DEALING WITH UNIQUE ASSETS – BUSINESS INTERETS AND TAX-FREE REORGANIZATIONS

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The information set forth in this outline should not be considered legal advice, because every fact pattern is unique. The information set forth herein is solely for purposes of discussion and to guide practitioners in their thinking regarding the issues addressed herein.

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TAX FREE REORGANIZATION

I. Introduction.

Family business succession planning is the cornerstone of any successful family business owner's estate plan. As is often the case, however, planning for the inter-generational transfer of ownership and control of the business becomes complicated by the intra-generational conflicts of the business owner's heirs. These conflicts among members of the second generation, if severe enough, can render the effective management of the business by the second generation virtually impossible, leading to a loss in productivity and profitability with a resulting decline in the enterprise's value.

A. Intra-Generational Conflicts.

There are myriad reasons why members of the second generation would not be, collectively, up to the task of carrying on the family business owner's legacy. The reasons can be as innocuous as differing interests or as emotionally damaging as estrangement between siblings resulting from a bitter rivalry. One very common dispute occurs between certain second generation members who want to reinvest the earnings of the business, adopting a growth philosophy, while their siblings want to maximize the business's cash flow to its shareholders, adopting an income philosophy. Whatever the form of the dispute, identification of the dispute along with the determination that the dispute will render the successful continuation of the business, in its current form, unlikely is extremely important. This task is often very difficult for both the first generation business owner and second generation to confront. However, identification of the problem early can significantly reduce the chances of a substantial loss in the business's value through destructive and ineffective management.

B. The Role of Entity Form.

The form of entity in which the family business exists plays a crucial role in divisive succession planning. A more "tax-friendly" entity form such as a partnership or limited liability company ("LLC") will afford the planner a much easier time in dividing up the family business without encountering significant adverse tax consequences. The corporate form, conversely, poses serious obstacles since the tax provisions governing corporations make the removal of assets from the corporation, very problematic.[1] Specifically, when a corporation distributes assets to a shareholder, the corporation is treated as selling those assets at their fair market value; the gain (i.e., the difference between the fair market value over the basis in the assets) is taxable to the corporation.[2] This is the case whether the corporation has filed an S election to achieve flow-through tax treatment, or has remained a C corporation subject to a separate corporate- level tax. The only difference is that the S corporation's gain on the distribution of assets flows through to its shareholders without a separate corporate-level tax.[3] A

[1] *See*, *generally*, Boris I. Bittker and James S. Eustice, *Federal Income Taxation of Corporations and Shareholders,(2000* 7th Ed).
[2] *See* IRC § 311.
[3] *See* IRC § 1366.

C corporation will pay a separate corporate level tax (currently 35%) on the gain.[4] In addition to the tax effects on the corporation, the shareholders face various tax consequences on the transfer of assets out of the corporation as well. The consequences vary dependent upon the corporation's status as a C or S corporation. The S corporation shareholder will recognize no gain or loss on the transfer of assets by the corporation to him, so long as the fair market value of those assets does not exceed his basis in his stock. The S corporation shareholder will pay a 15% tax on the amount representing the difference between the fair market value of the property over his basis in the S corporation stock owned for more than twelve months.[5] The C corporation shareholder will have to treat the distribution as either a dividend (upon which a 15% tax will be payable) or a redemption of some or all of his stock (in which case the shareholder will pay no tax as long as the fair market value of the property received does not exceed his basis in his stock but will pay a 15% tax on the amount representing the difference between the fair market value of the property over the shareholder's basis in his stock owned for more than twelve months).[6]

If, however, the business owner was fortunate to start the business as a partnership or limited liability company, the separation of business interests becomes a less daunting task than for the shareholder of a corporation. Partnership taxation, which generally governs partnerships and limited liability companies, provides for the relative ease of moving assets in and out of the entity. A partnership does not recognize gain on a distribution of property to a partner.[7] Conversely, a partner does not generally recognize gain on his receipt of the partnership's distribution of property, so long as the fair market value of the property received does not exceed the partner's basis in his partnership interest.[8] There are, of course, some exceptions to these general rules. If a partner contributes appreciated property to a partnership and receives a distribution (of something other than the contributed property) within seven years of his contribution, the partner will recognize gain on the distribution.[9] Other exceptions apply to the distribution of such contributed appreciated property by the partnership to another non-contributing partner.[10]

Unfortunately, many very successful business owners do not have their businesses inside such tax-friendly business entities, but have the business contained within corporations, both C and S. Many gave very little thought to entity tax planning at the outset or started their businesses at a time when their options for entity choice were very limited. These business owners now face a much more difficult task of dividing their business among second generation members due to the adverse tax consequences involved.

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[4] *See* IRC §11.
[5] *See* IRC §1367.
[6] *See* IRC §302(b)(3).
[7] *See* IRC §731(b).
[8] *See* IRC § 731(a)(1).
[9] *See* IRC § 737.
[10] *See* IRC § 704 (c)(1)(B).

Fortunately, however, Congress has provided a useful tool that serves as a planning tool for corporate owners faced with the dilemma of having to separate their business. Specifically, Section 355 of the Internal Revenue Code of 1986, as amended (hereinafter, "IRC § 355") allows for the tax-free division of businesses within a corporation by separating the businesses into separate corporations.

C. The Effect Of Timing.

Ideally, the business owner will have identified potential problems with the second generation continuing the business many years prior to the owner's death. Unfortunately, as is often the case, business owners either neglect to take the time to address such issues or, in fact, have no obvious reason to be aware of any possible rifts among members of the second generation. This is especially the case when the founder is the chief decision maker on big ticket items such as the company's investment decisions or business philosophy. Second generation members, even those with substantial management responsibility in the business, often do not make known points on which they differ significantly, out of deference to (or fear of) the founder. Thus, the conflicts do not arise until after the founder's retirement or death and the inter vivos or testamentary transfer of the remaining ownership to the second generation. In either case, partnership division planning or the tax-free corporate division under IRC § 355, as applicable, can be utilized to achieve the most positive outcome.

The timing of the transaction will affect the form that the transaction takes. In the case where the business owner is insightful and perceptive enough to conclude correctly that the members of the second generation have irreconcilable business differences, the owner will want to structure the transaction so that:

1. the appropriate members of the second generation will be separated from the others with whom they have conflicts, to have ownership of a separate entity;

2. the other members of the second generation will continue to have ownership in the original entity; and

3. the founder will continue to have ownership in both entities.

On the other hand, if the entity division is to take place after ownership has shifted entirely to the second generation, then there is little need for post-transaction common ownership. While a tax-free division can take place under either scenario, the form of the transaction will change accordingly.

D. Tax-Free Corporate Division.

It is very important to understand that the tax law governing tax-free corporate divisions is at least as complex as it is copious. Its use is contemplated in a number of instances for a host of different reasons outside of the family business succession planning scenario. An exhaustive treatment of all aspects of IRC § 355 divisions, therefore, is unnecessary and, in fact, counterproductive for the estate planner concerned with the tax-free corporate division's usefulness and application to family business succession planning. Therefore, these materials will focus on the tax-free corporate division as applicable to the "typical" family business, e.g. one that is non-publicly-traded, is owned and operated inter-generationally, has been operating well in excess of five years, and has appreciated significantly in value since its inception.

Tax-free corporate divisions can take one of three basic forms: spin-offs, split-offs and split-ups:

1. A "spin-off" usually involves the existing corporation (hereinafter referred to as the "Distributing Corporation") distributing the stock in its previously existing or newly-formed subsidiary corporation (hereinafter referred to as the "Controlled Corporation") to all of its shareholders without any surrender of stock by them. A spin-off is most commonly used where shareholders will receive stock in a spun-off subsidiary without having to surrender any of their initial stock.

2. In a "split-off," the Distributing Corporation distributes the stock of the Controlled Corporation to some or all of its shareholders in exchange for some or all of their stock in the Distributing Corporation. This is used most often in a shareholder dispute, where one group wants to leave the Distributing Corporation entirely.

3. A "split-up" involves the distribution of the stock in two or more Controlled Corporations by the Distributing Corporation to its shareholders in complete liquidation of the Distributing Corporation.[11]

Because of the nature of the family business succession motivated division, a pure pro-rata spin-off is not generally a useful tool. In fact, as will be discussed later, a pure pro-rata spin-off would not generally be permitted in a family business corporate division spurred solely by shareholder disputes. Split-offs and split-ups (as well as certain non-pro-rata spin-offs), however, can be very useful transactions in this respect. The following examples and diagrams illustrate the basic fact scenarios and transactional steps most often involved in the IRC § 355 tax-free corporate division of the family business contemplated in these materials. As will be discussed later in these materials, the motivation behind the division is an integral element to a successful tax-free corporate division, and the following scenarios incorporate the motivation (specifically, the shareholder dispute business purpose) in their fact patterns.

[11] *See* Ridgway 776-2nd T.M.,*Corporate Separations*, II A.1.a.

4. Examples of Tax-Free Corporate Divisions:

   a. The Corporate Split-Up Fact Scenario

      i. ABC Company (ABC) is a "C" corporation, valued at $5,000,000, founded and originally owned 100% by James and Sally Founder. James and Sally have three children, James Jr., William, and Carol. James, Jr. and William work in the business; Carol is not involved in the business but her husband, John Member, works in the business.

      ii. ABC is a computer software manufacturing company with one location in Texas. James, Jr. is Vice President – Manufacturing. William is Vice President – Distribution. John is Vice President – Research and Development.

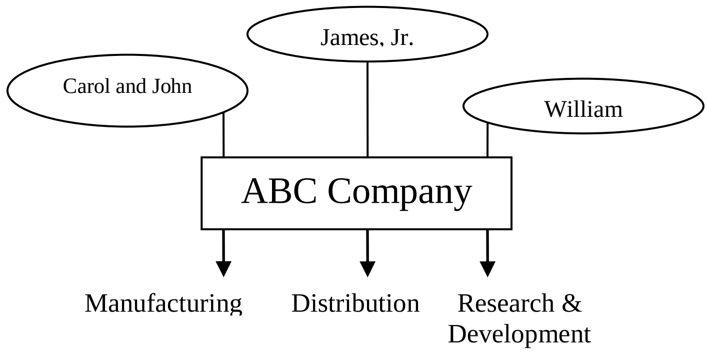
      iii. Consistent with estate planning objectives, James and Sally have gifted their voting stock in ABC in equal one-third's to James, Jr., William, and Carol and John jointly, so that the second generation now owns all of ABC equally.

      iv. During the time since the change of ownership, it has become clear to the Founder Family that James, Jr., William, Carol and John cannot function effectively together in control of ABC. While not obvious while James and Sally controlled ABC and its strategic business decisions, it has become clear that the second generation has irreconcilable differences of opinion and position regarding the allocation of ABC cash, and other tangible and intangible resources, among the three separate business divisions of ABC, a dispute that James, Jr., William, Carol and John believe threatens the business future of ABC. A decision has been made to separate ABC along functional lines into three separate businesses. This business division of ABC will allow each of James, Jr., William, and Carol and John to have 100% control and ownership of the separate business within ABC for which each of James, Jr., William and John has responsibility and will free them from the tension and disagreement associated with working with one another in ABC. The separate businesses would be the Software Research and Development business, the Software Manufacturing business, and the Software Distribution business. The division they choose is the corporate business division called the Corporate Split-Up.

b. The Corporate Split-Up Transactional Steps

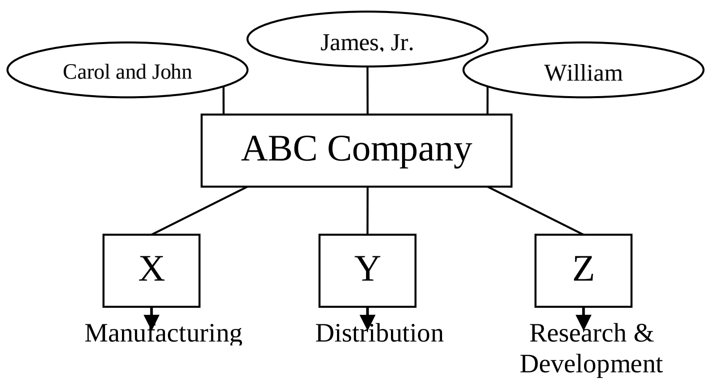
i. Existing Picture

ABC Company, a Delaware corporation ("ABC"), is owned equally by James, Jr., William, and Carol and John.



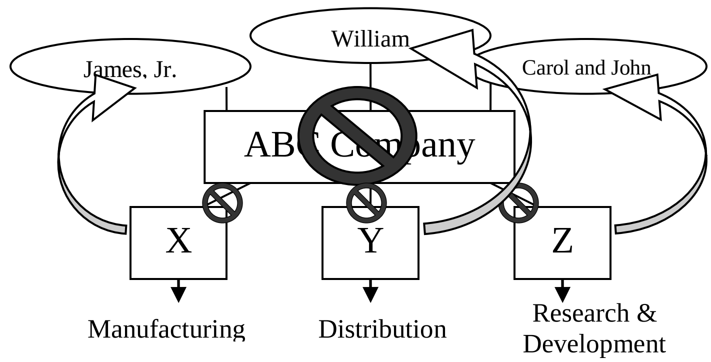
ii. Step One

ABC forms X, Inc., a Delaware corporation ("X"), Y, Inc., a Delaware corporation ("Y") and Z, Inc., a Delaware corporation ("Z"), all of which are wholly-owned subsidiaries of ABC. ABC transfers its Manufacturing division to X, its Distribution division to Y and its Research and Development division to Z.

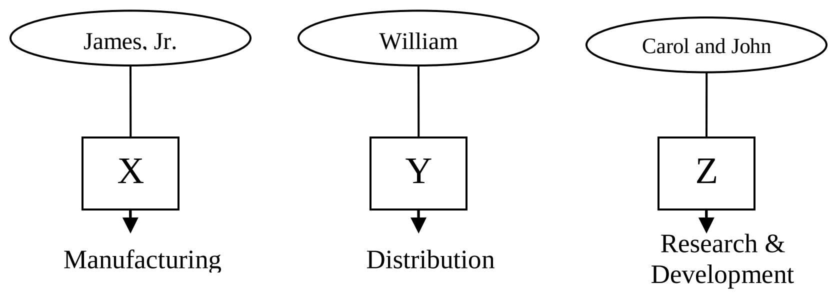


iii. Step Two

ABC distributes all of X's stock to James, Jr., all of Y's stock to William and all of Z's stock to Carol and John in complete redemption and liquidation of ABC.



iv. <u>Resulting Picture</u>
James, Jr. is the sole shareholder of X, William is the sole shareholder of Y and Carol and John are the sole shareholders of Z. ABC is dissolved and is no longer in existence.



c. The Corporate Spin-Off or Non-Pro Rata Spin-Off Fact Scenario

i. ABC Company (ABC) is an "S" corporation founded and owned by James and Sally Founder. James and Sally have three children, James Jr., William, and Carol, all of whom work in the business. James and Sally have seven grandchildren.

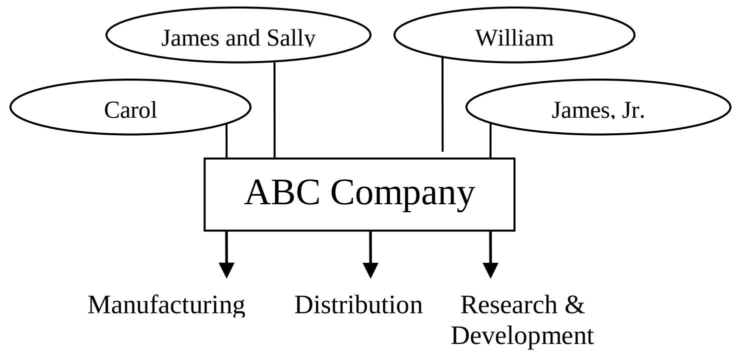
ii. James, Sally and their children are all owners of ABC that has a value of $5,000,000. ABC has two classes of stock, voting common stock and non-voting common stock. The voting common stock represents 10% of ABC equity. The non-voting common stock represents 90% of ABC equity. ABC is a computer software manufacturing company with one location in Texas. James, Jr. is Vice President–Research and Development. William is Vice President-Manufacturing. Carol is Vice President –Distribution.

iii. James and Sally have come to recognize that James, Jr., William and Carol will not agree regarding certain strategic business matters of ABC when James and Sally are no longer in control of ABC. One such business issue is the portion of annual net cash flow to be reinvested in ABC and the portion of ABC annual earnings to be passed through to the shareholders as "S" distributions. Factually, James, Jr.'s Research and Development component represents 1/3 of the value of ABC; however, James, Jr. demands a significant portion of ABC's net cash flow be reinvested in his Research and Development activities which James, Jr. sees as the future of ABC. Correspondingly, the Manufacturing component and Distribution component represent 2/3 of the value of ABC. William and Carol feel that a significant portion of the excess annual cash flow should be distributed to the shareholders, not reinvested in ABC activities. James and Sally, as controlling shareholders and directors of ABC, have been able to balance the desires of the conflicting views of their children. However, they recognize that the compromise they have been able to accomplish among their children will probably die with the survivor of the two of them when control is passed under the survivor's Will to the three children. Therefore, a strategic part of their estate planning goals prior to their deaths is to separate ABC into two separate business components: 1) Software Research and Development, and 2) Software Manufacturing and Software Distribution component so that James, Jr. can ultimately own and control the Research and Development component (and its cash flow) and William and Carol can ultimately own and control the Manufacturing and Distribution components (and that cash flow). The division they choose to accomplish their goal is the corporate business division called the Corporate Spin-Off.

d. The Corporate Spin-Off or Non-Pro Rata Spin-Off Transactional Steps

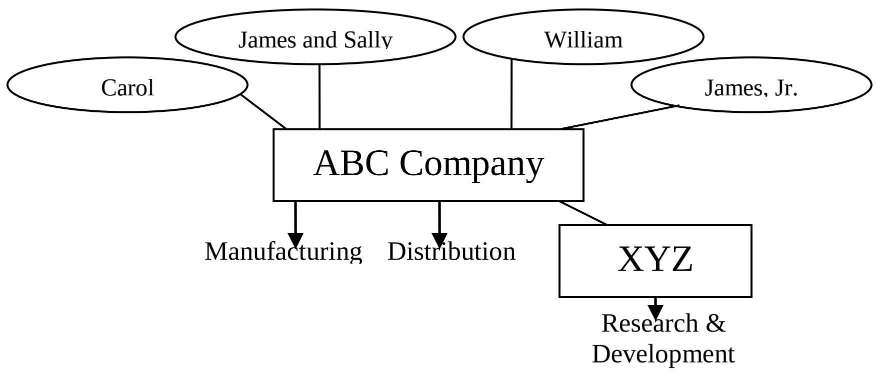
i. <u>Existing Picture</u>

ABC Company, a Delaware corporation ("ABC"), is owned by James, Sally, James, Jr., Carol and William.



