

# **Chapter 7- 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### **Subpart C - §341 - Repealed in 2003**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

## p.323

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Liquidation as a tax concept – termination of the corporate activities, satisfaction of liabilities, and distribution of the corporation's assets to (1) the creditors and (2) the shareholders.

Alternative mechanism for federal tax purposes: Assuming an “eligible entity” has “checked the box” for corporate status – change (“uncheck”) the tax status into a partnership or disregarded entity form.

# Liquidation vs. Dissolution

## Cont., p.323

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Dissolution – a state law concept (termination of the state issued charter). See Texas Business Organizations Code, §11.01 re “terminated entity” and “winding up.”

§11.051 & 11.052 re “winding up procedures.”

§11.101 re obtaining a “certificate of termination.”

# Options for Shareholder Taxation in a Liquidation

- 1) Non-recognition - reverse the earlier §351 treatment? But, how deal with the \$US cash?
- 2) Dividend distribution to the extent of E&P? But, how deal with the recovery of tax basis?
- 3) “Exchange” treatment, i.e., stock sale and tax basis recovery. Similar to redemption treatment qualifying as a “sale or exchange” under §302(b)? But, then, what treatment of the E&P account? Does it disappear without income tax effect? Yes.

# **Shareholder Tax Treatment for Liquidation Distribution**

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

**§334(a)** – the tax basis to the shareholder for any property received in the liquidation is its FMV at the time of the liquidation distribution (including debt, i.e., see the Crane case).

**Timing issues:** (i) installment obligations distributed - §453(h)(1)(A); and, (ii) creeping liquidation distributions (& cost recovery 1st)?

## **Problem (a)**

**p.327**

# **Liquidation Distribution**

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**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 to A under Code §331.**

**(\$20,000 received less \$10,000 cost basis)**

**E&P account is not relevant for this transaction.**

## Problem (b)

p.328

## Several Liquidation Payments

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\$10,000 is received in two consecutive years.

Timing question: See Rev. Rul. 85-48 (p.326) which permits full recovery of tax basis before reporting any gain (i.e., “open transaction” treatment appears available).

Cf., installment sales provision, Code §453(j)(2) – a ratable tax basis recovery is required - even when the selling price is not readily ascertainable.

Query: Is 1st distribution part of liquidation plan?

## Problem (c)

p.328

## Installment Reporting?

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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 for A's shares. The obligation is 1<sup>st</sup> received by Humdrum upon its sale of a capital asset after its liquidation plan is adopted.

Gain of \$10,000 is realized on the liquidation. Shareholder may report the gain on the installment note under §453(h)(1). *continued*

# **Problem (c), continued**

## **p.328**

**Installment sales reporting treatment:**

**4,000 LTCG on the 8,000 cash payment**

**500 LTCG on each later 1,000 payment**

**Alternative income tax reporting treatment:**

**(1) Basis recovery for 8,000, and (2) remainder of the transaction is reported on an installment basis.**

**If publicly traded stock: §453 is not available; §453(k)(2)(A) applies & 10,000 gain is to be immediately recognized to A.**

## Problem (d)

p.328

## Installment Note Received

Installment obligation was received two years ago and no payment has been made on the obligation. The limit on qualifying installment sale within 12 months of liquidation is applicable - §453(h)(1)(A). Installment method is not available to shareholder. 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).

## Problem (e)

p.328

## Later Payment of Judgment

1) A is required to pay a \$5,000 judgment against Humdrum in A's capacity as a transferee. Why?

*Arrowsmith* tax case - must take a \$5,000 LTCL.

The tax characterization relates back.

2) If paid by the corporation prior to liquidation:

For the corporation - (i) producing a \$5,000 ordinary deduction, and (ii) reducing the net proceeds by the \$5,000 payment (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 distributor corporation as to the distributed asset?

Result: §336(a) - (1) requires recognition by the distributing corporation of its accrued property gain (reversing *former* §337), and, (2) provides for the availability (in some situations) of a loss deduction. Cf., treatment of loss realized on a property distribution in the dividends context (i.e., no loss recognition).

# Historical Perspective - Corporate Level Gain Tax?

Note: Relevance/importance of the “fact finder.”

