Case Western Reserve Law Review

Volume 13 | Issue 2

1962

General Rules Re Liquidations

Sherman Dye

Tax Problems in Corporate Liquidations

I

GENERAL RULES RE LIQUIDATIONS

Sherman Dye

As in almost all areas of tax law, the area of corporate liquidations is one in which there are general rules, exceptions to those general rules, and frequently exceptions to the exceptions. The purpose of this article is to discuss the general tax rules which apply to corporate liquidations. The articles which follow will discuss some of the exceptions and the exceptions to the exceptions.

Reasons for Considering Liquidation

Before investigating the general rules, let us examine some of the situations in which liquidation of the corporate enterprise will be considered. The reasons for considering liquidation fall into two broad categories. First, there are natural business and economic reasons, and second, there are special tax considerations.

Termination of the Business Enterprise

The natural economic reasons for liquidation generally center around termination of the business enterprise. The manufacture of buggies is no longer profitable in this jet age, and a satisfactory substitute for the corporation to produce has not been found. Or, the business was built entirely around the dynamic personality of its late founder, who died leaving no one capable of carrying on the enterprise. These are typical situations in which the business enterprise has come to an end and it is necessary to wind up the affairs and to liquidate.

Conversion of Ordinary Income Into Capital Gain

Perhaps more commonplace today than liquidations because of termination of the business, and more important from the standpoint of this discussion, are the situations in which liquidation should be considered in order to achieve a desired tax result. Most of these situations arise in an attempt to convert ordinary income into capital gain. This is, of course, one of the major battlegrounds between taxpayer and tax collector. In light of the favorable tax treatment given to capital gain, alert taxpayers and alert tax practitioners are constantly trying to find ways of getting capital gain treatment for receipts which would normally be taxed on the less favorable ordinary income basis. Conversely, alert tax administrators and legislators are constantly seeking means of preventing the conversion of ordinary income into capital gain.

Many of the skirmishes in the capital gain-ordinary income fight have been in the liquidation area. The collapsible corporation rules, which are covered in an accompanying article,[1] are a result of this battle and have closed the door on such conversion in many situations. There are, however, still possibilities of converting ordinary income into capital gain through corporate liquidation.

For example, a corporation may find itself with excess assets, assets which are no longer needed in the business. To transfer these assets to the shareholders as a dividend would mean that they would be taxed to the shareholders as ordinary income. It may be possible, however, through either a partial[2] or a complete liquidation to convert this ordinary income into capital gain or even into a return of capital, where the only present tax consequence will be a reduction in the basis of the stock.

Another situation in which liquidation should be considered as a means of converting ordinary income into capital gain exists where the corporation holds depreciable assets which have a value substantially in excess of their basis for depreciation. The depreciable asset might be a fully depreciated building or a patent which has become valuable but has little or no cost.

Assume that the corporation has such a depreciable asset with a high value and a low basis. How can liquidation convert ordinary income into capital gain? First, we must assume that we are not dealing with a collapsible corporation and that the appreciated assets are not collapsible assets. This being true, if the corporation is liquidated and the business enterprise is carried on by the shareholder as sole proprietor or by the shareholders as partners, capital gain on the amount distributed will be realized at the time of liquidation, but the valuable asset will have a new basis for depreciation equal to its value. A capital gain tax will be incurred at the time of liquidation, but in the future, ordinary income will be reduced by depreciation, which would not have been available to the corporation. In other words, the taxpayer pays a present capital gain tax to eliminate ordinary income in the future. Thus, in the right situation, liquidation can be a very valuable planning device.

An example of the use of liquidation as a planning device for conversion of ordinary income into capital gain is found in the factual situation covered by Revenue Ruling 56-541.[3] In that case, the corporation

1. See Cavitch, *Collapsible Corporations*, p. 278 *infra*.
2. See Bickford, *Special Liquidations Other Than Under Section 337*, p. 270 *infra*.
3. 1956-2 CUM. BULL. 189, *revoked*, Rev. Rul. 61-156, 1961 INT. REV. BULL. No. 34, at 10.

had short-life assets with a low basis and a high value. These assets were sold to a new corporation in a transaction in which no gain was recognized to the selling corporation.[4] The purchasing corporation, in which certain of the shareholders of the old corporation had a minority interest, acquired a new basis for the assets, based upon the purchase price. Through depreciation deduction, the new corporation was able to offset what would have otherwise been taxable income.[5]

TAX CONSEQUENCES OF LIQUIDATION

Effect on the Corporation

The general rules of the tax consequences of liquidation to the corporation being liquidated are quite simple. There are exceptions to the general rules which are discussed elsewhere.[6]

The corporation which is liquidating can do one of two things with its property. It can either distribute the property to its shareholders or it can sell or otherwise dispose of the property and distribute the proceeds to its shareholders. Generally speaking, the corporation realizes no taxable income (capital or ordinary) upon distribution of assets in liquidation. On the other hand, generally speaking, the corporation does realize gain or loss (again either ordinary or capital) upon the sale of its assets prior to or contemporaneous with its liquidation. There are exceptions, but these are the basic rules: no income results from distribution in liquidation, and, income or loss does result from sale as a part of the liquidation.

Effect on the Recipient

The next set of general rules are those relating to the tax effect on the recipient of a distribution in liquidation. As usual there are numerous exceptions to the general rules. The major exceptions are discussed in other articles in this issue.[7] There are one or two minor exceptions which will be explained briefly in this article after review of the general rules.