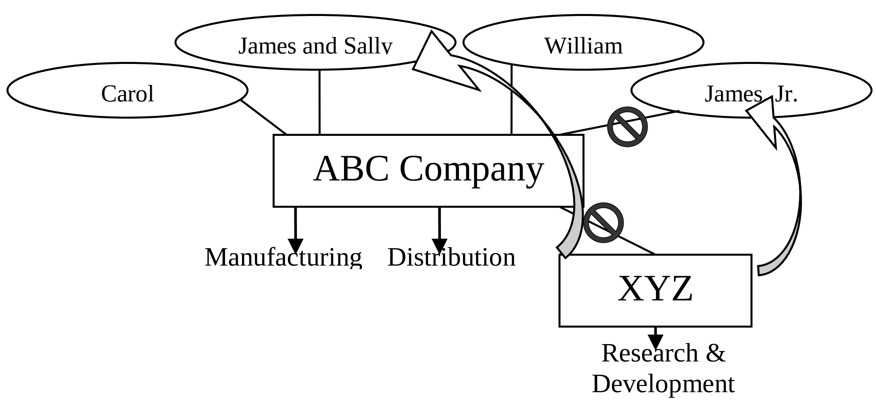
ii. Step One

ABC forms XYZ, Inc., a Delaware corporation ("XYZ"), which is a wholly-owned subsidiary of ABC. ABC transfers its Research & Development division to XYZ.



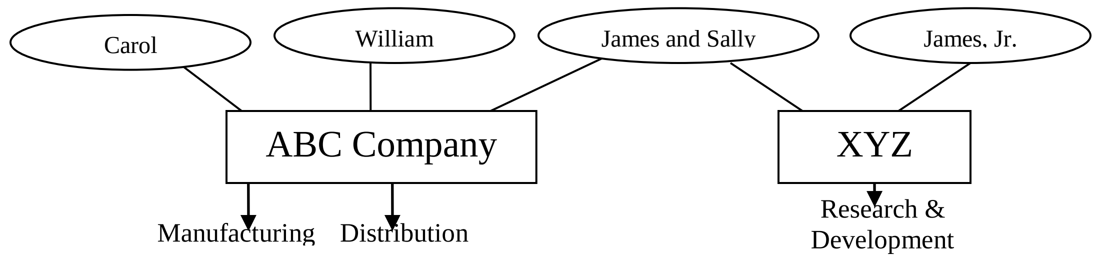
iii. Step Two

ABC distributes all of XYZ's stock to James, Sally and James, Jr.; James and Sally retain their stock in ABC, while James, Jr. gives up all of his stock in ABC.



iv. Resulting Picture

James, Sally and James, Jr. are the shareholders of XYZ; James, Sally, William and Carol are the shareholders of ABC.



e. The Corporate Split-Off Fact Scenario

i. ABC Company (ABC) is a "C" corporation founded and owned by James Founder and Sally Founder. James and Sally have three children, James Jr., William, and Carol. James, Jr. and William work in the business; neither Carol nor her husband, John Member, is involved in the business.

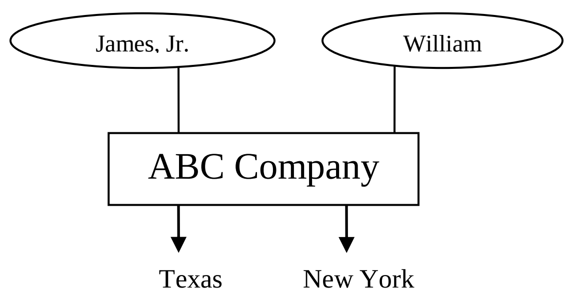
ii. James and Sally are the 100% owners of ABC that has a value of $5,000,000. ABC has a single class of stock, voting common stock. ABC is a computer software manufacturing company with two manufacturing plant locations. One location is in Texas. The other location is in New York. The manufacturing activities at each location are complete in themselves as to the software products produced at each location. James, Jr. lives in Texas and is a Vice President – Manufacturing and General Manager of the Texas manufacturing plant. William lives in New York and is a Vice President – Manufacturing and General Manager of the New York plant. The two plants work together in the acquisition of materials used in the manufacturing process to achieve volume purchase discounts. Other than joint purchasing, the two manufacturing plants operate separately.

iii. James and Sally, each 65 years old, were recently killed in a car accident. James and Sally Founder's Wills transfer ABC ownership to the two children working in ABC (James, Jr. and William), with an equitable transfer of other wealth to the child not working in ABC (Carol).

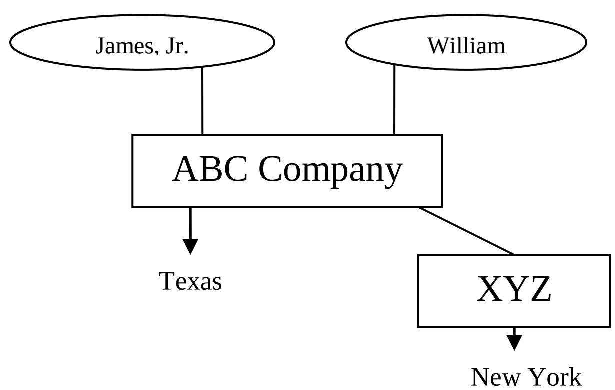
iv. After becoming equal owners of ABC, James, Jr. and William determine that they cannot work with one another in ABC now that James and Sally are no longer in control of ABC. James, Jr. believes a very conservative approach to debt and capital expenditure is in the best interest of the future financial stability of ABC. William takes a more aggressive financial posture for ABC. William believes that the combination of low interest rates, projected future economic upturn and the current low debt structure of ABC, positions ABC well to be aggressive regarding future research and development expenditures and software manufacturing expansion for ABC through debt. These basic business philosophy differences are irreconcilable on the part of James, Jr. and William. Therefore, it is necessary to separate ABC into two parts so that James, Jr. and William each will have 100% control and ownership of the separate businesses of ABC for which each has management responsibility and not be required to work with one another in ABC. The division they choose to accomplish this goal is the corporate business division called the Corporate Split-Off.

f. The Corporate Split-Off Transactional Steps

i. <u>Existing Picture</u>
ABC Company, a Delaware corporation ("ABC"), is owned equally by James, Jr. and William.

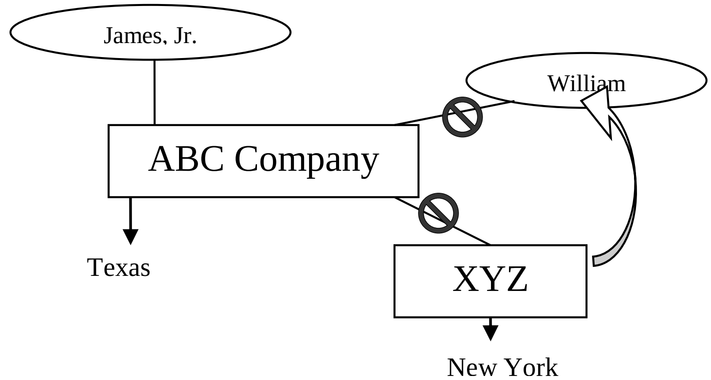


ii. <u>Step One</u>
ABC forms XYZ, Inc., a Delaware corporation ("XYZ"), which is a wholly-owned subsidiary of ABC. ABC transfers its New York operations to XYZ.



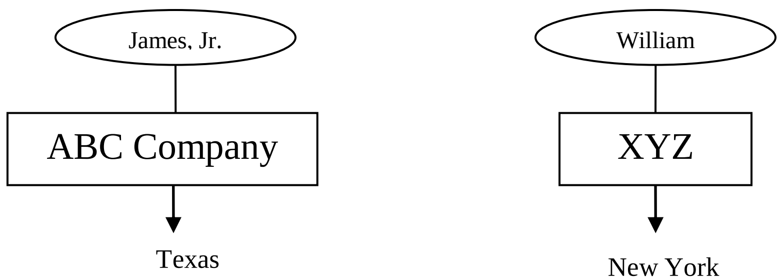
iii. <u>Step Two</u>

ABC distributes all of XYZ's stock to William in exchange for all of his stock in ABC.



iv. <u>Resulting Picture</u>

William is the sole shareholder of XYZ and James, Jr. is the sole shareholder of ABC.



E. <u>Tax-Free Partnership Division</u>

The founder of the family business who had the foresight to place the business into a partnership or LLC entity form will find himself in a much better position in the case where he must consider a division of the business among members of the second generation. As indicated earlier, tax treatment of partnerships is much more forgiving in the business entity division arena and allows for the tax-free continuation of the existing business albeit in two separate businesses afterwards. The partners will not have to run through the byzantine gauntlet of restrictions and purpose requirements that IRC § 355 holds for their corporate counterparts. Generally, when a partnership divides into two or more partnerships, especially in the family business scenario, one of the resulting partnerships will be considered a continuation of the prior partnership and the other resulting partnership or partnerships will be considered a new partnership.[12] Regulations under IRC §708 which governs partnership terminations and divisions allow for a significant level of freedom by the taxpayer to choose the form of division mechanically that the transaction takes and the resulting tax effects that accompany the transaction.

[12] *See* Treas. Regs. § 1.708-1(d).

Specifically, the partnership division can either take an "assets-up" or an "assets-over" form.[13]

1. In an "assets-over" division, the original partnership which is to be divided (the "Prior Partnership") is deemed to contribute certain of its assets and liabilities to a recipient partnership (the "Recipient Partnership") in exchange for interest in such Recipient Partnership, followed immediately by a distribution of the partnership interests in the Recipient Partnership to some or all of the Prior Partnership's partners in partial or complete redemption of their partnership interests in Prior Partnership.[14]

2. In an "assets-up" division, the Prior Partnership is deemed to distribute certain of its assets and liabilities to some or all of its partners in partial or complete liquidation of the partners' interest in the Prior Partnership, followed immediately by the contribution by such partners of the distributed assets and liabilities to a Recipient Partnership in exchange for interests in such Recipient Partnership.[15]

3. Partnership divisions can result in the Prior Partnership being divided out of existence, or continuing as the "divided partnership" afterwards, operating as the same partnership retaining its same identity.[16] Examples and diagrams of basic fact scenarios and transactional steps of tax-free partnership division include the following:

a. The Assets-Over Division Fact Scenario

   i. ABC, LLC (ABC) is a limited liability company founded and originally owned 100% by James and Sally Founder. James and Sally have three children, James Jr., William, and Carol, all of whom work in the business.

   ii. ABC is a computer software manufacturing company with one location in Texas. James, Jr. is Vice President – Manufacturing. William is Vice President – Distribution. Carol is Vice President – Research and Development.

   iii. Consistent with estate planning objectives, James and Sally have gifted their LLC interest in ABC in equal amounts to James, Jr., William, and Carol, so that, with the exception

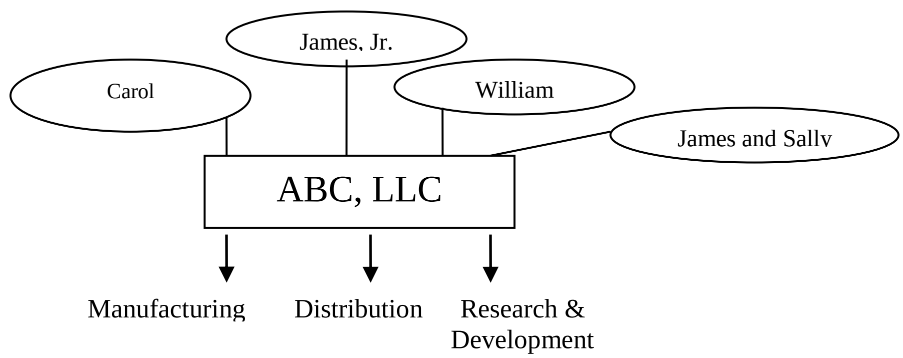
[13] *See* Treas. Regs. § 1.708-1(d)(3)(i).
[14] *See* Treas. Regs. § 1.708-(d)(3)(i)(A)
[15] *See* Treas. Regs. § 1.708-1(d)(3)(ii)(A).
[16] *See* Treas. Regs. § 1.708-1(d)(4)(i); Treas. Regs. §1.708-1(d)(2)(i).

of James and Sally's 1% LLC interest, the second generation now owns all of ABC equally.

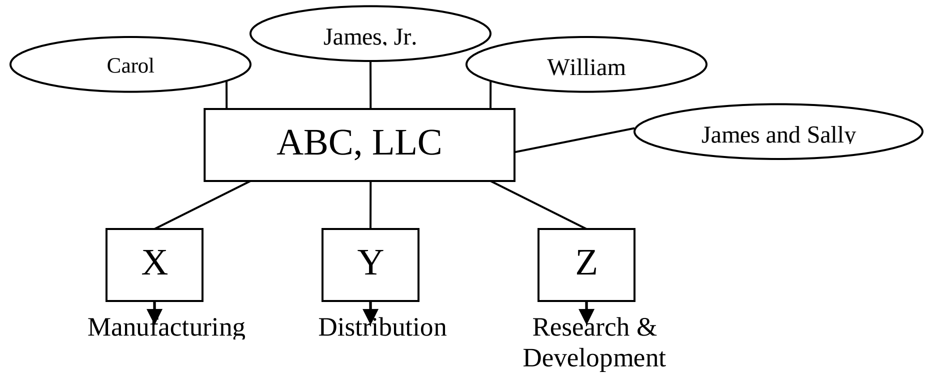
iv. A decision has been made to separate ABC along functional lines into three separate businesses. This business division of ABC will allow each of James, Jr., William, and Carol to have 100% control and almost 100% ownership of the separate business within ABC for which each of James, Jr., William and Carol has responsibility. The separate businesses would be the Software Research and Development business, the Software Manufacturing business, and the Software Distribution business. The division they choose is the Assets-Over partnership division where the Prior Partnership will dissolve.

b. The Assets-Over Division Transactional Steps

i. <u>Existing Picture</u>
ABC, LLC, a Delaware limited liability company ("ABC"), is owned by James, Jr., William, Carol and James and Sally.

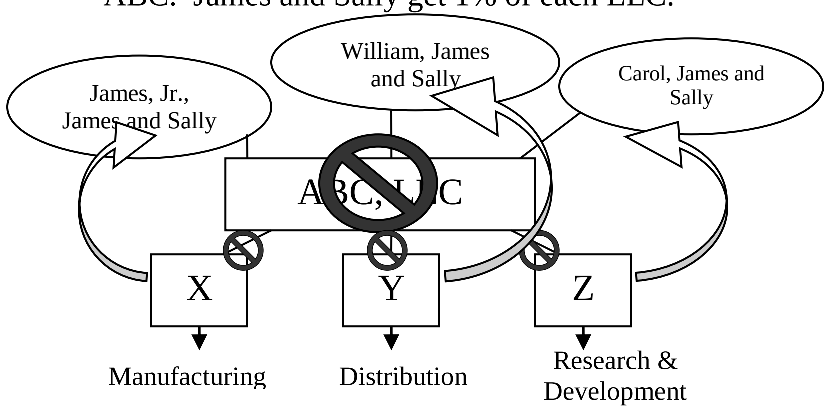


ii. <u>Step One</u>
ABC forms X, LLC, a Delaware LLC ("X"), Y, LLC, a Delaware LLC ("Y") and Z, LLC, a Delaware LLC ("Z"). ABC transfers its Manufacturing division to X, its Distribution division to Y and its Research and Development division to Z.



