CHAPTER 7 – LIQUIDATIONS

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7-1a. X Corp. distributes a pro rata share of each asset to A and B. It distributes to A an undivided 80% interest in Asset 1 with a $160,000 basis and $400,000 fair market value and an undivided 80% interest in Asset 2 with a $640,000 basis and $400,000 fair market value. It distributes to B an undivided 20% interest in Asset 1 with a $40,000 basis and $100,000 fair market value and an undivided 20% interest in Asset 2 with a $160,000 basis and $100,000 fair market value.

Because A and B are individuals, X Corp. determines its tax consequences for the liquidation under §336. On the distribution to B, X Corp. will recognize a $60,000 gain on its distribution of a portion of Asset 1 and a $60,000 loss on its distribution of a portion of Asset 2. Note that B is not related to X Corp. under §267. Section §336(d)(2)(B)(ii) potentially reduces the deduction since the property was acquired in a §351 transaction within two years of the adoption of a plan of liquidation. But under §336(d)(2)(A), X Corp.'s basis for determining the loss is not reduced since there is no excess of adjusted basis ($800,000) over fair market value ($900,000) immediately after the §351 transaction (i.e., Asset 2 did not have a built-in loss immediately after the §351 transaction).

Notice that Congress has written a provision that denies a corporate deduction for pre-incorporation losses, but there is no corresponding provision for pre-incorporation corporate gain. If there were such a provision, in this problem X Corp. would not recognize $100,000 pre-incorporation gain on Asset 2 and whatever pre-incorporation gain was built-in to Asset 1.

On the distribution to A, X Corp. will recognize the $240,000 gain on Asset 1 under §336. The loss of $240,000 on Asset 2 cannot be recognized under §336(d)(1). A, as an 80% shareholder, is a related party under §267 and the property was acquired in a §351 transaction within 5 years of the date of distribution. Note that §336(d)(1) denies the entire loss even though the loss arose after the property's incorporation. Why didn't Congress reduce the loss by pre-incorporation unrealized loss - in this case $0 -as it did in §336(d)(2)(A)? Not only does §336(d)(2)(A) deny X Corp. the deduction, but there is no basis preservation provision as there is in §267(d). Under that provision, the transferee can offset any gain on the eventual sale of the property with the loss that was disallowed to the transferor. In this problem, if A sells his interest in Asset 2 for $640,000, he will recognize a $240,000 gain which cannot be offset by the $240,000 loss not recognized by X Corp. on the liquidating distribution.

Note that in a liquidation the earnings and profits of X Corp. are unimportant. A and B will generally have capital gain and loss under §331.

A will have a $500,000 capital gain (long-or short-term depending on A's holding period for the stock). B will recognize a $400,000 capital loss. See §§331 and 1001. The shareholders will each take a fair market value basis in the distributed property. See

§334(a). Note that the loss disallowed to X Corp. on the distribution to A permanently disappears since A's basis in the loss property will be $400,000.

7-1b. This Problem allows students to consider an odd interplay of §362(e)(2) and §336(d).

Assume first that §362(e)(2) does not apply to the transfer of Asset 2 in the §351 transaction (*e.g.*, because the transfer occurred before §362(e)(2) was enacted or because the shareholder who transferred Asset 2 also transferred other assets in the same transaction with a $100,000 or greater built-in gain). The results are the same as in described in the answer to Problem 7-1a., except that X Corp. will not recognize a portion of its loss on Asset 2 on its distribution to B. Since X Corp. received Asset 2 in a §351 transaction during the 2-year period ending on the date of the adoption of a plan of liquidation, §336(d)(2)(B)(ii) will apply. Under §336(d)(2)(A), X Corp.'s basis will be reduced by built-in loss in Asset 2 immediately after its contribution. Presumably, the loss will be pro-rated between the portions of Asset 2 distributed to A and B, so that the $160,000 basis of the portion distributed to B will be decreased by $20,000 (20 percent times $100,000 built-in loss in Asset 2 immediately after the contribution). Then, X Corp. can deduct only a $40,000 loss on the distribution of Asset 2 to B. There is no effect on the distribution of Asset 2 to A since the loss is disallowed in its entirety under §336(d)(1).

