During the past decade, an unprecedented increase in the value of farmland has occurred.¹ Although the rise in farmland values has increased the wealth of the typical farm family, operational costs have also increased dramatically during this same period. One such operational cost, the federal estate tax, relatively insignificant a decade ago,² has risen dramatically³ with a financial impact that may take the next generation fifteen years to repay.⁴

Adverse financial consequences attributable to increased federal estate taxes created the climate for the congressional enactment in 1976 of special relief provisions for farm estates.⁵ Farm estates can now use an extended

1. Farm real estate values have increased approximately 1000% since 1942. In the period from 1960 to 1975 alone, the values increased 300%. *Hearings on Federal Estate and Gift Taxes Before the House Comm. on Ways and Means*, 94th Cong., 2d Sess. 11 (1976) (statement of Don Woodward, Nat'l Ass'n of Wheat Growers).

2. For example, in 1966 there were 1,828,136 deaths but only 97,339 estates filed estate tax returns. Of the estate tax returns filed, 67,404 estates actually paid an estate tax. *Hearings on Federal Estate and Gift Taxes Before the House Comm. on Ways and Means*, 94th Cong., 2d Sess. 1176 (1976) (statement of Asst. Sec'y of the Treasury Walker).

3. In 1975, the percentage of estates filing returns had increased to 11.2% (215,918 out of 1,936,000 deaths). Those estates paying estate taxes also increased to 7.7% of the total reported deaths for such year. *Id.* In that same year, it was estimated that approximately one-third of the value of a 320 acre farm would be required to pay estate and inheritance taxes. *Id.* at 587. (statement of Nat'l Livestock Tax Comm., Amer. Nat'l Cattlemens Ass'n, and Nat'l Livestock Feeders Ass'n).

4. Congress recognized such a 15 year period when it enacted I.R.C. § 6166, amended by the Revenue Act of 1978, Pub. L. No. 95-600, § 512, 92 Stat. 2763, in 1976. This section allows for payment of estate taxes over a fifteen year period provided that certain conditions are met. Prior to the 1976 Act, the estate taxes could be paid over a 10 year period. I.R.C. § 6166A.

The provisions of I.R.C. § 6166A, allowing installment payments of estate taxes, were inadequate to alleviate cash flow problems of many farm estates. This section allows the estate to pay the estate taxes over a 10 year period with interest at near market rates. Because a marginal income producing business like a farm might have difficulty meeting the required principal and interest payments under I.R.C. § 6166A, a more lenient installment payout was added by the Tax Reform Act of 1976, Pub. L. No. 94-455, § 2003, 90 Stat. 1862 (codified at I.R.C. § 6166). Under I.R.C. § 6166 the principal amount of estate taxes may be deferred for five years and payment spread over a subsequent 10 year period. In addition, a special interest rate of 4% is assessed against the estate taxes attributable to the first one million dollars of assets. I.R.C. § 6601(j)(2). To qualify for election under this section, the value of the decedent's interest in the closely held business must exceed 65% of the adjusted gross estate.

5. A reform included in H.R. 13966, but not enacted by Congress in the Tax Reform Act of 1976,

time for payment of estate taxes (at favorable interest rates) for that part of the decedent's gross estate attributable to the decedent's interest in a farm or closely held business.⁶ Second, farm estates may qualify for special use valuation for property included in the decedent's gross estate that is devoted to farming. If the conditions for special use valuation are satisfied, the farmland may be valued on the basis of its value as a farm as opposed to a fair market value based upon its highest and best use.⁷

Although the Tax Reform Act of 1976 may help lessen the death tax impact for many farm estates, the estate tax progressive rate structure, as well as restrictions placed upon the heirs or beneficiaries of a decedent when special use valuation is elected,⁸ tend to limit the effectiveness of the re-

was a tax credit for closely held businesses. H.R. 13966, 94th Cong., 2d Sess. § 2017 (1976). If enacted, this section would have allowed a maximum credit of \$25,000 for closely held businesses.

6. I.R.C. § 6166. See note 4 *supra*, for the qualifications necessary to use § 6166. Under I.R.C. § 6601(j)(2) approximately \$300,000 of estate tax liability can be financed at a 4% interest rate.

7. I.R.C. § 2032A. The special valuation rules of § 2032A added by the Tax Reform Act of 1976, Pub. L. No. 94-455, § 2003(a), 90 Stat. 1856, provide that real property used for farming or other trade or business may be valued on the basis of its use for the qualified purpose (*i.e.*, farming) rather than on the basis of its "highest and best" use. In no case may this alternative valuation reduce a gross estate by more than \$500,000, and certain conditions must be met before the election can be made:

- (1) The decedent must have been a citizen of the United States at the time of his death;
- (2) The property must pass to a qualified heir; that is, an ancestor or lineal descendant of the decedent, lineal descendants of the decedent's grandparents, the decedent's spouse or the spouse of any qualifying descendant;
- (3) 50% of the adjusted value of the gross estate must be comprised of property used in the trade or business. 25% of this must be "qualified real property";
- (4) During five of the eight years immediately preceding death, the decedent or a member of the decedent's family must have owned the property and materially participated in the operation of the business;
- (5) The executor must make an election by filing an agreement within the time for filing the estate tax return.

Obviously, if a farm is located in close proximity to a metropolitan area, its "highest and best" use may not be its use as a farm. But the use of § 2032A is not limited to the above hypothetical situation. Section 2032A can be used if the farmland is located in the middle of a rural area. In general, the value of a farm for farming purposes is found by applying § 2032A(e)(7). Under this subsection, the value of a farm for farming purposes is determined by *dividing* (a) the excess of the average annual gross cash rental for comparable land used for farming purposes and located in the locality of such farm, *over* the average annual state and local real estate taxes for such comparable land, by (b) the average annual effective interest rate for all new Federal Land Bank loans. The Code provides that each average annual computation shall be made on the basis of the five most recent calendar years ending before the date of decedent's death. To illustrate the valuation technique of § 2032A(e)(7), assume that the value of Blackacre using regular valuation techniques is \$2,000 an acre. Further assume that the average cash rent for the locality of Blackacre is \$100 an acre, the average real estate taxes is \$10 an acre, and the average annual effective interest rate for all new Federal Land Bank loans is 10%. Application of § 2032A(e)(7) would yield a special use valuation of \$900 an acre ($\frac{\$100 - \$10}{10\%}$). See note 8 *infra* for a discussion of the criteria for recapturing this tax benefit upon disposition of the property.

8. The special valuation rules were promulgated to encourage continued use of land for farming and small business purposes. H.R. REP. NO. 94-1380, 94th Cong., 2d Sess. 22 (1976). To guard against windfall benefits to the heirs or beneficiaries of an estate which elects the special valuation, certain recapture provisions were included in I.R.C. § 2032A. If the heir or beneficiary disposes of the land to a nonfamily member within 15 years after the death of the decedent, or ceases to use the land for the qualified use, the tax benefit of special valuation is subject to recapture. *Id.* § 2032A(c). If the disposition or cessation occurs within ten years after the decedent's death, the entire amount is recaptured. Between the tenth and fifteenth year the amount of tax benefit to be recaptured gradually decreases for each full month the property is held for the qualified use. *Id.* § 2032A (c)(3). Cessation of the qualified

forms. For this reason, practitioners must explore alternative methods to reduce the impact of the federal estate tax on farm estates.

In a previous article published in this journal,⁹ the use of a close corporation as a technique to maximize the farm estate during lifetime and to minimize shrinkage at death¹⁰ was explored. Notwithstanding the possible reduction of estate taxes through the use of a close corporation, several post mortem problems may cause the practitioner concern.¹¹ One post mortem problem that often occurs when a close corporation is used as an estate planning vehicle is the potential for family disharmony between second generation family members that may threaten the very existence of the family farm corporation. When family disharmony occurs, a decision may be made to divide up the farm corporation assets among the various shareholders. When such a decision is made by the controlling group, what is the most attractive method to effectuate a division of the family farm corporation?

This article will explore methods to achieve a corporate division with special emphasis on the use of section 355 of the Internal Revenue Code to accomplish the planning goal. Although this article discusses divisions in the context of family farm corporations, the analysis is applicable to many nonfarm corporations. In the interest of continuity, the following hypothetical will be used throughout this article in an effort to more effectively illustrate the problems of corporate division.

II. THE HYPOTHETICAL CORPORATION OF BAKER FARMS, INC.

Baker Farms, Inc. is the owner of a 640 acre farming operation in central Iowa. The 640 acres, consisting of two 320 acre farms (Stillcrest and Woodland), currently has a fair market value of \$2,000 per acre and an adjusted basis of \$500 per acre. Other assets of the corporation include: (a) farm equipment with a fair market value of \$140,000 and an adjusted basis of \$70,000; (b) harvested soybeans with a fair market value of \$30,000 and

use property will occur even though the use has not changed, if there have been periods aggregating three years out of the eight years after the death of the decedent during which there has been no material participation by the qualified heir of the decedent or any member of his family. *Id.* § 2032A(c)(7)(B).

9. Hood & Logan, *Close Corporations in Estate Planning After the Tax Reform Act of 1976*, 2 J. CORP. L. 207 (1977).

10. Lifetime benefits stemming from incorporation include important fringe benefits available to shareholder employees such as meals and lodging, medical and group life insurance and qualified pension, profit and stock bonus plans. Shrinkage at death may be minimized by reducing the size of the gross estate via inter vivos gift plans and by lower valuation of stock for estate tax purposes. *Id.* at 228-57.

11. One of the major problems is that the value of this stock is normally included in the decedent's gross estate for federal taxation purposes. I.R.C. § 2033. Since this stock is seldom readily marketable, it may be difficult for the estate to raise the cash necessary to pay the resulting tax. Disposition problems may also arise when a beneficiary desires a fixed income but dividends are paid irregularly; when beneficiaries/shareholders are deemed by the surviving stockholders to be undesirable, or when the beneficiary simply believes the stock to be an undesirable investment. Ellis & Russo, *Disposition of Interests in Closely Held Corporations*, 242-2nd TAX MNGMT (BNA) A-1 (1978). Thus, a stock redemption may be advisable. However, the attribution rules of § 318 may prevent an exchange under § 302. If this is true, the estate may decide to pay the estate taxes over a number of years by filing a proper election under § 6166 or § 6166A, seek exchange treatment under § 303, or use both of these approaches simultaneously.

an adjusted basis of zero,¹² and (c) \$10,000 of cash.

Baker Farms, Inc. was formed in 1965 by John Baker. In exchange for all of the corporation's stock (640 shares), John transferred the two farms, which he had acquired for \$320,000 cash (\$500 an acre) in 1964, to the corporation.¹³ From 1965 until his death on August 1, 1976, Baker was the president of the corporation and received a salary of \$20,000 a year. His two sons, Adam and Bart (hereinafter referred to as A and B respectively), were also employed by the corporation during this time. A received a salary of \$10,000 a year and lived rent free in the house on Stillcrest.¹⁴ B also received an annual salary of \$10,000 and lived rent free in the house on Woodland.¹⁵

From 1965 through 1975 Baker gave each of his two sons twenty-four shares of stock each year. During this eleven year period, the book value of each share of stock averaged \$500 a share. For gift tax valuation purposes, each share of stock was discounted 50 percent from its book value on the grounds that the gifts of stock constituted minority interests in Baker Farms, Inc.¹⁶

12. Under the Tax Reform Act of 1976, Pub. L. No. 94-455, § 207, 90 Stat. 1538 (codified at I.R.C. § 447), effective December 31, 1976, corporations—other than tax option corporations, "family" corporations and corporations with annual gross receipts of less than \$1 million—which are engaged in the business of farming, must (1) use the accrual method of accounting and (2) must capitalize what are called "preproductive period expenses." The Baker Farms as a family corporation may choose to use the cash basis accounting method. I.R.C. § 447. Cash basis accounting for the farmer (a) is simple; (b) usually involves less tax during years of increasing inventories; (c) may involve less over-all income tax in case of death; (d) reflects the farmer's actual cash position; and (e) lightens the tax load on sale of draft, dairy, breeding and sporting animals raised. On the other hand, the cash basis farmer (a) runs the risk of disproportionate sales in any one year; (b) might have to withhold from market products which are ready; and (c) may be at a tax disadvantage while inventory values are declining. See O'BYRNE, FARM INCOME TAX MANUAL §§ 104, 105 (4th ed. 1970).

13. This transaction qualified as a nontaxable exchange under I.R.C. § 351.

14. It is assumed that rent free use of the Stillcrest house was not taxable to A under I.R.C. § 119. This section provides:

There shall be excluded from gross income of an employee the value of any meals or lodging furnished to him by his employer for the convenience of the employer, but only if—

(2) in the case of lodging, the employee is requested to accept such lodging on the business premises of his employer as a condition of his employment.

For the application of § 119 to farm business, see *Caratan v. Commissioner*, 442 F.2d 606, 608-11 (9th Cir. 1971) and *Wilhelm v. United States*, 257 F. Supp. 16, 21 (D. Wyo. 1966).

15. Likewise, B did not derive additional compensation because of the free rent provided; he was required, within the meaning of § 119, to live on the farm as a condition of his employment. I.R.C. § 119(a)(2).

16. No provision of the Code refers to attribution of ownership rules among family members in valuing shares of closely held corporations. Thus, minority interest discounts have generally been allowed where small numbers of shares have been transferred among family members either as inter vivos gifts or by reason of death. See *H. Smith Richardson*, 12 T.C.M. (P-H) ¶ 43,496 (1943), *aff'd sub nom. Richardson v. Commissioner*, 151 F.2d 102 (2d Cir. 1945), *cert. denied*, 326 U.S. 796 (1946). In the case where the court has articulated the reasons for allowing the discount, the amount of the discount has been substantial. For example, in *Whittemore v. Fitzpatrick*, 127 F. Supp. 710 (D. Conn. 1954), the court computed separate discounts for lack of marketability and for the minority interest factor. After allowing a 50% discount for lack of marketability, the court held that the value of shares representing a minority interest should be discounted another 32% from the value of shares in a control block. The result was a total discount of 66% from net asset value per share. *Id.* at 717. See also *Drybrough v. United States*, 208 F. Supp. 279 (D. Ky. 1962); *Bartram v. Graham*, 157 F. Supp. 757 (D. Conn. 1957);

During this period, Baker and his wife elected to treat the gifts as jointly made under the split gift provisions.¹⁷ The 50 percent discount coupled with the split gift provision (which allowed Baker and his wife to claim two annual exclusions for each son), had the resultant effect of avoiding gift tax liability during this period.¹⁸ By the end of 1975, Baker had transferred a total of 528 shares to his two sons ($24 \times 2 \times 11 \text{ years} = 528 \text{ shares}$).¹⁹ On January 30, 1976, Baker's wife died leaving a small estate valued at \$1,000 to her husband. Shortly thereafter, on August 1, 1976, John Baker died leaving all of his stock in Baker Farms, Inc. (112 shares) to his two sons, A and B, in equal shares. After payment of funeral and administrative expenses, the assets left in Baker's estate were \$100 cash and the stock of Baker Farms, Inc. Because the value of surrounding farmland had risen substantially during 1975-1976, the executor decided that each share of stock (assuming all of the stock were owned by one person) had a fair market value of \$1,000 a share. However, since the stock owned by the estate was a minority interest in the corporation, the stock was valued at a discount of 50 percent for estate tax purposes.²⁰ Hence, the estate reported a tentative taxable estate (before deducting the \$60,000 exemption)²¹ of \$56,000 ($112 \text{ shares} \times 500 \text{ a share}$). After deducting the \$60,000 exemption, the taxable estate was zero. The Service contested this valuation, arguing for a \$1,000 per share value. After extended discussion, a final valuation of \$800 a share was accepted

Estate of Jessie Ring Garrett, 22 T.C.M. (P-H) ¶ 53,329 (1953). However, a contrary position was taken by the court in *Blanchard v. United States*, 291 F. Supp. 348 (D. Iowa 1968). In finding in favor of the government, the court in *Blanchard* relied specifically upon the family attribution rules in valuing closely held shares. *Id.* at 350-52. Under the facts of this case it would have been difficult to ignore that a family group was in control. For a more complete discussion, see Krahmer & Henderer, *Valuation of Shares of Closely Held Corporations*, 221 TAX MNGM'T (BNA) A-60 (1969). See also Feld, *The Implication of Minority Interest and Stock Restrictions in Valuing Closely Held Shares*, 122 U. PA. L. REV. 934 (1974); Martin, *Factors Used in Valuation of Closely Held Stock*, 20 NAT'L PUB. ACCOUNTANT 1973.

17. I.R.C. § 2513(a) provides that a gift made by one spouse to any person other than his spouse shall be considered as made one-half by him and one-half by his spouse if at the time both were residents of the United States. Consent of both spouses is required.

18. Each share of stock when discounted 50% was valued at \$250.00 ($500 \times 50\%$). The total value of the stock given each year to each son was, therefore, \$6,000 ($24 \text{ shares} \times \250.00 a share). By electing to treat the gifts as made equally by each spouse under I.R.C. § 2531(a), John Baker and his wife avoided gift tax liability. The \$6,000 gift was excludible since each spouse was entitled to a \$3,000 per donee annual exclusion. I.R.C. § 2503(b).

19. Although the brothers obtained control of the corporation when their holdings were aggregated neither could control the corporation in their own right. Thus, all gifts made to them were minority stock interests in a close corporation.

20. When valuing stock shares of closely held corporations, for estate tax purposes, the shares owned by the decedent at the date of his death are taken as a unit. Under the *Whittemore* rationale, a lifetime gift where the donor owns a controlling interest is extremely advantageous; gift and estate taxes will be assessed on the basis of minority interest values if no one thereafter has control. Krahmer & Henderer, *supra* note 16, at A-61.

21. Prior to the 1976 Tax Reform Act, § 2052 of the Code allowed a \$60,000 estate tax exemption. I.R.C. § 2052 (repealed by 1976 Tax Reform Act, Pub. L. No. 94-455, § 2001, 90 Stat. 1848). Since Baker died in 1976, the \$60,000 exemption applied. In lieu of this exemption and the \$30,000 lifetime gift exemption previously allowed, Congress adopted in 1976 a single unified credit of \$47,000 for decedents dying after 1976, to be phased in over a five year period. I.R.C. §§ 2010, 2505 (added by the Tax Reform Act of 1976, Pub. L. No. 94-455, §§ 2001(a)(2), (b)(2), 90 Stat. 1848, 1849-50). For a discussion of the unified credit, see Hood & Logan, *Closely Held Corporations in Estate Planning After the Tax Reform Act of 1976*, 2 J. CORP. L. 207, 210-12 (1977).

resulting in an estate tax liability of \$2,944.00.²²

In 1977, Baker Farms, Inc., had current earnings and profits of \$60,000 and accumulated earnings and profits of \$100,000. For the year 1978, the corporation is expecting to break even. The corporation reports on the cash basis method of accounting.

Since the time of John Baker's death the farming operation has floundered. Although part of the adverse financial condition of the corporation can be traced to an industry decline in farm profits, a considerable amount of the corporation's problems can be traced to friction between the two brothers.

After John Baker's death, A became president at a salary of \$18,000 a year and was provided the house on Stillcrest rent free. B became secretary-treasurer at a salary of \$13,000 a year and continued to live rent free in the house on Woodland. Although B is upset with his current salary arrangement, most of the controversy has arisen over proper farming techniques. As a result of the disharmonious relationship, the brothers have decided that in 1979 they will divide up the corporate assets so that each can engage in farming on their own.

III. TAXABLE CORPORATE DIVISIONS

There are several ways to achieve the division contemplated by the Baker brothers. The relative success of a particular division technique is directly related to the tax impact upon the redeemed shareholder and the corporation. One of the most favorable division techniques in a nontaxable corporate division under section 355.²³ However, section 355 may be inapplicable, or a taxable division may be desired.²⁴ For example, a taxable division may be beneficial if the division results in loss recognition, the elimination of unfavorable corporate tax attributes (*e.g.*, earnings and profits) or the elimination of unfavorable nontax attributes such as the release of a shareholder as a surety on a corporate note.²⁵ In this section, the relative advantages and disadvantages of various taxable division techniques are compared and contrasted. With this background, the use of section 355 as a corporate division technique will be examined in section IV.

22. Baker's taxable estate was increased to \$29,600 ($112 \times \$800 = \$89,600$ less \$60,000 exemption = \$29,600) as a result of the settlement with the government. The tax under § 2001 (in effect for the year 1976) was \$2,944. Tax liability was computed by reference to § 2001 of the 1954 Code, Int. Rev. Code of 1954, ch. 11, § 2001, 68A Stat. 373, as it existed prior to the enactment of the Tax Reform Act of 1976, Pub. L. No. 94-455, § 2001, 90 Stat. 1846 (codified at I.R.C. § 2001).

23. I.R.C. § 355.

24. For example, if the basis of the stock in a corporation exceeds its fair market value, the shareholders may decide that a complete liquidation of the corporation is advisable since loss will be recognized by the shareholders upon the liquidation. *Id.* §§ 331, 1001(c). This loss will usually be a capital loss. *Id.* §§ 165(f), 1211.

25. If a corporation has substantial earnings and profits, low basis assets, or an accumulated earnings tax problem, a complete liquidation of the corporation is a corporate division technique that can eliminate these unfavorable tax attributes.

A. Distribution of Corporate Assets

One possible division technique is to distribute part of the corporation's assets pro rata to each shareholder, and then have one of the shareholders acquire the other shareholder's portion of the distributed assets for cash.²⁶ For example, assume the two brothers agree to distribute to themselves all the farm equipment held by the corporation with A agreeing to acquire B's distributive share for \$70,000 cash after the distribution. The soybeans will be sold and the proceeds therefrom along with any other cash resources of the corporation will be divided equally between the brothers. Further assume that B will use the proceeds received from A to purchase new machinery to farm Woodland, and that A will use the machinery acquired from the corporation to farm Hillcrest. The parties informally agree that all of the income and expenses from Woodland shall belong to B in his individual capacity. A will have the same informal arrangement for the Hillcrest operation.²⁷

If the brothers were operating a partnership, the above haphazard plan may achieve the division goal without atrocious tax consequences. This is true because the arrangement would probably constitute a dissolution of the partnership under local law.²⁸ Furthermore, the dissolution of the partnership would probably not be a taxable event because of the equal distribution of each type of asset.²⁹ However, the proposed sale by B to A of his share of machinery would be a taxable event to B.³⁰

Unfortunately for the two brothers, they are operating a corporation and not a partnership. The distribution of the machinery would be a distribution subject to section 301 and dividend income would result to the extent

26. If the shareholders of a close corporation have guaranteed a corporate note in their individual capacities, a sale of the assets at the corporate level under § 337 may be advantageous. The cash can be used to satisfy corporate debts including those debts which are guaranteed by the shareholders. The usual goal of a corporate division, however, is to divide up the operating assets between competing shareholder groups in such a manner that each group can carry on the businesses previously operated by the corporation. A sale of the assets for cash at the corporate level would conflict with this goal unless the shareholders purchased the assets themselves. Whether this is feasible may depend upon whether the purchasing shareholders can obtain a new loan without personal liability to be used to repay the corporate debt, albeit received by the corporation in the form of part of the purchase price for the assets.

27. This informal arrangement is not unusual in the business world, especially if the parties have not sought legal advice prior to implementing the plan. Many clients because of their distrust of lawyers or their unwillingness to pay legal fees often decide to settle their affairs in such an informal fashion.

28. By implication, the brothers are agreeing to dissolve the business. This would probably constitute a dissolution within the meaning of the Uniform Partnership Act. See UNIFORM PARTNERSHIP ACT §§ 29, 31; Iowa Code §§ 544.29, 31 (1977); MO. REV. STAT. §§ 358.290, 310 (1969).

