

Complete Liquidations

8A General

(1) *X* realizes and recognizes \$700 gain on which *X* pays tax of \$250, netting \$350. Under § 1231, the gain would be capital, but part of the gain may be ordinary income under § 1250, although that does not matter on these facts. Although the sale would increase *X*'s current E&P, that is irrelevant because it does not affect the taxation of *A* here, since § 331 treats *A* as selling his stock under § 1001. *X*'s E&P disappears in its liquidation. B&E ¶ 10.05[2][b]. *X* distributes \$350 to *A*, who recognizes \$250 gain on the deemed sale of his stock. B&E ¶ 10.03[1]. *B* takes a § 1012 \$1,000 basis in the building.

There is no specific problem relating to the *Hillsboro/Bliss Dairy* issue. Consider discussing the contrast between midstream issues in the § 351 context and the liquidation context. B&E ¶¶ 3.17, 10.06.

(1)(a) Distributions by *X* over five years raise the factual question of whether the distributions are all part of a § 346(a) series. The no-ruling revenue procedure ordinarily declines ruling on a series of distributions over more than three years from plan adoption date. To the extent the distributions are not considered made in liquidation, *A* receives § 301 distributions. To the extent the distributions are received in liquidation, *A* recovers stock basis first, unlike the installment sale route. Rev. Rul. 68-348; B&E ¶¶ 10.02, 10.03[1]. Creating tax "ambiguity" here is not a good idea.

(1)(b) If *X* could report this as an installment sale, under Regs. § 15A.453-1(b)(2)(i) *X*'s gross profit ratio is 700/700; therefore, \$400, which is the sum of the excess of debt assumed over basis (\$400 - \$300 = \$100) plus the \$300 down payment, will be § 453 "payments" *X* recognizes in full as gain upon the closing of the sale. Regs. § 15A.453-1(b)(3)(i). In addition, § 453B(a) requires *X* to recognize all of the remaining \$300 gain upon distributing the note. *X* cannot report the gain on the installment method because *X* uses the accrual method, so the \$700 gain accrues upon the sale. Again, *X* pays tax of \$250. *A* receives \$50 cash plus *B*'s note for \$300 in exchange for *A*'s stock.

Section 453(h) permits *A* to report his § 331 stock sale on the installment method if *X* sells the building within the 12-month period from *X*'s adoption of a plan of complete liquidation to completion of the liquidating distributions. It appears from § 453(h)(2) (which does not literally apply here because all liquidating distributions occur in one year) that *A*'s stock basis should be applied ratably to the \$50 cash and the \$300 note payments (the usual gross profit ratio approach), yielding approximately \$36 gain recognized on the cash and \$214 recognized gain on all principal payments on the note when received.

The mandatory 12-month liquidation period in § 453(h) is the last remnant of the pre-1986 incarnation of § 337. Consider discussing the progression from *General Utilities* to *Curti Holding* to *Cumberland* to old § 337 to the 1986 repeal of *General Utilities* in § 336, for historical purposes, for an important STD study, and for an interesting example of judicial/legislative interplay. Also, some understanding of old § 337 is helpful in understanding current § 338, to be discussed in Lesson 8B. B&E ¶¶ 10.05[5], 10.06[4].

(1)(c) If *X* were an S corporation in question (1), *X* would still recognize \$700 gain, but it would not be taxed. The gain would pass through to *A* as § 1231 capital gain, increasing *A*'s stock basis to \$800 so that under § 331, *A* would also recognize a \$200 capital loss on the deemed sale of his stock for \$600 cash in liquidation of *X*. Note that § 1244 does not apply to loss created by stock basis increases attributable to S corporation income. IRC § 1244(d)(1)(B). Note also that § 267(a)(1) does not apply to either side of a complete liquidation exchange. *A* will recognize a net \$500 gain for the year. IRC §§ 1366, 1367, 1371(a); B&E ¶ 6.09[3]. If *A* recognized the building sale gain first and recognized the stock loss in a later year, the loss could not be carried back. IRC § 1212(b).

If *X* is an S corporation in (1)(b) above, and if § 453(f) otherwise applies, \$700 recognized gain passes through to *A* (rather than being taxed to *X*) in the year of the building's sale, resulting in a \$700 increase in *A*'s stock basis. That distribution of the note does not trigger *X*'s deferred gain on the note (§ 453B(h)), which was irrelevant because the gain was not deferred because *X* could not (but now can) use the installment method as an accrual method taxpayer. *A* recognizes his § 331 \$200 capital loss currently. Note that in the aggregate, both in (1)(a) and here, *A* only recognizes his \$500 stock gain, and the greater inside gain of *X* is not recognized.

