Practical Issues in Shutting Down a Closely Held Business
Outline

Eric L. Green
Convicer & Percy, LLP
41 Hebron Avenue
Glastonbury, CT 06033
Ph: (860) 657-9040
Fax: (860) 657-9039
egreen@convicerpercy.com
www.convicerpercy.com

Marcia Pereira
Marcia Pereira, Esq., PLLC
8300 NW 53rd Street, Ste. 350
Doral, FL 33166
Ph: (305) 742-2126
Fax: (786) 269-2277
marciapereira@pereiralawoffice.com
www.pereiralawoffice.com
I. Non-Tax Issues

1. Dissolution: In deciding to dissolve a business, there are a number of legal steps required to be taken in almost every jurisdiction, even if the particular details differ slightly:

   a. Resolution – there is usually a requirement that a majority of the board of directors (for a corporation), the members (for a limited liability company) or partners (for a partnership) vote to decide cease operations, wind-up the company’s business and dissolve the entity. For corporations, the Board of Directors will usually be required to vote and then recommend to the shareholders that the company be dissolved.\(^2\)

   When dealing with a limited liability company (“LLC”), the first step is generally to review the articles of organization that were filed when the entity was formed, in addition to any amendments filed thereafter, as well as the current operating agreement of the company. The steps stated in the entity documents should be followed. If the documents do not specify the manner in which the LLC is to be dissolved, then practitioners should review the state statute. In Connecticut, for example, the state statute\(^3\) specifies that, unless the entity’s legal documents specify otherwise, that the entity’s affairs shall be wound up upon the affirmative vote of a majority in interest of the members.

   b. Wind-up period – The period between the decision to cease operations and the mechanical dissolution of the company is referred to as the “wind-up” period, and it is during this time that the companies affairs are resolved: property is transferred, bills are paid, notice is given to clients and creditors, etc.

   c. Notice to Creditors – Many state laws require a final notice be made to known creditors and a notice be published so that unknown creditors may see the notice and take action prior to the assets being distributed to the shareholders. In addition, many states (such as Connecticut) require clearance be obtained from the state department of revenue that all taxes have been paid prior to the assets of the company are distributed.\(^4\)

   d. Filing Dissolution paperwork – Paperwork should be filed with the Secretary of the State or other executive agency that oversees the administration of legal

\(^1\) For purposes of this outline, the state law issues have been discussed in general terms and references are made to the Connecticut General Statutes, as the author practices in Connecticut. Practitioners should be sure to check their local state laws when determining the steps necessary to close a business in their particular jurisdiction.

\(^2\) Connecticut General Statute (CGS) § 33-881.

\(^3\) CGS § 34-206.

\(^4\) CGS § 33-885 – requires no final liquidating dissolution of assets be made to shareholders until the corporation has obtained a current statement that all taxes due have been paid from the Connecticut Department of Revenue Services and the Connecticut Administrator of Unemployment Compensation.
entities in your jurisdiction. Many states have pre-printed forms, others may require you to draft the dissolution documents. Corporations and limited liability companies doing business on other states (“Foreign Entities”) should be sure to file the proper documentation to withdraw from those jurisdictions that it previously had received permission to operate in.

2. **Contractual and Insurance Issues**: When a business decides to close it generally is not done in a vacuum: there are a number of moving parts to the entity that will need to be addressed, including lease and rental agreements as well as employment contracts. Insurance contracts on the business, its assets and its personnel will also (hopefully) be in place. Each of these will need to be reviewed and, unless ending under its own terms, will need to have its termination negotiated to avoid litigation. In addition, it is important that the insurance be kept in place during the windup period so there is no exposure to those officers, owners and employees involved in winding up the operations of the business.

3. **Retirement Plans**: The retirement plans will need to be transferred either to the employees or to a third party administrator depending upon the type of retirement plan the company had.

There are two basic forms of plans: defined contribution plans (401(k), 403(b), Simples, etc) and defined benefit plans (a traditional employer funded pension). If a company is shut down, the defined contribution plan accounts are generally rolled over to the employees as an IRA and the plan ceases to exist.

