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Planning for the Tax Effects of Liquidating and Reorganizing the Farm and Ranch Corporation

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PLANNING FOR THE TAX EFFECTS OF LIQUIDATING AND REORGANIZING THE FARM AND RANCH CORPORATION

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I. INTRODUCTION

Historically, corporations have distributed property to their shareholders in the form of dividends,[1] stock redemptions,[2] and liquidating distributions.[3] Quite often, the distributed assets have appreciated in value during the period that the corporation held the assets. Before 1986, when corporations made liquidating distributions of appreciated property to their shareholders, there was generally no tax at the corporate level and the amount of appreciation was recognized only by the shareholder.[4] This basic principle of nonrecognition at the corporation level is commonly referred to as the "General Utilities" doctrine.[5]

Under the Tax Reform Act of 1986 (TRA '86), Congress repealed the "General Utilities" doctrine.[6] Consequently, corporate liquidating distributions are now subject to tax at both the corporate and shareholder levels.

The impact of TRA '86 on farm estate and business planning is not insubstantial. For example, before TRA '86, conducting the farming operation in the regularly taxed "C" corporate form was popular for various reasons, including the limited liability of the shareholders for corporate acts or obligations, the continuity of the farming operation, the improved credit status, the provision of employee benefits for the owners, the ease and convenience of making property transfers to subsequent generations by sale, gift, or testamentary transfer of corporate stock shares, and the simplified estate settlement proceedings. However, after TRA '86, if the

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1. I.R.C. § 316(a) (West 1991) (all subsequent references to the I.R.C. are from the 1991 code).

2. *See* I.R.C. § 302.

3. *See* I.R.C. §§ 331-37.

4. Similarly, before 1986, a corporate liquidation closely followed by a transfer of the liquidated corporation's assets into another corporation could have had several favorable tax consequences. These included: (1) a stepped-up basis for assets (I.R.C. § 334); (2) a withdrawal of earnings and profits by the shareholders at capital gains tax rates; and (3) an elimination of earnings and profits that the liquidating corporation accumulated.

5. *See, e.g.*, General Utilities & Operating Co. v. Helvering, 296 U.S. 200 (1935).

6. Tax Reform Act of 1986, Pub. L. No. 99-514, § 631(e)(17), 100 Stat. 2085, 2275 (1986).

shareholders want to quit the corporate farming operation, or it becomes necessary to remove the assets from the corporation, or if they want to keep the farming operation going either as a partnership or as a sole proprietorship, the options are limited and most are taxable.

Estate planning practitioners can anticipate three types of corporate farm or ranch clients. First is the farmer or rancher who has been operating as a sole proprietor and has not considered structuring the operation in a manner that might better facilitate estate planning goals. Second is the farm or ranch client who currently is conducting the farm or ranch operation as a regularly taxed C corporation but desires to convert to a Subchapter S corporation. The third type of farm or ranch client that estate planning practitioners might face is the client who is currently operating the farm ranch as a C corporation but desires to liquidate. Each of the three types of the farm or ranch client requires estate planners to be cognizant of a whole range of factors that must be discussed with the farm or ranch client at the initial client consultation.

II. OVERVIEW OF THE PROBLEM

A. LIQUIDATING THE FARM OR RANCH OPERATION

If a corporate farm or ranch operation is liquidated, it will be necessary to distribute all of the corporate assets pro rata to the shareholders in exchange for the stock. Each shareholder will measure gain or loss by the difference between the value of the property received and the shareholder's stock basis.[7] If a shareholder held the stock for more than one year, the resulting gain or loss will be long-term capital gain or loss which will be aggregated with other capital gains or losses for the year.[8] If the shareholders recognized gain or loss on the distribution, they will receive a fair market value basis for the distributed property.[9] Similarly, if several items of property are distributed, each will carry a fair market value basis.[10]

Before TRA '86, there was ordinarily no gain to the corpora-

7. I.R.C. § 1001(a). It makes no difference whether cash or property or both are distributed. If property is received, its fair market value is also the basis for determining gain or loss upon the subsequent sale of such property. *See* I.R.C. § 334.

8. I.R.C. § 1222(3).

9. I.R.C. § 334(a). If the distributed property is not liability-free, the income tax basis is the unencumbered fair market value of the assets. *See* Crane v. Commissioner of Internal Revenue, 331 U.S. 1 (1947).

10. *See* I.R.C. § 334(a).

tion when it was liquidated.[11] However, after TRA '86, gain or loss is recognized to the corporation as if the corporate property had been sold at its fair market value.[12] Thus, the typical corporate liquidation will trigger two deemed sales; one at the corporate level and one at the shareholder level.[13] At the corporate level, gain will *always* be recognized.[14] Loss will usually be recognized at the corporate level, but losses arising from property contributed to the corporation by a shareholder in a tax-free transaction or as a contribution to capital within the previous five years will be disallowed in order to prevent the shareholders from putting loss properties into the corporation to offset gains on other properties in a liquidation.[15] Likewise, a non-pro rata distribution to a shareholder who is a related person will also deny losses to the corporation.[16]

B. ABC FARMS EXAMPLE

Operationally, the recognition of gain at the corporate level will generate tax in the corporation's final income tax return. When the corporation pays the tax, the value of the remaining corporate assets available for distribution is reduced.[17] The procedure and effect of a double-taxed liquidation can best be shown by considering the following example.

Father and son each own one-half of the stock in ABC Farming Corporation. Father inherited his stock from his father (son's grandfather) when the stock was valued at $200,000. Son bought his stock for $100,000 several years ago. ABC Farms is on the cash

11. I.R.C. § 336(a), *repealed by* The Tax Reform Act of 1986, Pub. L. No. 99-514, § 631(a), 100 Stat. 2085, 2269 (1986). Priv. Ltr. Rul. 86-42-019 (July 11, 1986).

12. I.R.C. § 336. However, as under prior law, no loss is recognized to the distributing corporation on a liquidating distribution to which § 332 applies. I.R.C. § 336(d)(3). Similarly, no gain or loss is recognized upon an exchange or distribution if the reorganization provisions of the Internal Revenue Code provide for nonrecognition. I.R.C. § 336(c). Likewise, the amount of gain or loss recognized on corporate farm property distributed in complete liquidation will not be limited by any special use valuation election that is in effect. *See* Priv. Ltr. Rul. 91-46-001 (Nov. 26, 1991).

13. I.R.C. §§ 1001(a), 336(a).

14. For many farm and ranch corporations, corporate income tax is likely to be substantial upon liquidation. *See infra* notes 18-19 and accompanying text.

15. I.R.C. § 336(d)(1)(B).

16. I.R.C. §§ 336(d)(1)(A), 267(b).

17. Note that the process could also work in reverse if the deemed sale resulted in a loss that qualified as a net operating loss. In this situation, the corporation could carry the loss back to three prior years and claim a tax refund. The refund would then be an asset available for distribution to the shareholders on liquidation. However, these operational rules do not apply to the liquidation of an 80% owned subsidiary. The liquidation of an 80% owned subsidiary is tax-free, and the basis of the subsidiary's assets carries over to the present. I.R.C. §§ 332, 337.

method of accounting, and has the following assets with the following fair market values and basis:

TABLE 1

		VALUE		BASIS
Land	$	1,000,000.00	$	450,000.00
Equipment		400,000.00		325,000.00
Buildings		115,000.00		65,000.00
Cash		50,000.00		50,000.00
Feed Inventory		31,000.00		25,000.00
Cattle/Livestock		150,000.00		- 0 -
Harvested Crops		7,000.00		- 0 -
	$	1,753,000.00	$	915,000.00

ABC Farming Corporation will recognize gain of $838,000 ($1,753,000 less $915,000).[18] At a 34% tax rate,[19] the corporation will pay an extra tax of $284,920 in the year of liquidation. Thus, the assets available for distribution to the shareholders will be reduced to $1,468,080 ($1,753,000 less $284,920). Upon liquidation of ABC Farm's remaining assets, both father and son will receive property valued at $734,040.

Assuming both father and son are married and both file a joint return,[20] father's taxable gain will be $534,040 ($734,040 less $200,000), resulting in a tax payment of $158,981.90, and son's gain will be $634,040 ($734,040 less $100,000), resulting in a tax payment of $189,981.90[21] which will be due on their respective individual tax returns for the year of distribution in question. As a result, the after tax value of ABC Farms has been reduced from $1,753,000 to $1,119,116.20 for an effective tax rate on total value

18. Included in the amount of gain that ABC Farms recognizes will be any amounts for recapture of depreciation under I.R.C. §§ 1245 and 1250, recapture of soil and water conservation expenses (I.R.C. § 175, repealed), recapture of federal and state cost sharing payments that have been excluded from gross income (I.R.C. § 1255), recapture of investment tax credit (Treas. Reg. § 1.47(a)(1) (1967)), and recapture of production expenses or depreciation attributable to unharvested crops (I.R.C. § 268; Treas. Reg. § 1.268-1 (1958)). Concerning the liquidating sale of land with an unharvested crop, the crop's tax basis is increased by the amount of items attributable to the crop's production (which are disallowed as deductions in computing taxable income), and the basis of other property is decreased by the amount of disallowed production costs that are attributable to that other property. *See* Treas. Reg. § 1.1016-5(g) (1987).

19. The rates on corporate income are 15% on the first $50,000 of income; 25% on the next $25,000; and 34% on the balance except that income between $100,000 and $335,000 bears a 5% surtax to phase out the lower rates on the first $75,000 of income. At $335,000 of income, all the low rate benefits are phased out and all taxable income is taxed at 34%. *See* I.R.C. § 11(b).

20. I.R.C. § 1(a).

21. *Id.*

of 36.2%.[22] Therefore, TRA '86 clearly warns farmers and ranchers considering incorporation that while they can transfer low-basis high-value property to a new corporation without gain,[23] tax will have to be paid to get out.

C. ADDITIONAL PROBLEMS FOR FARMERS AND RANCHERS UPON LIQUIDATION

An additional problem for the liquidation of many farm and ranch corporations is that the liquidation will necessarily occur in the midst of a production cycle,[24] which will likely result in expenditures being incurred in a period before liquidation and income recognized in a period after liquidation. For example, assume that ABC Farms has equipment, breeding stock, young animals in various stages of production for market, stored grain, hay, land and purchased feed and farm supplies. As indicated above,[25] the livestock and stored grain (harvested crops) have a zero income tax basis and will therefore produce a significant amount of gain upon liquidation. Additionally, ABC Farms probably already deducted the production costs of the livestock and stored gain. Hence, upon liquidation, father and son would receive the liquidating distributions and recognize gain upon the later sale. Therefore, the fair market value of certain distributed assets in a farm or ranch corporate liquidation may not adequately reflect the capacity to shift income from the liquidating corporation to the shareholders.

In order to reallocate income and expenditures between the corporation and shareholders to avoid income distortion, the Service may attack liquidating distributions of this nature on several grounds: assignment of income, reallocation of income and expenses, denial of expense deductions, tax benefit theory, and a change in accounting method.[26]

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22. 1 - (1,119,116.20 ÷ 1,753,000.00) = .3616.

23. I.R.C. § 1221 (1991).

24. For instance, livestock operations involve continuous and overlapping production cycles, and fall tillage, planting, and fertilizer application may have preceded the liquidation of a nonlivestock operation outside of the growing season.

25. *See supra* Table 1.

26. The repeal of the "General Utilities" doctrine means that, as a practical matter, the Service will statutorily tax liquidating distributions. Obviously, these methods of attack remain viable alternatives. However, the Service has frequently had difficulty prevailing on these theories in a given set of circumstances, so reliance on the statutory framework is easier and more efficient.

1. *Change of Accounting Method*

The Service has the authority to compel ABC Farms to use the accrual method of accounting if the cash method does not clearly reflect income.[27] While the cash method of accounting would clearly be permissible for ABC Farms if it continues in business, if ABC Farms liquidates in mid-stream, the cash method may not clearly reflect income.[28]

2. *Assignment and Reallocation of Income*

Income is taxed to the one who earns it rather than to the one who happens to collect it.[29] Thus, a corporation cannot escape corporate income tax by an anticipatory assignment of income to shareholders via a complete liquidation.[30] However, if ABC Farms liquidates without the presence of tax avoidance motives, they will likely avoid an income assignment challenge.[31] Similarly, the Service also has broad powers to reallocate income, deductions, credits or allowances to clearly reflect income.[32]

3. *Tax Benefit Challenge*

The Service may also bring a tax benefit challenge. If ABC Farms liquidates and distributes assets that generated deductions when acquired but that have not been fully consumed or amortized, the corporation might be required to give back the prior tax benefits.[33]

In *United States v. Bliss Dairy, Inc.*,[34] the Supreme Court held the tax benefit rule applicable to previously expensed amounts of income "when events occur that are fundamentally inconsistent with an earlier deduction."[35] In *Bliss Dairy*, a farm corporation

27. I.R.C. § 446(b).

28. *See, e.g.*, Jud Plumbing & Heating, Inc. v. Commissioner of Internal Revenue, 153 F.2d 681 (5th Cir. 1946).

29. *See, e.g.*, Commissioner of Internal Revenue v. Earl, 281 U.S. 111 (1930).

30. *See, e.g.*, J. Ungar, Inc. v. Commissioner of Internal Revenue, 244 F.2d 90 (2d Cir. 1957). However, the assignment-of-income doctrine applies only to income that has been accrued. Commissioner of Internal Revenue v. South Lake Farms, Inc., 324 F.2d 837 (9th Cir. 1963). Thus, the doctrine is not applicable to growing crops.

