Presentation:

Corporate Taxation
Chapter Seven: Complete Liquidations
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The Structure of *Part II* of Subchapter C

Subpart A – Effects on Recipients

§§331, 332, & 334

Subpart B – Effects on the Liquidating Corporation

§§336, 337, & 338

Subpart C – Repealed in 2003

§341

Subpart D – Definitions – Complete Liquidation Defined

§346(a)
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 Organizations Code §11.01 re “terminated entity” and “winding up”.

§11.052 re “winding up procedures”

§11.101 re “certificate of termination”
Shareholder Tax Treatment
For Liquidation Distribution

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

§334(a) – tax basis to the shareholder for any 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 (and cost recovery)?
Problem (a)  
Liquidation Distribution

FACTS: 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 §331. ($20,000 received less $10,000 basis).

E&P account is not relevant for this transaction.
FACTS: $10,000 is received in two consecutive years.

RESULT:

1. If the two cash transfers are both liquidating distributions, then Rev. Rul. 85-48 permits **full recovery of tax basis** before reporting any gain (i.e., “open transaction” treatment appears available). But, §453(j)(2) provides for **ratable** tax basis recovery even when the selling price is not readily ascertainable.

2. Unresolved Issue is whether the first distribution is part of a liquidation plan. This is a factual question.
FACTS: 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.

RESULT: Gain of $10,000 is realized on the liquidation, but the shareholder may report gain on the installment note under §453(h)(1). Installment sales reporting treatment: (i) $4,000 LTCG on the $8,000 cash payment and (ii) $500 LTCG for each later $1,000 payment. It is possible that A could use Rev. Rul. 85-48 to get basis recover first for the $8,000 and then report the remainder on an installment basis. If stock were publicly traded, then §453 is not available (see §453(k)(2)(A)) so $10,000 immediate gain.
FACTS: Installment obligation was received two years ago and no payment has been made on the obligation.

RESULT: Installment method is not available to the shareholder. The use of the installment sale method is not permitted when the note is created more than 12 months before the plan of liquidation. See §453(h)(1)(A). 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).
FACTS: A required to pay a $5,000 judgment against Humdrum in his capacity as a transferee.

RESULT: A must report a long-term capital loss on the payment. Why? *Arrowsmith* tax case. The payment characterization relates back to the earlier liquidation where long-term capital gain was reported. If the judgment had been paid by Humdrum prior to liquidation, it would have produced a $5,000 ordinary deduction to Humdrum and reduced its net proceeds distributed to A by $5,000 (less a $1,750 tax benefit).
Consequences to the Liquidating Corporation

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

Result: §336(a) – (1) requires recognition by the distributing corporation of accrued property gain and (2) provides for the availability (in some situations) of a loss deduction. Reversing former §337 and the General Utilities doctrine. Cf., treatment of loss on property distribution in the dividends context.
1) **Commissioner v. Court Holding Co.** (p.324) Substance of the transaction was a sale of an apartment house (corporation’s sole asset) by the corporation, not by the shareholders.

2) **U.S. v. Cumberland Public Service Co.** (p.326) Property transferred to the shareholders as a liquidation distribution in kind. Held: Sale by the shareholders and not by the corporation (and no corporate level gain).
1) Former Code §337 – Anti-Court Holding provision enabled income tax immunity for sales of corporate assets after the adoption of the liquidation plan. Seller could be either corporation or shareholder but no corporate level gain.

2) Subsequent response: 1986 repeal of the General Utilities doctrine and gain recognition is required at the corporate level for all asset sales, including after the liquidation plan adoption. Code §336.
Loss can be recognized (sometimes). §336(a).

Cf., §311 – no loss can be recognized when a corporation distribution is not in liquidation.

Certain losses are allowed even though the §267 loss limitation may apply to transfers of loss property between related persons.

Double loss may be permitted (corporation and shareholder levels) after a §351 dropdown of loss property. But, note: §362(e)(2).
Related Persons:

1) If the distribution is not prorata. §336(d)(1)(A)(i).