For defined benefit plans, the plan must vest the employee’s accrued benefit 100 percent. This means that the plan owes the employees all the pension benefits that have been have earned so far, even benefits the employees would have lost had they had voluntarily left the company’s employment. ERISA does not require that pension benefits be paid out before normal retirement age, usually age 65. The employer generally transfers the pension funds to a third party administrator and may have to add funds to cover the benefits for the employees, effectively purchasing an annuity for those participants covered by the pension. Traditional defined benefit plans are protected by the Pension Benefit Guaranty Corporation (PBGC), a Federal Government corporation. If a plan is terminated because an employer has financial difficulty and cannot fund the plan, and the plan does not have enough money to pay the promised benefits, the PBGC will assume responsibility for the plan. The PBGC pays benefits after termination up to a certain maximum guaranteed amount. Defined contribution plans, such as 401(k) plans, are not insured by the PBGC.

4. **Plant Closing Laws and Unemployment Issues**:

a. **Plant closing laws** – If the business has more than 100 employees, the federal Worker Adjustment and Retraining Notification Act (WARN) (29 USC §2101 et seq.) requires warning be given to the employees at least 60 days in advance of a business closing.
The WARN Act is a federal law requiring employers of 100 or more full-time workers to give 60-days advance notice of a plant closing or mass layoff.

Employers with 100 or more full-time workers are affected if they:
- close a facility or discontinue an operating unit with 50 or more workers; or
- lay off 50-499 workers (and these workers comprise at least 33% of the total workforce at a single site of employment); or
- lay off 500 or more workers at a single site of employment.

The law requires that this notification be given to the appropriate local chief elected official, the Dislocated Worker Unit of the State Department of Labor, and the collective bargaining representative of affected employees or each employee if the employees do not have representation.

b. *Unemployment Issues* – For business that have employees, notice is almost always required to the jurisdiction’s administrator of unemployment. In general, notice is required to be done in writing and delivered to the administrator of the state unemployment department notifying them of the closing of the business.

II. Tax Issues

1. General Aspects of Liquidation

   **S-Corporation**

   Shareholders will generally recognize gain or loss upon liquidating distribution of property. IRC 336(a) (as applicable through 1371(a)) requires shareholders to recognize gain or loss on distribution of property resulting from the liquidation as if the property were sold at its FMV.

   As a pass-through entity, no taxes will be imposed at the corporate level unless the S Corporation holds built-gains or passive investment income tax.\(^5\) If so, any gain or loss from these items of income must be recognized at the corporate level.

   **Exceptions to Recognition of Gain or Losses:**

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\(^5\) See 26 U.S.C. §§ 1374-1375. These are anti-abuse provisions included in the code to preclude a C-Corporation from sheltering income by making an S-election to avoid double-tax. Thus, these items of income will “carryover” from a C-Corporation when the latter adopts the S “status”. If all of the S-Corporation’s gains are built-in gains, the tax consequences are generally the same as if the corporation was liquidated as a C-Corporation because the entire gain will be subject to the regular corporate income tax treatment. For planning purposes, practitioners should also remember that the net built-in gain rule only applies if liquidation distribution occurs within the 10-year recognition period. 26 U.S.C. § 1374. Moreover, an S corporation may be subject to a tax on passive investment income for any year such income exceeds 25% of corporation’s gross receipts, and accumulated earnings and profits at the close of the year (from prior C corporation years). 26 U.S.C. § 1375. Both built-in gain and passive net income are taxed at the highest corporate tax rate.
Gain on Installment Notes: Gain recognition not required on the distribution of installment notes that acquired pursuant to a plan of liquidation and obtained during the 12-month period beginning on the date of plan is adopted and the plan is completed within such period.\(^6\)

Practice Point: Shareholders may use installment notes to report some or all of their gain on the liquidation under the installment method.

Anti-Abuse Provisions:
Losses will not be recognized if at least one the following scenarios apply:

Non-prorata distribution to a related person (defined under to IRC 267). The Related Person Rule applies to shareholders with more than 50\% of stock ownership.

Distribution of “disqualified property” to a related person
Disqualified Property is defined as any property acquired by the liquidating corporation from a shareholder in a 351 tax free exchange or Property acquired as a capital contribution during the 5-year period ending on the date of the distribution. Such losses are disallowed even if the shareholders take pro-rata distribution of the asset.

Basis Reduction (limitation on losses)
The basis of any property acquired by corporation in a tax free exchange or as capital distribution if property was transferred pursuant to a tax avoidance plan will be reduced by the excess of property’s adjusted basis over its fair market value immediately after property was acquired by the corporation.

