Chapter 19

Corporations: Distributions in Complete Liquidation and an Overview of Reorganizations

Eugene Willis, William H. Hoffman, Jr., David M. Maloney and William A. Raabe

Liquidations-In General

- Corporation winds up affairs, pays debts, and distributes remaining assets to shareholders
  - Produces sale or exchange treatment to shareholder
  - Liquidating corporation recognizes gains and losses upon distribution of its assets, with certain exceptions

Liquidations-Effect On Corporation (slide 1 of 3)

- Gain or loss is recognized by corporation on distribution in complete liquidation
  - Loss may be disallowed or limited if:
    - Property distributed to related parties, or
    - Property distributed has built-in losses
  - Property treated as if sold for FMV
  - Result:
    - Liquidating distribution subject to corporate level tax (gain), and shareholder level tax (receipt of proceeds)

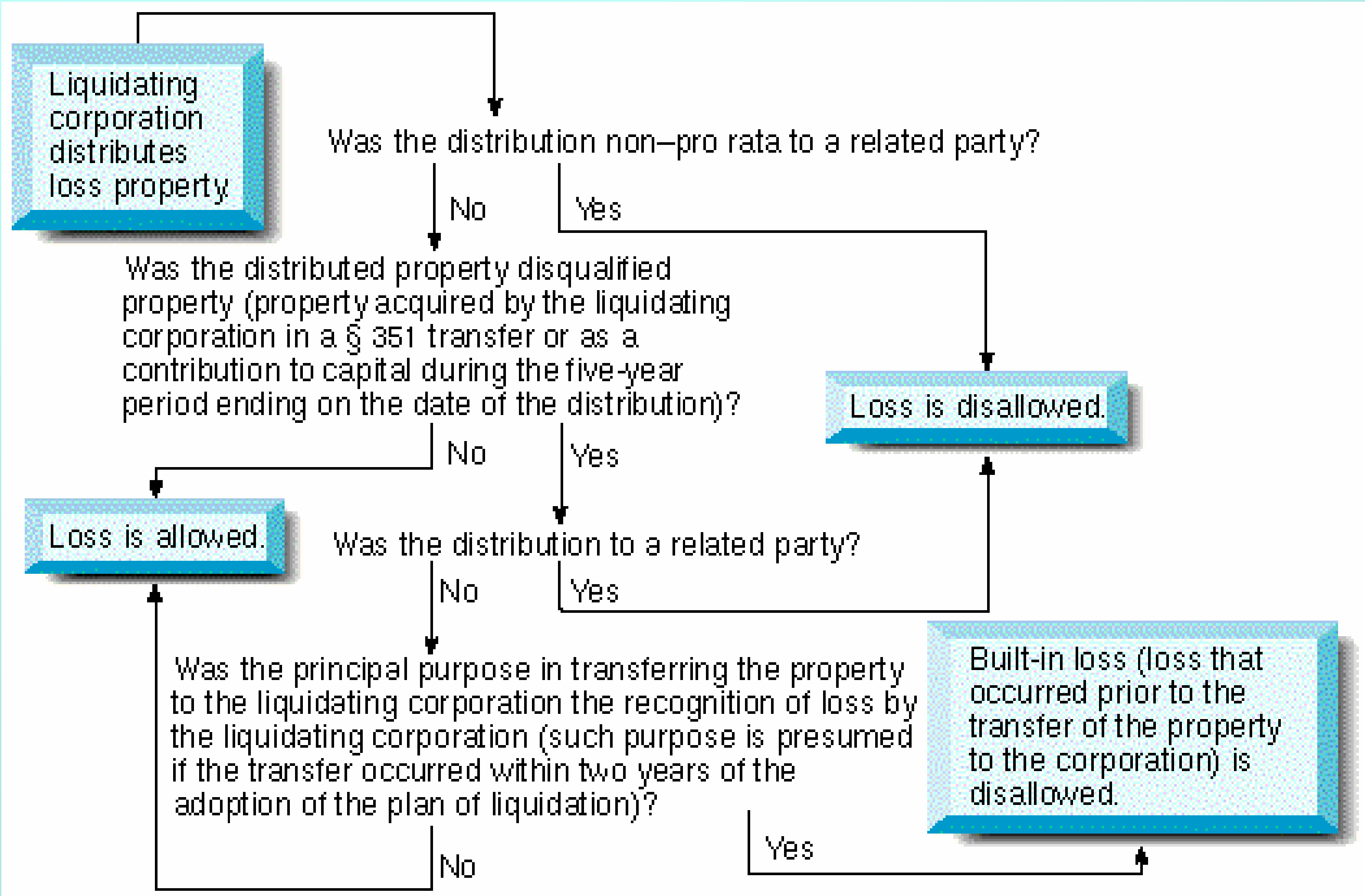
Liquidations-Effect On Corporation (slide 2 of 3)

