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Another Planning Option for C Corporations

-by Neil E. Harl*

In late 2012, we examined three possible options for dealing with a C corporation that had outlived its usefulness.[1] That article discussed the possibilities of corporate liquidation,[2] a type D, divisive corporate reorganization[3] and an entity sale of the C corporation. Each of those options has drawbacks – a corporate liquidation, under current corporate tax law, triggers a relatively heavy tax liability, especially at the corporate level, with all gains essentially treated as ordinary income; a corporate reorganization sidesteps that problem but still leaves the shareholders in a corporation, albeit it is usually their own corporation; and an entity sale typically endures a discounted selling price and could fall under the "applicable asset acquisition" rule that requires that the sale be deemed a sale of individual assets, not a sale of the entity.

Another possible option is a corporate stock redemption for the interest of a deceased shareholder or any other shareholder. That option is discussed in this article.

Redemptions (other than to pay death taxes and estate settlement costs)

The first point that should be made is that redemptions are governed by unusually complex rules and there is little hope that those rules will be simplified any time soon.

In a straightforward redemption, the corporation buys back the shares held by the shareholder wanting to give up their interest in the corporation (or shares held by an estate that views a redemption as a convenient way to convert the shares into cash). In general, the rules governing a redemption of a shareholder's stock offer various routes to the desired result – the redemption treated as a sale or exchange with the gains subject to capital gains treatment.[4] That result is a possibility if any one of three conditions is met – (1) the redemption is "not equivalent to a dividend;"[5] (2) the redemption is a "substantially disproportionate" redemption;[6] or (3) the redemption is a redemption of all of a shareholder's stock.[7] A redemption of stock not falling within any of those categories is treated as a dividend to the extent of corporate earnings and profits. Although capital gains and dividends in recent years have been taxed at the same rate,[8] the amount of gain involved may be different.

Redemption "not equivalent to a dividend." As originally enacted, the "not equivalent to a dividend" rule permitted redemptions of all of the stock of a shareholder with no treatment as a dividend.[9] Over the years, however, the regulations (and litigated cases) have narrowed that rule such that a redemption to qualify must result in a meaningful reduction of the shareholder's proportionate interest in the corporation *after application of the constructive ownership rules of I.R.C. § 318(a).*[10] With the constructive ownership or stock attribution rules considered in making the determination of whether a redemption

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is essentially equivalent to a dividend, it is almost impossible in a closely-held corporation owned by family members to meet the test.

Substantially disproportionate distribution. A distribution that is "substantially disproportionate" leaves the shareholders' interests essentially undisturbed and is, therefore, treated as a dividend.[11] In order to qualify as "substantially disproportionate," three requirements must all be met – (1) immediately after the redemption, the shareholder in question must own, directly or indirectly, less than 50 percent of the total combined voting power of all classes of stock entitled to vote (the attribution rules make this test difficult to meet in most closely-held, family owned corporations); (2) immediately after the redemption, the ratio of the shareholders' holdings of voting stock to all of the voting stock in the corporation must be less than 80 percent of the ratio which the voting stock the shareholder owned immediately before the redemption bore to the entire block of voting stock in the corporation; and (3) the redemption must not be carried out under a plan which is a series of redemptions resulting in a distribution which is not substantially disproportionate, in the aggregate, with respect to that shareholder. All of these possibilities are difficult to meet in a closely-held, family-owned corporation.

Termination of a shareholder's entire interest. A redemption is treated as a sale or exchange, entitled to capital gain treatment, if it is "in complete redemption of all of the stock of the corporation owned by the shareholder."[12] The key question is whether the attribution (or constructive ownership) rules apply. Usually, an individual is deemed to own the corporate stock held by a spouse, children, grandchildren and parents.[13] In addition to these "family" attribution rules, the stock owned by partnerships, estates, trusts and corporations is attributed to the beneficial owners.[14]