2) Where the property is acquired by the corporation within five years of distribution. An “anti-stuffing rule”. §336(d)(A)(ii).

All shareholders: §336(d)(2) – losses with a “tax avoidance” motive. Then only those losses accruing after contribution of loss property to the corporation are allowed to corp. on distribution.
Prorata distribution of assets to Ivan and Flo as tenants in common.

1. Corporation: $400 loss recognized and $300 gain is recognized. §336(d) loss limitation rule is not applicable because assets have been held by Corp. for five years and distributed pro ratably.

2. Shareholders: take FMV basis in each asset.
FACTS: Lossacre and cash to Ivan. Gainacre to Flo. Not a prorata distribution.

RESULT: Gain is recognized by X on the transfer to Flo per §336(a), but loss is not recognized since: (1) the distribution is not prorata - §336(d)(1)(A)(i) and (2) Ivan is related, i.e., he owns more than 50 percent of X Corporation - §267(b)(2).
FACTS: Gainacre and cash to Ivan.
Lossacre to Flo.

RESULTS: X Corporation recognizes the $300,000 of gain on the distribution to Ivan.
X also recognizes the loss of $400,000 on Lossacre to Flo because Flo is not a “related person” and so the §336(d)(1)(A) loss limitation is not applicable.

Flo and Ivan basis in property is $400,000.

Planning: Target loss property to minority shareholder.
Prorata distribution as tenants in common. Lossacre was acquired as a contribution to X Corporation capital four years ago.

RESULT: The $300,000 gain on Gainacre is recognized. Distribution of Lossacre represents “disqualified property” under §336(d)(1)(B). Consequently, only $160,000 (40%) of the $400,000 loss on Lossacre is recognized. Lossacre had a value of $1 million and a basis of $800,000 at the time contributed to X Corporation (i.e., appreciated). 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).
FACTS: 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.

RESULTS: Recognize $300,000 gain on Gainacre. FMV declines to $400,000 FMV.

If no §362(e)(2) application (no basis step-down), then a partial loss is recognized by X on its transfer of Lossacre to Flo of $300,000. The $400,000 is reduced by the amount of the pre-contribution built-in loss.
Gainacre and Lossacre transferred to X by Ivan. Flo contributes 200x. Ivan assets: 900x total basis and 800x FMV; Lossacre basis reduced by 100x to 700x at time of contribution to X by reason of §362(e)(2).

Prorata distribution from X means that §336(d)(1)(A) does not apply (distribution is prorata). However, Lossacre is disqualified property within the meaning of §336(d)(1)(B). X has no loss deduction for 80% of the 300x remaining built-in loss since 80% was distributed to a related party. 20% of the loss (i.e., 20% of 300 = 60) is deductible.
Assume: (1) §362(e)(2) applied to Ivan’s contribution to X and (2) §336(d)(2) applies to Lossacre because a plan by X existed to recognize the loss on that property.

No loss recognition is permitted.
A §331 Liquidation creates a separate taxable event at the shareholder and at the corporate level.

**Shareholder:** §331 Gain* or Loss.

*§453(h) allows installment sale treatment for distribution of installment note

§334 FMV basis in property received

**Corporation:** §336 Gain or Loss*

*§336(d) sets forth exceptions for loss recognition
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.
Question: What timing for measuring the ownership of at least 80% of the stock?

Redemptions 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.
§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, etc. potential.

No acceleration of the installment gain upon the upstream distribution of notes. §453(d).
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).
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 tax exempt’s unrelated trade or business - §511.

What impact when liquidation distribution is made to a foreign parent corporation?
Problem 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) and P 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 to I.

iii) Treatment to S? Recognition for inventory.
Problem 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).
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 §336(a).

Loss on the equipment to I is not preserved.
Problem 2(a)
When/How to Adopt Plan?

Child adopts plan of complete liquidation and distributes $2,000 cash to Uncle and 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).
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 a plan of complete liquidation – when Mother then owns 100 percent of shares of Child.

No gain recognition then occurring. The $10,000 NOL be preserved.
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.

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 so collapsed and treated as all part of a liquidation.