29. The consequences of a partnership buyout or dissolution are extremely complex. I.R.C. § 731(a)(1) provides that "gain shall not be recognized . . . , except to the extent that any money distributed exceeds the adjusted basis [of the partnership interest]." If Baker Farms was a partnership, the cash distributed would not exceed this basis. However, § 731 will not apply to the extent that § 751 applies in the distribution. *Id.* § 731(c). Since the rules of § 751 apply primarily to disproportionate distributions, the equal distribution of each type of asset as proposed in the text should make § 751 inapplicable. See *id.* §§ 731, 736, 741, 751. See also Bromberg, *Partnership Dissolution—Causes, Consequences, and Cures*, 43 TEX. L. REV. 631, 659 (1965); Swihart, *Tax Problems Raised by Liquidations of Partnership Interests*, 44 TEX. L. REV. 1209 (1966).

30. I.R.C. §§ 61, 1001(a).

of the corporation's earnings and profits.³¹ Furthermore, the distribution by the corporation, while generally nontaxable to the corporation under section 311, may nevertheless generate taxable income to the corporation under section 1245 of the Code.³² Investment credit recapture under section 47 may also be triggered by the corporate distribution of farm machinery.³³ Similarly, the sale of the soybeans and the subsequent distribution of all the corporation's cash would result in taxable income to the corporation³⁴ and dividend income to the shareholders.³⁵

To be sure, dividend treatment of the distribution of the farm machinery and the corporation's cash is a costly consequence that neither brother can ill afford. However, the above result may appear inconsequential in comparison to the potential tax consequences arising from the informal decision to divide up the farming operation without transferring the farms from the corporation to the shareholders. Even an internal revenue agent of average ability could find that the income and expenses of both farms are properly attributable to the corporation.³⁶ If the brothers each realized a profit of \$20,000 from their respective farming activities, it takes little imagination to reconstruct the transaction so that the corporation realizes a taxable income of \$40,000 and each brother has a \$20,000 constructive dividend.³⁷

A tax lawyer confronted with this situation after the fact may be able to argue successfully that the corporation is entitled to a deduction for the value of the brothers' services rendered to the corporation during the year.³⁸

31. Under I.R.C. § 301(c)(1), a distribution is includible in a shareholder's gross income to the extent that it is a "dividend," as defined in § 316. The definition of "dividend" in § 316 is two-edged: a distribution by a corporation to its shareholders is a "dividend" if it is made (1) out of earnings and profits accumulated after February 28, 1913, or (2) out of earnings and profits of the taxable year. Baker Farms, Inc. has approximately \$160,000 of earnings and profits. Consequently, the distribution would all be subject to taxation under § 301(c)(1).

32. I.R.C. § 1245(d) provides that § 1245 "shall apply notwithstanding any other provision of this subtitle." Consequently, upon a distribution of appreciated § 1245 property, the depreciation "recapture" rules of § 1245 will override § 311(a)(2) and cause recognition of gain to the distributing corporation to the extent of prior depreciation deductions taken with respect to such property. See B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 7.22 (3d ed. 1971) [hereinafter cited as B. BITTKER & J. EUSTICE].

33. In the event of a distribution that constitutes an "early disposition" of "section 38 property," an adjustment must be made that takes the form of an increase in the tax itself, rather than an addition to taxable income. See I.R.C. § 47(a)(1); Treas. Reg. § 1.47-1, T.D. 6931, 1967-2 C.B. 12, 16.

34. I.R.C. § 61(a)(2); Treas. Reg. § 1.61-4, T.D. 6272, 1957-2 C.B. 18, 22.

35. I.R.C. §§ 301(c)(1), 316. See also note 31 *supra*.

36. See generally *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945); *Lynch v. United States*, 192 F.2d 718, 720 (9th Cir. 1951), *cert. denied*, 343 U.S. 934 (1952).

37. For cases illustrating the constructive dividend doctrine, see *Prunier v. Commissioner*, 248 F.2d 818 (1st Cir. 1957); *Walter K. Dean*, 57 T.C. 32, 40 (1971).

Although constructive distributions ordinarily involve a receipt of money or property by the shareholder himself, nonarm's-length transactions between commonly controlled corporations have resulted in constructive dividends to the controlling shareholders. See *Sammons v. United States*, 433 F.2d 728 (5th Cir. 1970); *Equitable Publishing Co. v. Commissioner*, 356 F.2d 514 (3d Cir. 1966). See generally, B. BITTKER & J. EUSTICE, *supra* note 32, at ¶ 7.05.

38. I.R.C. § 162(a)(1) provides that "[t]here shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including (1) a reasonable allowance for salaries or other compensation for personal services actually ren-

Alternatively, an argument can be made that the brothers rented the farms from the corporation and only a portion of the net profit should be assigned to the corporation.³⁹ Even if one of these arguments is successful, a substantial part of the net farm profit will be taxed twice.⁴⁰ Clearly, the informal plan envisioned by the brothers is extremely unwise.

B. Redemption of Stock

A possible alternative method that might be used to achieve the contemplated division of the corporate assets, is the complete redemption of one of the brother's stock in Baker Farms, Inc. For example, B could exchange all of his stock in the corporation for one half of the cash, (\$5,000) farm machinery (valued at \$70,000) and soybeans (valued at \$15,000), and the transfer to him of Woodland. The successful utilization of this technique depends upon several nontax and tax considerations.

I. Nontax Factors

From a nontax standpoint, the corporate law restrictions applicable to a corporation when it acquires its shares must be examined. Under most state statutes, sufficient surplus, either earned surplus or capital surplus, must be present to cover the redemption.⁴¹ If this corporate law restriction is violated, the brothers, in their capacity as directors, may be exposing themselves to personal liability.⁴² Since the brothers own all of the stock, it is unlikely that any shareholder would bring an action against the directors for violation of the adequate surplus requirement. However, if the transaction

dered." *But see* Northlich, Stolley, Inc. v. United States, 368 F.2d 272 (Ct. Cl. 1966) (pro rata bonus payments to shareholder-officers treated as dividend distribution even though reasonable in amount).

The Service, however, would undoubtedly argue that a compensation deduction may not be taken unless it is established that, at the time in question, there was an actual intent to pay such compensation. *See* Paula Constr. Co. v. Commissioner, 58 T.C. 1055 (1972), *aff'd per curiam*, 474 F.2d 1345 (5th Cir. 1973); X-L Service, Inc. v. Commissioner, 32 T.C.M. (CCH) 701 (1973). But, for a recent case that has sanctioned the *retroactive* classification of compensation, see *Home Juice Co. v. Commissioner*, 46 T.C.M. (P-H) ¶ 77,386 (1977).

39. If this argument is accepted by the Service, the corporation would receive a rental deduction under § 162.

40. Even if a deduction is allowed for services rendered, unfavorable tax consequences result. For instance, assume a \$40,000 taxable income for the corporation with a \$10,000 deduction for services rendered; the corporation still has \$30,000 taxable income and the shareholder has \$30,000 dividend income and \$10,000 salary income. Thus, the \$30,000 will be taxed twice and the \$10,000 once.

41. G. HORNSTEIN, CORPORATION LAW & PRACTICE § 493 (1959). ("Most statutes impose . . . limitations, authorizing reacquisition only out of surplus or if it will not impair capital." (footnotes omitted)). *See, e.g.*, IOWA CODE § 496A.5 (1977) ("purchases of its own shares . . . shall be made only to the extent of surplus"); MO. REV. STAT. § 351.390 (1969) ("A corporation . . . shall not purchase . . . its own shares when its net assets are less than its stated capital, or when by doing so its net assets would be reduced below its stated capital."); KAN. STAT. § 17-6410 (1974) ("[N]o corporation shall use its funds or property for the purchase of its own shares of capital stock when the capital of the corporation is impaired or when such use would cause any impairment . . ."); ABA-ALI MODEL BUS. CORP. ACT § 6 (1971).

42. *See, e.g.*, KAN. STAT. § 17-6424(a) (1974). ("In case of any willful or negligent violation of the provisions of section [17-6410] the directors under whose administration the same may happen shall be jointly and severally liable. . . ."). *See also* ABA-ALI MODEL BUS. CORP. ACT § 48(b) (1971); IOWA CODE § 496A.44 (1977).

should lead to a corporate bankruptcy,⁴³ the trustee in bankruptcy may have a cause of action against the shareholders on behalf of the corporation for the benefit of corporate creditors.⁴⁴

If the corporation does not have the required surplus, there are techniques that can be utilized to create surplus. For example, in some jurisdictions a corporation can write up its asset to create revaluation surplus.⁴⁵ Alternatively, the corporation can reduce its stated capital in order to create reduction surplus.⁴⁶ In any event, regardless of which method is used, adequate surplus must be available to cover the redemption in order to avoid potential liability to the directors of the corporation.

A second nontax consideration is the rights of minority shareholders and creditors of the corporation under state law. In the Baker Farms situation, all of the stock is owned by the two brothers. Since both brothers will agree to the proposed redemption of B's stock, there will be no shareholder who will contest the redemption. Assume, however, that A and B each owns 45 percent of the stock, and Mr. Quinn, an unrelated individual, owns the remaining ten percent. In this situation, a fiduciary duty to the minority shareholder may arise. In the recent case of *Donahue v. Rodd Electrotape Co.*,⁴⁷ the Massachusetts Supreme Court held that the directors of a corporation and the majority shareholders, owe a fiduciary duty to the minority shareholders to insure that they have the same opportunity to sell their stock to the corporation on terms substantially similar to those offered to a majority shareholder.⁴⁸ Since the fairness of the price paid to the ma-

43. Thus, where either the insolvency test or the adequate surplus test is not met, the transaction is inviolate. See, e.g., IOWA CODE § 496A.5, .63 (1977) ("no redemption . . . shall be made . . . when such redemption . . . would render it insolvent"); MO. REV. STAT. § 351.200(1) (1969) ("no such redemption . . . shall be made . . . unless the assets of the corporation remaining after . . . redemption . . . are sufficient to pay any debts of the corporation . . .").

44. Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, § 543(c)(3), 92 Stat. 2549 (1978) (to be codified in 11 U.S.C. § 543(c)(3)). See, e.g., *Kettle Fried Chicken of America, Inc. v. Brock*, 513 F.2d 807 (6th Cir. 1975) (liability imposed on shareholders of bankrupt corporation on account of payments received from corporation in repurchase of capital stock when corporation stated capital was impaired).

45. The leading case for asset revaluation is *Randall v. Bailey*, 288 N.Y. 280, 43 N.E.2d 43, 23 N.Y.S.2d 173 (1940), *aff'd*, 262 App. Div. 844, 29 N.Y.S.2d 512, *appeal denied*, 262 App. Div. 994, 30 N.Y.S.2d 808 (1941). See also Kreidmann, *Dividends—Changing Patterns*, 57 COLUM. L. REV. 372 (1957).

A significant tax consideration, beyond the scope of this article, arises when there exists "unrealized appreciation" in the assets of a corporation, such as would typically arise with the value of the land. Distributions of a corporation are deemed to come from its most recent accumulation. An exception to this is contained in § 312(e), which provides that in the case of amounts distributed in a partial liquidation under § 346 or a redemption under § 302 or § 303, the part of distribution properly chargeable to capital account is not a distribution of earnings and profits. The concepts of "capital account" and the amounts "properly chargeable" thereto have caused much litigation. The Service position is set forth in Rev. Rul. 70-531, 1970-2 C.B. 76. The courts have not agreed with this position, however, and have permitted the entire earnings and profits account to be eliminated upon a redemption. For the latest opinion in this area, see *Anderson v. Commissioner*, 67 T.C. 522 (1976).

46. The reduction of stated capital is a widely recognized means of creating surplus in order to pay dividends. Ordinarily, the board of directors will adopt a resolution setting forth the amount of the reduction and the manner in which it is to be effected, and directing the question to be voted on by the shareholders. See, e.g., IOWA CODE § 496A.66 (1977); MO. REV. STAT. § 351.195 (Supp. 1975).

47. *Donahue v. Rodd Electrotape Co.*, 367 Mass. 578, 328 N.E.2d 505 (1975).

48. *Id.* at 598-99, 328 N.E. at 518.

majority shareholder was not in dispute in *Donahue*,⁴⁹ this duty will apparently arise even if the redemption is at a fair price. In remanding to the district court, the Massachusetts Supreme Court gave the district court two alternative remedies. Either the minority shareholders had to be bought out on the same terms and conditions as the majority shareholder member, or the redemption transaction was to be rescinded and the redemption proceeds returned to the corporate treasury.⁵⁰

The teaching of *Donahue* is clear: a corporate redemption may be difficult to achieve in Massachusetts without reserving additional funds for minority shareholders who are desirous of selling their stock to the corporation. Although it is too early to determine whether other states will follow Massachusetts,⁵¹ practitioners should advise their clients that an enterprising attorney for a minority shareholder might convince a court in a different jurisdiction to adopt the *Donahue* rule.

In the Baker Farms situation, a *Donahue* theory would appear inapplicable since there is no minority shareholder damaged as a result of the redemption. Assume, however, that the corporation is subsequently forced into bankruptcy. Would the trustee in bankruptcy be able to bring an action on behalf of the corporation on a *Donahue* theory? Since *Donahue* is based upon a breach of a fiduciary duty to a minority shareholder, apparently no corporate cause of action is available. However, if the corporation paid an excessive price for the stock, a corporate cause of action may be pursued against the directors for breach of a fiduciary duty owed by them to the corporation.⁵² In such a case, the trustee in bankruptcy can bring the action on behalf of the corporation for the ultimate benefit of creditors.⁵³ Therefore, for the proposed redemption of B's stock, the practitioner should take special precautions to insure that the property received in the redemption is not excessive in comparison to the value of the stock redeemed.

Since the interests of the remaining shareholders in a redemption are usually adverse to those of the redeemed shareholders, the self interest of the respective parties will usually insure a fair price for the redeemed stock. However, if the redeemed shareholder had managerial control at the time of the redemption, he could be in a position to misrepresent financial facts con-

49. *Id.* at 579, 328 N.E. at 508.

50. *Id.* at 603-04, 328 N.E. at 521.

51. For an excellent discussion of the ramifications of *Donahue* and the future, see Note, *Close Corporations—Rights and Duties of Shareholders—Fiduciary Relationship Among Shareholders—Shareholders' Right of Equal Opportunity to Participate in Corporate Purchase of its Own Shares for Corporate Treasury*, 61 CORNELL L. REV. 986 (1976).

52. Several cases suggest that a redemption of stock whereby excessive corporate assets are expended will be set aside. See, e.g., *Martin v. America Potash & Chem. Corp.*, 33 Del. Ch. 234, 92 A.2d 295 (1952) (suggesting that in the absence of existing or resulting corporate insolvency, the transaction will be set aside for any fraud or unfairness); *Duffy v. Omaha Merchants' Express & Transfer Co.*, 127 Neb. 273, 255 N.W. 1 (1934) (a sale of directors' stock to the corporation, where the directors fixed the terms of the price and the payment, was voidable where the sale absorbed a large amount of corporate cash and left the corporation indebted to the directors); *Hess v. Cedarhome Lumber Co.*, 139 Wash. 107, 245 P. 753 (1926).

53. Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, § 543(c)(3), 92 Stat. 2549 (1978) (to be codified in 11 U.S.C. § 543(c)(3)).

cerning the business to the detriment of the corporation and the remaining shareholders. In this latter situation, the corporation and remaining shareholders would have a cause of action against the redeemed shareholders on a breach of fiduciary duty theory.⁵⁴ Furthermore, an action under section 10(b) of the Securities Act of 1933 might be available to the corporation as a defrauded purchaser of the stock.⁵⁵ However, the remaining shareholders would not have a cause of action under rule 10b-5 since they would not meet the standing requirements of *Blue Chip Stamps v. Manor Drug Stores*.⁵⁶ In the Baker Farms situation, if each brother has equal access to corporate information, the possibility of a corporate or a shareholder cause of action appears to be quite remote.⁵⁷

2. Tax Factors of the Proposed Redemption

The tax consequences of the proposed redemption of B's stock may be the determining factor in choosing a redemption as a corporate division technique. Clearly, a minimum goal would be to achieve taxation of any gain recognized at capital gain rates. A necessary prerequisite for capital gain treatment is the attainment of exchange status under section 302.⁵⁸

Although a redemption is subject to the provisions of section 302, not all redemptions will qualify as an exchange under this section. Congress

54. H. HENN, LAW OF CORPORATIONS, § 335 (2d ed. 1970) ("In redeeming shares the directors are subject to fiduciary duties."). See, e.g., *Zahn v. Trans-America Corp.*, 162 F.2d 36 (3d Cir. 1947) (redemption to prevent shareholders from sharing equitably in the distribution of assets under a contemplated liquidation held improper); *Vann v. Indus. Processes Co.*, 247 F. Supp. 14 (D.D.C. 1965) (absent a showing of corporate purpose, corporation's purchase of shares of the brother of controlling shareholder held improper); *Buss v. J.O. Martin Co.*, 241 Cal. App. 123, 50 Cal. Rptr. 206 (1966) (redemption of sufficient portion of minority shareholder's stock to prevent involuntary dissolution was disallowed).

In such a transaction there may be liability for the profits arising from the sale of control. See *Pertman v. Feldmann*, 219 F.2d 173 (2d Cir.), cert. denied, 349 U.S. 952 (1955) (controlling shareholder held to owe corporation a fiduciary duty in selling control).

55. The early case of *Hooper v. Mountain States Sec. Corp.*, 282 F.2d 195 (5th Cir. 1960), cert. denied, 365 U.S. 814 (1961), held that a corporation represented by the trustee in bankruptcy had standing to maintain action under § 10b-5 when defrauded in sale of its stock for spurious assets. "We decline . . . to read . . . a holding that a corporation injured by a sale or purchase of securities has no private right of action under § 10(b) and X-10B-5." *Id.* at 203. While no cases on point have been found regarding a right of action for a closely held corporation defrauded in the purchase of its own securities, analogous authority would support such an action. See, e.g., *Bailes v. Colonial Press, Inc.*, 444 F.2d 1241 (5th Cir. 1971) (complaint held to state a 10b-5 cause of action where bankrupt corporation was defrauded into issuing shares for assets of acquired corporation later discovered to be insolvent); *Rekant v. Desser*, 425 F.2d 872 (5th Cir. 1970) (as a defrauded seller, corporation was held to have a cause of action under 10b-5 under complaint that alleged corporate president fraudulently caused corporation to issue treasury shares and a note to him for inadequate consideration).

56. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, rehearing denied, 423 U.S. 884 (1975) (upheld *Birnbaum* requirement (*Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir.), cert. denied, 343 U.S. 956 (1952))) that plaintiff must be either an actual purchaser or seller of securities before an action can be brought under 10b-5).

57. With equal access to information, it is less likely that the financial records of the corporation will be manipulated. Moreover, the adverse relationship tends to insure a fair price assuming that all the facts concerning the business are available to each brother.

58. Long term capital gain treatment will result if there is a sale or exchange of a capital asset held for more than one year. I.R.C. § 1222(3). If the conditions of § 302(b)(1), (2) or (3) are met, the exchange requirement for long term capital gain will be satisfied.

chose to make a distinction between those redemptions that resemble a sale to an outsider and those that are essentially equivalent to a dividend.⁵⁹ Redemptions that are equivalent to a sale will generally qualify for exchange treatment⁶⁰ whereas, those redemptions that are essentially equivalent to a dividend will, as a rule, result in dividend income to the shareholder.⁶¹

To obtain exchange treatment, one of three standards set out in section 302 must be met. First, exchange treatment will occur if there is a complete termination of the shareholder's interest in the corporation under section 302(b)(3). If a shareholder sells "all" of his stock, completely terminating his interest in the corporation (actually and constructively), an exchange will occur.⁶² Second, an exchange will result under section 302(b)(2) if the redemption is substantially disproportionate. In order to satisfy this test, two mathematical requirements must be satisfied. After the redemption the shareholder must own less than 50 percent of the total combined voting stock of the corporation.⁶³ Additionally, the percentage of voting stock that the shareholder owns in the corporation after the redemption must be less than 80 percent of shareholder's percentage ownership of voting stock before the redemption.⁶⁴ Finally, section 302(b)(2) will not apply unless the percentage of common stock (voting and nonvoting) the shareholder owns in the corporation after the redemption is less than 80 percent of the shareholder's percentage ownership of common stock before the redemption.⁶⁵ For purposes of this latter test, if there is more than one class of common stock, the 80 percent test is determined by reference to the fair market value of the stock.⁶⁶ Third, exchange treatment will result if the redemption is not essentially equivalent to a dividend within the meaning of section 302(b)(1). This section, which lacks mathematical certainty, will be satisfied if the taxpayer can convince the Internal Revenue Service or the courts, that the redemption results in a meaningful reduction of the shareholder's proportionate interest in the corporation.⁶⁷

59. For a comprehensive analysis of § 302 see H.R. REP. NO. 1337, 83d Cong., 2d Sess., S. REP. NO. 1622, 83d Cong., 2d Sess., and CONFERENCE REP. NO. 2543, 83d Cong., 2d Sess., reprinted in [1954] U.S. CODE CONG. & AD. NEWS 4209, 4870, 5294 respectively.

60. See I.R.C. §§ 302(b)(1), (2), (3).

61. *Id.* § 302(d). See *id.* § 301.

62. I.R.C. § 302(b)(3) provides that "[s]ubsection (a) shall apply if the redemption is in complete redemption of all of the stock of the corporation owned by the shareholder."

63. *Id.* § 302(b)(2)(B).

64. *Id.* § 302(b)(2)(C).

65. *Id.*

66. *Id.*

67. The leading case construing § 302(b)(1) is *United States v. Davis*, 397 U.S. 301 (1970). In *Davis*, the taxpayer had purchased preferred stock several years prior to the redemption in order to meet a lender's requirement for additional equity capital. After the loan was repaid, the preferred stock was redeemed. At the time of the redemption, Davis owned all of the preferred stock, and 25% of the common. The remaining common stock was owned by Davis' wife and his two children. The Supreme Court, in deciding against the taxpayer, stated that § 302(b)(1) exchange treatment will result if, and only if, there has been meaningful reduction of the shareholder's proportionate interest in the corporation. 397 U.S. at 313. When testing for exchange treatment under this standard, the Court held that the presence of a business purpose is irrelevant (*Id.* at 312) and further, that the attribution rules of § 318 must be applied to the transaction. *Id.* at 313. Once the attribution rules were applied in *Davis*, the

In determining whether any of the aforementioned tests have been satisfied, the stock attribution rules of section 318 must be applied to the transaction.⁶⁸ Section 318 is extremely complex and an in depth examination thereof is beyond the scope of this article.⁶⁹ However, a brief discussion of section 318 is warranted.

As previously mentioned, Congress felt it necessary to have specific rules to determine when a redemption should be accorded exchange treatment. The basic thrust of the redemption rules is to allow exchange treatment for those redemptions that resemble a sale. Thus, the effects of the complete termination provision of section 302(b)(3) and the substantially disproportionate rule of section 302(b)(2) are quite similar to the result that would occur if a shareholder sold stock to an outsider. Clearly, if a shareholder's stock interest has been substantially reduced under section 302(b)(2), the shareholder has lost a significant degree of control—the same result that would occur if the sale of stock occurred to an outsider rather than to the corporation. However, if two shareholders, A and B, own the stock of a closely held corporation, and B is A's son, a complete termination of A's interest by the corporation may not be the same as the situation where B is an unrelated individual. In this latter fact situation, Congress decided that the family member whose stock was redeemed may not lose any effective control as a result of the redemption.⁷⁰ Similarly, if A owns 50 percent of the stock of X corporation, and Able Corporation, wholly owned by A owns the other 50 percent, and if all of A's individually owned X stock was acquired by X corporation, A would still have 100 percent control of X by reason of his absolute control of Able Corporation. Because of this control potential, Congress decided that section 318 should be enacted. Section 318 provides for several types of attribution.

taxpayer was the constructive sole shareholder of the corporation. Consequently, no meaningful reduction of his interest in the corporation occurred. In fact, the Supreme Court flatly stated that redemptions of stock from a sole shareholder (including those who attain such status by reason of § 318) was always essentially equivalent to a dividend. *Id.* at 313.