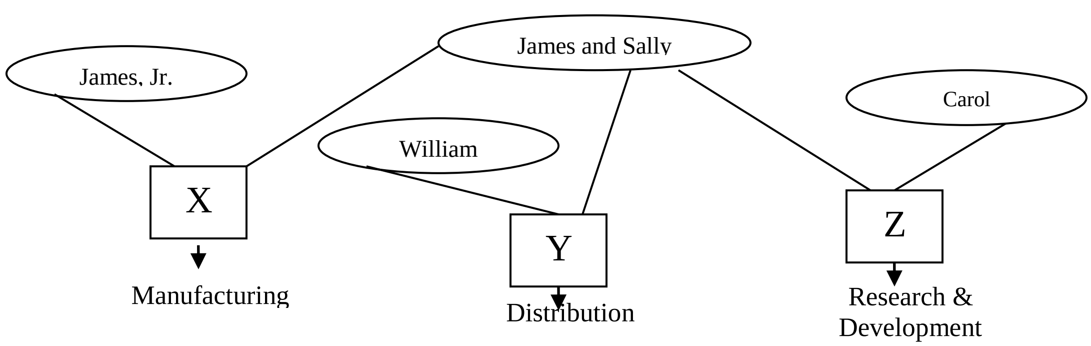
iii. <u>Step Two</u>

ABC distributes 99% of X's LLC interest to James, Jr., 99% of Y's LLC interest to William and 99% of Z's LLC interest to Carol in complete redemption and liquidation of ABC. James and Sally get 1% of each LLC.



iv. <u>Resulting Picture</u>

James, Jr. is the 99% LLC owner of X, William is the 99% LLC owner of Y and Carol is the 99% LLC owner of Z. James and Sally own 1% of each. ABC is dissolved and is no longer in existence.



c. The Assets-Up Division Fact Scenario

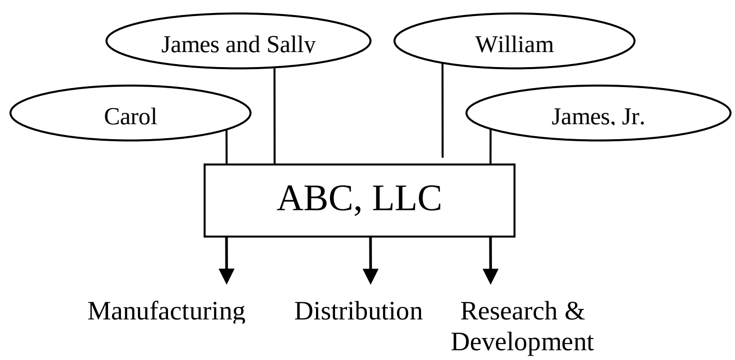
i. ABC, LLC (ABC) is a Delaware limited liability company founded and owned by James and Sally Founder. James and Sally have three children, James Jr., William, and Carol, all of whom work in the business.

ii. James and Sally are the 100% owners of ABC, a computer software manufacturing company with one location in Texas. James, Jr. is Vice President–Research and Development. William is Vice President- Manufacturing. Carol is Vice President –Distribution.

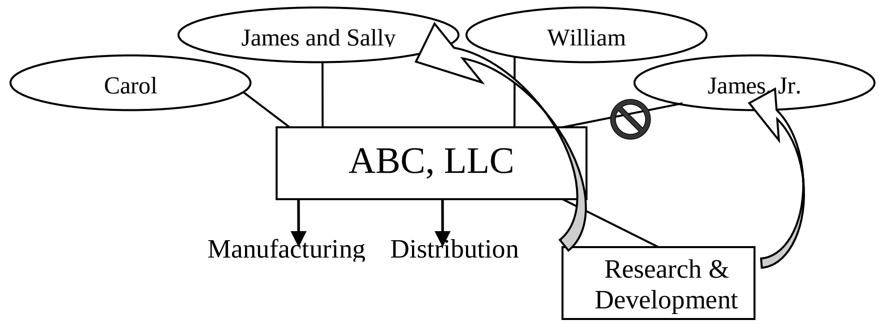
iii. James and Sally want to separate ABC into two separate business components: 1) Software Research and Development, and 2) Software Manufacturing and Software Distribution so that James, Jr. can ultimately own and control the Research and Development component (and its cash flow) and William and Carol can ultimately own and control the Manufacturing and Distribution components (and that cash flow). The division they choose to accomplish their goal is the Assets-Up division.

d. The Assets-Up Division Transactional Steps

i. <u>Existing Picture</u>
ABC, LLC, a Delaware limited liability company ("ABC"), is owned by James, Sally, James, Jr., Carol and William.

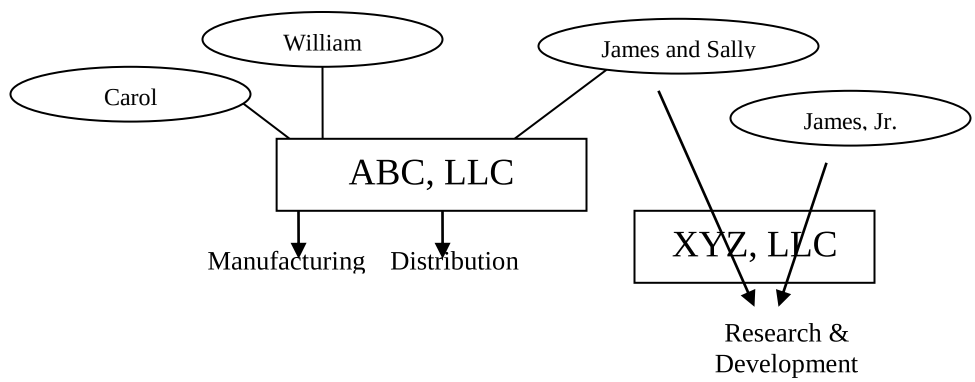


ii. <u>Step One</u>
ABC distributes all of the assets of ABC's Research & Development division to James, Sally and James, Jr.; James and Sally retain their LLC interest in ABC, while James, Jr. gives up all of his LLC interest in ABC.



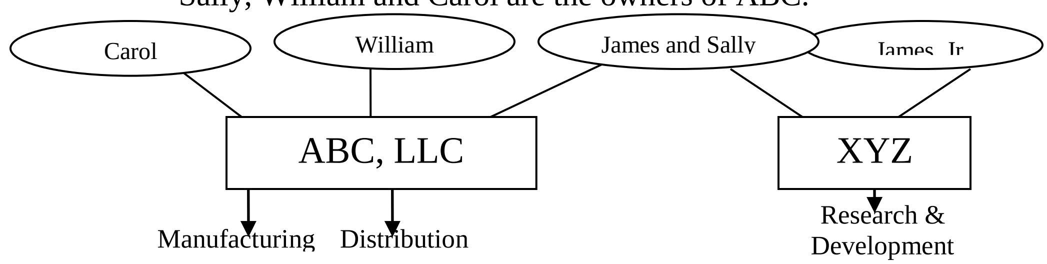
iii. <u>Step Two</u>

James, Sally and James, Jr. form XYZ, LLC a Delaware limited liability company, and each contribute their portion of the R&D assets to XYZ, LLC, a Delaware limited liability company.



iv. <u>Resulting Picture</u>

James, Sally and James, Jr. are the owners of XYZ; James, Sally, William and Carol are the owners of ABC.



These materials investigate the use of (i) the IRC § 355 tax-free corporate division, and (ii) the tax-free partnership division in the family business succession scenario. The IRC § 355 tax-free corporate division entails a much more complex fact (and tax law) intensive analysis than the partnership division. Therefore, most of these materials analyze the tax –free corporate division. Section II of this article provides a walk-through of the requirements of a tax-free IRC § 355 corporate division with the special analysis of the provisions as they apply to the family business succession plan. Specific attention will be paid to the corporate business purpose requirement of any IRC § 355 corporate division as that requirement will apply to the members of the second generation. Section III examines the tax consequences of IRC § 355 experienced by the original corporation, the newly formed corporation(s) and the shareholders of each. Section IV provides a walk through of the tax considerations and mechanics of a tax-free partnership division. Finally, Section V will set forth the main points of consideration for the estate planner when considering the possibility of an IRC § 355 corporate separation, as well as a tax free partnership division.

II. Requirements of a Section 355 Tax-Free Corporate Division.

A. Distribution to a Shareholder with Respect to the Shareholder's Stock.

The first requirement for a corporation to engage in a tax-free corporate division is that the Distributing Corporation must make a distribution to a shareholder with respect to the shareholder's stock.[17] As is illustrated in the diagrams in the Introduction, this distribution to the shareholders of the Distributing Corporation with respect to their stock in the Distributing Corporation can be pro-rata, disproportionate or a combination of the two.

1. Disproportionate Distribution. The distribution can be completely disproportionate, meaning that only some of the Distributing Corporation's shareholders will receive a distribution in the corporate separation, while others will receive nothing. This will most commonly occur in a Post-Succession Division where all of the Distributing Corporation's stock is owned by the second generation. The one shareholder (or group of shareholders) receiving the distribution will receive it in exchange for their stock in the Distributing Corporation. This is the classic "split-off" when one group will leave the Distributing Corporation and will no longer have ownership in it, taking instead their stock in the distributed corporation (the Controlled Corporation).

2. Pro-rata Distribution. Pro-rata distributions can be somewhat problematic since they appear on their face to be akin to a taxable dividend. The fact that a distribution is pro-rata, however, does not mean in and of itself that a tax-free corporate division cannot occur.[18] The pro-rata distribution, however, would be a very unlikely scenario in our family business succession model; in fact, it is likely that a pro-rata distribution, the classic

[17] *See* IRC § 355 (a)(1)(A)(i). The statute also refers to distributions "to a security holder, in exchange for its securities," which includes other instruments such as notes, debentures, or bonds and other forms of debt equity in the corporation. IRC § 355(a)(1)(A)(ii); *see* Boris I. Bittker and James S. Eustice, *Federal Income Taxation of Corporations and Shareholders*, ¶ 11.02[3] (2000 5th Ed.). For simplicity, these materials will refer only to stock being distributed and owned by shareholders of both the Distributing and the Controlled Corporations since that is by far the most common scenario for the family business owner contemplating the corporate divisions outlined herein.

[18] *See* IRC § 355 (a)(2).

"spin-off" would not be allowed if the stated purpose is a shareholder dispute.[19]

3. Quasi-Disproportionate Distribution. Similar to the disproportionate distribution, the quasi-disproportionate distribution involves one shareholder (or group of shareholders) leaving the Distributing Corporation entirely. The difference, however, is that one shareholder (the family business founder) receives stock in the Controlled Corporation and retains stock in the Distributing Corporation. This, of course, is the most likely scenario in a Pre-Succession Division when the corporate separation occurs prior to the death or retirement of the business founder, who will be the only individual retaining ownership in both the Distributing Corporation and Controlled Corporation after the corporate division. This corporate division would be a type of "split off."

B. Distribution Must be of Stock in a Controlled Corporation.

The Distributing Corporation must distribute stock in the Controlled Corporation which the Distributing Corporation controls immediately before the distribution.[20]

1. The term "control," as used in the statute is defined by reference to IRC § 368(c) which sets forth that a corporation controls another corporation if it owns stock:

   a. Possessing at least 80% of the total combined voting power of the Controlled Corporation; and
   b. At least 80% of the total number of shares of all other classes of stock of the Controlled Corporation.[21]

2. Furthermore, all of the stock of the Controlled Corporation must be distributed to the Distributing Corporation shareholders, or at least enough to constitute control as previously defined. [22]

3. There are certain safe harbor transactions where the Service has determined that it will not claim that a Distributing Corporation lacks control of a Controlled Corporation in those circumstances.[23]

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[19] The corporate business purpose for the tax-free corporate division is discussed in Section II.E. hereof. Still, as will be discussed later, this does not bar the use of the spin-off entirely in the family business setting, especially if other intervening factors are present.
[20] *See* IRC § 355 (a)(1)(A).
[21] *See* IRC § 355 (a)(1)(D)(2); IRC § 368 (c).
[22] *See* Treas. Regs. § 1.355-2(e)(1). If all of the stock of the Controlled Corporation is not distributed, that does not in and of itself render the distribution taxable; however, the taxpayer must show that the retention of some amount of stock of Controlled Corporation by the Distributing Corporation is not "in pursuance of a plan having as one of its principle purposes the avoidance of federal income tax." Treas. Regs. § 1.355-2(e)(2).
[23] Rev. Proc. 2016-40, Section 4 (Setting out a safe harbor where (i) the governing body of the Controlled Corporation does not take action within the 24 months following the distribution which would unwind the corporation and (ii) the Controlled Corporation engages in a corporate unwinding transaction with a third party, and

C. Distribution Cannot be a "Device."

The third requirement for a tax-free corporate division is that the transaction cannot be principally used as a "device for the distribution of the earnings and profits of the Distributing Corporation, the Controlled Corporation, or both."[24] The motivation behind the "no device" requirement is to prevent the abusive distribution by corporations of assets to their shareholders who would be able to recognize capital gain on the subsequent disposition of those assets. If appropriately characterized as a dividend, the shareholder would have to recognize such dividend as ordinary income and, as originally intended, pay at a much higher tax rate and do so immediately upon the distribution. The abusive distribution would, however, allow the shareholders to delay recognition until it disposed of the asset and, furthermore, only pay capital gains tax on the gain. The importance of this requirement has diminished somewhat in recent years as the tax rate on dividends from corporations paid to individual shareholders has been reduced to equal the capital gain rate. Since the tax rate disparity between dividends and capital gains on the sale of stock has disappeared, the motivation to principally use the corporate division as a device to distribute earnings and profits is arguably diminished. That motivation, however, is not diminished to the extent that the taxpayer wants to defer taxation (i.e., paying tax later upon the disposition of stock vs. paying tax immediately upon the receipt of a dividend) or utilize a relatively high basis in stock. Furthermore, the beneficial dividend tax provisions contained in the Tax Increase Prevention and Reconciliation Act ("TIPRA") of 2005 are scheduled to sunset December 31, 2010; therefore, the motivation to use the distribution as a tax reduction device has only been squelched temporarily, unless Congress acts to make the tax rates permanent. Therefore, although its significance has been reduced somewhat by the effects of TIPRA, the no device requirement should not be underappreciated or ignored.

There is no bright-line test to determine if a device is present. The presence of various device factors is, however, evidence of a device. It is purely a facts and circumstances determination.[25]

1. Pro-Rata Distribution. According to the regulations under IRC § 355, the existence of a pro-rata distribution in a tax-free division presents the greatest potential for the taxable treatment of dividends under the Internal Revenue Code of 1986 as amended (hereinafter, the "Code"). In other words, pro-rata distributions without any surrender of stock looks a lot like a dividend to the Internal Revenue Service (hereinafter, the "Service"). A pro-rata distribution not accompanied by a surrender of stock in the

no more than 20% of the interest of that third party is owned by the same owners that possess more than 20% of the interest in the Controlled Corporation).

[24] IRC § 355(a)(1)(B).

[25] *See* Treas. Regs. § 1.355-2(d)(2)(i).

Distributing Corporation invites significant scrutiny from the Service in determining whether the transaction is or is not a device.[26] This is generally not a concern for the family business succession-motivated division, since by design it should not be pro-rata. After all, what is worse than having sibling rivals as co-shareholders in a company? Answer: having them as co-shareholders in <u>two</u> companies!

2. <u>Subsequent Sale or Exchange of Stock</u>. This factor focuses on the fact that the tax-free corporate division is intended to be provided to a corporation that is seeking to continue its business, albeit separately. It is not intended to be used by taxpayers who want to cash out quickly after the tax-free division has occurred. Such dispositions may be viewed as post-division "cash outs" and be evidence of a device. As is the case with most requirements under IRC § 355 and its Regulations, this factor is a facts and circumstances test. Obviously, there are circumstances where an unplanned post-division disposition of the Distributing Corporation or the Controlled Corporation may be in the best interest for the family.[27] For example, a large company may approach one of the corporations six months after the separation seeking to purchase it with the proverbial "offer you can't refuse." The Service has issued rulings stating that significant changes in economic conditions may indicate that the post-separation disposition was not a device.[28] Successfully showing that the economic change is the motivating factor behind the sale of either of the companies should prevent the post-division sale from dooming the tax-free division.[29] Therefore, the subsequent sale or exchange of stock by either the Distributing Corporation or the Controlled Corporation, especially if it is done within a short time afterwards, may be evidence of a device.[30]

3. <u>Nature and Use Of Assets</u>. This factor is designed to prevent the distribution of a large amount (in terms of value) of (often liquid) assets that have nothing to do with the trade or business that is being distributed.[31] Therefore, if the Controlled Corporation is comprised of an auto parts store with a fair market value of $4 million and an ancient Egyptian artifact (which presumably has nothing to do with the auto parts store) worth $4 million, then this factor may be triggered to show evidence that the transaction was a device. In other words, the evidence shows that the taxpayer was more concerned about distributing the $4 million artifact

[26] Treas. Regs. §1.355-2(d)(2)(ii); *see also South Tulsa Pathology Laboratory, Inc. v. C.I.R.*, 118 T.C 84 (2002); IRS Non-Docketed Service Advice Review, Oct. 18, 1999, 1999 WL 33652545; PLR 9750040.
[27] If the post-division disposition is part of a plan that involved the tax-free division, the taxpayer also runs the risk of running afoul of the wholly separate requirements in IRC § 355(e) discussed in more detail in Section III.
[28] *See* PLR 9030037, PLR 8932039, PLR 9041078.
[29] *See* PLR 9030037.
[30] Treas. Regs. §1.355-2(d)(2)(iii); *see South Tulsa Pathology*, 118 T.C. at 93.
[31] Treas. Regs. §1.355-2(d)(2)(iv).

out of the Distributing Corporation than it was dividing active businesses.[32]

Another area that draws IRS scrutiny under this factor is the extent to which the Distributing Corporation and the Controlled Corporation have a post-division relationship, especially where one company continues to supply products or services in a stream of production or services exclusively to the other company. These exclusive dealings must also be coupled with the Controlled Corporation's ability to be sold without adversely affecting the business from which it was separated (i.e. Distributing Corporation) in order for post-division intercorporate activities to be evidence of a device.[33]

4. Various "Non-Device" Factors. In order to show that the transaction is not a device for the distribution of earnings and profits of the Distributing Corporation, Controlled Corporation or both, the statute and the Regulations set forth other factors which indicate "non-device" intent for the transaction. Similarly these factors in and of themselves do not prove that the no-device requirement has been successfully met, but rather the test is very facts and circumstances centered.[34] These non-device factors include the corporate business purpose. Acknowledging the uncertainty surrounding the determination of whether a distribution was used principally as a device, the Service has issued proposed Treasury Regulations which would set out a bright-line test to clarify when a distribution automatically qualifies as a device.[35]

This is a good opportunity to discuss one of the more confusing aspects of tax-free corporate divisions under IRC § 355. As indicated in the preceding paragraph, one of the factors that is evidence that a transaction is not a device to distribute earnings and profits is the presence of a corporate business purpose. The presence of a corporate business purpose is also a separate requirement, in and of itself, for the tax-free distribution. This certainly begs the question with most reasonably logical people of whether the no-device requirement would be satisfied if the separate corporate business purpose requirement were satisfied. This question may be somewhat academic considering that in the family business succession motivated corporate division, there normally is no intent to use the distribution as a device to distribute earnings and profits. However, each requirement must be demonstrated before tax-free status will be accorded

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[32] See Treas. Regs. § 1.355-2(d)(2)(iv)(A).
[33] *See* Treas. Regs. § 1.355-2(d)(2) (iv)(C)
[34] *See* Treas. Regs. §1.355-2(d)(3).
[35] REG-134016-14 (7/15/2016) (Determining whether the distribution is a device *per se* by looking at what percentage of the total assets of both the Distributing Corporation and the Controlled Corporation are considered nonbusiness assets, without regard to additional nondevice facts and circumstances present in the distribution.)

the distribution, and the satisfaction of one requirement does not render any other requirement unnecessary. That said, the demonstration of a corporate business purpose in furtherance of meeting the stand alone business purpose requirement usually goes a long way in also showing that the distribution was not a device for the distribution of earnings and profits.