The Internal Revenue Code provides for a presumption of tax avoidance for any property acquired by liquidating corporation within 2-year period ending on the date of the adoption of the plan of complete liquidation. Thus, general such properties may be presumed to have been transferred pursuant to a tax avoidance plan.

Practice Point I: in 1998, Congress has instructed the IRS to disregard such presumption unless transfer of asset has no connection to the conduct of the business (no business purpose for the asset transfer).\(^7\)

The basis reduction rule also taints any property to which adjusted basis is determined in whole or in part by reference to the adjusted basis of such property.

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\(^6\) This exception will not be available if the notes were acquired in exchange of corporate items (Built-in gains or passive net income items). See IRC 453(h).

\(^7\) Senate Report to the Technical and Miscellaneous Revenue Act of 1988 (TAMRA).
Practice Point II: when dealing with disqualified property, selling rather than distributing the asset may be preferable. An asset distribution will be governed by IRC 336(d) and result in complete forfeiture of losses whereas a sale of the same asset under IRC 267(d) will also disallow the losses, but preserve them for the transferee/buyer. The transferee will then be able to offset “future gain” against such losses.

C Corporations:
Two Separate Levels of Tax: A C corporation may be required to recognize gain or loss when it sells or distributes assets to the shareholders in full liquidation. The double tax nature of a C corporation also requires the shareholder to recognize gain or loss upon receipt of liquidating distributions. The recognition of losses will be limited in the case of non-prorata distribution to a related person or distributions of “disqualified property.” In addition, recognition of built-in losses on a sale, exchange, or distribution of property acquired by a corporation in a contribution of capital by substantially all the shareholders will be capped if made as part of plan with the principal purpose of tax avoidance.

Liquidation of Subsidiaries: a parent corporation will generally not recognize gain or loss when it receives property in complete liquidation of a subsidiary. The liquidating subsidiary will also not recognize any gain or loss when it distributes property to the parent. The liquidating subsidiary does, however, recognize gain (but not loss) when it distributes property to any minority shareholders. Parent and subsidiary are not required to have been filing consolidated returns in order to benefit from the nonrecognition provision.

A Practice/Planning Note on Liquidation of Subsidiaries. When liquidating a subsidiary, practitioners should have a good understanding of the nuances

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8 26 U.S.C. 336
9 Practitioners may consider an S-election prior to liquidation of a C corporation that qualifies for the election as a planning tool to receive pass-through entity treatment rather than be subject to double –tax.
10 Related person is defined under 26 U.S.C. § 267(c). Generally, property acquired by a C corporation in a contribution to capital by substantially all of its shareholders within 5 years prior its distribution will be considered disqualified property. However, 26 U.S.C. 351 would allow a tax free contribution of property by shareholders to the corporation so long the former keep 80% control of the corporation immediately after the transfer of property. Distribution of disqualified property to a related person will have limited losses regardless of whether distributions were pro-rata.
11 This limitation has also been part of our discussions on the limitation of loss recognition for S-Corporations. See 26 U.S.C. 336(d)(2).
12 26 U.S.C. 332 provides that the nonrecognition parent-subsidiary liquidation rule applies to a distribution if the following is true:
   (1) on the date on which the plan of liquidation is adopted and at all times thereafter until the receipt of the property, the parent corporation owns enough stock of the liquidating subsidiary to qualify as an “80% distributee”; and
   (2) either—
      (a) the distribution is in complete cancellation or redemption of all of the subsidiary's stock, and the transfer occurs within the taxable year; or
      (b) the distribution is one in a series of distributions in complete cancellation or redemption of all of the subsidiary's stock in accordance with the plan of liquidation under which the transfer of all of the property is to be complete within three years from the close of the taxable year in which the first liquidating distribution is made.
inherent in the liquidation provisions. For example, if some or all part of the assets of the liquidating subsidiary are sold, the subsidiary has to recognize the gain or loss realized in such sale. However, the same subsidiary will NOT be required to recognize gain or loss in its final return if it distributes its unsold assets to the parent together with the proceeds of sale, in complete liquidation. By the same token, the parent corporation would also be entitled to nonrecognition on receipt of the liquidating distributions up and until the parent makes liquidating distributions to its shareholders. Although a corporation must generally recognize gain (and sometimes loss) when it makes liquidating distributions to its shareholders, there is an exception for distributions made by a subsidiary to its parent corporation. These provisions apply regardless of whether Smith Co. and Smith Subsidiary file consolidated returns.

