CHAPTER 14

Corporate Liquidation and Dissolution

§ 14.1—Liquidations in Connection with Continuing Businesses.

The complete liquidation of a corporation is usually thought of as the last step in the discontinuance and winding up of a business.[1] Complete liquidation of a corporation marks the end not only of the corporate life but also of the business conducted by the corporation. Occasionally, complete liquidation of a corporation is motivated by reasons quite different from a desire to end the particular business operation. A corporation's liquidation may, indeed, play an important role in the continuance of a particular business operation.

§ 14.11—Changing to unincorporated operation.

The shareholder or shareholders may desire for tax or other reasons to shed the corporate form but to continue the same business in proprietorship or partnership form or as a limited liability company.[2] In such event, the corporation will be completely liquidated and dissolved.

An interesting tax question arises when a corporation's charter is revoked for failure to pay state franchise taxes, or for failure to file an annual information statement or report. Following such administrative dissolutions, states, Michigan included, routinely permit reinstatement of corporate status—even retroactively—upon compliance. Often the shareholders are not even aware of the charter revocation and continue to operate the corporate business without an effective charter. The tax consequences of these developments are uncertain.

For tax purposes, the dissolved corporation might continue to be treated as the same corporation, subject to corporate tax rates and without any constructive liquidation, or it might be treated as a partnership, with flow-through taxation after a deemed liquidation with its attendant tax consequences. One court held that the dissolved corporation should remain taxable as a corporation because it possessed at least three of the four corporate characteristics listed under the entity classification rules.[3] Another court held that corporate status continued because the business continued to be conducted without change, without analysis of the entity classification rules.[4]

The predicament of an administratively dissolved corporation is especially uncertain now that the check-the-box rules for entity classification have been finally adopted.[5] Under these rules, an unincorporated entity which does not elect to be treated as a corporation will be treated as a partnership for tax purposes. This appears to require partnership tax treatment for an administratively dissolved corporation, which is likely to be contrary to everyone's expectations.

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§ 14.1

[1] For purposes of this chapter, "winding up" means the reduction of all or part of business assets to cash or cash equivalents; "liquidation" means the distribution in cash or in kind of all of a corporation's assets to its shareholders; "dissolution" means the termination of the corporate entity.

[2] Occasionally, the objective of the shareholders can be accomplished without liquidating the corporation by merely electing tax treatment as an S corporation under the Internal Revenue Code. See ch. 3 *above*.

[3] *Eleanore Builders, Inc. v. United States*, 826 F. Supp. 1111 (N.D. Ohio 1993).

[4] *Hill v. Commissioner*, 66 T.C. 701 (1976).

[5] See § 1.78, *above*, for a discussion of the check-the-box rules.

§ 14.12—Merger of parent and subsidiary.

It may have been necessary or desirable in the past to conduct two or more businesses in parent and subsidiary corporations. If it is now desired to combine those separate corporate operations into one corporation, the complete liquidation of the subsidiary may be a relatively simple alternative to a statutory merger.

§ 14.13—Merger of brother or sister corporations.

The same individual or individuals may own the same proportionate stock interests in two or more corporations. If it is desired to merge those corporations, one method of doing so without going through the steps of a statutory merger[6] is for the stockholders to contribute their stock in all but one of the corporations to the remaining corporation. After transforming the brother or sister corporations into subsidiaries of one of the corporations, a practical merger of the corporations can be effected through the complete liquidation of the newly created subsidiaries.

§ 14.2—The Voluntary Liquidation and Dissolution of a Michigan Corporation.

The life of a corporation may end for all practical purposes as a result of inaction, cessation of business activity, the loss or sale of assets, a general assignment for the benefit of creditors, or a multitude of similar reasons.[1] However, the life of the corporation is only ended in the eyes of the law if the proper procedural requirements are fulfilled in accordance with the applicable statutes. Indeed, "as between the state and a private domestic corporation, there can be no voluntary dissolution of the corporation except as the state permits it."[2]

In Michigan, a corporation may be wound up or dissolved either voluntarily or involuntarily. If the proceedings are voluntary, they may be conducted either in or out of court. If the proceedings are involuntary, they must be under the supervision of the court.[3]

§ 14.21—The types of voluntary liquidation and dissolution.

At common law a corporation could not be dissolved by the shareholders without the consent of the state because a corporation was regarded as a creature of a contract which could not be cancelled by unilateral action of the corporation. While there have

[6] See § 12.74 *above.*

§ 14.2

[1] Michigan passed the Employee-Owned Corporation Act in 1985 to provide state aid through the State Departments of Labor and Commerce (now Consumer and Industry Services) to employees who wish to take over a closing Michigan plant or facility. M.C.L. §§ 450.731 *et. seq.,* M.S.A. §§ 28.70(1) *et. seq.*

[2] *Simms v. Bialy Hardware & Supply Co.,* 187 Mich. 375, 382, 153 N.W. 821 (1915). Moreover, a resolution by the shareholders to dissolve the corporation but unattended by any further action pursuant to the resolution does not effect a dissolution. *Kersjes v. Metzger,* 292 Mich. 83, 290 N.W. 336 (1940).

[3] The judicial reorganization of corporations for which a plan of reorganization has been confirmed by a judgment of a court of competent jurisdiction pursuant to any applicable state or federal law is governed by M.B.C.A. §§ 861–864.

been many changes of procedure over the years, the advance consent of the state to a voluntary surrendering of its charter by the state is now given by statute. Accordingly, under Michigan law, a corporation may be dissolved in any one of the following six methods.[4]

(a) Automatically by expiration of a period of duration to which the corporation is limited by its Articles.

(b) By action of the incorporators or directors under limited circumstances.

(c) By board recommendation and the majority vote of shareholders.

(d) By shareholder action pursuant to a provision in the Articles for dissolution at will or upon occurrence of a specified event.

(e) By a judgment of the circuit court.

(f) Automatically for failure to file an annual report or pay the filing fee.

In addition, a corporation whose assets have been wholly disposed of under court order in receivership or bankruptcy proceedings may be summarily dissolved by order of the court having jurisdiction of the proceedings.[5]

[1]—Dissolution by expiration of term. The life of most corporations formed under Michigan law is perpetual. However, the Articles may specify a shorter period for the corporate life at the end of which time the corporation is automatically dissolved.

[2]—Dissolution prior to commencing business. Dissolution by incorporators is a relatively new development. This procedure has proven useful where, for various reasons, such as name-holding or initiation of a new venture, a purpose that existed for the creation of a corporation has been completely realized or will never come to fruition. In such circumstances, a dissolution by incorporators avoids the necessity for issuance of shares, election of officers and directors and sometimes certain taxes. For this reason the requirements of dissolution are aimed primarily at preventing injury to third parties. Accordingly, a corporation may be dissolved by action of its incorporators or directors if the following conditions are met:[6]

(a) The corporation has not commenced business.

(b) The corporation has not issued any shares.

(c) The corporation has no debts or other liabilities.

(d) The corporation has received no payments on subscriptions for its shares, or, if it has received payments, has returned them, less any part thereof disbursed for expenses.

Under these conditions the dissolution is effected by a majority of the incorporators or directors who then execute and file an appropriate certificate of dissolution.[7]

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[4] M.B.C.A. § 801(1).

[5] M.B.C.A. § 801(2).

[6] M.B.C.A. § 803(1).

[7] M.B.C.A. § 803(2). See Form No. 34 *below*.

[3]—Dissolution by board resolution and majority vote of shareholders. A corporation may be dissolved by action of its board and shareholders under the following order of events:[8]

(a) The board must adopt a resolution that the corporation be dissolved.

(b) The proposed dissolution must be submitted for approval at a meeting of the shareholders. Notice must be given to each shareholder of record to vote and must state that a purpose of the meeting is to vote on dissolution of the corporation.

(c) At a meeting, a vote of shareholders must be taken on the proposed dissolution. The dissolution will then be approved upon receiving the affirmative vote of the holders of a majority of the outstanding shares of the corporation entitled to vote and, if a class or series is entitled to vote as a class, the affirmative vote of a majority of the outstanding shares of each such class or series.

(d) The corporation must then execute and file an appropriate certificate of dissolution.[9]

This lessening of the required action of voting shareholders is in accord with the general theme of majority vote and majority action set forth in the Michigan Business Corporation Act. Consequently, as a general proposition, the holders of a majority of shares can legally effect dissolution even if they have interests served by the dissolution which differ from those of the minority. This is, of course, subject to the rights of aggrieved shareholders under M.B.C.A. Section 489.

While some state statutes authorize dissolution by a 100-percent shareholder vote without a meeting and without board action, a similar result may be obtained in 100-percent shareholder accord situations by taking action without a meeting[10] as is available in Michigan which reduces board action to a mere formality. This will commonly be the situation in closely held corporations.

Amendments to the Michigan Business Corporation Act have added considerable detail regarding shareholder agreements and the right of shareholders to control many aspects of a corporation's life. An agreement requiring dissolution of the corporation at the request of one or more of the shareholders or upon the occurrence of a specified event or contingency is enforceable if part of an otherwise valid shareholder agreement.[11] The Board of Directors may, without shareholder approval, agree to transfer all of the assets to a wholly-owned subsidiary or from a wholly-owned subsidiary, unless shareholder approval of such a transaction is specifically required in the Articles of Incorporation.[12]

[4]—Dissolution by provision in the Articles. The Articles may contain a provision that a shareholder or the holders of any specified number or proportion of

[8] M.B.C.A. § 804.

[9] M.B.C.A. § 804(7).

[10] See M.B.C.A. § 407 discussed at § 2.11[2][1]—*above*.

[11] M.B.C.A. § 488.

[12] M.B.C.A. § 488(1)(g). See also M.B.C.A. § 751(1)(c).

shares, or of any specified number of proportion of shares of a class or series thereof, may require dissolution of the corporation at will or upon the occurrence of a specified event.[13] This provision is effective if contained in the original Articles or if the holders of record of all outstanding shares authorize the provision in an amendment to the Articles.

If the Articles contain this provision, dissolution may then be effected by the execution and filing of a certificate of dissolution on behalf of the corporation upon authorization by a holder or holders of the number or proportion of shares specified in the provision, obtained in such manner as may be specified, or if no manner is specified, when authorized by written consent signed by such holder or holders.[14]

If the Articles contain a dissolution provision, the existence of this provision must be noted conspicuously on the face of every certificate for shares issued by the corporation, and a holder of such certificate is conclusively deemed to have taken delivery with notice of the provision.[15]

This provision is intended as a protective device for minority shareholders in a closely held corporation, so careful planning is essential. Its most likely use will occur in the case of a deadlock, although other forms of consent-type conditions may be imposed. Its utilization will thus primarily depend upon the demands of minority shareholders and individuals furnishing capital or other financing to the corporation.