D. Active Business Requirement.

In order for the transaction to qualify as a tax-free corporate division under IRC § 355, the active business requirement must be met. At its core, the active business requirement provides that the Distributing Corporation, directly or through a subsidiary, must be engaged in the active conduct of a trade or business throughout the five year period that ends on the date of the distribution.[36] Further, the Distributing Corporation and the Controlled Corporation must each be engaged immediately after the distribution, in the active conduct of a trade or business; or, immediately before the distribution, the Distributing Corporation's only assets must be stock in the Controlled Corporation(s), and immediately after the distribution each Controlled Corporation(s) must be engaged in the active conduct of a trade or business.[37]

1. Criteria. The Corporation that is engaged in the active conduct of a trade or business must meet all of the following criteria:

   a. It must be engaged in the active conduct of a trade or business; and,

   b. Such trade or business must have been actively conducted throughout the five year period ending on the day of distribution; and,

   c. Such trade or business must not have been acquired within such five year period in a taxable transaction; in other words, the trade or business must not have been purchased or received in a taxable exchange (however, the contribution of the trade or business in a § 351 contribution would be acceptable); and,

   d. Control of a corporation conducting an active trade or business must not have been acquired in a taxable transaction in the same five year period.[38]

   In order to satisfy the requirement that a corporation be engaged in the active conduct of a trade or business, the corporation is treated as satisfying this requirement only if the corporation is actually engaged in

[36] *See* IRC § 355 (b)(2).
[37] *See* IRC § 355 (b)(1).
[38] *See* IRC § 355 (b)(2); Treas. Regs. § 1.355-3.

the active conduct of a trade or business.[39] In applying § 355(b)(3)(A), all members of such corporation's separate affiliated group shall be treated as one corporation.[40] Under prior law, the "substantially all" analysis was used in determining whether a holding company was engaged in the active conduct of a trade or business.[41] The "substantially all" test was initially suspended and set to return on January 1, 2011, subject to a sunset clause. The sunset clause was subsequently removed and then the "substantially all" language was removed altogether from § 355(b)(2). The presence of a holding company is no longer relevant under § 355(b). This new section makes it easier for corporate groups (especially corporate groups wherein the distributing corporation is a holding company that does not directly engage in the active conduct of a trade or business) to use a corporate tax-free division since it removes the need for restructuring that many companies must undertake to satisfy the active trade or business requirement. In May 2007, the Service promulgated proposed Treasury Regulations to provide guidance on the active business test under modified § 355(b). The proposed regulations contain fifty-one examples and also contain guidance resulting from the removal of the "substantially all" test. The proposed regulations will become effective when published as final regulations. However, the "substantially all" analysis used in determining whether a holding company is engaged in the active conduct of a trade or business remains applicable for distributions occurring on or before May 17, 2006, or those distributions subject to a special transitional rule.[42]

Additionally, on July 9, 2007, the Service issued Revenue Procedure 2007-42 to address whether a subsidiary limited liability company's active trade or business can be attributed to a Distributing Corporation in order for the distributing corporation to satisfy the active business requirement upon a spin-off of the stock of one or more corporate subsidiaries. This situation is common in family businesses that utilize a holding company structure with subsidiaries for each division of the family business (whether such subsidiary be in the form of a corporation, limited liability company, or partnership) and the first generation owners desire to spin-off certain divisions among the second generation owners.

[39] IRC § 355(b)(2)(A)

[40] A corporation's separate affiliated group is the affiliated group which would be determined under IRC § 1504(a) if such corporation were the common parent and § 1504(b) did not apply. *See* § 355(b)(3)(B).

[41] A corporation shall be treated as engaged in the active conduct of a trade or business if any only if it is engaged in the active conduct of a trade or business, or "substantially all" of its assets consist of stock of a corporation controlled by it (immediately after the distribution) that is itself engaged in the active conduct of a trade or business. See former IRC § 355 (b)(2)(A).

[42] Under the transition rule, the "substantially all" test applies to any § 355 distribution which was (1) made pursuant to an agreement binding on May 17, 2006 and at all times thereafter; (2) described in a ruling request submitted to the Service on or before May 17, 2006; or (3) described on or before May 17, 2006 in a public announcement or in a filing with the Securities and Exchange Commission. The preceding sentence shall not apply if the Distributing Corporation elects not to have such sentence apply to the distribution. The election by Distributing Corporation is irrevocable. See former § 355(b)(3)(C).

Revenue Procedure 2007-42 concluded that in order for a Distributing Corporation to be attributed the active trade or business of a subsidiary limited liability company, the Distributing Corporation must have a "significant interest"[43] in the limited liability company and the limited liability company must perform the required activities that constitute an active trade or business. [44]

2. Definition of "Active Trade or Business." The term "active trade or business" is defined by the Regulations under IRC § 355 and provide that a corporation is treated as engaged in an active trade or business "if a specific group of activities are being carried on by the corporation for the purpose of earning income or profit, and the activities included in such group include every operation that forms a part of, or a step in, the process of earning income or profit."[45]

3. Per Se "Non-Active Trade or Business." The Regulations also set forth specific activities which are not considered an active trade or business. Those activities include the holding of stock, securities, land or other property for investment purposes. Furthermore, the ownership and operation (including leasing) of real or personal property used in a trade or business is not itself an active trade or business, unless the owner performs "significant services with respect to the operation and management of the property."[46]

4. Division of an Active Trade or Business. Since both the Distributing Corporation and the Controlled Corporation are required to be engaged in an active trade or business for the five years immediately preceding the distribution, the shareholder must physically divide the business into separate active trades or businesses. This requirement is not too difficult to meet from a pure IRC § 355 perspective. The Regulations offer several examples of businesses that when separated satisfied the active trade or business requirement. Each example provides some method of separation of the single business, either through dividing up multiple stores, factories or contracts that are located or performable in disparate geographical locations, or the corporation's business is divided into specific stages of production, such as manufacturing and sales. Generally, as long as the five-year period is met and the business being conducted by each corporation is not a per se non-active type, then the corporations will have met the requirement.[47]

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[43] In Rev. Rul. 2007-42, 2007-28 I.R.B. 44, a 33 1/3% membership interest is classified as a "significant interest."

[44] In the event the distributing corporation does not own a "significant interest," the distributing corporation can still be attributed the active trade or business of a subsidiary limited liability company or partnership when the distributing corporation performs active and substantial management functions for the limited liability company or partnership and owns a 20% interest therein. See Rev. Ruls. 92-17, 1992-1 C.B. 142; 2002-49, 2002-2 C.B. 288.

[45] Treas. Regs. § 1.355-3(b)(2)(ii); *see also* Field Service Advisory, Nov. 8, 1993, 1993 WL 1469487.

[46] Treas. Regs. § 1.355-3(b)(2)(iv); *see also* Rev. Rul. 2002-49, 2002-2 C.B. 288.

[47] *See* Treas. Regs. § 1.355-3(c)(5).

From a logistical and functional standpoint, however, the division may be problematic if the Distributing Corporation, prior to the division, conducted a single business that does not easily lend itself to a physical division. For example, imagine if the founder owns a tool and die concern with one factory and one location. Furthermore, let's say that the manufacturing and selling function is so integrated that it cannot be separated. Theoretically, the business owner can form another business by paring off assets and equipment while leasing space for another location, but at what cost? This obstacle can prove to be the one factor that prevents the business owner from completing the tax-free corporate division. While the division of assets can probably be accomplished, in some instances the physical division that would be called for may be too costly or otherwise impractical.

While business owners may not be faced with the impossibly monolithic, integrated and immovable business such as the above tool and die concern, they may nevertheless find themselves in a situation where the whole is truly greater than the sum of its parts. In other words, division of the integrated business may sacrifice certain competitive advantages, such as pricing power or economies of scale that the business has worked very hard to achieve. If this proves to be the case, the business owners may have to resort to other less tax-friendly alternatives such as a buy-out of one of the shareholders.

E. Significant Corporate Business Purpose.

The Regulations require the tax-free corporate division be carried out for one or more corporate business purposes.[48] The motivation behind this requirement, according to the Regulations, is to make sure that corporate divisions are "incident to readjustments of corporate structures required by business exigencies and that effect only readjustments of continuing interests in property under modified corporate forms."[49] Furthermore, the corporate business purpose must be a real and substantial non-federal tax purpose. In other words, a division for the purpose of allowing the Controlled Corporation to have eligible shareholders to make an S election for federal income tax savings will fail the corporate business purpose requirement.[50]

It is important to note that the business purpose requirement is a corporate business purpose. A division purely for shareholder purposes will not pass this requirement. The Regulations specifically state, "A shareholder purpose (for example, the personal planning purposes of a shareholder) is not a corporate

[48] *See* Treas. Regs. § 1.355-2(b).
[49] Treas. Regs. § 1.355-2(b)(1).
[50] If the S election would save state and local taxes and those savings would exceed the federal tax savings, then the corporate business purpose requirement would be met. See Treas. Regs. §§1.355-2(b)(2), 1.355-2(b)(5), Exs. (6)-(8); Bittker & Eustice, ¶ 11.09[2][a] note 225.

business purpose."[51] The Regulations indicate, however, that "a shareholder purpose for a transaction may be so nearly coextensive with a corporate business purpose as to preclude any distinction between them."[52] In such a case, the transaction will be deemed carried out for one or more corporate business purposes. It is under this provision that the "shareholder dispute" corporate business purpose comes into play. There are a number of other business purposes, such as (i) compliance with business laws that prevent certain businesses from being conducted together; (ii) compliance with federal antitrust laws; (iii) separation of a business to let employees participate in ownership; (iv) expansion of access to credit or investment by separating a non-profitable division from an otherwise profitable corporation; (v) reduction in state, local or foreign (but not federal) taxes; and (vi) defense against a hostile takeover.[53] For the family business succession motivated division, however, the corporate business purpose motivating the transaction will normally be some form of shareholder dispute.

Since the shareholder dispute must be "co-extensive with a corporate business purpose," not just any old shareholder dispute will do. For instance if James, Jr., Carol and William from our ABC examples dislike each other because James, Jr. and Carol are Cowboys fans, while William is a Giants fan, such a dispute probably will not rise to the level needed to be co-extensive with a corporate business purpose. Similarly, if the shareholders take no part in the management of the business, then any dispute between them will have little effect on the business itself. Therefore, any separation based upon a dispute between passive shareholders who intend to remain passive would arguably not meet the corporate business purpose test as well. The example provided by the Regulations giving guidance on a shareholder dispute that is coextensive with a corporate business purpose involves the Distributing Corporation that is owned by two shareholders and is in the business of (i) manufacturing and selling furniture, and (ii) selling jewelry. Conveniently, one shareholder's favorite aspect of this bilateral business is making furniture, while the other shareholder wants to concentrate solely on selling jewelry. Since the corporation will benefit from having the appropriate shareholder spend all of his time on that business, then the corporate business purpose is fulfilled.[54]

Unfortunately, this example in the Regulations provides little practical guidance to businesses that do not house multiple disparate businesses within the same organization, such as the furniture manufacturing/jewelry sales enterprise listed in the example. Unless a taxpayer has such disparate businesses housed within the same corporation, the example will not provide the clear guidance desired by most real world family business operators facing their own significant shareholder disputes within normal "single function" businesses. Private letter rulings shed a

[51] Treas. Regs. § 1.355-2(b)(2).
[52] *Id*.
[53] *See* Bittker & Eustice, ¶11.09[2][a].
[54] Treas. Regs. § 1.355-2(b)(5) (Example 2).

little more light (and there are a great many of them); however, they do not generally get into specific detail of the disputes involving shareholders.[55] PLR 8943038 was requested by a taxpayer corporation where "friction [had] developed [between the shareholders] regarding fundamental management policy in the expansion of the business. Also the shareholders have been unable to agree to a current fair market value of the stock under the redemption agreement. In order to enable each of the shareholders to own the business managed by him, the taxpayers propose [to enter into the corporate division]."[56] PLR 9049038 indicates that the shareholders "disagree regarding business philosophies, investment opportunities, and the expansion of the businesses of both."[57] On at least one occasion, the Service has examined the legitimacy of a shareholder dispute business purpose in the context of a family business. The Service reviewed a situation where the Distributing Corporation distributed stock in a Controlled Corporation to one of its shareholders in order to fulfill the Distributing Corporation's (and its resulting shareholders') "desire to get out of the real estate business in order to concentrate on its manufacturing and leasing activities."[58] The ultimate shareholder of the Controlled Corporation desired to concentrate solely on the real estate activities. The IRS District Counsel's Office opined, "What [the Distributing Corporation] is describing amounts to a purpose to get out of peripheral business activities in order to concentrate on its core business activities. We view that as a legitimate business purpose."[59] The Advice Review then cites to Example 2 of Treasury Reg. § 1.355-2(v)(5) (our much heralded all-in-one furniture manufacturer and jewelry store example).

The development of a corporate business purpose involving a shareholder dispute, therefore, must be, to coin a term, "corporocentric." In other words, since the corporation is seeking to divide itself, the dispute between shareholders must be to such an extent that the corporation's business will be affected negatively if the division of the corporation is not carried out. This places a great deal of importance on the founder's ability to not just identify disputes among members of the second generation shareholders of the company, but also to identify if those disputes would indeed operate to negatively effect the profitability of the business. As mentioned before, the tax-free corporate division, therefore, is probably not appropriate in a situation where the disagreeing members of the second generation are purely passive shareholders and have every intent to remain passive. However, as mentioned in the Introduction to these materials, many times a shareholder dispute arises out of the fact that some shareholders want more money out of the business than they are currently receiving (while the other shareholders are happy to continue pouring the profits back into the business). Differences in business philosophies such as this (i.e., growth vs. income) should

[55] For a very thorough list of authorities and PLRs that cover the shareholder's dispute corporate business purpose, please see Ridgway ,776-2nd T.M., *Corporate Separations*, VIII.C.1. note 433.
[56] PLR 8943038.
[57] PLR 9049038.
[58] Non-Docketed Service Advice Review, March 5, 1996, 1996 WL 33325619.
[59] *Id.*

be a legitimate corporocentric purpose much like the shareholder dispute in PLR 9049038, where the shareholders disagreed "regarding business philosophies, investment opportunities and the expansion of the business." As previously stated, however, caution should be advised in the situation where the passive shareholder simply wants more money out of the business. This shareholder purpose might not be corporocentric enough if the managing shareholders just want to get a cash-flow-desiring passive shareholder out of their hair. Arguably, the corporation could continue operating under the management of the current shareholders without any real interference from the prodigal passive shareholder (other than perhaps the nuisance of constantly explaining to him that the family business is not his personal spending account) especially if that passive shareholder owns a very small percentage of the stock of the corporation and/or owns only non-voting stock of the corporation. In this case, it is questionable whether a legitimate corporate business purpose exists.

In our standard family business succession model, however, where most, if not all, members of the second generation of shareholders also have significant responsibilities in the management and operations of the corporation, a shareholder dispute between such individuals would normally affect the operations of the corporation. In these instances, it should not be too difficult to establish a shareholder purpose that is co-extensive with a corporate business purpose. (Please see Attachment 1 for the Family Business Objective Statement questionnaire to help the family business owners determine whether second generation disagreement is classified as "corporocentric.")

