Chapter 6: Planning for C Corp Termination

Please note. Corrections were made to this workbook through January of 2016. No subsequent modifications were made. For clarification about acronyms used throughout this chapter, see the Acronym Glossary at the end of the Index.

For your convenience, in-text website links are also provided as shortURLs. Anywhere you see **uofi.tax/xxx**, the link points to the address immediately following in brackets.

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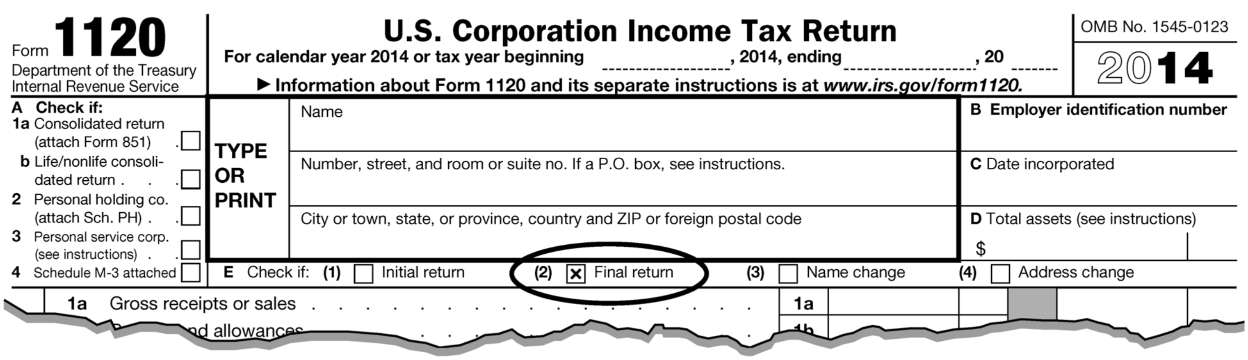
The tax consequences of liquidating a C corporation holding appreciated assets can be adverse. With maximum federal corporate rates of 35%, maximum individual rates on long-term capital gains of 20%, and the net investment income tax rate of 3.8%, **the combined federal tax burden can approach 60% of taxable income.** This does not even take into account state income tax on the corporation and the shareholder.

The final return box should be checked on Form 1120, *U.S. Corporation Income Tax Return*, when the final return is completed. There are many steps that precede this action. Checking this box communicates to the IRS that the corporation no longer exists. It should only be checked after the corporation is liquidated. In this case, the ending balance sheet on Schedule L should be blank.


Form 1120
Department of the Treasury
Internal Revenue Service
U.S. Corporation Income Tax Return
For calendar year 2014 or tax year beginning ____________, 2014, ending ____________, 20 ____
▶ Information about Form 1120 and its separate instructions is at *www.irs.gov/form1120.*
OMB No. 1545-0123
2014

A Check if:
1a Consolidated return (attach Form 851) ☐
b Life/nonlife consolidated return ☐
2 Personal holding co. (attach Sch. PH) ☐
3 Personal service corp. (see instructions) ☐
4 Schedule M-3 attached ☐

TYPE OR PRINT
Name
Number, street, and room or suite no. If a P.O. box, see instructions.
City or town, state, or province, country and ZIP or foreign postal code

B Employer identification number
C Date incorporated
D Total assets (see instructions) $

E Check if: (1) ☐ Initial return (2) ☒ Final return (3) ☐ Name change (4) ☐ Address change

1a Gross receipts or sales . . . 1a

A corporation that ceases operations and still has assets (with or without liabilities) generally transfers the remaining assets (and perhaps liabilities) to its shareholders before finalizing the liquidation.

A corporation may be liquidated by:

- Selling its assets and distributing the cash proceeds to shareholders,
- Selling its assets on an installment basis and distributing the debt obligations to shareholders,
- Making in-kind distributions of the remaining assets to shareholders (with or without lien obligations), or
- Using a combination of the preceding approaches.

Each of the following scenarios is an example of various circumstances that C corporations and shareholders may face. All of these scenarios have tax consequences that affect both the corporation and the shareholders.

SCENARIO 1

The business may be coming to an economic end. The business purpose of the corporation may become obsolete, but maintaining the corporate form could create a personal holding company tax liability[1] or an accumulated earnings tax liability.[2]

Consideration A

If the corporation liquidates the assets and retains proceeds in a brokerage account, the following factors may become relevant.

- Personal holding company issues under IRC §542 require an annual distribution or penalty taxes apply.
- Accumulated earnings tax may apply.
- Personal holding tax may apply.
- Current tax rates on sale of assets at the corporate level may be triggered.

This action avoids the second level of tax at the shareholder level (at least until any shareholder distributions are made).

Consideration B

If multiple shareholders are ready to leave the business, the following courses of action may be feasible.

- Complete liquidation of the corporation
- Division of the business by spinning off various sectors and giving shareholders subsidiary stock in exchange for their parent stock (Each shareholder then manages the subsidiary in which they own stock.)

SCENARIO 2

A retirement of the shareholders' interest may create corporate level tax on the distribution of appreciated property.[3]

Considerations

If a current shareholder wants to retire and leave the corporation to their heirs, a fixed asset (i.e. land/building) may need to be distributed to the retiring shareholder to generate retirement income. The following factors may become relevant in this situation.

- Additional tax at the corporate level with ordinary corporate tax rates
- Capital gains tax at the shareholder level
- The retiring shareholder receives a basis in the fixed asset equal to the fair market value (FMV) at the time of distribution (because that retiring shareholder has paid tax on the distribution).

SCENARIO 3

A redemption of corporate stock to pay death tax obligations of a shareholder should result only in corporate level tax.[4]

Considerations

A special share redemption under IRC §303 may be used if a shareholder dies and has insufficient funds to pay the estate tax.

- A sale of assets at the corporate level may create corporate income tax because assets inside the corporation do not receive a stepped-up basis.

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1. IRC §541.
2. IRC §531.
3. IRC §302(b)(2).
4. IRC §303.

SCENARIO 4

Succession and estate planning is leading to differences among family members because some of them wish to remain active in the business and some do not. This creates conflicting goals of shareholders that practitioners must address.

Considerations

Reorganization strategies could include:

- A spin-off of various assets (i.e., retail store and the wholesale business and the service business) into subsidiaries
- A transfer of parent company stock in exchange for subsidiary stock to each heir/child
- An S election by each subsidiary (discussed later) taking into account the consequences of liquidating an S corporation

> **Note.** If an S corporation is still within the confines of the built-in gains (BIG) tax, the tax consequences will be essentially the same as a C corporation liquidating. For further details on the BIG tax, see IRC §1374 and related regulations.

- Each subsidiary remains a C corporation or is liquidated and incurs the consequences of liquidating a C corporation.

SCENARIO 5

The corporation can sell its assets on an installment basis.

Considerations

Corporation receives installment obligation in exchange for sale of assets.

- Corporation reports the gain on the installment basis.
- When distributions (nonliquidating) are made to the shareholder, they are treated as dividends.
- If the corporation distributes the installment obligation in exchange for its corporate stock, an exception under Treas. Reg. §1.453-11 allows the **shareholder** to receive the installment obligation **and** not report the entire gain in the year of distribution. **However,** the **corporation** must report all "unreported gain" in the year of the distribution.

SCENARIO 6

If the corporation distributes property with related debt, the following considerations may become relevant.

Consideration A

If the corporation owns assets with basis lower than debt and FMV greater than the debt, then:

1. Assets distributed are deemed sold for their FMV and gain is computed on the difference between FMV and the basis, and
2. The value received by a shareholder in a liquidation is the FMV of the asset received minus the debt assumed. The basis of the asset is the FMV.

Consideration B

If the corporation has debt in excess of the FMV and basis of the assets, the following considerations may apply.

1. On distribution of these assets, the asset is deemed sold for the greater of FMV or debt. Gain is computed on the difference between basis and the greater of FMV or debt.
2. The shareholder receives the asset as a liquidating distribution, and the value is zero because debt is greater than FMV. The basis of the asset is the FMV.

SCENARIO 7

The C corporation may make an S election in order to avoid double taxation.

Considerations

Many factors must be considered if a C corporation makes an S election. The following factors should be considered.

- The corporation must meet the necessary requirements for an S election.
- After the S election has been made, the S corporation may become subject to the net excess passive income tax.[5]
- The corporation's S election will terminate if it has accumulated earnings and profits **and** more than 25% of its gross receipts are from passive investment income for three consecutive years.[6]
- During the required holding period for any assets subject to the BIG tax, the S corporation may be forced to forgo some economic gain on those assets.

SCENARIO 8

Selling assets for cash, and distributing the cash proceeds to shareholders in nonliquidating or liquidating transactions will create double taxation. Capital losses that individual shareholders have carried forward may lessen this impact.

Considerations

The corporation wants to sell the assets for cash and distribute the proceeds to the shareholder.

- Sale of assets creates income tax at corporate tax rates.
- Distributing cash may create tax at the shareholder level. The tax treatment to shareholders depends on whether the distribution is a liquidating or nonliquidating distribution.

If one of the other alternatives is not utilized, the last alternative may be a complete liquidation. This is the focus of the remainder of the chapter.

CORPORATE LIQUIDATION PLAN

References to corporate liquidation plans are found throughout this chapter. The particular terms of liquidation plans vary widely from corporation to corporation and largely depend on the following.

- The specific nature of the corporation's business
- The objectives of the shareholders, employees, and other stakeholders
- The assets to be distributed
- The tax considerations involved (Many of these tax considerations are discussed in this chapter.)

In many cases, the liquidation plan must address state statutory rules on the payment of secured and unsecured creditors and other requirements before dissolution is authorized. The liquidation plan may specifically address the filing of any required paperwork with the appropriate state agency in connection with the liquidation and dissolution. These forms frequently become part of the public record and may be announced in legal news publications. A liquidating corporation engaged in multistate business should consult the relevant statutes in all the states in which it conducts business to ensure compliance with all statutory rules.

> **Note.** For a sample of a corporate liquidation plan, see **uofi.tax/15b6x1** [www.sec.gov/Archives/edgar/data/1094895/000119312509130984/dex101.htm].

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5. IRC §1375.

6. IRC §1362(d)(3)(C)(i).

CORPORATE REPORTING REQUIREMENTS

FORM 966

Within 30 days of adopting a plan of liquidation, a corporation must file an information return that discloses details about the plan.[7] Form 966, *Corporate Dissolution or Liquidation,* is used for this purpose. The following are required.[8]

- The corporation's name and address
- The date and place of incorporation
- The date on which the liquidation plan was adopted (or the date of any amendment or supplement to the plan)
- The IRS service center to which the most recent corporate income tax return was sent and the tax year of the return

A certified copy of the corporate resolution adopting the corporation's plan of liquidation must accompany Form 966. This is generally signed by the secretary or officer of the corporation.

If the plan of liquidation is later amended or supplemented, additional disclosure is required. For an amendment or supplement, an additional Form 966 may be filed. Alternatively, the information in the preceding list may be provided along with the date of the previously filed Form 966 and a certified copy of the amendment or supplement.[9]

A shareholder is not denied the advantageous income tax treatment of dissolution distributions solely because the corporation failed to file Form 966 or filed it late. However, willful failure to file Form 966 may subject the corporation to criminal penalties.[10] Form 966 follows.