The first general rule is that the amount of money and property received by the shareholder is treated as being received in exchange for the

4. See Garver, *Liquidations Under Section 337*, p. 245 *infra*.

5. The revocation of Revenue Ruling 56-541 by Revenue Ruling 61-156 relates to the fact that the old shareholder had a continuing interest in the new corporation, and does not affect the basic principle that an increase in basis through a sale and liquidation or through a liquidation alone can result in the conversion of what would otherwise be ordinary income into capital gain.

6. See Bickford, *Special Liquidations Other Than Under Section 337*, p. 265 *infra;* Garver, *Liquidations Under Section 337*, p. 245 *infra*.

7. See Dye, *Tax Free Liquidation of a Subsidiary*, p. 273 *infra;* Bickford, *Special Liquidations Other Than Under Section 337*, p. 265 *infra;* Cavitch, *Collapsible Corporations*, p. 278 *infra*.

stock.[8] This means that the transaction gives rise to gain or loss. The gain or loss will be capital or ordinary depending on whether the stock is a capital asset, and long or short term depending on how long the stock has been held. The amount of the gain or loss is, of course, measured by the difference between the basis of the stock and the fair market value of the money and property received in the liquidation.[9] Gain is realized as soon as the value of the property received exceeds the basis of the stock, and thereafter additional amounts received result in additional gain. On the other hand, loss is not realized until the liquidation is completed, because the amount of the loss cannot be ascertained until that time. Finally, the basis in the hands of the recipient of property received in liquidation is its fair market value at the time it is distributed.[10]

Now let us examine some of the problems which arise in the application of these relatively simple rules. First, there are a few exceptions to the capital gain treatment. Naturally the gain or loss will not be capital if the stock is not a capital asset in the hands of the stockholder. For example, stock held in inventory by a broker for sale to customers is not a capital asset. Hence, any loss on liquidation would be ordinary loss and any gain would be ordinary income.

As will be presented in detail later, no gain or loss (capital or ordinary) is realized by a parent corporation upon liquidation of an eighty per cent owned subsidiary.[11] Other exceptions to the capital gain or loss treatment of liquidations relate to collapsible corporations, the special rules on liquidation within one calendar month, and the special rules on liquidation within one year. These are discussed in subsequent articles.[12]

There are no particular exceptions to the general rules with respect to the determination of the amount of gain or loss upon liquidation. It is measured by the difference between the basis of the stock and the fair market value of the assets received. The problems arise in determining fair market value when assets are distributed in kind. Serious consideration should be given to having an independent appraisal made of the assets which are being distributed in kind. Such a course of action may eliminate future controversy or, at least, materially strengthen the taxpayer's position in that future controversy.

The future of the business enterprise which is being transferred from the corporation may be a factor in valuation of the assets distributed. If

8. INT. REV. CODE OF 1954, § 331 [hereinafter cited as CODE §].

9. CODE §§ 1001-02.

10. CODE § 334(a).

11. See Dye, *Tax Free Liquidation of a Subsidiary*, p. 273 *infra*.

12. See Cavitch, *Collapsible Corporations*, p. 278 *infra;* Bickford, *Special Liquidations Other Than Under Section 337*, p. 265 *infra;* Garver, *Liquidations Under Section 337*, p. 245 *infra*.

the business has been terminated and is not to be carried on by or sold by the shareholders, then it is unlikely that goodwill or going concern value will become a factor in determining the amount of gain or loss. If, however, the intention is to carry on the corporate business in some other form, then goodwill or going concern value may be a factor in valuation of the assets received.

Of course, if assets are transferred subject to a liability, the amount of the liability will be a factor in valuing what the stockholders have received. Adjustment for the liabilities should be made in the return for the year of distribution, not the year when the liability is paid.

In *Arrowsmith v. Commissioner*[13] the liability did not arise until after distribution to the shareholders. The issue was whether the earlier year of liquidation should be reopened or a loss should be taken in the year the liability was paid (or incurred in the case of an accrual basis stockholder). The Supreme Court held that a capital loss occurred in the later years and that the prior year of liquidation should not be reopened.

Before we leave the subject of general rules of tax consequences of liquidation, a word of caution should be inserted. The general rules apply only to a bona fide liquidation. The Regulations provide that a liquidation which is preceded by or followed by a transfer of all or part of the assets to another corporation may not be treated as a liquidation, but may have the effect of a dividend or of a reorganization in which no loss is recognized.[14] The purpose of this provision is to deny capital gain treatment to a dividend disguised in the form of a liquidation, and also to prevent the securing of a stepped-up basis for depreciation in a transaction which is in reality a reorganization, not a liquidation.[15]

For example, a corporation has accumulated substantial liquid assets which are not needed in the business. Instead of paying a dividend it transfers the business assets to a new corporation and then liquidates. Under the rules we have reviewed, the shareholders would realize capital gain in the amount of the difference between the cost of their stock and the fair market value of the liquid assets and the stock of the new corporation which they receive. The net business result is no different, however, than if they had received the excess liquid assets as a dividend taxable as ordinary income. Obviously, in this example, the liquidation is a subterfuge, and it will not be taxed as a liquidation but as a dividend to the extent of the liquid assets received. The attempt to convert ordinary income to capital gain will fail.

Similarly, a liquidation as a part of a plan for transferring the business

13. 344 U.S. 6 (1952).

14. Treas. Reg. § 1.331(c) (1955).

15. See discussion of Rev. Rul. 56-541, note 5 *supra* and accompanying text.