**Liquidation status generally.** Once a corporation has entered into liquidation status, it must maintain such status until complete liquidation. A liquidation status is triggered when the corporation is no longer a going concern and its activities are merely for purposes winding down. A complete liquidation is achieved when the corporation is divested of all its properties. Also, the IRS will generally not recognize a complete liquidation if it takes more than three years to be concluded.

**Trap for the unwary:** No formal requirement to have a plan in order to liquidate a C-Corp. However if there is no liquidation plan in place, the IRS will determine whether (1) there is a manifest intent to liquidate; (1) if a continuing purpose to liquidate the corporation; and (3) the corporation’s activities were directed and confined to such purpose.

**Practice Point:** Have a liquidation plan! Don’t wait for the IRS to determine whether, the above three-prong test is satisfied under the facts or circumstances of your particular case.

**Partnership/LLCs**

It is probably common knowledge amongst practitioners that state laws of dissolution do not control the termination of the partnership for federal income tax purposes. A partnership may be terminated if (1) there has been a complete cessation of the partnership’s activities; (2) if the partnership simply ceases to

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13 See Treas. Reg. 1.332-2(c).

14 A complete liquidation may occur even if the company is not legally dissolved. For example, if a corporation wants to preserve its corporate name, it may retain a nominal amount of assets just sufficient to keep its legal existence and still be deemed liquidated for federal income tax purposes. Caveat: if the corporation engages in any activity business, it will not be considered liquidated. See PLR 9723044 and Thornton v. Comr., 159 F.2d 578 (7th Cir. 1947).

15 Typically, if the corporation holds a formal liquidation resolution, a plan of liquidation is deemed to have been adopted on the date the shareholders approve the authorizing resolution. See Kennemer v. Comr., 96 F.2d 177 (5th Cir. 1938).
operate in partnership form (e.g., the business is no longer carried by two or more partners); or (3) if 50% or more of the interests in the partnership are sold within a 12-month period.\textsuperscript{17} Thus, the termination rules in Section 708 apply without regard as to whether the partners may have actually agreed to dissolve the business entity.

2. Filing final tax returns

\textbf{S-Corporation}

A liquidating S-Corporation’s taxable year ends on the date it ceases to exist (IRC 1366(a)). The S-election does not automatically terminate with the complete liquidation. The S-Corporation must file a final return ending on the date of liquidation. Also, the end of the taxable year affects the timing of recognition of gain or loss at the shareholder level.

\textbf{C Corporation}

In addition to the filing of its final tax return, a C corporation is generally required to file the following documents with the IRS:

- Form 966 (Corporate Dissolution or Liquidation) must be filed with the IRS within 30 days the Corporation has adopted a plan of complete liquidation. A copy of the plan must be attached for this form. If the plan is altered, amended or supplemented, the corporation must file an amended form 966 within 30 days from the date of the alterations, amendments or additions. Failure to file this form does not render the complete liquidation invalid. However, filing the form is not only good practice, but also avoid certain criminal penalties for the willful failure to supply information required by the regulations.\textsuperscript{18}

- Forms 1099-DIV must be filed for each shareholder who receives liquidating distributions in the amount of $600 or more in a calendar year. Copies of the 1099-DIV must be submitted to the shareholders on or before January 31 of the year following the calendar year in which the distribution was made. Forms 1099-DIV must be filed along with form 1096 (transmittal form) and submitted to the IRS on or before February 28 of the year following the distribution, if filed by mail or March 31 if filed electronically.\textsuperscript{19}

\textsuperscript{17} 26 U.S.C. § 708.
\textsuperscript{18} Section 26 U.S.C. 6043(a)(1) provides for the filing of form 966. Section 26 U.S.C. 7203 and Rev. Rul. 65-80 address the potential criminal penalties associated with the failure to file.
\textsuperscript{19} Form 1099-DIV does not have to be filed in the case of a non-taxable subsidiary liquidation. As addressed before, no gain or loss will be recognized if the parent-subsidiary liquidation rule applies. For those who are required to file forms 1099-DIV, an automatic 30 day extension may be sought by filing form 8809. Should an additional 30-day extension be necessary, a signed request must be submitted prior to the expiration of the initial 30-day automatic extension with a detailed explanation as to why the additional extension is been sought. 26 C.F.R. § 1.6081-8
**Practice Point:** It is not uncommon for a C Corporation to seek expeditious finality in dissolution without the risk of post-dissolution assessment of federal income tax. In such case, the corporation may request a prompt assessment of tax liability by shortening the 3-year statute of limitations to 18 months from the date the request is filed. A corporation will not be entitled to prompt assessment of tax if: (1) there is an omission of more than 25% of gross income in the return; (2) a fraudulent return has been filed; or (3) the corporation is a personal holding company that has failed to file required schedules with the IRS. \(^{20}\) **The request must be filed in an envelope separate from the return at any time after the return is filed.\(^{21}\)**