31. *See, e.g.*, Tatum v. Commissioner of Internal Revenue, 400 F.2d 242 (5th Cir. 1968).

32. I.R.C. § 331. As a result, the Service may attempt to require a liquidating corporation to recognize gain on crops or livestock or refuse to allow deductions attributable to such items.

33. The rule applies in the farm or ranch context when the operation has deducted rather than capitalized the costs of tools and supplies and has incurred and deducted the expenses of raising an unharvested crop and thereafter liquidates before the gain associated with the unharvested crop is recognized.

34. 460 U.S. 370 (1983).

35. United States v. Bliss Dairy, Inc., 460 U.S. 370, 371 (1983).

deducted the cost of cattle feed purchased during the tax year which remained largely on hand at the end of the tax year. Two days into the next tax year, the corporation liquidated and distributed the cattle feed on hand to its shareholders without reporting any income. The shareholders then deducted the feed's income tax basis as a cost of doing business as the feed was fed. The Service challenged the procedure, and argued that the corporation should include the value of the feed distributed to the shareholders in the corporation's income.

The Supreme Court agreed with the Service and stated that the proper increase in taxable income was the portion of the cost of the feed attributable to the amount on hand at the time of liquidation. Thus, the tax benefit rule is likely to be applied in farm and ranch liquidations that involve distribution of previously expensed items such as feed, seed, supplies, hand tools, fuel and fertilizer.[36] Consequently, ABC Farms should report any previously expensed items into income at the corporate level upon liquidation.

4. *Section 268 Deductions Attributable to Unharvested Crops*

By applying section 268 of the Internal Revenue Code (IRC), the Service has been successful in denying corporate deductions attributable to unharvested crops sold with corporate land. Section 268 has also been applied in the context of a corporate liquidation requiring a recapture of expenses attributable to growing crops.[37]

III. INITIAL BUSINESS PLANNING

A. CONSIDERATION OF ALTERNATIVE ORGANIZATIONAL FORMS

For newly formed farm and ranch operations or for farmers and ranchers who, for the first time, are considering operating in a business entity form, the double taxation issue bears quite heavily on the choice of organizational form. For instance, before TRA '86, corporations were taxed at a relatively low rate compared to

36. *See* Byrd v. Commissioner of Internal Revenue, 87 T.C. 830 (1986), *aff'd without published opinion*, 829 F.2d 1119 (4th Cir. 1987). The tax benefit rule was reaffirmed by the *Byrd* court, which required the recapture of previously expensed inventory consisting of nursery stock. *Id.*

37. Beauchamp & Brown Groves Co. v. Commissioner of Internal Revenue, 371 F.2d 942, 943-44 (9th Cir. 1967).

individuals. However, under TRA '86, corporate tax rates will be greater than individual tax rates for certain levels of income.[38] Thus, under current law, the double taxation issue bears quite heavily on the choice of business entity.

In general, there are two options for new farming entities that seek to avoid the double tax effect of TRA '86. First, certain farming organizations may chose to elect Subchapter S status. For farm organizations that prefer to operate in the corporate form and are able to meet the rigorous Subchapter S qualifications, this organizational route is worth investigating in light of the farm organization's overriding estate and business planning goals. If a Subchapter S election is made for the first taxable year during which the farm or ranch operates in the corporate form, the provisions of TRA '86 requiring recognition will be inapplicable.[39] As an S corporation, the farming enterprise can avoid the double taxation effect of TRA '86 and can take advantage of lower individual rates by passing the income, losses, deductions, and credits through the S corporation to its shareholders to be taxed at individual rates.

The second organizational option that a new farming entity may select in order to avoid the double taxation effect of TRA '86 is to form a partnership. Similar to an S corporation, a partnership avoids double taxation by passing the income, losses, and credits through the partnership to the partners to be taxed at potentially lower individual rates. Thus, both the S corporation and the partnership organizational form can avoid the disadvantages of double taxation and inflexibility with respect to liquidating distributions.

B. THE S CORPORATION

One business organizational form that new farm or ranch busi-

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38. *See supra* note 19.

39. I.R.C. § 1374(d)(3). Any gain recognized upon the disposition of any asset will be presumed to be "built-in gain," unless the S corporation establishes that the asset was not held by it at the beginning of its first taxable year or that the gain is attributable to appreciation accumulated subsequent to the first taxable year. *Id.* TRA '86 extensively expanded § 1374 to cover *all* built-in gain property held by a C corporation at the time its S election becomes effective and recognized by the corporation at any time within the 10-year recognition period after Subchapter S status begins. *See* I.R.C. § 1374. The gains are to be taxed at the maximum rate prescribed by § 11(b), but the corporation is permitted to use its former C-year tax attributes, such as unexpected carryovers and credits, in computing the corporate level tax under § 1374(b). *See* I.R.C. § 1374(b). Section 1374 also applies asset by asset, but the amount of taxable gain is subject to an overall limitation equal to the net built-in gain at the beginning of the election period under § 1374(d)(1). *See* I.R.C. § 1374(c)(2). For a discussion of the effects of I.R.C. § 1374 in the event that a Subchapter S election has not been in effect for all years of corporate existence, see *infra* notes 115-132 and accompanying text.

nesses may select in order to avoid the double-taxed liquidation effect of the "General Utilities" repeal is the Subchapter S corporation.[40] The Tax Reform Act of 1986 significantly altered the federal tax rate such that the top individual rate (28%) is less than the top corporate rate (34%). In addition, the repeal of "General Utilities" and section 333 means that generally the income of regular C corporations will be subject to double taxation. These changes practically mandate that farm or ranch operations considering incorporation elect S status in order to obtain the benefits of lower individual rates and to eliminate the prospect of double taxation.

1. *Requirements*

Not every farm or ranch operation, however, can become an S corporation. Subchapter S applies only to a "small business corporation" defined by section 1361(b)(1) as a domestic corporation that does not have more than thirty-five shareholders[41] or more than one class of stock.[42] The corporation also must not have any

40. I.R.C. §§ 1361-79. A proposal to permit "small corporations which are essentially partnerships to enjoy the tax advantages of the corporate form of organization without being made subject to possible tax disadvantages of the corporation" and to "eliminate the influence of the federal income tax in the selection of the form of business organization" was enacted into law in 1958 as Subchapter S of the Internal Revenue Code. *Id. See also* S. REP. NO. 1983, 85th Cong., 2d Sess. 87 (1958), *reprinted in* 1958-3 C.B. 922, 1137. The main features of Subchapter S were extensively revised by the Subchapter S Revision Act of 1982, S. REP. NO. 640, 97th Cong., 2d Sess. 1 (1982), *reprinted in* 1982-2 C.B. 718.

41. I.R.C. § 1361(b)(1)(A). A husband and wife and their estates are treated as a single shareholder, regardless of whether they own the stock as joint tenants or as community property. I.R.C. § 1361(c)(1). Joint tenants and tenants in common other than spouses are treated as separate shareholders. Treas. Reg. § 1.1371-1(d)(1) (1990). For stock held by a nominee, agent, guardian, or custodian, the beneficial owner is usually treated as the shareholder. *See* Harold C. Kean, 51 T.C. 337, 344 (1968), *aff'd*, 469 F.2d 1183 (9th Cir. 1972). Conversely, stock owned by a partnership is treated as owned by the partnership itself. Treas. Reg. § 1.1371-1(d)(1) (1990). This precludes an S election because an election can be made only if all shareholders are individuals, estates, or trusts. I.R.C. § 1361(b)(1)(B). Four types of trusts can qualify as an eligible shareholder. I.R.C. § 1361(c)(2). They include: (1) a trust treated by §§ 671-78 as owned in its entirety by an individual citizen or resident of the United States under § 1361(d)—income beneficiaries of trusts meeting certain conditions can elect to qualify the trust under § 1361(c)(2)(1)(i) and be treated as the owner of the S corporation stock; (2) the same kind of trust as in (1) above that continues in existence for 60 days after the deemed owner's death or continues in existence for two years after death if the entire corpus is includable in the deemed owner's gross estate; (3) a trust that receives stock under a will, but only for the 60-day period following receipt of the stock; and (4) a voting trust. Shares held by these qualified trusts are allocated to the deemed owner in the case of class (1) trusts, to the deemed owner's estate in the case of class (2) trusts, to the testator's estate for class (3) trusts, and to each beneficiary for class (4) trusts. I.R.C. § 1361(c)(2)(B). The Internal Revenue Service treats stock that a custodian holds under the Uniform Gifts to Minors Act as owned by the minor and thus not requiring qualification under the trust provisions. Fed. Tax Serv. (P-H) ¶ 55, 211 (1958).

42. I.R.C. § 1361(b)(D). A corporation is considered to have more than one class of stock if the outstanding shares are "not identical with respect to the rights and interest which they convey in the control, profits, and assets of the corporation." Treas. Reg. § 1.1371-1(g) (1990). However, a corporation does not have more than one class of stock

nonresident alien shareholders[43] and must not be an "ineligible corporation."[44] Additionally, a newly formed farm or ranch business can only bring Subchapter S into effect by filing an election to which all shareholders consent.[45]

2. *Advantages of the S Corporation*

The advantages of operating in the Subchapter S form are primarily related to taxation. S corporations are not subject to income taxes.[46] Instead, S corporation income is taxed at the shareholders' marginal rates. As a result, there is no double taxation, because the S corporation's income and losses pass through to the shareholders on a per share basis.[47] However, due to the graduated tax rates on C corporate income,[48] if the farming or ranching operation projects taxable income of less than $123,318.75, a C corporation will pay less income tax than the shareholders of the S corporation.[49]

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merely because there are differences in voting rights among a single class of common stock. I.R.C. § 1361(c)(4). Presumably, this provision also includes nonvoting stock.

Debt obligations held in substantially the same proportion as nominal stock are treated as capital contributions rather than a second class of stock. Treas. Reg. § 1.1317-1(g) (1990). Likewise, straight debt meeting certain conditions is not treated as a second class of stock. *See* I.R.C. § 1361(c)(5).

43. I.R.C. § 1361(b)(1)(C). The reason for the restriction is that corporate income is exempt from tax under Subchapter S on the assumption that it will be subjected to the graduated individual income tax rates, whereas most nonresident aliens are taxed at a flat rate of 30% under § 871(a)(1). *Id.*

44. I.R.C. § 1361(b)(2). An ineligible corporation is any corporation which is a member of an affiliated group as defined in I.R.C. § 1504 as a corporation that owns 80% or more of another corporation (unless the other corporation has not begun business *and* has no taxable income). *See* I.R.C. § 1361(c)(6). It may also be a financial institution to which I.R.C. § 585 or § 593 applies, or an insurance company subject to tax under Subchapter L. I.R.C. § 1361(b)(2).

45. I.R.C. § 1362(a). The consent of a minor must be granted by the minor, the minor's legal guardian, or the minor's natural guardian if no legal guardian has been appointed, even if a custodian holds the minor's stock. Treas. Reg. § 1.1372-3(a); Rev. Rul. 66-116, 1966-1 C.B. 198. Additionally, the corporation must be qualified at the time the election is filed. Rev. Rul. 86-141, 1986-Z C.B. 151.

46. I.R.C. § 1363(a). Not only is the S corporation exempt from the corporate income tax of § 11, but it is also exempt from the alternative minimum tax of § 55, the accumulated earnings tax of § 531, and the personal company holding tax of § 541. Despite the exemption of § 1363(a), however, the taxable income of an S corporation must be computed in the same manner as the taxable income of an individual except for the disallowance of personal exemptions, itemized personal deductions allowed to individuals, charitable contribution and net operating loss deductions, and a few other items. *See* I.R.C. § 1363(b) (cross-referencing I.R.C. § 703(a)(2)). However, § 248 organizational expenses can be deducted. *See* I.R.C. § 1363(b)(3).

47. Moreover, in keeping with this conduit approach, S corporations are treated as individuals with respect to any stock that they may hold in a C corporation. I.R.C. § 1371(a)(2). Thus, an S corporation that receives dividends from a C corporation is not entitled to the dividends-received deduction allowed by § 243.

48. *See supra* note 19.

49. Assuming the shareholders are married and file a joint return, there is a savings to a C corporation of $2,080 for the first $50,000 of taxable income and an additional $750 for the next $25,000 of income. This advantage will be increased if fringe benefits are paid to

In determining their tax liability, the shareholders of an S corporation must take into account their pro rata shares of (1) the corporation's income, losses, deductions, and credits which, when treated separately, "could affect the liability for tax of any shareholder"; and (2) the corporation's "non-separately computed income or loss" defined as the corporation's gross income less its allowable deductions after excluding all separately stated items.[50] In computing these amounts, each item is first divided by the number of days in the year, and an equal amount of each item is allocated to each day.[51] The daily amount is then divided pro rata among the shares outstanding on that particular day.[52]

For S corporations engaged in farming or ranching, the direct pass-through of income to the shareholders may be of special significance because gross income from an S corporation engaged in farming or ranching will be treated as gross income from farming or ranching in the shareholder's hands for purposes of the estimated tax. Capital gains are not offset by ordinary losses at the corporate level. Likewise, section 1231 gains and losses (gains and losses on property used in the farm or ranch business such as breeding stock) pass through separately to the shareholders and are then aggregated with the shareholder's section 1231 gains and losses.[53]

Another advantage of the S corporation form is that, in general, contributions of property to an S corporation upon formation will not result in recognition of gain or loss to the contributing shareholders if such shareholders control the corporation immediately after the contribution.[54] However, once the S corporation has been formed, any later contributions of appreciated property

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the C corporation shareholders. Of course, if the C corporation makes a distribution, the shareholders will be subject to tax and the benefit of the graduated brackets will be lost. At a taxable income of $123,318.75, a C corporation and the shareholders of an S corporation will both pay a tax of $31,344.31. For an illustration of the effect of the graduated brackets, see Appendix "A."