F. Continuity of Proprietary Interest.

A tax free corporate division will only be allowed if there exists a continuity of interest in the Controlled Corporation by the shareholders of the Distributing Corporation. According to the Regulations, this is met if one or more persons who, directly or indirectly, were the owners of the enterprise prior to the distribution, own, in the aggregate, an amount of stock establishing a "continuity of interest in each of the modified corporate forms" in which the enterprise is conducted after the separation.[60] According to guidance by the Service on the obtaining of advance private letter rulings, the amount of stock that safely establishes continuity is 50% or more.[61]

This requirement can also be met if different original shareholders end up as shareholders of the resulting corporations. Some original shareholders must retain a meaningful continuing interest in each of the resulting corporations.[62] The purpose of this requirement is to make sure that the tax-free corporate division is not, in essence, a sale. The typical family business succession scenario described herein should sufficiently meet this requirement. Since all resulting

[60] Treas. Regs. § 1.355-2(c)(1).
[61] *See* Rev. Proc. 96-30, § 4.07.
[62] *See* Ridgway, 776-2nd T.M., *Corporate Separations*, VII.A.

corporations will be 100% owned by one former shareholder or another, no continuity of interest problems should occur.

G. Continuity of Business Enterprise.

The regulations also require that the business enterprise that existed before the division must still exist after the corporate division.[63] In general, both the Distributing Corporation and the Controlled Corporation should continue the "operation of the business or businesses existing prior to the separation."[64] This requirement will more than likely be met by virtue of the businesses meeting the separate active trade or business requirement.

III. Tax Effects on Distributing Corporation, Controlled Corporation and Shareholders.

A. Distributing Corporation.

If all of the provisions of IRC § 355 and its accompanying Regulations are met, then the Distributing Corporation will recognize neither gain nor loss on a distribution of the stock of the Controlled Corporation.[65] There are, however, certain instances where some of the provisions of IRC § 355 might not be met but the shareholders will still be accorded tax-free treatment. The Distributing Corporation in these instances, however, is not accorded such tax-free treatment and the Distributing Corporation must recognize gain on the distributions that would otherwise qualify as tax-free under IRC § 355.

1. The Disguised Sale Rules. IRC § 355(c) and (d) are referred to as the "disguised sale" provisions because they are intended to prevent the sale of a corporation carried out through a pretextual tax-free corporation division.[66] Simply put, IRC Sections 355(c) and (d) require the Distributing Corporation to recognize gain but not loss if a shareholder holds a 50% or greater interest in the Distributing Corporation or the Controlled Corporation immediately after the distribution, and that interest was purchased within the five-year period ending on the date of distribution.[67] Many times the disguised sale rules will not be applicable in family business succession scenarios since the five-year timetable is much shorter than the length of time which the family business founder (assuming he owns more than 50% of the stock) has owned the business.

Even if the family business founder has been engaged in the transfer of over 50% of the equity in his business within the five- year timetable, through gifting or if his stock was transferred upon his death, testamentary transfer, the disguised sale rules should not be implicated since they do not apply to transfers without consideration. The disguised sale rules,

[63] *See* Treas. Regs. § 1.355-1(b); *see also* Field Service Advisory, Jul.30, 1996, 1996 WL 33107161.
[64] Treas. Regs. § 1.355-1(b).
[65] *See* IRC § 355(a).
[66] *See* Ridgway, 776-2nd T.M. *Corporate Separations*, IX.A.3.
[67] *See* IRC §§ 355(c) and (d).

however, do apply to purchases for consideration, which would ostensibly apply to the founder's use of sales to intentionally defective grantor trusts (hereinafter, "IDGT"), an effective method, if done properly, to transfer ownership to the second generation. Arguably, the tax provisions governing sales to IDGTs would operate to take the sale out of the purview of IRC § 355(d). Assuming the family business founder is also the grantor of the IDGT, any sale to the IDGT by the family business founder should be treated as a sale to himself for federal income tax purposes.[68] Furthermore, exclusion of IDGT sales from the effects of IRC § 355(d) may be found in the statute itself. Specifically, IRC § 355 (d)(7)(A) states, "a person and all persons related to such person (within the meaning of section 267(b) or 707(b)(1)) shall be treated as one person."[69] Persons are related if they are members of the same family, and a person's family includes siblings (whether by whole or half-blood), spouses, ancestors and lineal descendants.[70] The term "related persons" also includes grantors and fiduciaries of the same trust.[71]

Therefore, if the family business founder makes sales of more than 50% of the Distributing Company's stock to the IDGTs within the five-year period preceding the corporate division and the fiduciaries (and beneficiaries) of the IDGT are members of the second generation shareholders, then by virtue of IRC § 267(b)(4), those sales would be made to related persons and are, by virtue of IRC § 355(d)(7)(A), treated "as one person." The same person should be deemed to have held the stock throughout the five-year period.[72]

2. <u>Distributions Part of a Prohibited Plan</u>. IRC § 355(e) is much like IRC § 355(d), however, it applies to the distribution if it is part of a "plan" pursuant to which one or more persons <u>acquire</u> a 50% or greater interest in the Distributing Corporation or the Controlled Corporation.[73] IRC § 355 (e) contains no fixed time period such as the five-year rule in IRC § 355(d); however, it does have a four-year period (two years before distribution and two years after distribution) in which a presumption of a plan exists.[74] Also conspicuously absent from the language of the IRC § 355(e) is a carve-out for non-consideration transfers. This would, on its face possibly be an obstacle to the business founder engaged in a well-advised plan of gifting (not to mention IDGT sales) in order to transfer ownership to the second generation during her lifetime. The Code section specifically sets forth exceptions from what is deemed an "acquisition" for purposes of IRC § 355(e); however, these exceptions are not substantive

[68] *See, generally,* IRC §§ 671-678.
[69] *See* IRC § 355(d)(7)(A).
[70] *See* IRC § 267(b)(1) and (c)(4).
[71] *See* IRC § 267(b)(4).
[72] *See* IRC § 355(d)(5)(a); Treas. Regs. §1.355-6(d)(1)(i)(A)
[73] *See* IRC § 355(e)(2)(B).
[74] *Id.*

carve-outs dictated by policy, but rather necessary additions so that IRC § 355(e) does not operate to render tax-free corporate division virtually impossible to achieve.[75] For instance, one of the exceptions includes the acquisition of Controlled Corporation's stock by the Distributing Corporation as one of the steps of the division[76] (otherwise, the subsidiary would have to be in place prior to the planning for the division--something that would rarely happen). As noted above, the statute establishes a presumption that a prohibited plan is present if the acquisition occurs during a four-year period, beginning two years prior to the distribution and ending two years after the distribution.[77] Under those circumstances, the acquisition will be presumed as having been accomplished pursuant to a prohibited plan, "unless it is established that the distribution and the acquisition are not pursuant to a plan or series of related transactions."[78]

The typical family business, however, may escape the problematic tentacles of IRC § 355(e) by virtue of an attribution provision present in IRC § 355(e)(4)(c) that incorporates the same related persons provision of IRC § 355(d)(7)(A). Put simply and very plainly, IRC § 355(e)(4)(C)(i) states that the rules treating all of the above relations as one person "shall apply."[79] It follows, therefore, that all of the stock owned by members of the same family would be treated as owned by one person, and the transfer between members of the same family, such as through succession plan gifting, would be viewed as a transfer to oneself. Furthermore, as is logically the case with the disguised sale rules, sales to IDGTs should be disregarded since the stock is treated as owned by the same person. Additionally, one of the above-mentioned exceptions that specifically lists as acquisitions not taken into account in applying IRC § 355(e) is the acquisition of stock in the Distributing Corporation "to the extent that the percentage of stock owned directly or indirectly in such a corporation by each person owning stock in such corporation immediately before the acquisition does not decrease."[80] Accordingly, so long as only members of the same family, or IDGTs with those family members as trustees (and beneficiaries), are shareholders before and after the succession plan transfers, the "acquisition" by second generation members should not be taken into account when determining the applicability of IRC § 355(e).

The Service had issued Temporary Regulations in order to shed some light on the interpretation of IRC § 355(e), however, they did not address the aggregation rules as they applied to family businesses.[81] Practitioners were

[75] *See* IRC § 355(e)(3)(A); *see also* PLR 200227016.
[76] *See* IRC § 355(e)(3)(A)(i).
[77] *See* IRC § 355(e)(2)(B).
[78] *Id.*
[79] IRC § 355(e)(4)(C)(i).
[80] *See* IRC § 355(e)(3)(A)(iv).
[81] Actually, the Service issued proposed Regulations in 1999, attempting to explain further the requirements needed to find the existence of a prohibited plan. These proposed Regulations met with significant criticism from

left to hope that this issue would be specifically addressed by the Service before the issuance of Final Regulations to IRC § 355(e). Unfortunately, in April 2005, the Final Regulations to IRC § 355(e) were issued without any further guidance by the Service on this specific issue. Practitioners are, therefore, left to interpret the statutory language itself which is very broad (simply stating that the family member aggregating rules "shall apply") and which can be reasonably interpreted to place any family business succession transfers beyond the reach of IRC § 355(e).

IRC § 355(e) would only have an impact upon the family business succession plan in cases where the founder was engaged in a plan to shift ownership to members of the second generation who were not lineal descendants of the founder (e.g. nieces and nephews). In such a case, the founder may need to establish that the transfer and tax-free division were not part of a plan. Unfortunately, the determination of the presence of a plan is made pursuant to a complex set of factors and (somewhat illusory) safe harbors. The Service provides a non-exclusive list of factors for a practitioner to evaluate in determining whether evidence of a plan exists.[82] The relative weight given to each factor depends on the facts and circumstances of each particular case.[83] In reviewing the factors to determine the existence or nonexistence of a plan, such determination is not dependant on the absolute number of factors in favor or opposed to such finding.[84] Further, unless one of the specifically enumerated safe harbors apply, then the fact finder is given vast discretion in deciding whether the facts and circumstances of a particular transaction qualify as a distribution pursuant to a plan. The weight accorded to each factor depends on the nature, extent, and timing of such factor.[85] However, the Final Regulations specifically provide that in the case of an acquisition within a two-year period following the date of distribution, the existence of an agreement, understanding, or arrangement at the time of distribution is given substantial weight.[86] Some commentators have labeled this factor the "super factor" since it receives such a considerable amount of deference from the fact finder.[87] Despite the weight given to the so called "super factor," the Final Regulations still provide that the determination of a plan is a fact and circumstances test and that even this "super factor" can be overcome by other factors establishing that the distribution and acquisition are not part of a plan.[88] Furthermore, as will be discussed in the final section, the existence of a plan is something that unfortunately

practitioners especially due to the fact that the Regulations required the Distributing Corporation, if a presumption of a plan were present, to rebut the presumption with clear and convincing evidence of the absence of a plan.

[82] Treas. Regs. § 1.355-7.

[83] Treas. Regs. § 1.355-7(b)(1).

[84] *Id*.

[85] Treas. Regs. § 1.355-7(b)(3).

[86] Treas. Regs. § 1.355-7(b)(3)(i).

[87] *See* Ridgway, 776-3rd T.M. *Corporate Separations*, IX.A.3.b.(3).

[88] Treas. Regs. § 1.355-7(b)(2).

cannot be determined prior to the transaction with the blessing of the Service. Any interaction on this point with the Service will be done, if at all, upon the Service's challenge of the corporate tax returns. Although the Service has demonstrated its desire to forgo making factual determinations on the presence of a plan under IRC § 355(e), the family business founder and the thoughtful planner should not view this requirement as having been waived by the Service. While it is uncertain how the Service will enforce this requirement and how the courts will interpret this requirement, it is incumbent on all businesses and planners who are planning to enter into a tax-free corporate division to understand that any associated acquisition may be problematic if done as part of a plan involving the tax-free corporate division.

B. The Controlled Corporation.

1. Gain or Loss – The Controlled Corporation will not recognize gain or loss even if the tax-free corporate division provisions are not followed.

2. Basis in the Controlled Corporation's assets. The assets received by the Controlled Corporation from the Distributing Corporation prior to the distribution of the Controlled Corporation's stock will have the same basis that the assets had in the hands of the Distributing Corporation before the transaction.[89]

3. Other Corporate Attributes. The Distributing Corporation will, when contributing assets to the Controlled Corporation, allocate some of its other corporate tax attributes, including its earning and profits. Earnings and profits are divided between the Distributing Corporation and the Controlled Corporation, generally, by the ratio of the fair market value of the assets contributed to the Controlled Corporation as compared to the fair market value of those assets retained by the Distributing Corporation.[90] Other tax attributes such as the net operating loss carry-over of the Distributing Corporation, if any, will not be transferred to the Controlled Corporation.[91]

C. Shareholders.

1. Gain or Loss. As stated above, if all of the provisions of the tax-free corporate division are followed, the shareholders of the Distributing Corporation and the Controlled Corporation will recognize no gain or loss on the receipt of Controlled Corporation stock. One exception is that the shareholders of the newly created Controlled Corporation may receive

[89] See IRC § 362.
[90] See Treas. Regs. § 1.312-10(a).
[91] *See* Rev. Rul. 77-133, 1977-1 C.B. 96.

"boot." Boot occurs when the shareholders of the Controlled Corporation receive assets other than Controlled Corporation stock (i.e., assets such as cash) in order to equalize the fair market value of the stock that they gave up in the Distributing Corporation. The gain recognized by the Controlled Corporation shareholder upon receipt of boot is limited by the amount of gain which would otherwise be recognized on the entire transaction if it were done outside of IRC § 355.[92] In addition, the shareholder that receives more stock then he would have been entitled to (based on his previous ownership in the Distributing Corporation) may be deemed to have received a gift from the other shareholders of the Distributing Corporation if the required donative intent exists.[93] It is important, therefore, that any disparity in fair market value of the stock received by the shareholders of the Controlled Corporation be documented sufficiently so that if no gift were intended by the other shareholders, boot can be attributed to the distributee shareholders. This should avoid any unintended gift tax liability for the other shareholders.

2. Shareholders' Basis and Holding Period in Stock. The aggregate basis of all of the shareholders' shares in the Distributing Corporation prior to the division will equal the aggregate basis of all of the shareholders' shares of both the Distributing Corporation and the Controlled Corporation after the division.[94] In other words, the total basis of all shareholders combined will be the same before and after the distribution. As to each individual shareholder, his or her basis is recalculated and allocated among the stock held after the distribution in proportion to each share's respective fair market value as compared to the fair market value of all of the shares.[95]
The holding periods for all stock will tack, i.e., include the shareholder's holding period prior to the IRC § 355 division. In other words, a shareholder who gives up stock in the Distributing Corporation in exchange for stock in the Controlled Corporation will have the same holding period attached to his stock in the Controlled Corporation.[96]

IV. The Tax-Free Partnership Division.

A. Tax-Free Division of a Partnership.

As indicated earlier, the tax-free division of a partnership is achieved with much less complication than the tax-free separation of a corporation. In fact, the degree of difference in taxpayer friendliness between corporate and partnership divisions is compounded by the fact that the tax-free partnership division provisions of the code and regulations provide the

[92] *See* Treas. Regs. § 1.356-5.
[93] *See* Treas. Regs. § 1.356-5(a).
[94] *See* IRC §358-(a)(c).
[95] *See* IRC § 358-(b); Treas. Regs. § 1.358-2(a).
[96] See Treas. Regs. § 1.1223-1(a).

taxpayers with choices as to how they structure the particular transaction.[97]

Similar to partnership mergers, partnership divisions allow the taxpayer to choose either an assets-over form or an assets-up form. Simply put, an assets-over form entails the partnership distributing out partnership interests of a sub-partnership, whereas the assets-up form entails the partnership distributing out assets which are then contributed by the partners to another partnership.[98] If the taxpayer does not specify or undertakes the division of a partnership without undertaking the necessary steps of distribution/contribution, etc., then the regulations provide that the division will be characterized under the assets-over form for federal income tax purposes.[99]

In partnership divisions the divided partnership (or original partnership) will continue in its existence unless none of the Resulting Partnerships meet the prior interest requirements. Specifically, the members of the Resulting Partnership or Partnerships must have had an interest in more than 50% in the capital and profits of the Prior Partnership. Any partnership that meets that requirement will be considered continuation of the Prior Partnership. Any other Resulting Partnership will not be considered a continuation of the Prior Partnership but be considered a new partnership.[100] Therefore, if none of the Resulting Partnerships have members which own an interest of more that 50% of the capital and profits of the Prior Partnership, then the Prior Partnership will be considered to have terminated. In any case, the partners of the Prior Partnership shall be deemed to have had their interests in the Prior Partnership liquidated as of the date of the division.[101] Thus, these partners will undergo a taxable transaction as if they had their partnership interest redeemed (therefore we should perhaps, refer to this as a "mostly" tax-free division.)

B. Tax Consequences.

The partnership division is generally going to be a tax-free division if the Prior Partnership is not terminated as a result of the division. Therefore, the only requirement that will need to be followed will be that one of the Resulting Partnerships has a partner or partners which owned more than 50% of the capital and profit interest of the Prior Partnership. In the family business succession model, this requirement will more than likely be met with sufficient ease. If these requirements are met, the Resulting Partnership that is treated as the divided partnership (i.e. the Prior Partnership which continues in existence) continues in its existence and

[97] *See* Treas. Regs. § 1.708-1(d).
[98] *See* Treas. Regs. § 1.708-1(d)(3).
[99] *See* Treas. Regs. § 1.708-1(d)(3)(i).
[100] *See* Treas. Regs. § 1.708-1(d)(1).
[101] *See id.*

will file a return for the taxable year of the partnership that has been divided and retain the employer identification number of the Prior Partnership. While the partnership will retain its identity of the Prior Partnership the partnership return should state that the partnership is a continuation of the Prior Partnership with the necessary information regarding partners before and after the division and their ownership of distributive shares of the Prior Partnership.[102] All other Resulting Partnerships that are regarded as new partnerships will need to acquire new employer identification numbers and will file new partnership tax returns.[103]

In the assets-over form of division, the Prior Partnership is treated as contributing a certain portion of its assets to a new partnership as its sole owner and then immediately distributing the interest in that partnership to some or all its partners. While the ownership of the subsidiary partnership by the Prior Partnerships is technically an ownership of a partnership by just one partner, the Prior Partnership momentary ownership of all of the interest in this Resulting Partnership will not prevent the Resulting Partnership from being classified as a partnership. This technical clarification is necessary to allow the transaction to proceed in its anticipated form.