Since *Davis*, the Internal Revenue Service has concentrated on a reduction of voting control when ruling on whether a proposed redemption constitutes a meaningful reduction of the shareholder's proportionate interest in the corporation. Thus, in Rev. Rul. 75-502, 1975-2 C.B. 111, a reduction of a shareholder's percentage ownership from 57% to 50% was treated by the Service as an exchange under § 302(b)(1). Logically, a meaningful reduction should occur when a shareholder shifts from a position of effective control of the corporation to a position wherein the control is evenly balanced. The Service, however, also ruled in Rev. Rul. 75-512, 1975-2 C.B. 112, that a minority shareholder can satisfy the *Davis* test when the percentage ownership of such shareholder is significantly reduced (e.g., from 30% to 24%).

68. I.R.C. § 302(c)(1).

69. For discussion concerning I.R.C. § 318, see Cavitch, *Problems Arising from the Attribution Rules*, 35 N.Y.U. ANN. INST. FED. TAX 801 (1977); Randall & Benson, *Family Dissension and the Attribution Rules of Sections 267, 318 and 544*, 53 TAXES 534 (1975); Zarky & Maron, *Stock Redemptions as an Estate Planning Tool*, 1974 SO. CAL. TAX INST. 181.

70. For an analysis of this section, see H. R. REP. NO. 1337, 83d Cong., 2d Sess., S. REP. NO. 1622, 83d Cong., 2d Sess., and CONFERENCE REP. NO. 2543, 83d Cong., 2d Sess., reprinted in [1954] U.S. CODE CONG. & AD. NEWS 4234, 4890-91, 5293-95. See also Act of Aug. 31, 1964, Pub. L. No. 88-554, 78 Stat. 761 (1964); Act of Oct. 16, 1962, Pub. L. No. 87-834, 76 Stat. 960 (1962); Act of Sept. 14, 1960, Pub. L. No. 86-779, 74 Stat. 998 (1960).

First, the family attribution rule of section 318(a)(1) provides that a shareholder is deemed to own stock which is owned by the members of his or her family. For purposes of the family attribution rule, the family is defined as the spouse of the individual, his children, grandchildren, and parents.⁷¹ Thus, in the above example where A and B are father and son, if all of A's stock is redeemed, section 318 will apply and thereby prevent a complete termination of A's stock for purposes of section 302(b)(3). Unless the waiver of attribution rule applies,⁷² A will own 100 percent of the stock before and after the redemption.⁷³

Section 318 also provides for various types of entity to beneficiary attribution. Under these rules, a shareholder is treated as owning the stock owned by a partnership or estate based upon his proportionate interest in such entities.⁷⁴ Thus, if X corporation is owned equally by A, an individual, and the AB partnership, and if A is a 50 percent partner, he would be treated as the constructive owner of 50 percent of the stock that the partnership owned in X corporation. Likewise, a beneficial interest in a trust that owns stock in a corporation may give rise to constructive ownership.⁷⁵ Here, however, stock owned directly or indirectly by or for the trust will be considered owned by the beneficiary, proportionate to her or his actuarial interest in the trust.⁷⁶ Another form of entity to beneficiary rule concerns stock ownership in related corporations.⁷⁷ For example, if A is a shareholder in X and Y corporations, and Y owns stock in X, A may be deemed to own additional stock in X because of his stock ownership in corporation Y. The attribution rules provide that if A owns 50 percent or more in value of the outstanding stock of corporation Y,⁷⁸ he will be considered the constructive owner of a proportionate share of the X stock that Y corporation owns.⁷⁹

Section 318 also contains beneficiary to entity attribution rules. If a corporation is redeeming stock from an entity and if the entity is a partnership or an estate, all of the stock in such corporation held by a partner or beneficiary is attributed to the partnership or estate.⁸⁰ Note that this rule is

71. I.R.C. § 318(a)(1)(A).

72. *Id.* § 302(c)(2).

73. *Id.* § 318(a)(1).

74. I.R.C. § 318(a)(2)(A) provides that "[s]tock owned, directly or indirectly, by or for a partnership or estate shall be considered as owned proportionately by its partners or beneficiaries."

75. I.R.C. § 318(a)(2)(B)(i) provides that "[s]tock owned, directly or indirectly, by or for a trust . . . shall be considered owned by its beneficiaries in proportion to the actuarial interest of such beneficiaries in such trust."

76. *Id.*

77. I.R.C. § 318(a)(2)(C) provides that

[i]f 50 percent or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, such person shall be considered as owning the stock owned, directly or indirectly, by or for such corporation, in that proportion which the value of the stock which such person so owns bears to the value of all stock in such corporation.

78. *Id.*

79. *Id.*

80. I.R.C. § 318(a)(3)(A) provides that "[s]tock owned, directly or indirectly, by or for a partner or a beneficiary of an estate shall be considered as owned by the partnership or estate."

different than the partnership and estate entity to beneficiary attribution rules. In the latter situation, only a proportionate amount of the stock is attributed from the entity to the beneficiary whereas all of the stock that the beneficiary owns will be attributed to the entity.⁸¹ A trust will be treated as the constructive owner of stock owned by a beneficiary unless the beneficiary's interest is a remote contingent interest—roughly defined as five percent or less of the actuarial value of the trust property.⁸² Finally, all stock held by a shareholder is attributed to a corporation if such shareholder actually or constructively owns 50 percent or more in value of the corporation's stock.⁸³

Section 318 contains option attribution rules as well as reattribution rules. Under the option rules, a person who has an option to acquire stock is deemed to own the stock under option.⁸⁴ Under section 318(a)(5)—sometimes referred to as the reattribution rules—chains of attribution are permitted. Thus, a shareholder may be deemed to be constructive owner of stock through a combination of an entity and a family attribution rule.⁸⁵ For example, if corporation X is owned equally by A, B (A's son), and Able Corporation (wholly owned by B), then A will be deemed to own 100 percent of the stock of X corporation. This result occurs because of his actual stock ownership and the application of section 318. Of course, A owns 1/3 of the stock of X in his own right. But A is also deemed owner, by reason of section 318(a)(1), of the 1/3 of the X corporation stock actually owned by his son B. Finally, A is deemed to own the 1/3 of the stock that B constructively owns as a result of the combination of an entity attribution rule and a family attribution rule. Thus, B is deemed to own all of the stock that Baker Corporation owns by reason of the entity to beneficiary rule.⁸⁶ The stock constructively owned by B, is reattributed to A under the family attribution rule.⁸⁷

3. Application to Baker Farms

Would the proposed redemption of B's stock qualify as an exchange under section 302(b)(1), (b)(2) or (b)(3)? A meaningful reduction of B's proportionate interest in the corporation within the meaning of section 302(b)(1) will occur since B's percentage ownership will be reduced from 50 percent to zero. Further, since B's stock ownership after the redemption will

81. *Id.* See also note 74 *supra*, where attribution is proportionate.

82. I.R.C. § 318(a)(3)(B)(i).

83. I.R.C. § 318(a)(3)(C) provides that "[i]f 50 percent or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, such corporation shall be considered as owning the stock owned, directly or indirectly, by or for such person."

84. *Id.* § 318(a)(4).

85. The general rule of I.R.C. § 318(a)(5)(A) provides "[e]xcept as provided in subparagraphs (B) and (C), stock constructively owned by a person by reason of the application of paragraph (1), (2), (3), or (4), shall, for purposes of applying paragraphs (1), (2), (3), and (4) be considered as actually owned by such person."

86. I.R.C. § 318(a)(2)(C).

87. *Id.* §§ 318(a)(5), 318(a)(1).

be zero, B will own less than 50 percent of the total combined voting power and less than 80 percent of his prior percentage ownership in the corporation. Consequently, the redemption will qualify as an exchange under section 302(b)(2). Finally, exchange treatment will result under section 302(b)(3) since B's interest in the corporation will be completely terminated. The attribution rules of section 318 will not apply to the proposed redemption since siblings are not included within the meaning of the term "family" as used in that section.⁸⁸

Since the redemption qualifies as an exchange under section 302, the determination of the amount of gain to B is made by applying section 1001. Under section 1001, gain will be realized and recognized to the extent that the amount realized from the transaction exceeds B's adjusted basis in the stock. Under section 1001(b) the amount realized upon the sale or other disposition of property (which includes an exchange of stock) is defined as the sum of money received plus the fair market value of property (other than money) received. Thus, the amount realized by B upon the redemption would be \$730,000 (\$5,000 cash, \$15,000 of soybeans, \$70,000 of machinery, and farmland valued at \$640,000). The basis of the stock redeemed from B would be determined under two sections of the code. The basis of stock given to B by his father during the father's lifetime will be the same as the father's basis increased by any gift tax paid thereon by the father.⁸⁹ The basis to John Baker (the father) of each share of stock was \$500.⁹⁰ Since no gift tax was incurred by John Baker upon the gifts of stock, the basis of the 264 shares given to B would be \$132,000 (264 shares \times \$500 per share). The stock B received from his father's estate (56 shares) would have a basis equal to the fair market value of the stock at the time of his father's death.⁹¹ Thus, the 56 shares will have a basis to B of \$44,800 (56 shares \times \$800 per share). Thus, the total basis for the stock redeemed will be \$176,800 (\$132,000 + \$44,800). The gain realized from the redemption then would be \$553,200 (\$730,000 amount realized less \$176,800 adjusted basis).

If B files a joint return with his wife for the year 1979, the tax resulting from the sale (assuming no other income or deductions) would approach \$125,300.⁹² Although general averaging under section 1301,⁹³ or the alter-

88. *Id.* § 318(a)(1).

89. *Id.* § 1015 (donee's basis for gain purposes equals the donor's basis plus any gift tax paid thereon).

90. See notes 12-13 *supra* and accompanying text. Since the only assets transferred by John Baker under § 351 were 640 acres of land which had an adjusted basis of \$500 an acre, the 640 shares received will have an adjusted basis of \$500 per share. See I.R.C. § 358.

91. I.R.C. § 1014(a) (Since John Baker died in 1976, the new I.R.C. § 1023 carry-over basis provision has no effect as it applies to decedents dying after December 31, 1979.). The Revenue Act of 1978, Pub. L. No. 95-600, § 515, 92 Stat. 2763, has extended the effective date of I.R.C. § 1023 until after December 31, 1979.

92. The tax computation for B would be as follows (assuming no other income):

Amount Realized	\$730,000
(less adjusted basis)	(176,800)
Gain Realized	553,200
(less § 1202 60% deduction)	(331,920)

native tax computation under section 1201,⁹⁴ may reduce this amount, the

Taxable Income	221,280
Tax from I.R.C. § 1(a)	<u>\$121,620</u>
Add-On Minimum Tax, I.R.C. §§ 56-58:	
Total Tax Preference Items (after Dec. 31, 1978, the add-on minimum tax is computed by excluding the capital gains deduction from the tax preference items)	\$ 0
Add-On Minimum Tax	<u>\$ 0</u>
Alternative Minimum Taxable Income (AMTI)	
Gross Income	\$553,200
(less capital gains deduction)	(331,920)
Tax Preference Items (capital gains are included tax preference items for purposes of § 55)	<u>331,920</u>
	<u>\$553,200</u>
Alternative Minimum Tax Imposed on AMTI	
\$20,000 Exemption	\$ 0
10% on next \$40,000	4,000
20% on next \$40,000	8,000
25% on excess over \$100,000 (\$553,200 - \$100,000)	113,300
Alternative Minimum Tax	<u>\$125,300</u>
Total Tax Imposed on B for 1979	
Greater of:	
Regular tax (I.R.C. § 1(a) plus Add-On)	\$121,620
Alternative Minimum Tax	\$125,300
Tax	\$125,300
93. I.R.C. §§ 1301-1305. Assume a base period income of \$10,000 for each of 4 preceding years for	
B. His tax using income averaging would be as follows:	
(1) Averageable income	
Current year taxable income \$276,600	
Base period amount: 30% × \$40,000 (\$12,000)	
Difference (averageable income) \$264,600	
(2) Tax on base period amount I.R.C. § 1(a)	\$ 1,425
(3) Tax on sum of base period amount and 1/5 of averageable income	
\$12,000 + \$52,920 = \$64,920.00	
Tax, I.R.C. § 1(a) \$22,334.80	
(4) Tax on averageable income	
\$22,334.80	
(1,425.00)	
\$20,909.80 × 5	
	<u>\$104,549</u>
(5) Total Tax	<u>\$105,974</u>
Add-On Minimum Tax, I.R.C. § 56-58	
Total Tax Preference Items	\$ 0
Add-On Minimum Tax	<u>\$ 0</u>
Alternative Minimum Tax, I.R.C. § 55	
Alternative Minimum Taxable Income (AMTI)	
Gross Income	\$553,200
(less capital gains deduction)	(331,920)
Tax Preference Items	331,920

reduction, if any, offers minimum relief to a cash-short taxpayer such as B. Consequently, the proposed redemption of B's stock would create an enormous tax liability for B. Furthermore, since the assets to be received upon the redemption are farm operating assets (land, machinery, etc.), B would have few liquid assets to pay the tax liability and thus might be forced to mortgage Woodland to pay the tax. Given the low return on investment capital for farming operations, the profit margin, after payment of debt service on a new mortgage, may be thin indeed.

The redemption will also cause Baker Farms, Inc. to recognize gain. In general, the regulations under section 311 provide that a corporation will not recognize gain upon the distribution of property in exchange for its stock.⁹⁵ An exception is provided for property subject to depreciation recapture under sections 1245 and 1250.⁹⁶ Likewise, the disposition of property upon which the corporation has taken the investment credit, may trigger recapture of all or part of this credit if the distribution constitutes a premature disposition within the meaning of section 47.⁹⁷ Finally, if the property transferred represents an item of income not yet included in the corporation's taxable income because of its method of accounting, the distribution of such property may cause recognition of income to the corporation under the assignment of income doctrine,⁹⁸ or possibly under section 446(b).⁹⁹

	<u>\$553,200</u>
Alternative Minimum Tax Imposed on AMTI	
\$20,000 Exemption	\$ 0
10% on next \$40,000	4,000
20% on next \$40,000	8,000
25% on excess over \$100,000	113,300
(\$553,200 - \$100,000)	
Alternative Minimum Tax	<u>\$125,300</u>
Total Tax Imposed if B Income Averages	
Greater of:	
Regular Tax (I.R.C. §§ 1301-1305 plus Add-On)	\$105,974
Alternative Minimum Tax	\$125,300
Tax	\$125,300

Note: If income averaging is elected, the alternative capital gains computation could not have been used in years prior to 1979 under § 1201(b). See *id.* § 1304(b)(3). In 1979, the alternative computation does not apply. See note 94 *infra*.

94. Section 1201(b), however, was repealed by the Revenue Act of 1978, Pub. L. No. 95-600, § 401, 92 Stat 2763. Accordingly, the alternative tax computation will not apply to taxable years beginning after December 31, 1978.

95. Treas. Reg. § 1.311-1(a), T.D. 6152, 1955-2 C.B. 61, 96.

96. I.R.C. §§ 1245, 1250, state that recapture income shall be recognized notwithstanding any other provision of this subtitle. See Treas. Reg. § 1.311-1(a), T.D. 6152, 1955-2 C.B. 61, 96 ("Except as provided in [sections 1245(a) and 1250(a)] no gain or loss is recognized to a corporation on the distribution, with respect to its stock . . . or property . . .").

97. I.R.C. § 47(a)(1) (the tax credit will be recaptured "[i]f during any taxable year any property is disposed of, or otherwise ceases to be section 38 property. . . , before the close of the useful life which was taken into account in computing the credit under section 38").

98. The assignment of income doctrine attributes the income for taxation purposes to the person earning the income and not to the person assigned the income-receiving item. See Bonovitz, *Corporate Liquidations—Section 331 and Related Problems*, 73-3d TAX MNGM'T (BNA) A-7 (1974) ("The assignment of income doctrine will apply . . . where the corporation remains in existence at the time a distributed contingent or inchoate income item is collected by its shareholders").

In 1969, Congress with the passage of section 311(d)¹⁰⁰ broadened the potential for a gain recognition to the corporation when it uses appreciated property in conjunction with a redemption of stock from a shareholder. Under section 311(d)(1), gain will be recognized to a corporation when it distributes appreciated property (other than an obligation of the distributing corporation) to a shareholder in redemption of all or part of his stock in the corporation, to the extent that the fair market value of the distributed property exceeds the adjusted basis of the property in the hands of the corporation. There are, however, several exceptions to this gain recognition rule.¹⁰¹ By far the most important exception is contained in section 311(d)(2)(A). Under this provision a distribution is exempt from section 311(d)(1) if it is in complete redemption of all of the stock of a shareholder who, at all times within the twelve month period prior to the redemption, owned at least 10 percent in value of the corporation's outstanding stock, but only if the redemption satisfies section 302(b)(3) determined without the application of the ten year forward rules of section 302(c)(2)(A)(ii).¹⁰²

Will Baker Farms, Inc. recognize gain upon the proposed redemption of B's stock? Since the redemption of B's stock will qualify as an exchange under section 302(b)(3), section 311(d)(1) will not apply. However, the farm machinery and the soybeans distributed to B may cause the corporation to recognize gain. If the difference between the fair market value of the machinery (\$70,000) and its adjusted basis (\$35,000) represents depreciation previously deducted by the corporation, section 1245 would require that gain be recognized by the corporation to the extent the depreciation is recaptured.¹⁰³ Since all of the costs involved in raising the soybeans have been previously deducted, the corporation has generated this income item. Therefore, a disposition to B may constitute an anticipatory assignment of income with the corporation recognizing income upon the distribution to B.¹⁰⁴ Alternatively the Service may require the corporation to recognize the income potential in the soybeans by changing the corporation's method of

99. I.R.C. § 446(b) (under this provision the Secretary has authority to select the method of accounting to clearly reflect income where no method has been regularly used by the taxpayer or the method used does not clearly reflect income).

100. Tax Reform Act of 1969, Pub. L. No. 91-172, § 905, 83 Stat. 487 (amending I.R.C. § 311(d)).

101. I.R.C. § 311(d)(2) (this subsection provides for the various exemptions to gain recognition as follows: exemption (B) excludes a distribution of a subsidiary (if 50% or more in value of the subsidiary's stock was owned by the distributing corporation within the nine-year period ending one year prior to distribution), where the subsidiary is engaged in a trade or business, and where the subsidiary has not received a substantial part of its assets as a contribution of capital or in a § 351 exchange; exemption (C) applies to a distribution pursuant to final judgment under the Sherman or Clayton Acts; (D) applies to distributions in redemption of stock to pay death taxes under § 303(a); (E) applies to a distribution to certain private foundations in redemption of stock; (F) applies to a distribution by a regulated investment company; and (G) applies to distributions subject to provisions relating to the Bank Holding Company Act).

102. *Id.* § 302(c)(2)(A)(ii) (the 10-year forward rule provides that the distributee does not acquire an interest described in § 302(b)(3) within 10 years from the date of distribution).

103. *Id.* § 1245(a)(1) ("Such gain shall be recognized notwithstanding any other provision of this subtitle.").

104. See Adolph Weinberg, 44 T.C. 233 (1965), *aff'd per curiam sub. nom.* Commissioner v. Sugar Daddy, Inc., 386 F.2d 836 (9th Cir. 1968) (assignment of growing crops to several newly formed corpora-

accounting as to this particular item under the authority of section 446(b).¹⁰⁵

4. Potential Use of Stock Redemptions in Other Situations

While a taxable corporate division of Baker Farms, Inc. appears to be unwise because of the potential large gain to B and to the corporation, a stock redemption as a division technique may be useful in other farm corporation situations. Practitioners frequently use a stock redemption when an inactive participant desires to sell her or his interest to the corporation.¹⁰⁶ For example, assume X corporation is owned equally by C (an active participant) and D (an inactive participant). Further assume that the stock owned by C and D was received by them from their father as testamentary gifts upon his death in 1977. Since the new carryover basis rule will not apply to decedents dying before January 1, 1980,¹⁰⁷ the stock received at death from the father will have a basis equal to the fair market value of the stock at the date of the father's death.¹⁰⁸ Assume D, the inactive participant, wishes to convert his stock holdings to a more liquid form of investment such as cash. If the corporation has two farms which have a value substantially in excess of their respective basis, then it may be feasible for D to exchange his stock for one of the farms.

Such an approach has several advantages. First, D's basis in his stock is relatively large, and thus the gain at the shareholder level may be relatively insignificant. Second, D will have absolute control over an asset which can be either sold for cash or held for investment purposes. If D retains the farm for investment purposes, he could lease the farm for cash rent to X corporation. A leaseback to X corporation may be especially attractive to C who may need the land to maintain an optimum level of productivity for the farm corporation. Third, the gain potential at the corporate level attributable to the farm received by D in the exchange, would not be recognized to the corporation under section 311. Since D's stock interest would be completely terminated within the meaning of section 302(b)(3), D qualifies for exemption from the gain recognition rule of section 311(d).¹⁰⁹ Finally, if farm land is transferred, rather than equipment and inventory, section 1245 recaptured income and the assignment of income doctrine generally will not apply.

Unfortunately, the use of the stock redemption as a division technique

tions was held to be an assignment of the proceeds resulting from the sale of the crops, the income from this sale was held taxable to the assignor).

105. See note 99 *supra*.

106. See Strouch, *Buy-Sell Agreements for Close Corporations*, 1 *SUCCESSFUL ESTATE PLANNING* (P-H) ¶ 2035 (1975); Zarky & Maron, *Stock Redemption as an Estate Planning Tool*, 1974 SO. CAL. TAX INST. 181.

107. On November 7, 1978, President Carter signed the Revenue Act of 1978, Pub. L. No. 95-600, 92 Stat. 2763, which, among other things, postponed the carryover basis rule until 1980. I.R.C. § 1023(a)(1), as amended by the Revenue Act of 1978, Pub. L. No. 95-600, § 515, 92 Stat. 2763. ("The basis of carryover basis property acquired from a decedent dying after December 31, 1979, in the hands of the person so acquiring it shall be the adjusted basis of the property immediately before the death of the decedent").

108. I.R.C. § 1014(a), (d), as amended by the Revenue Act of 1978, Pub. L. No. 95-600, § 515, 92 Stat. 2763.

109. *Id.* § 311(d)(2)(A).

is hampered by the section 318 attribution rules. In the above hypothetical situation, C and D are brothers, and, consequently, the attribution rules do not apply.¹¹⁰ However, assume D (the inactive participant) is C's mother and that she wishes to convert her stock holdings to a more liquid investment form. Under the fact situation hypothesized, D will have considerable difficulty obtaining exchange treatment under section 302. D (the mother) would constructively own all of C's (the son's) stock.¹¹¹ Consequently, D, by reason of the constructive ownership of her son's stock coupled with the actual ownership, would own 100 percent of X corporation immediately after the redemption.¹¹² With 100 percent ownership after the redemption, the conditions for exchange treatment under section 302(b)(1), (b)(2) or (b)(3) will not be satisfied.

