Corporate Tax  Segment 5D  
Corporate Liquidations

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Corporate Complete Liquidations

The Structure of Part II of Subchapter C

Subpart A - Effects on Recipients  
§§331, 332, & 334

Subpart B - Effects on the Liquidating Corp.  
§§336, 337 & 338

Subpart C - §341 - Repealed in 2003

Subpart D - Definitions  §346(a)

Complete liquidation defined
Liquidation vs. Dissolution

**Liquidation** as a tax concept – termination of corporate activities, satisfaction of liabilities and distribution of the corporation’s assets.

**Dissolution** – a state law concept (termination of the charter).

See Texas Business Corporation Act, §6.01 et. seq. concerning a voluntary corporate dissolution.

Options for Shareholder Taxation in a Liquidation

1) Non-recognition - reverse the earlier §351 treatment? But, how deal with the cash?
2) Dividend distribution to the extent of E&P? But, how deal with the recovery of tax basis?
3) "Exchange" treatment for the distributed assets - i.e., stock sale and tax basis recovery. Similar to redemption treatment qualifying as a “sale or exchange” under §302(b)?

But, what treatment of the E&P account?
Shareholder Treatment for Liquidation Distribution

§331(a) – a complete liquidation enables “sale or exchange” income tax treatment to the shareholder.

§334(a) – tax basis to the shareholder for property received in a liquidation is its FMV at the time of the liquidation distribution.

Timing issues: (i) installment obligations distributed- §453(h)(1)(A); and; (ii) creeping liquidation distributions.

Example (a)

A owns 100 shares of Humdrum Corp. purchased for $10,000 (i.e., tax basis). Humdrum has $12,000 accumulated E&P. Humdrum distributes $20,000 to A in exchange for A’s stock in its liquidation. Result: $10,000 LTCG under Code §331. ($20,000 received less $10,000 cost basis) E&P is not relevant for this transaction.
Example (b)

$10,000 is received in two consecutive years.
Timing question: See Rev. Rul. 85-48 which permits full recovery of tax basis before reporting any gain (i.e., “open transaction” treatment appears available).
Cf., Code §453(j)(2) - ratable tax basis recovery is required even when the selling price is not readily ascertainable.

Example (c)

Humdrum distributes $8,000 cash and an installment obligation of $12,000, payable $1,000 per year for 12 years, with market rate interest. $10x basis. The obligation is received by Humdrum upon its sale of a capital asset after liquidation plan adopted. Gain of $10,000 is realized on the liquidation. Shareholder may report gain on installment note under § 453(h)(1). continued
**Example (c), continued**

Installment sales reporting treatment:
- 4,000 LTCG of the 8,000 cash payment
- 500 LTCG of each later 1,000 payment

Alternative income tax reporting treatment:
- Basis recovery for 8,000 and remainder of the transaction reported on installment basis.

Publicly traded stock: §453 is then not available; §453(k)(2)(A).

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**Example (d)**

Installment obligation was received two years ago and no payment has been made on the obligation. Sale within 12 months’ of liquidation limit applicable - §453(h)(1)(A).

Not entitled to report on installment method.

A would: (1) recognize 10,000 LTCG (20,000 less 10,000 basis) and (2) take a $12,000 basis in the installment obligation under §334(a).
Example (e)

1) A required to pay $5,000 judgment against Humdrum in his capacity as a transferee. Arrowsmith case - must take a $5,000 LTCL. The tax characterization relates back.

2) If paid by corporation prior to liquidation:
For the corporation - (i) producing a $5,000 ordinary deduction, and (ii) reducing the net proceeds by 35% tax on $5,000 (or $1,750).

Consequences to the Liquidating Corporation

Issue: Does a distribution of property in kind in a complete liquidation trigger gain recognition to the distributor corporation as to the distributed asset?

Result: §336(a) - requires recognition by the distributing corporation of accrued property gain and also provides for the availability (in some situations) of a loss deduction. Reversing former §337.
Historical Perspective - Corporate Level Gain

1) Commissioner v. Court Holding Co.
Substance of the transaction was a sale of an apartment house (corporation's sole asset) by the corporation, not the shareholders.

2) U.S. v. Cumberland Public Service Co.
Property transferred to shareholders as a liquidation distribution in kind.
Held: Sale by shareholders and not by the corporation (and no corporate level gain).

