

**SPLITTING UP A FAMILY BUSINESS - ISSUES UNIQUE TO  
C CORPORATIONS**

**Closely Held Business (Tax); Business Planning Group (RPPT);  
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**ABA SECTION OF TAXATION**

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## I INTRODUCTION

There are several obvious threshold questions that must be answered before one can reasonably advise a family with respect to the split up of its business:

1. Is it the intent of the family to continue the business, and if not, what will be the timing of the cessation of business?
2. Do all, or just some of the family members intend to continue business on their own, and if so, will they be separate types of non-competitive businesses, or will they each carry on the same business separately and compete with each other?
3. Are the lines of business to be separated service businesses without significant tangible assets or are they capital intensive businesses with substantial tangible assets?
4. Is the business being split up owned by a single family, or is it a business owned by more than one family?
5. Is the business being split up before or after the death of the elder generation shareholder(s)?

In any of these cases, the most important issue to consider is the business purpose of the plan. Obviously, income, gift and estate tax considerations are important; however a plan driven exclusively by these factors is most likely to fail, and ironically is the most likely to be attacked by the Internal Revenue Service ( the “IRS”). Moreover, the elder generation shareholders should, to the extent possible, allow enough time to develop effective management skills in the next generation who will operate the split up businesses. For purposes of this outline, the writer assumes that the business purpose has been considered and the most tax-effective implementation is now the issue before him.

As to estate tax planning issues, while this outline may mention certain tools, a significant discussion thereof is beyond its scope. This outline will concentrate on issues unique to C Corporations; however, certain issues will have applicability to other types of entities. Finally, many of the considerations we face with respect to family businesses are more personal and psychological in nature rather than tax or

legal issues and it is critical to seek competent advice in those areas, often years before a split up is considered.

## **II DISCONTINUANCE OF BUSINESS**

### **A. SALE OF BUSINESS**

1. The most typical way in which a corporate business is discontinued is by either a sale of the assets followed by a liquidation, or a sale of the stock of the corporation.
2. In the context of the C Corporation, because of the potential for a second level tax if a sale of assets is followed by a liquidation of the corporation, it is preferable, if possible, to sell the stock of the corporation because this results in a single tax to the shareholders at the rate applicable to capital gains.
3. More often than not, in the case of closely held corporations, buyers are unwilling to purchase the stock of the corporation because they are not willing to rely on the sellers' indemnification to protect them against undiscovered and undisclosed corporate liabilities. Thus, in the post - General Utilities era, we are left with trying to negotiate a higher price to compensate for the second level tax incurred on the liquidation of the corporation and/or trying to allocate a significant portion of the purchase price to an intangible or intangibles owned directly by the shareholders. In addition, deductible bonuses and the like may be paid to owners in the year of sale; however, in most cases this insufficient to eliminate, or even make a significant dent in the amount subject to double taxation. Moreover, the income from these bonuses is taxed at ordinary income rates in the year received rather than at capital gains rates as would be the case where there was the sale of certain personal intangibles.
4. Section 197 of the Internal Revenue Code of 1986, as Amended ( the "Code")\*, provides that amortizable section 197 intangibles shall be amortized over 15 years,

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\* All references herein to section numbers are to sections of the Code unless otherwise indicated.

including purchased goodwill and the amount paid for a covenant not to compete, regardless of the fact that the non-compete period may be for a period shorter than 15 years.

5. Payments may be made directly to individual shareholders as employment, consulting and/or non-compete payments. Unfortunately, these payments will be subject to tax at ordinary income rates, and employment and consulting fees will also be subject to employment or self-employment taxes. Moreover, since the payments for the restrictive covenant must be amortized over 15 years regardless of its duration, the buyer is typically unwilling to pay more for that intangible than it would for goodwill, which is a capital assets in the hands of the seller.

6. Goodwill is an intangible asset associated with the going - concern value of a business. It has long been recognized by valuation authorities and by the courts that there are two types of goodwill:

(a) “business goodwill” which is intangible value associated primarily with the business entity, such as location, systems, customer lists and trained staff; and

(b) “personal goodwill” which is transferable intangible value that is primarily associated with an individual which generally requires the transferor to enter into a non-compete agreement and to communicate with the customers/clients of the business with regard to the purchaser succeeding him or her and to endorse the purchaser’s qualifications to do so.