Because of the harshness of the above result, Congress has provided for a limited waiver of the family attribution rule under section 302(c)(2) if the redemption otherwise qualifies under section 302(b)(3). If the conditions for use of section 302(c)(2) are met, the family attribution rule will not apply and a complete termination under section 302(b)(3) will result. The requirements for a waiver of the family attribution rule under section 302(c)(2) are:

- (1) Immediately after the distribution, the distributee must have no interest as a shareholder, officer, director, employee, or any other interest with the exception of an interest as a creditor;
- (2) the distributee must not reacquire any such interest within ten years from the date of the redemption unless the stock is acquired by bequest or inheritance;
- (3) the shareholder must file an agreement with the Internal Revenue Service wherein he agrees to notify the Service of his acquisition of any tainted interest within ten years from the redemption date.

Nevertheless, the above waiver rule will not apply if, a) any of the shares included in the stock redemption were acquired within a ten year period prior to redemption from a person whose ownership would be attributable (at the time of the distribution) to the distributee under section 318;¹¹³ or, b) if any person (whose stock would be attributable to the distributee under the section 318 attribution rules) owns stock acquired from the distributee within the ten year period prior to the distribution.¹¹⁴ The limitations in the preceding sentence will not apply if the transfers occurring within such ten year period did not have a principal purpose of avoiding federal income taxes.¹¹⁵

110. *See id.* § 318(a)(1)(A) (siblings are not included in the definition of family members under the attribution rules).

111. *Id.* § 318(a)(1)(A)(ii).

112. D, C's mother, actually owns 50% of X and constructively owns an additional 50%.

113. I.R.C. § 302(c)(2)(B)(i).

114. *Id.* § 302(c)(2)(B)(ii).

115. *Id.* § 302(c)(2)(B). For example, the transfer of stock to a spouse with the intention of retaining effective control indirectly through the stock held by the spouse or with the intention of subsequent

From the above analysis, it is apparent that exchange treatment for a redemption of stock from a family member in a family owned corporation will be difficult to achieve. If an older generation family member wishes to terminate her or his interest in the corporation, a practitioner must carefully examine the relationships between all of the shareholders to determine the applicability of section 318 to the transaction. If the shareholder whose stock is to be redeemed is the constructive owner of other stock in the corporation, the practitioner must examine section 302(c)(2) to determine the feasibility of a waiver of the family attribution rule. In making this determination, the practitioner must consider (a) the stock interest of the other family members to determine whether they have received stock within the tainted ten year period from the shareholder whose stock is to be redeemed and (b) the stock to be redeemed to determine if any of this stock has been received within the same ten year period from any other family member. If stock was acquired from another family member within the ten year period proceeding the redemption, then some consideration should be given to seeking a ruling from the Internal Revenue Service to the effect that the transaction did not have as its principal purpose the avoidance of federal income tax.¹¹⁶

5. Summary of Stock Redemptions

The use of stock redemptions as a corporate division technique may be an appropriate choice for the practitioner. However, the section 318 attribution rules as well as a potential large capital gains tax may deter its use. In any event, the use of a stock redemption to divide up the Baker Farms assets is unacceptable. The large capital gain tax to B definitely reduces the desirability of such technique.

C. A Complete Liquidation As A Division Technique

One possible division technique that the Baker brothers might consider is a complete liquidation of Baker Farms, Inc. Upon a complete liquidation, A could exchange all of his stock in the corporation for one half of all the assets (cash of \$5,000, farm machinery of \$70,000, soybeans valued at \$15,000 and Woodland valued at \$640,000). Similarly B could exchange all

redemption of transferred stock from the spouse would most likely constitute tax avoidance. However, where a sole shareholder transfers part of the corporate stock to his son, a long-time employee, shortly before a redemption by the corporation of the remainder of his stock, the purpose may not necessarily be for tax avoidance. Thus, in a recent revenue ruling, the fact that the son was knowledgeable in the affairs of the corporation and intended to control and manage the corporation in the future permitted the finding that the sole purpose of the transaction was to allow the father to retire and leave the business to his son. Rev. Rul. 77-293, 1977-2 C.B. 91. Another recent ruling held that a sale by a shareholder of common and preferred stock to his son and other employees prior to corporate redemption of the remainder of his stock was for the purpose of transferring voting control to his son and to allow key employees greater participation in the growth of the corporation. Thus, tax avoidance was not present and waiver of the attribution rule was permitted. Rev. Rul. 77-455, 1977-2 C.B. 93.

116. I.R.C. § 302(c)(2)(B).

of his stock for Stillcrest and one half of the cash, farm machinery, and soybeans.

In general, the receipt of the property by shareholders in a complete liquidation of a corporation is a fully taxable event to them.¹¹⁷ Each shareholder would recognize gain in an amount equal to the excess of the cash and the value of property received over the shareholder's basis in his stock.¹¹⁸ If the stock itself is a capital asset and if the corporation is not collapsible within the meaning of section 341, the gain would be taxed at long term capital gain rates.¹¹⁹ Both A and B would each recognize gain in the amount of \$553,200 (\$730,000 amount realized less \$176,800 adjusted basis).¹²⁰ Assuming joint returns for 1979 are filed by the brothers with their respective wives, the tax resulting from the liquidation would approach \$250,600.¹²¹

117. Under I.R.C. § 331, amounts distributed in complete liquidation of a corporation are treated as in full payment in exchange for the stock. Section 331(a) provides:

(1) COMPLETE LIQUIDATIONS—Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock.

(2) PARTIAL LIQUIDATIONS—Amounts distributed in partial liquidation of a corporation (as defined in section 346) shall be treated as in part or full payment in exchange for the stock.

118. The gain to a shareholder on liquidation is the excess of the amount realized in the distribution over the adjusted basis of the stock exchanged and the loss is the excess of his adjusted basis of the stock over the amount realized. The amount realized is the sum of any money received plus the fair market value of any property (other than money) received. See I.R.C. § 1001(a) for an explanation of the computation procedure. The recognized portion of the gain is defined in § 1001(c), which provides that "[e]xcept as otherwise provided . . . the entire amount of the gain or loss, determined under this section, on the sale or exchange of property shall be recognized."

119. Given the preferential treatment for capital gains, it becomes of critical importance to define the transactions which qualify. One factor relates to the nature of the asset involved, for capital gain treatment the asset must be a "capital asset" within the meaning of the Code. See I.R.C. § 1221. Another factor is that the disposition constitutes a "sale or exchange." See *id.* § 1222. Also, a holding period of one year must be met. See *id.* § 1222(3). There are two primary limitations, however, which must be considered. The first exception involves collapsible corporations dealt with in § 341 where gain from the sale or exchange of stock in such a corporation is treated as ordinary income. *Id.* § 341(a). The second exception is set forth in *Corn Products Refining Co. v. Commissioner*, 350 U.S. 46 (1955). The primary effect of *Corn Products* is that certain assets, which on a literal reading of the statute would be "property" not falling under any of the specific exclusions and would thus secure capital asset treatment, are nevertheless held under the particular transactions involved to yield ordinary income. 350 U.S. at 52-54. See also *Wineberg v. Commissioner*, 326 F.2d 157 (9th Cir. 1963); *Cranford v. United States*, 338 F.2d 379 (Ct. Cl. 1964); Surrey, *Definitional Problems in Capital Gains Taxation*, 69 HARV. L. REV. 985 (1956).

120. I.R.C. § 1001(a).

121. The tax computation for A and B would be as follows (assuming no other income):

Amount Realized by one shareholder, A*	\$730,000
(less adjusted basis)	(176,800)
Gain realized	553,200
(less § 1202 60% deduction)	(331,920)
Taxable Income	221,280
Tax from I.R.C. § 1(a)	\$121,620
Add-On Minimum Tax, I.R.C. §§ 56-58	
Total Tax Preference Items (after Dec. 31, 1978, the add-on minimum tax is computed by excluding the capital gains deduction from the tax preference items)	\$ 0

Baker Farms, Inc. may also realize and recognize gain upon a complete liquidation of the corporation. Although section 336 of the Internal Revenue Code generally provides that a corporation does not recognize gain upon the complete liquidation,¹²² there are several exceptions to this rule.¹²³

Sections 1245 and 1250 override section 336 and may require that depreciation deductions previously taken by the corporation be recaptured as income upon the complete liquidation of Baker Farms, Inc.¹²⁴ In addition, the liquidation may cause the recapture of investment credits previously taken by Baker Farms, Inc.¹²⁵ Thus, the distribution of the machinery with a value of \$140,000 and adjusted basis of \$70,000 would cause income recognition to Baker Farms, Inc. under section 1245 to the extent that the gain

Add-On Minimum Tax	\$ 0
Alternative Minimum Tax, I.R.C. § 55	
Alternative Minimum Taxable Income (AMTI)	
Gross Income	\$553,200
(less capital gains deduction)	(331,920)
Tax Preference Items (capital gains are included tax preference items for purposes of § 55)	331,920
	<u>\$553,200</u>
Alternative Minimum Tax Imposed on AMTI	
\$20,000 Exemption	\$ 0
10% on next \$40,000	4,000
20% on next \$40,000	8,000
25% on excess over \$100,000 ((\$553,200 - \$100,000))	113,300
Alternative Minimum Tax	<u>\$125,300</u>
Total Tax Imposed on A for 1979	
Greater of:	
Regular tax (I.R.C. § 1(a) plus Add-On)	\$121,620
Alternative Minimum Tax	\$125,300
Tax for A	\$125,300
Total Tax for A and B combined	\$250,600

* These calculations would also apply to the other shareholder, B.

Cf. note 92 *supra* (calculation of tax liability assuming B receives the full proceeds of a sale of Baker Farms, Inc.).

122. I.R.C. § 336 provides that "[e]xcept as provided in section 453(d) (relating to disposition of installment obligations), no gain or loss shall be recognized to a corporation on the distribution of property in partial or complete liquidation."

123. Although only one exception to nonrecognition treatment, the distribution of installment obligations, is expressly provided for in § 336, there are numerous other statutory exceptions to the general rule of nonrecognition, including depreciation recapture under § 1245 and § 1250, farm losses under § 1251, investment credit recapture under § 47, and the power of the Commissioner to change accounting methods under § 446(b). Judicially created remedies such as the assignment of income doctrine and the tax benefit rule exist as well and will be discussed later. The recognition provisions of § 1245 and § 1250 apply because they provide that "[s]uch gain shall be recognized notwithstanding any other provisions of this subtitle." See I.R.C. §§ 1245(a)(1), 1250(a)(1)(A).

124. See note 123 *supra*.

125. I.R.C. § 47(a)(1) provides for the recapture of the investment credit upon the early disposition of § 38 property. A liquidating distribution of § 38 property pursuant to § 331 constitutes a disposition of § 38 property. In the event the liquidating distribution occurs before the close of the useful life which was taken into account in computing the investment credit under § 38, investment credit recapture results. See *id.* § 47(a)(1); Treas. Reg. §§ 1.47-2(a)(1), 1.47-3(a)(1), (f), T.D. 6931, 1967-2 C.B. 12, 26, 28, 32.

represents depreciation deductions taken by the corporation after 1961.¹²⁶ Assuming that the machinery originally cost the corporation \$150,000, then the entire \$70,000 of gain potential (\$140,000-70,000) would be recognized by the corporation under section 1245. Furthermore, the distribution of the farm machinery may well create investment credit recapture for that portion of the machinery that has been prematurely disposed of within the meaning of section 47.¹²⁷

Another area of concern which may cause income recognition to the corporation is the disposition of the soybeans. Such a midstream transfer of a potential income item may create income recognition to the corporation under the assignment of income doctrine,¹²⁸ the tax benefit rule¹²⁹ or section 446(b).¹³⁰ All of the costs to develop the soybeans as an asset have previously been deducted by the corporation on its corporate return. Thus, if the corporation transferred the soybeans to the shareholders, the income potential would be shifted from the corporation to the shareholders. While the assignment of income doctrine requires that the income be taxed to its source, the courts are reluctant to apply the doctrine unless a tax avoidance motive is present.¹³¹ Since, the termination of a business enterprise through

126. A liquidating corporation which distributes § 1245 property to its shareholders recognizes gain taxable as ordinary income to the extent of the lesser of: (1) the excess of the fair market value of the property over its adjusted basis; or (2) the sum of depreciation deductions taken with respect to the property after December 31, 1961. See Treas. Reg. § 1.1245-1(a) (1), T.D. 6832, 1965-2 C.B. 298.

127. See note 125 *supra*.

128. The assignment of income doctrine, requiring the taxation of income to the person earning the income and not to the person who was assigned the income, applies to corporations liquidating under § 331. This doctrine may apply to the liquidating corporation when the distributed item is earned or accrued at the time of the distribution or is capable of determination of the amount, or where the corporation is still in existence when the distributed contingent item is collected by the shareholders or becomes capable of determination. See *Messer v. Commissioner*, 438 F.2d 774, 779-81 (3d Cir. 1971); *Wood Harmon Corp. v. United States*, 311 F.2d 918, 921-26 (2d Cir. 1963); *Williamson v. United States*, 292 F.2d 524, 527-31 (Ct. Cl. 1961). The leading case in the development of the entire doctrine is *Lucas v. Earl*, 281 U.S. 111 (1930), where Mr. Justice Holmes pointed out that the case "is not to be decided by attenuated subtleties" but rather on a "reasonable construction of the taxing act." 281 U.S. at 114. See also *Burnet v. Leininger*, 285 U.S. 136 (1932); *Irwin v. Gavit*, 268 U.S. 161 (1925); *Williamson v. United States*, 292 F.2d 524 (Ct. Cl. 1961); *Lyon & Eustice, Assignment of Income: Fruit and Tree as Irrigated by the P.G. Lake Case*, 17 TAX L. REV. 295 (1962).

129. See I.R.C. § 111; Treas. Reg. § 1.111-1(a) (1956). Early case law developed the principal that when a deduction in a prior year had reduced the taxpayer's taxable income, a subsequent recovery of the deducted item had to be included in income. *Dobson v. Commissioner*, 320 U.S. 489 (1943). For more recent illustrations see *Spitalny v. United States*, 430 F.2d 195 (9th Cir. 1970); *Commissioner v. Anders*, 414 F.2d 1283 (10th Cir. 1969). In *Tennessee Carolina Transportation, Inc.*, 65 T.C. 440, *aff'd*, 78 U.S.T.C. ¶ 9671 (6th Cir. 1978), the court held that the tax benefit rule overrode § 356.

130. A liquidating distribution of assets in kind may result in the Service seeking to change the liquidating corporation's method of accounting in the year such distributions are made. I.R.C. § 446(b) provides that "[i]f no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income." See *Standard Paving Co. v. Commissioner*, 190 F.2d 330, 332-34 (10th Cir.), *cert. denied*, 342 U.S. 860 (1951); *Jud Plumbing & Heating, Inc. v. Commissioner*, 153 F.2d 681, 684 (5th Cir. 1946).

131. The anticipatory assignment of income doctrine is of such uncertain scope that the results in litigated cases are unpredictable; moreover, it may be that the courts will be less willing to apply the principle if the corporation completely liquidates than if the shareholders receive the property in an ordinary distribution or partial liquidation, for the reason that a complete liquidation usually has more

a complete liquidation is a rather drastic step, and one usually not associated with tax avoidance motives, the assignment of income doctrine has been infrequently applied by the courts to complete liquidations.¹³²

Another reason for the infrequent use of the assignment of income doctrine to factual situations similar to the Baker Farms, Inc., relates to the type of asset under consideration. If Baker Farms, Inc. had sold the soybeans on contract to a local elevator and then distributed the contract to the two shareholders, a court might be more willing to apply the assignment of income doctrine.¹³³ Clearly, if the corporation was on the accrual basis, it would have to include the contract amount in its income on its final return for the year of liquidation.¹³⁴ The only barrier to immediate recognition for a cash basis corporate taxpayer is its method of accounting.¹³⁵ If collection of the income by a cash basis taxpayer is the only impediment to gain recognition by the corporation, courts may be willing to impose the assignment of income doctrine.¹³⁶ After all the uncertainty involved in valuing the soybeans has been eliminated, the entire income producing cycle has been completed by the corporation (production and marketing), and the income has been crystallized by the sale.

In sharp contrast, if the soybeans are not sold on contract but distributed to the Baker brothers in complete liquidation, the production cycle has been completed but no marketing has yet been undertaken. The lack of a crystallization event at the corporate level does not provide for a clear cut application of the assignment of income doctrine. Moreover, the courts may be unwilling to find that the distribution itself is the crystallization event because of the fluctuating market for a product such as soybeans. Thus, if the soybeans are worth \$30,000 at the time of distribution and are sold for \$25,000 two weeks later, a hardship could be imposed upon the corporation and shareholders if \$30,000 of income was assigned to the corporation upon complete liquidation.

To avoid the potential hardship envisioned above, a court may require Baker Farms, Inc. to recognize an amount of income equal to the expenses incurred and deducted in raising the soybeans.¹³⁷ To prevent a distortion of

drastic nontax consequences and is less likely to be employed principally for tax avoidance. See *The Shea Co.*, 53 T.C. 135 (1969); B. BITTKER & J. EUSTICE, *supra* note 32, at ¶ 11.62; note 137 *infra*.

132. See note 131 *supra* and authority cited therein.

133. The courts, in this situation, may apply the assignment of income doctrine since the event involves a crystallized transaction and the only thing preventing recognition is the method of accounting being employed. See note 128 *supra*.

134. If the taxpayer is on an accrual method of accounting, the receipt of cash or the equivalent of cash is usually not relevant. Instead, an accrual basis taxpayer must report income when all the events have occurred that establish the right to receive the income and the amount thereof can be determined with reasonable accuracy. See *Treas. Reg. § 1.451-1(a)*, T.D. 6282, 1958-1 C.B. 215, 221-22.

135. Under the cash receipts and disbursements method of accounting, such an amount is includible in gross income when actually or constructively received. In contrast to the accrual method, the cash method relies on the receipt of cash or its equivalent. See *id.*

136. See note 133 *supra*.

137. *Commissioner v. South Lake Farms, Inc.*, 324 F.2d 837 (9th Cir. 1963), involved the distribution of previously expensed items, incurred in producing a cotton crop and preparing the land for a barley crop, from a subsidiary corporation to its parent in complete liquidation. The court refused to

income, the deductions may be retroactively disallowed or income may be generated under the tax benefit rule since the deductions are in effect recovered by the corporation upon the distribution to the shareholders.¹³⁸ Alternatively, the commissioner may apply the provisions of section 446(b) to compel a method of accounting for the soybeans that more clearly reflects the income of the corporation.¹³⁹

The imposition of a substantial tax at the shareholder level and income recognition at the corporate level attributable to the farm machinery and soybeans, may be particularly undesirable to the Baker brothers. Both brothers desire to continue farming with the assets received upon liquidation. However, they are faced with a tax liability in excess of \$160,000 with cash resources of \$5,000 to pay the tax.¹⁴⁰ Although the farms could be mortgaged to obtain the necessary cash resources, the annual debt service on a new mortgage makes such an approach unattractive, especially in light of the low investment return on farm capital. Thus, a complete liquidation under section 331 is undesirable for the Baker brothers.

A possible alternative liquidation method for the Baker brothers is an elective one month liquidation under section 333. Under section 333, if certain conditions are met, the shareholder's gain upon liquidation may be postponed until a later date. The major purpose of an elective section 333 liquidation is to allow a corporation with little or no earnings and profits or cash, and having substantially appreciated property, to liquidate without the recognition of gain by its shareholders.¹⁴¹ In fact, gain recognition to the shareholders is dependent upon the corporation's earnings and profits and the amount of cash and stock or securities acquired after 1953.¹⁴²

Under section 333, the amount of a qualifying electing individual shareholder's taxable gain is limited to the greater of (1) the shareholder's ratable share of earnings and profits of the corporation accumulated after

apply the tax benefit rule to the previously expensed items on the ground that the liquidating corporation received nothing in exchange for its expensed items and hence there was no recovery. 324 F.2d at 839. Under *South Lake Farms*, a distribution of previously expensed items would not have to be restored to income. On the other hand, a sale of such items would result in ordinary income recognition to the selling corporation. *Id.* See *Connery v. United States*, 460 F.2d 1130, 1133-34 (3d Cir. 1972); *Spitalny v. United States*, 430 F.2d 195, 197-98 (9th Cir. 1970); *Commissioner v. Anders*, 414 F.2d 1283, 1287-88 (10th Cir. 1969); *Bishop v. United States*, 324 F. Supp. 1105, 1108-12 (D. Ga. 1971); Rev. Rul. 61-214, 1961-2 C.B. 60.

It must be pointed out that the Commissioner did not raise the applicability of the tax benefit rule in *South Lake Farms*, relying solely on § 446(b). For the most recent developments, see Rev. Rul. 77-67, 1977-1 C.B. 33. The 1977 ruling holds that the tax benefit rule described in Rev. Rul. 74-396, 1974-2 C.B. 106, is applicable to liquidations under § 336 of the Code. See 1977-1 C.B. at 34.

138. See note 137 *supra*.

139. See note 130 *supra*.

140. See note 121 *supra*.

141. The antecedent of § 333 was first enacted into law as part of the Revenue Act of 1938 but was merely designed as a temporary measure to facilitate the liquidation of personal holding companies. The provision was added to the 1939 Code as § 112(b)(7), another temporary measure, and was periodically reenacted until permanently included in the 1954 Code. See Int. Rev. Code of 1954, ch. 1, § 333, 68A Stat. 103. See generally McGaffey, *The Deferral of Gain in One-Month Liquidations*, 19 TAX L. REV. 327 (1964).

142. I.R.C. § 333(e)(2), (f)(1).

February 28, 1913 (determined as of the close of the month in which the transfer in liquidation occurs but without diminution by reason of distributions made during the month), and, (2) the sum of money received by the shareholder plus the fair market value of stock or securities received by him which were acquired by the corporation after December 31, 1953.¹⁴³ The gain to the individual shareholder will be treated as a dividend to the extent of such shareholder's ratable share of post-1913 earnings and profits of the corporation.¹⁴⁴ If the individual shareholder receives cash and/or stock and securities acquired by the corporation after December 31, 1953, and if such consideration exceeds the shareholder's ratable share of post-1913 earnings and profits, additional gain will be recognized, but at capital gain rates.¹⁴⁵ In the case of an electing corporate shareholder taxable gain is recognized by the same criteria applicable to individual shareholders (post-1913 earnings and profits and cash and/or stock and securities acquired after 1953, whichever is greater).¹⁴⁶ However, the characterization of the gain will usually be long term capital gain and no part of the gain will be taxed as a dividend to the corporate shareholder.¹⁴⁷

If section 333 applies, the gain is merely postponed not avoided. The postponement is accomplished by the carryover basis rules of section 334(c). Under section 334(c), the basis of the property received in liquidation by a qualifying electing shareholder is the same as the basis of the stock cancelled or redeemed in the liquidation, less any money received plus the amount of any gain recognized to him upon the liquidation. The carryover basis rule of section 334(c) may have an unexpected side effect which must be considered before an election under this section is consummated. While designed to postpone the gain, it may convert capital gain into ordinary income. As mentioned previously, a shareholder will usually recognize long term capital gain upon a nonsection 333 liquidation since the stock is usually a capital asset under section 1221.¹⁴⁸ In contrast, the character of the gain recognized upon a subsequent sale of property received in a tax postponement section 333 liquidation depends upon the character of the asset in the hands of the individual shareholder and whether the assets are disposed of in a sale or exchange.¹⁴⁹ Thus, if a corporation is liquidated under section 333 so that the business can be operated as an unincorporated business, the sale of inventory items in the ordinary course of business after the corporation is liquidated will be taxed at ordinary income rates.¹⁵⁰ If, however, the

143. *Id.* § 333(e).

144. *Id.* § 333(e)(1).