Liquidation of corporate debts may also be provided for in the Articles of Incorporation.[16] The Articles may provide for the corporation to propose an arrangement, a compromise, or a plan of reorganization with its creditors or any class of them or with its shareholders or any class of shareholders. The corporation may apply to the appropriate circuit court to order a meeting of the creditors (or class of creditors) or of the shareholders (or class of shareholders); application may also be made by a creditor or by a receiver appointed for the corporation. At such a meeting, creditors or shareholders, or any class thereof, who represent 3/4 in value of the creditors or shareholders (or class thereof) may agree to a compromise, arrangement, or reorganization. If the court sanctions the agreement, it is binding on all the creditors or shareholders (or class thereof) and also on the corporation.

[5]—Judicial action for dissolution. Michigan circuit courts have exercised an inherent right to liquidate the assets and business of a corporation in two general categories of lawsuits. The first is in a suit by shareholders who are suffering as a result of the conduct of the business in such a way that they can have no equitable relief without liquidation. The second is by a creditor who can have no relief unless the assets and business of the corporation are converted to cash and operations ceased. In an effort to define more carefully certain areas of judicial dissolution, various statutory types of action in the appropriate circuit court are provided as a means of dissolving a corporation. Prior to 1989, M.C.L. Section 450.1825, M.S.A. Section 21.200(825), gave the impression that dissolution was the primary remedy to be utilized by the courts

[13] M.B.C.A. § 805(1).

[14] M.B.C.A. § 805(2).

[15] M.B.C.A. § 805(3).

[16] M.B.C.A. § 204.

in the event of oppression of minority shareholders by the majority. The 1989 Amendments repealed M.C.L. Section 450.1825 and enacted new M.B.C.A. Section 489 which makes it clear that dissolution is just one of several remedies available to a court in a minority shareholder suit.[17]

[a]—Attorney General's action. The Attorney General may bring an action for dissolution upon the ground that the corporation has committed any of the following acts: (a) procured its organization through fraud, (b) repeatedly and wilfully exceeded the authority conferred upon it by law, or (c) repeatedly and wilfully conducted its business in an unlawful manner.[18] The enumeration of these grounds for dissolution does not exclude any other statutory or common law action by the Attorney General for dissolution of a corporation or revocation or forfeiture of its corporate franchises.[19]

[b]—Action in event of deadlock. A corporation may be dissolved by a judgment entered in circuit court action brought by one or more directors or by one or more shareholders entitled to vote in an election of directors of the corporation, upon proof of both of the following: (a) The directors, or the shareholders acting as directors pursuant to agreement,[20] are unable to agree by the requisite vote on material matters respecting management of the corporation's affairs, or the shareholders of the corporation are so divided in voting power that they have failed to elect successors to any director whose term has expired or would have expired upon the election and qualification of his successor, and (b) as a result of the aforesaid condition, the corporation is unable to function effectively in the best interests of its creditors and shareholders.[21] This action may be taken regardless of the solvency of the corporation and without demonstration of irreparable harm.

[c]—Action by shareholder for discretionary remedy. A circuit court may adjudge the dissolution of, and liquidate the assets and business of, a corporation, in an action filed by a shareholder when it is established that the acts of the directors or those in control are illegal, fraudulent or wilfully unfair and oppressive to the corporation or to such shareholder.[22] In such an action the court may make such order or grant such relief, other than dissolution, as it deems appropriate including (a) cancellation or alternation of a provision contained in the Articles or Bylaws, (b) cancellation, alternation or injunction against a resolution or other act of the corporation, (c) direction or prohibition of an act of the corporation or of shareholders, directors,officers or other persons party to the action, or (d) purchase at their fair value of shares of a shareholder, either by the corporation or by the officers, directors or other shareholders responsible for the wrongful acts, or (e) the award of damages to the corporation or a shareholder.[23] This statutory remedy affords a ready means of relief for oppressed minority shareholders of a closely held corporation while at the same time affords courts latitude to avoid the drastic step of dissolution if less drastic

[17] M.B.C.A. § 489.
[18] M.B.C.A. § 821(1).
[19] M.B.C.A. § 821(2).
[20] M.B.C.A. §488(1)(a)
[21] M.B.C.A. § 823.
[22] M.B.C.A. § 489.
[23] M.B.C.A. § 489(1).

remedies appear advisable. Various judicial questions still remain, however, including the exclusiveness of this remedy and definition of what acts or conduct are considered oppressive.

§489 of the Michigan Business Corporation Act, by its terms, and as originally drafted, appeared clearly to create a cause of action for shareholders against directors or those in control of the corporation. This language was called into question by the Court of Appeals decision in *Baks v. Moroun*, 227 Mich App 472; 576 NW2d 413 (1998). *Baks* held that §489 did not state a cause of action and also applied a two year statute of limitations for claims against directors just as is provided in Section 541a. Another panel of the Court of Appeals in *Estes v. Idea Engineering*, 245 Mich App 328; 631 NW2d 89 (2001) strongly criticized the *Baks* decision and ordered that a special panel of the Court of Appeals be convened to resolve the conflict. To clarify the matter, the legislature amended §489 to specifically provide a statute of limitations, which states that an action seeking damages must be commenced within three years after the cause of action under §489 accrued or within two years after the shareholder discovers or reasonably should have discovered the cause of action.[24] The amendment makes a specific reference to "the cause of action under this section".

On March 2, 2002, a special seven member panel of the Michigan Court of Appeals reversed *Baks* and found that § 489, even prior to the above amendments, did create a separate cause of action.[25] The Court of Appeals decision held that actions brought under § 489 were governed by the residual six year statute of limitations. The Court acknowledged that the 2001 amendment to § 489 would apply the six year statute of limitations to claims other than damage claims under the Section.

[d]—Court Supervision of Dissolution. Section 851 of the Business Corporation Act permits a corporation, a creditor, or a shareholder, to ask the Circuit Court in the county where the principal place of business of the corporation is located for supervision of liquidation of the dissolved corporation's assets. Courts have the power to appoint a receiver for this purpose. Courts also may permit creditors to file claims or commence proceedings within the time limits under Section 841 so long as the corporation has not completely distributed its assets. One court has held that an unexhausted liability insurance policy was not an "undistributed asset" of the dissolved corporation on the ground that an expired third party liability policy is not property that a corporation could transfer in the process of liquidating its assets.[26]

[6]—Dissolution for failure to file annual report. If a domestic corporation neglects or refuses for two consecutive years to file the annual reports or pay any annual privilege fee, the corporation is automatically dissolved, effective 60 days after the end of the two-year period.[27] The administrator must notify the corporation of the

[24] M.B.C.A. §489(1)(f).

[25] *Estes v. Idea Engineering & Fabricating, Inc.*, 250 Mich. App. 270, 649 N.W.2d. 84 (2002).

[26] *Gilliam v. Hi Temp Products*, 260 Mich. App. 98, 677 N.W.2d 856 (2003).

[27] M.B.C.A. § 922. If a foreign corporation neglects or refuses for one year to file the annual report or pay any annual privilege fee, its certificate of authority is subject to revocation. M.B.C.A. § 922(2).

impending dissolution no later than 90 days before the two years has expired. Until such a corporation has been dissolved, it is entitled to issuance, upon request, of a certificate of good standing setting forth that it has been validly incorporated as a domestic corporation and that it is validly in existence under the laws of Michigan.

After such dissolution has occurred, a dissolved corporation shall continue its corporate existence but shall not carry on any business except for the purpose of winding up its affairs.[28]

§ 14.22—Mechanics of voluntarily liquidating and dissolving a Michigan corporation.

Some of the mechanics of completely liquidating and dissolving a Michigan corporation are as follows:

[1]—Passing shareholders' and directors' resolutions. One of the first steps in the liquidation and dissolution of a corporation will ordinarily be the adoption by the directors and the shareholders of a resolution to dissolve the corporation. Such resolution should recite that the shareholders elect to dissolve the corporation, and it may contain any additional provisions necessary with respect to the proposed dissolution and winding up.[29] The resolution may, for example, authorize the directors to sell all or part of the assets and will ordinarily set forth the method of distribution in liquidation to the shareholders. If the assets of the corporation will be distributed wholly or partly in kind to the shareholders, the resolution of dissolution should so state. Furthermore, if the shareholders agree that certain assets will be distributed to one shareholder, other assets to another, etc., then the resolution of dissolution should so state. In addition, it is advisable for the resolution of dissolution to state that the directors and officers may execute any document, including IRS Form 966, and do any act deemed necessary or desirable in effecting the dissolution and winding up.[30] The resolution may name the particular officer or officers who are to be authorized to execute the various documents and perform the various acts in winding up and liquidating the corporation.

The resolution authorizing dissolution and winding up must be adopted in good faith, for reasons honestly believed to be for the advantage of the corporation and the shareholders generally, and not for the purpose of freezing out certain minority shareholders.[31] If a majority of the shareholders in their own interest vote to sell the assets, discontinue the business, and dissolve a prosperous corporation for the purpose of turning over the assets and business to another corporation controlled by themselves so as to exclude the minority or to deprive them of the fair value of their investment,

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[28] An officer of a dissolved corporation does not encounter any personal liability when paying the debts of a dissolved corporation. No personal liability would attach to an officer for monies owed on a promissory note which was executed after automatic dissolution of the corporation for a preexisting debt in the corporation's name. *Honegger's & Company, Inc. v. Frog Valley Farm Services, Inc.,* 98 Mich. App. 568, 296 N.W.2d 314 (1980).

[29] See Form No. 32 *below*.

[30] See Form No. 32 *below*.

[31] Meister, *Dealing with Minority Shareholder Freezeouts*, 64 Mich. B.J. 314 (1985); Moscow, *Shareholders' Rights*, 18 Wayne L. Rev. 1003 (1972).

the minority shareholder may have equitable relief in the form of injunction[32] if they act promptly, or they may be able to recover the full value of their shares. Michigan Business Corporation Act, Section 489 specifically provides both injunctive and damage remedies.

Most courts are reluctant to interfere with the business discretion of the management and the majority, and wide latitude is given to that discretion, particularly where the assets are disposed to third parties rather than to the majority.[33] After a transaction has been completed, courts historically have been reluctant to set it aside, because it is practically impossible to restore the parties to their former status.[34] At that time, payment of damages or compensation for the misappropriation of the complainants' interests is the usual remedy.

