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Neil E. Harl
Iowa State University, harl@iastate.edu

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CORPORATE LIQUIDATIONS: A MAJOR CONCERN

— by Neil E. Harl

Since repeal of the "General Utilities" doctrine in 1986, and expiration of the two-year rule for closely held corporations permitting prior law treatment for liquidating distributions completed before January 1, 1989, corporate liquidations have been subject to painful income tax consequences. For those wishing to separate warring factions but to continue the corporate form, a divisive "type D" corporate reorganization may be a superior alternative to a corporate liquidation.

The income tax consequences of corporate dissolution and liquidation differ depending upon the type of corporation involved.

Regularly taxed or C corporations

For regularly taxed corporations, taxed under Subchapter C of the Internal Revenue Code, in general gain or loss is recognized to a liquidating corporation as if the property were sold to the distributee at its fair market value. A pro rata part of each asset is considered sold to each shareholder.

The identity of the recipient is important in determining the type of gain or loss recognized. All gain on distribution of depreciable property to a related person is treated as ordinary income. A liquidating corporation does not recognize loss on distribution to a related person if the distribution is not pro rata or the distribution is "disqualified property." Disqualified property is any property acquired by the liquidating corporation during the five year period ending on the date of distribution if the property is acquired in a tax-free incorporation transaction or as a contribution to capital. Property whose basis is determined in whole or in part by reference to disqualified property received in a tax-free incorporation or as a contribution to capital is also disqualified property.

On a complete liquidation, a shareholder recognizes gain or loss to the extent of the difference between the value of the property received and the income tax basis of the stock given up. The amount of the distribution is the sum of the money received plus the fair market value of the other property received. Each shareholder is required to compute gain or loss on a per share basis where the stock was acquired at different dates and for different prices.

Thus, for C corporations, a complete liquidation normally triggers income tax consequences (usually a gain) at the corporate level and also income tax consequences (usually a gain) at the shareholder level. The two tax events often produce a substantial overall income tax liability.

Tax option or S corporations

Ordinarily, the complete liquidation of an S corporation does not trigger gain at the corporate level unless the built-in gains tax applies. The built-in gains tax is imposed on sales or exchanges of appreciated assets which are disposed of within 10 years after the corporation has become an S corporation. The tax imposed is the maximum corporate rate (now 35 percent) for the year in which the disposition occurs applied to the lesser of — (1) the net recognized built-in gains (the net of built-in gains and built-in losses) or (2) the amount of taxable income if the corporation were not an S corporation.

It is important to note that the corporate-level tax applies to all assets including inventory property; there is no de minimis rule applicable. IRS has indicated that the inventory method used by the taxpayer for tax purposes (LIFO or FIFO) will be used to identify whether property disposed of following conversion to S corporation status was held by the corporation at the time of the conversion. The tax only affects S corporations that had at some point operated as C corporations and applies to taxable years after 1986 "...in cases where the 1st taxable year for which the corporation is an S corporation is pursuant to an election made after December 31, 1986." For S corporation elections before 1987, the built-in gains tax does not apply. Apparently, the term "election made" refers to the date the Form 2553 is filed, not the effective date of the S corporation election.

Income tax is recognized at the shareholder level in the event of a complete S corporation liquidation, as with C corporations.

Other strategies

If the income tax cost of a complete liquidation is unacceptably high, the next best solution may be a divisive
corporate reorganization that splits off corporate assets (and shareholders) into a newly formed corporation. That procedure is discussed in the July, 1991, issue of Agricultural Law Digest.  

FOOTNOTES
7. I.R.C. § 1239(a).
10. Id.
12. I.R.C. § 1001(b).
17. I.R.C. § 1374(b)(1).
22. I.R.C. § 331(a). See ns. 11-13 supra and accompanying text.
24. N. Harl, "Divisive Corporate Reorganizations," 2 Agric. L. Dig. 121 (1991). Editor’s note: Reprints of the 1991 article may be ordered for $3.00 from Editor, Agricultural Law Press, P.O. Box 5444, Madison, WI 53705.

