



Agricultural Law Press

Publisher/Editor

Robert P. Achenbach, Jr.

Contributing Editor

Dr. Neil E. Harl, Esq.

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Divisive Reorganizations: Don't Forget "Active Conduct of a Trade or Business"

-by Neil E. Harl*

Divisive, type D reorganizations have always been viewed as a useful business planning tool.¹ More recently, the incidence of intra-family disputes² as farmland values have risen to high levels³ has focused attention on the options available to solve the resulting problems. One of those options (but not the only option) is the divisive, type D reorganization.

Major steps in a divisive reorganization

It is generally recognized that a divisive reorganization requires three steps, taken in the following order, once the decision is made to go in that direction. If properly conducted, a divisive reorganization can be undertaken without negative tax consequences with the major cost being for accounting and attorney's fees.

Formation of a subsidiary (or multiple subsidiaries). Once the decision is made to proceed with such a reorganization, the first step is to form one or more subsidiaries. The number created should be one less than the number of individuals involved with the reorganization. Thus, if there are three parties owning an interest in a corporation, and all three are willing to be participants in the reorganization process, there should be two subsidiaries formed. One of the parties will end up with ownership of the "old" corporation, reduced in scale by the assets transferred to the two newly formed subsidiaries, and the other two each become the sole owner of the stock of one of the two new subsidiaries. For the reorganization to work properly, the subsidiaries should be formed by the "old" corporation, not by one of the individuals. In one recent instance, one of the individuals co-owning the "old" corporation took it upon himself to form the new subsidiaries. Ownership of the subsidiaries by the "old" corporation is necessary to carry out the reorganization as a tax-free transaction.

Transfer of selected assets to each of the subsidiaries. In what is often the most contentious step in the reorganization process, the second step involves the selection of assets to transfer into the two newly formed subsidiaries with the remaining assets retained by the "old" corporation. Thus, decisions must be made (and agreed upon) as to who gets which piece of equipment, livestock, land, cash items and anything else owned by the "old" corporation.

* Charles F. Curtiss Distinguished Professor in Agriculture and Emeritus Professor of Economics, Iowa State University; member of the Iowa Bar.

The regulations warn against using this as an occasion to transfer the low income tax basis assets to the lowest tax-bracket taxpayer of the three. That is obliquely referred to as a “device” and is frowned upon to the point that it can derail a reorganization.⁴

Distribution of the “old” corporation’s stock in the respective subsidiaries in exchange for the “old” corporation’s stock held by each of the parties. Each of the parties give up their stock in the “old” corporation and become the sole owners of a particular subsidiary which has already been funded with agreed-upon properties. As is the case with tax-free exchanges generally, except to the extent gain or loss is recognized, the income tax basis of the stock in the “old” corporation carries over to the subsidiary for each individual owner. Likewise, the income tax basis of the assets as “qualified property”⁵ transferred from the “old” corporation carries over to the appropriate subsidiary.

So what does this all mean for farm and ranch reorganizations?

The lessons for farm and ranch reorganizations are spelled out in two revenue rulings.⁶ In the first of the two revenue rulings, *Rev. Rul. 1973-234*, the reorganization involved a livestock share lease with active involvement in the operation which satisfied the active business requirement. The ruling states that the term “actively conducted” connotes substantial management and operational activities. The other ruling, *Rev. Rul. 86-126*, involved a crop share lease⁷ with sharing of some expenses but with the tenant providing most of the management. The ruling recites that the activities of the corporate officers in renting the land, providing advice and reviewing accounts were not substantial enough to meet the active business requirement.

In general, cash rent leases are viewed as failing the “active business” test inasmuch as it is difficult to meet the requirements for eligibility under the active business test because of the dominance of the tenant in management decisions. But it is

important to note that *even share rent leases can fail the test for a reorganization*. That calls for a careful assessment of the importance of meeting that test as required by the statute even under a crop share or livestock share lease.

ENDNOTES

¹ I.R.C. § 368(a)(1)(D). See generally 8 Harl, *Agricultural Law* § 59.07[2] (2015); Harl, *Agricultural Law Manual* § 7.02[6][c][i] (2015); 2 *Farm Income Tax Manual* § 7.06[c][i] (2015 ed.). See also Harl, “Consequences of Divisive, Type D, Reorganizations for S Corporations,” 22 *Agric. L. Dig.* 25 (2011).

² See, e.g., Harl, “Fairness in Estate and Business Planning,” 23 *Agric. L. Dig.* 153 (2012); Harl, “Ignoring Reality: Iowa Supreme Court Decides Case Involving “Oppression” by Majority Shareholder in Farm Corporation,” 24 *Agric. L. Dig.* 113 (2013); Harl, “The Latest Chapter in the Baur Saga,” 25 *Agric. L. Dig.* 129 (2014); Harl, “Farm and Ranch Estate (and Business) Planning—Part I,” 42 *Estate Planning* 8, #3 (2015).

³ See Duffy, “2013 Iowa Farmland Value Survey,” Iowa State University, December 2013 (5.1 percent increase in average farmland values in Iowa, a record).

⁴ I.R.C. § 335(a)(1)(B). See Treas. Reg. § 1.355-2(d).

⁵ See I.R.C. §§ 355(d), 355(c)(2), 361(c)(2).

⁶ See *Rev. Rul. 73-234*, 1973-2 C.B. 180; *Rev. Rul. 86-126*, 1986-2 C.B. 58.

⁷ The language of the ruling leaves some question as to whether the arrangement was what might be termed a conventional crop share lease.

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr

BANKRUPTCY

NO ITEMS.

FEDERAL FARM PROGRAMS

BEANS. The AMS has announced that it proposes to revise the United States Standards for Grades of Canned Baked Beans. AMS is proposing to replace process-specific language “Product description” in the standard with language reflective of current canned baked bean manufacturing practices. Additionally, AMS proposes separating the canned dried beans, canned pork and beans,

and canned baked beans grade standards from one shared standard document into three separate standard documents. **80 Fed. Reg. 50262 (Aug. 19, 2015).**

POULTRY. The FSIS has issued proposed regulations amending the definition and standard of identity for the “roaster” or “roasting chicken” poultry class to better reflect the characteristics of “roaster” chickens in the market today. “Roasters” or “roasting chickens” are described in terms of the age and ready-to-cook (RTC) carcass weight of the bird. Genetic changes and management techniques have continued to reduce the grow-out period and increased the RTC weight for this poultry class. Therefore, FSIS is proposing to amend the “roaster” definition to remove the 8-week minimum age criterion and increase the RTC carcass weight from 5 pounds to 5.5 pounds. **80 Fed. Reg. 50228 (Aug. 19, 2015).**