However, even if the family attribution rules apply, it is still possible for a complete redemption to be carried out of all of a shareholder's stock, if specified conditions are met. The family attribution rules (which are usually the critical issue in closely-held, family-owned corporations) can be waived for complete redemption of a shareholder's stock.[15] Waiver is also extended to partnerships, estates, trusts and corporations if the same requirements are met.[16]

To accomplish a complete termination of stock, three conditions must be met – (1) the shareholder in question must have no direct interest in the corporation after the redemption (including an interest as an officer, director or employee) other than an interest as a creditor (and an interest as a creditor must not be "proprietary" and must not be subordinate to the claims of general creditors);[17] the shareholder must not acquire an interest in the corporation within 10-years from the date of the distribution (other than stock acquired by gift or inheritance);[18] and (3) the former shareholder must agree to notify the Internal Revenue Service of the acquisition of any interest (other than stock received by gift or inheritance) within that subsequent 10-year period.[19]

The Internal Revenue Service had taken the position that the waiver procedure is personal to the shareholder whose stock is redeemed *and that estates and trusts could not waive the attribution rules*.[20] Nonetheless, a number of litigated cases permitted waivers of attribution by estates and trusts.[21] In 1982, in the Tax Equity and Fiscal Responsibility Act of 1982,[22] Congress paved the way for waivers to be filed by entities under specified circumstances.[23]

This move has reduced the risk of challenge by IRS if the specific requirements are met which includes a requirement that related person must agree to joint and several liability if stock is re-acquired within the 10-year period.[24]

This makes the termination of the redeeming shareholder's interest the most attractive strategy in many closely-held, family-owned corporations. The regulations state that a taxpayer can take advantage of the waiver rules with an agreement filed with a first regular return (or amended return filed on or before the due date of the original return with extensions) for the taxable year in which the distribution occurred.[25]

What about income tax basis?

If a redemption is treated as a "dividend," the income tax basis may be lost. However, that "lost" basis can be added to the income tax basis of the other stock, if any, owned by the shareholder whose stock is redeemed.[26] If all of a shareholder's stock is redeemed, which is the most likely circumstance, but the distribution is treated as a dividend because of the attribution rules, the income tax basis of the redeemed shares apparently is transferred to the stock owned by the "related' shareholders.[27]

ENDNOTES

1 See Harl, "Planning Options for C Corporations," 23 *Agric. L. Dig*. 169 (2012). See generally 8 Harl, *Agricultural Law* § 59.01[1] (2013); 2 Harl, *Farm Income Tax Manual* § 7.05[1] (2013 ed.).

2 See I.R.C. § 336(a).

3 I.R.C. § 368(a)(1)(D).

4 See I.R.C. § 302.

5 I.R.C. § 302(b)(1).

6 I.R.C. § 302(b)(2).

7 I.R.C. § 302 (b)(3).

8 I.R.C. § 1(a), amended by the American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, 126 Stat. 2313 (2012).

9 T.D. 6152, December 2, 1955, 1955-2 C.B. 61.

10 See, e.g., United States v. Davis, 397 U.S. 301 (1970).

11 I.R.C. § 302(b)(2).

12 I.R.C. § 302(b)(3).

13 I.R.C. § 318(a)(1).

14 I.R.C. § 318(a)(2).

15 I.R.C. § 318(c)(1).

16 I.R.C. § 302(c)(2)(C)(i).

17 I.R.C. § 302(c)(2)(A)(i).

[18] I.R.C. § 302(c)(2)(A)(ii).

[19] I.R.C. § 302(c)(2)(A)(iii).

[20] Rev. Rul. 72-472, 1972-2 C.B. 202.

[21] See Rodgers R. Johnson Trust v. Comm'r, 71 T.C. 941 (1979) (trust could file waiver agreement); Estate of Crawford v. Comm'r, 59 T.C. 830 (1973), *non-acq.,* 1974-2 C.B. 5 (waiver by estate with stock held by estate and beneficiary redeemed at the same time); Rickey v. United States, 592 F. 2d 1251 (5th Cir. 1979) (ten-year agreement filed six years after death of shareholder); Cruvant v. United States, 82-1 U.S. Tax Cas. (CCH) ¶ 9354 (W.D. La. 1982) (trust as distributee filed waiver five years after original return; waiver held to be timely filed because at time of original return, IRS position was that trusts could not file waivers).

