COMPLETE LIQUIDATIONS

INTRODUCTION AND STUDY OBJECTIVES

A complete liquidation involves termination of a corporation’s existence—in other words, a corporate contraction. Corporate distributions to shareholders in complete liquidation generally give them capital gain or loss even though the corporation has earnings and profits. In certain circumstances, special types of liquidations offer particular tax advantages to the corporation and its shareholders. But where liquidation is contemplated at the time of organization, certain penalty provisions apply in an effort to discourage such a formation.

In studying the rules of corporate liquidations, the student should have these objectives:

1. To learn the general rules of corporate liquidation and to become familiar with the beneficial elections available to the taxpayer contemplating a liquidation.
2. To learn how a subsidiary of a parent corporation is liquidated and what elections are available to the parent corporation.
3. To become familiar with the provisions of “collapsible corporations” and how they apply to convert the character of income in a complete liquidation.

STUDY HIGHLIGHTS

COMPLETE LIQUIDATIONS IN GENERAL

1. Amounts that are distributed in complete liquidation of a corporation are usually treated as in full payment in exchange for stock, thereby creating capital gains to individual shareholders. The corporation itself generally does not recognize any gain or loss on the distribution of its assets. A summary of the liquidation provisions is as follows:

   § 331: The general rule for gain and loss to the shareholder.
   § 332: Complete liquidation of a subsidiary.
   § 334: The basis of assets received under §§ 331 and 332.
   § 336: The general rule for distributions of property by the liquidating corporation.
   § 337: The nonrecognition rules of a liquidation from a subsidiary to a parent corporation.
   § 338: Stock purchase treated as an asset purchase.
COMPLETE LIQUIDATIONS: EFFECT ON SHAREHOLDERS

2. Under § 331 each shareholder recognizes gain or loss equal to the difference between the fair market value (FMV) of the property received and the basis of the stock surrender. The basis of the property received by the shareholder under a § 331 liquidation is the FMV of that property on the date of distribution.

Example. In a liquidating distribution, L corporation distributes land to T, its sole shareholder. The land has a FMV of $68,000 and basis to L of $20,000. T has a basis of $26,000 in the stock she surrenders to L. Even though L may have earnings and profits, the amount taxable that will be taxable to T as capital gain will be $42,000. T's basis in the land received will be $68,000.

COMPLETE LIQUIDATION: EFFECT ON THE CORPORATION

3. In an effort to conform with the repeal of the General Utilities doctrine, Congress completely revamped the liquidation rules under the Tax Reform Act of 1986. As a result, § 336 provides that a corporation must recognize gain and loss on a distribution in complete liquidation beginning in 1987.

4. If a shareholder assumes a corporate liability or takes the property subject to a liability, the fair market value of the property is treated as being no less than the liability.

Example. Pursuant to a complete liquidation, M Corporation distributes to its sole shareholder land held as an investment having a basis of $100,000 and FMV of $230,000. If the land distributed is subject to a liability of $350,000, M must recognize a gain of $250,000 by substituting the liability for the fair market value of the property.

5. The basic difference between liquidating distributions and nonliquidating distributions is that a corporation can recognize a loss in a liquidating distribution. To prohibit potential abuses, however, Congress provided for two exceptions:

a. The first exception prohibits the deduction of the entire loss on certain distributions to related parties under § 267.

b. The second exception limits the amount of loss that can be taken where property is contributed to a corporation that contains a built-in loss. This will usually apply where the contribution takes place within the two years prior to liquidation.

Example. Z corporation is owned equally by two brothers. One year before Z liquidates, the shareholders transfer property with a basis of $200,000 and FMV of $130,000 [built-in loss] to Z in return for stock under § 351. In liquidation, Z returns the property (still worth $130,000) back to the brothers. The § 267 limitation applies because the brothers are deemed to own 100% the stock and disqualified property was transferred within two years of liquidation. Accordingly, none of the $70,000 loss can be recognized by Z corporation.
LIQUIDATION OF A SUBSIDIARY

6. Under § 332, gain or loss is generally not recognized upon the complete liquidation of a subsidiary. Instead, the basis of the subsidiary’s assets and other tax attributes are carried over to the parent corporation under basis rules provided in § 334.

7. For purposes of § 332, a subsidiary is defined as a corporation in which the parent owns 80 percent of the voting power and 80 percent of the total number of shares of all classes of stock other than nonvoting preferred stock.