See, e.g. Shannon Pratt, The Lawyer’s Business Valuation Handbook, pp. 13, 332 (2000); Martin Ice Cream Co. v. CIR, 110 T.C. 189 (1998); Norwalk v. CIR, TC Memo. 1998-279.

7. The advantage of a substantial allocation of the purchase price to the personal goodwill of the selling shareholder(s) is that the gain realized will be subject to one level of tax at the capital gains rate. Moreover, in the case of a personal service corporation, an allocation to personal goodwill avoids the flat 35% rate for corporate income.

8. The allocation of a portion of the purchase price to personal goodwill should be negotiated between the buyer and the seller. Since it is arguable that the buyer and the seller do not have competing tax concerns, the allocation may be subject to adjustment by the IRS. Therefore, it is advisable to have the allocation supported by a third-party appraisal.

9. The issue of personal goodwill has arisen for the most part in connection with the sale of professional practices and the professional practice owner. However, there is no reason why it cannot similarly be applied to any personal service business where there is a personal relationship between the owner(s) and the customers of the business. Moreover, in the proper circumstances, as in Martin Ice Cream, supra, it can be applied to non-professional mercantile businesses.

10. Care needs to be exercised in the use and valuation of non-compete agreements together with an allocation to personal goodwill. While most authorities agree that there must be a restrictive covenant agreed to by the selling shareholder in order for there to be a value assigned to his personal goodwill, there is conflict with regard to whether a substantial allocation to the non-compete restrictions will nullify any significant allocation to personal goodwill. The writer believes that in the proper circumstances, as for example where the selling shareholder is elderly, or moving out of the area where the business is located, a nominal allocation to the restrictive covenant would be justifiable along with a significantly larger allocation to personal goodwill.

11. Finally, if the elder generation shareholder(s) believe that it is likely that the business would have to be sold at sometime in the future, it might be worthwhile to consider an S Corporation election so that the corporate level tax can be eliminated if the sale takes place more than 10 years later.

## B. LIQUIDATION OF THE CORPORATION

1. As in the case of a sale of the business, the repeal of the General Utilities Doctrine in 1986 fundamentally effected the taxation of corporate liquidations. Before the changes wrought by the Tax Reform Act of 1986, a corporation generally did not recognize gain or loss on the distribution of property in connection with its complete liquidation. In addition, certain non-liquidating distributions could be made without a corporate level tax.

2. The complete liquidation of a corporation involves the transfer of all of the corporation's assets to its shareholders and/or creditors, as opposed to a partial liquidation which typically involves the transfer of only a part of the corporation's assets, often an operating line of business, to a shareholder or group of shareholders. These will be addressed in the context of the discussion of redemptions in II, below.

3. In some cases, although this does not often occur with respect to small family owned businesses, it may be difficult to ascertain if a complete liquidation is taking place, because the actual transfer of assets and the dissolution of the corporation may take place over a period of years. If you believe that this process will require more than one distribution of assets, you must prepare a plan of liquidation to be adopted by the corporation. Obviously, as well, the corporation must cease conducting business once the planned distributions have occurred.

4. For purposes of this outline, the writer assumes that the shareholders of the liquidating corporation are individual family members and not a corporation owning 80% or more of the stock thereof. Thus, Section 332 which generally allows for a tax-free liquidation of such a subsidiary will not be discussed.

5. If a complete liquidation occurs, the shareholders are treated under Section 331 as having exchanged their shares for the assets of the corporation. Collaterally, the liquidating corporation is treated as having sold its assets for fair market value and recognizes any gain or loss that would have resulted from such a sale. In the case of the corporation, the nature of the gain (capital or ordinary) is determined on an asset-by-asset basis. The recognition of losses, however, may be limited in certain circumstances.

6. Normally, when dealing with related parties, Section 267 prohibits the recognition of losses realized on the sale or exchange of property. However, Section 267(a)(1) exempt distributions in complete liquidation from this prohibition. But, Section 336(d) limits the ability of the corporation to recognize losses with respect to liquidating distributions to related parties if (i) the distribution is not pro rata to all shareholders, or (ii) the property is "disqualified property." Disqualified property is defined as (i) property acquired by the corporation in a Section 351 transaction during the 5-year period ending on the date of distribution, or (ii) any property with an adjusted basis determined in whole or in part by reference to property described in subparagraph (i), above. In

addition, Section 336(d)(2) contains a rule which limits losses on the distribution of property acquired by the corporation as part of a plan, a principal purpose of which was to recognize loss by the corporation on liquidation.