(2) Section 336 treats *X* as selling the building to the shareholder for \$1,000 and recognizing \$700 gain on which tax of \$250 will be due (B&E ¶ 10.05). § 1239 causes the character of *X*'s gain to be ordinary income (as could § 1250 as to part of the gain), but that is irrelevant here. Since the facts state that *A* got the building and *X* had no other assets, and since we always assume no other tax-relevant activity, we must assume that *X* did not pay its tax and that *A* will be liable under state law for *X*'s tax debt (which is a definite and certain liability) up to the amount *A* received, which tax can be assessed against *A* under § 6901(a)(1)(A)(i). Therefore, *A*'s amount realized again probably is the net value of \$350, and *A* realizes \$250 gain under §§ 331(a) and 1001. B&E ¶ 10.03[3]. *X*'s E&P account disappears. B&E ¶ 10.05[2](b). Note, however, that if *A*'s liability for *X*'s debts (tax or otherwise) were uncertain or contingent, the debt would likely not reduce the amount *A* realized but probably would create a capital loss when later paid by *A* under the *Arrowsmith* doctrine. B&E ¶ 10.03[3].

If the shares had varying costs, the gain would be computed separately on each share (or block).

A's basis in the building will be FMV of \$1,000. IRC § 334(a). B&E ¶ 10.04. Even if § 334(a) meant net FMV of \$350, we would add the debts under the *Crane* doctrine. Section 1060 might apply if the building is a business for purposes of that section (it also might have applied in problem (1) above). Upon sale of the building, *A* realizes \$1,000 (Regs. § 1.1001-2(a)) but realizes no gain because his basis is \$1,000. *B* gets a § 1012 \$1,000 basis that can be depreciated. If *X* had a life insurance policy on *A*, see IRC § 101(a)(2)(B).

Alternative: If *X* is an S corporation, *X* recognizes \$700 gain (ordinary income under § 1239 and possibly § 1250), which is not taxed to *X* but passes through to *A* and increases *A*'s stock basis to \$800. When *A* receives net value of \$600 for his stock, *A* recognizes a \$200 capital loss. Note that while § 1244 does apply to S corporation stock, under § 1244(d)(1)(B) the stock basis increases because of pass-through income of *X* cannot create loss that is subject to that section. The capital loss will be allowed to reduce the ordinary income only by \$3,000. IRC § 1211(b); B&E ¶ 6.09[5].

(3) This problem and problems (1) and (2) above illustrate that regardless of whether *X* sells first or liquidates first or whether *B* buys the stock and liquidates *X*, in order for *B* to get a FMV basis in the building, two levels of gain must be recognized if *X* is a C corporation, but only one level of gain must be recognized if *X* is an S corporation and

§ 1374 does not apply. *A* will most likely not choose the problem (2) route, however, because that route creates tax liability for *X* without cash in hand.

A recognizes \$500 gain. *B* takes a \$600 basis in the stock of *X*. Upon its liquidation, *X* recognizes gain of \$700 under § 336 and accrues a tax of \$250. *B* realizes \$350 and recognizes a short-term capital loss of \$250. Cf. B&E ¶ 10.03[4], which probably should not apply here. Section 1244 cannot apply because *X* did not issue the stock to *B*. On the most favorable assumption that *B* can utilize the loss to reduce his taxes by \$87.50 (35 percent of \$250), *B* still has a net real economic loss of \$162.50. *B* will take a \$1,000 basis in the building. *B* should not have paid \$600 for the *X* stock, particularly if he intended to liquidate it immediately. *X* carried a "hidden" liability in the form of the lurking gain (and the attendant tax) on its building. *B* should have negotiated a price closer to \$350. B&E ¶ 10.05.