8. When a subsidiary is liquidated under § 332, the property received by the parent corporation has the same basis that the subsidiary had in the property. This is known as a carryover basis under § 334(b)(1).

9. In 1982 Congress enacted § 338, which allows a parent corporation to elect to have the basis in the subsidiary’s assets received equal to the basis that the parent corporation had in the subsidiary’s stock.

10. Under the new rules of § 338, stock purchases will be treated as asset purchases when an acquiring corporation makes an election within 8 and one-half months after a qualified stock purchase to treat an acquired subsidiary as if the subsidiary had sold all of its assets in a taxable sale to itself. This sale must be reported on the subsidiary’s final tax return. On the day following the acquisition date, the “new” corporation will be treated as having purchased all of the assets of the old corporation.

Example. S corporation has a basis in all of its assets of $1.6 million, which have a fair market value of $3 million. During the year, P corporation purchases 80% the stock in S for $2.4 million (80% $3 million). Since the basis of the assets is less than the purchase price and in order to eliminate E&P, P elects § 338. In this manner, S is deemed to have sold all of its assets to itself for a grossed-up purchase price of $3 million ($2.4 million × [100% by 80%]) and must recognize a gain of $1.4 million. On a subsequent liquidation, P will take as its basis in the assets $2.4 million (80% the $3 million distributed).

11. Because the § 338 election is treated as a deemed asset purchase, no tax attributes carry over to the new corporation. The basis of the assets in the “new” corporation is their fair market value. The purchase price must be adjusted for ownership less than 100 percent, thereby giving consideration to minority interests.

12. Qualified stock purchase is the purchase of at least 80 percent of the voting power and at least 80 percent of the total number of shares of another corporation during a 12-month acquisition period. Acquisition date refers to the date on which the 80 percent level of acquisition is attained.

13. The § 338 regulations provide that the deemed purchase price of the stock is to be allocated to the subsidiary’s assets using the residual value approach. Thus, assets must be grouped into seven classes for purposes of making the allocation:

1. Class I: Cash, demand deposits, and other cash equivalents;
2. Class II: Certificates of deposit, U.S. government securities, readily marketable securities, and other similar items;
3. Class III: Accounts receivable;
4. Class IV: Inventory;
5. Class V: All assets other than those in Classes I, II, III, IV, VI, or VII;
6. Class VI: Section 197 intangibles other than goodwill or going concern value; and
7. Class VII: Intangible assets in the nature of goodwill and going concern value.
STUDY QUESTIONS

True or False

1. No loss shall be recognized to the liquidating corporation on the distribution of any property to a related person under § 267.

2. A corporation undergoing a § 338 liquidation will recognize gain on the appreciation of its assets on the deemed sale to itself.

3. A distribution received by a shareholder as a result of a complete liquidation when the shareholder receives less than her basis in the stock results in ordinary income.

4. A distribution of property received in a complete liquidation is its adjusted basis at the time of distribution.

5. The disposition of depreciable property, other than to a parent corporation, during the liquidation period will not result in the recognition of ordinary income.

6. A § 338 liquidation requires an election within 8.5 months that cannot later be rescinded.

7. After 1986 it is possible to have a bulk sale of inventory in a § 337 liquidation.

8. The basis of assets received in a general liquidation under § 331 is the fair market value on the date of distribution.

9. An in-kind liquidation is one in which the shareholder receives the property of the corporation without converting the property to cash.

10. A corporation can avoid treatment under § 341 if it realizes two-thirds of the income from its § 341 assets prior to the sale or liquidation.

11. In 2009 M corporation liquidated under § 331 and distributed depreciable personal property (purchased in 2001) with a fair market value of $80,000 and adjusted basis of $50,000. Depreciation claimed by the corporation was $25,000. M corporation should include $25,000 of ordinary income on its tax return.

Multiple Choice

1. Corporation T distributed marketable securities in redemption of its stock in a complete liquidation. The securities had a cost basis of $150,000 and an appreciated value of $225,000. What is the character of the gain or loss that Corporation T has to recognize on the distribution?

   a. None.
   b. Capital gain.
   c. Capital loss.
   d. Ordinary gain.
   e. Ordinary loss.
2. Which of the following statements is correct regarding the complete liquidation of a subsidiary corporation under § 332?
   a. Gain is recognized on the liquidation only to the extent of the parent corporation’s rateable share of the subsidiary’s earnings and profits.
   b. The tax attributes of the subsidiary corporation carry over to the parent.
   c. The liquidated corporation recognizes no gain or loss on the liquidation except for depreciation recapture under §§ 1245 and 1250.
   d. The minority shareholders must, like the parent corporation, recognize no gain or loss on the liquidation.
   e. None of the above.