50. I.R.C. §§ 1366(a)(1)(A)-(B).

51. I.R.C. § 1377(a)(1)(A).

52. I.R.C. § 1377(a)(1)(B). Under the formula, the shareholder accounts for capital gains, exempt interest, investment income, investment interest expense, and similar items as if the shareholder directly realized the item from the source incurred by the corporation. Characterization occurs in the shareholder's hands.

If a shareholder's interest terminates during the taxable year, the allocation can be made as if the taxable year consisted of two short taxable years, the first of which ended on the day of termination, provided that all persons who were shareholders during the entire year agree to this treatment. I.R.C. § 1377(a)(2).

53. I.R.C. § 1366(a).

54. I.R.C. § 351(a). For this purpose, control means the ownership of stock possessing at least 80% of the total combined voting power and representing at least 80% of the total number of non-voting shares. I.R.C. § 368(c).

will result in gain to the contributing shareholder, unless the contributing shareholder alone has a controlling interest in the corporation after the contribution. In contrast, the nonrecognition rules for contributions of appreciated property to a partnership contain no such control restrictions. Thus, any contribution of property in exchange for a partnership interest at any time generally will qualify for nonrecognition treatment.[55]

Distributions from an S corporation without accumulated earnings and profits to its shareholders will be tax-free to the extent of the shareholders' income tax basis in their respective shares of stock.[56] Conversely, an S corporation (like a C corporation) that distributes property in complete liquidation will generally recognize both gain and loss with respect to this distribution.[57] However, unlike a C corporation, if an S corporation sells all or a portion of its property for an installment obligation to its shareholders in a complete liquidation, no gain or loss generally will be recognized by the S corporation in connection with this distribution.[58]

In the family farm or ranch context, the S corporation may also be useful for shifting income from high bracket taxpayers to

55. I.R.C. § 721(a).

56. I.R.C. § 1368(b). A shareholder's stock basis is reduced by the amount of the distribution, and any excess is treated as capital gain. I.R.C. § 1368(b)(2). The amount of any distribution is the amount of cash distributed plus the fair market value of any property distributed. The income tax basis of a shareholder's stock in an S corporation is increased by income items, non-separately computed income (except income items included above), and the excess of depletion deductions over the income tax basis of property subject to depletion. I.R.C. § 1367(a)(1). Alternatively, under I.R.C. § 1367(a)(2), shareholders must reduce their stock basis (but not below zero) by their pro rata shares of the S corporation's deductions and losses, corporate distributions not included in the shareholder's income, non-separately computed loss (excluding loss items included above), corporate expenses that are not deductible in computing taxable income and not chargeable to a capital account, and the amount of a shareholder's deductions for depletion with respect to oil and gas wells.

If a shareholder's stock basis is reduced to zero by virtue of these adjustments, any additional adjustments are applied to the basis of any loans that the shareholder may have made to the corporation. I.R.C. § 1367(b)(2)(A). If a shareholder's deductions and losses exceed the combined basis of the shareholder's stock and debt investment, the shareholder may not use the excess on his individual return. I.R.C. § 1366(d)(1). Instead, the disallowed losses and deductions can be carried forward indefinitely to any subsequent year in which the shareholder has an income tax basis in the stock or indebtedness. I.R.C. § 1366(d)(2). If the S election terminates, any excess losses may be claimed in the year following the corporation's last S taxable year, if there is enough income basis in the corporation stock. I.R.C. § 1366(d)(3).

57. I.R.C. § 336(a). As in the case of nonliquidating distributions, the shareholders in this situation would have a basis in the distributed asset equal to its fair market value at the time of its distribution. I.R.C. § 334(a).

58. *See* I.R.C. § 453B(h). This favorable treatment no longer applies to a C corporation, since the prior version of § 453B(d)(2) was eliminated as part of the repeal of the "General Utilities" doctrine. Hence, a C corporation that distributes an installment obligation to its shareholders in liquidation generally will recognize gain (or loss) on the distribution under the general rule of § 453B(a).

lower bracket taxpayers. However, to curb the use of an S corporation as a detour around the family partnership rules[59] and to prevent the juggling of family income by shifting shares of stock among family members, the Commissioner is authorized to apportion or allocate income to reflect the value of services rendered to the corporation by its stockholders.[60]

If an S corporation without accumulated earnings and profits distributes appreciated property to a shareholder in complete liquidation, the corporation recognizes gain as though the property had been sold to the shareholder at fair market value.[61] However, the gain is not taxed to the corporation. Instead, the gain passes through to the shareholders and is reflected in the shareholders' respective individual returns with, in effect, only a net single level of tax. In general, the same result flows from a liquidating sale of the S corporation's assets.[62]

For example, assume ABC Farms is a C corporation which liquidates at a time when it has assets carrying a fair market value of ten million dollars and a basis of four million dollars. The gain under section 336(a) is six million dollars, subject to a maximum 34% corporate tax rate. The tax payable, therefore, would be $2.04 million (assuming there is sufficient income to use up the lower surtax exemptions). In contrast, if ABC Farms were an S corporation, tax on the six million dollar gain at the individual tax rate would only be $1.853 million.[63] In the former case, the income is still locked in the corporation, while with the S corporation the income will already be in the shareholders' hands. If the comparison were to take into account the tax costs of getting funds

59. Under I.R.C. § 704(e)(2), a partner reports his distributive share of the partnership income.

60. I.R.C. § 1366(e). "Family" has the same meaning as it does under I.R.C. § 704(e)(3), where the Commissioner has the power to reallocate income of family partnerships. While § 1366(e) restricts allocation or apportionment to family members (only § 704(e) permits reallocation between donor and donee, regardless of relationship), § 1366(e) permits a reallocation to reflect the value of a shareholder's services or capital even if the other family members acquired their stock from nonfamily members in an arm's length transaction. Similarly, income allocation must be initiated by the Service. *See, e.g.*, Johnson v. Commissioner of Internal Revenue, 720 F.2d 963 (7th Cir. 1983).

61. I.R.C. § 336.

62. *See* I.R.C. § 453(h) (permitting a liquidating S corporation to distribute an installment obligation in a qualified transaction without triggering gain to the distributing corporation (unless the S corporation has § 1374 built-in gains)). However, sale of all the S corporation's stock to a nonqualified shareholder (as defined under § 1361) with the buyer then liquidating the S corporation to get a stepped-up basis for its assets, results in the potential for double taxation; once to the selling shareholders to the extent of their gain on a stock sale, and again at the corporate level if the stock sale terminates the S election.

63. I.R.C. § 1(a) (subject to the table prescribed by the Secretary under § 1(f)(1) on November 18, 1991).

out to the shareholders, the difference would become even more striking.

Besides income taxation, an S corporation does not lose its other corporate attributes. It retains limited liability, transferrable shares, and other corporate characteristics. For farmers and ranchers, the major advantages of operating in the S corporation form depend upon the needs and goals of each particular situation. For example, the S corporation form may be desirable if the shareholders anticipate corporate losses and have substantial nonfarm income to offset against those losses. Similarly, the S corporation might be the proper organizational form if the stockholders desire to take income out of the corporation as it is earned. An S corporation may also be desirable if the shareholders want the tax structure of a partnership and the organizational permanence of a corporation.

If multiple organizations are used, an S corporation can be the operating corporation designed to distribute income in conjunction with a C corporation which owns the land in order to shelter income at corporate rates. Conversely, the C corporation may farm the ground that the S corporation owns. This organizational set-up will permit the co-existence of two separate taxpayers, the use of a graduated tax bracket by the C corporation, the possibility of a different taxable year, the exclusion of fringe benefits from employee income, the distribution of stock among on-farm and off-farm heirs, and the avoidance of double taxation if the land is sold or the S corporation is liquidated.

3. *Disadvantages of the S Corporation*

A special problem exists for S corporations because a single shareholder may effectively and involuntarily terminate the S election by transferring stock to an ineligible shareholder.[64] However, the IRS may overlook the disqualifying event and continue to treat the corporation as an S corporation if the IRS determines that the termination was inadvertent, the corporation and its shareholders take steps to become a qualified corporation again within a reasonable period after discovery of the termination, and the corporation and any person who was a shareholder at any time during the disqualification period agrees to make any adjustments

64. *See supra* notes 41-45 and accompanying text. As a result, no S corporation should be formed without executing a shareholder's agreement. *See* J.D. August, *Drafting Shareholder's Agreements for S Corporation Stockholders: Buy-Sell Procedures and Liquidated Damages Clauses*, 5 J. PARTNERSHIP TAX'N p. 167 (Spring 1988).

for the disqualification period that the IRS requires.[65] The IRS is usually lenient in its interpretation of what constitutes an inadvertent termination, especially when no tax avoidance would result from continued S treatment.[66] Similarly, intentional disqualification can occur if a share of stock is validly transferred to a disqualifying shareholder. In the case of an intentional disqualification, the only defense may be that the transfer was ineffective.[67] Even shareholder agreements and proscriptions against transfer may not avoid termination of the S election if the transfer was intentional and uncorrectable.[68]

From a tax standpoint, an S corporation may have several disadvantages. For example, because corporate income and losses are passed through to the shareholders, use of the corporation as a separate taxpayer for purposes of the graduated tax bracket is lost. Likewise, employer fringe benefit exclusions for any employee who owns more than two percent of the S corporation stock will be lost.[69]

In general, S corporations must adopt a "permitted" tax year.[70] "Permitted" is defined as a calendar year[71] unless the S corporation establishes (to the satisfaction of the IRS) a business purpose other than the mere deferral of income to the shareholders.[72]

Finally, it may be prudent to examine state law to see whether

65. I.R.C. § 1362(f); Prop. Treas. Reg. § 1.362-5.

66. *See, e.g.*, Priv. Ltr. Rul. 91-47-051 (Aug. 21, 1991) (unintentional failure to satisfy small business requirements); Priv. Ltr. Rul. 91-42-010 (July 17, 1991) (trustee of qualified trust inadvertently failed to recognize proper date for filing the election); Priv. Ltr. Rul. 90-36-027 (June 12, 1990) (issuance of a second class of stock to other shareholders which was subsequently redeemed and the owners accounted for their shares of profit during the period the shares were outstanding); Priv. Ltr. Rul 90-30-051 (May 2, 1990) (failure of a qualified trust to distribute income currently); Priv. Ltr. Rul. 90-17-049 (Jan. 30, 1990) (failure of a trust beneficiary to file an election required for the trust to be a qualified shareholder); Priv. Ltr. Rul. 90-17-016 (Jan. 25, 1990) (redemption of a sale of stock shares to a trust upon learning that the trust failed to qualify due to excess beneficiaries); Priv. Ltr. Rul. 90-03-015 (Oct. 18, 1989) (issuance of a second class of stock which directors forgot to modify in order to maintain S status); Priv. Ltr. Rul. 89-14-085 (Jan. 12, 1989) (merger into a less than 80% owned subsidiary that owned a dormant subsidiary used to hold title to foreign trademarks); Priv. Ltr. Rul. 89-05-046 (Nov. 8, 1988) (death of a trust beneficiary causing the trust to cease to be a qualified trust).

67. *See, e.g.*, Hook v. Commissioner of Internal Revenue, 58 T.C. 267, 272 (1972).

68. *See, e.g.*, Henry Assoc., Ind. v. Commissioner of Internal Revenue, 80 T.C. 886 (1983). As a result, qualified trust ownership of S stock may solve the intentional termination problem, since a trustee holding legal title to stock can be prohibited under both state law and the governing instrument from conveying it regardless of the beneficiary's wishes.

69. I.R.C. § 1372(a). However, § 1372(a) does not apply to pension and profit-sharing benefits. *See* I.R.C. § 410.

70. I.R.C. § 1378(a).

71. I.R.C. § 1378(b)(1).

72. I.R.C. § 1378(b)(2).

a corporation is eligible for S status for state income tax purposes. Many states recognize S status for state income tax purposes.[73] In addition, some states require income tax withholding on undistributed taxable income paid or credited to nonresident shareholders of S corporations.[74]

C. THE GENERAL PARTNERSHIP

As a business planning device, the farm or ranch partnership has a long and respectable history. A partnership engaged in the farming business, within the statutory definitions, is treated as a farmer for tax purposes. The farm or ranch partnership can therefore use the special rules for farmers and is not subject to any limitations on farmers. However, the farm or ranch partnership remains subject to partnership rules which could override applicable farm rules.

The partnership is well adapted to the business of farming or ranching. For example, in landlord-tenant situations, the landowner's farm can be combined with the tenant's labor and equipment so that both the landlord and the tenant can make operational decisions.[75]

1. *Defined*

A partnership is defined as "an association of two or more persons to carry on as co-owners a business for profit."[76] For farm or ranch partnerships based upon a written agreement, there is usually not much question about how the operation is organized. When no written agreement is present, however, an organizational question may arise concerning crop or livestock share leases or parent-child operating agreements.[77]

While receipt of a share of profits is prima facie evidence of partnership existence,[78] sharing of gross returns does not, in itself,

73. *See, e.g.*, IOWA CODE § 422.36(5) (1990); MINN. STAT. § 290.9725 (1989 & Supp. 1992); NEB. REV. STAT. § 77-2734.01(1) (1990); N.D. CENT. CODE § 57-38-01.4 (Supp. 1991).

74. *See, e.g.*, NEB. REV. STAT. §§ 77-2734.01(3)-(6) (1990).

75. However, landowners may be reluctant to enter into a partnership arrangement with the tenant out of a fear of increased potential liability for various farming activities.

