

Planning for Business Exits from C Corporations; Intrafamily Business Transactions; Other Developments

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Planning for Business Exits from C Corporations; Intrafamily Business Transactions; Other Developments

By: **Steve Gorin, Esq.**

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Planning for Business Exits from C Corporations; Intrafamily Business Transactions; Other Developments

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Overview


- Annual Charitable Contributions for Businesses after 2017 Tax Reform
- Sale of C Corp Stock – Code § 1202 Exclusion and Other Issues (including transitioning entities, which then ties into the last point below)
- Intrafamily Business Transactions after 2018 Tax Court Case

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Annual Charitable Contributions for Businesses after 2017 Tax Reform 


- \$10,000 limit (\$5,000 for married filing separately) for sum of state income tax, nonbusiness real estate tax, and nonbusiness personal property tax
- States started putting together ways around this using tax credits
- IRS responded with Notice 2018-54 (6/11/2018) and later Prop. Reg. §§ 1.170A-1(h)(3) and 1.642(c)-3(g), which would reduce the charitable deduction by the amount of the expected state tax credits if they exceed 15% of the contribution
- IRS response inadvertently omitted that this reduction would constitute a state income tax payment for federal income tax purposes

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Annual Charitable Contributions for Businesses after 2017 Tax Reform (II.G.4.d.i) 


- Nonbinding IRS announcement later said none of this affected deducting contributions as a business expense
- Transfers to a charity bearing a direct relationship to the taxpayer's trade or business that are made with a reasonable expectation of financial return commensurate with the amount of the transfer may constitute allowable deductions as trade or business expenses rather than as charitable contributions
- A taxpayer that promises to donate a portion of its sales or profits to organizations that it specifies may deduct those donations as business expenses so long as the expenditure is not expressly precluded from being deducted (the latter including lobbying expenses)

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Annual Charitable Contributions for Businesses after 2017 Tax Reform (II.G.4.d.i) 

Rev. Proc. 2019-12: C Corporation

- If a C corp makes a payment to charity and receives or expects to receive a tax credit that reduces a state or local tax imposed on the C corp in return, the C corp may deduct the payment under Code § 162(a) to the extent of the credit received or expected to be received, without needing to prove the business purpose for that part
- C corp receiving a 100% tax credit deducts entire contribution under Code § 162(a) - no need to prove business purpose
- C corp receiving an 80% tax credit deducts 80% without needing to prove business purpose and 20% if and to the extent that it proves business purpose

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Annual Charitable Contributions for Businesses after 2017 Tax Reform (II.G.4.d.i)



Rev. Proc. 2019-12 – S Corporation or Partnership But Not Disregarded Entity.

Same rules as C corporation apply if:

- Operate Code § 162 trade or business
- Credit is for state or local tax incurred in carrying on its trade or business that is imposed directly on the entity (not on the recipient of a K-1 from the entity)
- The state or local tax is not income tax (example states that real property tax qualifies)

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Sale of C Corp Stock – Code § 1202 Exclusion and Other Issues



- Code § 1202
- Other opportunities when dispose of C corporation stock
- Income tax dynamics for various types of exit
- Changing type of entity

Then transition to other topic of intrafamily business transactions after 2018 Tax Court case, which is relevant to changing type of entity

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Code § 1202 Exclusion (II.Q.7.k.)



- Amount of exclusion
- Stock issuance requirements
- Which businesses qualify
- Business structure

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Amount of Code § 1202 Exclusion

Greater of:

- \$10M (\$5M married filing separately) cumulative
- 10 times adjusted basis of stock sold during the taxable year


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Stock issuance requirements

Original issue stock

- Must be issued to seller & held for 5 years
- Purchased stock does not count
- Redemption 2 years before or after issuance might be stepped together
- Compensatory transfer from a shareholder to the taxpayer counts as originally issued to the taxpayer without triggering this rule


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Stock issuance requirements

Exceptions to original issue requirement:

- Seller received as compensation and is retiring or otherwise terminating service
- Passing by reason of death, gift, or trust distribution or bought within 3 years and 9 months from the date of the decedent's death
- Bought due to divorce, disability, or mental incompetency

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Stock issuance requirements

Multiplying \$10M exclusion by gifting:

- Gifts do not violate original issuance
- Holding period tacks, so gifts can be made at any time so long as not before assignment of income doctrine kicks in
- If insufficient lifetime gift tax exemption, consider incomplete gift nongrantor trust
- Beware Code § 643(f) multiple trust rules

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Which businesses qualify

Assets:

- Gross assets no more than \$50M immediately after issuance
- At all times after issuance, at least 80% of value of corporation's assets are used in the active conduct of one or more qualified trades or businesses
- Investment assets are OK if used in qualifying business within two years

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Which businesses qualify

Business cannot be:

- performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any other trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees


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Which businesses qualify 


Business cannot be:


- Banking, insurance, financing, leasing, investing, or similar business
- Farming or timber
- Production or extraction of products, such as oil, gas and mines, eligible for certain depletion deductions
- Operating hotel, motel, restaurant, or similar business

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Which businesses qualify 


- Cannot have more than 10% of the total value of its assets consist of real property which is not used in the active conduct of a qualified trade or business
- Ownership of, dealing in, or renting of real property is not treated as the active conduct of a qualified trade or business
- Renting the property to the business may be better anyway (for basis step-up opportunities)

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Business Structure 

- Cannot be a former S corporation
- However, an S corporation can own Code § 1202 stock
- An S corporation could transfer its assets to a new C corporation to qualify
- Corporate formation taxable if liabilities exceed basis
- Corporate reorganization to form C corporation may require keeping original tax ID, so asset transfer may be necessary


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Business Structure

Subsidiaries:

- Stock and debt in any subsidiary corporation are disregarded and the parent corporation is deemed to own its ratable share of the subsidiary's assets and to conduct its ratable share of the subsidiary's activities
- Parent must own more than 50% of the combined voting power or more than 50% in value of all outstanding stock


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Business Structure

Subsidiaries:

- Parent fails the active business asset test for any period during which more than 10% of the value of its assets (in excess of liabilities) are non business assets, which includes stock or securities in other corporations that are not subsidiaries of the parent
- Partnership interests are not covered by the subsidiary exception
- Presumably a single member LLC subsidiary would be disregarded, but why take risk when a wholly owned corporate subsidiary is largely transparent?


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Business Structure

Brother-Sister corporations:

- Each shareholder has a separate \$10M limitation for each C corporation
- Each business could be in a separate corporation
- However, moving funds between corporations can be awkward:
 - Distributions to shareholders used for equity infusions in other corporations would be taxable dividends
 - Inter-company loans (and other loans) are subject to interest deduction limits
 - Losses from one business cannot offset income from another

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Business Structure

Starting as a partnership and converting to a C corporation:

- Allows owners to deduct start-up losses (which is not always good)
- Avoids worrying about not having enough assets devoted to qualifying businesses during the start-up stage
- Allows tax-preferred exits in case changes need to be made while business takes shape
- Allows higher exclusion if assets exceed \$1 million at time of conversion

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Business Structure

Starting as a partnership and converting to a C corporation:

- Delays exit, because the 5-year holding period does not start until entity becomes a C corporation
- Prevents exclusion of gain on sale attributable to pre-conversion growth

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Other Ideas When Selling C Corporation Stock

- [II.G.7 Deferral or Partial Exclusion of Capital Gains \(Even from Investment Assets\) Invested in Opportunity Zones](#)
- [II.G.8 Abandoning an Asset to Obtain Ordinary Loss Instead of Capital Loss; Code § 1234A Limitation on that Strategy](#)
- [II.Q.7.l Special Provisions for Loss on the Sale of Stock in a Corporation under Code § 1244](#)
- [II.Q.7.m Deferring Gain on Sale of Marketable Securities by Investing in a Specialized Small Business Investment Company](#)