Would there be a different result if Asset 2 was business equipment used by X Corp. in its trade or business? The Conference Report at page II-200 through 202 indicates that the 2-year period creates a presumption that can be overcome by showing that the transferred property was used in the distributing corporation's trade or business.

Would there be a different result if Asset 2 was transferred 3 years before the plan of liquidation was adopted, but the purpose of the transfer was to create a corporate-level loss on the liquidation that might follow? A §351 transfer more than 2 years before adoption of a liquidation plan might fall within §336(d)(2)(B)(i)(ii) although the Conference Report states that such circumstances will arise only "in the most rare and unusual cases."

Next assume that §362(e)(2) applied to the transfer of Asset 2 and that X Corp. took a $700,000, rather than $800,000, basis in Asset 2. On the liquidating distribution to B, §336(d)(2) will not apply, because Asset 2's basis equaled its value immediately after its acquisition by X Corp. *Cf.* §336(d)(2)(A). Section 336(d)(1) does not apply to that distribution, because B is not related to X Corp. under §267. Thus, X Corp. recognizes a $40,000 loss on the distribution (the excess of $140,000 (20 percent of $700,000) over $100,000 (20% of $500,000)). For the same reasons as noted above, X Corp. recognizes none of its loss on its distribution of a portion of Asset 2 to A. Thus, the results to X Corp. are the same as if §362(e)(2) did not apply. (Note that if Asset 2 had appreciated in value while held by X Corp., the results would not be the same.)

The results to the shareholders are also the same. Thus, the pre-incorporation built-in loss is preserved at the shareholder level but eliminated at the corporate level.

Finally assume that §362(e)(2) applied to the transfer of Asset 2, but the transferring shareholder and X Corp. (foolishly) elected under §362(e)(2)(C) to reduce the transferring shareholder's basis in the X stock, rather than X Corp.'s basis in Asset 2. The results to X Corp. and the analysis are the same as when §362(e)(2) did not apply. Although §336(d) targets the duplication of loss, it also seems to target the shifting of loss from a shareholder to the corporation. (Note that §336(d)(2)(B)(II) looks to a principal purpose to "recognize loss by the liquidating corporation.") Perhaps future regulations to coordinate §336(d) and §362(e)(2) will change this result.

The results to the shareholder who transferred the built-in loss asset will differ, however. On the liquidation, that shareholder's loss will be decreased (or gain will be increased) by $100,000. Thus, the impact of the §362(e)(2)(C) election is to eliminate the pre-incorporation built-in loss at both the shareholder and corporate levels.

7-1c. Now the distributions to A and B are outside the confines of §336(d). Assuming that §362(e)(2) did not apply to the transfer of Asset 2, A recognizes a $500,000 gain and B a $400,000 loss. Further, X Corp. can recognize the $300,000 loss on the distribution of Asset 2 to A and B, which will offset the $300,000 gain on the distribution of Asset 1. §336(a). You might want to ask students why §267 does not bar the loss on the deemed sale under §336 to A - a related shareholder within the meaning of §267(b)(2). Section 267(a) contains a parenthetical that excepts complete liquidations from its coverage.

If, however, §362(e)(2) applied to the transfer of Asset 2 to X Corp., if the §362(e)(2)(C) election were not made, X Corp. would take a $700,000 basis in Asset 2, reducing its loss on the liquidation on Asset 2 to $200,000. The results to the shareholders would be the same. If, however, the election were made, X Corp. would take an $800,000 basis in Asset 2, so that it would have a $300,000 loss on Asset 2 on liquidation. The results to the shareholder who transferred the built-in loss asset would differ, however. On the liquidation, that shareholder's loss would be decreased (or gain increased) by $100,000. Thus, the impact of §362(e)(2) would be to eliminate a $100,000 loss (or increase gain by $100,000) at the shareholder or corporate level.

7-1d. Even though the transfer takes place more than 5 years prior to the liquidating distribution, X Corp. will not be able to recognize any loss on the distribution of Asset 2. Under §336(d)(1)(A)(i), the distribution is not pro rata, and there are no time limitations for non pro rata distributions of loss property to related shareholders. Note that the disallowance is of the entire loss and not just the non pro rata portion X Corp. was attempting to recognize. The taxpayer could try to argue that the property was distributed pro rata because overall A is getting 80% of the assets; however, this argument is unlikely to be successful. Note as well, that if a §362(e)(2)(C) election were made on the transfer of Asset 2 to X Corp., the $100,000 pre-incorporation built-in loss in Asset 2 would be eliminated at both the shareholder and corporate levels.