## 1) Commissioner v. Court Holding Co. (1945)

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. (1950)

Property was transferred to the shareholders as a liquidation distribution in kind. Held: Property sale was made by the shareholders and not by the corporation (and no corporate level gain).

# Response to Court Holding Decision p.334-336

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- 1) Former Code §337 – anti-Court Holding provision enabled income tax immunity for sales of corporate assets after the adoption of the complete liquidation plan (including the corporation's sales).
- 2) Subsequent response: 1986 repeal of the General Utilities rule & gain recognition is required at the corporate level for all asset sales – including after the liquidation plan adoption.  
Code §336.

# Limitations on Corporate Loss Recognition

## p.336

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 the §267 loss limitation rule may otherwise apply to transfers of loss property between related persons.

Double loss may be permitted (corporation & shareholder levels) - after a §351 dropdown of loss property. But, note: §362(e)(2) re basis to corp.

# Limitations on Corporate Loss Deduction Availability



A) Related persons: 1) If the distribution is not prorata to shareholders. §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)(1)(A)(ii).

B) All shareholders: §336(d)(2) - losses with a “tax avoidance” motive. Then, on distribution only those losses are allowed which accrue after the contribution of the loss property to corporation.

# Problem (a)

p.340

## Prorata Asset Distributions

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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 by Corp. for at least five years).

## Problem (b)

p.341

## Loss asset to majority owner

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Lossacre and cash to Ivan; Gainacre to Flo.

Not a prorata distribution.

a) \$300,000 gain is recognized by X Corporation on the transfer to Flo - §336(a).

b) \$400,000 loss is not recognized since: (1) the 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). Basis of 400,000 to Ivan for Lossacre when received.

## Problem (c)

p.341

## Loss asset to minority owner

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Gainacre and cash to Ivan; Lossacre to Flo.

Gainacre – X Corporation recognizes the \$300,000 of gain on the distribution to Ivan.

Lossacre 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. Flo's basis is \$400,000.

Planning: Target the loss property to the minority shareholder.

## Problem (d)

p.341

## Loss asset held less than 5 yr.

Gainacre - +\$300,000; Lossacre - (\$400,000).

Prorata distribution to tenants in common.

Lossacre was 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 (but not \$240,000).

Basis for Lossacre: \$240,000 & \$160,000. *continued*

# Problem (d), continued

## p.341 Disqualified Property

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Part 2: Lossacre had a value of \$1 million and a basis of \$800,000 at the time contributed to X corporation (i.e., appreciated). No change in result.

Loss is not “built-in”; but, the property is “disqualified property” - §336(d)(1)(B).

Property is (partly) distributed to a “related person.” Again: The loss on the distribution to Ivan is not recognized (i.e., 60% of the \$400,000 loss).

## Problem (e)

p.341

### 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 §362(e)(2) applies: (basis step-down of Lossacre to \$700,000).

Lossacre to Flo – no pre-contribution loss & no applicability of §336(d)(2) & 300,000 loss to corp.

Gainacre to Ivan: Gain of \$300,000 to corp. cont.

# **Problem (e) *continued*. P.341**

## **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 (no basis step-down):*

Lossacre to Flo – (Partial) loss is \$300,000 to corp. (realized while held by corp.), not \$400,000.

Even though distribution to Flo. §336(d)(2)(B)(i).

# Problem 2(a)

p.341

## Disqualified Property

(1) Gainacre & Lossacre (800x FMV) transferred to X by Ivan & (2) Flo contributes 200x cash.

Ivan's assets: 900x total basis and 800x FMV;

Lossacre basis reduced by 100x to 700x. §362(e)(2).

Prorata distribution. §336(d)(1)(A) does not apply (distribution is prorata). §336(d)(2) not applicable.

Lossacre is §336(d)(1)(B) “disqualified property.”

X has no loss deduction for 80% of the 300x remaining built-in loss (240x); but, loss of 60x OK.

## Problem 2(b)

p.341

### §§ 362(e)(2) and 336(d)(2)

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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 (e.g., transferred within two years).

No loss recognition of entire \$300,000 built-in loss is permitted. The prorata portion distributed to Flo (not a related person) is then not relevant & no loss deduction is allowed.