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Gain on Sale

Focusing on exclusion is one-dimensional:

- Buyers want to receive tax benefits from unrealized gain of corporate assets
- If buy stock instead of assets, buyers frequently require a Code § 338(h)(10) election to treat the sale as an asset sale followed by a corporate liquidation
- Code § 1202 exclusion does not protect gain on deemed asset sale


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Gain on Sale

- S corporation Code § 338(h)(10) or 336(e) election uses gain on deemed sale of assets to increase the seller's stock basis, often avoiding gain on sale of stock
- However, tax rates on deemed asset sale may be higher:
 - Currently, capital gain rates are relatively close to corporate tax rates, depending on NIIT
 - Depreciation recapture is ordinary income but is eligible for Code § 199A deduction

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Gain on Sale

However, this slightly increased tax on S corporations may be worth the benefits of S corporation:

- Corporations that distribute in excess of tax distributions may have lower effective annual tax burden. See the beginning of my [January 30, 2018 webinar](#) or a [condensed version](#).
- GRATs and sales to irrevocable grantor trusts don't work well for C corporations
- Basis step-up on death may obviate need for exclusion

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Seller – Financed Sale of Goodwill



Part II.Q., especially II.Q.1.a.i.

- C Corporation Triple Taxation and Double Taxation
- S Corporation Double Taxation
- Partnership Single Taxation
- Partnership Use of Same Earnings as S Corporation

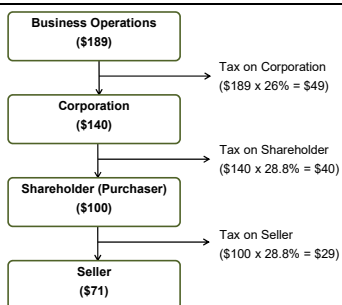
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C Corporation Triple Taxation



(II.Q.1.a.i.(a.))



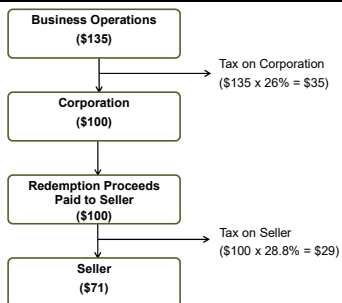
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C Corporation Redemption