Form **966**
(Rev. December 2010)
Department of the Treasury
Internal Revenue Service

Corporate Dissolution or Liquidation

(Required under section 6043(a) of the Internal Revenue Code)

OMB No. 1545-0041

Please type or print

Name of corporation	**Employer identification number**
Number, street, and room or suite no. (If a P.O. box number, see instructions.)	Check type of return ☐ 1120 ☐ 1120-L ☐ 1120-IC-DISC ☐ 1120S ☐ Other ▶
City or town, state, and ZIP code	

1 Date incorporated	**2** Place incorporated	**3** Type of liquidation ☐ Complete ☐ Partial	**4** Date resolution or plan of complete or partial liquidation was adopted
5 Service Center where corporation filed its immediately preceding tax return	**6** Last month, day, and year of immediately preceding tax year	**7a** Last month, day, and year of final tax year	**7b** Was corporation's final tax return filed as part of a consolidated income tax return? If "Yes," complete 7c, 7d, and 7e. ☐ Yes ☐ No
7c Name of common parent		**7d** Employer identification number of common parent	**7e** Service Center where consolidated return was filed

	Common	Preferred
8 Total number of shares outstanding at time of adoption of plan of liquidation		
9 Date(s) of any amendments to plan of dissolution		
10 Section of the Code under which the corporation is to be dissolved or liquidated . . .		
11 If this form concerns an amendment or supplement to a resolution or plan, enter the date the previous Form 966 was filed		

Attach a certified copy of the resolution or plan and all amendments or supplements not previously filed.

Under penalties of perjury, I declare that I have examined this form, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete.

▶ Signature of officer | Title | Date

7. IRC §6043(a)(1).
8. Treas. Reg. §1.6043-1(b)(1).
9. Treas. Reg. §1.6043-1(b)(2).
10. Rev. Rul. 65-80, 1965-1 CB 154.

REPORTING LIQUIDATING DISTRIBUTIONS

Form 1099-DIV, *Dividends and Distributions,* must be filed for each shareholder who receives a liquidating distribution of $600 or more in cash and/or property (based on the property's FMV). Cash and property distributions are reported in boxes 8 and 9, respectively. Form 1099-DIV generally must be filed with the IRS on or before February 28 of the year following the year in which the liquidating distribution is made.

Form 1099-DIV (with boxes 8 and 9 circled for reference) follows.

☐ CORRECTED (if checked)

PAYER'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no.	**1a** Total ordinary dividends $ **1b** Qualified dividends $	OMB No. 1545-0110 2015 Form **1099-DIV**	**Dividends and Distributions**
	2a Total capital gain distr. $	**2b** Unrecap. Sec. 1250 gain $	**Copy B** **For Recipient**
PAYER'S federal identification number / RECIPIENT'S identification number	**2c** Section 1202 gain $	**2d** Collectibles (28%) gain $	
RECIPIENT'S name	**3** Nondividend distributions $	**4** Federal income tax withheld $	This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported.
Street address (including apt. no.)		**5** Investment expenses $	
	6 Foreign tax paid $	**7** Foreign country or U.S. possession	
City or town, state or province, country, and ZIP or foreign postal code	**8** Cash liquidation distributions $	**9** Noncash liquidation distributions $	
FATCA filing requirement ☐	**10** Exempt-interest dividends $	**11** Specified private activity bond interest dividends $	
Account number (see instructions)	**12** State / **13** State identification no.	**14** State tax withheld $ $	

Form **1099-DIV** (keep for your records) www.irs.gov/form1099div Department of the Treasury - Internal Revenue Service

POST-LIQUIDATION TAX RETURN

For a corporation with ongoing business, Form 1120, *U.S. Corporation Income Tax Return,* must be filed on or before the 15th day of the third month following the close of its tax year.[11] A liquidated corporation must file its final tax return (and pay any tax liability) on or before the 15th day of the third full month after its dissolution.[12] If the due date falls on a Saturday, Sunday, or legal holiday, the return must be filed by the next business day. A corporation that has completed its liquidation is considered to have been dissolved for purposes of this rule.[13]

Example 1. Moore's Engine Works Inc. (Moore's) is a C corporation with a calendar tax year. Moore's plan of liquidation, adopted in January 2015, specifies that June 30, 2015, is the final liquidation date. On June 30, the final liquidation distribution is made and the liquidation is completed.

Moore's final tax year is a short year covering the period from January 1 through June 30, 2015. Moore's final tax return is due September 15, 2015.

> **Note.** For tax years beginning after December 31, 2015, the due date for most C corporation returns is the 15th date of the **fourth** month following the corporation's tax year. For more information, see the 2015 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 7: New Developments.

11. IRC §6072(b); Treas. Reg. §1.6072-2.
12. Rev. Rul. 71-129, 1971-1 CB 397.
13. Ibid.

LIQUIDATION EXPENSES

Generally, corporate expenses incurred to liquidate the corporation, such as legal and accounting fees, are deductible[14] as ordinary and necessary expenses in carrying on a trade or business. However, corporate expenses associated with the sale of assets are generally used to reduce the gain (or increase the loss) on these sales.[15]

Any organization costs that were capitalized are deductible upon liquidation as long as the corporation is actually dissolved and liquidated. No such deduction of capitalized organization costs is allowed with a merger or consolidation because the surviving entity continues to benefit from these capitalized costs.[16]

In addition, costs incurred to issue or sell a corporation's stock are not deductible, even with a corporate dissolution.[17] Similarly, no deduction is permitted for corporate expenses incurred to reacquire stock from shareholders.[18]

Expenses paid by shareholders to liquidate the corporation cannot generally be deducted by those shareholders. Instead, these expenses are applied against any gain (or used to increase the loss) arising from the liquidating distribution.[19]

The corporation may also claim losses for the abandonment of trademarks, service marks, and other intangibles. Doing so is allowed as long as there is no likelihood of these intangibles being used post-liquidation.[20]

GENERAL CORPORATE LIQUIDATION TAX RULES

Corporations do not generally recognize gains or losses when making cash distributions to shareholders. In addition, corporations historically have not recognized gains or losses when making in-kind distributions to shareholders. This treatment was upheld by the U.S. Supreme Court in 1935 and was part of the Code until the Tax Reform Act of 1986.

HISTORICAL BACKGROUND

The tax rules that affect liquidating corporations were first considered by the Supreme Court in 1935 in *General Utilities & Operating Company v. Helvering.*[21] General Utilities Company owned shares in Island Edison Company. General Utilities had originally purchased this stock for $2,000, but the value of the stock eventually increased to approximately $1 million. General Utilities **could** have sold the stock and distributed the cash proceeds to its shareholders. Doing so would have resulted in the following two levels of taxation.

- General Utilities Company would have paid tax on the recognized gain.
- General Utilities' shareholders would have reported and paid taxes on the subsequent dividends they received.

However, General Utilities did not sell the shares and distribute the after-tax proceeds as dividends. Instead, the company made an in-kind distribution of the Island Edison Company stock to its shareholders. The Supreme Court held that General Utilities recognized no gain from the in-kind distribution of the stock. Therefore, the corporate-level tax liability was eliminated, and only the shareholder-level tax liability was incurred.

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14. IRM 4.11.7.7 (2004).
15. IRM 4.11.7.7 (2004); *Woodward v. Comm'r,* 397 U.S. 572 (1970).
16. IRM 4.11.7.7 (2004); *Vulcan Materials Co. v. U.S.,* 446 F.2d 690 (5th Cir. 1971), *cert. denied,* 404 U.S. 942; *Kingsford Co. v. Comm'r*, 41 TC 646 (1964 *acq.* 1964-2 CB 6).
17. IRM 4.11.7.7 (2004); *McCrory Corp. v. U.S.,* 651 F.2d 828 (2nd Cir. 1981); *Surety Finance Co. of Tacoma v. Comm'r,* 77 F.2d 221 (9th Cir. 1935).
18. IRC §162(k); IRM 4.7.11.7 (2004).
19. Rev. Rul. 67-411, 1967-2 CB 124; IRM 4.7.11.7 (2004).
20. IRM 4.7.11.7 (2004).
21. *General Utilities & Operating Company v. Helvering,* 296 U.S. 200 (1935).

Congress initially agreed with this *General Utilities* nonrecognition doctrine, codifying it along with a parallel nonrecognition rule for in-kind liquidating distributions. However, because of increasing concern over lost tax revenue, Congress repealed the *General Utilities* doctrine with the Tax Reform Act of 1986. This repeal eliminated the ability to bypass corporate-level taxation with an in-kind distribution of appreciated property to shareholders. The repeal process brought about the current rules associated with corporate-level taxation upon liquidation.

CURRENT GENERAL RULES

The congressional repeal of the *General Utilities* rule eventually resulted in current-day IRC §§334 and 336. These Code sections govern corporate-level taxation on the distribution of property at liquidation (and the resulting basis rule for shareholders who receive the distributed property). The general rules are designed to preserve the **double taxation** aspect associated with C corporations.

- The **corporation** that is completely liquidating recognizes gain or loss upon the distribution of property.[22] The distributed property is treated as if it were sold to the shareholders at FMV as of the distribution date.
- The **shareholders** generally recognize a capital gain or loss in the same manner as if they sold the shares. The value of the liquidating distribution received by shareholders is treated as full payment in exchange for their stock in the corporation.[23]
- The tax basis of the distributed property in the hands of the shareholders after the gain or loss is triggered is generally equal to the FMV of that property at the time of distribution.[24]

Note. Shareholder tax ramifications in a corporate liquidation are discussed later.

LIQUIDATION DEFINED

In order for the tax rules associated with a liquidating distribution to apply, the distribution must be made pursuant to a plan of liquidation.[25] The liquidating distribution may involve a single distribution, or it may involve a series of distributions (which may take place over a number of tax years).[26]

A liquidation occurs when the corporation ceases to be a going concern and corporate activities are reduced to paying liabilities, winding up corporate affairs, and distributing the remaining assets to shareholders.[27] Cessation of business is the determining factor **regardless** of whether a **formal** plan of liquidation is adopted, how the distributions occur, or how shareholders characterize those distributions. In contrast, a corporation that continues its business activities through another corporation owned by the same shareholders is **not** considered liquidated.[28]

22. IRC §336(a).
23. IRC §331(a).
24. IRC §334(a).
25. IRC §346(a).
26. *Rollestone Corporation v. Comm'r*, 38 BTA 1093, 1105 (1938); *R. D. Merrill Co. v. Comm'r*, 4 TC 955 (1945); *J. Paul McDaniel v. Comm'r*, 25 TC 276 (1955); *Estate of Charles Fearon v. Comm'r*, 16 TC 385 (1951).
27. Treas. Reg. §1.332-2(c).
28. *K. D. Yeaman v. U.S.,* So. Div., Civil No. 2366 (E.D. Wash., 1969).

For tax purposes, a corporate liquidation does not require legal dissolution of the corporation.[29] A corporation that ceased all business activity and distributed all its assets to shareholders is considered liquidated. This is the case even if the corporate charter creating the corporation under state law has not been canceled and even if the shareholders never adopted a formal liquidation plan.[30]

> **Observation.** Case law indicates that adhering to state corporate dissolution formalities and adopting a formal plan of liquidation are not required. Nonetheless, taking these steps is prudent because case law suggests that a "facts and circumstances" approach is used in determining whether a corporation is liquidating. Taking these steps along with completely ceasing the corporation's business are factors that strongly support the occurrence of a bona fide corporate liquidation.

Exceptions for Declared Dividends and Mandatory Dividends in Arrears

When a corporate dividend was declared before the liquidating distribution, it is taxed as a dividend up to the amount declared.[31] If a corporation issued preferred stock that requires the corporation to pay mandatory dividends and the dividends are in arrears at the time of the liquidating distribution, these preferred stock dividends are also taxed as a dividend.[32]

Nonliquidating Distributions

Nonliquidating distributions usually constitute either a share redemption[33] or a dividend.[34] They are generally made by corporations that continue to exist as ongoing businesses.