145. *Id.* § 333(e)(2).

146. *Id.* § 333(f)(1), (2).

147. *Id.* § 333(f) provides for the recognition of gain but does not provide for its character. Thus, in the case of a corporate qualifying electing shareholder, the entire amount of gain recognized under § 333 will usually be treated as capital gain (except for very unusual situations involving the *Corn Products* doctrine or § 341, see note 119 *supra*). See Treas. Reg. § 1.333-4(c)(1) (1955).

148. See notes 119, 147 *supra*.

149. *Id.* See also *Osenbach v. Commissioner*, 198 F.2d 235 (4th Cir. 1952).

150. I.R.C. § 1221(1) explicitly excludes inventory items as capital assets. I.R.C. § 61 would include the gain derived from the sale of inventory in gross income and tax it at ordinary income rates.

liquidation was fully taxable under section 331, the gain attributable to inventory appreciation (absent 341 collapsibility) would probably be long term capital gain.¹⁵¹

Section 333 only applies to qualifying electing shareholders under section 333. For election purposes, corporate and noncorporate shareholders are treated separately.¹⁵² Thus, the benefits of section 333 are available to individual shareholders notwithstanding whether corporate shareholders elect 333.¹⁵³ Similarly, corporate shareholders can avail themselves of section 333 regardless of what the individual shareholders do as a group.¹⁵⁴

To become a qualifying electing shareholder a noncorporate shareholder must own stock at the time the plan of liquidation is adopted by the corporation,¹⁵⁵ and within 30 days thereafter file an election to be governed by section 333 and the regulations thereunder.¹⁵⁶ Moreover, section 333 will not be available to an individual shareholder unless similar elections are filed by noncorporate shareholders, who at the time of adoption of the plan of liquidation, own stock possessing at least 80 percent of the total combined voting power of noncorporate owned stock entitled to vote on the adoption of the plan.¹⁵⁷ Availability of section 333 to a corporate shareholder is dependent upon the following: (1) a corporate shareholder must own stock at the time the plan of liquidation is adopted;¹⁵⁸ (2) must not be an excluded

151. Provided that the stock of the liquidating corporation is a capital asset in the hands of a shareholder, gain or loss recognized in the liquidation will ordinarily be capital gain or loss. Furthermore, where gain or loss is recognized on the receipt of property, the basis of the property in the hands of the distributee shareholder is the fair market value of the property at the time of the distribution. I.R.C. § 334(a).

152. *Id.* § 333(c).

153. Although within each group of shareholders, corporate or noncorporate, the making of an effective § 333 election depends on whether other shareholders in that group also elect, the two groups are totally independent of one another insofar as determining whether the percentage requirements of § 333 have been satisfied. Noncorporate shareholders may elect even though corporate shareholders choose not to and vice versa. Treas. Reg. § 1.333-2(b)(2), T.D. 6152, 1955-2 C.B. 61,137.

154. *Id.*

155. I.R.C. § 333(c)(1) provides:

in the case of a shareholder other than a corporation, only if written elections have been so filed by shareholders (other than corporations) who at the time of the adoption of the plan of liquidation are owners of stock possessing at least 80 percent of the total combined voting power (exclusive of voting power possessed by stock owned by corporations) of all classes of stock entitled to vote on the adoption of such plan of liquidation.

156. The election by a shareholder to be governed by § 333 is made on Form 964. The original and a duplicate copy of Form 964 should be filed by each electing shareholder with the District Director of Internal Revenue. Form 964 must be filed within 30 days after the adoption of the plan of liquidation. See Treas. Reg. § 1.333-3 (1955).

157. A shareholder who files an election in accordance with § 333 will nevertheless not qualify under § 333 unless other shareholders in the same classification join in the making of the election so that elections are timely filed by such shareholders who own at least 80% of the voting stock. Thus, an individual shareholder owning 50% of the stock of a liquidating corporation was not entitled to the benefits of § 333 when the other individual shareholder, who also owned 50% of the stock, failed to file a timely notice. Virginia E. Ragen, 33 T.C. 706 (1960). See Treas. Reg. 1.333-2(c), T.D. 6152, 1955-2 C.B. 61, 137-38, for an excellent example of the 80% test.

158. I.R.C. § 333(c)(2) provides:

[I]n the case of a shareholder which is a corporation, only if written elections have been so filed by corporate shareholders (other than an excluded corporation) which at the time of the adoption of such plan of liquidation are owners of stock possessing at least 80 percent of the total

corporation¹⁵⁹—defined as a corporation which at any time between January 1, 1954 and the date the plan of liquidation is adopted, owned stock possessing 50 percent or more of the total combined voting power of all classes of stock entitled to vote on the adoption of a plan of liquidation;¹⁶⁰ (3) within 30 days after the plan of liquidation is adopted, files an election, in accordance with section 333 and the regulations thereunder, to be governed by the provisions of section 333,¹⁶¹ and; (4) similar elections are filed by corporate shareholders (other than an excluded corporation) which shareholders, at the time of the adoption of the plan of liquidation, own stock possessing at least 80 percent of the total combined voting power of all classes of stock owned by corporate shareholders (other than excluded shareholders) and entitled to vote on the adoption of the plan of liquidation.¹⁶²

In addition to the above mechanical requirement, certain other criteria must be met by the corporation before section 333 is available. Thus, the benefits of section 333 are available only if the corporation is a domestic corporation and is not a collapsible corporation to which section 341(a) applies.¹⁶³ The corporation must adopt a plan of complete liquidation,¹⁶⁴ and must distribute all of its property in liquidation within one calendar month in complete cancellation or redemption of all the stock.¹⁶⁵ The distribution within one calendar month need not be in the month the plan of liquidation is adopted.¹⁶⁶ This latter requirement is rather onerous and more than one practitioner has avoided using February as the month of liquidation.

While section 333 provides for relief at the shareholder level, gain at the corporate level is not affected by the election. Thus, the rules previously

combined voting power (exclusive of voting power possessed by stock owned by an excluded corporation and by shareholders who are not corporations) of all classes of stock entitled to vote on the adoption of such plan of liquidation.

159. *Id.*

160. *Id.* § 333(b).

161. Treas. Reg. § 1.333-3 (1955). See note 156 *supra*.

162. See note 158 *supra*; Treas. Reg. § 1.333-2, T.D. 6152, 1955-2 C.B. 61, 137-38.

163. I.R.C. § 333(a) sets forth the general rule involving property distributed in complete liquidation of a domestic corporation and excludes collapsible corporations to which § 341(a) applies. Section 341(a) requires the gain on the sale or exchange of stock in a collapsible corporation be treated as ordinary income. Even though a corporation may be collapsible under § 341(b), § 341(d) provides that the rules of § 341(a) will not apply to a particular shareholder under certain circumstances. Thus, a primary issue concerns the possibility of liquidating a corporation under § 333, even though it is technically a collapsible corporation under § 341(b), if an exception under § 341(d), or (e) applies. The statute would seem to permit the use of § 341 in this regard, and the regulations provide that "Section 333 has no application to gain in respect of stock of a collapsible corporation to which Section 341(a) applies." Treas. Reg. § 1.333-1(a), T.D. 6949, 1968-1 C.B. 107, 114. This analysis of the applicability of § 333 is somewhat different than that of § 337. I.R.C. § 337(c)(1)(A) provides that § 337 will not apply to collapsible corporations as defined in § 341(b). Thus, § 337 contains a different concept concerning collapsible corporations than § 333 does. Whereas all the exceptions in § 341 would likely apply to § 333, they would not apply to § 337 (with the exceptions of § 341(e)(2) and § 341(e)(4) which deal explicitly with § 337).

164. I.R.C. § 333(a)(1).

165. *Id.* § 333(a)(2).

166. Treas. Reg. § 1.333-1(b)(1), T.D. 6152, 1955-2 C.B. 61, 136-37. See also B. BITTKER & J. EUSTICE, *supra* note 32, at ¶ 11.23.

discussed in the context of a taxable liquidation apply to a corporation upon a section 333 election.¹⁶⁷ Sections 47, 1245, and 1250, the assignment of income doctrine, the tax benefit rule, and section 446(b), may have the effect of overriding the nonrecognition rule of section 336. If gain is recognized at the corporate level, it may have a disastrous effect on a contemplated section 333 election. Recognition of corporate gain will increase the earnings and profits of the corporation which in turn may create additional gain and dividend income to the individual shareholder.¹⁶⁸ Similarly, a corporate shareholder may have additional recognized gain (but not dividend income) as a result of the increased earnings and profits.¹⁶⁹

The application of section 333 to Baker Farms, Inc. is illustrative of the above discussion. Assume Baker Farms, Inc. adopts a plan of complete liquidation on July 1, 1979 and that A and B timely elect the provisions of section 333. Since A and B are individual shareholders and own all of the stock of Baker Farms, Inc., individual shareholders owning at least 80 percent (in this case 100 percent) of the total combined noncorporate shareholder voting power entitled to vote on the plan of liquidation, have filed elections to be taxed under section 333. Thus, A and B are qualifying electing shareholders within the meaning of section 333(c). Assume that Baker Farms, Inc. distributes all of its assets to A and B in the month of August, 1979, in complete cancellation of their respective stock interests in the corporation. As a result of the liquidation, A receives one half of the assets (\$5,000 cash, \$70,000 of farm machinery, \$15,000 of soybeans, and Woodland valued at \$640,000). B receives assets of an equal value (one half of cash, machinery and soybeans and Stillcrest).

Before examining the tax consequences at the shareholder level, the effect of the distribution upon Baker Farms, Inc. must be explored since gain

167. See notes 122-32 *supra* and accompanying text.

168. The recognition of gain by a liquidating corporation pursuant to § 1245 or § 1250 has an added detrimental effect when the liquidation qualifies under § 333. The recognition of gain will result in an increase in the earnings and profits of the corporation to the extent of the recognized gain less any corporate tax on the gain. This, in turn, could result in increased dividends to the shareholders taxable at ordinary income rates. Therefore, substantial § 1245 or § 1250 gain potential may make a § 333 liquidation unattractive. See Berlin, Nicholson & VanDeman, *Corporate Liquidations Under Section 333*, 58-5th TAX MNGM'T A-43(c) (1974). A potential bombshell to the unwary planner is Aaron Cohen, 63 T.C. 527 (1975). In *Cohen* the court found that capital gains accrued to the corporation that originally negotiated the sale of its sole corporate asset even though in form the asset was distributed to the shareholders in a liquidation and then transferred to the new purchaser. The facts in *Cohen* were similar to the facts of *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945), which was relied upon by the Tax Court, except that in *Cohen* the corporation had first executed a binding contract for the sale of the sole corporate asset and then distributed the asset in a § 333 liquidation. After the I.R.S. determined that the sale in *Cohen* had actually been made by the corporation, and that the corporation's earnings and profits had increased by the amount of the capital gains realized in the sale, the shareholders sought to avoid the recognition of dividend income equal to the corporation's accumulated earnings and profits by attempting to rescind their 333 election. However, the Tax Court held that the mistake in law and fact regarding the capital gains recognition would not allow the shareholder switch to a § 337 liquidation to avoid tax at the corporate level and dividend income at the shareholder level. Although no direct mention is made of the character of the corporate earnings and profits to be used in computing shareholder dividend income upon a § 333 liquidation, the *Cohen* decision implies that current as well as accumulated earnings and profits must be considered.

169. *Id.*

at the corporate level may affect the gain at the shareholder level. The distribution of the farm machinery and soybeans in 1979 will likely create taxable income to the corporation. Assume that all of the gain potential in the machinery represents depreciation deductions taken on the machinery after 1961. Thus, Section 1245 requires that the entire gain of \$70,000 (\$140,000-\$70,000) be recognized by the corporation upon the liquidation. Moreover, the distribution of the soybeans may create an additional \$30,000 of income under the assignment of income doctrine, the tax benefit rule, or section 446(b).¹⁷⁰ Potentially, \$100,000 of taxable income to the corporation will be triggered upon the liquidation resulting in a corporate tax liability of \$26,750.¹⁷¹ In turn, the corporation's earnings and profits will be increased by \$73,250 (\$100,000-\$26,750).

Upon the liquidation, the realized and recognized gain (disregarding the potential reduction for corporate tax liability of \$26,750) for A and B will be as follows:

<u>A's Realized Gain</u>		<u>B's Realized Gain</u>	
<u>Amount Realized</u>		<u>Amount Realized</u>	
Cash	5,000	Cash	5,000
Soybeans	15,000	Soybeans	15,000
Machinery	70,000	Machinery	70,000
Stillcrest	640,000	Woodland	640,000
Total Amount Realized	\$730,000	Total Amount Realized	\$730,000
Less adjusted basis of stock	176,800	Less adjusted basis of stock	176,800
Realized Gain	\$553,200	Realized Gain	\$553,200

Since Baker Farm's Inc. earnings and profits will be increased to \$233,250, as a result of corporate gain upon the liquidation, A and B would each recognize \$116,625 of the gain under section 333(e)(1). All of this gain would be treated as dividend income.¹⁷² The total basis of the assets in the hands of A and B would be determined under section 334(c). Under this section, the basis of the property received will be the same as the shareholder's basis in his stock, less any money received, plus the amount of any gain recognized to him upon the liquidation. Thus, the basis to A and B will be \$288,425 (\$176,800 adjusted basis of stock less \$5,000 cash received plus \$116,625 of gain recognized). This total basis will be allocated to the

170. See notes 128-225 *supra* and accompanying text.

171. I.R.C. § 11(b)(2) imposes the "normal" tax on corporations in the case of a taxable year ending after December 31, 1974, and before January 1, 1979, the sum of a 20% tax on the first \$25,000, a 22% tax on the next \$25,000, and a 48% tax on the excess. Thus, the corporate tax liability on \$100,000 of taxable income is \$34,500 (20% of \$25,000 plus 22% of \$25,000 plus 48% of \$50,000). The Revenue Act of 1978, Pub. L. No. 95-600, § 301, 92 Stat. 2763, changes the corporate tax rate schedule effective January 1, 1979, as follows: 17% on the first \$25,000, 20% on the second \$25,000, 30% on the third \$25,000, 40% on the fourth \$25,000, and 46% on the fifth \$25,000. Under this schedule, the corporate tax liability on \$100,000 of taxable income is \$26,750.

172. I.R.C. § 333(e)(1).

various assets received in the liquidation in proportion to the net fair market value of the assets.

If A and B file joint returns for 1979 with their wives their tax liability attributable to the liquidation will approach \$52,000. In addition, A and B will be responsible for the corporate tax liability of \$26,750 as a transferee of assets under section 6901. Consequently, while section 333 will postpone some of the tax upon liquidation, each shareholder will be required to pay approximately \$65,375 (\$52,000 individual and \$13,375 corporate) in taxes to the federal government. Notwithstanding the tax liability imposed by reason of the section 333 liquidation, this alternative may be more attractive than a fully taxable liquidation to A and B.

Since many farm corporations have substantially appreciated real estate, section 333 may be an attractive division technique. However, substantial earnings and profits, as well as sections 1245 and 1250 recapture income, inhibit the effectiveness of this division technique.

IV. NONTAXABLE CORPORATE DIVISIONS

Since the tax planning goal of the Baker brothers is to divide the assets of Baker Farms, Inc., between A and B with the smallest incidence of tax, the use of sections 368(a)(1)(D) and 355 of the Internal Revenue Code may be an attractive technique to accomplish this goal. Conceptually, this "tax free" plan requires the transfer of Woodland with certain other assets to a new corporation, "Controlled, Inc.," to be formed and owned by Baker Farms, Inc. Thereafter B will transfer his stock in Baker Farms, Inc. in exchange for all of the "Controlled" stock held by Baker Farms, Inc. Upon the completion of the corporate division, two corporations emerge, each owning approximately one-half of the assets previously held by Baker Farms, Inc., one of which, Baker Farms, Inc., is wholly owned by A and the other, "Controlled, Inc.," which is wholly owned by B.

When a single corporation is divided into multiple corporations, the division normally involves a type D divisive reorganization.¹⁷³ A divisive reorganization, similar to other reorganizations governed by section 368 of the Code, is essentially a tool for recognition postponement. The intent of Congress in its reorganization enactments has been that if the shareholder or the corporation has substantially the same investment after a reorganization as before, the mere change in the investment ought not to be a taxable incident.¹⁷⁴ In furtherance of this Congressional purpose, the Internal Revenue Service has stated that the underlying assumption for allowing this tax deferral is that the effect of the transaction upon the participants is more formal than substantial even though certain particular differences may exist

173. *Id.* § 368(a)(1)(D). However, stock and securities of an existing subsidiary may be distributed in accordance with § 355(a)(2)(C) without the use of § 368(a)(1)(D).

174. See SENATE FINANCE COMM., INTERNAL REVENUE CODE OF 1954, S. REP. NO. 1662, 83d Cong., 2d Sess., reprinted in [1954] U.S. CODE CONG. & AD. NEWS 4621, at 4681, 4912; HOUSE WAYS AND MEANS COMM., INTERNAL REVENUE CODE OF 1954, H.R. REP. NO. 1337, 83d Cong., 2d Sess., reprinted in [1954] U.S. CODE CONG. & AD. NEWS 4017, at 4064, 4256.

between the property disposed of and the property acquired.¹⁷⁵ To insure compliance with this basic philosophy, some taxable gain must be recognized in certain situations (*i.e.*, when boot is received) even though the transaction otherwise qualifies as a type D divisive reorganization.¹⁷⁶

Under section 368(a)(1)(D), a divisive D reorganization¹⁷⁷ occurs when one corporation transfers assets to another corporation and immediately after the transfer, the transferor, or one or more of its shareholders (or any combination thereof), are in control of the corporation to which the assets are transferred, *but only* if in pursuance of the plan stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 355 or section 356.¹⁷⁸

Because such a process contains the possibilities of tax avoidance, there are various tests that must be met under section 355 including:

- (a) a need of predisposition control of "Controlled" by Baker Farms, Inc.;
- (b) the post distribution active conduct of two or more businesses;
- (c) the 5 year predistribution active conduct of the trade or business rule;
- (d) the distribution of "all" stock or securities in "Controlled" or an amount constituting control thereof; and
- (e) the transaction must not be a device for distributing earnings and profits.

A. Only a "Controlled" Subsidiary Can Be Separated Tax Free

In order for a distribution to shareholders in a corporate division to be tax free, the subsidiary whose stock or securities are being distributed must be controlled immediately before the distribution by the parent.¹⁷⁹ If "control" is not present, the distribution will be taxed. The Service has ruled¹⁸⁰ that "control"¹⁸¹ requires the ownership of at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of each other class of the subsidiary's

175. The underlying assumption of the tax-free exchange provisions (§§ 354-368) is set forth in the regulations. "[T]he new property is substantially a continuation of the old investment still unliquidated; and, in the case of reorganizations, that the new enterprise, the new corporate structure, and the new property are substantially continuations of the old still unliquidated." See Treas. Reg. § 1.1002-1(c) (1957).

176. I.R.C. § 356.

177. A divisive D reorganization, whereby one corporate entity is divided into two or more separate entities, is one category of transactions that will qualify under § 368(a)(1)(D). The second category encompasses the nondivisive D reorganization whereby the transfer is made to a controlled corporation of substantially all the parent's assets, which is followed by a complete liquidation of the parent; § 354 will apply to this latter transaction.

178. Section 356 applies to a divisive D reorganization if the recipient, in a transaction otherwise qualifying under § 355, receives boot.

179. I.R.C. § 355(a)(1)(A).

180. Rev. Rul. 59-259, 1959-2 C.B. 115.

181. I.R.C. § 368(c).

stock.¹⁸²

Since Baker Farms, Inc. is forming "Controlled" in connection with this transaction pursuant to section 368(a)(1)(D), all of the stock, voting and nonvoting, will be held by the parent corporation. Consequently, the control requirement of section 355 will be satisfied in the Baker Farms situation.

B. Only Stock or Securities Can Be Distributed Tax Free

In conjunction with the "control" requirement set out in the preceding section, section 355(a)(1)(A) states that "solely stock or securities" can be distributed tax free. Other types of property (boot) can be distributed, within limited amounts, without upsetting the tax free treatment for the stock or securities distribution. When boot is distributed, section 355(a)(4) directs that the controlling section will be section 356. Section 356 in turn provides for the same tax treatment of the stock and securities as does section 355; its distinction is to provide for taxation of the boot.¹⁸³

Although the terms "stock and securities" are not defined in section 355, presumably they mean the same as they do for the other reorganization sections. Issues such as whether the distribution of "stock rights" rather than stock is taxable¹⁸⁴ are not typically encountered in a farm corporation and therefore will not be discussed.

C. Extent of Distribution

Section 355(a)(1)(D) requires that in connection with the distribution of "Controlled" stock, Baker Farms, Inc. either must transfer all of the stock and securities it owns in "Controlled" to B or if Baker Farms, Inc. desires to keep some stock in "Controlled" after the transaction, an amount of stock which satisfies the 80 percent control test of section 368(c) must be transferred to B. If less than all stock and securities of "Controlled" are to be transferred to B, the Service requires that the "retention by the distributing corporation of stock (or stock and securities) in the controlled corporation was not in pursuance of a plan having as one of its principal purposes the avoidance of federal income tax."¹⁸⁵

182. Any potential problems with small percentages of non-voting stock held by someone other than the parent corporation can usually be resolved by giving the non-voting stock a vote.

The Service will normally allow a corporation to acquire control of the subsidiary, even when it is evident that the acquisition was made to satisfy the control requirement, as long as the change of stock ownership is "permanent" and the control of the subsidiary was acquired in a tax-free transaction. *See* Rev. Rul. 71-593, 1971-2 C.B. 181; Rev. Rul. 70-18, 1970-1 C.B. 74; Rev. Rul. 69-407, 1969-2 C.B. 50. *See also* Rev. Rul. 70-225, 1970-1 C.B. 80; Rev. Rul. 63-260, 1963-2, C.B. 147 (tax free treatment was not allowed).

183. For an explanation of the taxation of boot received in a spin-off, see Cohen, *Corporate Separations—General Requirements*, 223-2d TAX MNGM'T (BNA) A-27 to 28 (1974).

184. *Compare* Commissioner v. Gordon, 382 F.2d 499 (2d Cir. 1967) with Commissioner v. Baan, 382 F.2d 485 (9th Cir. 1967).

185. I.R.C. § 355(a)(1)(D)(ii). It should be noted that unless everything is distributed, an advance ruling should normally be obtained in this area, particularly since the regulations reflect the Service's view that the business reasons surrounding the transaction will "ordinarily" require the distribution of all the stock and securities. Treas. Reg. § 1.355-2(d)(2) (1955). Of the possible business reasons for retain-

The extent of the distribution should not be a problem in our hypothetical. The possibility that B does not have enough stock to surrender to entitle him to all of "Controlled" stock should be remote in a carefully planned "split off"¹⁸⁶ when specific assets are transferred to a newly created corporation.

Another problem is the time span of the distribution—in other words, whether the distribution of "Controlled" stock to B can be distributed in a series of distributions over a period of time or whether it must all be distributed at one time.¹⁸⁷ In the vast majority of situations involving a closely held corporation, this problem can be avoided by distributing all the stock in a single distribution. Thus, in our hypothetical, B will receive 100 percent of "Controlled's" stock at one time to insure that this test is satisfied.

D. The "Device" Test

The previously discussed statutory requirements are largely mechanical but the "device" restriction of section 355(a)(1)(B) seems vague (perhaps intentionally so) by comparison. The device language, contained in section 355(a)(1)(B), is as follows:

[T]he transaction was not used principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both (but the mere fact that subsequent to the distribution stock or securities in one or more of such corporations are sold or exchanged by all or some of the distributees (other than pursuant to an arrangement negotiated or agreed upon prior to such distribution) shall not be construed to mean that the transaction was used principally as such a device).