3. A shareholder must meet certain requirements to qualify for the benefits of the nonrecognition of gain in a complete liquidation. Which of the following items is one of those requirements?
   a. Ownership of more than 50% of the corporation’s voting stock at the time the liquidation plan was adopted.
   b. Written election of nonrecognition of gain provisions filed by owners of 80 percent of the voting stock.
   c. Elections filed within 30 days after the plan’s adoption.
   d. Ownership of at least 50 percent of the voting stock by a corporation after 1954.
   e. None of the above.

The following information is to be used in answering Questions 4, 5, and 6.

R Corporation adopted a plan of complete liquidation on February 1, 2009. All the assets were distributed to the sole stockholder, R, on February 20, 2009. Since its formation in 1980, R Corporation had accumulated earnings and profits of $20,000. R’s basis in his stock is $10,000. R received the following assets in exchange for his stock:

<table>
<thead>
<tr>
<th>Cash</th>
<th>$15,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Securities</td>
<td>25,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$40,000</strong></td>
</tr>
</tbody>
</table>

4. Assuming the facts above, which amount will R report as dividend income?
   a. $0.
   b. $15,000.
   c. $20,000.
   d. $25,000.
   e. $40,000.

5. Assuming the facts above, which amount will R report as capital gain?
   a. $0.
   b. $5,000.
   c. $10,000.
   d. $20,000.
   e. $30,000.
6. Assuming the facts above, what is R’s basis in the securities?
   a. $0.
   b. $10,000.
   c. $15,000.
   d. $25,000.
   e. $35,000.

7. On October 1, 2009, A Corporation adopted a plan for a complete liquidation. Land bought in 1990 for
   investment with an adjusted basis of $30,000 was worth $90,000 in October 2008. On November 1, 2009,
   A distributed all of its assets to the stockholders. What is A’s recognized gain in 2009 on the distribution
   of the land?
   a. $0.
   b. $60,000 ordinary income.
   c. $60,000 long-term capital gain.
   d. $60,000 § 1250 gain.
   e. None of the above.

8. Assuming the same facts as above, what would your answer be if the distribution went to the sole
   shareholder, T corporation?
   a. $0.
   b. $60,000 ordinary income.
   c. $60,000 long-term capital gain.
   d. $60,000 § 1250 gain.
   e. None of the above.

Problems 9 and 10 are related:

9. N is a 50 percent shareholder in G Corporation. In 2008, G Corporation adopted a plan of liquidation that
   was properly executed and consented to by N. The earnings and profits of G Corporation were $20,000.
   N’s basis in her stock is $5,000. In 2009, G Corporation distributed the following to N in complete
   liquidation:
   
<table>
<thead>
<tr>
<th>Type of Asset</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$2,000</td>
</tr>
<tr>
<td>Fair market value of stock acquired in 1980 at a cost of $2,000</td>
<td>4,000</td>
</tr>
<tr>
<td>Land (acquired in 1980 at a cost of $5,000)</td>
<td>20,000</td>
</tr>
</tbody>
</table>

   What is N’s basis in the land after liquidation?
   a. $8,000.
   b. $10,000.
   c. $15,000.
   d. $18,000.
   e. $20,000.
10. Assuming the same facts as in Problem 9, what is N’s recognized gain in the § 331 liquidation?
   a. $0.
   b. $20,000.
   c. $21,000.
   d. $26,000.
   e. None of the above.

11. K purchased all 100 shares of N Corporation in 1990 for $50,000. N Corporation adopts a plan of liquidation on January 1, 2009. On May 1, 2009, N sells its only asset, land, for $10,000 cash and an installment note with a face amount and fair market value of $90,000. On December 1, 2009, N distributes the cash and note to K. N’s basis in the land is $36,000. On its final return, N will report a gain from the note of
   a. $0.
   b. $5,400.
   c. $27,000.
   d. $54,000.
   e. None of the above.