[2]—Filing IRS information return. Within 30 days after the stockholders have adopted the resolution of dissolution, the corporation must file an information return on IRS Form 966 with the appropriate District Director of Internal Revenue. The form itself is fairly simple and, being only an information return, no tax is paid with it. A certified copy of the stockholders' and directors' action pursuant to which the plan of liquidation was adopted must be filed with the Form 966.

[3]—Obtaining a "tax clearance." Dissolving Michigan corporations, as part of the dissolution process, must see to it that all outstanding taxes are paid. Prior law required that tax clearance from the Michigan Department of Treasury be obtained before the Department would file a Certificate of Dissolution. This is no longer the case. The Department will accept a Certificate of Dissolution without receiving tax clearance from the Department of Treasury. The dissolving corporation, however, must, as indicated above in the process of dissolution, pay the taxes and seek tax clearance from the Treasury and must do so within 60 days of filing the Certificate of Dissolution.[35] The common taxes for which clearance is sought are sales and use taxes, the single business tax, and employee withholding taxes.[36] The clearance procedure is initiated by the corporation itself by directing a letter to the Tax Clearance Division of the Michigan Department of Treasury asking that the necessary tax clearance certificate be sent to the Department as soon as clearance can be granted by the Tax Clearance Division.

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[32] *Lebold v. Inland Steel Co.,* 125 F.2d 369 (7th Cir. 1942), cert. denied, 316 U.S. 675, 62 S. Ct. 1045, 86 L. Ed. 1749 (1942), modified, 136 F.2d 876 (7th Cir. 1943), cert. denied, 320 U.S. 787, 64 S. Ct. 196, 88 L. Ed. 473 (1943), noted in 10 U. Chi. L. Rev. 77 (1943); *Godley v. Crandall & Godley Co.,* 212 N.Y. 121, 105 N.E. 818 (1914); *Theis v. Spokane Falls Gaslight Co.,* 34 Wash. 23, 74 P. 1004 (1904). See also 16 *Fletcher, Cyc. Corp.* §§ 8022, 8023 (perm. ed.).

[33] *Windmuller v. Standard Distilling & Distrib. Co.,* 114 F. 491 (D.N.J. 1902), 115 F. 748 (S.D.N.Y. 1902); *In re Paine,* 200 Mich. 58, 166 N.W. 1306 (1918).

See Sprecker, *Right of Minority Shareholders to Prevent the Dissolution of a Profitable Enterprise*, 33 Ky. L.J. 150 (1945); Note, 2 Minn. L. Rev. 526, 528 (1918).

[34] *Jones v. Missouri-Edison Elec. Co.,* 233 F. 49 (8th Cir. 1916).

See Hornstein, *Voluntary Dissolution: A New Development in Intracorporate Abuse*, 51 Yale L.J. 64, 81 (1942).

[35] MCLA §205.24.

[36] For a discussion of these taxes see § 2.13(a) *above*.

[4]—Notice and filing of claims. After a corporation has been dissolved, the corporation, or a receiver appointed for it, may give notice requiring all creditors to present their claims in writing.[37] Such a written notice to existing claimants must:

(a) describe information that must be included in a claim (the corporation being entitled to demand sufficient information to permit it to make a reasonable judgment whether the claim should be accepted or rejected); *and*

(b) provide a mailing address where a claim may be sent; *and*

(c) state the deadline, which may not be less than 6 months from the effective date of the written notice, by which the dissolved corporation must receive the claim; *and*

(d) state that the claim will be barred if not received by the deadline.[38]

The Act further provides that the giving of such notice does not constitute recognition that a person to whom the notice is directed has a valid claim against the corporation; that a claim against the dissolved corporation is barred if either (a) a claimant who was given such written notice does not deliver the claim to the dissolved corporation by the deadline, or (b) a claimant whose claim was rejected by a written notice of rejection by the dissolved corporation does not commence a proceeding to enforce the claim within 90 days from the effective date of the written notice of rejection; that for the purposes of the section of the Act in question, "existing claim" means any claim or right against the corporation, liquidated or unliquidated, but not a contingent liability or a claim based on an event occurring after the effective date of dissolution; and that for the purposes of the section of the Act in question, the effective date of the written notice is the earliest of (a) the date it is received, (b) five days after its deposit in the United States mail, as evidenced by the postmark, if it is mailed postpaid and correctly addressed, or (c) the date shown on the return receipt, if the notice is sent by registered or certified mail, return receipt requested, and the receipt is signed by or on behalf of the addressee.[39]

A corporation may also publish notice of dissolution at any time after the effective date of dissolution and request that persons with claims against the corporation present them in accordance with the notice.[40] Such a notice must:

(a) be published once in a newspaper of general circulation in the county where the dissolved corporation's principal office, or if none in Michigan, its registered office, is or was last located; *and*

(b) describe the information that must be included in a claim (the corporation being entitled to demand sufficient information to permit it to make a reasonable judgment whether the claim should be accepted or rejected) and provide a mailing address where the claim may be sent; *and*

(c) state that a claim against the corporation will be barred unless a proceeding to enforce the claim is commenced within 1 year after the publication date

[37] M.B.C.A. § 841a.

[38] M.B.C.A. § 841a.

[39] *Id.*

[40] M.B.C.A. § 842a.

of the newspaper notice.[41] The Act provides that if the dissolved corporation so publishes a newspaper notice, the claim of

(a) a claimant who did not receive written notice under the procedure described in the text at notes 35–37 *above,*

(b) a claimant whose claim was timely sent to the dissolved corporation but not acted upon, or

(c) a claimant whose claim is contingent or based on an event occurring after the effective date of dissolution,

is barred unless the claimant commences a proceeding to enforce the claim against the dissolved corporation within one year after the publication date of the newspaper notice, except that a claimant whose claim was known to the corporation at the time of publication and who did not receive written notice under the procedure described in the text at notes 35–37 *above* is in no event barred from suit until six months after he or she has actual notice of the dissolution.[42] Substantial compliance with the notice provisions is not effective, the protections in the statute require literal compliance.[43]

Asbestos claims against a dissolved corporation have been held to qualify as contingent claims under Section 842a(3)(c) of the Business Corporation Act because they were dependent on a future event; the manifestation of an asbestos-related illness. Accordingly, such claims were barred if not filed within one year after the publication of the notice of dissolution.[44]

[5]—Preparing and filing certificate of dissolution. The dissolution of the corporation—that is, its formal death as a legal entity—is effected when a certificate of dissolution is filed by the Department.

[6]—Effecting distribution in liquidation. Assets remaining after payment of, or provision for, claims against a corporation are distributed to shareholders according to their respective rights and interests.[45] A distribution to shareholders may be made either in cash or in kind, or both. The corporation may distribute cash to shareholders holding less than 5 percent of the outstanding stock of the corporation even if it makes distributions which are wholly or partly in kind to those with larger shareholdings[46] , provided that the shareholders receiving cash instead of distributions in kind without their written consent do not hold more than 10% of all outstanding shares.

Liquidating (i.e., distributing the corporation's assets to its shareholders) is generally not a difficult task in the closely held corporation. If the corporation reduces all of its assets to cash, then liquidation requires merely a computation of the amount of cash to which each shareholder is entitled and the issuance of appropriate checks. If the liquidation is wholly or partly in kind, then again the problem is not difficult with

[41] *Id.*

[42] *Id.*

[43] *Freeman v. Hi Temp Products,* 229 Mich. App. 92, 580 N.W.2d 918 (1998)

[44] *Gilliam v. Hi Temp Products*, 260 Mich. App. 98, 667 N.W.2d 856 (2003).

[45] M.B.C.A. § 855a.

[46] *Id.*

respect to the usual closely held corporation. It is usually desirable to have the corporation execute a general instrument of assignment of *all* of its assets in undivided ownership to the shareholders in proportion to their respective interests.[47] This is a safeguard to insure that contingent assets such as tax refunds, etc. are transferred to the shareholders. If the corporation distributes real estate, it will, of course, be necessary for the general instrument of assignment to be implemented by delivery of deeds by the corporation to the shareholders. Also, any bank accounts owned by the corporation which are to be distributed to the stockholders should be drawn upon and closed; in the alternative, if the same bank accounts are to be used in the continued operation of the business previously conducted by the liquidating corporation, the names on those accounts should be changed. Furthermore, the title to any registered motor vehicles should be properly transferred.

[7]—Which comes first: liquidation or dissolution? The terms "liquidation" and "dissolution" are often used interchangeably but they are not synonymous. Dissolution generally refers to the termination of the corporate life by the filing of the necessary certificate and other documents with the state of incorporation and the state in which the corporation is authorized to do business. Liquidation generally refers to the winding up of the corporate business activities accompanied by a distribution of assets to the stockholders. The question occasionally arises as to whether the liquidating distributions to the shareholders should be made prior to filing a certificate of dissolution, or whether dissolution should be effected first with the liquidating distributions made thereafter. Traditionally, the usual timing in this respect was to file the certificate of dissolution first, thereby effecting the formal termination of the corporation, and then to wind up and liquidate. There are often compelling reasons, however, why the liquidating distribution should precede the filing of the certificate of dissolution. A prior liquidation may be particularly important if the business theretofore conducted by the corporation is not to be discontinued, but rather is to be distributed in kind to the shareholders and conducted by them. In such event, it will ordinarily be important to the successor owners to know in advance the definite date on which their operation of the business will begin. The necessity of obtaining a tax clearance before a certificate of dissolution may be accepted for filing may, for example, render impossible an accurate prediction of the future date on which the dissolution will be effected. Ordinarily, however, it is a simple matter to time the liquidating distribution at any desired date. Furthermore, whether the liquidating distribution is to be made in cash or in kind, it is sometimes necessary or desirable for income tax reasons to complete the liquidation on or before a certain date.[48] If the liquidation is postponed until after the formal dissolution is perfected, it may be impossible to meet a particular deadline. In this respect, it must be emphasized that although the timing of the liquidation may be important from an income tax standpoint, the timing of the formal dissolution is of no income tax consequence whatever.[49]

[47] Where the liquidation is wholly or largely in kind, it may be difficult for the corporation to pay its debts prior to liquidation. In such event, the distribution should be made expressly subject to the payment of the corporation's debts.

[48] Such timing is particularly important where a controlled subsidiary is to be liquidated tax-free. I.R.C. § 332. See § 14.42[1]—*below*.

