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Corporate Liquidations

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TREATMENT TO THE SHAREHOLDER §331

Section 331(a)(1) states the general rule that amounts distributed in complete liquidation of a corporation shall be treated as payments to the shareholder in exchange for his stock.

The amount of the shareholder's gain or loss will, therefore, be the difference between the net fair market value of the property distributed to him in liquidation and the basis of his stock. The nature of the gain or loss will be capital if the stock is a capital asset in the shareholder's hands, which will usually be the case. This assumes that the corporation is not a collapsible corporation.[1]

So, on the one hand, §331(a)(1) does not treat amounts distributed in complete liquidation as a dividend to the extent of the corporation's earnings and profits. Rather it treats the transaction as a sale of stock by the shareholder. On the other hand, where the corporation's assets are distributed in kind to the shareholder he has not yet really terminated his interest in those assets, but because the transaction is treated as a sale or exchange of stock, he may be required to pay a tax on receipt of these assets if their value exceeds his stock basis. Unless a sale of the assets for cash follows shortly thereafter, this could cause difficulties.

There are two statutory provisions which we will discuss shortly, §§332 and 333, under which the shareholder may be able to avoid the recognition of gain on liquidation and postpone that gain until he sells the assets. As we will see, these sections are applicable only in limited circumstances.

Where the liquidation is goverened by the general rule of §331, the basis of the assets in the hands of the shareholders will be the fair market value of the assets at the time of liquidation. This ability to obtain a stepped up basis for assets at the cost of a capital gains tax is one incentive for the use of the liquidation-reincorporation device to be discussed later in the program.

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[1] I.R.C. §341

Upon a subsequent disposition of those assets the nature of the income or loss, if any, will depend on the nature of those assets in the shareholders' hands and whether the disposition was in the form of a "sale or exchange." If the assets are sold at their fair market value shortly after their taxable receipt in liquidation, there should be little further gain or loss since the basis of the assets will be their fair market value on the date of distribution.

TREATMENT TO THE CORPORATION §336

1. Introduction

Even though the corporation has adopted a plan of complete liquidation, the corporation must continue to report its income from sales, collections of rent or interest and from other sources until the corporation ceases business and dissolves, retaining no assets. Of course, there will not be recognition of gain or loss with respect to sales of certain property to the extent §337 is applicable. A separate concern is whether the corporation will have gain or loss if it distributes its assets in kind to its shareholders incident to liquidation.

2. General Rule of Non-Recognition

The general rule, set forth in §336, is that the corporation recognizes neither gain nor loss on the distribution of its assets in liquidation even though those assets may have appreciated or depreciated in value since acquisition.

3. Statutory Exceptions

Section 336, itself, contains an exception for installment obligations referring us to §453(d) for those situations where distribution of an installment obligation will cause gain recognition to the corporation. This topic has already been covered by an earlier speaker.

There are other statutory exceptions to the general rule of non-recognition. Although there are no explicit references in §336 to these other statutory exceptions, the terms of those sections make it clear that they override §336 in most situations.[2]

[2] The statutory exceptions to §336 usually do not apply to a liquidation under §332 where the basis of the assets in the hands of the parent is determined by §334(b)(1).

Thus, the depreciation recapture rules of § 1245 will apply to a distribution of appreciated "§ 1245 property" and may cause recognition of ordinary gain to the distributing corporation to the extent of prior depreciation deductions taken with respect to that property. Section 1250, the real estate depreciation recapture section, as well as § 1251 dealing with farm property also cut across § 336.

Under § 341(f)(2), dealing with collapsible corporations, gain must be recognized on the distribution of subsection (f) assets.

The corporation may also have to make an adjustment if it distributes property with respect to which an investment credit was taken, under circumstances constituting an early disposition of such property. Here the adjustment will be in the form of an increase in the tax for the taxable year of distribution as provided in § 47(a)(1).

It is important to note that § 311(d) added by the 69 Tax Reform Act to cause the recognition of gain to a corporation distributing appreciated property in redemption of its stock does not apply to distributions in partial or complete liquidation.