76. UNIFORM PARTNERSHIP ACT § 6 (1969) [hereinafter U.P.A.].

77. Each state has developed tests for determining what is and what is not a partnership. For example, most states require a sharing of profits, and some states require a sharing of losses. Thus, since both crop and livestock share leases and parent-child relationships usually involve a sharing of the crop or stock on a gross receipt basis with the landlord and tenant each bearing unique expenses, as the arrangement develops there may come a point at which net income is shared and a court might construe the arrangement as a partnership.

78. U.P.A. § 7(4).

establish a partnership.[79] For example, in Revenue Ruling 75-43,[80] a cattle owner agreed to supply cattle for fattening to a feedlot operator, purchase feed from the feedlot operator, and independently market cattle. In turn, the feedlot operator agreed to provide insurance, labor, facilities, equipment, and all other items necessary for the care and feeding of the cattle. Additionally, the feedlot operator guaranteed the owner a percentage return on the owner's cash investment, while the feedlot operator would receive a percentage of the owner's net profit in exchange for his services. The IRS held that the sharing of profits was merely a way of compensating the feedlot owner under a service and guarantee agreement, and that the arrangement was therefore not a partnership.[81]

Similarly, in *Form Builders, Inc.*,[82] a taxpayer agreed to provide personnel, facilities, production, and management while other parties agreed to provide equipment in return for a percentage of the partnership's gross receipts. The other parties failed to secure a taxpayer identification number, and no partnership tax return was filed. The tax court held that the arrangement was not a partnership in spite of the fact that gross receipts were shared because there was no intent to share profits.

While state law applies to the determination of partnership organizational form, the standards of federal tax law must be satisfied to achieve partnership tax status. Under the Internal Revenue Code, the partnership is not a taxpayer with respect to the partnership income.[83] The income tax is paid by the partners with the partnership serving as a conduit for income, losses, and certain deductions.[84] The partners are taxable in their individual capacities upon the distributive share of partnership taxable income, whether distributed to them or not.[85] In addition, under the Internal Revenue Code, a partnership is a much broader concept than statutory entities found in most states.[86]

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79. U.P.A. § 7(3).
80. Rev. Rul. 75-43, 1975-1 C.B. 383.
81. *Id.*
82. 59 T.C.M (P-H) 332 (1990).
83. I.R.C. § 701.
84. *Id.*
85. I.R.C. § 702(b).
86. For instance, federal tax law includes all joint ventures in the category of partnerships and commonly includes organizations that are not partnerships under state law. *See, e.g.*, I.R.C. §§ 761(a), 7701(a)(2); Treas. Reg. § 1.761-1 (1972); Roy P. Varner and Mary A. Varner, et al., 42 T.C.M. (P-H) 101, 105-07 (1973); Maurice W. Grober and Mabel Grober, et al., 41 T.C.M. (P-H) 1231, 1242-43 (1972).

2. *Family Partnerships*

For partnerships consisting of family members, it may be desirable to make some or all the children partners. Such a maneuver would reduce the income tax bill by shifting some of the income from the farm ranch partnership to these lower bracket taxpaying partners. However, if the children do not have property to contribute to the partnership, the partnership arrangement may be disregarded for tax purposes unless it can be shown that each child makes substantial capital contributions or that each child performs a substantial part of the labor or management.[87] Similarly, merely distributing a portion of the farm income to the children does not give rise to partnership status for income tax purposes.[88]

A family partnership may also arise by gift to some partners if the business is one in which capital is an income producing factor; the transfer is full, complete and in good faith; and adequate allowance is made for the donor's services and the apportionment of partnership income.[89] Whether a gift results upon creation of a family partnership depends upon the facts of each case. For instance, if a parent provides all or nearly all of the capital, the children are to provide most of the labor and management, and the income and capital shares are to be equal, a gift to the children may result.[90] As a result, partnership capital and income shares should be carefully calculated.

Estate planning for partners in a family partnership often involves the transfer of partnership interests to minors. For federal income tax purposes, a minor is generally not recognized as a member of a partnership unless a fiduciary exercises control of the property for the minor's benefit, or the minor is shown to be com-

87. *See, e.g.*, United States v. Ramos, 393 F.2d 618 (9th Cir.), *cert. denied*, 393 U.S. 983 (1968). In Lizzie M. Manual, 54 T.C.M. 138 (1983), a family farm partnership was held not to exist where the children partners did not contribute capital, the farm was not conducted like a partnership, and there was no written partnership agreement. *Id.* Similarly, under the Internal Revenue Code, a person is recognized as a partner if the person owns a capital interest in a partnership in which capital is a material factor in producing income. I.R.C. § 704(e)(1).

88. *See* Lizzie M. Manual, 54 T.C.M. 138 (1983).

89. I.R.C. § 704(e); Treas. Reg. § 1.704-1(e) (1988). To the extent that these requirements are not met, income is reallocated by making a reasonable allowance for the services of the donor and donees and by attributing the balance of the income to the partnership capital of the donor and of the donees in accordance with their respective interests. *See* Treas. Reg. § 1.704-1(e)(3)(i)(b) (1988). Also, the "reasonable allowance" rule for service rendered is not made applicable to family members who are not donors. *See* I.R.C. § 704(e)(3).

90. *See, e.g.*, Fischer v. Commissioner of Internal Revenue, 8 T.C. 732 (1947); Gross v. Commissioner of Internal Revenue, 7 T.C. 837 (1946).

petent to manage the property and participate in partnership activities.[91]

3. *Advantages of the Partnership Form*

In addition to the advantage of not being a taxpayer with respect to partnership income, a partnership may be organized tax free. Neither the partnership nor any partner realizes gain or loss on the transfer of property to an existing or newly formed partnership.[92] The basis of the contributed asset in the hands of the contributing partner carries over to the partnership.[93] However, if a partner loans or leases an asset to the partnership or contributes only its use to the partnership, the asset is treated as individually-owned for purposes of depreciation and income tax aspects of sale or exchange.[94]

A partner in a farm or ranch partnership may also have an advantage under the Social Security Law. Regardless of whether a partner contributes capital or services, the partner will have self-employment income which will be subject to tax and will yield Social Security benefits.[95]

In general, partnership interests are freely transferable with little risk of partnership termination.[96] Capital gain or loss, as

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91. Treas. Reg. § 1.704-1(e)(2)(viii) (1988). In general, a valid family partnership will not exist unless dominion and control of the partnership interest vests in the transferee. Treas. Reg. § 1.704-1(e)(1)(ii) (1988). Similarly, it is unclear whether a partnership interest is a "transferable share" so that the Uniform Gifts to Minors Acts (U.G.M.A.) would apply. *See* U.G.M.A. § 1(A) (1966). However, a minor will be considered competent to manage his own property if the minor "has sufficient maturity and experience to be treated by disinterested persons as competent to enter business dealings and conduct his affairs on equal footing with adults," regardless of the legal disabilities of minors under state law. Treas. Reg. § 1.704-1(e)(2)(viii) (1988).

92. I.R.C. § 721(a). *See, e.g.*, Otey v. Commissioner of Internal Revenue, 70 T.C. 312 (1978). However, the nonrecognition rules do not apply if the partnership is an investment company. I.R.C. § 721(b). The IRS has ruled that a partnership having assets consisting of 62% marketable securities, 35% timberlands, and 3% timber cutting rights was not an investment company. Priv. Ltr. Rul. 90-13-016 (Dec. 22, 1989). The IRS based its decision on the taxpayer's statements that the cutting rights would be disposed of within two years, that no timberland would be sold in the same two year period and not more than 10.5% would be sold within five years, and that less than 70% of partnership assets would consist of marketable securities in the following five years. *Id.*

93. I.R.C. § 723.

94. Treas. Reg. § 1.704-1(c)(1) (1988).

95. In Zampa v. Commissioner, 59 T.C.M. (P-H) 561 (1990), a wife became very involved in her husband's Amway distributorship and was found to be a partner subject to self-employment tax. However, a limited partner's share of partnership income is not self-employment income. I.R.C. § 1402(a)(12); Rev. Rul. 79-53, 1979-1 C.B. 286.

96. A partnership will terminate only if 50% or more of the interests are transferred within a 12-month period. I.R.C. § 708(b)(1)(B). *See also* Treas Reg. § 1.708-1(b)(1)(i)(a) (1956). Similarly, the death of a partner, of itself, does not terminate the partnership or close the partnership tax year as to the partnership, the surviving partners, or the deceased partner's interest. I.R.C. § 706(c)(1). If the decedent's estate continues as a partner, the estate simply steps into the shoes of the decedent. The taxable year of the partnership does

measured by the difference between the amount realized and the adjusted basis of the partner's interest in the partnership results from the sale or exchange of a partner's interest in the partnership.[97] However, the portion of proceeds attributable to the partner's share of unrealized receivables and substantially appreciated inventory is carved out and produces ordinary income or loss.[98]

4. *Disadvantages of Partnership Form*

Probably the best known and largest disadvantage of operating the farm or ranch business in the partnership form is the unlimited liability of partners for partnership obligations.[99] If the partnership becomes insolvent, the partnership creditors have priority against partnership assets.[100] The creditors of individual partners are first in line to grab the other property of the individual. If anything remains, partnership creditors can recover against assets of the individual partners.[101]

Partnerships are also relatively less stable than corporations. For federal income tax purposes, a partnership terminates when it ceases to operate or there is a change of fifty percent or more in partnership capital and profits within a twelve-month period.[102] When a partner dies, the partnership is terminated unless the decedent's estate (or other successor in interest) continues to share

not close, and the estate reports all the income for the year of death. The partnership tax year closes as to the deceased partner's estate when the estate's interest is completely liquidated or completely sold by the estate. Treas. Reg. § 1.706-1(c)(3)(i) (1987). An election may also be made permitting a stepped-up basis for partnership assets for a partnership interest that is sold or passes at death. I.R.C. § 754.

97. Treas. Reg. § 1.741-1(a) (as amended in 1980).

98. *Id.* Unrealized receivables are rights to payment for goods or services which have not been reported as income. I.R.C. § 751(c). For cash-basis farm partnerships, the right to the sales proceeds of all grain or livestock that has been sold, but for which payment has not been received, constitutes an unrealized receivable. *Id.* Potential depreciation recapture under I.R.C. §§ 1245 and 1250, potential recapture of soil and water conservation expense, land-clearing expense, and potential gain from "farm recapture property" are all considered to be unrealized receivables. I.R.C. § 751(c).

Substantially appreciated inventory means the entire partnership inventory if the inventory exceeds 10% of the fair market value of all partnership property other than money, and the total market value of the aggregate inventory exceeds 120% of the aggregate adjusted basis of the entire inventory. I.R.C. § 751(d)(1). Inventory includes all items held for sale and receivables and does not include capital assets or § 1231 items such as breeding stock, machinery, and land. I.R.C. § 751(d)(2).

99. U.P.A. §§ 13-17.

100. U.P.A. § 40(b)(I).

101. *Id.* Limited liability can be achieved through use of a limited partnership. *See* UNIFORM LIMITED PARTNERSHIP ACT (U.L.P.A.) § 303 (1976). A limited partnership is comprised of two or more persons with one or more general partners and one or more limited partners. *Id.* However, limited liability will be lost if a limited partner takes part in the control or management of the partnership business. *Id.* at § 303.

102. I.R.C. § 708(b)(1).

in profits or losses of the partnership business.[103] If the surviving partner continues the business, the partnership is terminated when the estate receives its last payment.[104]

Another disadvantage of the partnership organizational form is that a partner is unlikely to be an employee of the partnership for purposes of participating in fringe benefits and treatment of meals and lodging.[105] However, some courts have disagreed, and have granted partners employee status for purposes of meals and lodging,[106] and the foreign-earned-income exclusion.[107]

A partnership is usually restricted to a calendar tax year.[108] However, a partnership must conform its taxable year to the taxable year of one or more of its partners who have an aggregate interest in partnership profits and capital of more than fifty percent.[109] If the partners owning a majority of partnership profits and capital do not have the same taxable year, the partnership must adopt the same taxable year as its principle partners.[110] If neither rule can be met, the partnership must use a calendar year or other year that is prescribed in Regulations section 1.706-1T.[111]

Another disadvantage of partnership organizational form is that while ordinary income and losses pass through to the partners with a partner reporting his or her distributive share of partnership income in the calendar year (or fiscal year) during which the partnership taxable year ends, loss deductions by partners are limited to the income tax basis of the partnership share unless the partner invests more in the partnership or otherwise increases the basis of the partnership interest.[112] For instance, assume that ABC Farms is a partnership and that son (as a cash basis taxpayer) made

103. Treas. Reg. § 1.708-1(b)(1)(i)(a) (1956).

104. Treas. Reg. § 1.736-1(a)(6) (as amended in 1965).

105. Rev. Rul. 184, 1969-1 C.B. 256.

106. *See, e.g.*, Armstrong v. Phinney, 394 F.2d 661 (5th Cir. 1968).

107. *See, e.g.*, Miller v. Commissioner of Internal Revenue, 52 T.C. 752 (1969), *acq.*, 1972-2 C.B. 2.

108. I.R.C. § 706(b).

109. I.R.C. § 706(b)(1)(B)(i).

110. I.R.C. § 706(b)(1)(B)(ii). A principle partner is a partner having an interest of five percent or more in partnership profits or capital. I.R.C. § 706(b)(3).