[49] See Rev. Rul. 54-518, 1954-2 Cum. Bull. 142, for the irrelevance from a tax standpoint of the formal dissolution.

[8]—Judicial supervision if necessary. After a corporation has been dissolved in any manner, the corporation, a creditor, or a shareholder may apply at any time in circuit court for a judgment that the affairs of the corporation and the liquidation of its assets continue under supervision of the court.[50] The court may make such orders and judgments as may be required, including continuance of the liquidation of the assets by the officers and directors under the supervision of the court, or the appointment of a receiver to be vested with powers as the court designates to liquidate the affairs of the corporation. For good cause shown, and so long as the corporation has not made complete distribution of its assets, the court may also permit a creditor who has not otherwise timely filed his claim to file such claim or commence such action within such time as the court directs.

Judicial power in a dissolution context has been broadly construed to include the right to restrain creditors from commencing or continuing actions to recover debts.[51] The Uniform Fraudulent Conveyance Act[52] may apply to a dissolution; the Act thus may give the courts additional power to protect creditors' rights in the process.[53]

§ 14.23—Time and effect of dissolution.

Sometimes for various tax and non-tax reasons it is necessary to determine the time and effect of a dissolution.

[1]—Effective time of dissolution. A corporation is dissolved when any of the following occurs:[54]

(a) The period of duration stated in the Articles expires.

(b) A certificate of dissolution is filed pursuant to dissolutions before commencing business, by board resolution and majority vote of shareholders, or by provision in the Articles. The effective date of dissolution based upon a filed Certificate is the date the administrator files the Certificate and not the date it is delivered to the administrator.[55]

(c) A judgment of forfeiture of corporate franchises or of dissolution is entered by a court of competent jurisdiction and a copy of the order is forwarded promptly to the administrator by the receiver or other person designated by the court.

(d) Failure to file an annual report or pay the annual filing fee for two consecutive years.

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[50] M.B.C.A. § 851(1).

[51] *In re Esquire Products International, Inc.,* 136 Mich. App. 492, 357 N.W.2d 77 (1984). The Michigan Supreme Court remanded this case to the Court of Appeals which determined that the 1985 Court Rules continued to grant such receivership power to a receiver. *In re Dissolution of Esquire Products International, Inc. (on Remand),* 145 Mich. App. 106, 377 N.W.2d 356 (1985). Leave to appeal further to the Michigan Supreme Court was denied. 425 Mich. 872, 388 N.W.2d 680 (1986).

[52] M.C.L. § 566.11 *et seq.,* M.S.A. § 26.881 *et seq.*

[53] *Fireman's Fund Ins. Co. v. Harold Turner, Inc.,* 159 Mich. App. 812, 407 N.W.2d 82 (1987).

[54] M.B.C.A. § 831.

[55] *Freeman v. Hi Temp Products,* 229 Mich. App. 92, 580 N.W.2d 918 (1998)

The purpose of this provision is to more specifically define the precise time of dissolution to make it easier for third parties to determine the status of the corporation.

[2]—Effect of dissolution. Unless a court otherwise directs, a dissolved corporation continues its corporate existence but it cannot carry on business except for the purpose of winding up its affairs by (a) collecting its assets, (b) selling or otherwise transferring, with or without security, assets which are not to be distributed in kind to its shareholders, (c) paying its debts and other liabilities; and (d) doing all other acts incident to liquidation of its business and affairs.[56] Subject to the foregoing and except as otherwise provided by court order, a dissolved corporation, its officers, directors and shareholders continue to function in the same manner as if dissolution had not occurred.[57] Thus, without limiting the generality of this provision, the following specific conditions apply:[58]

(a) The directors are not deemed to be trustees of corporate assets and are held to no greater standard of conduct than normal.

(b) Title to corporate assets remains in the corporation until transferred by it in the corporate name.

(c) The dissolution does not change quorum or voting requirements for the board of shareholders, and does not alter provisions regarding election, appointment, resignation or removal of, or filing vacancies among, directors or officers, or provisions regarding amendment or repeal of Bylaws or adoption of new Bylaws.

(d) Shares may be transferred.

(e) The corporation may sue and be sued in its corporate name and process may issue by and against the corporation in the same manner as if dissolution had not occurred.

(f) An action brought against the corporation before its dissolution does not abate because of the dissolution.

These conditions are helpful in delineating powers, particularly in instances requiring the conveyance of real property. They also help remove other clouds on title and clarify authority to consummate transactions.

§ 14.24—Revocation of dissolution proceedings and renewal of term.

For various reasons the factors which rendered dissolution advisable may change or it is desired to renew the existence of a corporation whose life would otherwise be terminated.

Certain dissolution proceedings may be revoked before all of the assets have been distributed by filing a certificate of revocation executed, in person or by proxy, by all the shareholders, stating that revocation is effective and that all the shareholders have

[56] M.B.C.A. § 833.

[57] M.B.C.A. § 834.

[58] *Id.*

executed the certificate in person or by proxy.[59] This revocation procedure covers both dissolution by board resolution and majority shareholder vote and dissolution pursuant to provision in the Articles, so long as a proceeding is not pending in circuit court to supervise the liquidation. Furthermore, if a proceeding is not pending in circuit court to supervise the liquidation, dissolution proceedings commenced by board resolution and majority shareholder vote may also be revoked before all of the assets have been distributed by taking the following steps: (a) The board adopts a resolution revoking the dissolution which is submitted for approval at a meeting of shareholders where the same notice and vote approving such dissolution are given, and (b) a certificate of revocation is executed and filed on behalf of the corporation.[60]

This revocation procedure may be useful where the reason for the dissolution has changed and continuation of the corporate life is desirable. In such instances, the revocation procedure is simpler and less costly than winding up the corporation and creating a new corporation. A common example may occur in the sale of assets where the sale is not perfected but all resolutions and votes have been previously taken.

If a circuit court is not supervising the liquidation, a corporation whose term has expired may renew its corporate existence in the following manner:[61]

(a) The board must adopt a resolution that the corporate existence be renewed and this proposed renewal must then be submitted for approval at a meeting of shareholders. Notice must be given to each shareholder of record entitled to vote at the meeting within the time and in the manner provided generally for the giving of notice of meetings of shareholders and must state that a purpose of the meeting is to vote on the renewal of corporate existence.

(b) At the meeting a vote of shareholders entitled to vote must be taken on the proposed renewal and it is then adopted upon receiving the affirmative vote of a majority of the outstanding shares and the vote of a majority of a class or series if such class or series is entitled to vote.

(c) If the renewal of corporate existence is approved a certificate of renewal is executed and filed.

[1]—Effect of renewal or revocation proceedings. The corporation may again transact its business upon filing the certificate of revocation of dissolution or of renewal of existence which effectuates the revocation of the dissolution or the renewal of the corporate existence.[62] However, revocation of dissolution or renewal of corporate existence does not relieve the corporation of any penalty or liability accrued against it.[63] Moreover, if during the period of dissolution or expiration of term, the corporate name or a confusingly similar name has been assigned to another corporation, the administrator may require that the corporation adopt a different name upon filing of a certificate of revocation of dissolution or of renewal of existence.[64]

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[59] M.B.C.A. § 811(1).

[60] M.B.C.A. § 811(2).

[61] M.B.C.A. § 815.

[62] M.B.C.A. § 817(1).

[63] M.B.C.A. § 817(2).

[64] M.B.C.A. § 817(3).

§ 14.3—Partial Liquidation of a Michigan Corporation.

While a complete liquidation entails a winding up of all corporate affairs and a distribution of assets to the shareholders in cancellation of all of the corporate stock, a partial liquidation only entails a redemption of some, but not all, of the outstanding stock of the corporation. It is merely a contraction of the corporate business. Partial liquidations are governed by the general statutory rules pertaining to redemptions of stock.[1]

§ 14.4—Income Tax Treatment to Shareholders of Complete Liquidations.

Before 1987, the income tax treatment to shareholders who received liquidating distributions could vary widely, depending upon the value of the assets received, the amount of the corporation's earnings and profits, and the election of the shareholders. Since 1986, however, the rules and the analysis are much more simple. All liquidations, except liquidations of controlled subsidiary corporations, are subject to a single set of rules at the shareholder level. Liquidations of subsidiary corporations are subject to a completely different rule.

§ 14.41—The usual rule: sale or exchange treatment.

The usual tax treatment to the shareholder is the same as though he had sold his shares for an amount equal to the cash and fair market value of property received by him in the liquidation.[1] Even though the other property consists in whole or in part of accounts receivable, or installment obligations, the shareholder must ordinarily treat the fair market value of those assets as payment received for his stock.[2]

[1]—Tax consequences of sale or exchange treatment. Under the usual sale or exchange rule, the shareholder who receives cash or other property in an amount in excess of the tax basis of his shares will have a taxable gain to the extent of such excess. Conversely, the shareholder who receives cash and other property in an amount less than the tax basis of his shares will have a deductible loss. In most cases, the gain or loss will be capital gain or capital loss.[3]

If the shareholders of the liquidating corporation own qualified small business stock (QSB stock), then the liquidating distributions might be eligible for big tax benefits. If the shareholder has held his QSB stock for at least five years, then his capital gain should be taxable at only a 14-percent tax rate. And, if the shareholder rolls his

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§ 14.3

[1] See ch. 9, *above*.

§ 14.4

[1] I.R.C. §§ 331(a)(1), 1001.

[2] If, however, the shareholder receives an installment obligation which arose on account of a sale by the corporation after it adopted a plan of liquidation, the shareholder may be able to report each installment payment, rather than the obligation itself, as a payment for his stock. See § 12.22[6], *above*.

[3] If the corporation is a collapsible corporation, gain may be characterized as ordinary income. See § 14.41[2][c], *below*.

liquidation proceeds over into the purchase of other QSB stock within 60 days, then his capital gain is deferred until he sells the replacement QSB stock.[4]

[2]—Tax pitfalls to the shareholder. The usual sale or exchange tax treatment to shareholders is relatively simple. There are, however, certain pitfalls in this usual tax treatment which are easily overlooked.[5]

[a]—Valuation of tangible and intangible assets. Attorneys sometimes overlook the implications of the rule that gain or loss is determined by subtracting the tax basis of the shareholder's stock from the cash and *fair market value* of other assets received. It is wholly inadequate to look merely at the book values of the corporation's assets immediately prior to the liquidating distribution and to conclude that those book values will control in computing the shareholder's gain or loss.[6] Very often land, buildings, equipment, and even inventory, distributed in kind to shareholders will have a book value to the corporation substantially less than their fair market value. The higher fair market value, and not the corporation's book values, will control in the computation of the shareholder's gain or loss.[7] Furthermore, a corporation may have assets, particularly intangible assets such as goodwill, which are nowhere carried on the balance sheet, but which may have substantial value.[8] It must be emphasized that where the business previously conducted by the corporation is to be continued by the individual shareholder or shareholders in proprietorship or partnership form, the distribution of such going business may result in the shareholders being assessed with a large and unanticipated tax on account of an alleged goodwill value of such business.