4. Judicial Exceptions

On occasion, the courts have applied fundamental doctrinea or principles of income taxation, sometimes with the aid of specific statutory references, to override the statutory rule of non-recognition of gain or loss to the liquidating corporation contained in § 336. A substantial body of case law exists and we can just mention a few of the more important instances. A similar development has taken place with respect to § 311(a) which provides a general rule of non-recognition of gain or loss on non-liquidating distributions by a corporation and there is considerable overlap between the case law exceptions to these two sections.

Moreover, many of the cases creating exceptions to § 336 have their counterpart in case law exceptions to § 337.

A. The assignment of income doctrine may cause the corporation to be taxed on income earned by it before liquidation but not realized until after the right to the income has been distributed. In *Williamson v. U.S.*,[3] for example, a liquidating cash basis corporation was taxed on the distribution to its share-

[3] 292 F.2d 524 (1961).

holders of accounts receivable arising from its business activities. These accounts receivable would normally not have been included in the cash basis corporation's income until collected.

B. Other cases have required the corporation to recognize income upon liquidation on the theory that this result was necessary to clearly reflect the corporation's income under § 446 (b). In *Jud Plumbing and Heating Co. v. Commissioner*[4] and *Standard Paving Co. v. Commissioner,*[5] for example, corporations on the completed contract method of accounting under which income would be recognized only when the work was completed were required to shift to the percentage of completion method and to report a portion of their income from the incompleted contracts at the time the contracts were distributed in liquidation.

C. Finally, under certain circumstances, a sale by the shareholders of property distributed to them in liquidation will be imputed to the corporation with the result that the corporation may have to report the profit on the sale as income.

This, of course, is the *Commissioner v. Court Holding Co.*[6] doctrine which may be applied where the corporation participates in the sale transaction by negotiations, prior agreement or other significant activities warranting a conclusion that in substance the sale was made by the corporation and the shareholders were a mere conduit through which to pass title.

This issue freguently arose before 1954 because an outright sale by the corporation would be taxable to it and there would be a second tax to the shareholders on distribution of the liquidation proceeds. On the other hand, a liquidation prior to any negotiations with a purchaser would ensure that only a tax on liquidation would be imposed but the shareholders would then be taxed without the availability of a ready purchaser to convert the assets to cash. So attempts were made to arrange the sale before liquidation but have it consumated after liquidation with the result of one tax on liquidation but with a sale shortly thereafter generating cash. The problem was that these activities by corporate officers before liquidation sometimes caused the sale by the shareholders to be imputed to

[4] 153 F.2d 681 (5th Cir. 1946).
[5] 190 F.2d 330 (10th Cir. 1951).
[6] 324 U.S. 331 (1945).

the corporation with a resulting tax at the corporate level, followed by a tax to shareholders on liquidation.

Section 337 was enacted to alleviate this problem by providing for non-recognition of gain on sales by the corporation so that there will be only one tax, on liquidation, to be reported by the shareholders even if the sale is imputed to the corporation. But as you have seen, § 337 does not apply to sales of certain kinds of property, to collapsible corporations, to liquidations under § 333, and most liquidations under § 332 and the doctrine still has vitality in these areas.

The *Court Holding* doctrine is not really an exception to § 336, since where applicable, income is attributed to the corporation not because of the distribution of property to the shareholders but because of a determination that the subsequent sale by the shareholders was in reality made by the corporation.

5. Corporate Deductions Relating to Liquidation

On the deduction side, the costs incurred by the corporation in carrying out a plan of complete liquidation can be deducted by the corporation as an ordinary and necessary business expense. Where the liquidation is part of a tax free reorganization only the expenses allocable to the liquidation aspect of the transaction can be deducted. Also where there are sales of property by the corporation incident to the liquidation, expenses relating to such sales may have to be capitalized and applied to offset the proceeds received on the sale.

The corporation should also be able to deduct at liquidation previously capitalized items, such as unamortized organizational expenses or unrefunded prepaid insurance premiums at least if the benefits from such items expire with the corporation's liquidation.

§ 333 - ELECTIVE ONE-MONTH LIQUIDATION IN KIND: NON-TAXABLE LIQUIDATION

Let's look first at the treatment accorded shareholders under the provisions of § 333 and then mention some of the technical requirements that must be met to have this treatment apply.