**Shareholders** in a liquidated C corporation must prepare a statement disclosing property received in liquidating distribution and attach it to their tax returns if the liquidating distribution is not made pursuant to a corporate resolution where the distribution is expressly identified as made in complete liquidation and the corporation is not in fact completely liquidated and dissolved within one year after the distribution. \(^{22}\)

**Partnership**

Akin to other types of business entities, the partnership final tax year terminates at the time the liquidation is concluded at which point the partnership is required to file a final tax return to give the IRS notice that the partnership has been completely liquidated.

3. **Tax Liabilities**

a. **Employment Tax Liabilities** – When a company is being closed it is often due to financial difficulties. One of the first taxes to go unpaid is often the employment tax because it is the easiest loan to obtain. Given the multiple penalties and interest charged for failing to account and pay over the federal payroll taxes, it is also the most expensive loan business owners can take.

There are two issues that arise regarding paying the federal employment taxes the company owes: the ability of the company to pay and the issue of which owner and/or employee’s may be personally responsible for the “trust fund” portion of the employment taxes.

What are “Trust Fund” taxes? Employment taxes are made up of income taxes withheld from an employees pay, 6.2% of gross wages withheld from an

\(^{20}\) See 26 U.S.C. 6501(d).

\(^{21}\) A formal letter may satisfy the filing requirement for prompt assessment request as Treas. Reg. 301.6501(d)-1 does not seem to require a particular form needs to be filed other than stating that a “written request” has to be filed. However, the request must include the “classes of tax and the taxable periods for which the prompt assessment is requested, and must clearly indicate that it is a request for prompt assessment classes of tax and taxable periods”. 26 CFR § 301.6501(d)-1(b) [Emphasis added].

\(^{22}\) See 26 C.F.R. § 1.331-1(d).
employees pay for Social Security and 1.45% of gross wages withheld for Medicare taxes. The social security and Medicare taxes are collected as part of the Federal Insurance Contributions Act (“FICA”), and are referred to as FICA taxes. The company is then expected to match the FICA withholdings. The taxes withheld from the employees pay (income taxes and the portion of the FICA taxes withheld) are referred to as “Trust Funds” because the employer is holding these taxes in trust for the federal government. The employer’s match of the FICA taxes is not considered trust funds.

IRC § 6672 - The Trust Fund Recovery Penalty. To protect the trust funds being held by employer’s across the country Congress enacted Internal Revenue Code § 6672 which allows the IRS to pursue the collection of the trust funds taxes that are not paid over by employers from owners and employees of the company that were responsible for the companies' failure to collect, account for and pay over the trust fund portion of the employment taxes. This is accomplished through a penalty under IRC § 6672 which is equal to 100% of the trust fund taxes.

Closing the company to reduce the employment tax liability to just the trust fund portion. One clear strategy is that by closing down a corporation or multi-member limited liability company that the employment tax liability will be reduced for the responsible owners/employees to just the trust fund portion of the employment taxes. For single member limited liability companies (“SMLLC”), it will depend upon when the employment tax liability arose. For periods before January 1, 2009 members of a SMLLC will be deemed responsible for the entire amount of the employment tax liability. After January 1, 2009, based on the final regulations promulgated by the IRS, the member of a SMLLC will be personally responsible for only the trust fund portion of the employment taxes.\textsuperscript{23}

Designating Voluntary Payments. Voluntary payments may, according to Internal Revenue Code Section 7122(c)(2)(A), be designated toward the trust fund portion of a debt. See Revenue Procedure 2002-26. If the owners of a failing business are considering infusing cash to try and pay the employment tax liability, it would be wise for them to send the money to the IRS and designate the payment as a voluntary payment against the trust fund taxes. Otherwise the IRS will apply the funds in whatever way is in its own best interest: to the non-trust fund portion of the liability first.

