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Splitting Up the Family Corporation

By Lou Vlahos

Many of us encounter family-owned corporations in which the founder's children are engaged in the business to varying degrees. They may even own shares in the corporation. These situations present difficult estate and succession planning considerations for the family and the business.

It may be that two sibling actively participate in the business. They are capable and each aspires to lead the corporation. Eventually, their competing goals, personalities, or divergent management styles may generate enough friction between them, and within the business, so as to jeopardize the continued wellbeing of the business.

Alternatively, the siblings are interested in different parts of the corporation's business. Each sibling may be responsible for a different line of business; for example, a different product, service, or geographic region. Their differing interests may lead to disagreements as to the allocation of resources.

In other situations, the founder and his children may not see eye-to-eye. For example, the parent wants to emphasize the corporation's traditional line of business, while his children seek to develop an offshoot of that business.

It may be difficult, using traditional estate planning techniques, to accommodate the varying interests of family members involved in a single corporation. For example, assume that corporation is owned 80 percent by parent, 10 percent by daughter and 10 percent by son; it operates two lines of business; one line is managed by son and the other by daughter; neither has any interest in the other's line of business; how should parent transfer his shares of the corporation?

Equal gifts or bequests to each child would leave them as equal shareholders, with the potential for disagreement. Moreover, to the extent daughter's efforts increase the value of her business while son's business remains unchanged, will son be unfairly benefitted? Alternatively, what if parent operates an older line of business, while son and daughter operate a newer line? There is little growth potential for the older line, but the newer line is poised to take off. What estate planning can parent implement to shift the future appreciation of the new business line to the children and out of his estate?

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A solution may be found in a transaction that is associated with corporate tax planning, but which may yield estate planning benefits: the tax-free corporate separation.

When a corporation distributes appreciated property to its shareholders as a dividend or liquidating distribution, the corporation is treated as having sold that property for an amount equal to the property's fair market value, and it is taxed accordingly. The shareholders are taxed on their receipt of the property, either as a dividend or as payment in exchange for their shares.

There is an exception to this recognition rule, however, for certain distributions. In general, no gain will be recognized by either the distributing corporation ("Distributing"), or its shareholders if the following requirements are satisfied:

- Distributing distributes to some or all of its shareholders all of the stock of a subsidiary corporation controlled by Distributing ("Controlled");
- The distribution is not used principally as a device to distribute the earnings and profits of either corporation;
- Each of Distributing and Controlled is engaged, immediately after the distribution, in the active conduct of a trade or business, which has been actively conducted (by Distributing or Controlled) throughout the five-year period ending on the date of the distribution;
- There is a real and substantial business purpose for the distribution that cannot be accomplished by another nontaxable alternative, which is neither impractical, or unduly expensive;
- The distributee shareholders did not acquire their shares in Distributing by purchase during the five-year period ending on the date of distribution;
- Neither active trade or business was acquired in a taxable transaction during that period; and
- The distribution is not made pursuant to a plan by which at least 50 percent of Distributing or Controlled is acquired by third parties.

The determination of whether a trade or business is actively conducted is based on all the facts and circumstances. Generally, the corporation is required itself to perform active and substantial management and operational functions, though some of its activities may be performed by others. The holding of property for investment does not constitute the active conduct of a trade business; generally, neither does the ownership and operation of real estate.

Historically, the IRS has accepted a number of valid business purposes, including the following: (1) To provide equity in a business of Distributing or Controlled to a key employee; (2) To enhance the success of a line of Distributing's business by enabling the corporation to resolve management and other problems that arise in (or are exacerbated by) Distributing's operation of different businesses within a single corporation; (3) To resolve shareholder disputes in the management of a business.

These business purposes may be accomplished by contributing business assets to a new subsidiary (Controlled). These assets may represent a fraction of the assets used by Distributing in a single business; or they may represent a distinct business, separate from that retained by Distributing. After this asset transfer, Distributing distributes Controlled to some of Distributing's shareholders, in respect of or in exchange for some or all of their Distributing stock.

Assuming these requirements are satisfied, the three scenarios described above may be addressed as follows:

- Distributing creates Controlled, to which it contributes one-half of the business conducted by Distributing; Distributing then distributes Controlled to Parent and Son, in exchange for all of Son's shares in Distributing; this leaves Parent and Son as the owners of Controlled, while Parent and Daughter own Distributing; Parent may now transfer shares in separate corporations to each child.
- Distributing contributes one business to Controlled and then distributes Controlled to parent and son, as above. Parent and daughter continue to own Distributing and to operate the other business.
- Distributing contributes the "children's business" to Controlled and then distributes Controlled to Son and Daughter in exchange for all of their Distributing stock.

In each instance, the parties and their respective businesses may be separated without incurring income tax. This enables the children to pursue their own interests and retain the benefits of their own efforts. It allows parent to maintain some level of involvement, while also enabling parent to better tailor his gift and estate planning. In light of these benefits, a taxpayer should, in the appropriate circumstances, consider the application of a corporate separation to a family-owned business.

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