Suppose instead that X Corp. had made a pro rata distribution as in Problem 7-1c. Following the distribution, A exchanged a $100,000 interest in Asset 1 for B's $100,000 in Asset 2. Since A and B will each have a fair market value basis in the property received on liquidation under §334(a), the shareholders will experience no further gain on the exchange. If respected the pro rata distribution followed by a sale will leave A with all of Asset 2 and a $300,000 interest in Asset 1 and B with a $200,000 interest in Asset 1. However, by making a pro rata distribution, X Corp. can recognize the $300,000 loss under §336(a).

It seems likely, however, that the Service will characterize a pre-arranged liquidation and sale as a non pro rata distribution under the step-transaction doctrine. If the sale is not arranged before the liquidation, that characterization would be difficult.

Why is there a non pro rata rule? Presumably Congress was concerned that a corporation and its related shareholders would keep control of loss property while recognizing the loss. This is the same concern that motivated the enactment of §267. But if §267 does not apply to pro rata distributions, it is difficult to see why it should apply to non pro rata distributions. After all, X Corp. cannot selectively distribute some assets and not others in a complete liquidation.

7-1e. The order of sale and liquidation may make a difference. In Problem 7-1a, X Corp. could not deduct the loss on the distribution of Asset 2 to A. Consequently, X Corp. recognized a $300,000 gain and only a $60,000 loss. If A and B then sold the assets following liquidation, there would be no further gain or loss since the assets took a fair market value basis upon liquidation.

Suppose X Corp. sold the assets prior to liquidation. If the transaction was respected, X Corp. could recognize the entire $300,000 loss which would offset the $300,000 gain. On the distribution of cash in complete liquidation, X Corp. would recognize no gain or loss under §336, and A and B would recognize gain and loss as set forth in Problem 7-1a. Note that §336(d)(2) applies to sales by liquidating corporations if the property was acquired in a §351 transaction within two years of adoption of a plan of liquidation. But under §336(d)(2)(A), there was no built-in loss which would reduce the basis of Asset 2 for purposes of calculating the loss on the sale.

In Problem 7-1b, there is a $100,000 built-in loss in Asset 2 immediately after the §351 transfer (if §362(e)(2) did not apply or the §362(e)(2)(C) election was made). Then, when X Corp. sells the assets the basis of Asset 2 must be reduced from $800,000 to $700,000 thereby reducing the recognized loss to $200,000. §336(d)(2). If the property were distributed by X Corp. before a sale by the shareholders, no loss would be allowed to X Corp. on the distribution to A and only a $40,000 loss would be allowed on the distribution to B.

If §362(e)(2) applied but the §362(e)(2)(C) election was not made, the results would be the same to X Corp. The corporation would take a $700,000 fair market value basis in Asset 2 immediately after its contribution. Thus, §336(d)(2) would not apply to X Corp.'s sale of Asset 2, and X Corp. would still recognize a $200,000 loss on the sale. If the property were distributed by X Corp. before a sale by the shareholders, no loss would be allowed to X Corp. on the distribution to A and only a $40,000 loss would be allowed on the distribution to B.

A and B would recognize gain or loss as specified in the answer to Problem 7-1b. Again, the impact of the §362(e)(2)(C) election would be to eliminate the pre-incorporation built-in loss at both the shareholder and corporate levels.

If the sale of the property is not deemed made by X Corp. in connection with its liquidation, then §336(d)(2) will not apply and X Corp. will recognize the full loss on Asset 2. Section 336(d)(2) does not indicate when a sale will be connected with a liquidation. But suppose X Corp. sells the property 22 months after the §351 transaction but adopts a plan of liquidation 25 months after the §351 transfer? Section 336(d)(2) does not literally apply so that X Corp. can recognize the loss. Note, however, that the Service may try to attribute the adoption of a liquidation plan back to the sale as it sometimes did under old §337 when taxpayers sought to sell loss property before adopting a plan.