CASES, REGULATIONS AND STATUTES
by Robert P. Achenbach, Jr.

BANKRUPTCY
GENERAL

ESTATE PROPERTY-ALM § 13.03[3].* In 1990 and 1991, the debtor suffered crop losses from natural disasters and in December 1991, federal disaster payments for 1990 and 1991 crops were authorized by Congress. The debtor filed for Chapter 7 in January 1992 and received crop disaster benefits in April 1992. The debtor argued that the benefits were post-petition payments excluded from the bankruptcy estate. The court held that the disaster benefits were the proceeds of crops which would have been estate property but for the disasters; therefore, the disaster benefits were post-petition payments excluded from the bankruptcy estate. In re Ring, 160 B.R. 692 (M.D. Ga. 1993).

EXEMPTIONS-ALM § 13.03[3].*

HOMESTEAD. The debtors were allowed to include in their homestead a vacant lot across the street from their residence which was used for parking, a garden and storage. In re Flatt, 160 B.R. 497 (Bankr. N.D. N.Y. 1993).

IRA. The debtor was allowed an exemption for $9,000 in an IRA as reasonably necessary for the debtor’s support because the debtor was in school and had no other source of retirement funds. In re Baumgardner, 160 B.R. 572 (Bankr. S.D. Ohio 1993).

PERSONAL PROPERTY. The debtors claimed an exemption for the $77,000 cash value of a life insurance policy under Tex. Prop. Code § 42.002(a)(2) and $57,000 in personal property under Tex. Prop. Code § 42.001. The trustee argued and the court held that the cash value of the life insurance policy was allowed as an exemption but that exemption exhausted the debtors’ personal property exemptions which were limited to $60,000; therefore, no exemption was allowed for the other personal property. In re Bowes, 160 B.R. 290 (Bankr. N.D. Tex. 1993).

POST-PETITION PROPERTY. Within 180 days after filing a Chapter 7 petition, the debtor inherited property from a decedent. The debtor filed amended exemption schedules claiming a portion of the inherited property as exempt. The trustee argued that the debtor could only claim exemptions for property owned by the debtor on the date of the petition. The court held that the debtor could claim an exemption for property which became estate property after the filing of the petition. In re Magness, 160 B.R. 294 (Bankr. N.D. Tex. 1993).

FEDERAL TAXATION-ALM § 13.03[7].*

ADMINISTRATIVE EXPENSES. An involuntary petition was filed against the debtor in September 1988 and the debtor’s taxable year ended on December 31, 1988. The IRS filed an untimely claim for the 1988 taxes and sought administrative expense priority for the claim, arguing that because the taxes became due post-petition, the taxes were incurred by the bankruptcy estate. The court held that because all of the taxable income was received by the debtor pre-petition, the taxes were incurred by the debtor and not the estate. In re Pacific-Atlantic Trading Co., 160 B.R. 136 (N.D. Cal. 1993).

AVOIDABLE LIENS. The debtors sought to avoid pre-petition state and federal tax liens under Section 545(1)(D) as filed when the debtor was insolvent. The court held that the Section 545(1)(D) avoidance can occur only when a lien arose because of the debtor’s insolvency; therefore, Section 545(1)(D) did not apply in this case because the liens were filed independent of the debtor’s insolvency. In re Swafford, 160 B.R. 246 (Bankr. N.D. Ga. 1993).

CLAIMS. The Chapter 13 debtors had obtained confirmation of their plan in September 1991. The debtors filed a return for a prepetition tax year in 1992 and the IRS filed a claim in the case in 1993. The trustee moved to disallow the claim as untimely filed. The IRS argued that because the debtors’ plan provided for payment of all

* Agricultural Law Manual (ALM). For information about ordering the Manual, see the last page of this issue.