111. I.R.C. § 706(b)(1)(B)(iii). For an illustration of the approach of § 1.706-1T, see Priv. Ltr. Rul. 89-07-042 (Nov. 23, 1988). An exception to the above rules may be important for farm businesses. A partnership may retain a fiscal tax year if it receives the Commissioner's permission and can establish a business purpose. I.R.C. § 706(b)(1)(C). For farmers and ranchers, the existence of a natural business year which ends soon after the peak period is a good business purpose argument. For instance, if the farm or ranch receives 25% or more of its gross receipts in the last two months of the particular year and has done so for three years, the IRS will likely find a business purpose. *See* Rev. Proc. 83-25, 1983-1 C.B. 689. However, the fact that the farm or ranch uses more hired labor at particular times of the year does not support a business purpose.

112. I.R.C. § 705(a)(2).

a sole contribution of raised livestock valued at $75,000. Son's basis for his partnership share would be the basis to him of the contributed livestock, namely, zero. If ABC Farms loses money, son will not receive a deduction.[113]

As a result, if the possibility exists that the farm or ranch operation may be acquired at a later time, organizing the business as a partnership may not be desirable. An additional disadvantage of the partnership organizational form is that a partnership cannot be a party to a reorganization as defined in the Internal Revenue Code.[114]

VI. CONVERTING THE FARM OR RANCH C CORPORATION TO AN S CORPORATION

The second type of client contemplated for purposes of this article is the farmer or rancher who is currently operating the business in the regularly taxed C corporate form and desires to convert to a Subchapter S corporation. As we have already seen, TRA '86 has made the use of an S corporation significantly more attractive in many situations. However, the estate planning practitioner must realize that it is not possible to utilize Subchapter S to undermine the repeal of the "General Utilities" doctrine by having a C corporation elect Subchapter S status and then sell or distribute its assets and liquidate without incurring a double tax. Section 1374 of the Internal Revenue Code was enacted to prevent this result.

A. TAXATION OF BUILT-IN GAIN

In general, section 1374 imposes a tax at the corporate level on the appreciation of assets (referred to as "built-in gain") that occurred before the S corporation election.[115] The tax only affects S corporations that had operated as a C corporation at some point in time and applies to taxable years after 1986.[116] The amount of tax is determined by applying the highest rate of tax specified in section 11(b) of the Code[117] and is intended to result in a tax that is

113. For the purpose of computing loss deductions, the basis of a partner's partnership interest is computed at the end of the partnership year in which the loss occurred. Treas. Reg. § 1.704-1(d) (1988). Additionally, a partner's share of all partnership liabilities is added to the basis, even though it does not appear on the partnership books under the cash method. Rev. Rul. 60-345, 1960-2 C.B. 211.

114. *See* I.R.C. § 368(a)(1).

115. I.R.C. § 1374(a).

116. Tax Reform Act of 1986, Pub. L. No. 99-514, § 633(b) 100 Stat. 2085, 2269 (1986).

117. I.R.C. § 1374(b)(1).

equivalent to that which would have resulted had the sale or distribution occurred in a C corporation. However, treatment identical to that of a C corporation is not obtained because section 1374 imposes two levels of tax immediately. This result does not necessarily occur in a C corporation because no tax is imposed at the shareholder level until the sales proceeds are distributed. In contrast, the gain of an S corporation is passed through to the shareholders immediately. Therefore, the recognition of tax at the shareholder level is accelerated by section 1374.

While certain transitional rules concerning the applicability of section 1374 existed in the past,[118] section 1374 is fully applicable to C corporations that elect S status after December 31, 1988. The new section 1374 imposes a tax on the electing S corporation if the S corporation disposes of assets with built-in gain within ten years after the corporation has become an S corporation.[119] The tax is imposed on the net recognized built-in gain which is determined by computing the fair market value of the S corporation's assets as of the beginning of the first taxable year for which the S election is in effect over the aggregate adjusted basis of the corporation's assets.[120] As previously indicated, the amount of tax imposed is determined by applying the highest rate of tax specified in section 11(b) to the net recognized built-in gain for the taxable year.[121] In computing taxable income for this purpose, no net operating loss deduction is allowed and no deductions are allowed under sections 243 to 247, 249, and 240.[122]

For corporations that elect S status on or after March 31, 1988, the corporation must carry over the net recognized built-in gain which is not taxed because of the taxable income limitation.[123] This gain will be treated as recognized built-in gain in the next taxable year of the corporation.[124] Since the tax is imposed only on

118. TRA '86, Pub. L. No. 99-514, §§ 633(d)(1)-(8).

119. *See* I.R.C. §§ 1374(d)(3), (d)(7).

120. Installment reporting of net unrealized built-in gain (I.R.C. § 1374(d)(1)) is unavailable. I.R.S. Notice 90-27, 1990-1 C.B. 336.

121. I.R.C. § 1374(b)(1).

122. *See* I.R.C. § 1374(b)(1).

123. I.R.C. § 1374(d)(2)(B).

124. *Id.* The amount of any built-in gains tax for any taxable year is treated as a loss that the S corporation sustained during the taxable year with the character of the loss determined by allocating it proportionately among the recognized built-in gains that spawned the tax. I.R.C. § 1366(f)(2).

Operationally, if an S corporation is subject to the built-in gains tax for its current taxable year due to a carryover of recognized built-in gains from an earlier C corporation tax year, the amount of the built-in gains tax imposed may be used to reduce the corporation's income for the current taxable year which will be passed through to the shareholders. *Id.*

For example, assume in calendar year 1992 that ABC Farms (an S corporation electing an S corporation, termination of the election will eliminate the section 1374 tax. However, once the S election is terminated, the Subchapter C rules will reapply.

For tax years 1990 and later, net operating loss and capital loss carryforwards are not treated as separate items of built-in deductions, but simply offset net recognized built-in gains.[125] Similarly, built-in income and built-in deduction items (*i.e.*, accounts receivable and accounts payable of cash basis taxpayers) are accounted for in computing the net unrealized built-in gain of the S corporation as of the first day of the first taxable year as an S corporation.[126] In addition, an S corporation may use any amount of alternative minimum tax credit carryover and business credit carryforwards that arose in a C corporation tax year to offset built-in gains.[127]

If assets that are acquired while the S election is in effect are sold, gain from the sale is not subject to the section 1374 tax.[128] In addition, any appreciation in the value of assets occurring after the S election will not be taxed. For example, assume ABC Farms is a corporation and elects under Subchapter S for calendar year 1992. ABC Farms owns unimproved land having a fair market value of $1,000,000 and an adjusted basis of $450,000 on January 1, 1992. ABC Farms sells the land for $1,200,000 in 1994. Therefore, $550,000 of the gain will be subject to tax under section 1374, but the other $200,000 will not.

In an attempt to make the concept of net recognized built-in gain more understandable, consider the following examples. Assume that ABC Farms was a C corporation that elected under Subchapter S, effective January 1, 1992. At the time of its election, ABC Farms owned two assets, land with a basis of $800,000 and a value of $650,000, and cattle/livestock with a basis of zero and a

in 1992) has net recognized built-in gain of $200,000. The tax under I.R.C. § 1374 will be $68,000 (34% x $200,000). The amount of any gain passed through to the ABC Farms shareholders is accompanied by a loss to the shareholders equal to the corporate tax imposed by I.R.C. § 1374. The loss is allocated proportionately among the items of built-in gain which produce the tax and pass through to the shareholders. I.R.C. § 1374.

125. *See* I.R.C. § 1374(d)(5)(B).

126. I.R.C. § 1374(d)(5)(C).

127. I.R.C. § 1374(b)(3)(B).

128. I.R.C. §§ 1374(a), (d)(2)(A). However, the Service presumes that the gains on sale or distribution of assets are built-in gains except to the extent that the taxpayer can establish that the appreciation accrued after the conversion. *See* Tax Reform Act of 1986, Pub. L. No. 99-514, § 632(a), 100 Stat. 2085, 2269 (1986). As a result, it is probably desirable to conduct an appraisal of the corporate assets at the time the S election is made in order to establish the precise amount of built-in gain potentially subject to I.R.C. § 1374. Similarly, since the § 1374 tax also applies to inventory property, it is important to note that the Service will use the inventory method of the taxpayer for tax purposes to identify whether property disposed of following an S conversion was held by the corporation at the time of conversion. I.R.S. Announcement 86-128, 1986-51 I.R.B.

value of $150,000. Since the total assets when added together have no net gain, there is no net unrealized gain as of January 1, 1992, and ABC Farms will not be subject to a built-in gains tax under section 1374. Consequently, if ABC Farms sells either the land or the cattle/livestock during 1992, it would not be subject to a built-in gains tax under section 1374 on the gain recognized.

As another example, assume ABC Farms, a former C corporation, makes a Subchapter S election, effective January 1, 1992. On that date, ABC Farms has two assets, land with a value of $700,000 and a basis of $800,000, and cattle/livestock with a value of $150,000 and a basis of zero. Net unrealized gains as of the date of the election are therefore $50,000. This total results because recognized built-in losses are subtracted from recognized built-in gains in determining "net recognized built-in gain."[129] Thus, if the cattle/livestock were sold during 1992 for $150,000 while the land was retained, ABC Farms would recognize gain of only $50,000.

As a final example, assume that ABC Farms, a former C corporation, elected under Subchapter S for the year beginning January 1, 1992. At that time, ABC Farms owned the following assets:

	Land	Equipment	Buildings	Cattle/ Livestock
Value	$300,000	$400,000	$115,000	$150,000
Basis	$450,000	$325,000	$ 65,000	$ - 0 -
Built-In Gain	($150,000)	$ 75,000	$ 50,000	$150,000

The total value of the assets is $965,000 while the total basis is $840,000. As a result, net unrealized gains at the beginning of the first S corporation year totalled $125,000. Assume that the equipment is sold in 1992 for $420,000. The corporation would have recognized built-in gains in 1992 of $75,000. If the cattle are then sold in 1993 for $175,000, only $50,000 in recognized built-in gains will occur in 1993.

As noted in the above examples, the maximum amount of net recognized built-in gains on which tax may be imposed under section 1374 is limited to the net unrealized built-in gains of the C corporation as of the effective date of the Subchapter S election.[130] As a result, C corporation shareholders might be encouraged to transfer a loss asset to the corporation before an S election is made.

129. *See* I.R.C. § 1374(d)(2).
130. I.R.C. § 1374(c)(2).

This transfer of assets with a built-in loss would reduce the total net unrealized built-in gain, thereby sheltering future gain recognition events. However, the Service has stated that it would issue regulations providing that the contribution of loss assets to a corporation in contemplation of election under Subchapter S would not reduce the corporation's net unrealized built-in gain where tax avoidance motivated the contribution.[131] In addition, the Service indicated that contributions of loss property within two years of the earlier of the effective date of the S election or the date of filing of the election would be presumed to have a tax avoidance motive unless a clear and substantial relationship between a loss property and the current or future business of the corporation was shown.[132]

B. EXCESS PASSIVE INVESTMENT INCOME

Any time a Subchapter C corporation with even a nominal amount of Subchapter C accumulated earnings and profits is converted to a Subchapter S corporation, the amount and timing of passive income must be closely monitored. With respect to passive investment income, the practitioner must be aware of two potential problems any time a C corporation converts to an S corporation: (1) termination of the S election; and (2) imposition of the passive investment income tax.

A Subchapter S election terminates if, for three consecutive S corporation taxable years, the passive investment income of the corporation exceeds twenty-five percent of the gross receipts and the corporation has earnings and profits at the close of each of three consecutive taxable years from years that the corporation was a regularly taxed Subchapter C corporation.[133] As a result, a new S corporation, an existing corporation without Subchapter C earnings and profits, and an existing S corporation that distributes all Subchapter C earnings and profits before the year-end, will not be subject to the passive investment income test. If a corporation's Subchapter S election terminates because the passive income test is not met, the election terminates as of the beginning of the first taxable year following the third consecutive taxable year.[134]

For farm and ranch S corporations, crop or livestock share

131. I.R.S. Announcement 86-128, 1986-51 I.R.B.
132. *Id.*
133. I.R.C. § 1362(d)(3)(A).
134. I.R.C. § 1362(d)(3)(A)(ii).

leases must be structured so as to prevent classification of the income as passive income. In general, it is probably wise to have the S corporation participate in all major farming decisions in return for a share of the crop or livestock produced by the land. For instance, the corporation should be given the right to participate in decisions regarding compliance with federal farm programs, quality and quantity of seed, irrigation, fertilizers to be applied, timing of harvest, and length of grazing season.[135]

The second passive investment income issue that must be addressed each time a Subchapter C corporation converts to a Subchapter S corporation is the passive investment income tax.[136] S corporations with accumulated earnings and profits from C corporation years must endure a tax which will be imposed at the highest rate for corporate income on the passive investment income in excess of twenty-five percent of gross receipts.[137] If the excess net passive income exceeds the corporation's taxable income, the taxable income is substituted for the excess net passive income in determining the section 1375 tax.[138]

V. DIVIDING AND/OR REORGANIZING THE FARM OR RANCH CORPORATION

Even after 1986, farmers and ranchers may find it desirable to conduct their operations in the regularly-taxed corporate form. For example, the C corporation provides limited liability for investor-shareholders,[139] permits the use of either a fixed or calendar tax year, and allows the use of either the cash or accrual method of accounting.[140] The C corporate form also permits beneficial use of

135. *See, e.g.*, Priv. Ltr. Rul. 90-03-056 (Jan. 27, 1990) (discussing the degree of activity required of a farm owner to prevent income that is received from being characterized as passive investment income under I.R.C. § 1362(d)(3)(B)).

136. I.R.C. § 1375(a).

137. I.R.C. § 1375(a). Obviously if the 25% limit is exceeded for three consecutive taxable years, the S election will be terminated. However, the tax is not imposed if earnings and profits are accrued while the corporation is an S corporation.