Limitations on Corporate Loss Recognition

Loss can be recognized (sometimes). §336(a).
Cf., §311 - no loss can be recognized when a corporate distribution is not in liquidation.
Certain losses are allowed even though §267 loss limitation may apply when transfers of loss property made between related persons.
Double loss may be permitted (corporation & shareholder levels) - after a §351 dropdown of loss property.
Limitations on Corporate Loss Deduction Availability

Related persons: 1) If the distribution is not prorata. §336(d)(1)(A)(i).
2) Property is acquired by the corporation within five years of the date of distribution. An “anti-stuffing rule.” §336(d)(1)(A)(ii).

All shareholders: §336(d)(2) - losses with a tax avoidance motive. Only those losses accruing after contribution to the corporation are allowed. Note: §362(e)(2).

Example (a) Prorata Asset Distributions

Gainacre $300,000 accrued gain.
Lossacre $400,000 accrued loss.
Cash $200,000

Prorata distribution to tenants in common.

$300,000 gain is recognized by X Corp.
$400,000 loss is also recognized by X Corp.

§336(d) loss limitation rule is not applicable (assets have been held for five years).
Example (b)
Loss asset to majority owner

Loss acre and cash to Ivan; Gain acre to Flo.
Not a prorata distribution.
Gain is recognized by X Corporation on the transfer to Flo - §336(a).
Loss is not recognized since (1) distribution is not pro rata-§336(d)(1)(A)(i) &
(2) Ivan is related - i.e., he owns more than 50 percent of X Corporation - §267(b)(2).

Example (c)
Loss asset to minority owner

Gain acre and cash to Ivan; Loss acre to Flo.
Gain acre – X Corporation recognizes the $300,000 of gain on the distribution to Ivan.
Loss acre to Flo - not a "related person" and the §336(d)(1)(A) loss limitation is not applicable.
Therefore, X Corporation may recognize the §400,000 loss.
Example (d)
Loss asset held less than 5 yr.

Gainacre - $300,000; Lossacre - ($400,000).
Prorata distribution as tenants in common.
Lossacre acquired as a contribution to X Corporation capital four years ago.
The $300,000 gain on Gainacre is recognized.
Distribution of "disqualified property".
§336(d)(1)(B). Only $160,000 (40%) of the $400,000 loss on Lossacre is recognized. cont.

Example (d), continued

Lossacre had a value of $1 million and a basis of $800,000 at the time contributed to X corporation.
Loss is not “built-in”; but, the property is “disqualified property” - §336(d)(1)(B).
Property is distributed to a “related person”.
The loss on the distribution to Ivan is not recognized (i.e., 60% of the $400,000 loss).
Example (e)
Loss asset held less than 2 yr.

Lossacre (no relationship to X's business operations) is transferred to X by Ivan and Flo in a §351 transaction 18 months prior to the adoption of the liquidation plan when Lossacre had a FMV of $700,000 and an adjusted basis of $800,000. FMV declines to $400,000 FMV. If no §362(e)(2) application:
Lossacre to Flo - Loss is $300,000 to corp, not $400,000. Partial loss is allowed.

Example (f)

Gainacre and Lossacre transferred to X by Ivan and Flo contributes 200x.
Ivan assets: 900x basis and 800x FMV, and basis to be reduced by 100x.
Prorata distribution. §336(d)(1)(A) does not apply.
Lossacre is §336(d)(1)(B) disqualified property. X has no loss deduction for 80% of the 300x remaining built-in loss (240x).
Example (g)

Assume §336(e)(2) applied to Ivan’s contribution and §336(d)(2) applies to Lossacre because a plan existed to recognize loss on that property.
No loss recognition is permitted.

Liquidation of a Controlled Subsidiary

Liquidation of a subsidiary into a parent corporation - assets remain held in corporate form (i.e., held by the parent corporation).
Result to controlling corporate shareholder:
Under §332 - no gain or loss on the receipt by the corporation of property in the complete liquidation of an 80% or more subsidiary.
Corp. parent’s sub stock basis disappears.
§334(b)(1) - transferred asset bases to parent.
George L. Riggs

Question: What timing for measuring the ownership of at least 80% of the stock.
Redemption implemented by corporation to get to the 90% share ownership level in sub.
Held: The liquidation plan was adopted when the formal shareholder action was taken (and not adopted previously).
When is the liquidation plan adopted?
Result: § 332 is an elective provision.