Which party do we represent? Another issue that arises frequently when dealing multiple owners, an entity and the IRC § 6672 trust fund recovery penalty is which party do we represent? As a practice matter practitioners should always make sure their engagement letters specify which party they are representing: the company, a particular owner, etc. However in practice these issues generally start out with just the company and then run-over into the

\textsuperscript{23} Reg. § 301.7701-1(c)(2)(iv)(B)
owners, who end up in conflicting positions and potentially blaming each other once they realize that personal liability may follow. Practitioners can find themselves caught in a potential conflict of interest situation and may need to remove themselves from any further representation, or worse, may be blamed by one or more of the parties for failing to properly represent them due to such conflict of interest. The moment employment taxes are raised as an issue practitioners should be sure to confirm which party they represent (ie. the company) and recommend in writing to the other parties (the owners) that they seek independent counsel.

b. **IRS Tax Liens** – If taxes are owed when a business is being closed, consideration should be given to deal with the lien, which automatically attaches to the assets of the company regardless of whether a Notice of Federal Tax Lien is actually filed.

IRC § 6321 creates a lien automatically whenever a tax is due, demand for payment has been made and the taxpayer has failed to pay such tax. In addition, the IRS is authorized to file a Notice of Federal Tax Lien (“NFTL”) in favor the United States to protect the Government’s interest in the taxpayer’s property against third parties. The impact of the lien, whether a NFTL has been filed or not, is that the assets of the business being shut down are subject to the tax lien. In practice, taxpayer’s frequently wish to shut down their company and take the used equipment and assets and start a new company. Unfortunately the IRS lien prevents this, and needs to be dealt with. One strategy is to clear the title by having the taxpayer purchase the assets from the IRS. Mechanically, the practitioner files a Form 433-B along with any supporting documentation and appraisals of the company assets and offers to pay 80% of the fair-market-value of the company assets (referred to as “quick-sale value”). Upon reaching an agreement with the IRS, the taxpayers pay the IRS with a certified check and the IRS, upon receipt, will discharge its lien to the assets purchased, giving the taxpayer clear title to the assets.

4. Shareholder/Partner Basis Issues

**Shareholder’s basis in S-Corporation**

**Corporate Items**: Shareholder’s basis in the stock must first be adjusted to reflect corporate items of income, losses, and distributions made prior the S-election.

**Pass-through items**: Shareholder’s basis must also be adjusted to reflect gains or losses derived from the sale or distribution of assets pursuant to the liquidation plan.
Disallowed Losses in IRC 336(d): Shareholder’s basis upon liquidating distribution of disqualified property is the FMV of such property at the time of such distribution. 24

Practice Point: When drafting a plan of liquidation always keep in mind that losses are limited to shareholder’s basis. Losses in excess of shareholder’s basis will not be recognized. Since a complete liquidation will cause any shareholder’s suspended losses to extinguished, the timing of the liquidation becomes a major issue in liquidation planning.

Timing of Shareholder’s Recognition

Liquidating Distributions: Generally, the shareholder must recognize gain or loss realized in connection with liquidating distributions in the taxable year they are received.

Corporate Items: Shareholder must recognize the pro-rata share of corporate items in taxable year the S corporation liquidates. Shareholder may have a “bunching of income” in his/her return if the corporation adopted a fiscal year.

Practice Point I: bunching of income to the shareholder may be avoided by careful planning. For example, if shareholder is compelled to recognize income in Year 1 because the fiscal year corporation liquidates in the same year, a better planning would liquidate the corporation in Year 2 to permit the shareholder to defer recognition of corporate items to Year 2 rather than in Year 1.

Practice Point II: deferral of recognition may also be possible if liquidating distributions occur during more than one taxable year with the caveat that the IRS will require a business purpose for delaying/spreading liquidating distributions over the years. However, allowed losses cannot be recognized until all the liquidating distributions are completed.

