

# SECOND GENERATION PLANNING – THE CORPORATE DIVISION ALTERNATIVE

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## **INTRODUCTION.**

Successful transition planning for a family farming operation requires, among other things, that the ownership of the farming business assets (i.e., land, equipment and livestock) be transferred from the parents (first generation) to the children (second generation) in a manner that eliminates or minimizes gift, estate and income taxes. The ease of the transition will depend in part on the first generation's decisions concerning the ownership and operation of the assets. Unfortunately, in many cases decisions are made based on short-term needs without taking into account the long-term consequences that may affect transition planning. The result is that when transition planning becomes an immediate need, rather than a long-term goal, the most advantageous solutions may not be available. The purpose of this article is to encourage an awareness of the consequences that certain decisions, while good in the short-term, may bring in the long-term, particularly with regard to the need for disengagement of the second generation heirs from mutual corporate ownership and operation.

A common fact pattern involves farming operations that were incorporated in the late 60's and 70's as a means of facilitating the transition of ownership from the first to the second generation. Rather than gifting an undivided interest in specific farm assets, all farming assets were placed in corporate solution followed by the implementation of an annual gifting program of stock from the first to the second generation. Corporations were deemed the preferred transition vehicle based on various tax and non-tax reasons. Many of the original estate planning corporations were taxed under Subchapter C of the Internal Revenue Code, which at the time allowed tax-free liquidations under § 333.

The basis of the stock received by the first generation at incorporation is generally equal to the basis of the assets contributed to the corporation. As gifts of this stock are made, the original, low basis of the parents carries over to the second generation. Often, the major asset of a farming corporation is real estate, the basis of which is generally its original cost, carried over from the first generation contributor to the corporation. As a result of real estate appreciation, the basis of the stock in the corporation and the basis of the real estate held by the corporation is generally significantly lower than the current fair market value of the real estate.

## **THE PROBLEM.**

While the value of the land has been increasing over the transition period, the participation of the first generation shareholders has been decreasing. It is not uncommon for the first generation to "slow down" with age. Unless an active second generation family member is present, the operations of the corporation may have changed from active (an operating farm or ranch) to passive (all or mostly assets leased to others).

The dynamics of the families also change over time. While the parents are still alive, active in the business and transferring stock to the second generation, the second generation members will generally follow the lead of the parents and accept almost any situation. The farm is still generally viewed as "mom and dad's", even though the second generation may be performing more labor. The situation often changes dramatically, however, when the first generation is gone. The second generation members commonly have diametrically opposed goals, especially if some are operators and others are non-operators. This often leads to a desire to discontinue business relationships with one another as soon as possible.

After the Tax Reform Act of 1986 and the repeal of the General Utilities Doctrine, the liquidation of a corporation normally has significant income tax ramifications at both the shareholder and the corporate

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levels. Currently, corporate liquidations require the recognition of gain by the corporation to the extent that distributed assets have a fair market value in excess of their adjusted bases. Appreciated real estate generally reflects a significant built-in gain. Shareholders must individually recognize gain if the fair market value of the assets distributed to them in liquidation exceeds the adjusted basis of their stock. While the stock basis may increase due to the basis adjustment occurring in an estate (I.R.C. §1014), the underlying corporate assets will not receive a similar step-up. Further, if the parents have made significant inter-vivos gifts of stock to their children, only a small portion of the stock may receive a basis step-up in the estate. As a result of the change in tax law, and the tax exposure to the corporation and the second generation shareholders, a corporate liquidation is limited as a means of dividing the family farm among the second generation.

### **A SOLUTION – S ELECTION AND LIQUIDATION.**

Generally, the division of corporate assets can be accomplished by second generation members on a tax-free basis through a corporate liquidation, if there is sufficient time to implement a plan. The first step in planning involves the first generation retaining as much stock as possible without causing undue estate tax exposure. The stock distributed from the estates of the first generation to the second generation would then receive a step-up in basis under current Internal Revenue Code §1014.

Second generation members can then elect S corporation status, if this has not been previously elected. S corporation status, when coupled with a step up in basis in stock held by the family members, can result in essentially a tax-free corporate liquidation. However, because of the 10-year period to avoid the corporate built-in gain tax, long-term planning is necessary. After satisfying this 10-year period, if it applies, distribution of the corporate assets in liquidation can proceed as the family members have agreed. Family members can go their separate directions with their separate ownership of the divided family farming operation.