To take an extreme example, suppose that A, an individual, for some time, has operated a sole proprietorship which he now wishes to incorporate. The assets used in his business have a tax basis to him of $100,000 but because the business has substantial goodwill, it could be sold for $300,000. A transfers all of the business assets to a newly formed corporation to carry on the business. The incorporation is tax-free and, accordingly, A has a tax basis for his newly acquired stock of $100,000.[9] One week later, A decides that he made a mistake by incorporating; he therefore liquidates the corporation and returns the business to proprietorship form. The liquidation, even though only one week subsequent to the incorporation, will result in a taxable gain to A of $200,000, the difference between the $300,000 value of the assets received and the $100,000 tax basis of his stock.[10]

Determining whether goodwill is a corporate asset (resulting in double taxation upon liquidation) or an individual asset (not affected by liquidation) is an open question for tax purposes. If the corporation's income is derived mostly from the personal efforts

[4] I.R.C. §§ 1202, 1045.

[5] See also § 14.6, *below,* for a discussion of the "reincorporation" problem.

[6] See § 6.2, *above,* for a definition of "book value" of assets.

[7] I.R.C. § 1001(b).

[8] See § 6.2, *above.* See *Carty v. Commissioner,* 38 T.C. 46 (1962).

[9] See § 2.22[3], *above*.

[10] More accurately, the gain to A will be measured by the value of the assets received by him. The distribution by the corporation of an appreciated asset will result in recognized gain to the corporation (see § 14.5 *below*), so the value of the distribution to A will be reduced by the tax payable by the corporation.

or reputations of individuals who are not contractually obligated to continue to perform services for the corporation, or who are not restricted by non-compete covenants, then goodwill is more likely to be treated as an individual asset.[11] Conversely, if the corporation is perceived by customers as an entity which can reliably provide a product or service, then goodwill is more likely to be treated as a corporate asset. The tax practitioner must be careful. The tax issue is subtle, but the tax stakes are not.

[b]—Avoiding problems incident to debt between corporation and shareholder. Debt owing by the shareholder to the corporation, or by the corporation to the shareholder, under some circumstances, may present a problem in a corporate liquidation.

[i]—When the shareholder is indebted to the corporation. Shareholders of a closely held corporation are often tempted to borrow from their corporation, sometimes as an alternative to causing the corporation to pay dividends to them. Although such shareholder borrowing is always fraught with substantial danger that such borrowing may be treated for tax purposes as a dividend distribution, the complete liquidation of the corporation highlights this problem. Particularly is this problem highlighted where the corporation has only one shareholder, so that the net assets received by him will be the same whether or not he repays the debt. Since the distribution by the corporation of its receivable to the shareholder-debtor extinguishes the debt by merger, the shareholder is never required actually to repay the debt. The Internal Revenue Service might take the position that this extinguishment of the debt by merger is evidence that the purported borrowing from the corporation was not bona fide when made. If the year in which such purported borrowing took place is still open for adjustment, the liquidation might increase the risk that the initial borrowing be treated as a dividend distribution, with deficiencies plus interest owing from that year.

The evaluation of this risk necessarily depends upon the circumstances. If the borrowing is evidenced by a promissory note, if the shareholder-debtor was required to, and did, pay a reasonable rate of interest, if the maturity date has not been ignored or, if the note is a demand note, it has not been outstanding for an inordinately long time, if in short all relevant factors indicate the borrowing was bona fide, the risk of dividend treatment in the year in which the borrowing was made may be so slight as to be ignored. But if any significant question of its validity is presented, conservative planning will dictate that the debt be repaid by the shareholder prior to the liquidating distribution. The actual repayment of the loan, even though immediately prior to the liquidating distribution, is some evidence that the loan was bona fide at the time when it was made.

[ii]—When the corporation is indebted to the shareholder. When the shareholder is the creditor of the liquidating corporation, the debt owing to him

[11] See *Martin Ice Cream Co. v. Commissioner*, 110 T.C. No. 18 (1998); *Norwalk v. Commissioner*, 76 T.C.M. 208 (1998); *Rudd v. Commissioner*, 79 T.C. 225 (1982); *Longo v. Commissioner*, 27 T.C.M. 1075 (1968); *Bryden v. Commissioner*, 18 T.C.M. 810 (1959); *Estes v. Commissioner*, 168 F.2d 68 (6th Cir. 1948); *MacDonald v. Commissioner*, 3 T.C. 720 (1944).

will ordinarily be repaid as a part of the corporation's winding up. If a single distribution is made to the shareholder-creditor on account of his combined interest as a shareholder and a creditor, the distribution will be first marshalled against his creditor position. Ordinarily, the repayment of the debt will have no income tax consequences to the shareholder-creditor because he will ordinarily have a basis for the debt equal to the face amount. If so, no gain or loss is realized by him when the debt is repaid.

Sometimes, however, the corporation will be indebted to the shareholder on account of unpaid salary or rent, or some other item which, when paid, is ordinary income to the shareholder. The payment of this type of debt will give rise to ordinary income, rather than capital gain, to the shareholder. When this is disadvantageous, presumably because the shareholder has a substantial capital loss from other sources, the shareholder will be tempted to forgive the debt prior to receiving a liquidating distribution, with the objective of increasing by that amount the distribution to be made to him on account of his stock interest, a distribution which ordinarily gives rise to capital gain. This temptation will be particularly strong when the shareholder is the sole shareholder, or when several shareholders are creditors in approximately the same proportion as their proportionate stock ownership. Given this latter situation, however, where the prior forgiveness of debt will not significantly affect the amount of the total distribution to be received by the forgiving shareholder, the Service and the courts are likely to hold that the forgiveness is a sham which can be ignored for proper tax characterization.[12] The distribution first will be marshalled against the debt, despite the purported forgiveness.

The forgiveness of debt by a shareholder-creditor will also have adverse tax consequences to the corporation in those instances where the shareholder-creditor has a basis in the debt which is less than the amount owing.[13] This is likely to be the case where the debt represents unpaid salary or rent or some other item which, when paid, will constitute income to the shareholder-creditor. In these instances, the shareholder-creditor is not likely to have a basis in the debt. The forgiveness of this type of debt after 1986 results in taxable income to the corporation.[14]

[c]—Avoiding collapsible corporation tax treatment. When a collapsible corporation is liquidated, or a part or all of its shares are sold, the gain realized by a shareholder may be characterized as ordinary income rather than as capital gain.[15] Although the problems of collapsibility are as relevant to stock sales as to corporate liquidations, the subject is often popularly associated with liquidations and, as a matter of convenience, it is discussed in this chapter.[16] The reader who is concerned with the applicability of collapsible treatment to a stock sale should read the references on the following pages to "corporate liquidations" to mean "sales of stock."

[12] *Dwyer v. United States,* 622 F.2d 460 (9th Cir. 1980); *Braddock Land Co. v. Commissioner,* 75 T.C. 324 (1980).

[13] I.R.C. § 108(e)(6).

[14] For several years prior to 1987, the debtor corporation could elect not to have immediate income by applying the forgiveness to reduce the basis of depreciable property. This is no longer possible. See former I.R.C. § 108(a)(11)(C),(c), repealed by the Tax Reform Act of 1986.

[15] I.R.C. §§ 341(d) and (e).

[16] See § 12.23[4]—for the applicability of the collapsible corporation discussion to stock sales.

[i]—The tax loophole at which the collapsible corporation provisions are aimed. The collapsible corporation section first came into the Internal Revenue Code in 1950 as a loophole-plugging law. The loophole aimed at was one which was then prevalent primarily in the movie and real estate industries and enabled the tax-sophisticated businessman to convert ordinary income into favorably taxed long-term capital gain.

The problem and the solution can be illustrated by the following example. Suppose that an individual owns a large tract of raw land which he wishes to subdivide, improve, and sell as residential sites. If he proceeds without incorporating, the entire profit will constitute ordinary income. Similarly, if he forms a corporation to proceed with the project, and the corporation sells the lots, its profits will be taxed as ordinary income and, in addition, the after-tax profit will still be in the corporate till, normally requiring the payment of a second tax at the shareholder level in order to place those profits in the shareholder's pocket. Neither of these alternatives is ideal, to say the least.

Before 1950, there was a way out. The landowner could transfer his land to a newly formed corporation, have the corporation subdivide and improve the land, and then, prior to the sale of the lots, cause the corporation to liquidate. The shareholder would pay a long-term capital gain tax based on the difference between the cost of his shares and the *value* of the assets received[17] ; and the corollary would be that the shareholder would have a cost basis for the lots equal to their fair market value at the time of liquidation.[18] The corporation would pay no tax whatever on account of the increase in value occasioned by its efforts.[19] Upon a subsequent sale of the lots by the shareholder, no further tax would be incurred. The increased value to the land attributable to the development efforts would have been converted from ordinary income to the corporation to long-term capital gain to the shareholder, taxable in those days at a much lower rate.

This loophole is now largely blocked by Section 341. A shareholder who receives a liquidating or other distribution from a collapsible corporation, which distribution would otherwise give rise to long-term capital gain, will be treated as having received ordinary income unless one of several exceptions to collapsible treatment applies.[20]

[ii]—Definition of a collapsible corporation. The least understood aspect of collapsible corporations, the aspect which involves the most difficult statutory phraseology and is the occasion for the largest number of decided collapsible cases, is the definition of a collapsible corporation.[21]

A collapsible corporation is defined as

> ". . . a corporation formed or availed of principally for the manufacture, construction, or production of property, for the purchase of . . .[Section 341 assets], with a view to—

17 I.R.C. § 331. See § 14.41[1]*above*.

18 I.R.C. § 334(a). See § 14.44[1]*below*.

19 Under pre-1987 law, a corporation did not recognize taxable gain when it distributed appreciated assets in complete liquidation, with certain exceptions not relevant to this example.