Shareholder’s Basis in C-Corporations
Shareholder's basis in property received in a liquidating distribution is the fair market value of the property on the date of distribution and no reduction to basis is allowed with respect to any liabilities the shareholder assumes or subject to which he takes the property. A shareholder's holding period in distributed property begins on the date after distribution. Moreover, shareholder’s basis in C corporation stock generally equals to the stock purchase price adjusted by subsequent transactions. 25

24 See page 5 of this Outline discussing shareholder’s basis reduction.
25 For example, capital contributions, corporate distributions in excess of earnings and profits, and adjustments required by the consolidated return rules are examples of transactions that would require shareholder’s basis to be adjusted.
Unless property distributed was transferred to the business in a tax-free exchange,\textsuperscript{26} when a parent liquidates its subsidiaries, the parent will generally take the carryover basis in the assets distributed by the subsidiaries. E&P and any other existing tax attribute also carryover to the parent.\textsuperscript{27}

\textit{Practice Point}: the Internal Revenue Code provides for certain special treatment provisions applicable to small business. Although they are very particular, practitioners should always make sure to verify their applicability to any liquidating corporation advice is being given or liquidation plan is being drafted:

\begin{itemize}
  \item Section 1202 allows the \textbf{noncorporate} taxpayer (i.e., the shareholders) the exclusion of 50\% of the gain realized from the sale of “qualified small business stock”\textsuperscript{28} provided that such stock is held for more than five years. As part of the stimulus plan, Congress has passed law that allows for 75\% gain exclusion of \textbf{75\% of the gain} for stocks acquired after February 17, 2009 and before January 1, 2011\textsuperscript{29}. However, the amount of gain eligible for this exclusion cannot exceed the greater of $10 million or ten times the noncorporate taxpayer’s basis in the stock. While this provision does not specifically address liquidation, it should be given consideration when the liquidation plan is drafted.

  \item Section 1244 attempts to provide for a fix for the tax treatment disparity between incorporated and unincorporated businesses with respect to the deduction of losses. Because an unincorporated business may currently deduct operating losses against ordinary income (or carry it over to following years) and, if compared to shareholders of corporation who are not entitled to currently deduct such losses as those remain at the corporate level and ordinarily treated as capital losses,\textsuperscript{30} Section 1244 was enacted to allow these losses to be otherwise treated as ordinary losses. However, there is an annual limitation to the application of section 1244. The maximum amount a taxpayer may claim as ordinary loss for all losses sustained on §1244 stock in a taxable year is $50,000 generally, and
\end{itemize}

\textsuperscript{26} In such case the fair market value rule applies generally resulting in a step-up in basis to the subsidiary transferee. A good example would be a § 351 tax free exchange as well as the notion of mere change of form implicated in the basis provisions of sections 357, 358, 362, 1032 among others.

\textsuperscript{27} See 26 U.S.C. § 334(b).

\textsuperscript{28} Qualified small business stock is defined in Section 1202 as any stock in a C corporation which is originally issued after the date of the enactment of the Revenue Reconciliation Act of 1993, if (1) as of the date of issuance, such corporation is a qualified small business, and (2) such stock is generally acquired by the taxpayer at its original issue (directly or through an underwriter)in exchange for money or other property (not including stock), or (3) as compensation for services provided to such corporation (other than services performed as an underwriter of such stock). 26 U.S.C. § 1202(c).


\textsuperscript{30} At this point, the reader should be inquiring why this section is relevant here if shareholder may recognize losses upon liquidating distribution of a corporation. One should remember that in a liquidating distribution, these losses will be treated as capital losses whereas section 1244 allows deduction of the same losses against ordinary income. Actually, only capital losses qualify for the special treatment under this section.
$100,000 where a joint income tax return is filed, regardless of whether the losses are sustained by one or both spouses.

✓ One a quick digression, in the case of liquidating corporation holding patents, it is important to determine the character of proceeds derived from the sale or distribution associated with them. They may be treated either as capital gain or ordinary income depending on the interest retained in the patent.

Partner’s Basis Issues:
The tax consequences to the partners arising from the termination of a partnership largely depend on how the termination occurs. For example, if the partnership termination arises due to the cessation of its business activities, the partnership’s assets are treated as fully distributed to the partners as of the date of termination in the form of liquidating distributions.

Under the mere change in form approach of Subchapter K, no gain or loss is generally recognized upon distributions made to the partners. However, in winding down a partnership, the partners will take their share of gain or losses deriving from the liquidation. In computing a partner’s basis in the partnership, several adjustments may have to be made to partner’s capital account upon receiving liquidating distributions. Due to the inherent complexity of this subchapter, the practitioner should carefully consider the aspects of liquidating distributions of hot assets; application assets valuation rules; whether 754 elections for basis adjustments have been made; liquidating distributions made in connection with real estate property; among other relevant topics. Moreover, unless an election for installment method treatment is made, the recognition of losses may only be allowed after the last liquidating distribution. Lastly, as liquidating distributions must be made in pro-rata basis in accordance with partners’ interest in the partnership as determined in the partnership agreement. Any intended special allocations should be given careful consideration to ensure compliance with the applicable rules.