Unfortunately, the S corporation/liquidation alternative usually is either not known or chosen as a means of assisting the transition planning until it is too late. When faced with a new S election plus a ten year wait, second generation members often choose a more expeditious means to complete the transition and division of corporate assets. This generally takes the form of attempting to qualify for an Internal Revenue Code §355 tax-free division.

### **A SOLUTION – THE TAX-FREE CORPORATE DIVISION.**

An Internal Revenue Code §355 corporate separation is an alternative method for a tax-free division of highly appreciated incorporated assets among second generation family members. It is often the best solution available to second generation members that desire to go their own ways, if they are willing to have their shares of the family farming assets remain in corporate solution. The division of a single family farming corporation into several corporations is accomplished by the formation of subsidiary corporations into which a portion of the farming operations are placed. The stock of the subsidiary corporations are then allocated among second generation members in exchange for their stock of the parent corporation.

### **ACTIVE TRADE OR BUSINESS REQUIREMENT.**

The statutory requirements to accomplish a tax-free division under Internal Revenue Code §355 are numerous. Of specific concern with family corporations is that the distributing and controlled corporations must, immediately before the distribution, have been engaged in an active trade or business throughout the five-year period ending on the date of the distribution. As provided by Internal Revenue Code §355(b)(2), a corporation is actively engaged in an active conduct of a trade or business if it is engaged in the active conduct of a trade or business and such trade or business has been actively conducted throughout the five-year period ending on the date of the distribution. Both the distributing and controlled corporations must also be engaged in the active conduct of a trade or business immediately after the division (I.R.C. §355(b)(1)(A);

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Treas. Reg. §1.355-2(b)(2)). As the first generation ages, meeting the active trade or business test can become difficult, especially if there is no second generation operator.

If proper planning and discussion with regard to this alternative is not held with first generation shareholders they can ultimately make operational decisions (i.e., selling off machinery, livestock and leasing the land to independent third parties) that will impact the planning opportunities available to future generations. The balance of this article will review and address methods of conducting a farming business and whether or not said methods will rise to the level of an active trade or business for purposes of tax-free division under Internal Revenue Code §355.

Before attempting to determine whether or not a group of activities rises to the level of being considered an active trade or business, we must first review the different methods of conducting a farming business that may have been chosen by the first generation shareholders.

### ACTIVITIES OF A FARMING BUSINESS

The business of farming is comprised of a specific group of activities that are carried on by the company as the land owner for the purpose of creating income and profit. These activities include every operation that forms a part of or a step in the process of earning income or profit, including the collection of income (sale of crops) and the payment of expenses. There are numerous methods, involving different combinations of activity levels, by which the corporation could use its real estate and assets in a farming business. To assist with an understanding of the method chosen by the company, the following explanation may be helpful.

Activities that must be performed in a farming business include management and operational activities.

#### Management activities include:

- Determine crop to be planted (including the seed), when to plant and harvest, and harvesting method
- Determination of the quality, kind, timing and areas of application of fertilizer, herbicide and insecticide
- Determine crops and acreage to be irrigated and the application of water in the event of a water shortage or breakdown of irrigation equipment
- Marketing of grain
- Farm Service Agency related business
- Determine the need for new/additional irrigation equipment
- Legal and book work

#### Operational activities include:

- Performance of labor and operation of machinery for the maintenance of building, grounds and land
- Buying seed, fertilizer and chemicals
- Fertilizing, planting, cultivating, spraying, irrigating and harvesting
- Paying bills
- Making repairs
- Provide security for premises

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How a particular farming operation completes all of these activities will determine if it currently meets the active trade or business test of I.R.C. §355.

### METHODS OF CONDUCTING A FARMING BUSINESS

The activities required to conduct a farming business can be accomplished by a farming corporation by various methods. The extent to which the farming corporation completes the farming activities will determine if an active trade or business is present.

Alternative methods of using the farm land in a farm business are as follows:

1. Cash Lease. All of the real estate owned by the corporation is rented to a third party under a cash lease arrangement. The company receives cash for the use of its land and conducts few, if any, of the farming activities. It is an entirely passive operation. Virtually no employee participation is needed by the company, as the company receives none of the crops and is not responsible for any of the expenses of the farming operation conducted by a cash tenant. Little, if any, management or operational functions are required of the corporation's employees.

2. Full Scale Farming Operation. The company owns all of the real estate, all of the farm equipment and, through its employees, performs 100% of the management and operational activities that form a part of or a process in the farming business.