138. I.R.C. § 1375(b)(1)(A).

139. REVISED MODEL BUSINESS CORPORATION ACT § 6.22 (1984).

140. In general, C corporations must use accrual-basis accounting. I.R.C. § 448(a)(1). However, C corporations engaged in farming whose gross receipts have not exceeded $25 million in any post-1985 year may use the cash-basis method if:

> (1) at least 50% of the total combined voting power of all classes of stock entitled to vote and at least 50% of the total number of shares of all other classes of stock are owned by members of the same family (I.R.C. § 447(d)(2)(C));
> (2) on October 4, 1976, and after, the members of two families owned, directly or indirectly, at least 65% of the total combined voting power of all classes of stock of the corporation entitled to vote, and at least 65% of the total number of shares of all other classes of stock of the corporation (I.R.C. § 447(h)(1)(A)); and
> (3) on October 4, 1976, and all times thereafter, members of three families owned, directly or indirectly, at least 50% of the total combined voting power of

graduated tax brackets unless corporate taxable income exceeds \$123,318.75.[141]

For farmers and ranchers, perhaps the major tax benefit of incorporation lies in the corporation's ability to provide the farmer or rancher with a tax-free residence while deducting depreciation and maintenance on the residence.[142] Similarly, corporate employers can provide health insurance without any part of the value of the insurance premiums being included in the employee's income.[143]

The C corporation, however, is a less appealing organizational form after 1986 due to the repeal of the "General Utilities" doctrine.[144] For corporate liquidations occurring before 1987, each shareholder's gain or loss was measured by the excess of the fair market value of the distribution (minus liabilities assumed) over the shareholder's income tax basis for the stock.[145] A shareholder's gain or loss was computed on a per share basis[146] and was treated as capital gain or loss if the stock was a capital asset in the shareholder's hands. As a general rule, the liquidating corporation did not recognize gain or loss.[147]

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all classes of stock entitled to vote and at least 50% of the total number of shares of all other classes of stock, and substantially all of the remaining stock is owned by corporate employees or their family members or by a tax-exempt employees' trust for the benefit of the employees (I.R.C. § 447(h)(1)(B)).

Likewise, C corporations engaged in farming or ranching can utilize the cash basis method of accounting if the gross receipts in all tax years began after December 31, 1975, have been less than \$1,000,000. I.R.C. § 447(d).

141. *See supra* note 19 and Appendix "A."

142. I.R.C. § 119. Similarly, farm or ranch hands who receive room and board on the premises which enables them to be present for early morning or late evening chores may exclude the value of the lodging from income, even if the corporation deducts a like amount from wages. Treas. Reg. § 1.119-1 (as amended in 1985); *see also* Greene v. Kanne, 38-1 U.S.T.C. ¶ 9206 (D. Haw. 1938) (value of living quarters provided to plantation manager not taxable); Wilhelm v. United States, 257 F. Supp. 16 (D. Wyo. 1966) (value of food and lodging provided by ranching corporation not taxable to shareholder-employees); J. Grant Farms, Inc., T.C. Memo. 1985-174 (value of lodging and cost of utilities of a sole shareholder farm manager and his family not includable in income because on-farm residence was a necessary condition of employment in the swine raising and grain drying operation).

143. I.R.C. § 106. If the corporation does not provide health insurance but rather reimburses employees for incurred medical expenses, the employee need not include any part of the reimbursement in income unless the expenses have been deducted as medical expenses under I.R.C. § 213. *Id.* Corporations must be careful not to reimburse in favor of highly compensated individuals. I.R.C. §§ 105(h)(2)(A)-(B). Presumably, seasonal farm and ranch workers would be excluded from reimbursement without risk of discrimination.

144. *See supra* part I.

145. I.R.C. § 336.

146. Treas. Reg. § 1.331-1(e) (as amended in 1968).

147. However, gain could be recognized because of recapture of depreciation under I.R.C. § 1245 (*see* Treas. Reg. § 1.1245-1(a) (1971)) and § 1250 (*see* Holiday Village Shopping Center v. United States, 5 Ct. Cl. 566, 84-2 U.S.T.C. ¶ 9549 Ct. Cl. (1984), *aff'd* 773 F.2d 276 (Fed. Cir. 1985)). Similarly, gain could also be recognized from recapture of soil and water conservation and land clearing expense deductions (I.R.C. § 1252), recapture of

After TRA '86, however, the liquidating corporation recognizes gain or loss "on the distribution of property in complete liquidation as if the property were sold to the distributee at its fair market value."[148] As a result of this major change in the tax law, the potential for liquidating the farm or ranch operation must be factored into the simultaneous solution of the estate and business planning problem.[149]

Typically, liquidating or restructuring the farm or ranch business occurs because of the emergence of circumstances not anticipated at the time of corporate formation.[150] Similarly, there are many circumstances under which the shareholders of the farm corporation may desire to be free of it. For example, the death of the operator or the operating parents of the farm property may leave all shareholders in a position of being passive investors. A subchapter S election may not be possible because of the passive income rules.[151] The investors may wish to continue ownership and operation of the farmland, but may also wish to have the income distributed to them routinely without double corporation taxation. In such an event, liquidation is necessary and must be accompanied by a decision on the part of the shareholders as to the organization of their mutual ongoing endeavor.

If it becomes necessary to liquidate the farm or ranch corporation, a division or reorganization rather than a liquidation may accomplish the same goal with much less tax. For instance, a "type D" divisive reorganization[152] may be desirable upon the deaths of the parents who owned a controlling interest in a large farm or ranch operation so that the operation can be divided into separate entities for the on-farm and off-farm heirs. Similarly, a divisive reorganization may be utilized to retain assets in the cor-

government cost share payments excluded from income (I.R.C. § 1255), and from the disallowance of deductions for the expenses of an unharvested crop (I.R.C. § 1231(b)(4); Treas. Reg. § 1.1231-1(c)(5) (1982)).

148. I.R.C. § 336(a). *See supra* note 12. However, the liquidating corporation does not recognize gain or loss on its distribution of property to an "80% distributee" in a complete liquidation to which I.R.C. § 332 applies. *Id.* at (d)(3). Section 332 applies to a corporation which receives property from another corporation which distributed the property in complete liquidation. I.R.C. § 332.

149. A liquidation of the farm or ranch business may result, for example, from changed circumstances relative to the nature, size and scope of the operation, disagreements among shareholders, or further changes in tax laws pertinent to the farming or ranching operation.

150. Liquidation or restructuring may also occur if the purposes behind corporate formation have been fulfilled.

151. Under I.R.C. § 1362(b)(3)(A), a subchapter S election is not permitted if the corporation had subchapter C earnings and profits at the close of each of three consecutive post-1981 election years, and more than 25% of the corporation's gross receipts for each of those years consisted of passive income as defined by § 1362(d)(3)(D).

152. I.R.C. § 368(a)(1)(D).

porate form while dividing shareholder interests due to shareholder disputes or other valid business purposes.[153]

A. PROCEDURE

A divisive reorganization which has the effect of a liquidation involves three steps: (1) a formation of a new corporation (the subsidiary); (2) transfer of the assets of the distributing corporation (parent) to the subsidiary in exchange for its stock;[154] and (3) distribution of the stock in the subsidiary to the parent corporation's shareholders in exchange for their stock in the parent.

B. REQUIREMENTS TO ACHIEVE TAX-FREE STATUS

A divisive reorganization is essentially a tool that can be used to postpone gain recognition. While Congress intended that a change in investment ought not to be a taxable incident if the shareholder has essentially the same investment after the reorganization as before,[155] because a divisive reorganization contains the possibility of tax avoidance, there are various tests that must be met to achieve tax-free status.[156]

1. *Controlled Subsidiary*

In order for a distribution to shareholders in a corporate division to be tax-free, the subsidiary corporation whose stock or securities[157] are being distributed must be "controlled"[158] by the parent corporation immediately *before* the distribution.[159] In most corporate divisions, the control test is automatically satisfied because the parent corporation creates the subsidiary and holds all the voting and nonvoting stock.[160]

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153. *See infra* notes 168-74 and accompanying text.

154. The transfer would be a non-taxable exchange under I.R.C. § 351, unless liabilities in excess of basis are involved. *See* I.R.C. § 357(c).

155. *See* SENATE FINANCE COMM., INTERNAL REVENUE CODE OF 1954, S. Rep. No. 1662, 83d Cong., 2d Sess., *reprinted in* U.S.C.C.A.N. 4621, 4681, 4911-12 (1954).

156. The tests for tax-free status are contained in I.R.C. § 355.

157. Only stock or securities of the controlled corporation may be distributed tax-free. I.R.C. § 355(a)(1)(A). Boot is taxed. I.R.C. § 356(b)(2). While "stock and securities" are undefined in § 355, they presumably mean the same thing as they do for the other reorganization sections.

158. "Control" is defined in I.R.C. § 368(c) as the "ownership of stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock of the corporation." Under this definition, stock is divided into two classes—voting stock and nonvoting stock. Thus, ownership of 100% of voting stock and 60% of nonvoting stock would not constitute "control."

159. I.R.C. § 355(a)(1)(A).

160. Likewise, sufficient control is usually present if it was acquired in a tax-free

2. *Active Business*

Immediately *after* the distribution, both the parent corporation and the subsidiary corporation must be engaged in "the active conduct of a trade or business"[161] that has continued for the five-year period immediately preceding the distribution.[162] In the past, the Service maintained that the active business requirement could not be met if a single business were divided.[163] After suffering two judicial defeats,[164] the Service agreed that a single business could be divided.[165] Therefore, a single integrated, predistribution farm or ranch corporation can be divided into two separate post-distribution entities.

A corporation is considered to be engaged in the active conduct of a trade or business either if it is itself engaged in such trade or business or if substantially all of its assets consist of the stock and securities of a corporation (or corporations) that it controls (immediately after the distribution) which is engaged in the active conduct of a trade or business.[166] Active trade or business is defined as a corporation engaged in specific activities for earning income or profit.[167] Hence, a trade or business is a pursuit carried on for profit. For a pursuit to be recognized as a business, a profit motive must be present.[168] Likewise, a group of activities will be consid-

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exchange and the change of stock ownership was permanent. *See* Rev. Rul. 593, 1971-2 C.B. 1981.

161. I.R.C. § 355(b)(1)(A). The active business requirement is also met if, immediately before the distribution, the parent had no assets other than stock or securities in the subsidiary, and the subsidiary is engaged in the active conduct of a trade or business immediately after the distribution. I.R.C. § 355(b)(1)(B); *see also* Treas. Reg. § 1.355-3(c) (as amended in 1989) (listing numerous examples of what constitutes an active business).

162. I.R.C. § 355(b)(2)(B). The five-year requirement creates a presumption that if a business was actively conducted for five years, it was not created for avoiding the tax on dividends. While it is necessary that the same business be conducted over the five-year period, changes in business form are usually not material. However, a change in form that might pose a continuity problem is conversion from grain farming to dairy farming or cattle breeding. Alternatively, expansion of the farm operation, even if geographically remote, should permit tacking of the previous business history. Treas. Reg. § 1.355-4(b)(3) (as amended in 1989).

163. Treas. Reg. § 1.355-1(a) (as amended in 1989).

164. *See* Edmond P. Coady v. Commissioner of Internal Revenue, 33 T.C. 771 (1960), *acq.* 1965-2 C.B. 4, *non-acq.*, 1962-2 C.B. 9 (withdrawn), *aff'd*, 289 F.2d 490 (6th Cir. 1961); United States v. Marrett, 325 F.2d 28 (5th Cir. 1963).

165. Rev. Rul. 64-147, 1964-1 C.B. 136; Treas. Reg. § 1.355-1(b) (as amended in 1989).

166. I.R.C. § 355(b)(2)(A). The active business requirement is not satisfied if the subsidiary was acquired in a taxable exchange during the five-year period. Treas. Reg. § 1.355-4(b)(1) (as amended in 1989).

167. Treas. Reg. § 1.355-3(b)(2)(ii) (1992).

168. Under Rev. Rul. 75-366, 1975-2 C.B. 110, a person is engaged in the farming business for purposes of I.R.C. § 6166(b) if the person cultivates, operates, or manages a farm for gain or profit, either as an owner or tenant, and if the person receives a rental based upon farm production rather than a fixed rental. Similarly, in Treas. Reg. § 1.183-2(c) (1973) example (4), a person who operates a farm in the same manner as the parents operated it before their deaths and who does much of the labor around the farm could be

ered a business if the activities include every operation that forms a part of, or step in, the farming or ranching business.

The active business requirement is designed to prevent the transfer of liquid assets to a subsidiary followed by a liquidation, sale, or redemption of the subsidiary.[169] In general, the determination of whether a trade or business is "actively conducted" is made from an examination of all of the facts and circumstances.[170] The corporate performance of active and substantial managerial and operational functions is also required.[171] As a result, a division of the farm or ranch corporation may present particular problems. For example, the Service has stated that "the ownership and operation of land or buildings all or substantially all of which are used and occupied by the owner in the operation of a trade or business" does not constitute a business.[172] Consequently, a landholding corporation might not be engaged in a "business" for purposes of the active business requirement.[173]

For landholding to form an active business, the degree of activity must approximate that which is classified as material participation in other contexts.[174] For division of farm or ranch corporations into separate land owning and operating entities, the land should be leased to the operating entity under a crop share arrangement, with a strong record of involvement by the officers of the land owning entity, rather than on a cash rent basis for purposes of the active business requirement.[175] However, if the land-

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found to be engaged in a trade or business for profit. However, the passive receipt of income from leasing vacant land is not the active conduct of a trade or business. Rev. Rul. 68-284, 1968-1 C.B. 143.