As with a liquidating distribution, a **redemption distribution** is also an exchange of property for shares between a corporation and one or more shareholders. However, the share redemption rules are **not** applicable to corporations in **complete** liquidations.[35]

The dividend taxation rules provide the guidelines for categorizing nonliquidating distributions as dividends (to the extent of the corporation's earnings and profits), returns of capital (up to the amount of the shareholders' stock basis), or gains from the sale or exchange of property.

> **Note.** For further details regarding dividend taxation rules, see *Limited Liability Companies: Electing Partnership vs. S Corporation Status* (2011 ed., University of Illinois, 2011).

GENERAL RULES FOR CORPORATE LIQUIDATION

As mentioned earlier, the liquidation of a corporation generally results in recognition of gains and losses by the corporation and the shareholders. The specifics of the transactions determine:

- If the gains are treated as ordinary income or capital gains, and
- If the losses are subject to limitations.

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29. Ibid.
30. *P. Shore v. Comm'r,* 286 F.2d 742 (5th Cir. 1961); Rev. Rul. 54-518, 1954-2 CB 142; *Intercounty Development Corporation v. Comm'r,* TC Memo 1961-217 (Jul. 31, 1961).
31. Rev. Rul. 69-130, 1969-1 CB 93.
32. Rev. Rul. 75-320, 1975-2 CB 105.
33. IRC §§302(b)(1)-(4).
34. IRC §301.
35. IRC §§331(b) and 301(f)(1).

Corporate Gain Recognition

A C corporation generally recognizes gains on the assets distributed. However, the nature of the assets distributed determines whether the gain is a capital gain or an ordinary gain. For example, a liquidating distribution of machinery or equipment is treated as an IRC §1231 capital gain. In contrast, a corporate distribution of inventory results in an ordinary gain.[36]

Example 2. Disappointing Corp. (DC) is a C corporation with three shareholders. Each shareholder owns an equal interest in DC stock. DC has assets with a basis of $100,000. These assets have an FMV of $250,000 on May 1, 2015 — the date shareholders decide to dissolve DC and the date on which a liquidating distribution of these assets is made to the three shareholders.

As a result of the liquidating distribution, DC recognizes a gain of $150,000 ($250,000 FMV − $100,000 basis). The liquidating distribution is treated as a sale of assets (at FMV) to the shareholders in exchange for the shareholders' stock.

The nature of the gain is determined by the nature of the assets. Capital assets result in capital gains. Assets in the liquidating distribution that DC held for more than one year result in a long-term capital gain to DC. Assets that DC held for one year or less result in short-term gains for DC. In addition, assets in the liquidating distribution that are noncapital assets (such as inventory) result in an ordinary gain for DC.

Observation. Distinguishing capital gain income from ordinary income is important if the corporation has capital loss carryforwards. Although there is no tax rate difference between corporate capital gains and ordinary income, capital losses can be used to offset capital gains.

Corporate Loss Recognition

As a general rule, with a **complete** liquidation, the corporation may also recognize a loss realized upon distributing property to shareholders. Just as with a gain, the loss is calculated as if the corporation sold its assets at FMV to the shareholders.[37]

Note. This general rule is in contrast with the rule regarding nonliquidating distributions. Generally, with a **nonliquidating** in-kind distribution, the corporation must recognize a gain but is **not allowed to recognize a loss.**[38] The taxation of nonliquidating distributions that are considered dividends is generally governed by IRC §§301 and 311. The dividend tax rules do not apply to liquidating distributions.[39]

Example 3. Analog Cogsbad Inc. (AC) is a C corporation with five shareholders. Each shareholder owns an equal interest in AC stock. On May 1, 2015, the shareholders decide to dissolve the corporation and distribute its assets to the shareholders.

The only asset AC owns is inventory valued at $60,000, which has a basis of $100,000. AC recognizes an ordinary loss of $40,000 ($60,000 FMV – $100,000 basis).

36. IRM 4.11.7.6 (2004).

37. IRC §336(a).

38. IRC §311(b).

39. IRC §331(b).

However, there are **limitations** on this general rule.

1. No loss is allowed for certain distributions to **related parties.**[40]
2. A liquidating corporation may not recognize a loss for certain property acquired in certain **carryover basis transactions (anti-stuffing rules).**[41]

Related-Party Rules Regarding Losses. The liquidating corporation may not recognize a loss on property **distributed to a related party** if **either** of the following is true.

- The distribution is **not a pro-rata distribution.**
- The property is **disqualified property** under IRC §336(d)(1)(B).

Disqualified property is any property distributed by the liquidating corporation that:

1. Originally was contributed to the corporation,
2. Qualified as a tax-deferred transaction under IRC §351 (or as a contribution to capital), and
3. Was contributed in the 5-year period ending on the distribution date.

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> **Note.** The definition of **disqualified property** includes any property contributed to the corporation with a corporate basis that is determined (entirely or partially) by reference to the precontribution basis in the property.[42] A transaction under §351 is the most common type of transaction included in this definition, but the definition includes other types of transactions that use a substituted or transferred basis. This includes property received in a like-kind exchange.

> **Note.** For further details on the contribution of property to a corporation and the provisions of IRC §351, see the 2009 *University of Illinois Federal Tax Workbook,* Chapter 10: C Corporation Issues. This can be found at **uofi.tax/arc** [www.taxschool.illinois.edu/taxbookarchive].

For purposes of disallowing a loss on corporate distributions, 14 relationships are considered **related parties.**[43]

1. Members of a family, including the following.
    a. Husband and wife
    b. Brothers and sisters (including half-siblings)
    c. Ancestors (parents, grandparents, etc.)
    d. Lineal descendants (children, including adopted children, grandchildren, etc.)
2. An individual and a corporation in which the individual owns, directly or indirectly, more than **50%** of the value of the outstanding stock
3. Members of a **parent–subsidiary** controlled group

> **Note.** For the definition of a **parent–subsidiary controlled group,** see IRC §1563(a)(1). However, under the related-party rules associated with corporate dissolution losses, a threshold of 50% is used instead of 80% under IRC §1563(a)(1).

40. IRC §336(d)(1).
41. IRC §336(d)(2).
42. IRC §336(d)(1)(B).
43. IRC §336(d)(1)(A), referencing IRC §267, which cross references IRC §1563(a).

4. Members of a **brother–sister** controlled group in which five or fewer persons (individuals, estates, or trusts) own, directly or indirectly, more than **50%** of the combined voting power or total value of all classes of stock of each corporation (When calculating whether more than 50% is owned, only identical ownership is taken into account.)
5. A grantor and a fiduciary of any trust
6. A fiduciary of a trust and a fiduciary of another trust if the same person is a grantor of both trusts
7. A fiduciary and a beneficiary of a trust
8. A fiduciary of a trust and a beneficiary of another trust if the same person is a grantor of both trusts
9. A fiduciary of a trust and a corporation in which more than 50% of the value of the outstanding stock is owned, directly or indirectly, by or for the trust or a person who is a grantor of the trust
10. A person and a tax-exempt organization[44] to which IRC §501 applies and that is controlled, directly or indirectly, by such person or by members of their family
11. A corporation and a partnership if the same persons own more than 50% of the value of the outstanding stock of the corporation and more than 50% of the capital or profits interest in the partnership
12. An S corporation and another S corporation if the same persons own more than 50% of the value of the outstanding stock of each corporation
13. An S corporation and a C corporation if the same persons own more than 50% of the value of the outstanding stock of each corporation
14. An executor and a beneficiary of an estate, except in the case of a sale or exchange in satisfaction of a pecuniary bequest

Note. Some of the preceding relationships involve stock ownership thresholds. Special constructive ownership rules are applied to determine if the ownership thresholds are met. For further details, see IRC §267(c). In addition, see the 2015 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 1: Depreciation. This chapter includes examples showing how the constructive ownership rules are applied.

Note. For further details about the related-party rules under IRC §267, see the 2009 *University of Illinois Federal Tax Workbook,* Chapter 8: Related Parties. This can be found at **uofi.tax/arc** [www.taxschool.illinois.edu/taxbookarchive].

44. IRC §267(b)(9), referencing IRC §501.

Example 4. Double U Corporation (DU) purchased some vacant land in 2001 for $100,000. DU also owns some machinery, equipment, and other assets. The company's three shareholders have the following ownership interests.

- **Alan:** 70%
- **Barbara:** 15%
- **Claire:** 15%

In 2015, the shareholders agree to liquidate DU. At the time of liquidation, the vacant land has an FMV of $60,000. In accordance with the liquidation plan, the vacant land is distributed to the shareholders on a pro-rata basis, with Alan, Barbara, and Claire obtaining 70%, 15%, and 15% interests in the vacant land, respectively. The machinery, equipment, and other assets held by DU are also distributed to the three shareholders in accordance with their ownership interests.

Because Alan holds more than a 50% interest, he is a related party to DU. However, because the vacant land was purchased directly by the corporation, it is not disqualified property. The land was distributed on a pro-rata basis to the shareholders. Thus, DU can claim the loss on the vacant land. DU has a capital loss of $40,000 ($60,000 FMV – $100,000 basis).

Example 5. Use the same facts as **Example 4,** except the vacant land is distributed exclusively to Claire. DU's machinery, equipment, and other assets are distributed such that the total amounts distributed to the shareholders for all assets is pro rata.

Claire owns less than 50% of DU and is therefore not a related party to the company. Because she is not a related party, DU can recognize the $40,000 loss on the vacant land.

Example 6. Use the same facts as **Example 4,** except the vacant land is distributed by DU exclusively to Alan. DU's machinery, equipment, and other assets are distributed such that the total amounts distributed to the shareholders for all assets is pro rata.

Alan owns more than a 50% interest in DU and is therefore a related party to the company. Because the vacant land was distributed to a related party and its distribution was not pro rata, DU cannot recognize the $40,000 loss on the vacant land upon liquidation.

Example 7. Use the same facts as **Example 4,** except the vacant land is distributed in a manner that provides Alan with a 20% interest and Barbara and Claire each with a 40% interest. DU's machinery, equipment, and other assets are distributed in a manner that makes the overall liquidating distribution pro rata.

Only the portion of the loss that is allocable to the ownership transferred to Alan is disallowed, because only Alan is a related party. The total loss is $40,000. Alan received 20% of the ownership of the land. Therefore, 20% of the loss ($8,000) is not allowed on the liquidating distribution of the land.

Because neither Barbara nor Claire is a related party, the remaining $32,000 loss allocable to each ($16,000) may be recognized by DU.

Observation. It seems odd that the corporation cannot recognize Alan's portion of the loss when the vacant land interest allocated to him is less than his percentage ownership in the corporation. However, this reflects the intent of IRC §336(d). The rules were designed to prevent related parties with controlling interests from using asset transfers into and out of corporations to create losses.

Example 8. Informatics Corp Inc. (Info Corp) was established in 2001. Devon and Eve are the two shareholders. They own 60% and 40% of the corporation's stock, respectively.

In February 2012, Devon and Eve contributed additional capital to Info Corp. Eve contributed $40,000 of cash. Devon contributed vacant land in which his basis was $50,000. At the time of the contribution, the vacant land had an FMV of $60,000.

The capital contribution by each shareholder qualified under IRC §351. Accordingly, Devon was not required to recognize any capital gain on the transfer of the vacant land. Moreover, the corporation received a transferred basis[45] in the land equal to Devon's basis of $50,000.