3. Custom Farming. All management and operational functions of the farming business are the responsibility of the company. The company's employees generally perform all management functions and some of the operational functions. The remaining operational functions, such as harvesting the crop, are performed by "custom farmers" using their own equipment. The custom farmer is paid cash, usually on a per acre basis, for providing the labor and equipment needed for those functions. Under this arrangement, the company, as the land owner, receives the entire crop and is responsible for all expenses, including the custom farmer's bill.

4. Crop Share Arrangements. There are many types of crop share arrangements that are used throughout the country. In a crop share arrangement, the corporation, through its employees, generally completes all management functions. A portion of the equipment and labor required for operational functions also is provided by the company. The balance of the operational labor and equipment is provided by a tenant farmer. In a typical crop share agreement, the company, as land owner, provides the real estate, irrigation equipment, and a portion of the labor (through its employees). In return, the company receives a percentage of the crop at harvest and is responsible for a percentage of the expenses of operation.

Tenant farmers generally provide equipment such as tractors, trucks, planters, harvesters, etc., and a percentage of the labor for farming the corporate-owned real estate. They also are responsible for a percentage of the operational expenses. In exchange, they receive a percentage of the harvested crop. The tenant farmer normally does not provide labor for the maintenance of the company-owned real estate or equipment, security, maintenance of roads, fences, irrigation ditches, etc.

In a typical share crop agreement between the corporation (the landowner) and the operators/tenant farmers, the corporation is responsible for specific duties and expenses that include the following:

1. Providing all real estate.
2. Providing the irrigation water and equipment.
3. Providing labor for the normal repair and maintenance of the irrigation equipment (may be divided).
4. Performing major repairs to the irrigation equipment.
5. 40% to 50% of fuel and electrical expense for irrigation.

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6. 40% to 50% of all expenses of growing the crops, such as fertilizer, herbicide, and insecticides.
7. An agreed-upon portion of the labor required for planting, fertilizing, cultivating, spraying, harvesting, discing, stalk, cutting, and transportation of the crops.

The operators/tenants are responsible for labor items and expenses as follows:

1. Most or all of the labor and machinery necessary for planting, fertilizing, cultivating, spraying, harvesting, monitoring and control against insects and other pests, infestations in grain stored in the granaries, and the transportation of the crops.
2. All fuel and repairs for the farm machinery provided by the operator.
3. 50% to 60% percent of all expenses of growing the crops, such as fertilizer, herbicides, and insecticides, and 100% of the seed expense.

The authority for the operation, cropping, pasturage and management of the premises generally is in the owner. The following activities are commonly decided by mutual agreement of the owner and operator:

1. The nature, acreage planted and location of all crops.
2. The quantity, kind and areas of application of commercial fertilizer and natural fertilizer, herbicides and insecticides.
3. The time of planting and harvesting, and the selection of seeds and harvesting methods.
4. Crops and acreage to be irrigated and the application of water in the event of water shortage or breakdown of irrigation equipment.

The owner typically receives 40% to 50% of the crop at harvest and the operator/tenant receives the remaining 50% to 60% of the crop. Each party is responsible for the sale and marketing of its own share of the crop.

### What Is An Active Trade Or Business?

Prior to determining which methods of farming may be an active trade or business, it is necessary to review the Code provisions, regulations, case law and guidance from the Internal Revenue Service on this issue.

#### Internal Revenue Code

Internal Revenue Code § 355(b)(1) provides as follows:

Subsection (a) shall apply only if either --

- (A) the distributing corporation, and the controlled corporation (or, if stock of more than one controlled corporation is distributed, each of such corporations), is engaged immediately after the distribution in the active conduct of a trade or business, . . .

Internal Revenue Code § 355(b)(2) provides as follows:

For purposes of paragraph (1), a corporation shall be treated as engaged in the active conduct of a trade or business if and only if --

- (A) it is engaged in the active conduct of a trade or business, or substantially all of its assets consist of stock and securities of a corporation controlled by it (immediately after the distribution) which is so engaged,

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(B) such trade or business has been actively conducted throughout the 5-year period ending on the date of the distribution.

### Internal Revenue Regulations

Treasury Regulation § 1.355-3(b)(2)(ii), (iii) and (iv) provides, in part, as follows:

(ii) Trade or business. A corporation shall be treated as engaged in a trade or business immediately after the distribution if a specific group of activities are being carried on by the corporation for the purpose of earning income or profit, and the activities included in such group include every operation that forms a part of, or a step in, the process of earning income or profit. Such group of activities ordinarily must include the collection of income and the payment of expenses.

