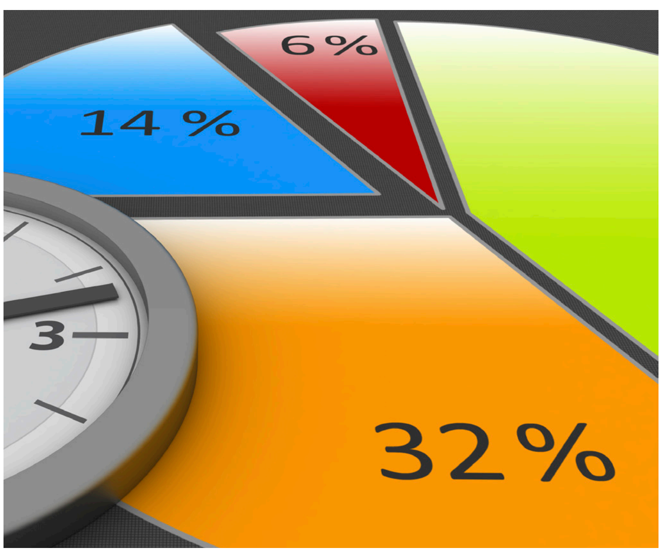
Splitting the "Difference"

By Fred B. Weil



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Frequently, a business founded by a family member or by a group of friends will become the scene of conflict when ownership passes into the hands of succeeding generations or as the business evolves from what it was at its beginning. Often, a sale of the business, a redemption of one party's shares or liquidation are the only answers. But, in some cases, a split-off can provide a satisfactory—and tax-free—solution.

A corporation's business may be, or as it grows may become, more than one business. Examples include a farming company that evolves into farming and cattle ranching, or a manufacturing company that develops a marketing business that handles products beyond its own products, or an insurance broker that develops a service or consulting division. With the evolution of the corporation, differing opinions may emerge as to how the corporation should be operated or its resources employed. While a split-off is subject to many complex rules under the Internal Revenue Code, a simple example below illustrates its potential to resolve a difficult dispute among owners.

For this discussion, we will assume that shareholder Groups A and B are in hopeless conflict as to how to run Company X, but Group A would be happy to run Business A (founded 25 years ago) and Group B would be happy to run Business B (founded about 6 years ago). Business B is worth only 25% of the total value of Company X, but the two Groups each own 50% of Company X. The conflict could be solved by dissolving Company X, but that would be disruptive to the businesses and cause Company X and all of the shareholders to incur significant taxes. Another solution might be to have Company X distribute the assets of Business B plus some cash to Group B in exchange for Group B's stock, but that distribution would be treated as a sale of the Business B assets, and could result in significant taxes for Company X and Group B. Only the IRS could like either of these solutions.

The proper solution for these unhappy Groups may be a tax-free split-off under Internal Revenue Code Section 355[1]. The split-off occurs when Business B is dropped into a newly formed subsidiary of Company X, called Corp B, along with some cash or other assets, and the stock of Corp B is distributed to Group B in exchange for all of their stock in Company X. The Group A shareholders wind up owning 100% of Company X and can continue to operate Business A as they choose. Group B can run Business B without interference from Group A.

In addition to the benefit of ending the conflict between Group A and Group B, a tax-free split-off under IRC Section 355 could provide the following additional advantages:

1. Liquidation of Company X is not required in order for each Group to go its own way.

2. Significant taxes for all parties can be avoided or postponed indefinitely.

3. Because no taxes would be incurred, cash requirements to equalize shareholder values where the business values are unequal may be greatly reduced.

To have an effective split-off, Company X must have operated at least two active businesses for more than five years, which is true under our example. After the distribution, Company X must continue to operate at least one of those businesses and Corp B must continue to operate at least one of those businesses. Under Section 355, Corp B can be organized for the sole and express purpose of receiving one of those businesses and then having its stock distributed immediately thereafter. Business B does not have to be operated for any particular period in the separate corporation before the split-off.

A split-off is well recognized in the tax law as an appropriate technique for allowing two shareholder groups to go their separate ways where the conditions described above have been met. However, in our example, the two businesses are of unequal value. Within certain limits, the value of Corp B can be increased through the injection of cash and other assets in order reach 50% of the total value of Company X. Although Section 355(g) provides that less than two-thirds of the value of Corp B can consist of "investment assets," that term is defined to include only cash, stock or securities in a corporation, an interest in a partnership, debt instruments, derivatives (such as options and futures contracts), foreign currency or similar assets. Land, buildings and other hard assets, even if not used in Business B are not counted in the limitation. In our example, if Company X is worth $100x and Business B is worth $25x, it would take only an infusion into Corp B of $25x to equalize values. Even if the infusion consists only of cash borrowed

1 Section references in the balance of this Article are to the Internal Revenue Code of 1986, as amended.

by Company X, the two-thirds limitation would not be violated.

Real life situations are generally more complex than hypotheticals. For example, where a manufacturing company has a sales division, questions may arise as to whether there are two distinct businesses that have been operated by that company for five years. If the sales division handles only the company's products the answer is probably no, but if that division has for the last five years sold significant amounts of products from other companies the answer might be yes. There are also issues as to how long each business must continue, and how long the ownership of the distributing corporation or the distributed corporation must remain in the same hands, after the split off. Thus, the facts surrounding a proposed split-off must be carefully analyzed. Nevertheless, in the right circumstances, a split-off can produce an amicable and tax-free solution to an otherwise painful corporate relationship.

The foregoing is a general discussion of split-offs. The reader is cautioned to seek the advice of competent counsel before proceeding with a split-off.

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