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The Trap in Liquidating an S Corporation That Was Formerly a C Corporation

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The dramatic shift in rules governing corporate liquidations in the Tax Reform Act of 1986, has led to the development of strategies to ease the draconian provisions that have governed corporate liquidations for the past two decades including shifting to S corporation status.

While such a shift in status may lead to a single tax (at the shareholder level) rather than the double tax characteristic of a C corporation, the liquidation of an S corporation after the transition from C corporation status may lead to tax consequences from the accumulated earnings and profits from the time the corporation was regularly taxed. That trap is especially likely to impact situations where a shift from C corporation status to S corporation status occurs and the strategy is pursued of waiting until the major shareholders die before the S corporation is liquidated.

Income tax treatment of C corporations on liquidation

In general, gain or loss is recognized to a liquidating C corporation on the distribution of property in complete liquidation as if the property were sold at its fair market value. The gain is taxed to the liquidating C corporation as ordinary income (even gain on capital assets and Section 1231 trade or business assets which is ordinarily entitled to capital gain treatment).

For many farm and ranch C corporations, the income tax liability at this first level of tax on liquidation is substantial, often totaling 30 to 35 percent of the gain involved.

On a complete liquidation, each shareholder recognizes gain or loss to the extent of the difference between the value of cash and property received and the income tax basis of the stock given up regardless of the form in which the distribution is received. Each shareholder’s gain or loss is the difference between the amount of the distribution and the income tax basis of the stock. If the stock had been held for more than one-year, the gain would be long-term capital gain.

The income tax basis of the property received in the liquidation is the fair market value at the date of the distribution.

Thus, the liquidation of a C corporation involves two levels of tax – (1) income tax (at ordinary income tax rates) at the corporate level on the gain or loss from a deemed sale of the assets and (2) capital gains treatment at the shareholder level on any gain or loss involved on the exchange of stock for the distribution in liquidation.

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Income tax treatment of S corporations on liquidation

On the liquidation of S corporations, no gain or loss is normally recognized at the corporate level unless the built-in gains tax applies. The built-in gains tax applies to sales or exchanges of appreciated assets which are disposed of within 10-years after the corporation became an S corporation. The tax imposed is the maximum corporate rate tax in which the disposition occurs applied to the lesser of – (1) the net recognized built-in gain (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.

Income tax is recognized at the shareholder level as with C corporations. For an S corporation without earnings and profits, distributions are first treated as a non-taxable return of basis on the stock with the remainder taxed as gain from the sale or exchange of property.

If an S corporation has earnings and profits, distributions are treated as follows –

- A non-taxable return of capital to the extent of the “accumulated adjustments account;”
- Dividends, to the extent of the S corporation’s accumulated earnings and profits;
- Non-taxable return of capital, to the extent of the shareholder’s remaining stock basis; and
- Gain from the sale or exchange of property for the remainder of the distribution.

The trap

Some corporations have shifted from C corporation status to S corporation status and waited for the major shareholders to die with a new income tax basis equal to the fair market value as of the date of death or the alternate valuation date. That assumed that no or very little income tax would be due if more than 10-years had elapsed since the corporation shifted from C to S corporation status and if the deaths of the shareholders would eliminate the gain at the shareholder level. However, the presence of earnings and profits in an S corporation that formerly operated as a C corporation results in a taxable distribution as a dividend even though the stock basis would otherwise have eliminated all gain. That limits the benefits of a not uncommon strategy.

FOOTNOTES

3 I.R.C. § 1368(c).
5 I.R.C. § 1(h).
6 I.R.C. § 331(a).
7 Treas. Reg. § 1.331-1(b).
8 I.R.C. § 1221(a).
9 I.R.C. § 334(a).
11 I.R.C. § 1374(a).
12 I.R.C. § 1374(d)(3).
13 I.R.C. § 1374(b)(1).
15 I.R.C. § 1368(b). See Treas. Reg. § 1.1368-1(c) (distribution by S corporation without earnings and profits not included in shareholder’s income to extent distribution does not exceed the adjusted basis of all of the shareholder’s shares of stock).
16 I.R.C. § 1368(e)(1).
17 I.R.C. § 1368(c)(2).
18 I.R.C. § 1368(c); Treas. Reg. § 1.1368-1(d).
19 I.R.C. § 2031(a).
20 I.R.C. § 2032(a).
21 I.R.C. § 1374(d)(7).