(iii) Active conduct. For purposes of Section 355(b), the determination whether a trade or business is actively conducted will be made from all of the facts and circumstances. Generally, the corporation is required itself to perform active and substantial management and operational functions. Generally, activities performed by the corporation itself do not include activities performed by persons outside the corporation, including independent contractors. A corporation may satisfy the requirements of this subdivision (iii) through the activities that it performs itself, even though some of its activities are performed by others . . .

(iv) Limitations. The active conduct of a trade or business does not include --

(A) The holding for investment purposes of stock, securities, land, or other property, or

(B) The ownership and operation (including leasing) of real or personal property used in a trade or business, unless the owner performs significant services with respect to the operation and management of the property.

### Revenue Rulings

The Internal Revenue Code § 355 activity requirement has been the subject of the two published rulings – Rev. Rul. 73-234, 1973-1 C.B. 180, and Rev. Rul. 86-126, 1986-2 C.B. 58. These rulings are summarized as follows:

#### Rev. Rul. 73-234:

In this ruling, a farm corporation's activities were in part performed by tenant farmers acting as independent contractors. In addition, the corporation itself, through its employees, performed substantial management and operational functions in conducting farming activities. Under the facts and circumstances of the case it was held that the farm corporation satisfied the active business requirements of Internal Revenue Code § 355(b).

The Corporation had been engaged in farming operations for more than five years. The planting, raising and harvesting of crops and the breeding and raising of livestock in its farming operation was completed by tenant farmers, who were compensated by a share of the proceeds from the sale of all crops and livestock resulting from the farm operation. The Corporation employed a general handyman to maintain the farm property and equipment and an additional individual, who was an experienced farmer, to participate in the farm operation. This individual, on behalf of the corporation, entered into agreements with the tenant farmers and allotted to each of them responsibility for a portion of the farm operation. The corporation supplied all equipment and arranged for all financing necessary for its operation. The corporation engaged a local mechanic for maintenance and repairs of the equipment that was not performed by the corporation's employee or the tenant farmers.

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The corporation's employee devoted significant time and effort to the farm business of the corporation. He studied federal price support and acreage reserve programs, planned all rotation, planting and harvesting of crops, and purchased and planned the breeding of livestock. He hired seasonal workers and purchased farm equipment, was responsible for handling sales of all crops and livestock, and was responsible for accounting to the tenant farmers for their shares of the proceeds of the sale.

After the division, the corporation was to continue to operate its business in the same manner. In holding that the requisite requirements of an 'active trade or business' were met, the ruling noted the following:

“Section 1.355-1(c) of the income tax regulations, in defining ‘active business’, provides, in part, that a trade or business consists of a specific existing group of activities being carried on for the purpose of earning income or profit from only such group of activities, and the activities included in such group must include every operation which forms a part of, or a step in, the process of earning income or profits from such group. Such group of activities ordinarily must include all collection of income and the payment of expenses.

“Section 355 of the Code, by requiring that a trade or business be actively conducted, connotes substantial management and operational activities directly carried on by the corporation itself, and not the activities of others outside the corporation, including independent contractors. However, the fact that a portion of the corporation's business activity is performed by independent contractors will not preclude the corporation from being engaged in the active conduct of a trade or business if the corporation itself directly performs active and substantial management and operational functions.”

The ruling indicated that the corporation had two year-round employees (the president and a handy man) as well as seasonal workers, supplied all equipment and arranged all the financing for the farm. These activities were the direct performance of substantial management and operational functions. On these facts, it was ruled that the corporation's operation of the farm was an active business.

### Rev. Rul. 86-126:

In this ruling, the active trade or business requirement was not met because of the absence of substantial operational and managerial activities. Under the stated facts, the operations of the corporation consisted of leasing farm land to tenant farmers. There were only two officers and shareholders, each holding 50 percent of the outstanding common stock. Both were farmers who farmed their individually-own tracts of land. Each tract owned by the corporation was leased for one year at a time to a tenant farmer, who agreed to share one-half of all income and expenses of the farm. Each party to the lease was responsible for securing the financing necessary to pay that party's share of expenses. The tenant farmers planted, raised, harvested and sold the crops using their own equipment and supplies. They also repaired and maintained the equipment, irrigation system, fences, and other fixtures located on the property. After consulting with two shareholder-officers, the tenant farmer contracted to sell the entire crop, either at a future date or at harvest. Each tenant farmer was responsible for accounting to the corporation for its share of the proceeds.