12. X is the sole shareholder of Z Shipping Corporation. In anticipation of the corporation’s liquidation, X in 2009 contributed an ancient wharf to the corporation with a built-in loss of $1 million (value $2 million, basis $3 million). In 2010, Z distributed the wharf along with land purchased and held for business purposes by the corporation worth $900,000 (basis $200,000). What is the amount of gain/loss recognized by Z?
   a. $1 million loss, $700,000 gain.
   b. $700,000 gain.
   c. $0.
   d. $1 million loss.
   e. None of the above are correct.

13. The treatment of distributions in liquidation differs from that in nonliquidating distributions in that the corporation is normally allowed to recognize loss on a liquidating distribution. To prevent abuse of this privilege to circumvent the gain recognition rule, restrictions prohibit the liquidating corporation from recognizing losses on distributions to related parties if:
   a. the distribution is non-pro rata (i.e., each shareholder did not receive his or her pro rata share of each type of property).
   b. the property was acquired during the first two years of a corporation’s existence.
   c. there is a “clear and substantial relationship” between the contributed property and the corporation’s current or anticipated business.
   d. All of the above.
   e. None of the above.

14. Q Corporation had assets with a basis of $800,000 and no liabilities. P Corporation bought all the stock of Q Corporation for $1 million. Three years later, when Q Corporation’s assets had shrunk to a basis of $600,000, P Corporation liquidated Q Corporation in a tax-free liquidation under § 332. What is P Corporation’s basis in the assets received from Q Corporation? (Assume that P Corporation’s basis in its assets not received from Q Corporation at the time of liquidation of Q was $750,000.)
   a. $400,000.
   b. $800,000.
   c. $1 million.
   d. $600,000.
   e. None of the above are correct.
15. Assets are grouped into seven classes under provisions of § 338. The method of establishing the value of Class VI, or intangible, assets in the nature of going concern value is

a. to determine the fair market value by appraisal on election date.
b. to assign 20 percent of fair market value to intangible assets according to the 20 percent allocation rule.
c. to assign what remains, after fair market value allocations to the five previous classes, to the intangible assets value.
d. all of the above.
e. none of the above.

Fill In the Blanks

1. A shareholder’s basis of property received in a complete liquidation is _______ _______ _______ on the date of distribution.

2. A corporation can recognize a loss in a _______ distribution.

3. The repeal of the _______ _______ doctrine now requires that a corporation recognize a gain or loss on the distribution of assets in complete liquidation.

4. If a parent corporation liquidates a subsidiary, the basis of the assets received by the parents is a _______ _______.

5. Section 338 allows a subsidiary corporation to make a _______ _______ of its assets to itself to step up their basis.

6. A “qualified” stock purchase under § 338 must be made within a _______ month acquisition period.

7. Under the “collapsible” corporation rules, the sale of a shareholder’s stock is treated as an _______ gain or loss.

8. The general rule for distributions of property by the liquidating corporation is found in § _______.

Code Section Recognition

For each of the following Code sections, try to match the response that most properly identifies the underlying provision.

1. § 331  a. collapsible corporations

2. § 332  b. shareholder gain or loss recognized

3. § 334  c. liquidations of subsidiaries

4. § 336  d. shareholder basis in liquidation

5. § 341  e. corporate gain or loss recognized
SOLUTIONS TO STUDY QUESTIONS

True or False

1. True. §336(d) cannot be revoked at any time.

2. True.


4. False. FMV on date of distribution.

5. False. § 1245 takes precedence over the liquidation provisions.

6. True.

7. False. The bulk sale rules were eliminated by the TRA of 1986.

8. True.


10. True.

11. True.

Multiple Choice

1. b.

2. b.

3. e. The shareholder must be a corporation owning 80% or more of the liquidating corporation.

4. a.

5. e. The realized gain on the transaction.

6. d. Fair market value.

7. c. § 336 requires recognition of the investment asset.

8. a.

9. e. $20,000 fair market value.

10. c. $26,000 received – $5,000 basis.
Complete Liquidations

11. d. Full gain must be reported.
12. b. $900,000 − $200,000 because the distribution is to a related party.
13. a. b and c are exceptions to the basis reduction rule.
14. d. P takes a carryover basis.
15. c. This is known as the “residual value” approach.

Fill In the Blanks

1. Fair market value.
2. Liquidating.
4. Carryover basis.
5. Deemed sale.
6. 12.
7. Ordinary.
8. 336.

Code Section Recognition

1. b.
2. c.
3. d.
4. e.
5. a.