The basic policy behind the device test is to prevent a corporate division from being used as a technique to bail out earnings and profits through the use of a tax free distribution of stock coupled with a subsequent sale of such stock by the shareholders at capital gain rates.¹⁸⁸

ing stock or securities that might arise in the farm corporation area, the only one that would seem to have any relevance would be a possible state law restriction inhibiting the distribution because of the insufficiency of the parent's surplus (even this has doubtful application). Even if all the stock is distributed, the conservative approach may be to seek an advance ruling from the Service regarding the qualification of a particular fact situation. Revenue Procedure 72-3, 1972-1 C.B. 698, sets forth the procedure rules for the issuance of rulings and determination letters. Revenue Procedure 74-26, 1974-2 C.B. 478, lists the operating rules pertaining to the issuance of ruling letters handled by the Reorganization Branch of the Service. Finally, Revenue Procedure 75-35, 1975-2 C.B. 561, presents an extensive checklist of information which must be included in a request from the Service for a ruling under § 355. The choice of whether or not to seek an advance ruling or determination letter from the Service is beyond the scope of this presentation. Obviously, it depends upon the facts presented in each case.

186. A "split off" is the same as a "spin off" in which a distribution is made by one corporation of the stock of a subsidiary to the parent's shareholders, except that the shareholders of the distributing corporation give up part of their stock in the distributing corporation in exchange for the stock of the subsidiary. A "split up" occurs when the parent corporation distributes its stock to two or more subsidiaries and then completely liquidates.

187. See *Commissioner v. Gordon*, 391 U.S. 83, 95-96 (1968).

188. See *Bondy v. Commissioner*, 269 F.2d 463, 466 (4th Cir. 1959); B. BITTKER & J. EUSTICE, *supra* note 32, ¶ 13.02, at 13-6 to 13-9; Mette, *Spin-Off Reorganization and the Revenue Act of 1951*, 8 TAX L.

The origin of the device test can be traced to the landmark case of *Gregory v. Helvering*.¹⁸⁹ In that case, the taxpayer, Mrs. Gregory, caused her wholly owned corporation to form a new subsidiary and then to transfer certain investment assets to it which assets the taxpayer wished to ultimately sell to an outside third party.¹⁹⁰ In consideration for the transfer, the subsidiary corporation issued all its shares to Mrs. Gregory.¹⁹¹ Within a few days thereafter Mrs. Gregory caused the new corporation to be dissolved with its assets being distributed to her for ultimate sale to the third party.¹⁹² Obviously, if Mrs. Gregory had not caused the subsidiary to be formed, but had the parent corporation distribute the assets directly to her, the distribution would have been subject to the dividend distribution rules¹⁹³ with ordinary income the probable result.¹⁹⁴ Should the mere insertion of a corporate shell, albeit used in a transaction that literally complies as a tax free reorganization, change the net result of the transaction which is in substance an ordinary dividend distribution? The Supreme Court in *Gregory* held that it should not. The Court noted that the transaction had no business or corporate purpose¹⁹⁵ and was a device used to masquerade the net effect of the transaction, in other words, a dividend distribution.¹⁹⁶

In response to the *Gregory* case, Congress eliminated the tax free spin off provision relied upon by Mrs. Gregory.¹⁹⁷ However, the tax free spin off was reinstated by Congress in 1951 with several restrictions including the device restriction.¹⁹⁸ In 1954, Congress enacted section 355(a)(1)(B) which was taken almost verbatim from section 112(b)(11) of the 1939 code—the forerunner of section 355.¹⁹⁹

The regulations construing the device restriction concentrate on the bailout potential of subsequent sales of stock.²⁰⁰ Regulation 1.355-2(b) expressly states that sales of stock or securities of either corporation after the distribution, if pursuant to an arrangement negotiated or agreed upon prior to the distribution, will be evidence that the transaction was used principally as a device for the distribution of the earnings and profits.²⁰¹ The regula-

REV. 337, 347-49 (1953); Wolff, *Divisive Reorganizations as Affected by the Revenue Act of 1951*, 31 TAXES 716, 722 (1953).

189. *Gregory v. Helvering*, 293 U.S. 465 (1935).

190. *Id.* at 467.

191. *Id.*

192. *Id.*

193. Int. Rev. Code of 1939, ch. 1, §§ 22 (e), 115(a), (b), (j), 53 stat. 12, 46, 48 (now I.R.C. §§ 301, 316).

194. Under the predecessor statutes of I.R.C. §§ 301, 316 in effect at the time of *Gregory* every distribution was a dividend to the extent of current earnings and profits. Int. Rev. Code of 1939, ch. 1, §§ 22 (e), 115(a), (b), (j), 53 Stat. 12, 46, 48 (now I.R.C. §§ 301 (c) (1), 316).

195. 293 U.S. at 468.

196. *Id.*

197. Revenue Act of 1934, ch. 477, Pub. L. No. 73-216, 48 Stat. 680.

198. Revenue Act of 1951, Pub. L. No. 82-183, 65 Stat. 521, amending Int. Rev. Code of 1939, ch. 1, § 112(b) (11), 53 Stat. 47.

199. B. BITTKER & J. EUSTICE, *supra* note 32, ¶ 13.06, at 13-27.

200. Treas. Reg. § 1.355-2(b)(1) (1955).

201. The relevant statutory language of § 355(a)(1)(B) is as follows:

tions further state (in apparent contradiction of the statutory language)²⁰² that while nonprearranged sales made after the distributions are not determinative of the tainted bailout purpose, such sales are at least some evidence of such a purpose.²⁰³

As one commentator has stated, the regulations do not expressly state that prearranged sales are determinative.²⁰⁴ However, a comparison of the language of the regulation suggests by implication that prearranged sales may be considered by the Service to be determinative of the tainted purpose.²⁰⁵ This same regulation suggests that the Service will also attack a quick sale on the grounds that the continuity of interest doctrine has not been satisfied.²⁰⁶ From a planning standpoint no sales of stock or securities should be made for a considerable period of time after the distribution. Obviously the longer the time span between the corporate division and a subsequent sale the more likely that the device clause will be inapplicable. To protect the integrity of a section 355 transaction from device problems, the practitioner may wish to consider stock transfer restrictions which effectively inhibit subsequent sales for a considerable period of time.

Another aspect of the "device" clause must be noted. If a transaction could escape dividend treatment in the absence of section 355, the Service has ruled that it will not constitute a "device" for the distribution of earnings and profits.²⁰⁷ Thus where a shareholder exchanges all his stock in the distributing corporation for all of the stock of the controlled corporation (a "split off") which could presumably qualify for capital gain treatment under section 302, the transaction should not be construed to be a device for the distribution of earnings and profits.

Until recently the Service has concentrated its enforcement efforts under section 355 on the active business requirement. Consequently, only a few cases have been decided under the device clause.²⁰⁸ However, the Treasury Department recently proposed new regulations²⁰⁹ for section 355,

([b]ut the mere fact that subsequent to the distribution stock or securities in one or more of such corporations are sold or exchanged by all or some of the distributees (other than pursuant to an arrangement negotiated or agreed upon prior to such distribution) shall not be construed to mean that the transaction was used principally as such a device). . . .

The use of the parenthetical language within the parenthetical quote, suggests that Congress intended prearranged sales to be evidence of the tainted purpose.

202. The statutory language quoted in note 201 *supra* clearly states that the mere fact of sale after the distribution that is not prearranged, shall not be construed to be a device. In sharp contrast, regulation § 1.355-2(b)(1) states that sales that are not prearranged, while not determinative of the tainted purpose, will be evidence of such purpose.

203. Treas. Reg. § 1.355-2(b)(1) (1955).

204. B. BITTKER & J. EUSTICE, *supra* note 32, ¶ 13.06, at 13-27.

205. Treas. Reg. § 1.355-2(b)(1) (1955). By stating that sales that are not prearranged are not determinative of the tainted purpose but are some evidence thereof, the implication arises that the Service will consider prearranged sales to be determinative.

206. *Id.*

207. See Rev. Rul. 64-102, 1964-1 C.B. 136.

208. See, e.g., Sidney L. Olson, 48 T.C. 855 (1967); Marne S. Wilson, 42 T.C. 914 (1964); Albert W. Badanes, 39 T.C. 410 (1962).

209. The proposed regulations for I.R.C. § 355 were originally published in the Federal Register at 42 Fed. Reg. 2694 (1977). Because of a slight error they were republished on January 21, 1977, at 42

which, if adopted, will result in a major overhaul of the existing regulations. The proposed regulations, while lacking the force of law, obviously represent the Service's position on the construction of section 355. In general, the proposed regulations are consistent with the views of the Service expressed in its rulings, and with those cases in which the Service has acquiesced.

The Service has noted in its proposed regulations that distributions which are completely or substantially pro rata among the shareholders possess the greatest bailout potential for earnings and profits and are "more likely to be undertaken principally as a device for the distribution of earnings and profits."²¹⁰ The Service also acknowledges that where a distribution to a shareholder would be treated "as a redemption to which section 302(a) would apply if it were taxable, the transaction is ordinarily not considered to be a device for the distribution of earnings and profits."²¹¹

An important change in the proposed regulations deals with prearranged sales or exchanges. Under proposed regulation 1.355-2(c)(2), if: twenty percent or more of the stock of either the distributing corporation or the controlled corporation is to be sold or exchanged after the distribution, the distribution will be considered to have been used principally as a device for the distribution of earnings and profits of the distributing corporation, the controlled corporation, or both.

If anything less than twenty percent of the stock or any or all of the securities are subsequently sold, it will be considered "substantial evidence" of the "device."²¹² The proposed regulation also attempts to clarify the effect of predistribution discussions of a subsequent stock sale by stating that such sale shall ordinarily be considered as made "pursuant to an arrangement negotiated or agreed upon before the distribution."²¹³

Although the current and proposed regulations concentrate on post-distribution sales as evidence of a device, proposed regulation 1.355-2(c)(3) lists additional factors that the Service will consider in determining whether a transaction was used principally as the forbidden device including:

- (1) the nature, kind, and amount of the assets of both corporations (and corporations controlled by them) immediately after the transactions and the use of the assets by the respective corporations;
- (2) whether a substantial portion of the assets of any post-distribution corporation consists of a trade or business acquired within the preceding five years "in a transaction in which the basis of such assets was not determined in whole or part by reference to the transferor's basis";

Fed. Reg. 3866 (1977). For an analysis of the proposed regulations, see Lee, *Proposed Regs. Under 355 Overhaul Device Test and Single-Business Divisions*, 46 J. TAX. 194 (1977).

210. Prop. Treas. Reg. § 1.355-2(c)(1).

211. *Id.*

212. *Id.* § 1.355-2(c)(2).

213. *Id.* See Rev. Rul. 77-377, 1977-2 C.B. 111 ("split up" acceptable with later prearranged plan to redeem a portion of stock under § 303(a)).

(3) whether the "transfer or retention of cash or liquid assets" (*e.g.*, securities and accounts receivable) are not related to the business of the transferee or retaining corporation;

(4) whether the former subsidiary corporation remains in basically the same relative position as before the distribution (*e.g.*, supplier of materials or services like research and development).

If adopted as final regulations, the practitioner will have to closely scrutinize a proposed devise transaction to ensure that the device clause does not pose a problem. Within our hypothetical, the device provision does not appear to be a problem. Both A and B wish to operate their respective farming operations as their own and do not contemplate selling any stock. Consequently, the problems associated with post distribution sales are not present. Furthermore, the factors set out in proposed regulation 1.355-(2)(c)(3) are not present in our hypothetical situation. "Controlled" will not be a supplier of materials or services for Baker Farms, Inc. after the distribution. In addition, neither corporation will hold cash or liquid assets that are not related to their respective businesses. Finally, the assets were not acquired within the preceding five year period in a transaction in which the basis of the assets was not determined in whole or in part by reference to the transferor's basis.

If, however, B was an inactive participant who was contemplating a sale of his stock after a section 355 transaction, the device problem would be more meaningful and would need to be addressed seriously. Nonetheless, it would seem that even then a prearranged sale or post-arranged sale following a "nonpro rata" spin off should not be a device for the distribution of earnings and profits.²¹⁴ However, in such a situation, a taxable redemption of the brother desiring to sell out would be a more certain route and no more costly in tax dollars.²¹⁵ Alternatively, if Agribusiness, Inc., a publicly held corporation, is desirous of acquiring Baker Farms, Inc. and B wished to sell his interest, A could receive the stock of "Controlled" in a preliminary "split off" and B could then cause Baker Farms, Inc. to be merged into Agribusiness, Inc. in exchange for stock of the latter corporation. In general, the disposition of stock after a corporate division by reason of participating in another tax free reorganization as opposed to a cash sale, has been permit-

214. New York State Bar Ass'n, Tax Section, Comm. on Reorganizations, *Report on Proposed Section 355 Regulations*, 55 TAXES 656, 661 (1977).

215. If a shareholder's stock is completely redeemed in exchange for corporate assets, exchange treatment under § 302(b)(3) (assuming § 318 does not apply) will result. In an attempted split off with a subsequent sale of the stock, the device clause may prevent the transaction from being a valid D reorganization. If § 368(a)(1)(D) is inapplicable, the parent might attempt to qualify the incorporation of the subsidiary under § 351. A potential problem for § 351 qualification is the requirement that the transferor (the parent) be in control of the subsidiary immediately after the transfer. If the stock of the subsidiary is immediately distributed to the shareholder in a split off, this control requirement may not be met, especially if the parent is obligated to make the distribution. For discussion of the control requirement of § 351, see B. BITTKER & J. EUSTICE, *supra* note 32, ¶ 3.08, at 3-29. If the control requirement of § 351 is not met, then the incorporation will be a taxable event to the corporation. On the shareholder level if § 355 is inapplicable, the shareholder can argue that the transaction qualifies as a complete redemption of his stock in the parent under § 302(b)(3).

ted.²¹⁶

E. The Active Business Requirement

In contrast to the section 355(a)(1)(B) "device" restriction discussed in the previous section, the active business requirements for a tax free corporate division are set forth in section 355(b) in considerable detail. Section 355(b) requires that immediately after the distribution, both corporations must be engaged in "the active conduct of a trade or business"²¹⁷ that has been actively conducted for five years prior to the distribution.²¹⁸ A corporation is considered to be engaged in the active conduct of a trade or business if it is itself engaged in such trade or business, or if substantially all of its assets consist of the stock and securities of a corporation or corporations controlled by it (immediately after the distribution), each of which is engaged in the active conduct of a trade or business.²¹⁹

Despite the fact that a business can be shown to have been actively conducted for the five year period before the distribution of the stock of the subsidiary, the active business test will not be satisfied if the business was acquired in a taxable transaction during the five year period.²²⁰ Also, active business status cannot be achieved by acquiring control of another corporation in a taxable transaction.²²¹

The purpose underlying the active business test is to prevent a corporation from siphoning off its liquid assets from its operating assets by incorporating the liquid assets, and then distributing the stock of the subsidiary to its shareholders for their ultimate sale or redemption upon liquidation of the subsidiary. The foregoing process, if allowed, would convert ordinary dividend income into capital gain.²²² The five year predistribution period inhibits the ability of the distributing corporation to utilize liquid assets to acquire, shortly before the distribution, a new and active business that can be "spun off" without any contraction of the old operating assets. If the business was "actively conducted for five years, it presumably was not created for the purpose of avoiding the tax on dividends."²²³

Despite the importance of the phrase "active conduct of a trade or business," the Code does not define this term. However, the regulations attempt to define the phrase and give a number of examples of what constitutes an active business.²²⁴ The existing regulations indicate that there must be two

216. See generally Rev. Rul. 68-603, 1968-2 C.B. 148. See also Rev. Rul. 70-225, 1970-1 C.B. 80; Rev. Rul. 58-68, 1958-1 C.B. 183.

217. I.R.C. § 355(b)(1)(A).

218. *Id.* § 355(b)(2)(B).

219. *Id.* § 355(b)(2)(A).

220. *Id.* § 355(b)(2)(B), (C); Treas. Reg. § 1.355-4(b)(1) (1955).

221. I.R.C. § 355(b)(2)(D)(i).

222. Analogous to the situation described in the text is the attempted "conversions" attacked by the collapsible corporation provisions of the Code. *Id.* § 341.

223. See B. BITTKER & J. EUSTICE, *supra* note 32, ¶ 13.05, at 13-22.

224. Treas. Reg. § 1.355-1(c) (1955).

separate active businesses, and that the hallmark of a separate business is the independent production of income:

For purposes of section 355, a trade or business consists of a specific existing group of activities being carried on for the purpose of earning income or profit from only such a group of activities, and the activities included in such group must include every operation which forms a part of, or a step in, the process of earning income or profit from such group. Such group of activities ordinarily must include the collection of income and the payment of expenses.²²⁵

These regulations may create problems for the proposed division of Baker Farms, Inc. The two separate business requirement of the regulations would appear to preclude section 355 treatment for the Baker operation. Also, the nature of the assets (real estate) may create additional problems. In the following sections, these and other problems are examined.

1. Vertical Division of a Single Business

In the past, the Service's requirement that there must be more than one business for a division to fall within section 355 (*i.e.*, that there could be no vertical division of a single business)²²⁶ was a deterrent for taxpayers such as the Baker brothers. The farming operation conducted by Baker Farms, Inc. appears to be a single business and thus appears to run afoul of the regulations. Fortunately, this prohibition against a vertical division of a single business was successfully challenged by taxpayers in *Edmund P. Coady*,²²⁷ and *United States v. Maret*.²²⁸

In *Coady* the division of a construction company was effected by dividing a single predistribution business into two post-distribution businesses, each of which was wholly owned after the division by one of the two shareholders who had equally owned the predistribution business. To accomplish the division, the two shareholders caused the parent corporation to transfer a major construction contract, cash and construction equipment to a newly formed subsidiary in exchange for all of the subsidiary's stock. Thereafter, the stock of the subsidiary corporation was distributed to one of the shareholders in exchange for all of his stock in the parent corporation. Immediately after the "split off" each corporation had similar assets and each carried on all the functions of the predistribution business. The Tax Court held that a vertical division of a single predistribution business met the active business requirements of section 355 so long as each of the post distribution businesses carried on all of the functions of the predistribution

225. *Id.*

226. For discussion of vertical divisions, see Cohen, *Corporate Separations—Active Business Requirements*, 224-2d TAX MNGM'T (BNA) A-13 to 15 (1975).

227. 33 T.C. 771 (1960), *aff'd sub. nom.* Commissioner v. Coady, 289 F.2d 490 (6th Cir. 1961).

228. 325 F.2d 28 (5th Cir. 1963).

business.²²⁹ To the extent that regulation 1.355-1(a) ruled otherwise, it was held invalid.²³⁰

Since both Woodland and Stillcrest have been owned by Baker Farms, Inc. for more than five years, it would seem that the active business requirements of section 355 could be satisfied in our hypothetical. Although a single predistribution business exists, after the division two post-distribution businesses emerge, each carrying on all of the functions of the predistribution business. Thus, applying the *Coady* rationale to our facts, the active business requirement is met. Moreover, as discussed later in this section,²³¹ the active business requirement would probably be satisfied even if one of the farms was acquired within the five year period.

After its defeats in *Coady* and *Marrett*, the Service published Revenue Ruling 64-147,²³² conceding that a single business could be divided, and declared regulation 1.355-1(a) invalid to the extent that it held otherwise. In Revenue Ruling 75-160,²³³ the Service reaffirmed its intention to follow the *Coady* and *Marrett* approaches to the division of a single business and also announced it would follow *Rafferty v. Commissioner*,²³⁴ a case involving owner occupied real estate, in disposing of cases involving the active trade or business requirement.

2. Ownership of Real Estate as an Active Business

In *Rafferty*, Mr. Rafferty and his wife were the sole owners of a corporation engaged in processing and distributing steel products. Mr. Rafferty caused a new subsidiary corporation to be formed and transferred the real estate owned by the parent corporation, and upon which the steel business was conducted, to the new subsidiary. Thereafter the real estate corporation leased the property back to the parent corporation. The subsidiary received all its income from rents due from the parent. It had no office, employees or independent officers, although it kept separate books and filed separate returns. No dividends were paid by the subsidiary despite a substantial accumulation of surplus.

The First Circuit, because of the questionable breadth of the regulations, refused to base its decision upon the regulation,²³⁵ which provides that owner occupied real estate is not an active business asset.²³⁶ The court, however, rejected the subsidiary as an active business since it lacked the

229. Edmund P. Coady, 33 T.C. 771, 778 (1960).

230. *Id.* at 779. New examples in the proposed regulations incorporate the facts of *Coady* and *Marrett*, squaring the regulations with existing case law. See Prop. Treas. Reg. § 1.355-3(c); Lee, *supra* note 209, at 198.

231. See notes 235-46 *infra* and accompanying text.

232. 1964-1 C.B. 136.

233. 1975-1 C.B. 112.

234. 452 F.2d 767 (1st Cir. 1971), *cert. denied*, 408 U.S. 922 (1972). *Rafferty* also discussed the business purpose requirement, analyzed at notes 265-97 *infra*, and accompanying text.

235. *Rafferty v. Commissioner*, 452 F.2d 767, 772 (1st Cir. 1971).

236. Treas. Reg. § 1.355-1(c)(2) (1955).

"objective indicia of such corporate operations"²³⁷ (i.e., no employees, offices, etc.). The court further stated that the subsidiary's business operations resembled an "investment in securities,"²³⁸ an activity which was "the type of 'passive investment' which Congress intended to exclude from § 355 treatment."²³⁹

A case which the Service failed to mention in Revenue Ruling 75-160, which was decided approximately four months after *Rafferty*, was *King v. Commissioner*.²⁴⁰ There the Sixth Circuit held that three subsidiaries, owning truck terminals leased solely to the parent corporation's trucking business, were engaged in the active conduct of a trade or business under section 355, since all three subsidiary corporations had been engaged in substantial construction and leasing activities.²⁴¹

The net result of the *Rafferty* and *King* decisions is that real estate (e.g., a farm) utilized by the taxpayer or its subsidiary may qualify as an active business asset as long as the taxpayer performs "sufficient activities" in connection with the property. Perhaps responding to *King*, the Service has announced in its proposed regulations²⁴² that a corporation will be considered to be engaged in active trade or business if it leases real estate occupied in part by the distributing corporation and if the subsidiary performs substantial management and operational functions, as opposed to leasing on a net lease basis.

Since each of the Baker brothers intends to manage and operate his respective post distribution business, the proposed division of Baker Farms, Inc. would appear to satisfy the test of "performance of substantial management and operational functions" under the proposed regulations. If however, B intended to have "Controlled" leaseback Woodland to Baker Farms, Inc. on a cash rent basis, the active business rule would probably not be met.²⁴³ Moreover, a crop sharing arrangement, which typically involves minimal management responsibilities, may also run afoul of the active business rule.²⁴⁴ If B does not wish to farm Woodland, but still wishes to satisfy

237. *Rafferty v. Commissioner*, 452 F.2d 767, 772 (1st Cir. 1971).

238. *Id.*

239. *Id.*

240. 458 F.2d 245 (6th Cir. 1972).

241. *King v. Commissioner*, 458 F.2d 245, 250-51 (6th Cir. 1972).

242. Prop. Treas. Reg. § 1.355-3(b)(2)(iii). For example, in management of a building, negotiating leases, seeking new tenants and repairing and maintaining the building satisfies the test, whereas net leasing property will not. See Lee, *supra* note 209, at 199. See Prop. Treas. Reg. §§ 1.355-3(b)(2)(iv)(B), 1.355-3(c) examples (4), (5).