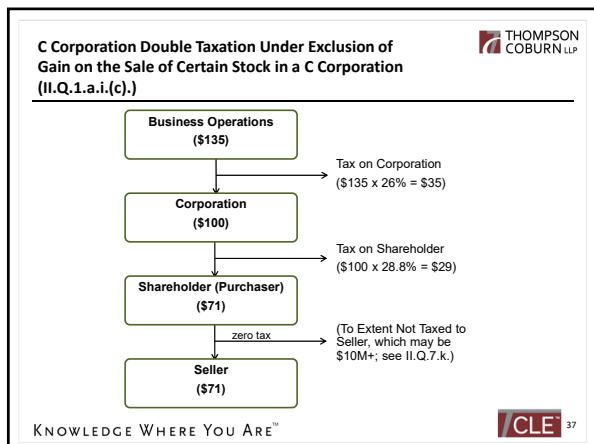


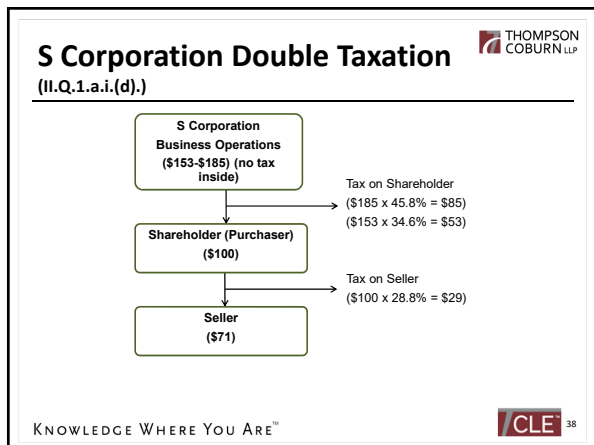
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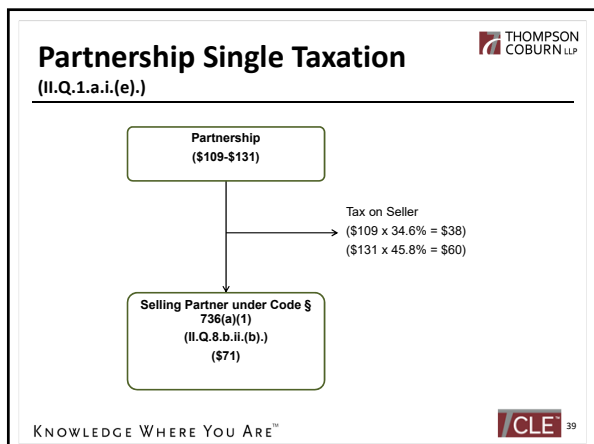


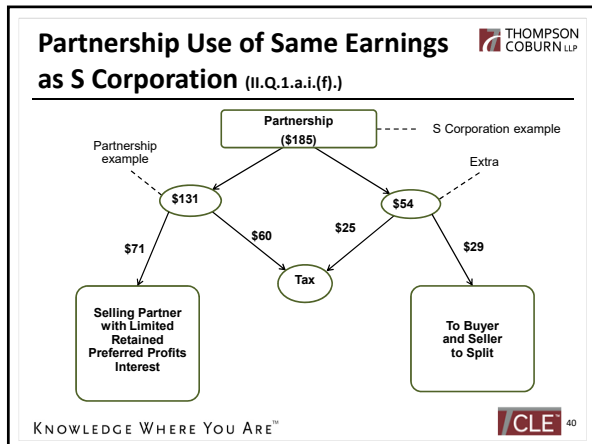
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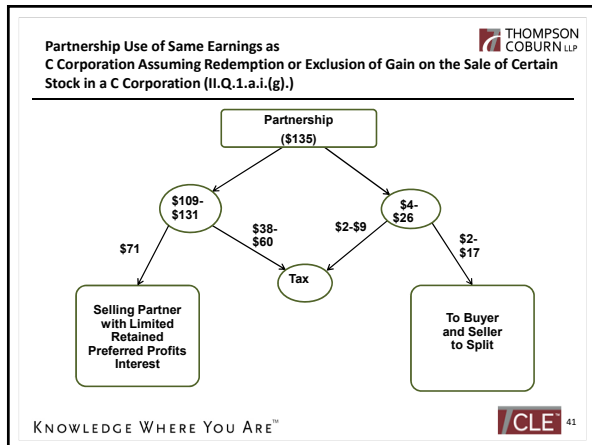


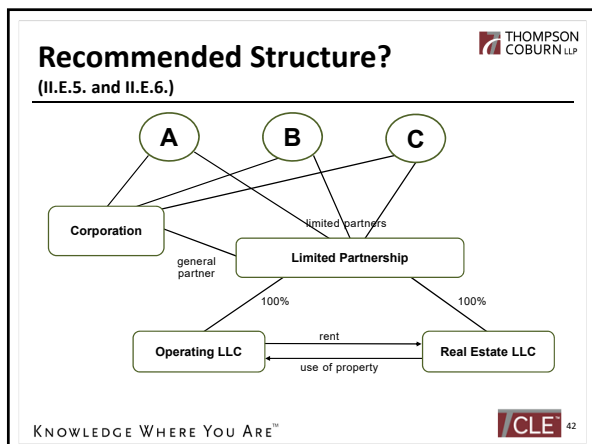

















Recommended Structure?