In October 2015, the two shareholders decide to cease Info Corp's business operations and to dissolve the corporation. All property held by Info Corp (including the vacant land) is distributed to the two shareholders on a pro-rata basis. The FMV of the land at the time of the distribution dropped to $20,000 due to the discovery of a nearby toxic waste site.

The loss on the vacant land distribution attributable to Devon may **not** be recognized by Info Corp because it is a distribution of disqualified property to a related party. The vacant land is disqualified property because it was contributed to the corporation under IRC §351 within the 5-year period ending on the distribution date. However, the loss on the distribution of vacant land attributable to Eve **may** be recognized by Info Corp because she is not a related party.

The loss on the vacant land realized by Info Corp attributable to each shareholder is as follows.

	Total	Devon	Eve
FMV of land	$20,000		
Less: basis	(50,000)		
Corporate loss realized	($30,000)	($30,000)	($30,000)
Pro rata share		× 60%	× 40%
Pro rata loss amount attributable to shareholder		($18,000)	($12,000)

Accordingly, Info Corp realizes a $30,000 loss on the distribution of the vacant land to the shareholders. It may recognize only $12,000 of that loss for tax purposes, however.

Anti-Stuffing Rules. In addition to the related-party rules, the anti-stuffing rules may also limit the corporation's ability to fully recognize a loss upon liquidation. The anti-stuffing rules are triggered if **both** of the following factors are present.[46]

1. The corporation acquires the property in a §351 transaction (or other transaction using a substituted or transferred basis).
2. The corporate assets distributed in liquidation were originally acquired by the corporation as part of a plan with the principal purpose of recognizing corporate loss upon liquidation.

Note. These corporate loss limitation rules are referred to as the **anti-stuffing rules** because they were enacted to prevent shareholders from "stuffing" loss properties into a corporation to generate a claim of corporate loss upon subsequent liquidation.

45. IRC §§362(a) and 7701(a)(43).

46. IRC §336(d)(2)(B).

If both factors are present, the basis of the distributed property is reduced by the amount by which the property's basis exceeds its FMV immediately **after the property is acquired by the corporation.**[47]

Example 9. Zip Enterprises Inc. (Zip) has several unrelated shareholders. Zip owns several retail outlets and uses a calendar tax year. In January 2015, Zip sells assets that have substantially appreciated in value. Zip is required to recognize substantial capital gains in 2015.

Some of the shareholders jointly own a parcel of vacant land. Their basis in the vacant parcel is $60,000. These shareholders contribute the parcel to Zip in January 2015 shortly after adopting a plan of liquidation. Immediately after the parcel is contributed to Zip (done in a manner that meets §351 requirements), the FMV of the parcel is $10,000.

The shareholders intend the loss to offset some of the large gains Zip must recognize on the asset sales made in early 2015. Although the contribution rules under IRC §351 would usually provide Zip with a transferred basis of $60,000 (the shareholders' basis), the anti-stuffing rules require Zip to reduce this basis.

Zip must reduce its basis in the parcel from its transferred basis of $60,000 to its FMV of $10,000. If the property's FMV is still $10,000 when it is subsequently distributed in a liquidating distribution to the shareholders, this $10,000 basis will prevent the corporation from claiming the loss as the shareholders had planned.

Example 10. Use the same facts as **Example 9,** except at the time of liquidation, the FMV of the parcel is $3,000. The $50,000 built-in loss that existed when the shareholders transferred the parcel to Zip is still disregarded. However, Zip can recognize the loss in value that occurred subsequent to the contribution of the parcel to the corporation.

Transferred basis	$60,000
IRC §336(d)(2) basis reduction	(50,000)
Reduced basis	$10,000
FMV of parcel on liquidation	(3,000)
Loss realized	$ 7,000

Zip can recognize its $7,000 realized loss upon the liquidation distribution.

Observation. Under the related-party rules discussed earlier, the amount of loss attributable to a liquidating distribution to a related party may be entirely disallowed. However, under the anti-stuffing rules, the amount of disallowed loss is limited to the built-in loss that existed when the property was transferred to the corporation. Any loss due to further devaluation of the asset to a value below the adjusted basis is generally allowable.

6

47. IRC §336(d)(2)(A).

If the corporation acquired the property **within two years** before the date on which a complete corporate liquidation plan is adopted, then the property is presumed to have been acquired as part of a plan with the principal purpose of recognizing a corporate loss upon liquidation.[48] The IRS has never drafted the regulatory guidance for taxpayers to rebut this presumption. Legislative history provides some guidance, however.[49] The conference report issued about this Code section indicates that the presumption "will be disregarded unless there is no clear and substantial relationship between the contributed property and the conduct of the corporation's current or future business enterprises."

Observation. Given this legislative history, it appears that if the contributed assets were integral to the corporation's business activities, the presumption is either inapplicable or at least easily rebuttable. However, because no clear guidance exists, it remains a gray area.[50]

Example 11. Use the same facts as **Example 9,** except the shareholders transferred the devalued parcel to Zip on June 30, 2013. The parcel was transferred with the intention of developing it into a retail outlet location. However, due to a severe downturn in business, the shareholders adopted a liquidation plan on January 1, 2015.

The parcel was contributed to Zip within the 2-year period prior to adoption of the liquidation plan. Thus, it is presumed that Zip acquired the parcel as part of a plan with the principal purpose of claiming a loss on the parcel upon Zip's liquidation. Unless the shareholders can successfully rebut this presumption, Zip must reduce its transferred basis (as discussed in **Example 9).** Doing so will eliminate the corporation's ability to claim the $50,000 capital loss on the liquidating distribution of the parcel.

However, if the shareholders can establish that the parcel was an asset integral to Zip's retail business, they may avoid reducing the parcel's basis.

Observations on Example 11.

1. Rebutting the presumption is a gray area that can be avoided if the shareholders wait until after June 30, 2015, to adopt their liquidation plan.
2. Even if the liquidation plan is adopted after expiration of the 2-year presumption period, the IRS may still contend that the basis must be reduced because the shareholders' transfer of the parcel to Zip was part of a plan for which the principal purpose was recognizing a corporate loss upon liquidation.
3. The shareholders should **document** that the business purpose of transferring the parcel to Zip was **unrelated** to the adoption of a liquidation plan.

Distributions Involving Debts

In addition to distributing money and property, a liquidating corporation may distribute liabilities to its shareholders. Along with receiving the corporation's property and/or money, the shareholders assume its liabilities.

Under such circumstances, the corporation must include at least the full amount of the liability assumed by shareholders when calculating the FMV of distributed property.[51] However, the **assigned** FMV must be treated as not less than the debts assumed by the shareholders when the property is distributed. This is true even if the amount of that liability exceeds the FMV of the property distributed.

48. IRC §336(d)(2)(B)(ii).
49. HR 841, 99th Cong. 2d Sess. at II-201 (1986).
50. For further information, see Cheryl D. Block, *Corporate Taxation,* 291-292 (4th ed., Aspen, 2010).
51. IRC §336(b).

Example 12. River Corporation, a C corporation, has a lien on its assets to secure a bank loan made to the corporation. The unpaid loan at the time of the liquidation is $15,000. The FMV of the property owned by the corporation is $100,000. The basis of the property is $30,000.

The corporation is taxed as if it had sold its assets to its shareholders at FMV. River Corporation has a taxable gain of $70,000 ($100,000 FMV – $30,000 basis). The assumption of debt does not impact the calculation of the taxable gain.

Example 13. Use the same facts as **Example 12,** except the unpaid loan at the time of liquidation is $120,000. The corporation is considered to have distributed property with an FMV of $120,000 (the debt amount) instead of $100,000, as appraised. The corporation recognizes a gain of $90,000 ($120,000 FMV – $30,000 basis). Because the assumption of debt exceeds the property's FMV, the deemed sale amount is the amount of assumed debt.

CORPORATE TAX ATTRIBUTES

Generally, tax attributes belong to the corporation. A corporation must track tax attributes while operating as an ongoing business. These tax attributes may include earnings and profits and net operating losses (NOLs). Upon the dissolution of a C corporation, these tax attributes cease to exist.

> **Note.** Although corporate tax attributes disappear upon liquidation of the corporation, this is **not** true if the liquidating corporation is an 80%-controlled subsidiary of a parent corporation. In such a case, the liquidated subsidiary's tax attributes generally carry over to the parent. This is covered in more detail later in the chapter.

Example 14. At the time of liquidation, MegaCorp had $120,000 of earnings and profits. During its years of business operation, MegaCorp's earnings and profits were tracked annually to ensure that dividend distributions to shareholders were taxed appropriately under IRC §301.

MegaCorp also had an NOL of $30,000. Upon liquidation, both the NOL and earnings and profits amounts cease to exist.

TAXATION OF SHAREHOLDERS

CALCULATION OF SHAREHOLDER GAINS OR LOSSES

Generally, an amount received by a shareholder in complete liquidation of a corporation is treated as full payment in exchange for the stock.[52] A shareholder who holds stock as a capital asset must report the distribution as a sale of their stock, and they recognize a gain or loss depending on their basis.[53] The following general formula may be used to determine a shareholder's capital gain or loss.[54]

	Amount of cash received in the liquidation
+	FMV of property received in the liquidating distribution
–	Stock basis
	Capital gain or loss

52. IRC §331(a).

53. Treas. Reg. §1.331-1(b).

54. Ibid.

The FMV of property received in the liquidating distribution becomes the shareholder's basis in that property.[55] The FMV of the property is determined as of the date of distribution.[56]

Example 15. Emu Enterprises Inc. (Emu) was formed in 1986 by its two shareholders, Alfred and Barbara. Each shareholder contributed $20,000 in exchange for 50% of Emu's stock. No further contributions were made. Each shareholder holds their respective shares as a capital asset.

In 2015, the shareholders adopt a plan of complete liquidation. The liquidating distribution to the shareholders consists of corporate property in which Emu has a basis of $30,000. The property has an appraised FMV of $100,000 at the time of the liquidating distribution.

The corporation is taxed as if it had sold its assets to the two shareholders at FMV. Emu has a capital gain of $70,000 ($100,000 FMV – $30,000 basis). The character of this gain depends on the character of the assets distributed (and Emu's holding period).

The liquidating distribution is treated as full payment for the exchange of each shareholder's stock. Alfred and Barbara each calculate their gain by subtracting their stock basis from the FMV of the property received. The relevant calculations follow.

	Alfred	Barbara	Total
FMV of property received	$50,000	$50,000	$100,000
Less: stock basis	(20,000)	(20,000)	(40,000)
Gain recognized	$30,000	$30,000	$ 60,000

Each shareholder held their shares as a capital asset and they were held for longer than one year. Thus, the $30,000 gain to each shareholder is treated as a long-term capital gain.

Gain or loss is computed on a share-by-share basis.[57] If a series of liquidating transactions occur, the shareholder may recover the basis first before any gain is recognized.[58] In addition, gains or losses must be computed separately for the specific blocks of shares acquired by the shareholder on different dates. Once the adjusted basis of a specific block of shares has been recovered, all subsequent distributions allocable to that block are recognized entirely as gain. Before a loss can be deducted, all liquidating distributions must be made.[59]

To determine how much of a distribution to allocate to a block of shares, the proportion of the block of shares to the total number of shares held by the shareholder is used. If the shareholder receives a series of liquidating distributions, the full amount of the shares owned is used in the calculation. This amount is used regardless of whether some of those shares were surrendered to the corporation prior to the final liquidating distribution.[60]

55. IRC §334(a).

56. Ibid.

57. Treas. Reg. §1.331-1(e).

58. Rev. Rul. 85-48, 1985-1 CB 126.

59. IRS Pub. 550, *Investment Income and Expenses.*

60. Rev. Rul. 85-48, 1985-1 CB 126, amplifying Rev. Rul. 68-348, 1968-2 CB 141.

Example 16. Shawna owns 300 shares of Grancorp Inc. She acquired her shares at different times and paid a different amount for each block of shares she purchased. The most recent block of shares was acquired in December 2014. The following table summarizes the relevant details of Shawna's three blocks of shares.