243. An analogy can be drawn to the subchapter S situation regarding a transfer-leaseback arrangement and the potential classification of the rental income of the corporation as passive investment income. If there is material participation by the landlord corporation in the farm operation through physical work or management decisions, or both, then the amounts received are not rent for purposes of § 1372(e)(5). Rev. Rul. 61-112, 1961-1 C.B. 399, 399-400. See also Rev. Rul. 67-423, 1967-2 C.B. 221.

Similar results to those suggested by *King* and *Rafferty* have been found for the active trade or business requirement under § 355. See Rev. Rul. 73-234, 1973-1 C.B. 180 (farm corporation satisfies active business requirements where its activities are in part performed by tenant farmers, but it performs substantial management and operational functions in conducting the farm activities).

244. See, e.g., Gladys M. Kennedy, 33 T.C.M. (CCH) 655, 658-59 (1974), *appeal dismissed*, (9th Cir. June 4, 1975)(corporation's subchapter S election was terminated due to the passive nature of investment

the active business rule, he must either cause "Controlled" to significantly participate in management functions through some sort of partnership arrangement,²⁴⁵ or to have it farm Woodland through the use of independent contractors (such as custom farming).²⁴⁶

3. *The Use of Independent Contractors to Satisfy Active Business Test*

The use of "independent contractors" is somewhat related to the owner-occupied real estate issue. The Service has indicated that activities of an independent contractor on behalf of a corporation are not to be considered in determining whether the corporation is engaged in the active conduct of a trade or business.²⁴⁷ It would appear, however, that a corporation which uses independent contractors can still meet the active business requirement of section 355 if the management activities of the corporation are otherwise substantial in nature. For example, in Revenue Ruling 73-234,²⁴⁸ a parent corporation, which operated an insurance agency, also owned a subsidiary farming corporation that utilized tenant farmers acting as independent contractors. The Service ruled that the farm corporation satisfied the active business requirement, but only because that corporation directly performed active and substantial management and operational functions.²⁴⁹ This requirement was met because the subsidiary had two full time employees who maintained the farm property and equipment, negotiated the agreements with the tenant farmers, and were responsible for the accounting functions of the corporation.²⁵⁰

From the above analysis, it would appear that "Controlled" would meet the active business requirement, if after the division B caused "Controlled" to contract for the work needed to produce the crops on Woodland. In such a situation, "Controlled" must make the majority of management decisions, including: how many acres to put into production, the amount of acreage allotted to various crops, the type of seed to be used, conservation and maintenance decisions for the land and buildings, and all marketing decisions connected with the sale of the crops. While the activities of a farm corporation in connection with a "custom farming" arrangement appear substantial enough, a prudent course may be to seek an advance ruling from the Service, especially in view of their previous announcement regarding independent contractor activities.

income arising from a crop sharing arrangement in which the landowner furnished nothing except the use of the land and a crop share and the lessee furnished all management, labor and supplies while receiving the proceeds from his share of the crops).

245. A partnership could be formed between "Controlled" and another farmer who could perform the services as a joint partner.

246. In custom farming, all management decisions are made by the owner who merely hires the physical work to be done.

247. Lee, *Section 355 Active Business Requirement: What Advice to Give Clients Today*, 45 J. TAX. 272, 276 (1976).

248. 1973-1 C.B. 180. Two other rulings dealing with the independent contractor situation are Rev. Rul. 73-236, 1973-1 C.B. 183 and Rev. Rul. 73-237, 1973-1 C.B. 185.

249. 1973-1 C.B. 180, 181.

250. *Id.*

4. The Five Year Rule—Changes in the Business During the Critical Period

The courts have tended to strictly construe the five year history, at least insofar as the longevity portion thereof is concerned.²⁵¹ The measuring period is five *complete* years from the date of distribution.²⁵² The Service takes the position that a business has begun (for purposes of measuring the five year period), only when all the elements of that business have commenced.²⁵³ However, for purposes of the five-year rule, the statute allows "tacking" as long as the business was not acquired in a taxable transaction.²⁵⁴ Thus a farmer could operate as a sole proprietor and then incorporate under section 351 of the Code.²⁵⁵ In such a situation, so long as the individual's total time as a farmer has exceeded five years, the five-year test of section 355(b)(2)(B) will be satisfied.

The regulations allow certain changes in the nature of the business during the five year period, "provided the changes are not of such a character as to constitute the acquisition of a new or different business."²⁵⁶ This can be a potentially dangerous area for the farmer who has changed the complexion of his operation within the five years preceding the distribution. Existing regulations²⁵⁷ concentrate on geographic location and view independent activities (e.g., purchasing an additional 160 acres in the next state to raise soybeans) commenced at a new location without terminating activities at the old location, as having started a "new" business. The proposed regulations, however, modify that position.²⁵⁸

The cases have tended to downplay geographic location as a factor in finding separate businesses. For example, in *Lockwood v. Commissioner*,²⁵⁹ the Tax Court disallowed a tax-free division when a farm equipment business opened a new branch in a different part of the country (it expanded from Nebraska to Maine) and then tried to spin it off within five years after it opened. The Eighth Circuit²⁶⁰ reversed the Tax Court, holding that a single business was divided, choosing to tack on the preexpansion time to the new branch.²⁶¹ In *Burke v. Commissioner*,²⁶² decided before the Eighth Circuit reversed its *Lockwood* decision, the Tax Court held that the opening of a new branch of a radio parts business within the same state was suitable to spin off within five years. The *Burke* type of expansion appears to be

251. Edward H. Russell, 40 T.C. 810 (1963); Isabel A. Elliott, 32 T.C. 283 (1959).

252. See note 251 *supra*.

253. Rev. Rul. 57-492, 1957-2 C.B. 247.

254. I.R.C. § 355(b)(2)(C).

255. The transferor in the § 351 transaction, however, must not have recognized any gain or loss.

256. Treas. Reg. § 1.355-4(b)(3) (1955).

257. *Id.* § 1.355-1(d) example (9) (1955). See also Rev. Rul. 58-54, 1958-1 C.B. 181; Rev. Rul. 56-344, 344, 1956-2 C.B. 195.

258. Prop. Treas. Reg. § 1.355-3(b)(3).

259. Estate of Lockwood, 23 T.C.M. (CCH) 1233 (1964), *rev'd sub. nom.* Estate of Lockwood v. Commissioner, 350 F.2d 712 (8th Cir. 1965).

260. Estate of Lockwood v. Commissioner, 350 F.2d 712 (8th Cir. 1965).

261. *Id.* at 719.

262. Patricia W. Burke, 42 T.C. 1021 (1964).

within the limits of the proposed regulations.²⁶³

A more serious problem is the expansion through a new type of operation. For example, could a farm that has long concentrated its efforts by producing corn and soybeans, utilize its liquid assets to commence a poultry business which is then spun off within five years of its commencement? Or could a rancher who has long raised his cattle on the range, start a feedlot and then spin it off before the five year period has expired?

Prior to the ability to divide vertically a single business, taxpayers often were in the position of attempting to demonstrate that two separate businesses existed before the attempted split off. With the ability to divide vertically after *Coady*, when one of the divisions to be divided is less than five years old, taxpayers often attempt to establish that the divisions to be separated have inherited a common five-year history from a single business rather than evolving from separate businesses. Thus, where a corporation expands by developing a new business less than five years prior to the proposed split off, does a single business exist with a five year history, or do two separate businesses exist, one of which does not have a five year history? The test under the proposed regulation would appear to relate to the commonness of management and income producing activities.²⁶⁴ Even if Woodland had been acquired less than five years prior to the division, with common management and income producing activities, it should still be a suitable vehicle to be "spun off." However, a practitioner contemplating such a transaction, should closely monitor the proposed and final regulations.

F. Nonstatutory Requirements

1. Business Purpose

The regulations prevent a corporate separation from qualifying as a tax free division when the distribution of the corporation's stock or securities is "carried out for purposes not germane to the business of the corporations."²⁶⁵ This requirement is in addition to, but also distinct from the statutory mandate that the distribution not be a "device" for the distribution of the corporation's earnings and profits.²⁶⁶ The distinction is illustrated by the Ninth Circuit's decision in *Commissioner v. Wilson*.²⁶⁷

In *Wilson*, two brothers operated a furniture store business under the name Wilson's Furniture, Inc. In 1958 the corporation formed a subsidiary, Wil-Plan, and transferred to it conditional sale contracts (from furniture sold on deferred payments) and an automobile. Subsequently, the parent corporation transferred all of the subsidiary's stock to the Wilson brothers, the sole shareholders of Wilson's Furniture, Inc., who treated the stock dis-

263. Prop. Treas. Reg. § 1.355-3(c) example 12.

264. *Id.* § 1.355-3(b)(3).

265. Treas. Reg. § 1.355-2(c) (1955).

266. I.R.C. § 355(a)(1)(B).

267. *Commissioner v. Wilson*, 353 F.2d 184 (9th Cir. 1965).

tribution as tax free under section 355. The Tax Court, relying on the fact that the Wilson brothers had retained the stock for at least five years after the distribution, rejected the Commissioner's argument that the transaction was a "device" for the distribution of earnings and profits.²⁶⁸ Despite the fact that the Tax Court rejected the Service's "device" argument, it felt that the business reasons advanced by the taxpayers were insufficient: "We are highly skeptical on the record before us that these three reasons [i.e., the business reasons], either separately or in the aggregate, were responsible to any substantial degree for the transfer. We think these reasons were largely colorable rather than real."²⁶⁹ After indicating that the business reasons were specious, the Tax Court nevertheless held in favor of the taxpayer stating:

Notwithstanding that the three foregoing reasons do not appear to have been bona fide motives for the incorporation of Wil-Plan, we are nevertheless satisfied that the requirement of section 355(a)(1)(B) has been met. . . . But even if petitioners failed to persuade us as to these three reasons, it was still open to them to convince us that the transaction was not in fact used principally as a device for the distribution of earnings and profits. And we think that the record before us establishes that the transaction was not so used.²⁷⁰

On appeal to the Ninth Circuit the Tax Court was reversed.²⁷¹ While agreeing with the Tax Court that there was no "tax avoidance purpose in the creation of the subsidiary,"²⁷² the Ninth Circuit nevertheless concluded: "[E]ven if there is no tax avoidance motive, a reorganization having no business reason does not result in the tax advantages which section 355 confers upon those who satisfy the legal requirements for its benefits."²⁷³ The Ninth Circuit clearly held that the advantages conferred upon taxpayers under section 355 were available only if supported by an independent valid business purpose. The Service, in Revenue Ruling 69-460,²⁷⁴ adopted the *Wilson* rationale and ruled that a corporate division must satisfy the business purpose doctrine.

While the Ninth Circuit and the Service require an independent business purpose test under section 355, the First Circuit in *Rafferty v. Commissioner*²⁷⁵ has interwoven the business purpose requirement with the "device" test. Evidence of a "lack" of business purpose is considered relevant to the "device" test.²⁷⁶ Although the Ninth Circuit's test may be more

268. *Marne S. Wilson*, 42 T.C. 914 (1964).

269. *Id.* at 922.

270. *Id.* at 923.

271. *Commissioner v. Wilson*, 353 F.2d 184 (9th Cir. 1965).

272. *Id.* at 187.

273. *Id.* at 187-88.

274. Rev. Rul. 69-460, 1969-2 C.B. 51.

275. *Rafferty v. Commissioner*, 452 F.2d 767 (1st Cir. 1971), *cert. denied*, 408 U.S. 922 (1972).

276. *Id.* at 770.

severe, from a practical standpoint the same result—denial of section 355 status—will often be reached under both approaches.

Another factor that must be taken into account is the Service's position in Revenue Ruling 69-460:²⁷⁷ "The fact that there is a valid business reason for the creation of a new corporation does not necessarily satisfy the business purpose requirement for the *distribution* of the stock pursuant to section 355 of the Code."²⁷⁸ Thus, the tax practitioner must not only establish a legitimate business purpose for the division of the assets into a separate and new corporation, but must also show that separate stock ownership (by the shareholders of the parent) is also necessary. The ruling gives two examples of what the Service considers sufficient business purposes for the creation of a new subsidiary and its divestiture by the parent. The example which can be most readily translated into the corporate farm environment is probably also the most common—irreconcilable shareholder differences that are so serious that they will affect the normal operations of the business if allowed to continue.²⁷⁹ Such disharmony appears to exist in our hypothetical and should satisfy the business purpose test. Another illustration of a valid business purpose is found in the *Commissioner v. Morris Trust*²⁸⁰ situation, where the Comptroller of the Currency ordered divestiture of a part of the bank business.

Another very important aspect of the business purpose doctrine is found in the "source" of the purpose—shareholder or corporation. The Service has insisted that a corporate business purpose is necessary to make the corporate distribution tax free.²⁸¹ However, the Second Circuit, in *Estate of Parshelsky v. Commissioner*²⁸² reversed the Tax Court principally for the reason that the "Tax Court's inquiry into business purpose was too narrow since it evaluated only those reasons for the spin-off which benefitted the corporation and ignored any valid shareholder non-tax-avoidance reasons which might be present."²⁸³ The court stated:

We find that the distinction between corporate and share-

277. Rev. Rul. 69-460, 1969-2 C.B. 51.

278. *Id.* at 52 (emphasis added).

279. *Id.* at 52 (situation 1). Several agricultural corporations in 1977 and 1978 sought Letter Rulings on proposed corporate divisions. In all cases, the business purpose was to end disputes between shareholders, which had an adverse effect on the operation of the business, and give individual shareholders their part of the farm. See 50 I.R.S. Letter Rulings (part II) 7807038 (Nov. 16, 1977) (disagreements over allocation of work, wages, and ultimate authority); 49 I.R.S. Letter Rulings (part II) 7806027 (Nov. 8, 1977) (disputes over which crops to grow, management personnel, and contingencies upon death of a shareholder); 46 I.R.S. Letter Rulings (part II) 7803032 (Oct. 19, 1977) (disagreement on future of operations—cattle or farming); 26 I.R.S. Letter Rulings (part II) (June 7, 1977) (disputes over salaries, pension and profit sharing plan, culminating in a deadlock of the annual meeting in voting for a new board of directors). In 1977 and 1978, approximately 50% of the corporations applying for § 355 Letter Rulings represented disputes between shareholders was the business purpose for the division.

280. *Commissioner v. Morris Trust*, 367 F.2d 794 (4th Cir. 1966). The Service in Rev. Rul. 68-603, 1968-2 C.B. 148, announced that it would follow *Morris Trust* insofar as the business purpose element was concerned.

281. See Treas. Reg. § 1.355-2(c)(1955); Rev. Rul. 69-460, 1969-2 C.B. 51.

282. *Estate of Parshelsky v. Commissioner*, 303 F.2d 14 (2d Cir. 1962).

283. *Id.* at 15.

holder benefit does not accord with the purpose of Congress in enacting § 112(b)(11) [the 1939 Code's predecessor to § 355]. We hold that while corporate benefit is relevant to the application of the tax-free spin-off provision, shareholders' personal non-tax-avoidance reasons must also be considered.²⁸⁴

While taxpayers residing in the Second Circuit can rely on *Parshelsky*, those residing in other circuits may have difficulty satisfying the business purpose test if the source thereof is personal. For example, the Ninth Circuit in *Wilson*,²⁸⁵ and the First Circuit in *Rafferty*²⁸⁶ appear to adopt the Service's position that only a corporate business purpose will suffice.²⁸⁷

In this regard, the recently issued proposed regulations state in pertinent part:

Business purpose and continuity of interest—(1) . . . Depending upon the facts of a particular case, a shareholder purpose for a transaction may be so nearly coextensive with a corporate business purpose as to preclude any distinction between them. In such a case, the transaction is carried out for purposes germane to the business of the corporations. On the other hand, if a transaction is motivated solely by the personal reasons of a shareholder, for example, if a transaction is undertaken solely for the purpose of fulfilling the personal planning purposes of a shareholder, the distribution will not qualify under section 355 since it is not carried out for purposes germane to the business of the corporations.²⁸⁸

Unlike the existing regulations, the proposed regulations give specific examples of fact situations illustrating the business purpose doctrine.²⁸⁹ Thus, a "spin off" following an antitrust divestiture order, similar to the situ-

284. *Id.* at 17.

285. *Commissioner v. Wilson*, 353 F.2d 184 (9th Cir. 1965).

286. *Rafferty v. Commissioner*, 452 F.2d 767 (1st Cir. 1971).

287. In *Rafferty*, the appellate court stated:

Our question, therefore, must be whether taxpayers' desire to put their stockholdings into such form as would facilitate their estate planning, viewed in the circumstances of the case, was a sufficient personal business purpose to prevent the transaction at bar from being a device for the distribution of earnings and profits. While we remain of the view, which we first expressed in *Lewis v. Commissioner of Internal Revenue*, 176 F.2d 646 (1st Cir. 1949), that a purpose of a shareholder, qua shareholder, may in some cases save a transaction from condemnation as a device, we do not agree with the putative suggestion in *Estate of Parshelsky v. Commissioner of Internal Revenue*, 303 F.2d 14, 19 (2d Cir. 1962), that any investment purpose of the shareholders is sufficient.

Id. at 770.

It should be noted that the *Rafferty* court did not discount the examination of the shareholders' purpose altogether:

This is not to say that a taxpayer's personal motives cannot be considered, but only that a distribution which has considerable potential for use as a device for distributing earnings and profits should not qualify for tax-free treatment on the basis of personal motives unless those motives are germane to the continuance of the corporate business. . . . We prefer this approach over reliance upon formulations such as "business purpose," and "active business."

Id.

288. Prop. Treas. Reg. § 1.355-2(b)(1).

289. *Id.* § 1.355-2(b)(2), examples (1)-(4).

ation approved as a valid business purpose in *Morris Trust*,²⁹⁰ constitutes a valid business purpose under the proposed regulations.²⁹¹ On the other hand, in example (3) of the proposed regulations, a "spin off" following a drop down of certain assets to a new subsidiary, which occurs in order to separate one business from the "risks and vicissitudes" of another business, will not constitute a valid business purpose.²⁹² Lack of a business purpose in the latter situation is not surprising in light of Revenue Ruling 69-460²⁹³ which forbade the subsequent distribution of a new subsidiary's stock to the shareholders since it would not be required in order to protect one business from another.²⁹⁴

Since an agricultural corporation will not frequently encounter antitrust litigation, the two noteworthy examples in the proposed regulations are examples (2) and (4). In example (2), a valid business purpose for a corporate division exists when shareholder differences arise so that "A and B [brothers] no longer can agree on major decisions affecting the operation of the corporation."²⁹⁵ It should be noted that the example does describe the brothers as "managing shareholders."²⁹⁶ Example (4) postulates the same facts contained in example (3) which did not meet the business purpose test (*i.e.*, formation of a new subsidiary to protect the assets of the parent), except that the parent corporation also requires outside financing in order to expand the business it desires to protect.²⁹⁷ In order to prevent the "potential diversion" of funds to the unstable business, the lender requires a separation of the two businesses and the distribution of the stock of the new subsidiary to the shareholders. The Service accepts this as a valid business

290. *Commissioner v. Morris Trust*, 367 F.2d 794 (4th Cir. 1966). See Prop. Treas. Reg. § 1.355-2(b)(2), example (1) (a valid business purpose was found in this situation).

291. "In view of the divestiture order, the distribution of the stock of the new corporation to the shareholders of (the divesting corporation) will be considered to have been carried out for a real and substantial nontax reason germane to the business of the corporations." Prop. Treas. Reg. § 1.355-2(b)(2), example (1).

292. Prop. Treas. Reg. § 1.355-2(b)(2), example (3) (in this illustration no valid business purpose was found since, "[t]he purpose of protecting the candy business from the risks of the novelty toy business [by transferring the latter] to the new corporation, does not satisfy the requirement that there be a substantial nontax reason, germane to the business of the corporation, for the distribution of the stock of the new corporation to the shareholders.")

293. 1969-2 C.B. 51.

294. Even though the subsidiary's stock is not distributed, if that stock is available to a creditor of the parent and consequently the creditor could control the corporation, management and the future of the subsidiary could vary dramatically.

295. Prop. Treas. Reg. § 1.355-2(b)(2), example (2).

296. *Id.*

297. *Id.* example (4).

This justification has become very common in representations made for Letter Rulings. Some represented association with an inactive or depressed business decreased lending. See 21 I.R.S. Letter Rulings (part II) 7730027 (April 28, 1977) (metals division inhibited "glamorous" powder manufacturing); 44 I.R.S. Letter Rulings (part II) 7801014 (Oct. 6, 1977) (better financing impossible unless holding company rid itself of horseracing and implications of organized crime). Similarly, legal lending limits may provide a reason to split corporations and obtain more financing. When the maximum limit has been reached, a division resulting in independent corporations may allow further borrowing since the combined legal lending limit has been increased. See 48 I.R.S. Letter Rulings (part II) 7805019 (Nov. 2, 1977); 36 I.R.S. Letter Rulings (part II) 7745056 (Aug. 15, 1977).

purpose as long as the "lender's requirements are based upon customary business practice," obviously an attempt to thwart any collusion between the taxpayer and his friendly banker.

It would seem that a desire to separate Baker Farms, Inc. because of differences in management philosophy ought to be sufficient without the need to allege inability to agree on major decisions affecting the operation of the corporation. If the proposed regulations are adopted as final regulations, it remains to be seen how many "family feuds" or "demands" of a third party, such as a lending institution, will be fostered in order to achieve a tax free division of the corporation. It would appear that "pure" estate planning and other family considerations will have to face litigation a la *Parshelsky*.

2. Continuity of Interest

Both the existing regulations²⁹⁸ and the proposed regulations²⁹⁹ contemplate a continuity of interest "on the part of those persons who, directly or indirectly, were the owners of the enterprise prior to the distribution or exchange."³⁰⁰ This requirement is based on the Service's position, supported by case law,³⁰¹ that a tax free reorganization cannot be used to effect what is essentially a sale. The Service's position is that the old shareholders should retain at least 50 percent of the transferee's stock.³⁰² A possible exception occurs when the facts disclose no intention of using section 355 as a device for the distribution of earnings and profits.³⁰³ In most cases, availability of an exception will entail a sufficient "aging" process (*i.e.*, holding the stock for a considerable period of time prior to sale) or the development of facts to show that the exigencies of the subsequent sale or distribution to nonshareholders were sufficiently unrelated to the tax free distribution (*e.g.*, an inheritance).³⁰⁴

298. Treas. Reg. § 1.355-2(b)(1), 2(c) (1955).

299. Prop. Treas. Reg. § 1.355-2(b)(1).

300. Treas. Reg. § 1.355-2(c) (1955); Prop. Treas. Reg. § 1.355-2(b)(1).

301. *Helvering v. Minnesota Tea Co.*, 296 U.S. 378, 385 (1935). ("this interest must be definite and material; it must represent a substantial part of the value of the thing transferred. This much is necessary in order that the result accomplished may genuinely partake of the nature of merger or consolidation.") See also *LeTulle v. Scofield*, 308 U.S. 415 (1940); *Pinellas Ice & Cold Storage Co. v. Commissioner*, 287 U.S. 462, 470 (1933); *Rena Farr*, 24 T.C. 350 (1955).

302. See Rev. Proc. 74-26, 1974-2 C.B. 478; Rev. Proc. 66-34, 1966-2 C.B. 1232.

303. Cohen, *Corporate Separations—General Requirements*, 223-2nd TAX MNGM'T (BNA) A-24 (1974) ("Presumably, because dispositions of stock after a spin-off are so restricted, the continuity of interest requirement is rarely violated by a transaction otherwise meeting the requirements of § 355.")