The shareholder-officers devoted a substantial part of their time to their own respective farms, which were not connected with the corporate farmland. In their capacity as corporate officers, they occasionally inspected the crops and improvements located on each leased tract. If any corrective steps were required, they pointed out the problem to the tenant, who made the correction in the manner the tenant deemed appropriate. The shareholder-officers decided what portion of each tract would be leased each year, in the light of soil conservation needs, market conditions, and federal price support and acreage reserve programs. They reviewed each tenant farmer's accounting of operations and sales.

The shareholder-officers desired to divide the corporation so that each owned 100 % of his own corporation, which would own 100% of specific tracts. Otherwise, they would continue to conduct operations in the same manner.

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The analysis of this Ruling, cited *Rafferty v. Commissioner*, 425 F.2d 767, 772 (1st Cir. 1961), cert. denied, 408 U.S. 922 (1972), stating that the corporation must “engage in entrepreneurial endeavors of such a nature and to such an extent as to qualitatively distinguish its operations from mere investments. Moreover, there should be objective indicia of such corporate operations”, which are found in active and substantial managerial and operational activities of the corporation. In addition, the business activity must be the activity of the corporation itself (through its officers and employees) and not the activity of independent contractors. Rev. Ruls. 80-181, 1980-2 C.B. 121, 79-394, 1979-2 C.B. 141, and 73-234, 1973-1 C.B. 180.

Rev. Rul. 73-234 was distinguished because here, the corporation either did not engage in the required activities at all, or engaged in them only on a limited basis. At best, the corporation could be considered to engage in some managerial and operational activity, but not enough to “qualitatively distinguish its operations from mere investments.” The ruling held that:

“Because of the absence of active and substantial operational and managerial activities, the active business requirement of Section 355(b) of the Code is not met and P’s distribution of the S stock is not governed by Section 355. B will recognize gain on the receipt of the S stock in exchange for P stock, and P will be subject to the provisions of Section 311. See Rev. Rul. 74-516, 1974-2 C.B. 121.”

### WHICH METHODS MEET THE ACTIVE TRADE OR BUSINESS TEST?

#### 1. Cash Lease:

Unless significant services are provided by the corporation, a cash lease of its land will not generally be considered an active trade or business. Treas. Reg. §1.355-3(b)(2)(iv)(B).

#### 2. Full-Scale Farming Operation:

A full-scale farming operation, where employees of the corporation complete all required activities of the farming trade or business, including substantial management and operational functions, will generally be considered as having met the active trade or business test. Treas. Reg. §1.355-3(b)(2)(iii).

#### 3. Custom Farming Operation:

Many farming operations make limited use of custom farmers. The vast majority of all activities necessary in a farming trade or business are completed by corporate employees. These employees generally complete all management activities and the most of the operational activities. A custom farmer can, however, be used on a limited basis by the corporation for operational activities such as harvesting. Here, the corporation will generally be considered as having met the active trade or business test of Internal Revenue Code §355. Treas. Reg. §1.355-3(b)(2)(iii).

#### 4. Crop Share Arrangements:

A determination of whether or not a particular crop share arrangement will meet the active trade or business test must be made on a case-by-case basis. Crop share arrangements that do not provide for any participation by the employees of the corporation in the farming business will always fail to meet the active trade or business test. Conversely, substantial participation by corporate employees in a crop share arrangement should permit the corporation to meet the active trade or business test of Internal Revenue Code §355.

### ANALYSIS

To meet the active trade or business test, the facts and circumstances of a typical crop share arrangement and the activities performed by the landowner must constitute a trade or business and must meet the active test.

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Trade or Business - Treas. Reg. § 1.355-3(b)(2)(ii) provides that the corporation is treated as engaged in a trade or business immediately after a distribution of stock if a specific group of activities are being carried on by such corporation for the purpose of earning income or profit from the group of activities, and the activities in the group include every operation that forms a part of, or a step in, the process of earning income and profit from the group. The group of activities ordinarily must include the collection of income and the payment of expenses. Since even cash leasing of real estate is considered a trade or business, the operation of farm land by a corporation pursuant to a crop share arrangement whereby the corporation receives a portion of the crop and pays of a portion of the normal operating expenses, the collection of income and the payment of the expense test of a “trade or business” will generally always be met under a crop share arrangement.