20 See § 14.41[2][c][iii]*below*.

21 I.R.C. § 341(b)(1).

(A) the sale or exchange of stock by its shareholders (whether in liquidation or otherwise) . . . before the realization by the corporation manufacturing, constructing, producing, or purchasing the property of two-thirds of the taxable income to be derived from such property, and

(B) the realization by such shareholders of gain attributable to such property."

Unfortunately, the definition is even more complex than it appears. Its complexity and importance require that we examine that definition in detail, stopping at each key phrase.

[A]—". . . formed or availed of . . ." The corporation may be formed *or* availed of for the proscribed purpose. The disjunctive is meaningful.[22] A collapsible corporation is often thought of as one which is relatively new, one which has not yet received a significant amount of taxable income. That will *normally* be true, but it is not necessarily true. An old corporation—one which has operated profitably for fifty years or more—can be *availed of* for the proscribed purpose and land the shareholders in tax trouble. This problem will be discussed in more detail after we have examined the relevant key phrases.[23]

[B]—". . . principally . . ." A collapsible corporation must be formed or availed of principally for the manufacture, production, etc., of property. The work "principally" modifies "manufacture, production, etc." and not "with a view to." One hard-pressed taxpayer attempted to squirm out of a collapsible penalty by arguing that his corporation was formed or availed of *principally* to make money, not principally to obtain an income tax advantage. But the Court of Appeals for the Second Circuit reminded him that he had missed the whole point.[24] The view to collapse the corporation need not be the principal purpose for the formation or availing of the corporation. "Principally" defines "manufacture, etc.," and is therefore of little or no help in attempting to avoid collapsible status.

[C]—". . . manufacture, construction, or production of property . . ." The manufacture, construction, or production of property has been broadly defined both by the courts and the Internal Revenue Service.[25] An attempt to get out from under collapsible treatment on the ground that the corporation was collapsed too early in the game, before the manufacture, construction, or production began, must face the obstacle of a strict interpretation. Any integral step in the construction process will be considered construction. For example, the mere rezoning of land from

[22] See *Temkin v. Commissioner,* 35 T.C. 906 (1961).

[23] See § 14.41[2][c][iii][d]*below*., It has been held that where a minority shareholder's stock interest is redeemed by the corporation or purchased by his co-shareholders in order to resolve a dispute, or because the minority shareholder is unable to advance his pro rata share of additional funds, or presumably for other good and unanticipated business reasons, the corporation has not been availed of for the proscribed purpose. *Goodwin v. United States,* 320 F.2d 356 (Ct. Cl. 1963); *Commissioner v. Lowery,* 335 F.2d 680 (3d Cir. 1964).

[24] *Weil v. Commissioner,* 252 F.2d 805 (2d Cir. 1958).

[25] *Abbott v. Commissioner,* 258 F. 2d 537 (3d Cir. 1958); *Sterner v. Commissioner,* 32 T.C. 1144 (1959); Rev. Rul. 57–346, 1957–2 Cum. Bull. 236; Rev. 56–137, 1956–1 Cum. Bull. 178.

residential to commercial has been ruled to be construction.[26] So has the required subordination by a lessor of his lease interest to the lessee's construction mortgage, together with the lessor's right to approve the lessee's construction plans.[27] The preparation of preliminary architect's drawings is probably construction.[28] Simply entering into an agreement obligating the taxpayer to build an access road has been held to constitute construction.[29] The obtaining of long-term leases, even before any other work is done in the construction of a shopping center or an office building, would probably be considered construction for this purpose.

Furthermore, the corporation will be deemed to have engaged in construction if someone else does construction work and then transfers the property to the corporation in a tax-free exchange.[30] Similarly, if the corporation constructed property and then exchanged that constructed property for other property in a tax-free exchange, the corporation will be deemed to have constructed the property so acquired, even if the corporation did not in fact lift a finger with respect to the acquired property.[31]

[D]—"Section 341 assets." As indicated in the immediately preceding subsection, a corporation may be collapsible if it manufactures, constructs, or produces any kind of property. In addition, a corporation may be collapsible if it purchases property defined as "section 341 assets." "Section 341 assets" are defined in detail in the Code.[32] Very generally speaking, such assets are assets held for less than three years which are inventory or inventory-like property, property held for rental, or receivables acquired by virtue of the sale of the foregoing types of property.

[E]—". . . with a view to . . ." Statutory language which purports to define a subjective state of mind is always troublesome. It is therefore not surprising that the great bulk of collapsible litigation to date has centered on the meaning of the phrase "with a view to."[33] A collapsible corporation must be formed or availed of

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[26] Rev. Rul. 56–137, 1956–1 Cum. Bull. 178. The Tax Court has held that the mere rezoning of land (in this case, from agricultural use to apartment use) does not constitute "construction." *Thomas v. Commissioner,* 42 T.C.M. 496 (1981). In so holding, it distinguished its prior holding in *Sproul Realty Co. v. Commissioner,* 38 T.C. 844 (1962), where the corporation not only rezoned the land, but also hired an architect to prepare plans for a shopping center, began negotiations for building permits, obtained two tenants and had attempted to obtain permanent financing for the project. The distinction is not entirely persuasive. In all likelihood, the Service's continuing view is that rezoning alone is sufficient.

[27] Rev. Rul. 69–378, 1969–2 Cum. Bull. 49.

[28] *See Sterner v. Commissioner,* 32 T.C. 1144 (1959); *Farber v. Commissioner,* 312 F.2d 729 (2d Cir. 1963); but cf. *McPherson v. Commissioner,* 21 T.C.M. 583 (1962), where the mere filing of a tentative plat, not the final plat, was held not to constitute construction.

[29] *Manassas Airport Industrial Park, Inc. v. Commissioner,* 66 T.C. 566 (1976), affirmed without opinion 557 F.2d 1113 (4th Cir. 1977).

[30] I.R.C. § 341(b)(2)(B); Treas. Reg. § 1.341–2(a)(5).

[31] I.R.C § 341(b)(2)(C); Treas. Reg. § 1.341–2(a)(5).

[32] I.R.C. § 341(b)(3).

[33] *Braunstein v. Commissioner,* 374 U.S. 65, 83 S. Ct. 1663 (1963); *Jacobson v. Commissioner,* 281 F.2d 703 (3d Cir. 1960); *Spangler v. Commissioner,* 278 F.2d 665 (4th Cir. 1960); *Sidney v. Commissioner,* 273 F.2d 928 (2d Cir. 1960); *Payne v. Commissioner,* 268 F.2d 617 (5th Cir. 1959); *August v. Commissioner,* 267 F.2d 829 (3d Cir. 1959); *Glickman v. Commissioner,* 256 F.2d 108 (2d Cir. 1958); *Burge v. Commissioner,* 253 F.2d 765 (4th Cir. 1958); *Riley v. Commissioner,* 35 T.C. 848 (1961), acq. 1972–2 Cum. Bull.

principally for the manufacture, etc., of property *with a view* to collapsing the corporation prior to the realization of corporate profits.

The still-unsettled question is: *when* must that view to collapse first come into existence in order for the corporation to be collapsible?

Various answers are possible. The answer most favorable to taxpayers, and the one which most easily follows the statutory language, is that the view to collapse must arise at some time *during* the construction process. Suppose, for example, that a corporation is formed for the construction and leasing of a shopping center. After construction is completed, the shareholders decide for the first time that the corporation should be liquidated, or that its shares should be sold. Accordingly, the corporation is collapsed and the shareholders realize a substantial gain. Under this favorable interpretation of the statute, the corporation will not be collapsible even though all of the other elements of collapsibility might be present. It will not be collapsible because the view to collapse did not exist at any time during the construction process.

The requirement that the view to collapse exist at some time *during* the construction, etc., process seems to be the proper interpretation of the statute.[34] Indeed, even the Treasury Department, in a diluted fashion, acknowledges this in its Regulations. The Regulations state that if the view to collapse is attributable solely to circumstances which arose after the construction, the corporation will ordinarily be considered noncollapsible.[35]

For a time, however, it seemed that two courts of appeals, plus five of the judges of the Tax Court, interpreted the statute more favorably to the Government than did the Treasury Department.[36] In dicta written by both courts and by the five minority judges of the Tax Court, the unusual position was advanced that the Treasury Department has in this respect been unwarrantedly generous to the taxpayers. These authorities took the position that the "view to" language in the statute does not modify the "manufacture, construction, or production" language which precedes it. Rather, it is simply introductory to the "sale or exchange" language which follows it: that, in effect, when a corporation is collapsed there must of necessity be a *view* to collapse it and that therefore the "view to" language is always satisfied whether the intention rose during the construction process or after it. This is, or course, an unfavorable interpretation since it reads out altogether any limiting significance to the "view to" language. Under this interpretation the "view to" requirement will always be met.

In 1972, the Internal Revenue Service formally acquiesced in the pro-taxpayer position, indicating an end to the battle on this critical point.[37] If the view, or intention,

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3; *Temkin v. Commissioner,* 35 T.C. 906 (1961), acq. 1972–2 Cum. Bull. 3; *Sterner v. Commissioner,* 32 T.C. 1144 (1959); *Mintz v. Commissioner,* 32 T.C. 723 (1959); *F.T.S. Associates, Inc. v. Commissioner,* 58 T.C. 207 (1972), acq. 1972–2 Cum. Bull. 2.

[34] *Jacobson v. Commissioner,* 281 F.2d 703 (3d Cir. 1960); *Riley v. Commissioner,* 35 T.C. 848 (1961); *Temkin v. Commissioner,* 35 T.C. 906 (1961); *Saltzman v. Commissioner,* 22 T.C.M. 336 (1963).

[35] Treas. Reg. § 1.341–2(a)(3).

[36] *Sidney v. Commissioner,* 273 F. 2d 928 (2d Cir. 1960); *Glickman v. Commissioner,* 256 F.2d 108 (2d Cir. 1958); *Burge v. Commissioner,* 253 F.2d 765 (4th Cir. 1958); *Temkin v. Commissioner,* 35 T.C. 906 (1961) (dissenting opinion); *Riley v. Commissioner,* 35 T.C. 848 (1961) (dissenting opinion).

[37] Acquiescences were filed in *Charles J. Riley* and *Maxwell Temkin supra,* Note 29, *above.*, 1972–2 Cum. Bull. 3.

to sell the stock or liquidate the corporation arises after the completion of the manufacture, construction, production, or purchase, and is not attributable to circumstances which existed during the manufacture, etc., the corporation cannot be collapsible. This is an impor tant concession, and can often be significant for planning purposes.