304. Rev. Rul. 66-25, 1966-1 C.B. 67, 68. ("Ordinarily, the Service will treat 5 years of unrestricted rights of ownership as a sufficient period for the purpose of satisfying the continuity of interest requirements of a reorganization.") See *Schweitzer & Conrad, Inc. v. Commissioner*, 41 B.T.A. 533 (1940) (continuity not adversely affected as a partial call of redeemable preferred shortly after the reorganization since an immediate redemption had not been originally contemplated); Rev. Rul. 68-22, 1968-1 C.B. 142 (continuity of interest not adversely affected when certificates received in exchange were redeemable solely in the discretion of distributing corporation at rate of 10% a year and where there was no present intent to redeem); Whitman, *Draining the Serbonian Bog: A New Approach to Corporate Separations Under the 1954 Code*, 81 HARV. L. REV. 1194, 1246 (1968).

However, section 355(a)(2)(A) allows for a nonpro rata distribution,³⁰⁵ and consequently the continuity of interest doctrine would appear to permit a transaction which leaves the ownership of the distributing corporation with one shareholder and the equity interest of the controlled corporation in the hands of a different shareholder.³⁰⁶

There are few cases or published rulings in this area. This is probably due to the fact that continuity of interest is often considered homogeneous with both the "device" restriction of section 355(a)(1)(B) and the business purpose doctrine. One of the latest rulings in the area is also perhaps the most enlightening. Revenue Ruling 76-528³⁰⁷ stated that the continuity of interest requirement of regulation 1.355-2(c) would be satisfied in a transaction in which a partnership holding a 60 percent interest in a distributing corporation subsequently dissolves and distributes its stock in the distributing corporation proportionately to the partners.

G. Tax Impact to the Corporation and Shareholders Upon a Section 355 Transaction

To utilize section 355 for the Baker Farms operation, the corporate separation will be effected as follows:

- (1) Baker Farms, Inc. will first organize a new corporation, "Controlled, Inc.";
- (2) thereafter, Baker Farms, Inc. will transfer (a) Woodland (valued at \$640,000), one half of its machinery (valued at \$70,000), (b) one half of its cash (\$5,000), and (c) one half of its soybeans (or other assets of Baker Farms, Inc. of a value of \$15,000)³⁰⁸ to "Controlled" solely in exchange for all the stock of "Controlled";³⁰⁹ and
- (3) Baker Farms, Inc., will finally distribute to one of the Baker brothers, B, all of the stock of "Controlled" in exchange for all of the stock of Baker Farms, Inc. held by B.

1. Tax consequences to the corporations

The above described transfer by Baker Farms, Inc. of assets to "Controlled" in exchange for all the stock of "Controlled," followed by a distribution of the "Controlled" stock to B in exchange for all of his Baker Farms, Inc. stock should constitute a reorganization within the meaning of section

305. I.R.C. § 355(a)(2)(A) (§ 355 will apply to a transaction regardless of "whether or not the distribution is pro rata with respect to all the shareholders of the corporation.")

306. B. BITTKER & J. EUSTICE, *supra* note 32, ¶ 13.09, at 13-38, 39.

307. Rev. Rul. 76-528, 1976-2 C.B. 103, 103-04. See also Rev. Rul. 75-406, 1975-2 C.B. 125; Rev. Rul. 70-18, 1970-1 C.B. 74; Rev. Rul. 69-293, 1969-1 C.B. 102; Rev. Rul. 59-197, 1959-1 C.B. 77; Rev. Rul. 55-103, 1955-1 C.B. 31.

308. The assets transferred in the proposed 355 division are the same as those transferred in the taxable divisions discussed previously. See text accompanying notes 27, 41, 117, 170 *supra*.

309. The possible substitution of other assets for the soybeans is designed to avoid possible income recognition on the midstream transfer of the soybeans. See text accompanying notes 315-26 *infra*.

368(a)(1)(D) of the Internal Revenue Code.³¹⁰ Baker Farms, Inc. and "Controlled" will each be "a party to a reorganization" as defined in section 368(b).³¹¹

Pursuant to sections 361(a)³¹² and 357(a)³¹³ of the Internal Revenue Code, no gain or loss should be recognized by Baker Farms, Inc., upon the transfer of the assets described to "Controlled." Similarly, under section 1032(a),³¹⁴ no gain or loss will be recognized by "Controlled" upon its receipt of the assets from Baker Farms, Inc. in exchange for all the outstanding stock of "Controlled."

While the gain potential inherent in Woodland is clearly nontaxable under section 361, will the machinery and the soybeans escape recognition under this section? In the taxable divisions discussed in section III, section 1245 of the Code overrode sections 311 and 336 and required the corporation to recognize gain upon the transfer of machinery to the extent that the realized gain thereon constituted post 1961 depreciation recapture.³¹⁵ However, a corporate division under section 355 is exempt from the section 1245 recapture rules,³¹⁶ thereby making the 355 transaction more attractive to the Baker brothers. The recapture potential in the machinery transferred to "Controlled" is not avoided but merely postponed and transferred to "Controlled" to be recognized by it when the machinery is disposed of in a nonexempt transaction.³¹⁷ Similar to the potential recognition problems

310. I.R.C. § 368(a)(1)(D) defines a reorganization to include among other types of transactions:

[A] transfer by a corporation of all or part of its assets to another corporation if immediately after the transfer the transferor, or one or more if its shareholders . . . is in control of the corporation to which the assets are transferred; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354, 355, or 356.

311. I.R.C. § 368(b) defines a party to a reorganization to include: "(2) both corporations, in the case of a reorganization resulting from the acquisition by one corporation of stock or properties of another." (emphasis added).

312. I.R.C. § 361(a) provides: "No gain or loss shall be recognized if a corporation a party to a reorganization exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation a party to the reorganization." In the instant case, Baker Farms, Inc. transfers property solely in exchange for stock of "Controlled" and consequently, § 361(a) applies.

313. In the hypothetical as set out in section II of this article, Baker Farms, Inc. had no liabilities. In the typical case there will be liabilities and it is possible that some will be assumed by the controlled corporation in a D reorganization. The general rule of § 357(a) is that liabilities assumed or taken subject to by the controlled corporation in a transaction governed by § 361 (which includes a type D reorganization) shall not be considered boot received by the transferor. There are two exceptions to this general rule. Under § 357(b), if the principal purpose of the assumption was a purpose to avoid Federal income tax on the exchange, or was not a bona fide business purpose, then all of the liabilities assumed or taken subject to by the controlled corporation shall be considered boot received by the transferor. Thus, if Baker Farms, Inc. borrowed money on Woodland immediately before the transfer to "Controlled" and "Controlled" assumed the liability, or acquired Woodland subject to the liability, § 357(b) will probably apply. Second, under § 357(c) if the liabilities assumed or taken subject to by "Controlled" exceed the total adjusted basis of the property transferred, then the excess shall be considered gain from the sale or exchange of a capital asset or of property which is not a capital asset as the case may be.

314. I.R.C. § 1032 provides: "No gain or loss shall be recognized to a corporation on the receipt of money or other property in exchange for stock (including treasury stock) of such corporation."

315. See text accompanying notes 32, 96, 124, 167 *supra*.

316. I.R.C. § 1245(b)(3).

317. Treas. Reg. § 1.1245-2(c)(2), T.D. 6832, 1965-2 C.B. 292, 306.

encountered upon the transfer of soybeans to B in a taxable division,³¹⁸ the midstream transfer of the soybeans to "Controlled" in a section 355 transaction may be a taxable event. If the transfer of the soybeans from Baker Farms, Inc., a cash basis taxpayer, to "Controlled" is a nontaxable event, the effect is to shift income from one taxpayer (Baker Farms, Inc.) to another ("Controlled").

Although a potential income shift can occur upon a midstream transfer in a section 355 division, the tax avoidance opportunities are limited when compared with taxable divisions. If soybeans are transferred to a shareholder in a complete liquidation or in a complete redemption and if the gain potential in the soybeans is not recognized by the corporation at such time, the gain attributable to the soybeans will never be recognized at the corporate level. Moreover, the corporation deducted the expenses of growing the soybeans in previous taxable years and, consequently, received significant tax benefits therefrom. Although the soybeans received by the shareholder will increase his amount realized in a complete liquidation or complete redemption of his stock, such gain will be taxed at capital gain rates³¹⁹ with the soybeans receiving a stepped up basis equal to the fair market value on the date of distribution.³²⁰ Thereafter, a sale of the soybeans on the open market by the former shareholder at a price equal to its fair market value on the date of distribution, will be nontaxable since no additional gain is realized.³²¹ However, if the corporation had sold the soybeans on the open market and then distributed the cash proceeds (less a reserve for the income taxes attributable to the sale) to the shareholder along with other assets in a complete liquidation or redemption, a taxable event would have occurred at the corporate level and the gain therefrom would be includable in the corporation's return for the taxable year of the sale.³²² Thus, a nontaxable midstream transfer of the soybeans directly to the shareholder in a taxable division has the effect, not only of shifting income potential to the shareholder, but of avoiding a double tax on this income item. In sharp contrast, a transfer of the soybeans to "Controlled" in a section 355 division as envisioned above does not have the effect of avoiding the double tax on this income item, albeit it does shift the income potential from one corporate taxpayer to another corporate taxpayer. Consequently, the courts may be more reluctant to require the gain recognition upon the transfer of the soybeans in a section 355 transaction.³²³ However, since Baker Farms, Inc. has

318. See text accompanying notes 98, 128, 167 *supra*.

319. In the taxable divisions discussed in section III *supra*, the soybeans (valued at \$15,000) increased by \$15,000 the amount realized by the shareholder and also the realized and recognized gain by a similar amount. Since the stock was a capital asset (assuming § 341 is inapplicable), the gain potential attributable to the soybeans is taxed at capital gain rates.

320. I.R.C. § 334(a).

321. If the sale of the soybeans is for \$15,000 cash, no gain is realized since the basis of the soybeans under I.R.C. § 334(a) is also \$15,000. Care must be taken, however, to avoid having the sale imputed to the corporation under the doctrine of *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945).

322. I.R.C. §§ 61, 1001.

323. Cash basis taxpayers have been allowed to transfer accounts receivable with a zero basis to a corporation in a § 351 exchange without recognizing the potential income therein. See Thomas W.

previously deducted the expenses attributable to growing the soybeans, a persuasive argument can be made that income should be recognized by Baker Farms, Inc. to the extent of tax benefits derived by it from the deductions previously taken.³²⁴ Although the potential tax benefit to Baker Farms, Inc., may not prevent a favorable ruling³²⁵ upon the transfer of the

Briggs, T.C.M. (P-H) ¶ 56086, at 56-358 (1956). See also *Thatcher v. Commissioner*, 533 F.2d 1114 (9th Cir. 1976); *Bongiovanni v. Commissioner*, 470 F.2d 921 (2d Cir. 1972); *Donald D. Focht*, 68 T.C. 223 (1977), involving the application of § 357(c) on the assumption of accounts payable by a cash basis taxpayer in a § 351 exchange. In these three cases, it was held that § 357(c) did not apply (even though liabilities exceeded basis of receivables) to "deductible liabilities" assumed by the corporation. The implicit holdings of these decisions is that the income potential in account receivables will not be recognized upon the § 351 exchange. See B. BITTKER & J. EUSTICE, *supra* note 32, ¶ 3.17, at 3-59 n.98.

From a policy standpoint there appears to be no reason for distinguishing between a § 351 exchange and a § 355 division. In fact, a transaction that meets the requirements of § 355 may also comply with the requirements of § 351. However, since the reorganization rules are more comprehensive than the § 351 formation rule, the former should control. See B. BITTKER & J. EUSTICE, *supra* note 32, at ¶ 3.19. If accounts receivable can be transferred without recognition in a tax free exchange, the transfer of *inchoate* income items such as soybeans would appear to be an easier case for the taxpayer. Nevertheless, litigation based upon the transfer of *inchoate* income items (where the income producing process is incomplete at the time of transfer) has produced mixed and sometimes inconsistent results. Compare *Adolph Weinburg*, 44 T.C. 233 (1965), *aff'd per curiam sub nom. Commissioner v. Sugar Daddy, Inc.*, 386 F.2d 836 (9th Cir. 1967) (newly formed corporation's sale of growing crops treated as sale by the transferor who held them until shortly before harvesting) with *South Lake Farms, Inc.*, 36 T.C. 1027 (1961), *aff'd sub nom. Commissioner v. South Lake Farms, Inc.*, 324 F.2d 837 (9th Cir. 1963) (expenses of raising agricultural crop not restored to income upon liquidation) and with *Central Cuba Sugar Co. v. Commissioner*, 198 F.2d 214 (2d Cir. 1952) (expenses incurred in planting a crop must be allocated between the transferring corporation and newly formed corporation to clearly reflect income).

The applicability of the above described cases to the Baker Farms situation is uncertain. However, the Supreme Court's decision in *Nash v. United States*, 398 U.S. 1 (1970), allowing the bad debt reserve of a transferor of an unincorporated business to avoid recognition (under tax benefit rules) upon a § 351 exchange, may have undermined adverse taxpayer decisions. This is especially true in a § 355 transaction where the carryover basis rules of § 362 will at least require the recognition of the income item at the corporate level at ordinary income rates.

324. Cf. *Central Cuba Sugar Co. v. Commissioner*, 198 F.2d 214 (2d Cir. 1952) (holding that expenses incurred in planting a crop must be allocated between the transferring corporation and the newly formed controlled corporation to clearly reflect income and to deny the power to shift income arbitrarily among controlled corporations). Generally the provisions for nonrecognition of gain are subordinate to the Commissioner's statutory authority to clearly reflect income by allocating income and deductions. See B. BITTKER & J. EUSTICE, *supra* note 32, at ¶ 3.17.

325. In several private rulings in the farm corporation area, representations had been made by the taxpayers therein that no items of income (receivables) would be transferred to the controlled corporation in a § 355 transaction where the right to such income had been earned by distributing corporation. See 50 I.R.S. Letter Rulings (part II) 7806027 (Nov. 8, 1977); 35 I.R.S. Letter Rulings (part II) 7744019 (Aug. 3, 1977); 31 I.R.S. Letter Rulings (part II) 7740040 (July 11, 1977). Thus, the issue of midstream transfer of potential income items that were completely earned was not at issue in those rulings. However, in several recent private rulings in the context of service corporations such as medical and legal professional corporations, accounts receivables of cash basis taxpayers were transferred to the controlled corporation. Representations had been made in the ruling requests that no items of income or deductions attributable to such income items would be omitted or duplicated as between the distributing and controlled corporation. The Service ruled that no gain or loss would be recognized on the transfer of such items to the controlled corporation. See 53 I.R.S. Letter Rulings (part II) 7810013 (Dec. 1, 1977); 40 I.R.S. Letter Rulings (part II) 7749015 (Sept. 1, 1977); 39 I.R.S. Letter Rulings (part II) 7748062 (Sept. 2, 1977); 28 I.R.S. Letter Rulings (part II) 7737038 (June 17, 1977).

One wonders what the result would be to farm corporations if receivables were represented as being transferred to the controlled corporation. If recognition and deduction occur at the corporate level, presumably there should be no difference in treatment between a farm corporation and a professional service corporation. Moreover, if accounts receivable are allowed to be transferred to the controlled corporation, a persuasive argument can be made that soybeans can be transferred without gain recogni-

soybeans, it may be simpler to avoid transferring the soybeans and in lieu thereof, to substitute additional machinery or cash.³²⁶

Certain other adjustments will be necessary. Any investment credit previously taken on any "section 38" property³²⁷ transferred from Baker Farms, Inc. to "Controlled" must be adjusted in the year of the transfer if the disposition of such property was an early disposition within the meaning of section 47(a)(1) of the Internal Revenue Code.³²⁸ Although a divisive D reorganization might appear at first glance to be exempt from section 47 on the grounds that the transfer to "Controlled" constituted a mere change in form under section 47(8),³²⁹ the disposition of the stock to a shareholder in the split off will probably make section 47(b) inapplicable because the taxpayer, Baker Farms, Inc., would not retain a substantial interest in "Controlled" after the reorganization.³³⁰ Thus, any recapture under section 47 must be paid by Baker Farms, Inc.³³¹

Under section 312(h) of the Internal Revenue Code, the earnings and profits of Baker Farms, Inc. must be allocated between "Controlled" and Baker Farms, Inc. in accordance with regulations 1.312-10(a).³³² This regulation provides that in the case of a newly formed corporation such as "Controlled," the allocation of earnings and profits generally shall be made in proportion to the fair market value of the business retained by Baker Farms,

tion because crystallization of their income potential has not yet occurred at the time of transfer. However, since private rulings are not regarded as precedent by the Internal Revenue Service whether a favorable ruling can be received by Baker Farms, Inc. on the transfer of soybeans is unpredictable.

326. A possible problem with the substitution of cash or machinery is whether such assets can qualify as part of the active business (with a five year history) transferred to "Controlled" within the meaning of § 355.

327. I.R.C. § 38. Section 38 allows a credit against taxes for investment in certain depreciable property, mainly to provide an incentive for modernization and growth of private business. In the case of Baker Farms, § 38 property would include tangible personal property, *e.g.*, farm equipment, to which depreciation is allowable for such property having a useful life of three years or more, *see* I.R.C. § 48(a)(1), and possibly livestock other than horses. *See* I.R.C. § 48(a)(6).

328. I.R.C. § 47(a)(1) increases taxes if § 38 property is disposed of before its useful life ends. The additional tax is:

equal to the aggregate decreases in the credits allowed under section 38 for all prior taxable years which would have resulted solely from substituting, in determining qualified investment, for such useful life the period beginning with the time such property was placed in service by the taxpayer and ending with the time such property ceased to be section 38 property.

Id.

329. I.R.C. § 47(b) states:

Subsection (a) shall not apply to:

- (1) a transfer by reason of death, or
- (2) a transaction to which section 38(a) applies.

For purposes of subsection (a), property shall not be treated as ceasing to be section 38 property with respect to the taxpayer by reason of a mere change in the form of conducting the trade or business so long as the property is retained in such trade or business as section 38 property *and the taxpayer retains a substantial interest in such trade or business.* (emphasis added).

Although § 381 deals with tax attributes carried over in reorganizations, divisive D reorganizations are not covered by § 381. I.R.C. § 381(a). Moreover, the required distribution of the stock to the shareholder in a § 355 division would appear to make the flush language cited above inapplicable to a § 355 transaction.

330. The Service has so ruled in Rev. Rul. 74-101, 1974-1 C.B. 7.

331. I.R.C. § 47(a)(1).

332. Treas. Reg. § 1.312-10 (1955).

Inc. (the distributing corporation) and the fair market value of the business transferred to "Controlled" (the controlled corporation).³³³ The regulations further state that in proper cases (without elaborating on what constitutes a proper case) the allocation shall be made in proportion to the net basis of the assets transferred and of the assets retained.³³⁴ Finally, the regulations provide that in proper cases a different method shall be used as may be appropriate under the facts and circumstances of the case.³³⁵ Since one-half of the assets of Baker Farms, Inc. will be transferred to "Controlled," one-half of the earnings and profits of Baker Farms, Inc. (\$80,000)³³⁶ will be allocated to "Controlled" under the general rule described above.³³⁷

In the hypothetical presented in section II,³³⁸ we assumed for simplicity that Baker Farms, Inc. had no liabilities. In the usual case a corporation will have liabilities and it may be wise to have "Controlled" assume the liabilities that are related to the business transferred to it so long as those liabilities do not exceed the total adjusted bases of the assets transferred.³³⁹ But, as mentioned earlier, any attempt to shift income and expenses may create problems and should be avoided.³⁴⁰

Finally, the basis of the assets transferred to "Controlled" will be the same as the basis of those assets in the hands of Baker Farms, Inc.³⁴¹ This technique of dividing assets among families should not disturb earlier uses of sections 6166,³⁴² 6166A,³⁴³ and 2032A.³⁴⁴

2. Taxation of Shareholder Upon the Distribution of Stock

Upon the distribution of "Controlled" stock to B in exchange for all of his stock in Baker Farms, Inc., no gain or loss will be recognized by B by reason of section 355(a)(1). Furthermore, no gain or loss will be recognized

333. *Id.*

334. *Id.*

335. *Id.*

336. In 1977, Baker Farms, Inc. had current earnings and profits of \$60,000 and accumulated earnings and profits of \$100,000. In 1978 it expects to break even. See text in section II *supra*.

337. It is assumed that the general rule of Treas. Reg. § 1.312-10(a) (1955) is applicable to the Baker Farms situation.

338. See text in section II *supra* wherein it is stated that Baker Farms, Inc. has no liabilities.

339. A favorable ruling from the Service for a cash basis taxpayer concerning the transfer of potential income items to the controlled corporation, is more likely if liabilities incurred and attributable to the income items are also assumed by the controlled corporation. In such a case distortion of income might be mitigated since the income when collected and the liabilities when paid will be reflected in the controlled corporation's return as income and deductions as the case may be.

If, however, the liabilities exceed the total aggregate basis of the property transferred to the controlled corporation, gain must be recognized to the extent of the excess under § 357. I.R.C. § 357(c).

340. See text accompanying notes 319-26 *supra*.

341. I.R.C. § 362(b).

342. *Id.* § 6166(g)(1)(C).

343. *Id.* § 6166A(h)(1)(C).

344. *Id.* § 2032A(c)(1)(A). See also Prop. Treas. Reg. §§ 1.1402(a)-4, 20.2032A-3, 20.2032A-4 (special rules regarding material participation for closely held businesses, partnerships and trusts, which would indicate the potential of helpful construction of material participation for a disposition under § 2032A).

by Baker Farms, Inc., upon the distribution of "Controlled" stock to B.³⁴⁵

Under section 358 of the Code, the basis of the "Controlled" stock in the hands of B will be the same as the basis of the Baker Farms, Inc. stock, surrendered by B in the exchange. Moreover, the holding period of the "Controlled" stock received by B will include the holding period of the Baker Farms, Inc. stock surrendered in exchange therefore, assuming that the Baker Farms stock held by B is a capital asset in his hands.³⁴⁶

The tax deferred division of Baker Farms, Inc. in a section 355 split off results in a minimum of tax upon the corporate separation. As illustrated above, the transfer from Baker Farms, Inc. to B is accomplished without the recognition of any gain or loss. Insofar as the corporations are concerned, investment credit recapture and possibly income recognition will occur under the tax benefit rule upon the transfer of the soybeans to the controlled corporation. However, section 1245 will not apply in a 355 transaction and midstream income can be avoided by not transferring the soybeans. Although the gain potential is carried over to "Controlled" and to B as a result of the substituted basis provisions, the deferral of the tax until a later date is obviously more attractive than a taxable division where the gain is recognized and substantial tax must be paid. Overall, a 355 split off will achieve the Baker brothers goals of (1) dividing the farming operation and (2) minimizing their tax expense. Because of large tax consequences that occur upon a taxable division, the prudent practitioner may desire a ruling from the Internal Revenue Service to ensure that the proposed 355 division qualifies under that section.

V. CONCLUSION

We have discussed in this article a variety of methods with which to attempt to solve the problems of the disharmonious family farm corporation. Depending upon the fact situation, any one of the suggested approaches may afford the best solution. Thus, for example, a division of a corporation with few earnings and profits plus substantially appreciated real estate may be best accomplished under Internal Revenue Code section 333. Other factors may lead to a variety of other choices including a taxable liquidation under section 331, a complete redemption of a shareholder's stock under section 302, or a corporate division under section 355. Whether these or other approaches are taken is dependent upon careful tax analysis including both the immediate and long-term tax implications, which will hopefully lead the client to modest happiness. The techniques are, of course, equally applicable to any closely held nonfarm corporation.

345. *Id.* § 311(a).

346. *Id.* § 1223(1).