C. Potential Pitfalls in Partnership Divisions.

While the tax free partnership divisions is accomplished much more easily than the corporate tax free division under § 355, certain pitfalls exist that can lead to some adverse tax consequences for the unwary. Specifically, gain under Treas. Regs. § 1.708-1(d)(2)(i).)(1)(B) and §737 may be triggered if IRC § 704(c) property is distributed in a partnership division. If the division is an assets-over division, the partnership interest in the Recipient Partnership is distributed to the partners of the Prior Partnership, will be treated as a §704(c) asset if the Prior Partnership contributed §704 (c) property to the Recipient Partnership before distributing the interests.[104] Therefore, if the partner that receives the interest in the Recipient Partnership that has had §704(c) property contributed to it, is not the partner who contributed the original IRC § 704(c) property to the Prior Partnership, gain under §704(c)(1)(B) will be triggered. Similarly, IRC §737 may be triggered if a partner who contributed IRC §704(c) property receives an interest in a Recipient Partnership that is not attributable IRC § 704(c) property.[105]

[102] *See* Treas. Regs. § 1.708-1(d)(2)(i).
[103] *See id*.
[104] *See* Treas. Regs. § 1.704-4(d)(1).
[105] *See* Treas. Regs. § 1.737-2(b)(2).

V. A Final Word On Entity Divisions– Private Letter Rulings and Points to Remember for the Estate Planner.

A. Private Letter Rulings.

Historically, taxpayers wishing to undertake a tax-free corporate division have been well advised to obtain a private letter ruling in advance of entering into a transaction. Due to the factual nature involved in each division, taxpayers sought the benefit of getting the Service's blessing on their transaction. The process of getting a private letter ruling was fairly labor intensive and required the taxpayer to make a number of representations regarding the facts and circumstances surrounding their specific transaction. In 1996, the Service issued Rev. Proc. 96-30 which set forth a checklist (which was updated from time to time) of information and representations that the Service usually required in order to issue a ruling that a distribution of the stock of the Controlled Corporation was tax-free under IRC § 355.[106] In 2003, the IRS issued Rev. Proc. 2003-48 in which it acknowledged that it had previously not adhered strictly to its guidelines on issuing private letter rulings for tax-free corporate divisions. Specifically, the Service noted that "it generally is the policy of the Service not to issue 'comfort rulings' on transactions the treatment of which is clearly and adequately addressed in published guidance."[107] The Service concluded that it was appropriate to adhere more closely to its general policies by using its resources less on making factual determinations. Therefore, in a stark departure from previous practice, the Service will no longer issue private letter rulings that comment upon the viability of the corporate business purpose claimed by the tax-payer in the tax-free corporate division. Also, the Service indicated that it will not comment on whether a transaction is used principally as a device or whether the distribution and acquisition are part of a plan as set forth in IRC § 355(e). "Rather," the Service offers rather dryly, "these determinations may be made upon an examination of the taxpayer's return."[108]

This revenue procedure significantly changes the landscape of the tax-free corporate division. While the decision not to rule on whether the no device requirement has been met under a specific set of facts can be justified by the current equality between tax rates on dividends and capital gain, the refusal to give rulings on corporate business purpose and the plan requirement under IRC § 355(e) can only be attributed to the Service's discomfort with making factual determinations. Only time will tell if the Service will aggressively pursue enforcement of these provisions through its examination process.

[106] Rev. Proc. 96-30.
[107] Rev Proc 2003-48.
[108] Id.

Given the dramatically scaled back factors upon which the Service will make rulings, it is now not so automatic (as it once was) to encourage the client to undergo the expense and time to obtain a private letter ruling, especially if the taxpayer has concerns about the legitimacy of his corporate business purpose. The thoughtful planner and taxpayer who intend to enter into a tax-free corporate division now must do so preparing for a possible first encounter with the Service under the negative auspices of an examination of the taxpayer's return. Sufficient planning and documentation, therefore, throughout the transaction are all the more necessary in completing a successful tax-free corporate division that can withstand scrutiny by the Service on possible audit and examination.

In May 2009, the Service issued Rev. Proc. 2009-25 concerning obtaining letter rulings for § 355 transfers.[109] In order to increase the availability of private letter rulings, the Service has undertaken a pilot program that permits taxpayers to request private letter rulings on part of an integrated transaction without ruling on the larger transaction if the requested ruling addresses one or more issues that: (1) are under the jurisdiction of the Associate Chief Counsel (Corporate); (2) are significant (as defined in Section 3.01(38) of Rev. Proc. 2009-3); and (3) involve the tax consequences or characterization of a transaction (or part of a transaction) that occurs in the context of a § 355 distribution.[110] Under Rev. Proc. 2009-25, the Service may issue a ruling on a particular legal issue under a Code section or Treasury Regulation without ruling on all aspects under that particular Code section or regulation.[111] However, all pertinent no-rule policies governing the Services ruling practice will still govern requests made pursuant to Rev. Proc. 2009-25 (i.e., the Service will not rule on Corporate business purpose and device under § 355 or on § 355(e) plan issues).[112]

B. <u>Estate Planners' Points to Remember</u>

As previously indicated in these materials, the complex and voluminous nature of the tax law pertaining to tax-free corporate divisions renders an exhaustive understanding of it by estate planners quite impractical. The intent of these materials is to make estate planning practitioners aware of this useful tool in the real world of business succession planning. Many of the aspects of IRC § 355 will be of little consequence to estate planners working with their client's business succession plan; however, some points are extremely applicable and worthy of attention. So, in the spirit of "If you remember nothing we have told you today, please remember this…." We offer the following "Estate Planners' Points to Remember."

[109] Rev. Proc 2009-25.
[110] Id.
[111] Id.
[112] Id.

1. Corporate Business Purpose. The business purpose required for the corporate division to be a tax-free corporate division under IRC § 355 must be a corporate business purpose which is a benefit to the corporation itself. In this respect the founder's identification of the possible shareholder rift can be somewhat premature if the founder has not transferred any ownership to those shareholders. If the founder continues to transfer ownership after the identification of the shareholder dispute, especially if the identification of the dispute occurs prior to transfer of any ownership, this factor may cast a doubt upon the veracity of the corporate business purpose. The Service's response could conceivably be to question the reasoning behind the continued transfer of ownership to disputing shareholders, if such a shareholder dispute were indeed that serious.

2. Be Diligent. Due to the fact that the number one concern (having a valid corporate business purpose) cannot be blessed ahead of time by a PLR, it is very important that the shareholders prepare for the transaction as if it will be audited, since that is the only time the Service will examine the transaction, if at all. Documentation of the dispute in the form of shareholder/director meeting minutes and internal memoranda would be very helpful in establishing a corporate business purpose.

3. "Give Diplomacy a Chance." Regardless of when the shareholder dispute arises or is discovered, the shareholders need to be absolutely certain that their conflict is serious enough to be permanently damaging to the company. The logistics involved in facilitating the corporate division can be extremely complex depending upon how tightly integrated the business is. There may be times when the expense of the division would certainly outweigh the tax benefits of accomplishing it tax-free.

4. Incorporation with Current Succession Plans. Above all, have a succession plan. Even if the business founder is unsure of the second generation's ability to work together, do not let that fact scare the client into inaction. The availability of the tax-free corporate division to business owners in almost any phase of the succession plan makes it possible to continue operating the business without putting valuable estate planning on hold. A cautionary point is warranted to those founders who are engaged in "non-traditional" family business succession plans, (i.e. transferring ownership to non-descendants). Be aware that significant transfer of ownership within a short time prior to the corporate division may subject the taxpayer to the reach of IRC § 355(e) and make the transaction taxable to the Distributing Corporation. For more traditional succession plans, however, such

planning (including IDGT transfers) should continue to be implemented.

5. Business Valuation. Even after navigating the complexities of IRC § 355 the practitioner will often run into significant "non-tax" hurdles in implementing a successful corporate division. While meeting the requirements set forth in IRC § 355 is of paramount importance to the practitioner, the client will be just as concerned about the economic aspects of the transaction. Specifically, any family business owner who has decided upon a corporate division will be extremely concerned that the division be done in the most economically equitable manner as possible. The business valuation therefore, becomes indispensable in this process. A qualified business appraiser should be retained to value the business as a whole, as well as the proposed resulting corporations that will be in existence after the division. This accomplishes two goals. First, it insures that the various second generation shareholders each receive business operations whose value is in proportion to their previous ownership of the Distributing Corporation prior to the split. Second, it enables the owners to quantify the true economic cost of undertaking the division by comparing the two resulting business-values relative to each other and the value of the corporation as a whole. Sometimes the disparity between the whole corporation and the sum of its parts will not be significant; however, in some cases, the difference may be substantial enough to justify other less tax friendly approaches (e.g. a buy-out of one of the shareholders).

6. Ethics. A primary concern for practitioners who represent family businesses is the identification of the person or entity that practitioner actually represents. In a non-adversarial environment, that many family businesses typically enjoy, the lines of communication and distinction between parties can easily become blurred. Ideally, the practitioner will have specifically identified his client at the outset of representation and will have made that clear by written declaration (i.e. engagement letter) to the party he represents as well as the other related parties whom he does not represent. If that clarity has not been achieved at the outset of representation, confusion can result when there is a corporate division inspired by family conflict on the horizon. In most cases, during happier times the practitioner will represent numerous parties; the business owner, the business owner's spouse, the company itself and often times one or more of the business owner's children and grandchildren. Once the practitioner becomes aware of a possible conflict between family members which may lead to the consideration of a corporate division, the practitioner should be extremely careful to make a written

recommendation that the conflicting parties each retain separate counsel. Generally, the practitioner can remain as counsel for the entity or for the first generation owners while instructing the second generation members who are involved in to the division to retain separate and independent counsel. Separate and independent counsel will be in a much better position to advocate the best situation economically for their client and to insure that any resulting corporation to be owned by their client will be appropriate to the value that they have given up.

EXHIBIT A

DEVELOPMENT OF A FAMILY BUSINESS OBJECTIVES STATEMENT (AKA FAMILY BUSINESS MISSION STATEMENT)

A. <u>LONG-TERM, MID-TERM, SHORT-TERM GOALS FOR THE FAMILY BUSINESS</u>

1. Do you plan to continue ownership and control of the Business by Family Members OR do you want to sell the Business (and if so when)?

Continue ownership of Business ____________

Sell Business ____________

a. as soon as possible ____________
b. next 2 years ____________
c. next 5 years ____________
d. next 10 years ____________
e. ______ other ____________

2. Do you want the Business to grow and expand OR do you want the Business to maintain its current size?

Grow and expand ____________

Maintain current size ____________

3. If you want the Business to expand, do you want expansion to be limited to the present geographic market areas?

Yes ____________ No ____________

Do you want the Business to expand to new metropolitan areas (and if so to which areas)?

Yes ____________ No ____________

New Metropolitan areas: ________________________

Do you want the Business to expand to new states (and if so, to which states)?

Yes ____________ No ____________

New states: ____________________________________

4. If the Business is to expand, do you want to expand through acquisitions of existing operations OR by establishing new operations OR both?

Acquisitions of existing operations ____________

Establishing new operations ____________

Both ____________

5. If the Business is to expand, do you want expansion of the Business to be limited to the present line(s) of business OR do you want to establish new line(s) of business OR both?

Present line(s) of business ____________

Establish new line(s) of business ____________

Both ____________

6. If the Business is to expand, will the expansion be conducted through:

The existing Business entity ____________

A subsidiary of the existing Business entity ____________

A new entity ____________

Combination of above ____________

7. If a new entity is used, will the Family Members have the same ownership in the new entity as the existing Business entity?

Yes ____________ No ____________

8. Will additional benefits be provided to the employee-Family Members who participate in the expansion of the Business?

Yes ____________ No ____________

If yes, which of the following benefits will the Business elect to use to compensate the key employee-Family member?

Increased compensation Yes ______ No ______

Bonus packages based on the profitability of the old and new businesses
Yes ______ No ______

Equity options in the new entity Yes ________No ______

Phantom Equity Plans/Equity Equivalency Plans in the new business Yes ______ No ______

9. What <u>approval</u> will be required before the Business can pursue expansion plans?

Majority vote of the Governing Body Yes ______ No ______

Majority vote of the Owners Yes ______ No ______

2/3 vote of the Governing Body Yes ______ No ______

2/3 vote of the Owners Yes ______ No ______

Unanimous vote of the Governing Body Yes ______ No ______

Unanimous vote of the Owners Yes ______ No ______

10. If the Business is to expand and grow, would this expansion be funded by internal cash flow, borrowing, or raising additional equity capital, OR a combination of the above?

Internal cash flow ____________

Borrowing ____________

Additional equity ____________

Combination ____________

11. Do your goals for the Business include one or more public offerings?

Yes ____________ No ____________

Would you consider taking steps to make the Business more suitable for taking the Business public such as:

Audited Financial Statements ____________

Outside Members on Governing Body ____________

Hiring Investment Banker to analyze public company option ____________

Discussing options with Underwriters for taking company public ____________

12. Please write a brief summary of your view regarding growth and expansion of the Business.

____

____

B. EQUITY OWNERSHIP

1. Will equity ownership in the Business be limited to only "Family Members" **[as discussed below in Section B(2)]** OR will both "Family Members" and "non-Family Members" be allowed to own equity in the Business?

Family Members only ___________________

Both Family Members and non-Family Members ___________________

2. If equity ownership in the Business is limited to "Family Members", then who would be considered a "Family Member"?

Children (including adopted children) ______

Grandchildren	______	Aunts	______
Spouse	______	Uncles	______
Parents	______	Cousins	______
Grandparents	______	In-laws	______
Siblings	______	Others	______

3. If equity ownership in the Business is not limited to Family Members, then who else could own equity in the Business?

A key employee Yes ______ No ______

An unrelated third party financial partner Yes ______ No ______

Others ____

4. Would an owner of the Business be required to work in the Business in order to own equity in the Business? Yes_________ No__________

If so, for what time Period? ____________________.

If not, should there be differences in the classes of equity (i.e., voting and non-voting) held by Family Members based upon whether they work in the Business.

Yes _____________ No _____________

5. Would a Family Member be able to transfer equity by gift to members of his or her family without the consent of the other owners?

Yes _____________ No _____________

6. Should there be a mandatory purchase of the equity of a Family Member by the Business upon the occurrence of the following events?

Death of a Family Member ____________

Disability of a Family Member ____________

7. Should the Business and/or other Family Members have an option to purchase equity of a Family Member upon the occurrence of any of the following events:

Death of a Family Member ____________

Disability of a Family Member ____________

Attempted sale of equity to a third party ____________

Termination of employment of a Family Member from the Business ____________

Divorce of Family Member where spouse is awarded equity by divorce decree ____________

Death of spouse of a Family Member where deceased spouse does not leave equity to Family Member spouse ____________

8. In the event an employee-Family Member should voluntarily terminate his or her employment with the Business should the other Family Members or the Business be required or have the option to purchase the withdrawing Family Member's equity in the Business?

Yes ____________ No ____________

What should be the purchase price for the withdrawing Family Member's equity?

Predetermined Fixed Amount Per Share ____________

Book Value ____________

Fair Market Value ____________

Other Value ____________

How should the purchase price be paid?

All Cash Up-front ____________

Part Cash/Part Note (i.e. financed) ____________

All Note ____________

Should a withdrawing Family Member be required to enter into a covenant-not-to-compete as a condition to the purchase of his or her equity?

Yes ____________ No ____________

9. Should there be differences in the classes of equity (i.e., voting and non-voting) in the Business based upon the following:

Age of a Family Member Yes ______ No ______

Experience in working in the Family Business Yes ______No ______

10. Should equity ownership in the Business be equally divided among the second generation families?

Yes ____________ No ____________

11. How can a Family Member who does not already own equity in the Family Business acquire equity in the Business?

By gift or inheritance Yes ______ No ______

By purchase of equity based upon the full fair market value Yes ______ No ______

By purchase of equity pursuant to an Equity Option plan Yes ______ No ______

`

12. Do you wish to use Phantom Equity/Equity Equivalency plans in lieu of equity ownership for the Family Members who do not own equity in the Business?

Yes ____________ No ____________

C. EMPLOYMENT OF FAMILY MEMBERS IN BUSINESS

1. Will all Family Members be guaranteed a job in the Business?

Yes ____________ No ____________

If a job is to be guaranteed, will a Family Member be guaranteed a job in management OR a job based upon the skill level of the Family Member?

Management ____________

Skill level ____________

2. Will a college degree be required in order for a Family Member to participate in the management of the Business?

Yes ____________ No ____________

3. Should there be a training program for a new employee-Family Member of the Business?

Yes ____________ No ____________

If so, should the training program be limited to new employee-Family Members who satisfy the criteria to become a member of management of the Family Business?

Yes ____________ No ____________

If there is a training program for new employee-Family Members, how many Family Members should oversee the training program?

1 ______
2 ______
3 ______
Other ______
The Governing Body ______

D. <u>COMPENSATION OF FAMILY MEMBERS EMPLOYED IN BUSINESS</u>

1. Will all employee-Family Members receive the same compensation or will compensation levels vary based upon such factors as position and responsibilities, experience, performance, length of service, etc.?