	Block 1	Block 2	Block 3	Total
Acquisition date	12/31/2009	12/31/2011	12/31/2014	
Number of shares	100	100	100	300
Purchase price	$10,000	$20,000	$30,000	$60,000

In 2015, the shareholders adopt a plan of liquidation for Grancorp. During the year, Grancorp makes a series of three liquidating distributions to Shawna. Each of the first two liquidating distributions is $30,000, and the final distribution is 60,000, for a total of $120,000.

The calculations in connection with these distributions, Shawna's basis recovery, and her recognized gain are as follows.

	Block 1	Block 2	Block 3	Total
Acquisition date	12/31/2009	12/31/2011	12/31/2014	
Number of shares	100	100	100	300
Allocable portion of distribution	33.33%	33.33%	33.33%	100.00%
Allocable amount of distribution 1	$10,000	$10,000	$10,000	$ 30,000
Allocable amount of distribution 2	10,000	10,000	10,000	30,000
Allocable amount of distribution 3	20,000	20,000	20,000	60,000
Total allocated distributions	$40,000	$40,000	$40,000	$120,000
Less: available basis	(10,000)	(20,000)	(30,000)	(60,000)
Amount of recognized gain	$30,000	$20,000	$10,000	$ 60,000

Of the $120,000 distributed to Shawna, $60,000 represents a recovery of share basis, and the remaining $60,000 is capital gain. Because Shawna did not hold the third block of shares for more than one year, the gain attributable to this block is a short-term gain.

A capital **loss** from a series of distributions may be claimed by the shareholder only when the loss is certain. The loss is certain when the **final liquidating payment is made** to the shareholders.[61] Using an estimate of the net assets of the liquidating corporation before the loss becomes certain is impermissible.[62]

However, a shareholder can recognize a loss if the only reason the final distribution has not been made is because of an unresolved contingency that would not have a substantial effect on the loss amount.[63]

Shareholder-Creditors

A special rule applies if the shareholder is also the creditor of the liquidating corporation. Liquidating distributions received by the shareholder-creditor are first applied against the indebtedness. Only amounts received **in excess** of the indebtedness are used to determine the shareholder's gain or loss upon liquidation.[64]

61. Rev. Rul. 68-348, 1968-2 CB 141; *Braun v. Comm'r,* 23 BTA 536 (1931).

62. *Northwest Bancorporation v. Comm'r,* 32 BTA 1218, *aff'd,* 88 F.2d 293 (8th Cir. 1937).

63. Rev. Rul. 69-334, 1969-1 CB 98.

64. *Haden Co. v. Comm'r*, 165 F.2d 588 (5th Cir. 1948).

ASSUMPTION OF CORPORATE DEBTS

Debts Assumed at the Time of Liquidation

Generally, if a shareholder assumes corporate liabilities upon liquidation of the corporation, the amount of their gain is reduced by the amount of corporate liabilities assumed (or the amount of their loss is increased). The assumed liability does not increase the shareholder's basis in the property received in the liquidating distribution.[65]

Example 17. Use the same facts as **Example 15,** except the property has a lien against it to secure a bank loan made to the corporation. The unpaid loan at the time of liquidation is $15,000. In addition to receiving the property, the shareholders also assume the $15,000 debt as part of the liquidation plan.

The shareholder assumption of a debt that is less than the FMV ($100,000) of the property does not change the tax consequences of the liquidation distribution for the corporation. However, the amount of gain recognized by the shareholders is reduced by the amount of assumed debt. Each shareholder has a long-term capital gain calculated in the following manner.

	Alfred	Barbara	Total
FMV of property received	$50,000	$50,000	$100,000
Less: stock basis	(20,000)	(20,000)	(40,000)
Less: debt assumed	(7,500)	(7,500)	(15,000)
Gain recognized	$22,500	$22,500	$ 45,000

If the amount of debt assumed by the shareholders exceeds the FMV of the property distributed, the corporation must treat the full amount of the debt as if it is the FMV of the property distributed in the liquidating transaction.[66]

Example 18. Use the same facts as **Example 15,** except the amount of the corporate debt assumed by the shareholders is $120,000. Therefore, the corporation is considered to have distributed property with an FMV of $120,000 (the debt amount) instead of $100,000 (as appraised). The corporation recognizes a gain of $90,000 ($120,000 FMV – $30,000 basis). The character of this gain depends on the character of the assets distributed (and Emu's holding period).

The amount of any gain recognized by the shareholders is reduced by the amount of assumed debt. Each shareholder's long-term capital loss is calculated as follows.

	Alfred	Barbara	Total
FMV of property received	$60,000	$60,000	$120,000
Less: stock basis	(20,000)	(20,000)	(40,000)
Less: debt assumed	(60,000)	(60,000)	(120,000)
Loss recognized	($20,000)	($20,000)	($ 40,000)

Emu Enterprises reports the distributions of property to Alfred and Barbara on Forms 1099-DIV. Alfred and Barbara report the transactions on Forms 8949, *Sales and Other Dispositions of Capital Assets,* and Schedule D, *Capital Gains and Losses.* Alfred's copies of these forms follow.

65. Rev. Rul. 59-228, 1959-2 CB 59.

66. IRC §336(b).

For Example 18

☐ CORRECTED (if checked)

PAYER'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no.

Emu Enterprises, Inc.
2250 Midway St.
Columbus, IN 47201

1a Total ordinary dividends $

1b Qualified dividends $

OMB No. 1545-0110

2015

Form 1099-DIV

Dividends and Distributions

2a Total capital gain distr. $

2b Unrecap. Sec. 1250 gain $

Copy B
For Recipient

PAYER'S federal identification number: **36-1234567**

RECIPIENT'S identification number: **123-45-6789**

2c Section 1202 gain $

2d Collectibles (28%) gain $

RECIPIENT'S name

Alfred Emu

3 Nondividend distributions $

4 Federal income tax withheld $

5 Investment expenses $

Street address (including apt. no.)

123 Washington St.

6 Foreign tax paid $

7 Foreign country or U.S. possession

City or town, state or province, country, and ZIP or foreign postal code

Columbus, IN 47201

8 Cash liquidation distributions $

9 Noncash liquidation distributions $ **60,000.00**

FATCA filing requirement ☐

10 Exempt-interest dividends $

11 Specified private activity bond interest dividends $

Account number (see instructions)

12 State

13 State identification no.

14 State tax withheld $ $

This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported.

Form **1099-DIV** (keep for your records) www.irs.gov/form1099div Department of the Treasury - Internal Revenue Service

For Example 18

Form 8949 (2015) Attachment Sequence No. **12A** Page **2**

Name(s) shown on return. Name and SSN or taxpayer identification no. not required if shown on other side	Social security number or taxpayer identification number
Alfred Emu	123-45-6789

Before you check Box D, E, or F below, see whether you received any Form(s) 1099-B or substitute statement(s) from your broker. A substitute statement will have the same information as Form 1099-B. Either will show whether your basis (usually your cost) was reported to the IRS by your broker and may even tell you which box to check.

Part II **Long-Term.** Transactions involving capital assets you held more than 1 year are long term. For short-term transactions, see page 1.

Note: You may aggregate all long-term transactions reported on Form(s) 1099-B showing basis was reported to the IRS and for which no adjustments or codes are required. Enter the totals directly on Schedule D, line 8a; you aren't required to report these transactions on Form 8949 (see instructions).

You *must* check Box D, E, *or* F below. Check only one box. If more than one box applies for your long-term transactions, complete a separate Form 8949, page 2, for each applicable box. If you have more long-term transactions than will fit on this page for one or more of the boxes, complete as many forms with the same box checked as you need.

☐ **(D)** Long-term transactions reported on Form(s) 1099-B showing basis was reported to the IRS (see **Note** above)

☐ **(E)** Long-term transactions reported on Form(s) 1099-B showing basis was **not** reported to the IRS

☒ **(F)** Long-term transactions not reported to you on Form 1099-B

1 (a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold or disposed of (Mo., day, yr.)	(d) Proceeds (sales price) (see instructions)	(e) Cost or other basis. See the **Note** below and see *Column (e)* in the separate instructions	Adjustment, if any, to gain or loss. If you enter an amount in column (g), enter a code in column (f). See the separate instructions. (f) Code(s) from instructions	(g) Amount of adjustment	(h) Gain or (loss). Subtract column (e) from column (d) and combine the result with column (g)
500 Sh Emu Enterprises	6/1/86	12/31/15	60,000	20,000	0	(60,000)	(20,000)
2 Totals. Add the amounts in columns (d), (e), (g), and (h) (subtract negative amounts). Enter each total here and include on your Schedule D, **line 8b** (if **Box D** above is checked), **line 9** (if **Box E** above is checked), or **line 10** (if **Box F** above is checked) ▶			60,000	20,000		(60,000)	(20,000)

Note: If you checked Box D above but the basis reported to the IRS was incorrect, enter in column (e) the basis as reported to the IRS, and enter an adjustment in column (g) to correct the basis. See *Column (g)* in the separate instructions for how to figure the amount of the adjustment.

Form **8949** (2015)

For Example 18

SCHEDULE D (Form 1040)

Department of the Treasury
Internal Revenue Service (99)

Capital Gains and Losses

▶ Attach to Form 1040 or Form 1040NR.
▶ Information about Schedule D and its separate instructions is at *www.irs.gov/scheduled*.
▶ Use Form 8949 to list your transactions for lines 1b, 2, 3, 8b, 9, and 10.