- Facilitates inside basis step-up
- Avoids self-employment tax on distributive share
- General partner may be S corporation (to maximize pass-through) or C corporation (to tax reinvested income at lower C corporation annual rates)
- General partner interest may be 1% (pristine formation) or 10% (if restructuring from corporate structure) or some higher number (reinvested C corporation earnings)
- Not ideal for Code § 199A deduction

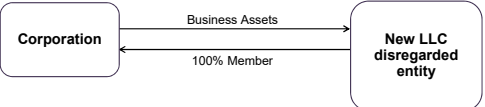
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Migrating Existing Corporation into Preferred Structure (II.E.7, II.E.7.c.i.(a).)

Corporation Forms New LLC – Two Options

Direct Formation of LLC (1st option)



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Migrating Existing Corporation into Preferred Structure


Corporation Forms New LLC

Direct Formation of LLC (1st option)

Advantages

- Corporation Can Keep Nonbusiness Assets
- Corporation Can Keep Business Assets That Would Generate Complications if Transferred to the Limited Partnership Structure and Then Had Income Recognition Event
- New LLC Can Stay as a Disregarded Entity for a While as Transition to New Structure and Get Everyone Used to Working in LLC Structure

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Migrating Existing Corporation into Preferred Structure 


Corporation Forms New LLC

Direct Formation of LLC (1st option)

Disadvantages

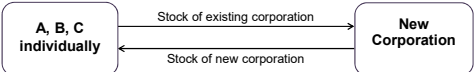
- Piecemeal Transfer of Assets
- Some Assets Not Readily Transferable


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Migrating Existing Corporation into Preferred Structure (II.P.3.i.) 

Corporation Forms New LLC

Use F Reorganization to Form LLC (2nd option)

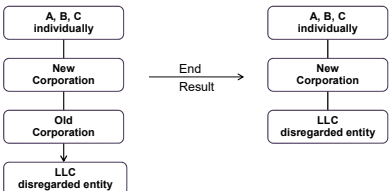



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Migrating Existing Corporation into Preferred Structure (II.E.7.c.) 

Corporation Forms New LLC

Use F Reorganization to Form LLC (2nd option)



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Migrating Existing Corporation into Preferred Structure 


Corporation Forms New LLC

Use F Reorganization to Form LLC (2nd option)

Advantage

- Moves all assets in one fell swoop

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Migrating Existing Corporation into Preferred Structure 


Corporation Forms New LLC

Use F Reorganization to Form LLC (2nd option)

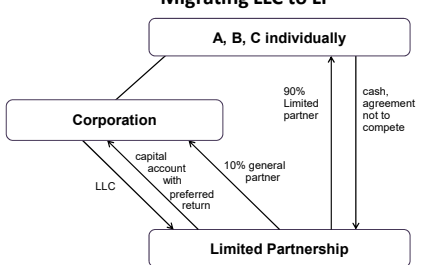
Disadvantages

- No Selectivity of Retained Assets
- Contribution of Stock of Old Corporation to New Corporation and Merger or Conversion of Old Corporation into New Corporation Need to Be Done at the Same Time
- If S Corporation Involved, New Corporation Does New S Election and Old Corporation Does Qualified Subchapter S Subsidiary Election

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Migrating Existing Corporation into Preferred Structure (II.E.7.c.ii., II.Q.7.h.) 