Same compensation ____________

Varying compensation ____________

2. Will employee-Family Members receive a minimum salary (i.e. no Employee Family Member will be paid less than $40,000 per year regardless of position)?

Yes ____________ No ____________

3. How will employee-Family Members in the Business be compensated?

Below fair market value Yes ______ No ______

Fair market value based on industry standards Yes ______ No ______

Above fair market value based upon industry standards Yes ______ No ______

4. Who will determine the compensation of the employee-Family Members?

Chief Executive Officer Yes ______ No ______

Governing Body Yes ______ No ______

Advisory Board to the Governing Body Yes ______ No ______

Other Yes ______ No ______

5. Will a key employee-Family Member receive special compensation treatment based upon an increase in value of the Business?

Yes ____________ No ____________

Based upon an increase in profits?

Yes ____________ No ____________

6. If the employee-Family Member is to receive some special compensation arrangements, will it be paid:

On an annual basis through bonuses?

Yes ____________ No ____________

By issuing Phantom Equity bonuses to be paid upon sale of the Business?

Yes ____________ No ____________

Upon sale of the Business through use of a covenant not to compete, bonus or severance pay arrangement?

Yes ____________ No ____________

7. Should the Business pay fees to its Governing Body?

Yes _____________ No _____________

8. Should the Business, if taxed as a C-corporation, consider revising its structure in order to be taxed as an S corporation?

Yes _____________ No _____________

E. OTHER BUSINESS ACTIVITIES

1. Will an employee-Family Member be restricted from pursuing other business activities outside of the Business while he or she is an employee of the Business?

Yes _____________ No _____________

What approval will be required before an employee-Family Member can pursue another business activity outside of the Business:

Majority vote of the Governing Body Yes ______ No ______

Majority vote of the Owners Yes ______ No ______

2/3 vote of the Governing Body Yes ______ No ______

2/3 vote of the Owners Yes ______ No ______

Unanimous vote of the Governing Body Yes ______ No ______

Unanimous vote of the Owners Yes ______ No ______

2. Will the vote of the Owners/Governing Body-Family Member desiring to engage in another business activity be counted in the above votes?

Yes _____________ No _____________

3. If an employee-Family Member is allowed to pursue another business activity should there be a compensation adjustment for that person?

Yes _____________ No _____________

Who determines the salary adjustment?

Governing Body Yes _____________ No _____________

Owners Yes _____________ No _____________

Advisory Board to the

Governing Body Yes_______________ No ____________

4. Should there be a limitation on the amount of time an employee-Family member of the Business can spend on an outside activity?

Yes ____________ No ____________

What limitations of time, if any, should be placed on the employee-Family Member?

None ______
10 hours a week ______
15 hours a week ______
20 hours a week ______
30 hours a week ______
40 hours a week ______

F. MANAGEMENT SUCCESSION PLAN

1. Can a person other than a Family Member be the Chief Executive Officer of the Business?

Yes ____________ No ____________

2. Can an in-law be considered for the position of Chief Executive Officer of the Business?

Yes ____________ No ____________

3. Should a person reach a certain education level before such person can be eligible for the position of Chief Executive Officer?

Yes ____________ No ____________

What education level should a person achieve before he or she can be considered for the position of Chief Executive Officer?

High school degree ____________

College degree ____________

Graduate degree ____________

4. How many years should a person be employed by the Business before he or she can be considered for the position of Chief Executive Officer?

5 years	______
10 years	______
15 years	______
20 years	______
Other	______

5. Who should be <u>involved</u> in making the decision of who the new Chief Executive Officer of the Business will be?

The existing Chief Executive Officer	Yes	______	No	______
The Governing Body	Yes	______	No	______
The Advisory Board to the Governing Body	Yes	______	No	______
The Owners	Yes	______	No	______

Should greater than majority approval of the electing body be required in the selection of the new Chief Executive Officer?

Yes ______ No ______

If greater than majority approval is required, what percentage approval is necessary?

60%	______
66-2/3%	______
75%	______
100%	______
Other	______

EXHIBIT B

CHOOSING A BUSINESS ENTITY IN TODAY'S BUSINESS WORLD

INTRODUCTION.

Not all that long ago, choosing a business entity used to be a relatively painless process. If you wanted limited liability you incorporated; and if limited liability was not important, you operated as a sole proprietorship or a general partnership. In a relatively short period of time, state and federal tax law changes along with the advent of new types of business entities have made the choice of entity a much more difficult and, in many respects, a much more important, decision for would-be business owners. Today the menu of business entities from which to choose is quite lengthy: a sole proprietorship, a general partnership, a limited partnership, a C or S corporation or a limited liability company; furthermore, certain entities offer various "extras" in certain situations, such as registering as a limited liability partnership or choosing to operate as a professional corporation or limited liability company. The choice will vary from state to state based upon the liability and tax considerations peculiar to each state. While the vast majority of businesses are operated in one of three forms, i.e. a corporation, a limited partnership or a limited liability company, most of the time, there is no absolute right or wrong answer. The circumstances of the business owners, their goals and desires and their long term plans all play a role in deciding which type of entity is the best for the business owner or business owners.

The choice of entity can vary depending upon the activity to be undertaken by the business owner. In certain industries, i.e. real estate, the use of limited partnerships is very common and accepted by third parties you would be dealing with in your business. In other industries, a corporation is the preferred entity in which to operate because of the familiarity of corporate form to investors, suppliers, customers and other third parties. In some situations, the business owner may want to transfer a substantial amount of the equity to family members while still maintaining control. While the limited partnership can be easily structured to satisfy this arrangement, with proper drafting, the limited liability company can also be utilized to accomplish this objective. In any event, prior to implementing the business strategy, business owners should consult with a lawyer familiar with all types of entities. Additionally, the business owner should make sure there is good coordination between his legal counsel and his accountant regarding the entity, the planning and the long term goals of the business owner. Only through proper coordination between all the advisors, will the business owner receive the best possible advice. Finally, this outline is not intended to be comprehensive, addressing all of the issues of each entity. To do so would be impractical and would be more confusing than enlightening. This outline is intended to provide a listing and brief discussion of many of the major issues in choosing an entity. Each business owner's situation is unique and the choice of entity in each situation can only be determined after understanding all of the goals and plans of the particular owner.

TYPES OF BUSINESS ENTITIES.

Sole Proprietorships.

Overall. Generally, a sole proprietorship is a business operated by a single individual without the benefit of any other independently created business entity. Many "mom and pop" businesses are typically reported as sole proprietorships even though more than one owner is involved in the operation of the business. There are other business entity types that deal with direct ownership and involvement of the business that are frequently understood to be similar to a sole proprietorship. These include undivided interests in property, co-ownership or joint ownership of property, or other similar arrangements.

Additionally, a single owner LLC is treated as a sole proprietorship for federal income tax purposes unless an alternative election is made by the owner. (See Section 4 below)

Practical Operational Issues. Operationally, a sole proprietorship normally operates under an assumed name, with a bank account utilizing the owner's individual social security number. No state law filings are required (other than necessary for the assumed name certificate) and all contracts and obligations are the individual responsibilities. The business owner is personally liable for all debts and obligations (including tortious and negligent acts of employees) of the sole proprietorship. No protection is provided for the business owner's personal assets other than any protection afforded through business liability insurance. It is the simplest of the operational forms but also the form with most risk in terms of liability from its operations. It would only be recommended for a business owner with limited personal assets that would be placed at risk from the business operations.

Tax Issues. The sole proprietorship operates under the social security number of the business owner. A separate tax return is not required for the sole proprietorship but instead all income and losses are reported on Schedule C on the business owner's individual income tax return. One of the major concerns of the IRS in auditing sole proprietorships is unreported income and the deduction of individual personal expenses which are not business related. Income of a sole proprietorship is not subject to the Texas Margin Tax, but all income received by the sole proprietor that is also classified as "self-employment income" under federal tax law is subject to self-employment tax.

General Partnership.

Overall. A general partnership is just a step removed from a sole proprietorship. In other words, a general partnership could be viewed as a collection of sole proprietorships. A general partnership is basically a collection of individuals or entities operating together to produce a profit through a business enterprise. The only difference between a general partnership and a sole proprietorship is that a general partnership is normally operated pursuant to a written general partnership agreement among the partners outlining the terms of their agreement for sharing profits and losses, management, dissolution and transfers of partnership interests (although a written partnership agreement is not required to form a general partnership in Texas). To the extent these types of matters are not addressed in a partnership agreement, each state has enacted statutory laws to provide an overall structure for the management and operation of the general partnership.

Practical Operational Issues. As with the sole proprietorship, the general partnership is not a preferred entity to be used by individuals because each partner will be jointly and severally liable for debts and obligations of the general partnership. This means that Partner A will be liable for the acts of Partner B as well as the acts of the employees of the partnership, i.e. car accident, sexual harassment, discrimination, etc. This causes the individual business owner to be personally at risk for the operations of the partnership.

General partnerships are the easiest entity to set up and dissolve among multiple owners. No state law filing is required to set up a general partnership. In fact, you could have an oral general partnership based upon the agreements of the parties. As stated above, no written agreement is required to run a general partnership. It is always recommended, however, that a written general partnership agreement be put in place in order to have a clear understanding among the partners of: (1) their ownership interest; (2) their sharing of profits and losses; (3) their obligation to contribute additional capital; (4) the sharing of management among the parties; (5) the ability of a partner to withdraw from the partnership or to cause a dissolution of the partnership; (6) the restrictions on transfer of partnership interests; and (7) the ability to incur debt or other liabilities for the partnership. No business owner should enter into a general partnership without clearly understanding the liability risk, the investment obligations, and the management structure.

Tax Issues. For federal income tax purposes, the income and losses of the general partnership flow through to the partners based upon their profit and loss sharing ratio as set forth in the agreement. A general partner will be able to deduct losses to the extent of his outside basis in his partnership interest, which will include his share of any debt of the partnership. Any income that flows through to the partner will be subject to self-employment tax at the partner level if the partnership's income from operations would have qualified as self-employment income. Partnership income tax law is probably the most complicated area of the federal income tax laws. This complication is a blessing and a curse for the unaware; the partnership tax rules can be a trap and cause recognition of income unanticipated by the partner. However, the complexity of the partnership tax law also provides for great flexibility and benefits to the informed business owner. Some of these benefits include innumerable methods of structuring special allocations of profits, losses and cash distributions, the use of a "profits interest" to provide equity to key employees without triggering income tax on receipt of the equity interest, the ability to use partnership debt to increase the outside basis of the partner in order to deduct losses in excess of the contribution amount of the partner and other tax beneficial arrangements. Due to the aggressiveness of many practitioners in the past fifteen years in stretching the partnership tax rules to the extreme, Congress has consistently modified the tax laws to try to curtail what they view as abusive or sham transactions. Any business owner who is attempting to take advantage of the partnership tax rules should receive clear advice from a practitioner familiar with the partnership tax laws and then should have that advice coordinated with his CPA in order that all of his advisors understand the structure and the plan. A general partnership is subject to the Texas Margin Tax unless all of its owners are natural persons or the partnership falls under certain limited exceptions to the tax.

Limited Partnership.

Overall. The limited partnership has received tremendous publicity in the last fifteen years because of its use in the family planning area to transfer wealth at a discounted rate. In fact, the limited partnership has been used for a number of years in the business setting because of the flexibility of its tax arrangement (See Section 2 above), the fact that it previously was not subject to Texas franchise taxes, and the ability, if properly structured, to have liability protection for the ultimate owners of the limited partnership. A limited partnership will be structured with one or more general partners and one or more limited partners. The general partner or general partners will have control of the day-to-day operational aspects of the partnership and any other matters allowed the general partner as set forth in the Limited Partnership Agreement. In almost all cases, the general partner is a corporation, limited liability company, or another limited partnership because the general partner is ultimately liable for all of the debts and obligations of the limited partnership. To keep this liability from flowing through to the individual owners, the general partner is almost always an entity. The limited partners can be individuals or other entities because they do not have liability for the operations of the limited partnership unless they participate in the management of the business in their capacity as a limited partner. A limited partner participating in the management of the limited partnership as an employee of the partnership or an employee of the general partner will not cause the limited partner to be liable for the debts and obligations of the limited partnership. State law has been expanded to allow a limited partner to participate in multiple actions related to the partnership without causing the limited partner to be liable for the debts and obligations of the limited partnership, i.e. become a general partner. In fact, state law in Texas says that a limited partner will not be liable for the acts of the partnership with a general partner as long as the acts he has undertaken on behalf of the limited partnership are set forth in the limited partnership agreement. The major negative in operating a business entity as a limited partnership is the additional cost in the setup, as the limited partnership will normally involve at least two entities, i.e. the limited partnership itself and an entity as the general partner.

Practical Operational Issues. A limited partnership is a state created entity and in order for the limited partners to receive liability protection, the limited partnership must file a Certificate of Formation with the State of Texas. Business owners can come together and sign a limited partnership agreement, but if the entity does not file a Certificate of Formation, then for state law purposes, it is considered to be a general partnership. All limited partnerships should have a limited partnership agreement which clearly sets out the rights and obligations of the partners, including the responsibilities of the general partner and the matters upon which the limited partners will have control or a vote regarding the operations of the limited partnership. The structure of the limited partnership is very flexible and can provide that the general partner will have control over almost all of the operational aspects of the limited partnership with the ability to only be removed "for cause." In this fashion, a 1% owner, a ½% owner or even a 0% owner, i.e. the general partner, could control the operations of the limited partnership as a whole, even though it only has minimal or no ownership. This aspect of the limited partnership planning has been very favorably received for years for promoters who want to control the operation of a business entity in which they retain outside investors even though they have minimal capital risk. It has also been popular with the elder family members who wish to retain control of the business operation while transferring equity to succeeding generations. The limited partnership is a sophisticated planning tool which can be structured to accomplish a number of the goals of the business owner.

Tax Issues. Like the general partnership, the limited partnership is a flow through entity, as all income and losses flow through to the partners based upon their profit and loss sharing percentage set forth in the limited partnership agreement. The partnership itself does not pay any federal income taxes, although it does file a federal income tax return evidencing its income and the flow through of the income to its limited partners. One advantage of the limited partnership is that the income that flows through to its limited partners is not normally subject to self-employment tax like it is in a general partnership or in certain circumstances in a limited liability company. Subject to certain exceptions, limited partnerships are subject to the Texas Margin Tax. Finally, as discussed above regarding general partnerships, partnership tax laws provide great flexibility to the business owners to accomplish certain tax planning designs not available for corporations.

Limited Liability Company.

Overall. The limited liability company ("LLC") is an entity that has grown in popularity and has become more and more familiar to the business owner and legal and accounting practitioners. The LLC was originally enacted as a hybrid entity that actually combines the features of a corporation and a partnership. It is a single entity in which all of its owners (called members) have liability protection from the operations of the LLC. However, for federal income tax purposes, it is treated as a partnership (unless an election is made to be taxed as a corporation). So therefore, it combines the benefits of the limited liability of the corporation for all of the owners of the LLC while retaining the tax advantages of a partnership. This has caused it to be the entity of choice in most states.

The members can have the power to run the day to day operations of the LLC or they can provide for managers to run the day to day operations of the LLC. Managers are similar to the Board of Directors of the corporation and operate in a similar fashion.

Practical Operational Issues. An LLC is a state created entity which means that you must file a Certificate of Formation to obtain the benefit of limited liability company status. Instead of Bylaws, the LLC normally has an operational document called a Company Agreement which is a hybrid of Bylaws (corporation) and a Partnership Agreement (partnership).

The operational aspects of LLCs are very flexible under the Texas law. Unlike corporations which have a somewhat rigid operational structure (e.g., annual shareholder meetings, annual Board of

Director meetings, election of officers, evidence of authorization of corporate act, minute books, etc.), LLCs require much less with regard to "maintenance" of the entity. Whereas in a corporate situation, the Board of Directors must elect officers in order to bind the corporation to any act or obligation, an LLC's managers are able to bind the LLC directly and do not have to elect officers. Furthermore, LLC law is very liberal with respect to the evidencing of consent to authorize a manager to bind the company. Whereas a corporation must show appropriate resolutions, meeting minutes or consents in lieu of meetings, an LLC generally can rely on any "reasonable method" in order to evidence the particular person's authority to act on behalf of the LLC. Presumably, this can include meetings, resolutions, or consents in lieu of meetings, but may also include simple oral representation. Furthermore, LLC members and managers are not required to have annual meetings. These attributes cause the LLC to be a very attractive form of business especially for those who desire a low maintenance option to the rigidities of corporate law.

Another advantage that the LLC (and the limited partnership) has over the corporation is the treatment of judgment creditors of each entity's owners. Specifically, a judgment creditor may attach a debtor's stock in a corporation in order to satisfy its claim against the debtor. If this action occurs, the judgment creditor assumes the stock and also assumes the role as a shareholder in the company with all rights that belong to such shareholder including voting and all accompanying rights of distribution. In other words, the other shareholders of the company run a danger of becoming the unwitting co-shareholders with the judgment creditor. Under Texas LLC law (and Texas limited partnership law), it appears that a judgment creditor who attempts to attach an LLC interest owned by a debtor can only obtain a charging order giving the judgment creditor the right to receive distributions to which the judgment debtor would otherwise have been entitled in respect of the debtor's ownership interest. It does not appear that the judgment creditor obtains any other rights of ownership such as voting on any matter of the LLC (or LP). This includes the decision of the LLC (LP) to make distributions in the first place. While the judgment creditor would have the right to any distributions made, the judgment creditor would not have any control over whether such distributions were made. This makes the LLC interest (or LP interest) somewhat unattractive as an asset for creditors and encourages the judgment creditor to seek satisfaction of its obligation owed to it by attaching other assets of the debtor and significantly reduces the chances that other co-owners of the LLC (or LP) having to go into business with a creditor of a co-owner.