A "qualified electing shareholder," as we will define later, will recognize no gain on the receipt of a liquidating distribution if the corporation has no earnings and profits accumulated after

February 28, 1913, *and* if he receives in liquidation no money or stock or securities acquired by the liquidating corporation after December 31, 1953.[7]

If these items are present, then any realized gain (the excess of the fair market value of assets distributed to him over his adjusted basis for his stock) will be recognized to the extent of the greater of:

(1) his ratable share of the corporation's post-1913 earnings and profits as of the end of the liquidation month; or

(2) the sum of the cash plus the fair market value of any stock or securities acquired by the corporation after December 31, 1953, received by him.[8]

If the shareholder is a corporation, any recognized gain is treated as a capital gain entirely.[9] With respect to non-corporate shareholders gain required to be recognized will be taxable as a dividend to the extent of the non-corporate shareholder's ratable share of earnings and profits as of the end of the liquidation month undiminished by liquidating distributions and the remainder of the recognized gain if any will be taxable as capital gain.[10]

For example: A corporation owns land with a basis of $300,000 and a fair market value of $700,000 and also has cash and post-53 securities totalling $300,000 in value. The corporation has earnings and profits of $200,000. Assume also that a sole individual shareholder has a stock basis of $600,000. If the corporation liquidated under §333, the shareholders' realized gain of $400,000 would be recognized to the extent of $300,000, and of that amount $200,000 would be ordinary dividend income and $100,000 capital gain. That is the way Section 333 works. Of course, Section 333 would not be elected in such a case. The shareholder would rather recognize his full gain under §331 of $400,000 capital gain, but this example illustrates how §333 may be far from a non-recognition provision. Section 333 is best suited to the liquidation of a corporation holding appreciated assets but having little or no earnings and profits or cash or post-53 stock or securities. *E.g.*, a corpora-

[7] I.R.C. §333(e), §333(f).
[8] I.R.C. §333(e), §333(f).
[9] I.R.C. §333(f).
[10] I.R.C. §333(e).

tion whose principal asset is a parcel of unimproved real estate.

So where the corporation has substantial earnings and profits a §333 election is usually not advisable. That is easily stated but there may be difficulty in accurately determining just what the amount of the corporation's earnings and profits are.

Of particular concern where a sale of the assets by the shareholders is contemplated is the application of the *Court Holding* principal since §337(c)(1)(B) makes the protective provisions of §337 inapplicable to a liquidation under §333. Thus a sale by the shareholders which is attributed to the corporation will cause not only a gain at the corporate level, but an increase in corporate earnings and profits which may have an effect on the amount; and if the shareholders are individuals, the nature of the recognized gain at the shareholder level. This result can occur whenever gain is recognized by the corporation on a liquidating distribution under any of the statutory or judicial exceptions to §336 we spoke of.

The fact that the receipt of cash causes the shareholder to recognize his gain to that extent can be understood in light of the fact that there is no hardship in reporting gain at the time of liquidation to the extent cash is received, and it would not be feasible to give money a basis other than its full value.

The section in effect treats stock and securities acquired after December 31, 1953, as the equivalent of cash in causing gain recognition if distributed to the shareholders in liquidation. The reason for this was to prevent the corporation from converting its cash into temporary investments just prior to liquidation to avoid a tax to the shareholders. But instead of stating that stock or securities acquired within a certain period prior to liquidation will cause gain to the shareholders if distributed, Congress just used a specific date, December 31, 1953, (when enacting the 1954 Code), and this date has been brought forward only in special cases. So gain can be recognized to the shareholders in 1973 on the distribution of stock or securities acquired almost 20 years ago under a provision meant to block last minute conversions of cash to investment securities. On the other hand, it seems possible for the corporation to reduce its cash by purchasing assets other than stock or securities or by paying off its debts although in appropriate cases the IRS might claim these were sham transactions.