7. Since gain or loss is recognized, the distributee - shareholders are entitled to a basis in the assets received equal to their fair market value at the date of distribution.

8. In ascertaining the amount of gain or loss to be recognized by the corporation, distributed property subject to a liability is deemed to have a value at least equal to the amount of the liability. The same rule applies if property is distributed not subject to a liability, but the distributee - shareholder assumes a corporate liability in connection with the distribution.

9. Section 6043(a) requires the liquidating corporation to file a Form 966 with the Ogden Service Center within 30-days after the adoption of a plan or resolution for the liquidation or dissolution of the corporation.

### **III CONTINUANCE OF THE BUSINESS(ES)**

#### **A. REDEMPTIONS**

1. If Section 355 (discussed below) is not applicable, and the distribution does not constitute a complete liquidation of the corporation, Section 301 and Section 302 govern the taxation of corporate distributions to shareholders. Unless the distribution qualifies as an exchange treated as a redemption under Section 302, the general rule of Section 301 will apply. That is, the distribution will be treated as a dividend and typically taxed at ordinary income rates.

2. In order to qualify the distribution as a redemption, which is taxable as an exchange rather than a dividend, the transaction must meet one of the requirements of Section 302. They are as follows:

- (i) the redemption is not essentially equivalent to a dividend;
- (ii) the redemption is a substantially disproportionate redemption of the shareholder's stock;

- (iii) the redemption is in complete termination of the shareholder's interest; or
- (iv) the redemption is of a non-corporate shareholder and made in partial liquidation of the corporation.

3. Since our hypothetical situation envisions the splitting up of the business, the distribution of corporate assets would be in exchange for all of the shareholder's shares and the distributee - shareholder would likely have no further association with the distributing corporation.

4. On first blush, it would appear that using a redemption to distribute a portion of the corporation's assets to a shareholder in exchange for all of his or her shares in the corporation would satisfy one or more of the requirements of Section 302 and qualify as an exchange. However, in the case of a family held business, there is an extra step that must be taken as a result of the family attribution rules of Section 318.

5. Under Section 318, the ownership of corporate shares by certain members of the redeemed shareholder's family will be attributed to that shareholder. Thus, absent some further circumstances or actions, the redemption will not satisfy the requirements of section 302 set forth above.

6. Section 302(c)(2) provides for relief from this result if a waiver of the family attribution rules is elected and certain prescribed conditions are met. Such waiver is allowed if immediately following the redemption, the redeemed shareholder has no interest in the corporation (other than as a creditor), acquires no such interest for a period of 10-years after the date of the redemption (other than through inheritance) and the distributee files an agreement with the Treasury to the effect that he or she will notify the Secretary of any such acquisition during the aforementioned 10-year period. Care needs to be taken before services as an independent contractor are rendered to the distributing corporation by the redeemed shareholder during that 10-year period. The IRS maintains that such services will constitute an "interest in the corporation," although the Tax Court has held that might not be the case in certain circumstances. See M. Lennard Est., 61 TC 554 (1978)(Nonacq.).

7. Finally, if the distribution in exchange for stock is of appreciated property, Section 311 requires the corporation to pay a corporate level tax on the deemed gain.

## B. CORPORATE DIVISIONS

1. Prior to the Tax Reform Act of 1986 and its codification of the General Utilities doctrine repeal, Section 355, which is the primary section dealing with corporate divisions, was primarily useful in that it provided that corporate distributions which met the requirements of that section, could be implemented without a shareholder-level tax. Subsequent to 1986, it became the most significant method still available to effect the distribution of an appreciated asset from a corporation to its shareholder(s) without incurring a corporate level tax as well on the appreciation. As a result, both the Congress and the IRS have been particularly vigilant with respect to perceived abuses of Section 355 and have consistently tightened the availability of its use.