Active Test - Internal Revenue Code § 355 does not actually define the types of activities that are necessary to distinguish a passive investment from an active conduct of a trade or business. In accordance with Treas. Reg. § 1.355-3(b)(2)(iii), “the determination of whether a trade or business is actively conducted will be made from all of the facts and circumstances. Generally, the corporation is required itself to perform active and substantial management and operational functions.” Thus, the corporation must be engaged in the active conduct of a trade or business, as distinguished from a passive investment.

Under Treas. Reg. § 1.355-3(b)(2)(iv) the active conduct of a trade or business does not include (1) the holding for investment purposes of stock, securities, land, or other property, or (2) the ownership and operation (including leasing) of real or personal property used in a trade or business, unless the owner performs significant services with respect to the operation and management of the property. This regulation usually frustrates attempted corporate separations in which the real estate used in the business is to be separated from the entity conducting the trade or business.

*Rafferty v. Commissioner*, 452 F. 2d 767, 772 (1st Cir. 1971), Cert. Denied, 408 U.S. 922, (1972), held that the corporation's activities must “qualitatively distinguish its operations from mere investments” and that there must be “objective indicia” of these activities in the form of “active and substantial managerial and operational activities” of the corporation. The § 355 activity requirement has been the subject of a published ruling based on *Rafferty v. Commissioner*, which is Rev. Rul. 86-126, involving farm operations.

In this context, “active trade or business” is defined by the regulations as the conduct of specific activities for earning income or profit (Treas. Reg. § 1.355-3(b)(2)(ii)). If real estate is involved, the degree of required activity is described as material participation (*King v. Commissioner*, 458 F.2d 245, (6th Cir. 1972)). The use of independent contractors concerning the conduct of an active trade or business will not, in and of itself, disqualify the business from being considered active. Internal Revenue Code § 1.355-3(b)(2)(iii) provides that “generally, activities performed by the corporation itself do not include activities performed by persons outside the corporation, including independent contractors. *A corporation may satisfy the requirements of this subdivision (iii) through the activities that it performs itself, even though some of its activities are performed by others.*” In a crop share arrangement, the tenant farmers (share croppers) act as independent contractors, and the portion of the activities they perform cannot be attributed to the landowner. However, this use of independent contractors does not automatically result in the corporation having failed to meet the active trade or business test.

If the corporate landowner can prove that it conducts management and operational functions that exceed the activities conducted by the farming corporation in Rev. Rul. 73-234, the active trade or business test will generally be met. It will be easier to meet the test if the corporation also supplies some equipment and machinery for the farming operation, but this should not generally be necessary. An analysis of the estimated hours of work performed by the employees of the corporation for the management and operational functions should be completed. The corporation must be able to prove that it, through its employees, directly performs active and substantial management and operational functions to a greater degree than was

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represented under the facts of Rev. Rul. 86-126. If the sharecroppers complete all planting, raising and harvesting of the crops, and also supply all of the farm equipment (including repairs and maintenance), it will be difficult, if not impossible, for the corporation to prove that it, through its employees, is actively conducting a trade or business.

A corporation that attempts to qualify as an “active trade or business” must be able to show that its employees perform substantial management and operational functions over and above those performed by the sharecroppers. This includes evidence that the corporation’s employees perform substantial management functions, including marketing the grain, purchasing input materials, and enrolling the corporation’s real estate in federal agricultural programs, soil conservation programs, etc. The corporation should also show that its employees maintain the corporate-owned property and real estate, grade the roads, clean irrigation ditches, maintain irrigation equipment, provide security against trespassers, hunters, etc., if it is to be any chance of meeting the active trade or business requirement.

### Conclusion

Business transition planning is an essential part of the life-cycle of a family business. The determination of the goals of both the first and second generation of business owners is necessary to develop a transition plan that will meet the needs of the people involved. In most cases, minimization of income and transfer taxes will be a primary goal of all of the parties. This goal normally can be best achieved when it is set in advance and the short-term operational decisions are made with this goal in mind. In the case of a corporate division under §355, the operational decisions must reflect the need to maintain an active trade or business using the property that is to be the subject of the division. If the activity level is not sufficiently maintained, a tax-free division is not a viable alternative and, unless the new generation of owners can work together, substantial taxes may be incurred in dividing the business.

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