169. Such a transaction could convert ordinary income into capital gain, thereby facilitating the bail-out of corporate earnings.

170. Treas. Reg. § 1.355-3(b)(2)(iii) (as amended in 1989).

171. *Id.*

172. Treas. Reg. § 1.355-3(b)(iv) (as amended in 1989). Similarly, the active business requirement specifically excludes passive business activities such as holding stock, securities, land or other property for investment purposes. *Id.*; *see also* Rev. Rul. 66-204, 1966-2 C.B. 113.

173. Treas. Reg. § 1.355.3(b)(2)(iv)(A). While the division of a farm or ranch corporation may result in separate operating entities each having sufficient land, livestock, and machinery to continue the operation, the division may also result in a single entity possessing the land and leasing it to the operating entity.

174. King v. Commissioner of Internal Revenue, 458 F.2d 245 (6th Cir. 1972).

175. For example, in Rev. Rul. 73-234, 1973-1 C.B. 180, an experienced farmer entered into agreements with approximately six tenants. *Id.* The farmer devoted significant time and effort to the farming business, including analysis of farm price support and acreage reserve programs, plans on crop rotation, planting, and harvesting, and plans on livestock breeding. *Id.* Additionally, the farmer hired seasonal workers, purchased farm equipment, and assumed responsibility for the sale of all crops and livestock. *Id.* The Service concluded that the active business requirement had been satisfied because the activities of the land-owning entity included the direct performance of substantial management and operational functions, separate from the functions that the tenant farmers performed. *Id.* at 181.

owning entity crop shares all of its land holdings and performs only managerial functions, it will likely fall short of satisfying the active business requirement due to the failure to perform substantial operational functions.[176] For planning puposes, it may be desirable for counsel to encourage farmers and ranchers to maintain a diary in order to provide the documentation necessary to substantiate the management and operational functions actively performed. Likewise, professional counsel should consider obtaining a private letter ruling on the proposed farm or ranch division if the facts and circumstances do not clearly indicate the likely outcome.

3. *"All" & "Only" Stock and Securities*

For a distribution to shareholders in a corporate division to be tax-free, the corporation must also distribute all of the stock and securities of the controlled corporation held by it immediately before the distribution, or an amount of stock in the controlled corporation constituting control as defined by section 368(c) of the Internal Revenue Code.[177] Distributions can be made on a non-pro-rata basis,[178] the distributing corporation's shareholders need not surrender stock,[179] and stock distribution of the controlled corporation need not be a distribution pursuant to a plan or reorganization within the meaning of section 368(a)(1)(D).[180]

Similarly, the distribution must be of "solely stock or securities."[181] Any other property will be treated as boot, and will be taxable.[182]

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176. *See, e.g.*, Rev. Rul. 86-126, 1986-2 C.B. 58 (finding that a farm corporation crop-shared rented farmland and shared expenses with a tenant who used the tenant's equipment to plant, raise, harvest, and sell crops did not satisfy the active business requirement, because the activities of the corporate officer who leased land, provided technical advice, and reviewed accounts were not substantial).

177. I.R.C. § 355(a)(1)(D). If all of the stock is not distributed, the corporation must convince the I.R.S. that the retention of stock was not for the purpose of tax avoidance. I.R.C. § 355(a)(1)(D)(ii). Similarly, the controlled corporation's stock should not be distributed on a piecemeal basis, since to do so may jeopardize the tax integrity of the transaction. *See* Commissioner of Internal Revenue v. Gordon, 391 U.S. 83 (1968).

178. I.R.C. § 355(a)(2)(A).

179. *Id.* § 355(a)(2)(B).

180. *Id.* § 355(a)(2)(C).

181. *Id.* § 355(a)(1)(A).

182. *Id.* § 356(b). Limited amounts of boot can be distributed without risk to the tax-free treatment of the stock and securities. *See id.* § 355(a)(4)(A). Boot includes obligations of the subsidiary corporation (*see* Priv. Ltr. Rul. 85-14-020 (Jan. 3, 1985)), money (*see* I.R.C. § 356(b)(2)), stock or securities of a noncontrolled corporation (*see* I.R.C. § 355(a)(1)(A), stock rights or warrants (*see* Treas. Reg. § 1.355-1(a) (as amended in 1989)), and the subsidiary's stock acquired within five years of a taxable exchange (*see* I.R.C. § 355(a)(3)(B)) or securities to the extent their principal amount exceeds the principal amount of securities surrendered in the distribution (*see* I.R.C. §§ 355(a)(1)(D), 368(c)).

4. *No "Device"*

To qualify as a tax-free division, the distribution must not be used "principally as a device for the distribution of earnings and profits of the distributing corporation or the controlled corporation or both."[183] The "no device" requirement is designed to preclude the use of a corporate division as a technique to remove earnings and profits from the corporation via a tax-free stock distribution preceding a shareholder's stock sale at capital gain rates.[184]

In general, the determination of whether a corporate division was used principally as a device for the distribution of earnings and profits will be based upon a consideration of all of the facts and circumstances surrounding the transaction.[185] A balancing test that takes into consideration the presence of device and nondevice factors will be utilized.[186] However, a corporate division that does not present the potential for tax avoidance will not be regarded as a device transaction regardless of the presence of any device factors.[187]

The presence of device factors is evidence of a device transaction, the strength of which depends upon the particular facts and circumstances surrounding the division,[188] including: (1) pro rata or substantially pro rata distributions;[189] and (2) a subsequent sale or exchange of the parent or subsidiary's stock after the distribution.[190]

Conversely, the presence of non-device factors is evidence of a non-device transaction, the strength of which depends upon the

183. I.R.C. § 355(a)(1)(B).

184. *See* Rev. Rul. 86-4, 1986-1 C.B. 174.

185. Treas. Reg. § 1.355-2(d)(1) (as amended in 1989).

186. *Id.*

187. *Id.* § 1.355-2(d)(5)(i). For instance, a corporate division will not be considered to be a device transaction if both the parent and the subsidiary have no accumulated earnings and profits at the beginning of their respective tax years, if the parent and the subsidiary have no current earnings and profits at the date of distribution and the parent corporation has no gain recognition (resulting in current earnings and profits) upon the distribution for the tax year of the distribution. *Id.* §§ 1.355-2(d)(5)(ii)(A)-(C).

Likewise, a corporate division is not a device for the distribution of earnings and profits if the transaction could escape dividend treatment in the absence of I.R.C. § 355. *See id.* § 1.355-2(d)(5)(iv). A transaction in which a shareholder exchanges all of the shareholder's stock in the parent corporation for all of the stock in the subsidiary (which would presumably qualify for capital gain treatment under I.R.C. § 302) is an example of such a transaction. *See* Rev. Rul. 83-114, 1983-2 C.B. 67.

Similarly, a corporate division will not be considered as a device for the distribution of earnings and profits if the transaction could escape redemption treatment in the absence of I.R.C. § 355. Treas. Reg. § 1.355-2(d)(5)(iii).

188. *Id.* § 1.355-2(d)(2).

189. *Id.* § 1.355-2(d)(2)(ii).

190. *Id.* § 1.355-2(d)(2)(iii).

particular facts and circumstances surrounding the division,[191] including: (1) a corporate business purpose;[192] and (2) the fact that the parent corporation is publicly traded and widely held.[193]

From a planning standpoint, a stock transfer restriction may be necessary. Such a restriction should prohibit the sale of stock or securities until a considerable time period after the distribution in order to avoid the Service's challenge that the distribution is a device for distributing earnings and profits.

5. *Judicial*

A corporate division will not be tax-free if it is carried out for purposes not germane to the business of the corporations.[194] Thus, the readjusted corporate structure must have a valid business purpose driven by substantially nontax reasons.[195] Examples of legitimate business purposes include shareholder disputes that affect the normal business operation,[196] court ordered divisions,[197] compliance with lender requirements for borrowing,[198] a desire to provide greater incentive to family members,[199] and attempts to make the parent corporation less vulnerable to takeovers.[200]

Additionally, the regulations provide that there must be a continuity of interest in all or part of the business enterprise on the part of those persons who, directly or indirectly, were the owners of the enterprise before the distribution or exchange.[201] This "continuity of interest" requirement is designed to prevent a tax-

191. *Id.* § 1.355-2(d)(3)(i).

192. *Id.* § 1.355-2(d)(3)(ii).

193. *Id.* § 1.355-2(d)(3)(iii).

194. Treas. Reg. § 1.355-2(b).

195. *Id.* § 1.355-2(b). However, a corporate division designed to avoid local taxes will constitute a valid business purpose in certain circumstances. *See, e.g.*, Priv. Ltr. Rul. 91-37-048 (Sept. 24, 1991).

196. *See, e.g.*, Priv. Ltr. Ruls. 91-41-029 (Oct. 22, 1991), 91-35-039 (Sept. 10, 1991), 91-33-026 (Aug. 27, 1991), 91-33-022 (Aug. 27, 1989), 89-13-047 (Jan. 4, 1989). *See also* Treas. Reg. § 1.355-2(b)(2), example (2). The shareholder dispute must be potentially damaging to the success of the business. Transactions undertaken solely for reasons personal to shareholders will *not* qualify. Treas. Reg. § 1.355-2(b)(1) (as amended in 1989).

197. *See, e.g.*, Commissioner of Internal Revenue v. Morris Trust, 367 F.2d 794 (4th Cir. 1966).

198. *See, e.g.*, Rev. Rul. 85-122, 1985-2 C.B. 118; Priv. Ltr. Rul. 81-37-125 (June 19, 1981).

199. *See, e.g.*, Priv. Ltr. Rul. 81-37-086 (June 17, 1981).

200. Priv. Ltr. Ruls. 91-47-039 (Aug. 20, 1991), 89-30-055 (May 3, 1989).

201. Treas. Reg. § 1.355-2(c) (as amended in 1989). The Service takes the position that the parent corporation's shareholders should retain at least 50% of the stock (Rev. Proc. 74-26, 1974-2 C.B. 478), because if the value of the stock given up is less than the value of the stock received, the excess is not shielded under § 355. *See also* Priv. Ltr. Rul. 88-21-001 (Oct. 20, 1987).

free division from accomplishing a result identical to a sale.[202]

C. CORPORATE TAX EFFECTS OF DIVIDING THE FARM OR RANCH BUSINESS

Assume that for valid estate and business planning purposes, the shareholders of ABC Farms (father and son) desire to divide the assets of ABC Farms between them. To effect the corporate separation, ABC Farms will initially organize XYZ Farms, a new corporation. ABC Farms will then transfer one-half of all of its real estate and other assets to XYZ Farms, solely in exchange for all of the stock of XYZ Farms. Finally, ABC Farms will distribute to either father or son all of the stock of XYZ Farms for all of that person's stock in ABC Farms. Upon completion of these transactions, two corporations emerge. Each corporation owns approximately one-half of the assets previously held by ABC Farms, one of which is wholly owned by father and the other of which is wholly owned by son.

In general, no income tax problems should be encountered upon formation of the subsidiary, and no gain or loss should be recognized upon conveyance of the real estate and other assets from ABC Farms to XYZ Farms if the transfer is solely for XYZ's stock and securities.[203] In addition, XYZ Farms does not recognize gain or loss upon receipt of assets from ABC Farms in exchange for stock or securities of XYZ Farms.[204]

The question remains, however, whether the transfer of assets from ABC Farms to XYZ Farms (for the distribution of stock or securities or both) triggers recapture of certain deductions as ordi-

202. *See, e.g.*, LeTulle v. Scofield, 308 U.S. 415, 421 (1940); Farr v. Commissioner of Internal Revenue, 24 T.C. 350 (1955).

203. I.R.C. § 361(a); *see also* Priv. Ltr. Ruls. 91-38-038 (Oct. 1, 1991), 91-33-026 (Aug. 27, 1991), 91-27-031 (Apr. 5, 1991), 91-27-026 (Apr. 4, 1991). The formation and transfer of assets from ABC Farms to XYZ Farms as a preliminary step to the division will constitute a division under I.R.C. § 368(a)(1)(D). XYZ Farms will carryover ABC Farms basis (I.R.C. § 362(b)) and holding periods (I.R.C. § 1223(2)). *See also* Priv. Ltr. Ruls. 91-47-039 (Aug. 20, 1991), 81-42-052 (Jul. 21, 1981). Similarly, if the assets transferred to XYZ Farms include an installment obligation, ABC Farms will not recognize gain or loss on the transfer (Treas. Reg. § 1.453-9(c)(2) (1976)), and XYZ Farms will report the payments as gain, return of basis, and interest in the same manner that ABC Farms reported them before the transfer (Treas. Reg. §§ 1.453-9(c)(3), (d)). I have assumed throughout that the assets involved are either liability free or are subject to liabilities that do not exceed the particular asset's adjusted basis. If, however, XYZ Farms assumed liabilities that exceeded the adjusted income tax basis of the property transferred to it, the excess would be considered gain. I.R.C. § 357(c). Additionally, if XYZ Farms assumed liabilities primarily to avoid income tax on the exchange (or there was no valid purpose for the transfer), then all liabilities that XYZ Farms assumed would be treated as boot received by ABC Farms. I.R.C. § 357(b).