OMB No. 1545-0074
2015
Attachment Sequence No. 12

Name(s) shown on return	Your social security number
Alfred Emu	123-45-6789

Part I **Short-Term Capital Gains and Losses—Assets Held One Year or Less**

See instructions for how to figure the amounts to enter on the lines below. This form may be easier to complete if you round off cents to whole dollars.	(d) Proceeds (sales price)	(e) Cost (or other basis)	(g) Adjustments to gain or loss from Form(s) 8949, Part I, line 2, column (g)	(h) Gain or (loss) Subtract column (e) from column (d) and combine the result with column (g)
1a Totals for all short-term transactions reported on Form 1099-B for which basis was reported to the IRS and for which you have no adjustments (see instructions). However, if you choose to report all these transactions on Form 8949, leave this line blank and go to line 1b .				
1b Totals for all transactions reported on Form(s) 8949 with **Box A** checked				
2 Totals for all transactions reported on Form(s) 8949 with **Box B** checked				
3 Totals for all transactions reported on Form(s) 8949 with **Box C** checked				

4 Short-term gain from Form 6252 and short-term gain or (loss) from Forms 4684, 6781, and 8824 .	4	
5 Net short-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1	5	
6 Short-term capital loss carryover. Enter the amount, if any, from line 8 of your **Capital Loss Carryover Worksheet** in the instructions	6	( )
7 **Net short-term capital gain or (loss).** Combine lines 1a through 6 in column (h). If you have any long-term capital gains or losses, go to Part II below. Otherwise, go to Part III on the back	7	

Part II **Long-Term Capital Gains and Losses—Assets Held More Than One Year**

See instructions for how to figure the amounts to enter on the lines below. This form may be easier to complete if you round off cents to whole dollars.	(d) Proceeds (sales price)	(e) Cost (or other basis)	(g) Adjustments to gain or loss from Form(s) 8949, Part II, line 2, column (g)	(h) Gain or (loss) Subtract column (e) from column (d) and combine the result with column (g)
8a Totals for all long-term transactions reported on Form 1099-B for which basis was reported to the IRS and for which you have no adjustments (see instructions). However, if you choose to report all these transactions on Form 8949, leave this line blank and go to line 8b .				
8b Totals for all transactions reported on Form(s) 8949 with **Box D** checked				
9 Totals for all transactions reported on Form(s) 8949 with **Box E** checked				
10 Totals for all transactions reported on Form(s) 8949 with **Box F** checked.	60,000	20,000	(60,000)	(20,000)

11 Gain from Form 4797, Part I; long-term gain from Forms 2439 and 6252; and long-term gain or (loss) from Forms 4684, 6781, and 8824	11	
12 Net long-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1	12	
13 Capital gain distributions. See the instructions	13	
14 Long-term capital loss carryover. Enter the amount, if any, from line 13 of your **Capital Loss Carryover Worksheet** in the instructions	14	( )
15 **Net long-term capital gain or (loss).** Combine lines 8a through 14 in column (h). Then go to Part III on the back	15	(20,000)

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 11338H **Schedule D (Form 1040) 2015**

6

For Example 18

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Part III **Summary**

16	Combine lines 7 and 15 and enter the result	**16**	**(20,000)**
	• If line 16 is a **gain,** enter the amount from line 16 on Form 1040, line 13, or Form 1040NR, line 14. Then go to line 17 below. • If line 16 is a **loss,** skip lines 17 through 20 below. Then go to line 21. Also be sure to complete line 22. • If line 16 is **zero,** skip lines 17 through 21 below and enter -0- on Form 1040, line 13, or Form 1040NR, line 14. Then go to line 22.		
17	Are lines 15 and 16 **both** gains? ☐ **Yes.** Go to line 18. ☒ **No.** Skip lines 18 through 21, and go to line 22.		
18	Enter the amount, if any, from line 7 of the **28% Rate Gain Worksheet** in the instructions ▶	**18**	
19	Enter the amount, if any, from line 18 of the **Unrecaptured Section 1250 Gain Worksheet** in the instructions ▶	**19**	
20	Are lines 18 and 19 **both** zero or blank? ☐ **Yes.** Complete the **Qualified Dividends and Capital Gain Tax Worksheet** in the instructions for Form 1040, line 44 (or in the instructions for Form 1040NR, line 42). **Do not** complete lines 21 and 22 below. ☐ **No.** Complete the **Schedule D Tax Worksheet** in the instructions. **Do not** complete lines 21 and 22 below.		
21	If line 16 is a loss, enter here and on Form 1040, line 13, or Form 1040NR, line 14, the **smaller** of: • The loss on line 16 or • ($3,000), or if married filing separately, ($1,500) **Note.** When figuring which amount is smaller, treat both amounts as positive numbers.	**21**	(**3,000**)
22	Do you have qualified dividends on Form 1040, line 9b, or Form 1040NR, line 10b? ☐ **Yes.** Complete the **Qualified Dividends and Capital Gain Tax Worksheet** in the instructions for Form 1040, line 44 (or in the instructions for Form 1040NR, line 42). ☐ **No.** Complete the rest of Form 1040 or Form 1040NR.		

Schedule D (Form 1040) 2015

Post-Liquidation Debt Liability

After complete liquidation of a corporation, shareholders may continue to be liable for certain debts and obligations that formerly belonged to the corporation. These liabilities include corporate taxes and product liability claims.

If a liability existed at the time of liquidation, subsequent payment of the liability by shareholders is considered part of the original liquidation. Accordingly, the nature of the loss as capital or ordinary is determined by the original liquidation.[67] However, the loss is recognized in the year the shareholder makes payment, and the gain or loss within the year of liquidation is unaffected.[68] Liabilities arising after the liquidation are not considered part of the original liquidation.[69]

> **Note.** Shareholders may remain liable for corporate taxes after the liquidation of the corporation as transferees. Transferee tax liability is governed by IRC §6901.

Example 19. Cryogenic Initiatives Inc. (CI) is a C corporation that was completely liquidated in 2014. The two shareholders, Yolanda and Zachary, are liable as transferees for CI's unpaid taxes and interest after the liquidation.

In 2015, the IRS determined that CI underpaid its federal income taxes for 2013. Yolanda and Zachary pay the tax liability and the interest on it. The amount of unpaid tax liability and the interest attributable to the period ending on the date of liquidation are treated as part of the final liquidation in 2014. Payment of this amount results in a capital loss to each shareholder that is deductible in 2015.

DISTRIBUTION OF GOODWILL

With a corporate liquidation, goodwill must receive special attention. In a corporate liquidation setting, the existence of goodwill and its valuation are gray areas subject to IRS scrutiny.

The term **goodwill** is difficult to define. The term generally means the value of a trade or business attributable to the expectancy of continued customer patronage, due to a business's name, reputation, or other factor.[70] Elaboration on the term appeared in a revenue ruling that discussed the valuation of closely held corporate stock. The IRS made the following statement about goodwill as a component of corporate value.[71]

> *In the final analysis, goodwill is based upon earning capacity. The presence of goodwill and its value, therefore, rests upon the excess of net earnings over and above a fair return on the net tangible assets. While the element of goodwill may be based primarily on earnings, such factors as the prestige and renown of the business, the ownership of a trade or brand name, and a record of successful operation over a prolonged period in a particular locality, also may furnish support for the inclusion of intangible value. In some instances it may not be possible to make a separate appraisal of the tangible and intangible assets of the businesses. The enterprise has a value as an entity. Whatever intangible value there is, which is supportable by the facts, may be measured by the amount by which the appraised value of the tangible assets exceeds the net book value of such assets.*

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67. *F. D. Arrowsmith v. Comm'r,* 73 S.Ct. 71 (1952); *S. M. Milliken v. Comm'r,* 196 F.2d 135 (2nd Cir, 1952), *cert. denied* 344 U.S. 884.
68. *J. Abdalla v. Comm'r*, 69 TC 697 (Feb. 13, 1978); *E. B. Stevenson v. Comm'r*, TC Memo 1975-257 (Aug. 7, 1975).
69. *F. C. Ewing v. Comm'r*, 27 TC 406 (1956), *aff'd* 254 F.2d 600 (6th Cir. 1958).
70. Treas. Reg. §1.197-2(b)(1).
71. Rev. Rul. 59-60, 1959-1 CB 237.

Generally, two types of goodwill may exist in the liquidation of a C corporation.[72]

- Business goodwill
- Personal goodwill

Business goodwill belongs to the corporation, whereas personal goodwill belongs to the shareholders. In a corporate liquidation, the existence of any goodwill and whether it is business or personal goodwill depends on the facts and circumstances. Generally, business goodwill exists if the corporate managers and key employees may be characterized as investors in a corporation that has separate interests and a separate identity from those managers and shareholders. In contrast, if a shareholder's reputation, skill, business relationships, or expertise are critical to the success of the corporation, personal goodwill may exist for that shareholder.

Note. Identifying goodwill as either business or personal goodwill is frequently difficult. Goodwill is frequently mischaracterized. Moreover, goodwill may be both business and personal, making valuation difficult. Business goodwill may trigger corporate and/or shareholder taxes in a corporate liquidation. However, if the goodwill is personal, such tax liability is generally avoided.[73]

Generally, if the corporate liquidation is accompanied by a termination of business, the shareholders do not receive any goodwill as part of the liquidating distribution. This is because goodwill cannot exist apart from the going concern that established it.

However, if the shareholders plan to continue the business of the liquidated corporation in some way, they arguably have received some degree of goodwill.[74] In such a case, the IRS may take the position that the amount of liquidating distributions received by shareholders should be increased by the value of the business goodwill received. In litigation, the particular facts and circumstances of the individual case largely determine whether goodwill exists, whether it is business or personal goodwill, and how it is valued.

For example, based on the ruling in *W.C. Tucker v. Alexander,* it appeared settled that goodwill is received by shareholders who continue the business of the liquidated corporation in some manner.[75] Yet in *F.D. Akers v. Comm'r,* the court held that no transfer of goodwill to shareholders occurred when the liquidated corporation owned a franchise that was terminated upon liquidation. The court ruled this way despite the fact that the shareholders obtained a subsequent franchise contract with similar terms to carry on business after the liquidation.[76]

Another significant case is *Longo v. Comm'r*.[77] In this case, the Tax Court held that if a liquidating corporation's goodwill is attributable solely to the individual abilities of the corporation's officers with whom there is no noncompetition agreement, no goodwill is passed to the shareholders in the liquidation. This general rule seems settled despite rulings in more recent cases.[78] These cases have also indicated that no goodwill exists if the corporate business depends on key employees, unless those employees enter into a noncompetition agreement with the corporation (or some other type of agreement that indicates their personal relationships with customers becomes corporate property).

Observation. Rescinding or voiding a noncompetition or similar agreement with key employees prior to liquidation may reduce or eliminate goodwill as a corporate asset that passes on to shareholders in a corporate liquidation. It may be prudent to address such agreements in the plan for liquidation.

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72. See *Goodwill as Part of a Corporate Asset Sale.* Payne, Jackson. May 1, 2014. AICPA. [www.aicpa.org/publications/taxadviser/2014/may/pages/payne_may2014.aspx] Accessed on Jun. 16, 2015.

73. *Longo v. Comm'r,* TC Memo 1968-217 (Sep. 26, 1968).

74. *W.C. Tucker v. Alexander,* 25 F.2d 425 (8th Cir. 1928), *cert. denied,* 278 U.S. 619.

75. Ibid.

76. *F.D. Akers v. Comm'r,* 6 TC 693 (1946).

77. *Longo v. Comm'r,* TC Memo 1968-217 (Sep. 26, 1968).

78. *Martin Ice Cream v. Comm'r,* 110 TC 189 (1998); *Norwalk v. Comm'r,* TC Memo 1998-279 (Jul. 30, 1998).

SUBSIDIARY LIQUIDATION

A parent and a subsidiary are parts of the same overall corporate "family." If the subsidiary liquidates and the parent corporation receives the liquidating distribution, assets have simply been shifted from one family member to another. This type of liquidation is equivalent to a merger of the parent and subsidiary. Without special tax rules in place to address subsidiary liquidations, an entire chain of taxation **might** occur as follows.

- The parent corporation could be taxed on the receipt of the subsidiary's liquidating distribution.[79]
- The subsidiary could be taxed on making the liquidating distribution.[80]
- The shareholders of the parent corporation could eventually be taxed[81] on the same assets that were received from the liquidated subsidiary. This could occur if the parent liquidates or if the parent distributes the assets as an operating dividend.[82]

However, special tax rules were developed to provide tax-free treatment for certain types of subsidiary liquidations. These rules[83] reflect Congress's desire to ensure that tax is not imposed when assets are simply shifted from a liquidating subsidiary to a parent that has substantial control over the subsidiary.

EXCEPTION FOR 80%-CONTROLLED SUBSIDIARIES

As a general rule, a corporation must recognize gain or loss on liquidation. However, an exception applies if the liquidating corporation is a subsidiary that distributes its property to a parent corporation that owns at least 80% of the liquidating subsidiary's stock.[84] Under this exception, a **liquidating subsidiary generally does not recognize gain or loss** on the distribution of property to its parent.[85] Moreover, **the parent does not recognize gain or loss** upon receipt of the liquidating distribution from the subsidiary.[86] For this exception to apply, **all** the following conditions must be met.