2. There are three primary types of corporate divisions covered by Section 355. They are: a spin-off, a split-off and a split-up. In addition, the IRS has also recently used the term, “splint-off” which refers to a split-off followed by a spin-off. In a spin-off, the distributing corporation distributes stock of a controlled subsidiary, usually pro-rata, to its shareholders, without requiring any surrender of stock by the shareholders. In a split-off, the distributing corporation distributes stock of a controlled subsidiary to some or all of its shareholders in exchange for some or all of their shares in the distributing corporation. In a split-up, the distributing corporation distributes stock of two or more controlled subsidiaries to its shareholders in complete liquidation. These distributions may be pro-rata or they may be apportioned in another manner among the shareholders.

3. In order to qualify for tax-free treatment under Section 355, the following statutory requirements must be met:

(a) Solely stock or securities of the controlled subsidiary must be distributed to the distributing corporation’s shareholders and the distributed stock or securities must constitute control of the subsidiary;

(b) Both the distributing corporation and the controlled subsidiary must conduct an active trade or business; and

(c) The distribution must not be a device for distributing earnings and profits.

In addition to the aforesaid statutory requirements, the courts have created business purpose, continuity of interest and continuity of business enterprise requirements which must be complied with to qualify for tax-free treatment under Section 355. Moreover, the Congress enacted Section's 355(d), 355(e) and 355(f) to give further teeth to General Utilities doctrine repeal enforcement. However, these latter provisions primarily result in tax only at the distributing corporation level, but not to the shareholders.

4. Tax-free treatment only applies to the distribution of stock or securities of the controlled subsidiary. Any additional property received by the shareholders is taxable "boot." Included in the definition of property other than stock or securities is stock of a controlled corporation that was acquired by the distributing corporation within the five years immediately preceding the distribution date. It should be kept in mind that the excess principal amount of securities distributed over the principal amount of securities exchanged therefor will also constitute "boot." Finally, the amount of stock of the controlled subsidiary which is distributed must constitute control of such subsidiary, and if any stock in the subsidiary is retained by the distributing corporation, it must establish that it did not intend to avoid federal income tax by distributing some stock and retaining the remainder. See Regs. Section 1.355-2(e)(2).

5. Both the distributing corporation and its controlled subsidiary must meet the five-year active trade or business requirement. This prevents a distribution of stock in a controlled subsidiary which contains solely passive or liquid assets, which collaterally reinforces the device requirement discussed below. The active business requirement can be satisfied either by a corporation's direct conduct of a business or by its ownership of no substantial assets other than the stock of subsidiaries that directly conduct such businesses. In determining whether a trade or business is being actively conducted, all of the facts and circumstances are examined to ascertain whether the corporation, itself, is performing "active and substantial management and operational functions." See Regs. Section 1.355-3(b)(2)(iii). Regs. Section 1.355-3(b)(2)(iv) specifies the type of conduct that does not constitute the carrying on of an active trade or business. Anything not specifically enumerated in those regulations are governed by a facts and circumstances test which is governed by the general guidelines contained in the regulations.

6. One of the common occurrences in family owned businesses is the ownership of real estate in which the business, itself, and/or others are tenants. Over the years, the application of the active trade or business requirement to the ownership of this type of real estate has sparked significant debate among taxpayers and the IRS. The IRS position that seems to have evolved is set forth in Regs. Section 1.355-3(b)(2)(iv)(B). That regulation provides that the ownership and operation (including leasing) of real property does not qualify as an active trade or business unless the owner performs significant services with respect to the operation and management of the property. Thus, a triple net leased building will not qualify as the active conduct of a trade or business, particularly if owner-occupied. Even absent a net lease, a completely or substantially owner-occupied building will weigh heavily against a finding by the IRS of an active trade or business. Certainly, it will result in increased scrutiny of any attempted tax-free distribution of a subsidiary which owns such real estate in order to determine whether significant services are being performed by the owner so as to qualify as an active trade or business.