But the Service imposes, and the courts enforce, a difficult burden on the taxpayers to prove a complete absence, during the construction process, of any intention to collapse.[38] If the intention to collapse exists at any time during the construction process, unconditionally, or as a recognized possibility, the "view to" requirement will be met. Indeed, if merely the *circumstances* giving rise to the view were present during construction, or could reasonably be anticipated during the construction, the view would be deemed to exist.[39] Only in those rare instances where it can be shown that no view to collapse existed at all during construction, that wholly unanticipated circumstances arose *after* the construction was complete, and that the intent to collapse was motivated solely by these subsequent circumstances, will the corporation be noncollapsible on this account, at least in the approach of the Treasury Department.[40] But this burden of proof can sometimes be met, as witness a few taxpayer victories in court on this issue.[41]

Indeed, there are recent indications that even the favorable interpretation may be too restrictive for some circumstances. Under the favorable interpretation, it will be recalled, the "view" requirement is met if the intent to collapse arises at any time during the construction process. It was long believed that if the intent so arose, it was immaterial that it is motivated by a compelling business reason other than tax saving.[42] But a few cases have made an inroad into that generalization. In *Commissioner v. Solow,*[43] one of two equal shareholders was held not to have the requisite view when he sold his shares to the other shareholder *during the construction process*, because of threats from the purchaser that he would ruin the seller if he did not sell. In *Commissioner v. Lowery,*[44] the taxpayer owned substantial minority interests in two corporations formed to construct apartment buildings. The projects cost more than was anticipated. The taxpayer was unable or unwilling to make the necessary additional contribution. Accordingly, he sold his shares to another, *while the projects were still in construction.* The court held that he did not have the requisite view because he

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[38] Treas. Reg. § 1.341–2(a)(2), (3); *Spangler v. Commissioner,* 278 F.2d 665 (4th Cir. 1960); *Payne v. Commissioner,* 268 F.2d 617 (5th Cir. 1969); *August v. Commissioner,* 267 F.2d 829 (3d Cir. 1959); *Braunstein v. Commissioner,* 374 U.S. 65, 83 S. Ct. 1663 (1963); *Sterner v. Commissioner,* 32 T.C. 1144 (1959); *Mintz v. Commissioner,* 32 T.C. 723 (1959); *Epstein v. United States,* 221 F. Supp. 479 (N.D. Ohio 1963).

[39] *See King v. United States,* 641 F.2d 253 (5th Cir. 1981); *Sterner v. Commissioner,* 32 T.C. 144 (1959); *Mintz v. Commissioner,* 32 T.C. 723 (1959).

[40] Treas. Reg. § 1.341–5(c), Ex.(3). *Ellsworth J. Sterner,* 32 T.C. 1144 (1959).

[41] *Jacobson v. Commissioner,*, 281 F.2d 703 (3d Cir. 1960); *Elliott v. United States,* 205 F. Supp. 384 (D. Ore. 1962); *Southwest Properties, Inc.,* 38 T.C. 97 (1962); *Riley v. Commissioner,* 35 T.C. 848 (1961), acq. 1972–2 Cum. Bull. 3; *Temkin v. Commissioner,* 35 T.C. 906 (1961), acq. 1972–2 Cum. Bull. 3; *Felix v. Commissioner,* 41 T.C.M. 1040 (1981).

[42] Treas. Reg. § 1.341–5(c), Ex. (3). *Sterner v. Commissioner,* 32 T.C. 1144 (1959).

[43] 333 F.2d 76 (2d Cir. 1964).

[44] 335 F.2d 680 (3d Cir. 1964). *Lowery* was nonacquiesced by the Commissioner in 1972. 1972–2 Cum. Bull 3.

was compelled to sell by circumstances beyond his control. In *Joseph M. Crowe v. Commissioner,*[45] the taxpayer and X, a large, publicly-owned corporation, each became 50 percent shareholders in a land development corporation. At the time of incorporation, X insisted that it be given an option to purchase taxpayer's shares, so that X could obtain sole ownership in the event of disagreement. Although taxpayer was opposed to granting the option, he was compelled to do so by virtue of X's superior bargaining position. Later, during construction, dissension developed between taxpayer and X, and X exercised the option. The Tax Court held in favor of taxpayer because he was forced to sell by circumstances beyond his control. Taxpayer had no free choice when he granted the option and, of course, he retained no control once the option was given. It may be that the *Solow, Lowery* and *Crowe* cases stand only for the limited proposition that the "view" requirement is not met when a sale is made during the construction process by a person who is not in control of the corporation and who, because of circumstances arising after he became a shareholder, has no real freedom to choose to remain a shareholder. But the cases may also herald a generally more liberal approach by the courts. The trend may be towards finding that the "view" requirement is not met where an unanticipated circumstance motivates a sale or liquidation even though the circumstance and the intent arise during the construction process and, indeed, the sale itself takes place during the construction process. Further developments in this area are a virtual certainty.

The Service's attitude with respect to this question is not entirely clear. It nonacquiesced in *Lowery* indicating, in its broadest interpretation, that it was opposed to any exception to the "view" requirement when the sale is made during the construction process. Yet it later acquiesced in *Crowe,* indicating that *some* sales during the construction process may be free of the requisite view. Perhaps the rationale between the nonacquiescence in *Lowery* and the acquiescence in *Crowe* is the fact that in *Crowe* the taxpayer was completely without any control in refusing to sell, whereas in *Lowery*, the taxpayer's act of selling his shares involved some volition on his part. But the distinction on the facts is tenuous. (Interestingly, the Service neither acquiesced nor nonacquiesced in *Solow,* which probably lies midway between the other two cases with respect to the degree of volition on the taxpayer's part. There, it will be recalled, the taxpayer was not legally required to sell, but a refusal would have endangered either his purse or his body.) Without further elaboration by the Service, further litigation is inevitable.

[F]—". . . two-thirds of the taxable income to be derived from such property . . ." A fundamental requirement of collapsibility is that the corporation must be collapsed *prior* to the realization by the corporation of a *two-thirds* of the taxable income to be derived from the property manufactured, constructed, etc. A problem will frequently be presented in attempting to determine the amount of the total taxable income to be derived from a property. Obviously, in virtually all cases, the total will have to be estimated in some manner. Where the project consists of constructing and selling property—for example, single-family residences within a subdivision—the courts will ordinarily determine the total taxable income to be derived

[45] 62 T.C. 121 (1974), acq. 1974–2 Cum. Bull. 2.

by reference to the profit derived on the sales to the date of the collapse.[46] And any argument by the taxpayer that two-thirds has already been realized because business is not likely to be good in the future will not be persuasive unless the taxpayer can document his case, a fairly unlikely possibility. In brief, several courts have announced that they will not speculate pessimistically over the likelihood or unlikelihood of future profits.[47]

[G]—". . . gain attributable to such property." To fall within the collapsible proscription, a shareholder must realize gain which is attributable to the property manufactured, constructed, etc., by the corporation. The early litigation in the collapsible area centered largely around the taxpayer's contention that his gain was *not*, attributable to property constructed by the corporation.[48] Many of these cases were "excess mortgage" cases. For example, a corporation would be formed to build an apartment project to be financed by an FHA-insured mortgage. The shareholders would put in little or nothing. Apparently, it was not unusual in the immediate post-war years for builders to obtain FHA commitments substantially in excess of construction cost. In these instances, when the project was completed or substantially completed, and before the corporation had any earnings, the excess mortgage proceeds would be distributed out to the shareholders. The corporate distribution, to the extent it exceeded the shareholders' basis for their shares, would normally be taxed as long-term gain.[49] The Commissioner argued, however, that the collapsible provision applied to make the gain taxable as ordinary income. The issue in most of these cases was whether the gain was attributable to property constructed by the corporation.

The Government invariably won these "excess mortgage" cases and in the process it has been pretty well established that the phrase "gain attributable to such property" is to be broadly construed. If the gain would not have been realized by the shareholders *but for* the manufacture, construction, etc., by the corporation, then the gain is virtually certain to be attributable to the property so constructed.[50]

[H]—Statutory presumption of collapsibility. Since 1954 the collapsible section of the Code has contained a provision creating, in certain defined instances, a rebuttable presumption that the corporation meets the definition of a collapsible corporation.[51] This presumption applies if, at the time the corporation is collapsed the fair market value of its Section 341 assets[52] is (1) 50 percent or more of the fair market value of its total assets,[53] and (2) 120 percent or more of the adjusted basis

[46] See, for example, *Commissioner v. Zongker,* 334 F.2d 44 (10th Cir. 1964), and *Commissioner v. Kelley,* 293 F.2d 904 (5th Cir. 1961).

[47] *Spangler v. Commissioner,* 278 F.2d 665 (4th Cir. 1960); *Payne v. Commissioner,* 268 F.2d 617 (5th Cir. 1959); *Mintz v. Commissioner,* 32 T.C. 723 (1959).

[48] *Payne v. Commissioner,* 268 F.2d 617 (5th Cir. 1959); *Burge v. Commissioner,* 253 F.2d 765 (4th Cir. 1958); *Short v. Commissioner,*, 35 T.C. 922 (1961).

[49] See § 7.24 *above*.

[50] See, in addition to the cases cited in N. 48 *above, Braude v. Commissioner,* 35 T.C. 1162 (1961); *Gerber v. Commissioner,* 32 T.C. 1199 (1959).

[51] I.R.C. § 341(c). Relied upon in *Tobias v. Commissioner,* 40 T.C. 84 (1963).

[52] See § 14.41[2][c][ii][d]*above*.

[53] For this purpose, "total assets" does not include the corporation's cash, obligations which are capital assets to the corporation, most government obligations even though not capital assets, and stock in other corporations. I.R.C. § 341(c)(2).

of such Section 341 assets. In view of the difficult burden of proof imposed by the courts upon taxpayers who are trying to prove the noncollapsibility of their corporations, it is not likely that this statutory presumption will add greatly to taxpayers' woes.