- The liquidation of the subsidiary must involve a complete cancellation or redemption of the subsidiary's stock.[87]
- The parent corporation must own at least 80% of the subsidiary's stock.
- The liquidating distribution(s) must be made within certain time limits (discussed later in the chapter).
- The subsidiary must not be insolvent.

If these conditions are met, the **nonrecognition treatment is mandatory.** However, if the parent corporation does not want the exception to apply, it may deliberately fail to meet the requirements of the 80%-ownership test or fail to meet the applicable time limits.

> **Caution.** Under the Code, the IRS has the authority to prescribe anti-abuse regulations to prevent nonrecognition rules from being circumvented.[88] However, no current regulations specifically target these transactions.

79. IRC §331.
80. IRC §336.
81. IRC §331.
82. IRC §301.
83. Generally found in IRC §332.
84. IRC §§332(a) and 332(b)(1), referencing IRC §1504(a)(2).
85. IRC §§337(a) and 336(a).
86. IRC §332.
87. IRC §332(b)(2).
88. IRC §337(d).

Ownership Test

To meet the 80%-ownership requirement, the parent must own at least:

- 80% of the total combined voting power of all classes of subsidiary stock, **and**
- 80% of the total value of the subsidiary stock.[89]

For purposes of this rule, the definition of **stock** does **not** include any stock that meets **all** the following requirements.[90]

- The stock is nonvoting stock.
- The stock is preferred stock as to dividends and does not significantly participate in the growth of the subsidiary corporation.
- The stock's liquidation and redemption rights do not exceed its issue price plus a reasonable liquidation or redemption premium.
- The stock is not convertible into any other class of stock.

Moreover, the parent must meet this 80%-ownership test from the time it adopts the subsidiary liquidation plan up to the time it receives the liquidating distribution.[91]

Observation. This 80%-ownership test should not be confused with the 80% test used under IRC §351, which applies to contributions of capital to a corporation.

Time Limit for Liquidating Distributions

For nonrecognition of a gain or loss, the liquidating subsidiary must either:[92]

- Transfer all property in liquidation to the parent within the tax year, or
- Distribute all property to the parent in a series of distributions within three years in accordance with a plan of liquidation.

Basis Rule

When the subsidiary liquidation exception applies, the parent corporation inherits the subsidiary corporation's basis in the assets received by the parent.

Note. There is an exception to this basis rule if the subsidiary distributes built-in loss property or if the subsidiary must recognize tax on the distribution under another Code section. For further information on these exceptions, see IRC §362(e) and Prop. Treas. Reg. §1.362-3.

89. IRC §§332(b)(1) and 1504(a)(2).
90. IRC §1504(a)(4).
91. IRC §332(b)(1).
92. IRC §§332(b)(2) and (3).

Example 20. Parentco has owned 100% of the voting shares of Subco since Subco was established in 2009. These voting shares are the only shares of Subco that were issued and are outstanding.

Upon the formation of Subco in 2009, Parentco contributed land with a $60,000 basis to Subco in exchange for its 100% ownership interest. This transaction qualified under IRC §351. Accordingly, Parentco obtained an exchanged basis of $60,000 in its Subco shares.[93] In 2015, Parentco's basis in its Subco stock remains the same.

The land is the only asset held by Subco. On June 1, 2015, the FMV of Subco's land is $100,000. Parentco adopts a plan to liquidate Subco on January 2, 2015, and a single liquidating distribution is made on June 1, 2015.

Parentco realizes a $40,000 ($100,000 FMV – $60,000 basis) gain in the liquidating transaction. However, this $40,000 gain is **not** recognized for tax purposes because Parentco meets the relevant tests.

- Parentco owned at least 80% of the voting power and the value of Subco stock at the time the liquidation plan was adopted **and** at the time of the liquidating distribution.
- All Subco's assets are distributed during the 2015 tax year, which is within the applicable time limit to make the liquidating distribution.

Subco does **not** recognize any gain or loss on its liquidating distribution to Parentco because Parentco meets the nonrecognition exception.[94] Parentco receives a $60,000 transferred basis from Subco on the assets received in the liquidation.[95]

Observation. Because Parentco directly owns the assets received from Subco and has a transferred basis from Subco, the $40,000 gain is preserved in Parentco for later recognition if Parentco sells those assets at FMV. This reflects the rationale of the nonrecognition rule for the liquidation of a subsidiary.

However, if Subco sells the assets first and subsequently liquidates, it must recognize a gain on the assets sold prior to the liquidation. This is because the gain has actually been realized, unlike the theoretical gain attributable to fluctuations in market values.

Indebtedness Rules

The exception to the normal recognition rule applies even if the parent is indebted to the subsidiary and the subsidiary cancels the parent's obligation upon liquidation.[96] However, if the subsidiary is indebted to the parent, any gain or loss realized by the parent upon liquidation of the subsidiary must be recognized for tax purposes.[97]

For example, suppose the parent corporation purchased its subsidiary's bonds at a discount and the parent corporation receives payment for the face amount of the bonds upon liquidation of the subsidiary. In this case, the parent corporation must recognize the income from redemption of the bonds. The taxable gain is the difference between the cost or other basis of the bonds to the parent and the amount received in payment of the bonds.[98]

93. IRC §358(a).
94. IRC §§ 337(a) and 332.
95. IRC §§334(b) and 7701(a)(43).
96. Rev. Rul. 74-54, 1974-1 CB 76.
97. Treas. Reg. §1.332-7.
98. Ibid.

Insolvency

If the subsidiary does not make any payment or liquidating distribution, no gain or loss is attributable to an asset transfer to be recognized or not recognized by either corporation. If no distributions are made in exchange for the parent corporation's stock, the parent has realized a loss to the extent of its basis in the subsidiary's stock. [99] In this situation, the parent corporation may recognize the loss as if the stock were sold on the last day of the tax year.[100]

MINORITY SHAREHOLDERS

If any **minority shareholders** own an interest in the subsidiary, they do not receive the benefits of nonrecognition treatment of liquidation distributions from the subsidiary.[101] Minority shareholders must recognize a capital gain or loss under general capital gain and loss tax rules. The amount of any cash and the FMV of any property received in the liquidating distribution are generally considered payment for the minority shareholders' interest. From this amount, the basis in the shareholders' minority interest is subtracted.

Example 21. Use the same facts as **Example 20,** except in February 2015, Parentco sells 15% of its Subco shares to Brenda, a shareholder unrelated to Subco. Prior to the liquidating distributions, Subco holds cash as well as the land. Brenda pays Parentco $15,000 for her shares.

On June 1, 2015, Subco makes a liquidating distribution to Parentco (which receives the land worth $100,000) and to Brenda (who receives cash of $17,647).

Before Parentco sold a 15% interest in Subco to Brenda, it owned 100% of Subco and had a stock basis of $60,000. After selling 15% of these shares to Brenda, Parentco's basis in the remaining 85% of the shares is $51,000 ($60,000 × 85%). Because Parentco's interest in Subco still meets the 80% test, Parentco is exempt from recognizing a gain/loss on the liquidating distribution. The realized gain of $49,000 ($100,000 – $51,000) is not recognized. Parentco receives Subco's $60,000 basis in the land under the transferred basis rule.

Brenda is a minority shareholder. Nonrecognition treatment is inapplicable to a minority shareholder. Therefore, the amount of gain Brenda recognizes is $2,647 ($17,647 liquidating distribution – $15,000 basis). Because Brenda's holding period for the shares is less than one year, the $2,647 is a short-term gain.

Note. If Brenda received property in the liquidating distribution, the FMV of the property would be taken into account when calculating her capital gain or loss.

When property is distributed with an FMV that is less than the basis, it may be possible to structure the dissolution in a way that allows the parent corporation to recognize the loss in the asset's value. However, as the following examples illustrate, all the relevant limitations imposed by the Code must be caefully considered.

99. Treas. Reg. §1.332-2(b).

100. Treas. Reg. §1.332-2(b), referencing IRC §165(g)(1).

101. Treas. Reg. §1.332-5.

Example 22. Use the same facts as **Example 21,** except when Parentco adopts the plan of liquidation on January 2, 2015, the **FMV of the land held by Subco is $12,000.** In addition, Brenda pays Parentco $3,000 for **25%** of the shares of Subco.

Because Parentco wants to recognize a loss for tax purposes upon the liquidation of Subco, Parentco does not want nonrecognition treatment to apply to the transaction. Accordingly, Parentco sells the 25% interest in its Subco ownership to Brenda, reducing its ownership in Subco to 75%.

Parentco no longer owns at least 80% of the stock of Subco. Therefore, nonrecognition treatment does not apply to the liquidation. Instead, general liquidation rules apply to the transaction.

Parentco's basis in its 100% interest in Subco shares was $60,000. After the sale of the 25% interest to Brenda, Parentco's basis in the remaining 75% interest is $45,000 ($60,000 × 75%).

On June 1, 2015, Subco makes a liquidating distribution: Parentco receives land worth $12,000, and Brenda receives cash of $4,000. Overall, the liquidating distribution is pro rata.

Parentco's plan to recognize the loss **fails** because the **land** is not distributed pro rata. Even though the overall distribution is pro rata, the distribution of the **loss property** is not pro rata. As a related party, Parentco may not claim a loss for property that is not distributed to all shareholders proportionately.[102]

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Observation. Parentco could have recognized a loss if Subco had first sold the property for its $12,000 FMV and then distributed the proceeds on a pro-rata basis to Parentco and Brenda. The sale of the property results in a fixed economic loss at the time the property is sold, unlike a distribution of property that may recover its value.

Example 23. Use the same facts as **Example 22,** except the land is Subco's only asset and it is distributed to Parentco and Brenda as tenants-in-common on a pro-rata basis. Parentco receives a 75% interest in the land, and Brenda receives a 25% interest.

Even though Parentco is a related party under the loss limitation rules,[103] Parentco can recognize a loss because the land is distributed on a pro-rata basis. The amount of the loss Parentco can recognize is calculated as follows.

FMV of land	$12,000
Parentco's interest	× 75%
FMV of land received by Parentco	$ 9,000
Less: Parentco's remaining basis in Subco shares	(45,000)
Capital loss recognized by Parentco	($36,000)

Brenda reports the distribution as a sale of her stock. Her 25% share of the land is worth $3,000 ($12,000 × 25%), which is equal to the $3,000 she paid for the stock. Therefore, she does not have a gain or a loss on the liquidating distribution.

102. IRC §336(d)(1).

103. Ibid.

LIQUIDATING DISTRIBUTIONS WITH INSTALLMENT OBLIGATIONS

GAIN TO THE CORPORATION

A liquidating corporation recognizes gain or loss upon distributing an installment obligation to shareholders.[104] Generally, the amount of gain or loss recognized is determined by the difference between the FMV of the installment obligation at the time of distribution and the corporation's basis in that installment obligation.

Example 24. Oceanside Corporation, a C corporation, has property with an FMV of $100,000 and basis of $20,000. The corporation has one shareholder, Lloyd. As part of a plan of liquidation, Oceanside sells its assets to a third-party purchaser on the installment method. Subsequent to this sale, Oceanside distributes the obligation to Lloyd as part of the liquidation. Oceanside must recognize taxable income of $80,000 ($100,000 FMV – $20,000 basis). This tax result applies regardless of whether the installment obligation is a qualifying installment obligation (defined later). This same tax result for Oceanside would occur if the property were distributed to Lloyd.