204. I.R.C. § 1032(a). *See also* Priv. Ltr. Ruls. 91-38-038 (Oct. 1, 1991), 91-36-023 (Sept. 17, 1991), 91-35-019 (Sept. 10, 1991), 91-33-025 (Aug. 27, 1991), 91-27-031 (July 16, 1991).

nary income (as is the case with liquidations).[205]

Depreciation on depreciable personal property is not recaptured in a wholly tax-free corporate division, but it is recaptured to the extent gain is recognized on the transaction.[206] Thus, the recapture potential on the equipment transferred to XYZ Farms is not avoided, but merely postponed and transferred to XYZ Farms.[207] XYZ Farms will recognize the recapture depreciation when the equipment is disposed of in an nonexempt transaction.[208] Similarly, excess depreciation on the real estate transferred to XYZ Farms is not recaptured (except to the extent gain is realized),[209] but is postponed and will be encountered upon XYZ Farms' subsequent disposition of the property.[210]

The recapture rules also do not apply to soil and water conservation[211] or land clearing expense[212] deductions claimed on land transferred in a tax-free corporate division, except to the extent gain is recognized.[213] Likewise, if the land transferred to XYZ Farms had (at some point in time) been "acquired, improved or otherwise modified" due to government cost-sharing payments that were excluded from income, the excluded amount is apparently not recaptured as ordinary income, except to the extent that gain is recognized.[214]

If a farm or ranch corporate division involves the transfer of property (before the expiration of the property's useful life) upon

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205. *See* Beauchamp & Brown Groves Co. v. Commissioner of Internal Revenue, 371 F.2d 942, 943-44 (9th Cir. 1967). A similar concern is whether the IRS will attempt to reallocate income and deductions, assign income, bring a tax benefit challenge, or claim that the transaction lacks a business purpose. These so-called "midstream" challenges are particularly likely for farm and ranch corporations utilizing the cash method of accounting due to zero basis grain and livestock inventories for which prior deductions have been claimed.

For the liquidation of farm or ranch corporations, avoiding tax at the corporate level is possible by converting gain on zero basis inventory into capital gain. Thus, a variety of midstream challenges is possible for liquidations.

For tax-free divisions of farm or ranch corporations, however, all of the assets remain corporate property subject to the recognition of gain at corporate income tax rates upon sale or exchange. Thus, if the division of ABC Farms is carried out without obvious tax avoidance motives while existing patterns of crop and livestock sales and the timing of supplies and equipment purchases are maintained, midstream challenges should not occur.

206. I.R.C. § 1245(b)(3).

207. Treas. Reg. § 1.1245-2(c)(2) (1987).

208. *Id.*

209. I.R.C. § 1250(d)(3).

210. *Id.*

211. I.R.C. § 175.

212. I.R.C. § 182. A farmer could elect to treat expenditures paid or incurred in the clearing of land for the purpose of making the land suitable for farming as expenses not chargeable to a capital account (and therefore deductible) for tax years ending on or before December 31, 1985.

213. Treas. Reg. §§ 1.1252-2(c)(1), (c)(2)(iii) (1976).

214. I.R.C. § 1255(b)(1).

which investment tax credit has been claimed, the investment tax credit is recaptured unless the transfer is a "mere change" in the form of conducting the trade or business, or the transaction was subject to section 381(a) of the Code.[215] In order for the "mere change" exception to apply, four tests must ordinarily be met.[216]

First, the transferred property must be retained in the same business.[217] While the division of ABC Farms will result in both ABC Farms and XYZ Farms being engaged in a trade or business,[218] the two corporations will not be engaged in the "same business." Accordingly, recapture will occur.

The Regulations also require the parent corporation to retain a substantial interest in the subsidiary.[219] This requirement also poses significant problems for the division of ABC Farms. For example, while formation of XYZ Farms will not be troublesome,[220] once XYZ Farms' stock and securities are distributed to ABC Farms' shareholders, ABC Farms will not hold a "substantial interest" in XYZ Farms. As a result, investment tax credit will likely be recaptured.

In addition, the Regulations require substantially all of the assets (whether or not investment tax credit assets) to be transferred to the subsidiary in order to avoid recapture.[221] This requirement is almost never met and is not met in our case here, because we have assumed that only one-half of ABC Farms' assets will be transferred to XYZ Farms.[222]

215. See I.R.C. § 47(b)(2), as it existed prior to amendment by 90 P.L. 101-508, § 11813(a), which amended Code section 47 as part of the amendment to subpart E of part IV of subchapter A of Chapter 1, effective for property placed in service after Dec. 31, 1990. *See also* I.R.C. § 381(a); Giovanni v. United States, 90-2 U.S.T.C. § 50,542 (D. Or. 1990); Rev. Rul. 89-18, 1989-1 Cum. Bull. 14.

216. Treas. Reg. § 1.47-3(f)(1)(ii) (1988).

217. *Id.* § 1.47-3(f)(1)(ii)(a).

218. *See* I.R.C. § 355(b)(1)(A).

219. Treas. Reg. § 1.47-3(f)(1)(ii)(b) (1988).

220. Upon formation of XYZ Farms, ABC Farms would hold all the stock in securities in XYZ Farms.

221. Treas. Reg. § 1.47-3(f)(1)(ii)(c) (1987). In Baicker v. Commissioner of Internal Revenue, 93 T.C. 316 (1989), a shareholder of an S corporation that was formed following a type D divisive reorganization was not permitted to claim his pro rata share of an investment tax credit (ITC) based upon the amount of ITC recaptured by the parent corporation upon the reorganization. *Id.* at 317-19. The transfer of the assets from a division of the parent to the S corporation did not independently give rise to any ITC because the original use of the assets began with the parent corporation. *Id.* at 321. As a result, the assets could not be considered "new Section 38 property" in the hands of the S corporation. *Id.* at 330. In addition, I.R.C. § 381 (regarding carryovers of corporate attributes) could not be used to claim the recaptured ITC, because the S corporation did not receive substantially all of the parent's assets. *Id.*

222. However, in Loewen v. Commissioner, 76 T.C. 90 (1981), *acq.*, 1983-1 C.B. 1, investment tax credit was not recaptured upon the formation of a farm business where the farmland was retained in individual ownership rather than being transferred to the subsidiary. Similarly, based on Rev. Rul. 83-65, 1983-1 C.B. 10, the rental of retained

Finally, the Regulations require that the basis of qualifying investment tax credit property in the subsidiary's hands should be determined by reference to the basis in the parent's hands.[223] Thus, if no gain or loss is recognized when the assets are transferred from ABC Farms to XYZ Farms, no recapture of investment tax credit should occur.

In general, land used in a farming or ranching business for more than one year that is sold with an unharvested crop is treated as property used in the taxpayer's business.[224] As a result, the gain applicable to the farmland is subject to long-term capital gain treatment.[225] However, the growing crop receives capital gain treatment only if the underlying land is sold, exchanged, or converted at the same time and to a single person in a single transaction.[226] In order to prevent the deduction of costs incurred in raising a crop (that has been sold, exchanged, or involuntarily converted) against ordinary income, expenses of producing the crop are disallowed[227] and are added to the crop's income tax basis.[228] While it is not necessary for gain to be recognized on the sale, exchange, or involuntary conversion of farmland with unharvested crops to disallow production expense deductions,[229] it is necessary that a land transfer be in the nature of a taxable exchange for production expense deductions to be disallowed.[230] Thus, the rule disallowing production expenses for an unharvested crop would be inapplicable to a tax-free corporate division, except to the extent gain is recognized.[231] Consequently, if father and son anticipate gain recognition on the transaction, they may want to time the division to take place when there are no unharvested crops. A corporate division will also require ABC Farms' earnings and profits to be allocated between ABC Farms and XYZ Farms[232] in proportion to the fair market value of the "business" that ABC Farms retains and the fair market value of the "business" transferred to

farmland to the newly formed production entity should not result in recapture of investment tax credit because of the failure to transfer substantially all of the assets to the subsidiary.

223. Treas. Reg. § 1.47-3(f)(1)(ii)(d) (1987).

224. I.R.C. § 1231(b)(4).

225. *Id.*

226. *Id.* § 1231(b)(4).

227. *Id.* § 268.

228. *Id.* § 1016(a)(11).

229. *See* Beauchamp & Brown Groves Co. v. Commissioner of Internal Revenue, 371 F.2d 942 (9th Cir. 1967).

230. I.R.C. § 361; *see* Priv. Ltr. Rul. 79-42-094 (May 14, 1979).

231. Treas. Reg. § 1.268-1(b)(1)(A) (1958).

232. I.R.C. § 312(h)(1).

XYZ Farms immediately after the transfer.[233]

D. TAX EFFECTS TO THE SHAREHOLDERS

Upon ABC Farms' transfer of the stock and securities in XYZ Farms to son in exchange for son's stock in ABC Farms, neither father nor son will recognize gain or loss.[234] The basis of XYZ Farms' stock and securities in the hands of son will remain the same as the basis of ABC Farms' stock that son gave up in the exchange.[235] In addition, the holding period of the XYZ Farms stock that son receives will include the holding period of the ABC Farms' stock surrendered in the exchange (assuming that the ABC Farms' stock that son holds is a capital asset in son's hands).[236] The basis will be allocated among the stock and securities that son receives and any stock or securities of ABC Farms that were retained.[237]

VI. SUMMARY

The impact of TRA '86 on farm and ranch estate and business planning is substantial. Perhaps the major change wrought by TRA '86 was the repeal of the "General Utilities" doctrine, whereby corporate liquidating distributions will be subject to tax at both the corporate and shareholder levels. Thus, if the shareholders want to quit the corporate farming operation or it becomes necessary to remove the assets from the corporation or keep the farming operation going either as a partnership or as a sole proprietorship, the options are limited and most are taxable. As a result, practitioners must utilize alternative organizational forms and operational techniques as a means of accomplishing their client's estate and business planning objectives with much less tax.

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233. Treas. Reg. § 1.312-10(a) (1956).

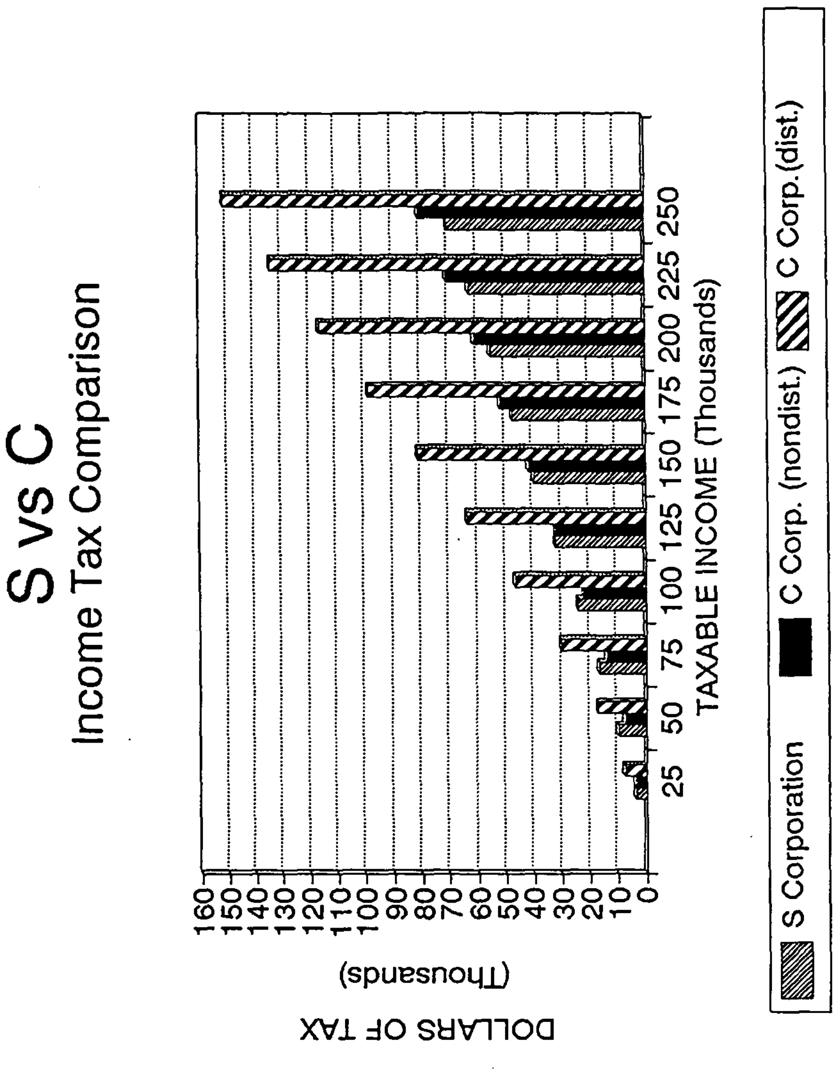
234. I.R.C. § 355(a)(1)(A); *see also* Priv. Ltr. Ruls. 91-38-038 (June 21, 1991), 91-35-039 (June 3, 1991), 86-11-014 (Dec. 9, 1985).

235. I.R.C. § 358(b)(1); *see also* Priv. Ltr. Ruls. 91-38-038 (June 21, 1991) and 91-27-031 (Apr. 5, 1991).

236. I.R.C. § 1223(a); *see also* Priv. Ltr. Ruls. 91-38-038 (June 21, 1991) and 91-27-031 (Apr. 5, 1991).

237. I.R.C. § 358(b)(2). The available income tax basis will be allocated on the basis of the fair market values of the stock and securities. Treas. Reg. §§ 1.358-2(a)(2), (3), (4) (as amended in 1979).

APPENDIX A


S vs C
Income Tax Comparison
DOLLARS OF TAX
(Thousands)
0
10
20
30
40
50
60
70
80
90
100
110
120
130
140
150
160
TAXABLE INCOME (Thousands)
25
50
75
100
125
150
175
200
225
250
S Corporation
C Corp. (nondist.)
C Corp.(dist.)