[22] Pub. L. No. 97-248, 96 Stat. 324 (1982).

[23] I.R.C. § 302(c)(2)(C).

[24] I.R.C. § 302(c)(2)(C)(i)(II).

[25] Treas. Reg. § 1.302-4(h).

[26] Treas. Reg. § 1.302-2(c).

[27] See Treas. Reg. § 1.302-2(c), Ex. 2. See also Ex. 1. Example 3 appears to have been reserved and removed in 2009).

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr

ADVERSE POSSESSION

POSSESSION. The plaintiff purchased a rural property in 1976 neighboring the defendant's land which the defendant purchased in 2003. When the defendant purchased the property in 2003, $5000 was placed in escrow pending the resolution of a boundary dispute between the plaintiff and the seller of the defendant's property. The defendant had a survey done at the time of the purchase but the plaintiff alleged that the survey was incorrect and showed the boundary line well on to the plaintiff's property. The trial court ruled that the survey was incorrect and inconsistent with prior deeds transferring the defendant's property. The trial court also ruled that the plaintiff had acquired title to the disputed strip through continuous possession after purchase in 1976. The defendant had asserted at trial that the defendant had possessed the disputed strip for over seven years, counting from the date of possession, and had obtained title by adverse possession. However, the deed was not recorded until three months later, less than seven years before the plaintiff filed the current action. The court noted that, until the recording of the deed, the defendant could not claim adverse possession under color of title. The defendant also sought title by adverse possession by tacking on the possession time of the previous owner. The trial found that the defendant did not perform any farming activities on the disputed property for several months, breaking the continuity of possession and use from the previous owner. Thus, the appellate court affirmed the trial court's ruling and awarded title to the disputed strip by adverse possession to the plaintiff. **Pierce v. Paschall, 2013 Tenn. App. LEXIS 839 (Tenn. Ct. App. 2013)**.

The plaintiff and defendant purchased their neighboring farm properties from the same bankruptcy estate. The plaintiff's 1991 deed was corrected when the defendant purchased the neighboring property in 1992. At the time of the purchases an old electric fence ran along the boundary between their properties and the defendant had a survey performed and a new electric fence constructed to replace the existing fence. The survey showed the new fence was over the boundary by one to two feet. The plaintiff did not object to the location of the new fence and contributed to the cost of the fence. The survey was performed by locating a parallel line to the other side of the property. Unknown to either party, the county had moved the monument marker for the whole quarter section containing the parties' properties. When a survey was conducted in 2011 by the plaintiff, the surveyor used the relocated marker and determined that the fence was five to 21 feet on to the plaintiff's property. The trial court ruled that the 2011 survey was correct and that the defendant had not acquired title to the disputed strip by adverse possession or acquiescence because possession had not exceeded 20 years at the time of the petition. Although the trial court ordered the defendant to vacate the disputed strip, the trial court ordered the plaintiff to bear the cost of moving the fence, if the plaintiff elected to move the fence. The defendant argued that possession of over 20 years had occurred because the defendant could tack on the possession of the prior owner. The court rejected this argument because both properties were acquired from a single owner. A sole prior owner cannot acquire title by adverse possession or acquiescence of a fence from itself. finally, the court held that the fence did not establish the boundary by acquiescence because the defendant failed to show that the parties made an agreement to use the fence as their property boundary. **Valley Beau Farms, Inc. v. Schick, 2013 Wisc. App. LEXIS 1010 (Wis. Ct. App. 2013)**.

BANKRUPTCY

GENERAL

EXEMPTIONS.

IRA. The debtors, husband and wife, claimed an exemption for funds received from the husband's decedent mother's IRA. The debtor filed a declaration from the custodian of the IRA account that the custodian had received a Favorable Determination Letter from the IRS that the IRA was a tax-exempt account. The court