You might want to point out that prior to the Tax Reform Act of 1986, the purpose of old §337 was to render the order of sale irrelevant. Under prior law, X Corp. would not have been taxed on the liquidation and so could recognize neither gain nor loss on a sale after adopting a plan of liquidation but before timely completion. With the repeal of the *General Utilities* doctrine, X Corp. recognizes gain or loss on liquidation and so the need for old §337 has disappeared. But as this Problem illustrates, perfect symmetry is lacking so that the order of sale and liquidation still may matter.

7-1f. This problem takes students through the second liquidation pattern - §§337-332-334(b) and may be used to introduce the next section. On the distribution of property to A Corp., an 80 percent distributee under §§337(c) and 332(b), X Corp. will recognize no gain or loss. See §337(a). (X Corp. might recognize gain and loss on the distribution to A if A were a foreign corporation (see §367(e)(2)) or a tax-exempt corporation (see §337(b)(2)). Since the Code regards this subsidiary liquidation as a simplification of corporate structure, A Corp. will not recognize gain or loss under §332 if it meets the timing requirements of §332(b).

A Corp. will take the assets with a carryover basis under §334(b). A's interest in Asset 1 will have a basis of $160,000, and A's interest in Asset 2 will have a basis of $640,000. Under §§381(a)(1) and (c)(2), A will succeed to 80 percent of X Corp.'s earnings and profits account. See Regs. §1.381(c)(2)-1(c)(2).

The application of §332 to A will have consequences on the distribution to the minority shareholder B as well. Under §336(d)(3), X Corp. cannot recognize the $60,000 loss on the distribution of Asset 2 to B. At first glance, it may be unclear why X Corp. should not recognize this loss merely because §332 applies to A. *Cf*. §311. Perhaps Congress was concerned that the distributing corporation - X Corp. - would distribute gain property to A, the shareholder subject to §332, while distributing loss property to B, a minority shareholder. Such a distribution pattern would allow X Corp. to avoid recognizing gain on the distribution to A under §337 while recognizing loss on the distribution to B.

Pages 272-273: Section 332 is perhaps best viewed as a provision that allows simplification of corporate structure without an immediate tax bite. If §332 applies to the liquidation of a subsidiary into a parent corporation, the liquidation eliminates the parent's built-in gain or loss in its subsidiary stock. For shareholders not satisfying the three-part test under §332(b) (*i.e.*, generally shareholders other than the 80-percent corporate distributee), the consequences of the liquidation are determined under §§336-331-334(a).

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7-2. This problem raises some of the issues discussed in *Associated Wholesale Grocers, Inc.* For convenience, the answers to the problem treat division 1 and 2 as each having just one asset. The problem also implicitly assumes that X and Y are not members of the same consolidated group.

7-2a. Section 332 applies to the liquidation, because X owns all Y stock (and therefore an affiliated interest in the Y stock) from the date of the adoption of the plan of liquidation until the final liquidating distribution, and Y makes a distribution on all of its stock (assuming that it has only one class of stock). Assume that the liquidating distributions occur all within one year.

On the §§337-332-334(b) liquidation, Y recognizes no gain or loss on the liquidating distributions. §337(a). X recognizes no gain or loss on its exchange of the Y stock for the Y assets. §332. X takes transferred bases in the Y assets, preserving the built-in loss in the division 1 assets and the built-in gain in the division 2 assets. §334(b). On the sale of the division 2 assets to P, X recognizes a $40,000 §1231 gain (assuming no depreciation recapture). P takes a cost basis of $100,000 in the purchased assets. §1012.

7-2b. If the distribution is not treated as part of the liquidation, Y could not recognize a loss on its distribution of division 1. §311. Y has sufficient earnings and profits, so X recognizes dividend income of $400,000. §301(c)(1). However, X can rely on the dividends-received deduction (§243) and perhaps deduct 100 percent of the dividend, leaving a net inclusion of $0. X takes a $400,000 basis in the division 1 assets distributed. §301(d). On the sale to P, Y recognizes a $40,000 gain. §1001. On the liquidation, neither Y nor X recognizes gain or loss. §§337,332. If the nonliquidating and liquidating distributions are stepped together, the results are the same as in problem 7-2a. However, it is unlikely that the taxpayer would be able to disavow the form selected, and the Service is better off with the form selected by the taxpayer.