B cannot avoid the tax on *X* by electing S status for *X* because *X* would then have to pay \$250 § 1374 tax. B&E ¶ 6.07[1]. Gain of \$450 (the \$700 gain, net of the tax under § 1366(f)(2)) passes through to *B* for "double" gain recognition on the deemed sale of the building. This gain will be treated as ordinary income under § 1239. *B*'s stock basis will be increased to \$1,050, so under § 331, *B* will have a \$700 short-term capital loss, the utility of which is limited by § 1211(b). If *B* had paid \$350 for the stock, he would recognize a \$450 short-term capital loss on the liquidation (but for §§ 1239, 1250, and 1211(b)), recognize no net gain and have no capital loss carryover, and still hold the building with a \$1,000 basis. B&E ¶ 6.09[5].

Alternative: If *X* always had been an S corporation, *X* would not be subject to § 1374 and the \$700 gain would pass through to *B*, increasing his stock basis to \$1,300 so that *B* would have a \$700 short-term capital loss upon the liquidation. Since the gain would be ordinary income under § 1239 (and possibly § 1250), the loss would not offset the gain beyond \$3,000. IRC § 1211(b). *B* can only carryover, and not carryback, a capital loss. IRC § 1212(b). Where *X* is already an S corporation, *B* should especially want to buy assets, not stock. B&E ¶¶ 6.09[3], 6.09[5].

(4) This may be one of those "rare and extraordinary" cases in which the taxpayer is entitled to assert that the transaction is "open." Regs. § 15A.453-(d)(2)(iii). B&E ¶ 10.05[2]. Assuming the contingent right has no ascertainable fair market value, *X* must recognize only \$700 gain (a now-or-never advantage for the liquidating corporation) and *A* takes the contingent right with a zero basis. Upon collecting any amount under it, *A* would recognize additional capital gain of the same nature as the gain originally

recognized on the stock. Likewise, *B* should then adjust his basis in the building upward by \$500. IRC § 1016(a)(1). If the building is a § 1060 trade or business, then the § 338 regulations can apply.

(5) *X* recognizes \$500 loss under § 336 on § 1231 property, which would be ordinary loss. Section 267(a)(1) does not disallow the loss. Contrast § 311(a). *X*'s resulting NOL can be carried back two years to produce a refund under § 172(b)(1)(A), but if the NOL cannot be used up in that fashion, the parties should consider a stock sale and retention of *X*'s high basis in the building, although § 382 (to come in a later lesson) will severely restrict the utility of this gambit. Assuming the loss produces no tax refunds for *X*, *A* now realizes \$600 and recognizes \$500 gain and no additional gain on the sale to *B*. B&E ¶ 10.05.

If the property had been contributed in a § 351 transaction less than five years ago, § 336(d)(1) would disallow the \$500 *X* loss. *A*, however, would recognize a \$500 loss. B&E ¶ 10.05[3].

(6) *X* recognizes \$100 gain under § 336(b) (and § 7701(e)), which applies only to nonrecourse debt), incurring \$35 tax liability. *A* realizes \$0, has worthless stock, and recognizes \$100 loss. Since *A* received no net value, there probably is no § 6901 transfer, and the tax probably could not be assessed against *A* and probably should be added to the building's basis (or reported as a loss) only if and when for some reason *A* later actually paid it. While *A*'s basis in the building is somewhat uncertain, it appears that FMV under § 334(a) means \$350 here. Upon *A*'s transfer of the building to *B* subject to the debt of \$400, *A* probably should not realize the debt to the extent it was not taken into his basis in the building (thus, no gain on the building). Regs. § 1.1001-2(a)(3). If, however, § 1060 applies to *A*'s acquisition of *X*'s asset(s), it appears that the basis result will be the same and that the liability would not be realized upon sale. Discuss *Pleasant Summit* and *Estate of Isaacson*. Regs. § 1.338-6(c)(4). B&E ¶¶ 10.04, 10.40.

(7) An S election will not avoid double tax on the installment sale payments received at any time (see Regs. § 1.1374-4(h)(1)) and on future sale of the inventory and building within the 10-year § 1374 recognition period, since all three are built-in gain assets held at the time of the S election, although § 1374 tax would be limited to tax at the highest corporate rate on the unrealized built-in gain at the time of the election. An S election would also probably be short lived since three years of passive rental income

and interest on cash would not only attract an inside tax under § 1375 in every year (another "double tax") but would also result in loss of the S election after the third such year under § 1362(d)(3). Beware § 1363(d). B&E ¶¶ 6.04[3], 6.07[2].