# Liquidation of a Controlled Subsidiary - §332 p.341

Liquidation of an 80% subsidiary into a parent corporation, i.e., assets remain held in corporate form (i.e., held by the parent corporation).

Result to the controlling corporate shareholder:

Under §332 - no gain or loss recognized on receipt by the parent corporation in the complete liquidation of an 80% or more subsidiary.

Corporate parent's sub stock tax basis disappears.

§334(b)(1) - transferred asset bases to the parent.

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**p.343**

## **Liquidation Plan Adoption**

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**Question: What timing for measuring the ownership of at least 80% of the stock?**

**Redemptions were implemented by the corporation to get to the 90% share ownership level in the sub.**

**Issue: When is the liquidation plan adopted?**

**Held: The liquidation plan was adopted when the formal shareholder action was taken (and not adopted previously on an informal basis).**

**Result: § 332 is an elective provision. Date of plan adoption controls stock ownership testing.**

# **Consequences to the Distributing Corporation**



**What treatment of the liquidating subsidiary?**

**See p. 350. Code § 337 provides that nonrecognition of gain or loss results on distributions of property by a subsidiary to its parent corporation in a complete liquidation to which Code §332 applies.**

**No recognition of installment gain on upstream distribution of instalment notes if §332 applies.**

# Consequences to the Parent Corporation

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## Collateral consequences:

### §334(b)(1) - parent corporation takes

- 1) a transferred tax basis for assets, and
- 2) carryover of the recapture of depreciation (e.g., §1245) potential.
- 3) transferred basis for installment obligations received by parent corporation.

# Distributing Corporation & Minority Shareholders

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Distribution of assets by the corporation in §332 liquidation to minority shareholders triggers gain, but not loss, to corporation on those distributions.

FMV basis for assets received by minority. §334(a).

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 p.351

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**Situation:** transfer of (loss?) 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 from sub to parent and not as a taxable disposition event.

Objective: Precludes picking loss property for transfer to eliminate debt, while having a tax-free transfer of the appreciated property in the §332 liquidation. §334(b)(1) transferred basis to P.

# Tax-Exempt & Foreign Parent Corp. Recipients

P. 352. §337(b)(2) - nonrecognition treatment for the liquidation of a subsidiary is not available where the parent recipient corporation is a tax-exempt organization.

UTBI Exception: This taxable treatment is not applicable if the property is used in the tax exempt's unrelated trade or business - §511 tax.

What impact when liquidation distribution is made to a foreign parent corporation? Recognition unless continuing U.S. income tax jurisdiction.

# Problem 1(a)

p.353

## 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) & P gets 90% of E&P of S.

§334(b)(1) transferred basis for assets received by P.

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

iii) Treatment to S? 900x recognition for inventory.

## **Problem 1(b)**

**p.353**

### **Depreciated Property to Indiv.**

Equipment (depreciated) 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 stock basis equals 800 gain; 1,000 (stepped-down) basis to I for the equipment received by I.
- 3) S - §336(d)(3) - No loss recognition to S on the distribution to I (& no E&P adjustment).

# **Problem 1(c) p.353**

## **High Tax Basis for Sub Stock**

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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 to P for the S 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(b)(1).

P's loss on the equipment to I is not preserved.

P receives 1,800 (90%) of S's E&P.

# **Problem 1(d)**

**p.353**

## **Avoiding §332 Applicability**

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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 at time of liquidation, 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, a §336(d)(1)(A) limit on non-pro-rata distribution?

## Problem 2(a)

p.353

## When/how to adopt plan?

Child Corp. adopts plan of complete liquidation & distributes \$2,000 cash to Uncle & remaining assets to Mother Corp. No §332 nonrecognition.

- 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 (3,000 less 2,000).
- 3) Mother has 5,000 gain; also, not succeeding to the \$10,000 NOL of Child (less any gain realized).

## Problem 2(b)

p.353

## Redemption of Uncle's Shares

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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 is then occurring.

Can the \$10,000 NOL be preserved in this situation? Is step transaction treatment applicable?

# Problem 3

p.354

## Debt Owed 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. See §337(b)(1).

Result: Is the step-transaction doctrine applicable?  
Loss limitation under Code § 267?