Tax Issues. An LLC can be classified as a sole proprietorship, a partnership or an association for federal income tax purposes. A single member LLC is classified as a sole proprietorship for federal income tax purposes and no federal income tax return is filed for the LLC. Instead all income and deductions of the LLC are reported on Schedule C of the sole owner. Therefore, while the single owner has limited liability, he receives the benefit of less complexity as he or she does not have to file a separate federal income tax return for the LLC.

If there are two or more owners of the LLC, then the LLC is treated as a partnership for federal income tax purposes unless the owners elect to be treated as an association (i.e. a corporation). Being able to be treated as a partnership for federal income tax purposes is advantageous to an LLC in that it allows it to take advantage of the flexibility in the partnership tax area discussed above, while still retaining limited liability for all of its owners in a single entity. However, there are disadvantages in the tax area to LLCs that each prospective business owner must be aware. To the extent the members/managers of the LLC are involved in the operations of the LLC (or if there are no managers, the members are involved in the operations of the LLC) the IRS has proposed regulations which provide that the flow through income of the LLC may be subject to self-employment tax for the member/managers or members who are involved in operations. Unlike the S corporation, C corporation or limited partnership, where only compensation income is subject to employment taxes, these proposed regulations subject flow through income to the parties involved in management to self-employment tax, even though the income is clearly beyond the normal amount that would be paid for compensation. While Congress initially voiced disapproval over the Service's proposed regulations and indicated it would enact legislation to resolve the issue and equalize treatment in this area among limited partnerships, LLCs and S corporations, no action has been taken as of this time by Congress. Furthermore, the moratorium period placed by Congress on the Service (directing the Service not to make the proposed regulations final) has passed. While the Service is presumably free to make its regulations final, the assessment by many practitioners and academics is that the Service is going to wait until Congress acts on the issue before making any decisions. Therefore, the prospective business owner must be clearly aware of the self-employment tax implications of his or her ownership in the LLC if he or she is also going to be involved in the operations. LLCs are subject to the Texas Margin Tax and are not able to qualify as a "passive entity" similar to a limited partnership in order to avoid application of the Texas Margin Tax.

S Corporations.

Overall. An S corporation is a corporation formed under state law by filing a Certificate of Formation. The shareholders then make an election with the IRS to be taxed as an S corporation for federal income tax purposes which will cause all income and deductions of the corporation to flow through to the shareholders based upon their stock ownership. An S corporation is a federal tax law classification and therefore, in order to qualify and elect to be an S corporation, the business owners must satisfy the federal income tax rules attributable to it. This includes limiting the number of shareholders (no more than 100) and the type of shareholder who can own S corporation stock (U.S. citizens and resident aliens, estates, certain trusts and another S corporation provided it owns 100% of the subsidiary S corporation). Additionally, the flexibility of multiple classes of stock is not available, as S corporation rules require there only be one class of stock. However, the S corporation rules do allow differences in voting rights, thereby allowing you to have a class of voting stock and nonvoting stock. Certain debt instruments that have equity features can be considered as separate class of stock and can cause the loss of S corporation status.

Practical Operational Issues. An S corporation is a regular corporation for state law purposes. In order to form the corporation, the business owners must file a Certificate of Formation with the Secretary of State's office. As with limited liability companies, the owners, i.e. shareholders, are not subject to the debts and obligations of the corporation unless they have otherwise agreed to become obligated for such debt, i.e. personal guarantees. State law regarding the operation and management of corporations is well established and provides a fairly clear operational structure for the entity. An S corporation is subject to Texas Margin Tax.

S corporations are subject to very technical, unforgiving rules of federal income tax law regarding the qualification and maintenance of S corporation status. If an S corporation was previously a C corporation, there could be tax issues related to built-in gains tax, or passive investment income tax issues. Changes of ownership to nonqualified S corporation shareholders can terminate the S corporation status and cause future adverse tax consequences. The shareholders of the corporation have the ability under state law to enter into shareholder agreements to document certain operational control issues, succession planning and buy-sell arrangements. This flexibility allows the shareholder to document unusual business agreements in a manner that will be enforceable on all the parties. The advantages of the S corporation are that it is a single entity providing liability protection for its owners and it is a state law corporation with which most parties are familiar.

Tax Issues. Normally, an S corporation is not subject to corporate income tax as all gains and losses flow through to the shareholders based on their stock ownership. However, an S corporation that previously operated as a regular (C corporation) corporation could be subject to certain taxes at the corporate level, i.e. built-in gains tax and passive investment income tax. Any business owner of an S corporation that previously operated as a C corporation should seek legal advice regarding the impact of these corporate level taxes on his or her operations. Unlike an LLC, the income that flows through to its shareholders is not subject to self-employment tax under the IRS's proposed regulations. For many years, small business owners would pay themselves small salaries and then pull out their profits through S distributions to avoid paying FICA taxes on the majority of what normally would be wages. In recent years, the IRS has begun to review this issue more closely and require the business owner to take out a reasonable salary. However, to the extent that the business owner makes distributions to himself or herself above the reasonable compensation amounts, these amounts will not be subject to self-employment tax. Finally, in most situations, a partnership and an LLC are able to distribute their assets out to the owners without triggering tax at the entity level. An S corporation, however, will be required to recognize gain on any assets distributed to its shareholders, whether such distribution is a liquidating or nonliquidating distribution. This means that if the S corporation distributes assets to the shareholders, it will recognize income at the S corporation level that will flow through to the shareholders based upon their ownership percentages. While such distributions by the S corporation will not cause the full double tax that a C corporation would incur (see below), the recognition of gain at the corporate level reduces the planning opportunities in an S corporation thereby providing less flexibility and tax planning as compared to the partnership and LLC. The S corporation is subject to the Texas Margin Tax.

C Corporations.

Overall. A C corporation is a regular corporation created under state law just like the S corporation. The difference between the C corporation and the S corporation is that the shareholders did not elect for the corporation to be taxed as an S corporation, thereby not causing all the income and losses of the corporation to flow through to its shareholders. In other words, if the shareholders decide not to make (or fail to make) an "S corporation" election with the IRS, the corporation, by default, will be treated as a C corporation for federal income tax purposes. A C corporation is its own taxpayer (i.e. separate taxpaying unit) and is responsible for corporate level tax on all of its income. The operational issues and other matters are, for state law purposes, identical to an S corporation. A C corporation is liable for Texas Margin Tax and there are no self-employment taxes on any dividend distributions by the C corporation to its shareholders. Prior to 1986, a C corporation was the preferred entity for most business owners. However, in today's business world, very few closely-held corporations operate as C corporations anymore because of the double tax nature of the entity, i.e. corporate profits are taxed at the corporate level, and any distributions (i.e. dividends or liquidating distributions) to the shareholders, other than compensation, are again taxable at the shareholder level. C corporations are very disadvantageous on a sale of the corporations business, as most buyers want to buy assets not stock. An asset sale causes full double taxation to the shareholders if they want to receive the proceeds of the sale, i.e. a corporate tax at the C corporation level on the gain on the corporation's sale of its assets and an individual tax at the shareholder level based upon the proceeds received by the shareholders in liquidation over the tax basis in the shareholder's stock.

Practical Operational Issues. The operational issues for a C corporation are very similar to an S corporation for state law purposes. In most situations C corporations today are only used when the owners of the entity are not qualified S corporation shareholders and the entity was set up prior to the availability of the LLC law. Additionally, venture capital investors and entrepreneurs who plan on growing the company to go public prefer the C corporation structure in order that they can insure that all profits are reinvested in the corporation to build and grow value so that they can cash out at capital gains rate upon sale.

Tax Issues. As discussed above, the C corporation is not a favored entity for federal income tax purposes due to its double tax nature. Because of this, very few entities formed today are structured to be a C corporation.

<u>CONCLUSION</u>.

Taxes, liability protection, and other considerations have caused the choice of business entity by a new business owner, or an existing owner, to be an issue requiring competent advice from the business owner's lawyer and accountant. Only after understanding all of the goals and plans of the business owner, both short term and long term, can a business owner's advisors recommend to him or her the proper entity for their business operations. This outline is intended to raise the issues for a business owner to consider – not to provide answers. Only after a thorough analysis and review can the answers be provided by the business owner's advisors. Good luck on your selection.

APPENDIX A

Organizational Entity Chart

CONSIDERATIONS IN MAKING THE CHOICE OF BUSINESS ENTITY

	Sole Proprietorship	General Partnership	Limited Partnership	LLC	S Corporation	C Corporation
Number of Owners	1	At least 2.	At least 2 (including 1 general partner and 1 limited partner)	At least 1 (Need at least 2 to be considered a partnership for federal tax purposes.)	1 to 100.	At least 1
Limited Liability for Owners	No	No, unless Partnership registers as LLP.	General Partner: No, unless Limited Partnership registers as a LLP. Limited Partner: Yes, other than amount invested.	Yes, other than amount invested.	Yes, other than amount invested.	Yes, other than amount invested.
Levels of Federal Income Tax	One Entity level: N/A Owner level: Yes	One Entity level: No Owner level: Yes	One Entity level: No Owner level: Yes	One Entity level: No Owner level: Yes	Generally: One. Entity level: No, except entity level tax if a former C corporation and too much passive income or built-in gains under Section 1374 and 1375. Owner level: Yes	Two Entity level: Yes Owner level: Yes, to the extent Corporation pays dividends to shareholders.

	Sole Proprietorship	General Partnership	Limited Partnership	LLC	S Corporation	C Corporation
Classification for federal income tax purposes	Sole Proprietorship	Partnership (default)	Partnership (default)	1 Single member: Default: Disregarded as an entity separate from owner (i.e., sole proprietor) Election: S-corporation or C-corporation 2 Multiple members: a. Default: Partnership b. Election: S-corporation or C-corporation	Corporation (must timely file IRS Form 2553 and meet other IRS requirements for S-corporation status).	Corporation
Self Employment Tax on Individual Owner	Yes	Yes	General Partner: Yes Limited Partner: No (other than guaranteed payment for services).	Maybe	No, but reasonable compensation should be paid to shareholder active in the business. Caution: Excessive distributions to shareholder without reasonable salary may be recharacterized as compensation.	No, but reasonable compensation should be paid to shareholder active in the business. Caution: Excessive compensation to shareholder may not be deductible to Corporation and recharacterized as a dividend.
Texas Margin Tax	No	Yes, unless all direct partners are natural persons without liability protection OR the entity is a "passive entity"	Yes, unless the entity is a "passive entity"	Yes	Yes	Yes

	Sole Proprietorship	General Partnership	Limited Partnership	LLC	S Corporation	C Corporation
Types of Owner	No restrictions	No restrictions	No restrictions	No restrictions	Ownership is limited to individuals who are U.S. Citizens and residents and to certain U.S. trusts (i.e. grantor trust, QSST, or ESBT). No entity may be an owner (except S corporation which is 100% owner OR a single member LLC that is disregarded for federal tax purposes OR certain exempt organizations).	No restrictions.
Classes of Ownership Interests	One	Multiple classes are permitted	Multiple classes are permitted	Multiple classes are permitted.	Only one class of stock is permitted (i.e., can't have preferred stock). However, there can be differences in voting rights.	Multiple classes are permitted.

	Sole Proprietorship	General Partnership	Limited Partnership	LLC	S Corporation	C Corporation
Voting Rights of Owners	N/A	Voting rights of owners are usually set forth in Partnership Agreement. To the extent the Partnership Agreement does not address voting rights of owners, Texas statutory law controls.	Voting rights of owners are usually set forth in the Limited Partnership Agreement. To the extent the Limited Partnership Agreement does not address voting rights of owners, Texas statutory law controls	Voting rights of owners are usually set forth in the Company. To the extent the Company Agreement does not address voting rights of owners, Texas statutory laws control.	Voting rights of owners are provided in Texas statutory law, as well as set forth in the Bylaws and Certificate of Formation. Board of Directors Mergers, conversion, sale of substantially all assets, dissolution/winding up Amendments of Certificate of Formation and maybe Bylaws. (voting rights may be modified by Shareholders' Agreement or Voting Agreement	Same as S Corporation
Restriction on Ownership of Subsidiaries	No restrictions	No restrictions	No restrictions	No restrictions	No restrictions	No restrictions
Tax Year	Calendar	Generally calendar	Generally calendar	Generally calendar	Generally calendar	No restrictions
Organizational Filing Costs with TX SOS	N/A	None, unless LLP. LLP filing fee is $200 per Partner annually.	The filing fee for a Texas Limited Partnership is $750.	The filing fee for a Texas LLC is $300.	The filing fee for a Texas corporation is $300	The filing fee for a Texas corporation is $300.
Day to day management structure	N/A	Partners (default)	General Partner (default)	Members (if LLC is Member-Managed) or Managers (if LLC is Manager-Managed).	Board of Directors/ officers (unless other-wise provided in Shareholders' Agreement	Same as S Corporation

	Sole Proprietorship	General Partnership	Limited Partnership	LLC	S Corporation	C Corporation
Taxation of Contributions of Property to Entity	Nontaxable	Nontaxable unless disguised sale, violate investment partnership rules or the partner is relieved from debt.	Nontaxable unless disguised sale, violate investment partnership rules or the partner is relieved from debt.	Nontaxable unless disguised sale, violate investment partnership rules or the member is relieved from debt	Taxable, unless the transferors meet the 80% control test of IRC §351, in which case the transfer is nontaxable except to the extent of debt relief.	Taxable, unless the transferors meet the 80% control test of IRC §351, in which case the transfer is nontaxable except to the extent of debt relief.
Maximum Marginal Federal Tax Rate on Income from Business (Not including 3.8% Net Investment Tax, if applicable)	39.6% (maximum individual rate)	39.6% (maximum individual rate)	39.6% (maximum individual rate)	39.6% (maximum individual rate)	39.6% (maximum individual rate)	Fluctuating corporate rate. Rule of thumb is 35% average rate. 20% for shareholder's receipt of dividends from corporation. If shareholder's tax rate is 39.6%, otherwise, 15%.
Special Tax Allocations of Income and Loss	N/A	Yes	Yes	Yes	No	N/A
Deductibility of Losses (and basis for entity-level debt) (subject to at-risk and passive loss rules)	Generally, no restrictions	A partner may deduct his allocable share of partnership's losses only to the extent of his tax basis in his partnership interest <u>which includes</u> his allocable share of partnership debt.	A partner may deduct his allocable share of partnership's losses only to the extent of his tax basis in his partnership interest <u>which includes</u> his allocable share of partnership debt.	A member may deduct his allocable share of LLC's losses only to the extent of his tax basis in his LLC interest <u>which includes</u> his allocable share of LLC debt.	A shareholder may deduct his allocable share of corporation's losses only to the extent of his tax basis in his stock (<u>which does not include</u> any portion of the corporation's debt) AND such shareholder's tax basis in his loans to the corporation.	Shareholders may not deduct any of the corporation's losses.

	Sole Proprietorship	General Partnership	Limited Partnership	LLC	S Corporation	C Corporation
Taxation of Cash Distributions	N/A	Nontaxable to the extent of a partner's tax basis in his partnership interest.	Nontaxable to the extent of a partner's tax basis in his partnership interest.	Nontaxable to the extent of a member's tax basis in his LLC interest.	Nontaxable to the extent of the shareholder's tax basis in his stock	Taxable as dividends to the extent of the corporation's earnings and profits and then nontaxable to the extent of the shareholder's tax basis in his stock.
Taxation of Distributions of Appreciated Property	N/A	Nontaxable	Nontaxable	Nontaxable	Taxable at corporate level (gain flows through to shareholder and increases stock tax basis). Taxable to shareholder if FMV of distributed property exceeds stock tax basis	Taxable to both corporations and shareholders.
Taxation Upon Liquidation	N/A	Nontaxable	Nontaxable	Nontaxable	Taxable at corporate level (gain flows through to shareholder and increases stock tax basis). Taxable to shareholder if FMV of distributed property exceeds stock tax basis	Taxable to both corporations and shareholders.
Section 754 Election to Adjust Inside Basis of Owner and Entity Upon Sale of an Owner's Interest or Distribution of Property	N/A	Yes	Yes	Yes	No	No

	Sole Proprietorship	General Partnership	Limited Partnership	LLC	S Corporation	C Corporation
Charging Order as sole remedy of Judgment Creditor of Owner against Owner's Interest in Entity	N/A	Yes	Yes	Yes	No	No
Restrictions on Transfer of Owner's Interest in Entity (other than federal/state securities laws)	None	None unless restricted per Partnership Agreement or other written agreement. Transferee has rights of an assignee only until admitted as a partner.	None unless restricted per Limited Partnership Agreement or other written agreement. Transferee has rights of an assignee only until admitted as a partner.	None unless restricted per Company Agreement or other written agreement. Transferee has rights of an assignee only until admitted as a member.	None unless restricted per Certificate of Formation, Bylaws, Shareholders Agreement or other written agreement	None unless restricted per Certificate of Formation, Bylaws, Shareholders Agreement or other written agreement
Annual meetings/resolution, necessary for perpetuation of management	N/A	No	No	No	Yes (unless Share-holders' Agreement provides for perpetual management)	Same as S Corporation