On the other hand, if A is willing to have X invest its cash in a new business and, if necessary, to sell the building at least by the third year of the S election (the receipts from which should not be passive), an S election would be desirable to subject active income to single tax and to shield X from the accumulated earnings tax and the personal holding company tax (though the tax rate in both of these sections was reduced to 15 percent in 2003), which appear to threaten X unless X pays out its future income in dividends. Theoretically, X could also avoid S election termination and tax due to passive income by distributing all of its E&P from years as a C corporation, but the dividend cost probably would not be worth the result here. IRC § 1368(c)(3). A will probably want to keep X alive, however, to avoid the substantial gain on A's stock through a § 1014 basis adjustment for his heirs.

8B Subsidiary Liquidations and § 338

(1) X recognizes \$700 gain, pays \$245 tax, and distributes \$355 to Y, whose basis in (and lurking gain on) X stock disappears; Y takes the cash without recognition of gain or loss under § 332. Y inherits X's tax attributes, including particularly E&P (augmented by the building sale gain) under § 381(a)(1). Z takes a \$1,000 basis in the building. B&E ¶ 10.21.

Consider noting how the purchase of the assets with a certain type of debt could run afoul of § 279 if Z were extraordinarily ill-advised. B&E ¶ 4.26.

(2) Under § 337, X does not recognize gain on the distribution in kind; under § 332, Y does not recognize gain on the liquidation. Y takes a carryover \$300 basis in the building under § 334(b) and Y's E&P is increased by X's \$200 under § 381(a)(1). Y recognizes \$700 gain on the sale to Z, and Z takes a \$1,000 basis in the building. B&E ¶ 10.22.

(3) Y recognizes \$500 gain, and Z takes a \$600 basis in the stock. Upon the liquidation, Z takes a \$300 carryover basis in the building; no gain is triggered to X because of § 337, and X's E&P carries up to Z. Even when Z pays the mortgage debt, Z's basis in the building does not increase.

Z, directly or indirectly, has paid \$1,000 for a building worth \$1,000 but subject to a built-in-potential tax liability of \$245. Only in this third problem does Z not get the benefit of a FMV basis in the building. The culprit is the §§ 332/334(b) carryover basis. Z could make a § 338 election because Z has acquired 100 percent of the stock "by purchase" within 12 months (which used to be a feat of great interest when a § 338 election was attractive). The deemed consequences of a § 338 election are described in B&E ¶ 10.42[1]. While the election would give X (without being liquidated) a FMV basis in its building, the cost would be \$245 tax due now, which X (as a subsidiary of Z) would have to pay. Assuming tax rates remain constant, it is never worth paying \$245 tax today to avoid paying \$245 tax in the future, which is what an increase in the building basis from \$300 to \$1,000 is worth. B&E ¶ 10.41[4]. Therefore, the most important thing to know about § 338 probably is not to elect it as a general rule. Previously, the possibility of a deemed election and how to avoid one by making a protective carryover basis election were questions of key importance, but the regulations significantly diminish the chances and consequences of an inadvertent deemed election. B&E ¶ 10.42[4].

If X had a compensating built-in loss in other assets or had NOLs, however, or if there were a particular need to cleanse X's tax history, a § 338 election might make sense; neither § 382 nor § 384 would prevent X from using its own losses against its own gains. B&E ¶¶ 10.42[1], 14.44[7][b], 14.45.

If X has a built-in loss of \$500 and § 338 is not elected, however, the later recognition of the loss by X or Z would be limited by § 382, but to the extent that the loss was still available, it could be disallowed to Z under § 269(b) if X's quick liquidation was for the principal purpose of Z using the loss. B&E ¶¶ 14.41[3][e], 14.44[7][a].

At this point, we have identified the carryover basis problem peculiar to corporate acquirers of control and the dubious solution in the form of § 338, which will give a FMV asset basis but at a cost that usually is too great to bear. Perhaps the existence of the complex provisions of § 338 and its formidable corpus of regulations will make the student curious as to how it came to be. Therefore, you can "back into" a discussion of the *Kimbell-Diamond* doctrine (Note: a government victory¹), its codification in former § 334(b)(2) for quick liquidations of X, its transmutation into § 338 so as to avoid liquidating and the driving engine of old § 338, which was old § 337 (touched upon in Lesson 8A). Section 337 made an odd union indeed with § 338, since old § 337 by itself could not even apply to sales by a controlled subsidiary. Consequently, § 338 is largely a vestige of a bygone nonrecognition. A review of this