Breaking Up a Corporation: How Shareholders Can Avoid a Federal Income Tax Liability Issue

The pressures of the current economic situation have many corporations considering a division of businesses into separate entities. Considering the tax consequences is a serious issue, and requires tax law expertise.

By Ira J. Kaltman, Esq.
Beattie Padovano, LLC

For shareholders of a corporation that decide to break up and go their separate ways, there is a means by which they can divide the business into two separate corporations without incurring a federal income tax liability. But the rules are complicated and the situation must only be approached with the utmost care to avoid a tax catastrophe.

Let us assume we have a corporation "P," which operates four commercial real estate buildings. For simplicity's sake, we will assume the buildings are substantially equal in value. The stock of the corporation is owned by Frank and Dan, each of whom holds 50 shares of the outstanding stock.

If, after many years, Frank and Dan have a falling out, one would think that the simple way for them to go their separate ways would be for the corporation to distribute two of the buildings to each of them (or to corporations or LLCs that they respectively form), and that would be the end of the matter.

Unfortunately, the IRS is not so kind with regard to transferring assets out of a corporation, and if these buildings were distributed to Frank and Dan, respectively, it is likely that an enormous tax would have to be paid by the corporation (and thereby, ultimately, Frank and Dan) which would be based upon the difference between the tax basis (cost of each building reduced by depreciation) and its fair market value on the date of distribution. If the corporation had been operating for a long period of time, it is more than likely that the basis that it had in each of these buildings would be negligible compared to its fair market value.

Fortunately, there are sections of the tax code which permit a type of transaction that results in a significant amount of the income tax being deferred, a so-called "Divisive Reorganization." In fact, if the rules prescribed by the IRS and the Internal Revenue Code are followed to the letter, the entire transaction may be free of federal income tax except where certain elements referred to as "boot" are present.

"Boot" generally refers to any cash receipts in the transaction, and in the case of a real estate corporation, would include the amount by which any mortgage would exceed the corporation's tax basis in the buildings.

A common form of the transaction is as follows. "P" creates two new subsidiaries, "A" and "B," and "P" distributes two of the buildings to each of the corporations in return for the outstanding stock of each respective corporation. Immediately subsequent to "P" acquiring the stock of "A" and "B," the owners of "P," Frank and Dan, will each trade in all of their "P" stock and receive all of the stock of a subsidiary of "P." In our example, Frank will receive all of the shares of "A" from "P" and Dan will receive all of the shares of "B" from "P."

When the smoke clears, Frank and Dan will each own a corporation ("A" and "B" respectively) which has two buildings. As "P" no longer has assets, it will be liquidated and dissolved for state purposes. If all of the requirements set forth in the Treasury regulations for Divisive Reorganizations are met, the transaction will not result in any gain, except for "boot."

Please note that this type of transaction should not be considered without IRS approval in the form of a private letter ruling confirming the non-taxable nature of the transaction. The tax law and related authorities contain conditions and guidelines as well as the issues that must be addressed in the ruling request. Obtaining the advice of a tax advisor familiar with this particular area of tax law is essential. ■