Practice Point: in planning the termination of a partnership, practitioner should investigate whether the partners hold suspended losses from prior loss years in that suspended losses are generally extinguished when the partnership terminates.

5. Shareholder/Partner Loans

S-Corporation
Shareholder as a creditor: Gain or loss may accrue if a corporation transfers appreciated or depreciated property to shareholders in satisfaction of a debt. As a consequence, shareholders may have gain if the fair market value of property

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33 26 C.F.R. 1.704-1(b) delineating the substantial economic effect requirements for special allocations.
transferred is higher than shareholder’s basis in the debt. Limitation of losses may also apply if the shareholder is deemed to be a related person. The shareholder is treated as a creditor and as such will have the debt satisfied prior to receiving any liquidating distribution.

**Shareholder’s Assumption of Liability:** If shareholder receives assets subject to liability, such liability cannot exceed the asset’s FMV.

**C-Corporation**

When shareholders lend money to a corporation and such loans are outstanding at the time of liquidation, the tax treatment of such loans lies on the financial status of the corporation. A Shareholder may not have to recognize any gain or loss if corporation is solvent at the time of liquidation. However, if the corporation is insolvent and only pays part of shareholder’s loan, shareholder may recognize a loss. Such loss will typically be treated as capital losses. When a loan is made in shareholder’s capacity, the losses will be treated as nonbusiness debt.

**Partners as creditors**

Partners may routinely lend money to the partnership in which they hold an interest. If the loan becomes uncollectible and it is not a deemed capital contribution, the creditor-partner may deduct the unpaid amount as bad debt. However, a partner may not be entitled to bad debt deduction if he lacks a separate business purpose for making the loan, or he is in the business of making loans. In addition, if a partner forgives part of the debt owed to him or her of the winding partnership, cancellation of indebtedness (COD) income may arise. The potential consequences of COD income are briefly discussed below.

**6. Cancellation of Indebtedness Income**

Upon liquidation, business entities may have part (or all) of its debts forgiven by creditors. If that happens, the business entity will most likely have Cancellation of Indebtedness Income (COI). Thus, business taxpayers may frequently be caught off guard when they receive 1099s they were not expecting. However, the mere fact that 1099s were received in connection with COI income does not mean that the taxpayer will accrue additional tax liability. COI income may not be included from taxpayer’s income if incurred in connection with bankruptcy, insolvency, qualified farm indebtedness or qualified real property indebtedness as provided under 26 U.S.C.§108. Thus, practitioners should become familiarized with the requirements and intricacies of this exclusionary rule.

In the case of C or S Corporations, COI income is determined at the corporate level. In such cases, no adjustments need to be made to shareholder’s basis in stock if COI income is excluded under one of the exceptions provided by IRC 108 and dealt with then. On the flipside, partnerships or LLCs have COI income taken at the partner/member’s level. Thus, any COI income must be recognized by the partner in accordance with the computation of the capital accounts unless
the partner himself qualifies for an exclusion under § 108. COI is typically characterized as ordinary income.

**Small Business Deferral of Cancellation of Indebtedness Income**

Section 108(i) was added to the Internal Revenue Code by virtue of the 1231 of the American Recovery and Reinvestment Tax Act of 2009, enacted on February 17, 2009. Section 108(i) provides an election for deferral of the inclusion of COD income deriving from the reacquisition after December 31, 2008, and before January 1, 2011, of an “applicable” debt instrument.\(^\text{34}\) If a taxpayer makes the election, the deferred COD income generally is includible in gross income ratably over a 5-taxable-year period, beginning with the taxpayer's fourth or fifth taxable year following the taxable year of the reacquisition (inclusion period). If, as part of a reacquisition to which section 108(i)(1) applies, a debt instrument is issued (or is treated as issued) for the applicable debt instrument and there is any OID with respect to the newly issued debt instrument, then the deduction for all or a portion of the OID may be deferred (deferred OID deductions) under section 108(i)(2).

\(^{34}\) A “applicable debt instrument” is defined as any debt instrument which was issued by a C corporation, or any other person in connection with the conduct of a trade or business by such person. 26 U.S.C. 108(i)(3)(A).