The purpose of § 333 is to relieve the shareholders from the burden of paying a tax on liquidation where appreciated assets are distributed to them, but it was only intended to provide tax postponment, not tax forgiveness. Therefore, the basis of the distributed property, other than cash, to an electing shareholder will be the basis of his *shares* in the liquidating corporation less any money received, plus any gain recognized.[11] This will ensure that upon subsequent sale of the distributed property the gain postponed at the time of liquidation will be recognized. But note that the nature of the postponed gain will now depend on the nature of the asset in the hands of the shareholder.

THE ELECTION AND OTHER REQUIREMENTS OF § 333

As far as the technical requirements which must be met, they are numerous and become rather complex particularly where you have a large number of shareholders, some corporate and some individual. The essential requirements are as follows:

Section 333(a)(1) requires that the liquidation be pursuant to a plan of liquidation adopted before the first distribution under the liquidation occurs.

All electing shareholders must file with the IRS written elections (on Form 964) within 30 days after the adoption of the liquidation plan.[12]

As to non-corporate shareholders, election must be made by shareholders who at the time of the adoption of the plan own at least 80% of the total combined voting power of all classes of stock entitled to vote owned by non-corporate shareholders. Corporate shareholders are tested separately and must meet the same percentage test. However, a corporate shareholder who at anytime between January 1, 1954, and the date of adoption of the liquidation plan owned 50% or more of the voting power of all classes of stock entitled to vote is excluded from the corporate calculation and from the use of § 333;[13] so one group may use § 333 if their 80% test is met even though the other group decides not to. As to non-electing or excluded shareholders, their gain or loss is governed by general liquidation

[11] I.R.C. §334(c).

[12] I.R.C. §333(d); Treas. Reg. §1.333-3.

[13] I.R.C. §333(b), §333(c)(2).

provisions.

The corporation must then distribute all property (except property retained to meet claims) to shareholders in complete liquidation within some one calendar month.[14] It is difficult to see the reason for this one-month limitation, since it does not have to be the month in which the plan of liquidation was adopted or even the same taxable or calendar year of the corporation. Many of the problems regarding complete distribution of assets within this time period remind one of similar problems under § 337 with its 12 month period and, in fact, most relevant cases and rulings are under § 337.

Since this is an elective provision providing favorable treatment through the postponment of gain to the shareholders, the courts have tended to be rather strict in requiring attention to its details, especially the filing of the election properly and on time.[15]

On the other hand, the regulations provide that the election once made is irrevocable.[16] This may pose a problem where there had been an error in determining the amount of earnings and profits. For example, in one case[17] it was thought that earnings and profits were $80,000, but after the elections were filed it was discovered that they were $900,000. In that case, the shareholders were allowed to withdraw their elections, but other courts have not been as sympathetic.

Finally it should be recalled that § 333 is not applicable to a collapsible corporation unless it meets the tests of § 341(e) or it is a collapsible corporation to which § 341(a) does not apply because, for example, it meets one of the exceptions contained in § 341(d).[18]

§ 332 LIQUIDATION OF A SUBSIDIARY

No gain or loss is recognized by a parent corporation on the receipt of property in complete liquidation of a subsidiary if the

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[14] I.R.C. §333(a)(2).

[15] Posey v. U.S., 449 F.2d 228 (5th Cir. 1971). Failure to file form 964. Held §333 did not apply.

[16] Treas. Reg. § 1.333-2(b).

[17] Meyer's Estate v. Commissioner, 200 F.2d 592 (5th Cir. 1952).

[18] I.R.C. §333(a).

conditions of § 332 are met. This is, of course, like § 333 an exception to the general rule requiring the recognition of the shareholder's gain or loss on liquidation.