7. Like the active trade or business requirement, whether or not the device restriction requirement is satisfied must be ascertained based upon all of the existing facts and circumstances. Regs. Section 1.355-2(d) discusses this requirement and provides guidance with respect to factors which would evidence a device and those that would not, and also lists three transactions that will not be considered a device even if there otherwise are factors present that would normally be device factors. They involve transactions in which neither the distributing corporation nor the controlled subsidiary have any earnings and profits, transactions that would otherwise qualify as a Section 303(a) redemption and transactions that would otherwise qualify as a Section 302(a) redemption (disregarding the 10-year prohibition). The anti-device requirement is primarily addressed at individual shareholders so as to prevent them from taking advantage of Section 355 tax free treatment in order to ultimately convert to capital gain what would have been taxed at ordinary income rates and to defer gain to a time when it becomes advantageous to sell the asset.

8. Even though Section 355 does not expressly incorporate a business purpose requirement, Regs. Section 1.355-2(b)(1) mandates that all distributions seeking tax-free treatment under Section 355 must have one or more corporate business purposes. A shareholder purpose (e.g., the personal planning purposes of a shareholder) is not a corporate business purpose. The facts and circumstances of a

particular case, however, particularly in the case of family owned businesses, may show that a shareholder purpose for a transaction may be nearly identical to a business purpose so as to preclude any distinction being made between them. In such a case, that purpose will be considered a corporate business purpose. For example, the benefit to a family business by splitting it up to avoid the effects of shareholder conflict, or to better direct the skills of particular shareholders to particular lines of business would clearly constitute a corporate business purpose even though it served a shareholder purpose as well. Generally, a corporate business purpose is a real and substantial non-federal tax purpose pertaining to the business of the distributing corporation, the controlled subsidiary, or the affiliated group to which the distributing corporation belongs. Regs. Section 1.355-2(b)(3) provides that if the corporate business purpose can be achieved through a nontaxable transaction that does not involve the distribution of the stock of a controlled subsidiary, and the alternative is neither impractical nor unduly expensive, the separation is not deemed to be carried out for a valid corporate business purpose. It should be noted that the IRS changed its ruling policy in 2003. It will no longer determine whether a proposed transaction satisfies the business purpose test. Rather, taxpayers are now required to represent that such requirement is met, and the IRS reserves the right to review this upon examination of the tax return for the year of the distribution. See Appendix A of Rev. Proc. 96-30, 1996-1 C.B. 696, which provided guidelines for the previous IRS ruling policy on business purpose as a useful tool in advising clients on this subject.

9. The courts have also imposed the requirement that there be continuity of proprietary interest, and this requirement has been incorporated in the regulations. See Regs. Section 1.355-2(c). As such, the owners of the business prior to the transaction must continue to own a sufficient amount of the stock of the resulting corporations so that there is deemed to be a continuity of proprietary interest. While the regulations do not define or quantify what is sufficient to amount to the required continuity of proprietary interest, the IRS, for advanced ruling purposes, considers there to be continuity of proprietary interest when one or more persons who, directly or indirectly, were the owners of the distributing corporation prior to the distribution own, in the aggregate, 50% or more of the stock of each of the modified corporate entities after the separation, although a lesser percentage has been accepted by the courts.

10. In addition to continuity of proprietary interest, the courts and the regulations have also imposed a requirement that the business or businesses carried

on prior to the distribution continue to be carried on after the distribution. Since the Code requires both the distributing corporation and the controlled subsidiary to conduct active trades or businesses both before and after the transaction in order to qualify for tax free treatment under Section 355, the continuity of business enterprise requirement is likewise generally satisfied.

11. Section 355(d) imposes a tax at the distributing corporation level for so-called “disqualified distributions.” A disqualified distribution is defined as one that, if immediately thereafter, any person holds disqualified stock in the distributing corporation or the controlled subsidiary which constitutes a 50% or greater interest in either corporation. Disqualified stock is defined as stock in either corporation which was acquired by purchase within five years prior to the distribution, or any stock in the controlled subsidiary received with respect to disqualified stock in the distributing corporation. Purchase is generally defined as any transaction in which the basis of the stock is not determined, in whole or in part, with reference to the adjusted basis of the stock in the hands of the person from whom it was acquired.

12. In general, a transaction is disqualified under Section 355(e) when the distribution of the controlled subsidiary is part of a plan or a series of related transactions in which there is an acquisition of 50% of the distributing corporation or the controlled subsidiary. Such a plan or series of related transactions is presumed to exist (subject to rebuttal by the taxpayer) if the change of ownership occurs within two years before or after the purported Section 355 distribution.