Consequences to the Distributing Corporation

§337 - nonrecognition of gain or loss results on distributions of property by a subsidiary to its parent corporation in a complete liquidation to which § 332 applies.
§334(b)(1) - parent corporation takes (i) a transferred basis for assets and (ii) carryover of recapture of depreciation potential.
No acceleration of the installment gain upon upstream distribution of notes. §453B(d)(1).
Distributing Corporation & Minority Shareholders

Distribution of assets by the corporation in §332 liquidation to minority shareholders triggers gain, but not loss, to the corporation. Loss distributions - see §336(d)(3) limitation. No loss deduction - to avoid directed distributions of loss property to the minority shareholders (who do have a recognition event upon the receipt of the distribution).

Cancellation of Debt Owing from Sub to Parent

Situation: transfer of property to satisfy debt of the subsidiary to the parent corporation. §337(b)(1) - any transfer of property in satisfaction of a debt is treated as a distribution and not as a taxable event. Objective: Precludes picking loss property for transfer in eliminating debt, while having a tax-free transfer of the appreciated property in the §332 liquidation. §334(b)(2).
§337(b)(2) - nonrecognition treatment for the liquidation of a subsidiary is not available where the parent recipient corporation is a tax-exempt organization.

Exception: This taxability treatment is not applicable if the property is used in the charity’s unrelated trade or business - §511.

What impact when liquidation distribution is made to a foreign parent corporation?

Example 1(a)

**Property Distributions**

S distributes inventory (appreciated) to I (10%) and other assets to P, Inc. (90%).

i) No recognition to P - realized gain of $6,000 ($9,000 less $3,000); & gets 90% of the E&P.
   §334(b) transferred basis for assets received.

ii) Individual shareholder - recognize stock gain. $800 LTCG - basis 200 and inventory of 1,000 received. §334(a) re inventory basis.

iii) Treatment to S? Recognition for inventory.
Example 1(b)
Depreciated Property to Indiv.

Equipment to I and other assets to P.

1) P has land and inventory received with §334(b)(1) basis; plus 90 percent of 2,000 E&P (or 1,800) to P.

2) I recognizes 800 stock gain - 1,000 FMV less 200 basis equals 800 gain; 1,000 (stepped-down) basis to I for the equipment received.

3) S - §336(d)(3) - No loss recognition to S on the distribution to I (& no E&P adjustment).

Example 1(c)
High Tax Basis for Sub Stock

P's basis in its S stock is $30,000 and S also had a $30,000 basis in the land. If S is liquidated the 30,000 basis for the stock and the loss potential for the stock disappears.

The potential tax loss on the land is preserved in P's hands through a transferred tax basis for the land under §334(a).

Loss on the equipment to I is not preserved.
Example 1(d)
Avoiding §332 Applicability

How avoid §332 applicability to enable (i) S to recognize built-in loss on the equipment and (ii) P to recognize the loss on its S stock? P could (i) sell S stock to get below 80 percent requirements, or (ii) intentionally fail to meet the time requirements of §332 by liquidating P over a period longer than the 3 year time limit in §332(b)(3). But, §336(d)(1)(A)?

Example 2(a)
When/how to adopt plan?

Child adopts a plan of complete liquidation and distributes $2,000 cash to Uncle and the remaining assets to Mother Corp. No §332. 1) Child recognizes 3,000 on the distribution of the installment obligation; 900 gain on the land; 900 §1245 gain on the equipment. 2) Uncle - 1,000 loss on the stock. 3) Mother has 5,000 gain; also, not succeeding to the $10,000 NOL of Child (less any gain).
**Example 2(b)**
**Redemption of Uncle’s Shares**

2,000 cash to Uncle for a redemption of his 25 shares and the subsequent adoption of a plan of liquidation by Child (into Mother).

Distribution of remaining assets to Mother pursuant to plan of complete liquidation - when Mother owns 100 percent of the shares of Child. No gain recognition then occurring.

Can the $10,000 NOL be preserved in this situation? Step transaction treatment?

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**Example 3**
**Debt Owing by Subsidiary**

P owns all the S stock (having $1,000 basis in the stock) and holds S bonds with a tax basis and a face value of $1,000.

Depreciated inventory and appreciated land.

Distribution of inventory in satisfaction of $1,000 debt prior to adopting a formal plan of liquidation. Objective of S is to recognize the $9,000 loss on the inventory.

Result: Step-transaction doctrine applicable?