- Limitations on losses-Related Party Situations
  - Losses are disallowed on liquidating distributions to related parties if:
    - Distribution is not pro rata
      - In pro rata distributions, each shareholder receives their share of each asset
    - Property distributed is disqualified property
      - Disqualified property is property acquired by corp in a §351 transaction during the five-year period ending on date of distribution

Liquidations-Effect On Corporation(slide 3 of 3)

- Limitations on losses-Built-in Loss Situations
  - Losses are disallowed when property distributed was acquired in a §351 transaction and principal purpose was to cause recognition of loss by corp on liquidation
  - Purpose is presumed if transfer occurs within two years of adopting liquidation plan

Distribution of Loss Property in Liquidation



Liquidations-Effect On Shareholder (slide 1 of 2)

- Gain or loss recognized on receipt of property from liquidating corporation
  - Amount = FMV of property received - basis in stock
    - Generally, capital gain or loss
  - Basis in assets received in liquidating distribution = FMV on date of distribution

Liquidations-Effect On Shareholder (slide 2 of 2)

- Special rule for installment obligations
  - Shareholder may defer gain recognition to point of collection
  - Corporation must recognize all gain on distribution

Liquidations: Parent-Subsidiary Situations (slide 1 of 4)

- Parent corporation does not recognize gain or loss on liquidation of subsidiary
  - Also, subsidiary recognizes no gain or loss on property distributions to its parent

Liquidations: Parent-Subsidiary Situations (slide 2 of 4)

- To qualify:
  - Parent must own at least 80% of voting stock and value of subsidiary's stock
  - Subsidiary must distribute all property within three years from first distribution
  - Subsidiary must be solvent

Liquidations: Parent-Subsidiary Situations (slide 3 of 4)

- Liquidating distributions to minority shareholders
  - Treated same way as nonliquidating distribution
    - Distributing corp recognizes gain but not loss
    - Minority shareholders recognize gain or loss
      - Amount=FMV of property received-basis in stock

Liquidations: Parent-Subsidiary Situations (slide 4 of 4)

- Basis of property received by parent
  - Has same basis as subsidiary's basis (unless election is made under §338)
    - Parent's basis in subsidiary's stock disappears
    - Parent acquires tax attributes of subsidiary
      - e.g., NOLs, business credit carryovers, capital loss carryovers, subsidiary's E & P
    - May result in some inequities

Election Under §338

(slide 1 of 4)

- Parent may elect to treat acquisition of stock in acquired corp as a purchase of the acquired corp.'s assets if:
  - Election is made by fifteenth day of ninth month following qualified stock purchase
    - Qualified stock purchase occurs when corp acquires stock representing at least 80% of voting power and value within a 12-month period
    - Must be acquired in taxable transaction
      - Stock purchases by affiliated group members count

Election Under §338
(slide 2 of 4)

- Tax Consequences
  - Parent corp has basis in subsidiary's assets = basis in subsidiary's stock
    - Subsidiary may, but need not, be liquidated

Election Under §338
(slide 3 of 4)

- Tax Consequences (cont'd)
  – Subsidiary is deemed to have sold its assets for an amount determined with reference to parent's basis in subsidiary's stock, adjusted for liabilities of subsidiary

Election Under §338
(slide 4 of 4)

- Tax Consequences (cont'd)
  - Gain or loss is recognized by subsidiary
  - Subsidiary is treated as a new corporation that purchased all of its assets on the day after the acquisition date

Reorganizations-In General

- Refers to any corporate restructuring that may be tax-free under §368
  - To qualify, must meet certain general requirements:
    - Must be a plan of reorganization
    - Must meet continuity of interest and continuity of business enterprise tests
    - Must have a sound business purpose
    - Tax-free status can be denied under step transaction doctrine

Summary of Different Types Of Reorganizations

- The term reorganization includes:
  - Statutory merger and consolidation
  - Stock for stock exchange
  - Stock for assets exchange
  - Divisive exchange
  - Recapitalization
  - Change in identity, form, or place of organization
  - Transfers in bankruptcy or receivership

Tax Free Reorganization Consequences, in General (slide 1 of 3)