Migrating LLC to LP



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    graph TD
      Corp[Corporation] --> LLC[LLC]
      LLC --> LP[Limited Partnership]
      LP -- "10% general partner" --> Corp
      LP -- "90% Limited partner" --> A["A, B, C individually"]
      A -- "cash, agreement not to compete" --> LP
      LP -- "capital account with preferred return" --> LLC
  
```

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Intrafamily Business Transactions After 2018 Tax Court Case



Dynamo Holdings Ltd. Partnership v. Commissioner,
T.C. Memo. 2018-61

- Intrafamily sale of stock (taxpayers lost):
[II.Q.7.h.iv. Taxpayer Win in Cox Enterprises When IRS Asserted That Contributing Property to Partnership Constituted Distribution to Shareholders \(2009\); Dynamo Holdings' Limitation on Using Cox Enterprises \(2018\).](#)
- Intra family loans (taxpayers won):
[III.B.1.a.i.\(a\) Loans Must be Bona Fide](#)

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Intrafamily Sales



Cox Enterprises, Inc. & Subsidiaries v. Commissioner,
T.C. Memo. 2009-134

- Corporation's contribution of a television station to a partnership did not constitute a dividend even though the partnership interest it received was originally worth \$60.5 million less than the assets it contributed
- The partners in the partnership were the remaindermen of certain trusts.
- Trusts, indirectly and collectively, owned 98% of the corporation's stock.

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Cox Enterprises




The corporation:

- Contributed assets worth \$300 million
- Became the managing general partner
- Received a majority partnership interest, which entitled it to 55% of partnership distributable profits and liquidation proceeds up to specified base amounts and 75% of distributable profits and liquidation proceeds in excess of those base amounts


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Cox Enterprises

- The other partners contributed assets worth \$62 million and received the balance of the rights to distributions
- Thus, the corporation contributed nearly 83% (\$300 million divided by \$362 million) of the assets and received the right to profits of 55%-75%


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Cox Enterprises

Tax Court held no gratuitous transfer:

- The partnership's formation had nontax business reasons.
- As recommended by independent consultants, the corporation tried to sell these operating assets but was unable to do so.
- The partnership's formation allowed the corporation to retain, for use in other areas, the working capital it had previously needed for the television station


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Cox Enterprises

Tax Court held no gratuitous transfer:

- Other partners required to make cash contributions to the partnership "in an amount corresponding to the fair market value of the partnership interests acquired by" those other partners.
- Other partners' acquisition of partnership interests was to "be on terms and conditions no less favorable to" the corporation "than the terms and conditions that would apply in a similar transaction with persons who are not affiliated with" the corporation

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Cox Enterprises

Tax Court held no gratuitous transfer:

- Independent appraisal of other partners' minority interest in the partnership as of the date of formation
- Other partners made contributions based on the appraised amount
- Three years later, the corporation's management discovered errors in computing the other partners' interests in the partnership and obtained a new appraisal. The other partners made additional contributions to bring their contributions up to the appraised value

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Cox Enterprises

Tax Court held no gratuitous transfer:

- Court relied on *United States v. Byrum* to find controlling shareholders subject to fiduciary duties to the minority shareholders
- In *Cox*, 2% of stock was owned by people who were not members of the controlling family and were employees of the corporation
- These minority shareholders did not own interests in the other partners and "would not be made financially whole for the likely shortfall in income and liquidation (or sale) proceeds" if the partnership formation constituted a transfer to the other partners

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Cox Enterprises

Tax Court held no gratuitous transfer:

- The remaindermen of the shareholder trusts held significant interests in the partners, so a transfer to the other partners would have accelerated the remaindermen's interests in violation of the trust agreements
- Because the trusts were the controlling shareholders, the trustees would have violated their fiduciary duties by accelerating the interests of the remaindermen.
- Thus, a gratuitous transfer to the other partners would have been detrimental to the shareholder trusts as entities and would have violated the trustees' fiduciary duties

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Dynamo Holdings

Tax Court described “constructive distribution”:

- Transfer of property from one entity to another for less than adequate consideration may constitute a constructive distribution to an individual who has ownership interests in both entities
- However, a bargain sale, including a bargain sale based on competing property valuations, between related parties does not automatically result in a constructive distribution.

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Dynamo Holdings

Two prong test for “constructive distribution”:

- Objective test – did the transfer cause funds or other property to leave the control of the transferor corporation and allow the stockholder to exercise control over such funds or property either directly or indirectly through some instrumentality other than the transferor corporation
- Subjective test – did the transfer occur primarily for the common shareholder’s personal benefit rather than for a valid business purpose
- Must meet both for “constructive distribution”

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Dynamo Holdings

Objective prong – because the common shareholder does not directly receive funds or property in a transfer between entities, such a transfer is a distribution if:

- The transferred funds leave the control of the transferring entity, and
- The owner controls the funds, directly or indirectly, through some means other than the transferor

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Subjective prong:

- Whether the transfer occurred primarily for the benefit of the common shareholder, rather than for a valid business purpose
- Search for this underlying purpose usually involves the objective criterion of actual primary economic benefit to the shareholders as well


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Dynamo Holdings

Subjective prong:


- If the primary purpose is a valid business purpose, then the primary purpose is not for the shareholder benefit
- Benefit to the shareholder when the primary purpose of the transfer is to or for the benefit of a member of the shareholder's family

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Dynamo Holdings

- Cox involved a single instance of undervaluing an interest
- *Dynamo* found five bargain sales exceeding \$200M
- Bargain sale properties went to *Dynamo*, enhancing its value
- This directly benefited the dynasty trusts and furthered the principal owner's estate planning

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Dynamo Holdings

- Thus, taxpayers lost the sale aspect of this income tax case
- However, taxpayers won on intra-family loans
- To be treated as loans, advances required “an unconditional obligation on the part of the transferee to repay the money, and an unconditional intention on the part of the transferor to secure repayment.”

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Dynamo Holdings

- Special scrutiny to intrafamily transfers and transactions between entities in the same corporate family or with shared ownership
- Transfers between family members presumed to be gifts
- Presumption can be rebutted by “an affirmative showing that there existed a real expectation of repayment and intent to enforce the collection of the indebtedness.”

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Dynamo Holdings

- Useful to compare the transactions at issue to arm's-length transactions and normal business practices
- However, be mindful of the business realities of related parties
- Security and other creditor protections are less important in a related-party context

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Evaluate all the pertinent facts and circumstances of the case, including whether:

- There was a promissory note or other evidence of indebtedness
- Interest was charged
- There was security or collateral
- There was a fixed maturity date
- Demand for repayment was made


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Evaluate all the pertinent facts and circumstances of the case, including whether:

- Transferee had the ability to repay
- Any records maintained by the transferor and/or the transferee reflected the transaction as a loan
- Manner in which the transaction was reported for Federal tax is consistent with a loan


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Defects in documentation here:

- No contemporaneous promissory note identifying all the terms of the agreement
- No collateral set aside to ensure repayment
- No invoice or demand made by lender
- No fixed maturity date or intent to force borrower into bankruptcy if required to ensure repayment

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Dynamo Holdings

Helpful facts:

- Borrower and lender maintained records that reflected advances as debt in their general ledgers
- Some promissory notes
- Management of debtor and lender was the same, and they had full knowledge of and access to all financial information

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- “We have consistently held that these formal indicia of debt are little more than declarations of intent without accompanying objective economic indicia of debt”
- Consistent tax reporting of interest income and expense
- Borrower had objective ability to pay, did in fact pay, and also repaid third party lenders

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Dynamo Holdings

Conclusion: “After analyzing the facts, we hold that Dynamo and Beekman entered into a bona fide creditor-debtor relationship. At the time the advances were made, Dynamo had an unconditional obligation to repay the loans, and Beekman had an unconditional intent to be repaid. A bona fide loan precludes a constructive distribution. Because we found that the advances were bona fide debt, the advances are not constructive distributions. Likewise, Dynamo is entitled to deduct the interest expenses.”


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Conclusion

- February 12 webinar [Fiduciary Income Tax Refresher and Update 2019](#)
- Code § 199A webinars include February 20 ACTEC/ALI and March ABA RPTE
- April 23 webinar for First Quarter Newsletter
- Blog: [Business Succession Solutions](#)
- Reports on Heckerling: <http://www.thompsoncoburn.com/forms/gorin-heckerling>
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