Section 332 and its basis provision § 334(b) may come into play in two very different factual settings. The first situation is where a parent corporation that has owned a subsidiary for a number of years decides to liquidate the subsidiary and bring its assets within the parent structure. The relevant code provisions treat this as a mere change of form and not an appropriate time to impose a tax. Thus no gain or loss is recognized to the shareholders on the liquidation, and § 334(b)(1) provides that the parent corporation takes over the assets at the subsidiary's basis. As far as the subsidiary's gain or loss on distribution of its assets, the statutory exceptions to the non-recognition of gain or loss rule of § 336 usually do not apply where there is a § 332 liquidation with a carryover basis for the assets. For example, there will be no depreciation recapture under § 1245 or § 1250 in such a case, or investment credit recapture.[19]

A quite distinct situation arises where a business has been sold by means of a stock sale and the corporate purchaser now wishes to liquidate the newly acquired subsidiary in order to acquire its assets directly. Section 332 is still the provision governing the recognition of gain or loss to the purchaser parent corporation on liquidation. However, if the purchasing corporation in this case were required on liquidation to carry over as its basis for the assets the basis they had in the hands of the subsidiary, it might not get the advantage of the true cost of these assets to it, namely the price it paid for the stock. For this reason § 334(b)(2) was enacted in 1954 providing that the parent corporation's basis for property acquired in a § 332 liquidation under these circumstances is determined by the cost of the stock, rather than the subsidiary's basis for the assets.[20] If § 334(b)(2) is applicable as the governing basis provision, the purchaser will have approximated the results of a direct asset acquisition.

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[19] I.R.C. § 1245(b)(3); I.R.C. § 1250(d)(3).

[20] This result had already been reached judicially. See Kimbell-Diamond Milling Co. v. Commissioner, 14 T.C. 74, *aff'd per curiam* 187 F.2d 718 (5th Cir.)

This requires a closer look at some of the main requirements of § 332 and § 334(b)(2).

(1) *Requirements for non-taxable subsidiary liquidation*

(a) Purchasing corporation must own at least 80% of all classes of stock (by vote and number except for preferred which is non-voting). The 80% test must be met on the date the plan of liquidation is adopted and maintained until the final liquidating distribution is received by the parent.[21]

(b) The distribution must be pursuant to a plan of liquidation adopted by both the parent and the subsidiary. A resolution authorizing distributions in complete liquidation will constitute a plan.[22]

(c) There are also time limits within which the assets must be distributed in liquidation.[23]

(d) All the subsidiary's property must be distributed in cancellation of all its stock.[24]

(2) *§ 334(b)(2)*

(a) In order to qualify for the basis treatment provided for by § 334(b)(2), stock sufficient to satisfy the 80% stock interest requirement of § 332 must have been acquired by the parent by "purchase" within a 12 month period. As to the meaning of "purchase" § 334(b)(3) and the regulations tell us that any stock acquisitions qualifies if:

(1) Thebasis of the stock in the parent's hands is not determined either by reference to the basis of an immediately preceding shareholder (*i.e.*, a carryover basis) or by reference to § 1014(a) relating to property acquired from a decedent.

(2) Stock is not acquired in a § 351 exchange (corporate formation).

(3) Stock is not acquired from a person related to the parent under § 318(a) (the stock attribution rules).

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[21] I.R.C. §332(b)(1).
[22] I.R.C. §332(b)(2).
[23] I.R.C. §332(b)(2), (3)
[24] I.R.C. §332(b)(2).

(b) A plan of liquidation must be adopted within 2 years after the final qualifying purchase.

(c) The liquidation itself must qualify as non-taxable under § 332.

So an 80% interest must be acquired within a 12 month period, and that period runs from the date of the earliest qualifying purchase.

Again, if § 334(b)(2) applies, the corporate purchaser of stock may allocate the purchase price of the stock over the assets acquired (except cash) and this should approximate the fair market value basis the purchaser would have had if it purchased the assets directly. This allocation of the stock basis to the assets may at times involve some complicated adjustments.

As far as the tax consequence to the liquidating corporation, the basic rule of no gain or loss on distribution of property in complete liquidation will be overcome by most of the same statutory and judicial exceptions first mentioned when we discussed § 336. Immunity from these gain recognizing exceptions to § 336 is only granted to those § 332 liquidations in which the parent's basis for the acquired assets is a carryover of the basis those assets had in the hands of the subsidiary.

For non-corporate purchasers of stock, the liquidation would be covered by § 331 and technically a taxable transaction. Usually, however, there will be no gain or loss since the value of the distributed assets should equal the cost basis of the stock. The purchaser would take a basis in the property equal to the fair market value of the property at the time of distribution.