- Consequences to Acquiring Corporation
  - No gain or loss recognized unless it transfers property to the target corporation as part of the transaction
  - Basis of property received retains basis it had in hands of target corp plus any gain recognized by the target

Tax Free Reorganization Consequences, in General (slide 2 of 3)

- Consequences to Target Corporation
  - No gain or loss unless it retains "other property" received in exchange or it distributes its own property to shareholders

Tax Free Reorganization Consequences, in General (slide 3 of 3)

- Consequences to Target or Acquiring Co. Shareholders
  - No gain or loss unless shareholders receive cash or other property
  - Basis of shares received is same as basis of those surrendered, decreased by boot received, increased by gain and dividend income, if any, recognized in the transaction

Judicial Doctrines (slide 1 of 2)

- Besides meeting specific requirements of reorganization, several judicially created doctrines must be met
  - Reorganization must exhibit a sound business purpose
    - Not a well defined test
  - Continuity of interest test
    - IRS deems this test met if shareholders of Target receive stock in Acquirer equal to at least 50% of value of Target stock

Judicial Doctrines (slide 2 of 2)

- Continuity of business enterprise test
  - Requires the acquiring corp to either:
    - Continue the Target's historic business, or
    - Use a significant portion of Target's assets in business
- Step transaction doctrine
  - Ensures that a series of transactions are not used to obtain tax benefits that would be unavailable if the transaction were accomplished in a single step
  - IRS generally views any transactions occurring within one year of reorganization as part of the restructuring

Carryover Of Corporate Tax Attributes (slide 1 of 4)

- Assumption of liabilities
  - Acquiring corp either assumes liabilities of Target or takes property subject to liabilities
- Allowance of Carryovers
  - In Type A, C, acquisitive D, F, and G reorganizations, the Target's tax attributes are acquired
  - In Type B reorganizations, Target retains its assets and tax attributes

Carryover Of Corporate Tax Attributes (slide 2 of 4)

- NOL Carryovers
  - Amount of NOL that can be used in first tax year after ownership change is limited to a percentage representing the remaining days in the tax year over the total number of days in the year

Carryover Of Corporate Tax Attributes (slide 3 of 4)

- NOL Carryovers (cont'd)
  - NOL can be further limited in first and succeeding years if:
    - An owner shift occurs
      - Generally, a change in stock ownership of a 5 percent shareholder
    - An equity structure shift occurs
  - NOL can be used to the extent of the value of the loss corp's stock on the date of the ownership change multiplied by the long-term tax-exempt rate

Carryover Of Corporate Tax Attributes (slide 4 of 4)

- Earnings and Profits
  - Positive E & P of acquired corp carries over
  - E & P of a deficit corp are deemed received by acquiring corp as of change date
    - Deficit may only be used to offset E & P accumulated by acquiring corp after the date of transfer

Comparison of Reorganization Types (slide 1 of 5)

Type	Advantages	Disadvantages
A. Merger/ Consolidation	Consideration need not be voting stock Up to 50% of consideration can be in cash	State law may give dissenters rights or require s/holder mtgs. All liabilities of Target are assumed by Acquirer

Comparison of Reorganization Types (slide 2 of 5)

Type	Advantages	Disadvantages
B. Stock-for-Stock	Stock can be acq'd from shareholders	Only voting stock of Acquirer can be used
	Procedures are not complex	Must have 80% control of Target -May have minority after reorg.

Comparison of Reorganization Types (slide 3 of 5)

Type	Advantages	Disadvantages
C. Stock-for-Assets	Less complex as to state law than "A"	"Substantially all" assets of Target must be transferred
	Cash or property are OK consideration if 20% or less of FMV of property transferred	Liabilities count as "other property" for 20% test if any other consideration used. Target must distribute assets rec'd to s/holders

Comparison of Reorganization Types (slide 4 of 5)

Type	Advantages
D. Division (generally)	Permits corporate division without tax consequences if no boot is involved
E. Recapitalization	Allows for major change in makeup of shareholders' equity without gain recognition requirement

Comparison of Reorganization Types (slide 5 of 5)

Type	Advantages
F. Change in form, identity, or place of organization	Survivor is treated as same entity as predecessor; tax attributes of predecessor can be carried back or forward
G. Court approved reorganization	Creditors can exchange notes for stock tax-free and state merger laws need not be followed

If you have any comments or suggestions concerning this PowerPoint Presentation for West's Federal Taxation, please contact:

Dr. Donald R. Trippeer, CPA

donald.trippeer@colostate-pueblo.edu

Colorado State University-Pueblo