7-2c. This transaction resembles the transaction in *Associated Wholesale Grocers*. If form is followed, Y recognizes a $300,000 loss and $40,000 gain on the sale of the division 1 and division 2 assets. §1001. The excess loss can be used to offset other income or carried over to another year. On the liquidation, neither Y nor X recognizes gain or loss. §§337,332. Upon the purchase of assets by X, P recognizes no gain or loss, because it has a $400,000 basis in the division 1 assets it purchased. As in *Associated Wholesale Grocers*, it is likely the Service would contend that the sale by Y and the repurchases by X should be stepped together. Under this view, the transactions would be characterized in the same manner as in problem 7-2a with the same tax consequences. The step-transaction doctrine is likely to apply, unless X could show that the sale by P to X was not part of a prearranged plan. You may want to discuss whether the taxpayer can avoid the result in *Associated Wholesale Grocers* by leasing the division 1 assets back from P Corp.

7-2d. On the sale of the division 2 assets to P, Y recognizes a $40,000 gain. §1001. On the sale of the division 1 assets to X (assuming that form is followed), Y defers its loss under §267(f), X succeeds to that loss, and X takes the loss into account under the timing principles of Treas. Regs. §1.1502-13 (*e.g.,* as the loss assets are sold). See Treas. Regs. §1.267(f)-1(a)(2). X takes a basis of $400,000 in the division 1 assets. Neither Y nor X recognizes gain or loss on the liquidation. §§337,332. Would a sale from Y to A and B of division 1 assets avoid the §267 problem? No. The attribution rules still bar recognition of the loss.

7-2e. This variation may produce some desirable tax results for X and Y if the transactions are respected. If X sells exactly 20 percent of the Y stock to P, X recognizes a $30,000 loss. P Corp. takes a cost basis of $100,000 in the Y Corp. stock. §1012. On the liquidation of Y Corp., §§332 and 334(b) apply to the distribution to X. Accordingly, neither Y nor X recognizes any loss on the distribution of the division 1 assets. X takes those division 1 assets with a basis of $700,000 which preserves the $300,000 loss. §334(b). Y would recognize a $40,000 gain under §336 on the distribution of the division 2 assets to P. P, which takes a $100,000 basis in the stock purchased from X, recognizes no gain or loss on the liquidating distribution pursuant to §331 and takes a $100,000 basis in the division 2 assets. §334(a).

Suppose that X sells slightly more than 20 percent of the Y stock to P. (This might be the case if the division 2 assets have a fair market value of more than $100,000.) If X owns less than 80 percent of Y when Y is liquidated, then §336 and 331 will apply. Y, at first glance, may appear to recognize a $300,000 loss on the liquidating distribution to X. However, because the distribution is not pro rata, §336(d)(1) would deny the loss deduction. X would recognize approximately a $120,000 loss under §331 on the liquidation (in addition to the $30,000 loss on the sale of the 20+ percent of Y stock to P.) Consider *Day & Zimmermann, Inc.* and *Granite Trust Co*., page 277, and in the *Associated Wholesale Grocers*.

7-2f. On the sale of the division 2 assets to P Corp., Y Corp will recognize a $40,000 gain. §1001. P Corp. will take a cost basis of $100,000 in the division 2 assets. By taking 18 months to complete the liquidation, X and Y Corp. are attempting to avoid §§332 and 337 so that the $300,000 loss on the division 1 assets can be recognized by Y Corp. pursuant to §336, and a $150,000 loss can be recognized by X Corp. pursuant to §331. §332(b)(2) seems to help the taxpayer accomplish this result because the section provides that the distribution of all the property in a liquidation must be completed within 12 months for §§332 and 337 to apply. However, §332(b)(3) specifically provides that the distributions must be completed within 3 years after the first year in which a liquidating distribution occurs. Since Y Corp. completed the liquidation within 18 months after adopting a liquidation plan, §§332 and 337 applies to the transaction thereby denying both X Corp. and Y Corp. any losses. But the loss on the division 1 assets will be preserved under §334(b). If Y Corp. had not adopted a plan of liquidation, it might successfully have avoided §337, unless the Service determined that there was a de facto plan. See, e.g., *International Inv. Co,. v. Commissioner*, 11 TC 678, 685 (1948), *aff'd per* *curiam*, 175 F2d 772 (3d Cir. 1949) no need for a formal plan of liquidation if one can be discerned from the circumstances surrounding the liquidation).