Note. For further details about how a capital gain or loss is calculated on an installment obligation, see IRC §453B(b) and related regulations.

ORDINARY INCOME PROPERTY

In a pre-liquidation transaction, a corporation may sell ordinary income property (such as inventory) to a third party in exchange for consideration that includes an installment obligation. Under the Code, a sale of inventory generally does not qualify for the installment method.[105]

However, special rules apply with corporate liquidations. If **substantially all** the inventory of the corporation is sold to one person in one transaction, it is considered to be sold **in bulk.**[106] Installment obligations for inventory sold in bulk may be qualified installment obligations if all the other tests are met.[107]

If the corporate inventory is sold in smaller segments, the partial inventory sale is referred to as the sale of a **broken lot of inventory.**[108] An installment obligation that is received in consideration for a broken lot sale of inventory is **not** a qualified installment obligation.

An installment obligation may be associated with the sale of other corporate assets in addition to a broken lot of inventory (a **mixed** sale). In this case, only the portion of the obligation attributable to the other assets is qualified. The portion attributable to the broken lot of inventory is **not** qualified.[109]

104. IRC §453B(a).
105. IRC §453(b)(2)(B); IRS Pub. 537, *Installment Sales,* p. 9 (2014).
106. IRC §453(h)(1)(B).
107. Ibid.
108. Treas. Reg. §1.453-11(c)(4).
109. Ibid.

Generally, in a mixed sale, the following formula is used to determine the amount of the installment obligation that is not qualified.[110]

	FMV of broken lot of inventory
–	Cash received
–	FMV of other property received
–	Unsecured liabilities assumed by buyer
–	Secured liabilities encumbering the broken lot assumed by buyer
	Nonqualified amount of installment obligation

Payments received on a mixed-sale installment obligation with qualified and nonqualified portions are applied first to the nonqualifying portion to determine the shareholder's reportable gain.[111]

Note. For further details about installment obligations used in the sale of inventory, including examples of how the above formula is used to separate a mixed-sale installment obligation into its qualified and nonqualified components, see Treas. Reg. §1.453-11(c)(4).

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RESTRICTED TRANSACTIONS

Generally, an installment obligation may not be used by a liquidating corporation for certain types of transactions that would not otherwise qualify for the installment method. The types of restricted transactions in which installment reporting may **not** be used include the following.

- Dealer dispositions, which include the following[112]
  - Sales of personal property by parties who regularly sell this type of personal property in the ordinary course of business
  - Sale of real property held by sellers for sale to customers in the ordinary course of business

Note. Dealer dispositions do not include farm property, residential parcels, and timeshares (see IRC §453(l)(2)).

- Sales of personal property under revolving credit plans[113]
- Sales of stock and other securities[114]or other property of a type regularly traded on an established market[115]
- Sales of depreciable property between **related parties**[116]
- Sales of property to a **related person** that resells the same property within two years of the first sale[117]

Note. For further details on the types of transactions that do not qualify for installment method reporting, see IRC §453.

110. Treas. Reg. §1.453-11(c)(4)(ii).
111. Treas. Reg. §1.453-11(c)(4)(iii).
112. IRC §453(b)(2)(A).
113. IRC §453(k)(1).
114. IRC §453(k)(2)(A).
115. IRC §453(k)(2)(B).
116. IRC §453(g).
117. IRC §453(e)(2).

Anti-abuse rules prohibit treating an installment obligation acquired by a liquidating corporation as a qualifying installment obligation. This applies if the corporation was formed with the principal purpose of avoiding restrictions on the use of the installment method through transactions with a related party.

> **Note.** For further details on these anti-abuse rules, see Treas. Reg. §1.453-11(c)(5).

Related-Party Restrictions

Depreciable Property. If a shareholder receives installment payments from a related party, the installment method may not be used to the extent that the installment obligation relates to the sale of **depreciable property.** In such a case, all payments received by the shareholder from the installment obligation relating to the depreciable property must be reported in the tax year in which the shareholder receives the installment obligation.[118]

For purposes of this rule, a related party includes the following.[119]

- The shareholder's spouse
- Any entity controlled by the shareholder (Under these rules, the shareholder is considered to control an entity if more than 50% of the value of the outstanding stock (or more than 50% interest in the capital or profits interest in a partnership) is owned either directly or through application of the constructive ownership rules under IRC §267.)[120]

> **Note.** For further details about the constructive ownership rules of IRC §267, see the earlier section in this chapter regarding corporate loss recognition and limitations applicable to related parties.

- A trust in which the shareholder (or shareholder's spouse) is a beneficiary, except when the beneficiary's interest is a remote contingent interest[121]
- An executor of an estate and a beneficiary of such estate, except in the case of a sale or exchange in satisfaction of a pecuniary bequest

Resale Rule. To prevent related parties from manipulating the deferral of gains recognized from installment agreements, the Code includes special provisions when the property is resold within two years after the first sale.[122] When this happens, the first seller must report the gain on the installment sale in the year that the second sale of the property occurs.[123] However, if the taxpayer can prove to the IRS that the principal purpose of the transactions was not tax avoidance, this rule may be waived.[124]

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118. IRC §453(h)(1)(C).
119. IRC §§453(h)(1)(C) and 1239(b).
120. IRC §1239(c).
121. Within the meaning of IRC §318(a)(3)(B)(i).
122. IRC §453(e)(2).
123. IRC §453(e).
124. IRC §453(e)(7).

The running of the 2-year period is suspended during any period in which the related person's risk of loss with respect to the property is substantially diminished by one of the following.[125]

- The holding of a put with respect to such property (or similar property)
- The holding by another person of a right to acquire the property
- A short sale
- Any other transaction that significantly reduces the risk of loss

Caution. The statute of limitations covering the resale rule does not expire until two years after the date on which the person making the first disposition notifies the IRS of a second disposition of the property.[126] This notice may be made by completing part III of Form 6252, *Installment Sale Income*.

For purposes of this rule, whether a party is related is determined by reference to both of the following.[127]

- The relationships covered by IRC §267(b) between the first and second seller (These relationships are listed earlier in the chapter.)
- The stock **attribution** rules of IRC §318(a) (without regard to the option ownership rule in §318(a)(4))

Several types of resales are **excluded** from this rule, including:[128]

- A second disposition resulting from involuntary conversion of the property if the initial installment sale occurs prior to the threat of conversion, and
- A second disposition that occurs after the death of the first or second seller.

GAIN TO THE SHAREHOLDER

In anticipation of liquidation, a corporation often sells assets to a third party. Part or all of the consideration paid by the third party for the corporation's assets may be in the form of an installment obligation. The installment obligation subsequently may become part of the liquidating distribution to one or more shareholders.

Generally, a **qualifying shareholder** who receives a **qualifying installment obligation** in a complete liquidation of a corporation may use the installment method for reporting any gain realized from the liquidating distribution.[129] In such a situation, the shareholder may treat the payments received on the obligation (rather than the entire obligation) as a receipt of payment in exchange for the shareholder's stock in the liquidating corporation.[130]

A **qualifying shareholder** is a shareholder who is subject to the general corporate liquidation tax rules of IRC §331.[131]

Note. IRC §331 refers to shareholders that participate in taxable sale or exchange treatment on their shares in a corporate liquidation under the normal corporate liquidation rules described earlier in this chapter.

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125. IRC §453(e)(2).

126. IRC §453(e)(8).

127. IRC §453(f)(1).

128. IRC §453(e)(6).

129. IRC §453(h); Treas. Reg. §1.453-11(a).

130. Treas. Reg. §1.453-11(a).

131. Treas. Reg. §1.453-11(b).

A **qualifying installment obligation** is an installment obligation received by the shareholder in a corporate liquidation transaction in which **both** the following apply.[132]

1. The shareholder receives the installment obligation from a liquidating corporation during the 12-month period beginning on the date the liquidation plan was adopted.
2. The liquidation of the corporation is completed during that 12-month period.

As a general rule, the nature of corporate assets sold by a corporation and the subsequent corporate tax consequences that arise from the sale have no impact on whether an installment obligation is a qualified installment obligation.[133] However, the following exceptions apply to the general rule.

- An installment obligation received solely in exchange for cash is not a qualified installment obligation.[134]
- Some installment obligations related to the sale of inventory may not be qualified installment obligations.
- An installment obligation may not be used in a corporate liquidation for transactions that would otherwise not qualify for the installment method (referred to as **restricted transactions).**

> **Note.** Inventory-related installment obligations and restricted transaction limitations are discussed earlier in the chapter. For more information regarding installment agreements that are not qualified, see Treas. Reg. §§1.453-11(c)(4) and (5).

If a qualifying shareholder receives a qualifying installment obligation in a corporate liquidation, the transaction is treated as a deemed sale of the shareholder's stock to the issuer of the obligation. Accordingly, the shareholder must treat the installment obligation as if it were received directly from the issuer of the installment obligation in exchange for the stock in the liquidating corporation.[135] In addition, the installment agreement is treated as newly issued on the date of the distribution for purposes of determining the adjusted issue price.[136]

The **adjusted issue price** of the qualifying installment obligation is calculated as follows:[137]

	Issue price of the debt instrument
+	Qualified stated interest[138] that has accrued prior to the distribution but that is not payable until after the distribution
−	The amount of any payment previously made on the debt instrument other than a payment of qualified stated interest
	Adjusted issue price of qualifying installment obligation

> **Note.** If the qualifying installment obligation has unstated interest, see Treas. Reg. §§1.466-2(c) and (d) for the applicable rules regarding the calculation of the installment obligation issue price.

Example 25. Use the same facts as **Example 24.** Lloyd is a qualifying shareholder as defined earlier. His basis in the stock is $30,000. Oceanside distributes the installment obligation to Lloyd. The installment obligation is a qualifying installment obligation as defined earlier. Lloyd can report the installment obligation under the IRC §453 installment method. Lloyd's basis in the installment obligation is $30,000.

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132. IRC §453(h)(1)(A).
133. Treas. Reg. §1.453-11(c)(2).
134. Ibid.
135. Treas. Reg. §1.453-11(a)(2)(i).
136. Treas. Reg. §1.453-11(a)(2)(ii).
137. Ibid.
138. As defined in Treas. Reg. §1.1273-1(c).

SHAREHOLDER REPORTING REQUIREMENT[139]

Generally, every **significant shareholder** that transfers stock to a liquidating corporation in exchange for property in a corporate liquidation transaction must file a special statement. This statement must accompany the shareholder's tax return for the year in which the liquidating distribution is made.

A **significant shareholder** is defined as:

- A shareholder who owns at least **5%** of the total outstanding stock of a **publicly** traded corporation, or
- A shareholder who owns at least **1%** of the total outstanding stock of a **privately** held corporation.

Filing such a statement is **not required,** however, if both the following apply.

- The property received is from a distribution made in accordance with a **corporate resolution** indicating that the corporation will completely liquidate.
- The corporation is completely liquidated and dissolved within one year after the distribution.

> **Observation.** For this exception to the filing requirement to apply, dissolution is necessary. This means that the necessary form(s) must be filed at the state level to formally terminate the existence of the corporation once the liquidation is completed.

The statement that a shareholder files with their tax return to comply with this requirement must have the following title.

Statement Pursuant to §1.331-1(d) by [name and TIN of shareholder], a Significant Holder of the Stock of [corporate name and EIN]

The statement must include the following information.

- A description of the property the significant shareholder received from the liquidating corporation
- The FMV and basis of the stock transferred to the liquidated corporation by the significant shareholder

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139. Treas. Reg. §1.331-1(d).