[iii]—Limitations on adverse collapsible treatment. The second matter of fundamental importance in working with the collapsible rules is that there are certain statutory exceptions to collapsible *treatment* even though the corporation may admittedly be collapsible. That is, even though the definition of a collapsible corporation is clearly satisfied, the gain realized by a shareholder will *not* be converted from capital gain to ordinary income if one of the statutory exceptions applies.In many cases involving the closely held corporation, there will be reasonable assurance, for planning purposes, that the collapsible penalty will not apply *only if one of these statutory exceptions is applicable.*

[A]—Three-year limitation. Even though the corporation may be admittedly collapsible, the penalty will not apply on a shareholder sale or corporate liquidation to the extent of the gain realized after the expiration of three years following the completion of the manufacture, construction, etc., of the property.[54] For this purpose, the Treasury Department takes the position that the three-year period does not begin to run until the particular property or project is *completely* finished; substantial completion is not enough in the view of the Treasury Department.[55] The courts are somewhat equivocal on this point, but *apparently* will support the Treasury.[56]

In many instances, this exception will be an important planning tool. The liquidation or sale of shares of a corporation owning a shopping center or office building, or apartment project, may in some instances conveniently be postponed for a time until the three-year period has run. This is particularly true since an executory contract to sell shares in the future may be entered into during the three-year period, so long as the sale is not in fact effected until the expiration of the period.[57] This alternative

[54] I.R.C. § 341(d)(3). The period of a predecessor's ownership is tacked on if the corporation acquired the property in a wholly or partly tax-free transaction. Rev. Rul. 57–491, 1957–2 Cum. Bull. 232.

Rev. Rul. 70–93, 1970–1 Cum. Bull. 71, explains the method of computing the portion of the liquidating gain which is attributable to property constructed beyond the three year period.

[55] Treas. Reg. § 1.341–4(d); Rev. Rul. 56–137, 1956–1 Cum. Bull. 178. But see Rev. Rul. 63–114, 1963–1 Cum. Bull. 74, where minor alterations and corrections made after the completion of an office building in accordance with the plans and specifications were disregarded in determining when the three-year period began. See, also, Rev. Rul. 72–422, 1972–2 Cum. Bull. 211, which amplifies Rev. Rul. 63–114.

In *Computer Sciences Corp. v. Commissioner,* 63 T.C. 327 (1974), the Tax Court held that an intangible asset—in this case, computer programs for preparing tax returns—is fully constructed when it is reduced to commercial practice, even though modifications are made continuously thereafter.

[56] *Glickman v. Commissioner,* 256 F.2d 108 (2d Cir. 1958); *Sterner v. Commissioner,* 32 T.C. 1144 (1959). But cf. *Temkin v. Commissioner,* 35 T.C. 906 (1961), where, in holding that the view to collapse did not arise during construction, the Tax Court ignored the fact (or deemed it insignificant) that the lawn and landscaping were not completed until after the view arose.

[57] Rev. Rul. 67–100, 1967–1 Cum. Bull. 76.

is not likely to be feasible in the case of a corporation which owns a residential subdivision ready for sale.

[B]—The "subsection (e)" limitation. A second exception to collapsible treatment is couched in statutory terms which clearly take top prize for obscurity of meaning.[58] No attempt will be made in this treatise to unravel the garbled language of this limitation.[59] It will suffice for present purposes to state simply that the section applies if the unrealized appreciation in corporate assets which could be sold by the corporation or by certain shareholders only as ordinary income items does not exceed 15 percent of the corporation's total net worth, as adjusted in various ways. In working with this limitation, it is essential to have the precise facts and figures of a given situation and to analyze them in terms of each phrase of this difficult provision.[60]

[C]—The "5-percent shareholder" limitation. A third exception to collapsible treatment applies to a *particular* shareholder if he did not, at any time during the construction process or thereafter, own more than 5 percent in value of the corporation's stock, provided further that during such time none of his stock was attributable to a more-than-5-percent shareholder.[61] Both in testing the 5-percent ownership and in determining whether any of a shareholder's stock is attributable to another, very broad attribution ownership rules apply.[62]

This stock ownership limitation will rarely be helpful with respect to the closely held corporation. It suggests, however, a possible escape from collapsible treatment if the collapsible corporation can be disposed of by way of a tax-free reorganization. That is, if the stock or assets of a collapsible corporation are exchanged for stock of a publicly-held corporation in a transaction which is completely tax-free,[63] there can be no collapsible tax treatment by virtue of that exchange. Thereafter, if the shareholder does not own, after the application of attribution rules, more than 5 percent of the publicly-held corporation's stock, he will be able to dispose of such stock free of collapsible worries.[64]

[D]—The "70-percent" limitation. A fourth, and important, exception requires a little explanation. No matter how collapsible the corporation may be, a

[58] I.R.C. § 341(e)

[59] For a more detailed treatment of this limitation, see Cavitch, *Tax Planning for Corporations and Shareholders* (Matthew Bender & Co.), § 12.05.

[60] The principal purpose for the enactment of this complex limitation was to narrow the area in which the collapsible sections operated to convert into ordinary income what would have been capital gain even without the incorporation. The *"subsection (e)"* limitation does indeed limit this area, but does not eliminate it. See *Braunstein v. Commissioner,* 374 U.S. 65, 83 S. Ct. 1663 (1963).

[61] I.R.C. § 341(d)(1).

[62] Thus, for example, attribution of ownership applies for this purpose between brothers-in-law and sisters-in-law, as well as between various other relative by marriage.

[63] See § 12.22[4]—*above.* If the sale is tax-free, the collapsible status of the corporation which is sold does not make the transaction taxable. Rev. Rul. 73–378, 1973–1 Cum. Bull. 113.

[64] Also, it may be possible to conclude with reasonable assurance that the publicly held corporation is not collapsible in the first instance, in which event it would be unnecessary to meet one of the limitations in order to escape collapsible tax treatment.

particular shareholder will not be penalized at all unless more than 70 percent of *his*, gain is attributable to the assets which have made the corporation collapsible.[65] An example will be helpful.

> Suppose that X Corporation has been in existence for thirty years. For the first twenty-nine years it was engaged in a retail grocery business and did quite well, having accumulated a substantial amount of earned surplus. One year ago it invested a portion of its resources in the construction of a shopping center and before the construction was complete, it became obvious that the shopping center was worth a great deal more than it cost X Corporation to construct. The shareholders decide to sell their stock. There are two equal shareholders, A and B. A was one of the founders of the corporation; the cost basis for his shares is only $10,000. B purchased his shares one year ago, just before the shopping center construction commenced, and he paid $200,000 for his shares. Each of A and B realizes $300,000 for his shares and each would have realized $200,000 if the shopping center had never been constructed. On these facts, shareholder A would realize a total profit of $290,000 but only $100,000 of that profit is attributable to the collapsible property. Since the portion of his gain which is attributable to collapsible assets is less than 70 percent, no part of his profit will be ordinary income. By contrast, shareholder B realizes a profit of $100,000 and all of it is attributable to the collapsible property. All of his profit will be ordinary income.

The point is that this 70-percent test is applied to each shareholder separately, and it requires a computation of the percentage of *his*, profit which is attributable to the collapsible assets—that is, a computation based upon the difference between the profit actually realized and what would have been realized by him if the corporation had not manufactured, constructed, etc., the relevant collapsible property.

The applicability of this 70-percent test should be contrasted in one important respect with the "two-thirds of taxable profit" portion of the collapsible definition.[66] The corporation will be noncollapsible if at least two-thirds of the profit anticipated *from the particular project as to which the requisite view* exists has been realized by the corporation. Corporate profits previously realized from completed projects as to which no view to collapse was present are of no consequence for this purpose. Suppose, for example, that a corporation has $1,000,000 of earned surplus. It embarks upon an entirely new project, the construction and sale of houses, upon which the entire profit will be $100,000. Prior to the completion of the project, the shareholders decide to collapse the corporation. At the time when the corporation is collapsed, it has already realized $20,000 of the anticipated $100,000 profits. The corporation will be collapsible notwithstanding that the corporation's total earned surplus at the time it is collapsed is $1,020,000 and its unrealized profit is only $80,000. The relevant fact for this purpose is that *with respect to the collapsible property* (the property as to which the requisite view exists), only 20 percent of the profit has been realized by the corporation.[67]

By contrast, some or all of the shareholders may be free of the collapsible penalty by virtue of the 70-percent limitation even though the corporation is collapsible. In

[65] I.R.C. § 341(d)(2).

[66] See § 14.41[2][c][ii][f]*above*.

[67] See Treas. Reg. § 1.341–2(a)(4).

applying the 70-percent limitation, only the shareholder gain which is attributable to noncollapsible property is helpful. Not only does the unrealized profit count against the shareholder, *so also does the realized profit which is attributable to the collapsible property.* In our prior example, the entire $100,000 profit—realized and unrealized—will count against the shareholder. Only the shareholder gain attributable to the $1,000,000 of corporate earnings derived from prior completed projects as to which no collapsible view existed will be considered as noncollapsible gain.[68]

[E]—The "consent" limitation applicable to sales. The collapsible statute was amended in 1964 to provide for a new, and relatively simple, exception to collapsible treatment. With respect to *sales* of stock, but not to corporate liquidations, any recognized gain will not be converted to ordinary income if the corporation consents to the recognition of gain to it on any subsequent disposition (whether in liquidation, sale, transfer as a dividend, or otherwise[69]) of certain assets owned by it at the time of the stock sale.[70] The assets to which the subsequent corporate tax will apply are any assets which are not capital assets of the corporation, and any real property and unrealized receivables of fees (whether or not such real property and receivables or fees are capital assets).[71] If the requisite consent is made by the corporation, this limitation will apply whether the stock sold is all or a part only of the total outstanding shares. If the consent is filed, the corporation will be taxed on the subsequent disposition of certain assets, even though it might later be determined that the corporation was not collapsible in the first instance. Before 1987, this latter consequence could prove very costly to the corporation since many dispositions which are now tax-recognized in any event were otherwise tax-free. This was generally true of liquidating distributions, and in certain limited circumstances was also true of some dividends in kind and transfers in redemption of stock. Under current, post-1986 law, however, these various dispositions by a corporation are tax-recognized to the corporation in any event, so that relief to the shareholders under subsection (f) is not likely to impose a significant added burden on the corporation.

§ 14.42—Special tax-free rule on liquidation of controlled subsidiary.

The tax treatment to a corporate parent on the complete liquidation of a controlled subsidiary is in a pigeonhole by itself.[72] The liquidation of a controlled subsidiary will occasion no tax whatever, nor give rise to a deductible loss, to the recipient parent corporation if certain requirements are met.

[1]—Distribution by subsidiary must be with respect to "stock". The distribution of assets from the subsidiary to the parent must be ". . . in complete

68 Treas. Reg. § 1.341–4(c)(4).

69 The consenting corporation will not be taxed, however, on subsequent dispositions to another corporation if such disposition is pursuant to certain tax-free transactions, and if the transferee consents to have taxable gain recognized to it when it subsequently disposes of the assets. I.R.C. § 341(f)(3).

70 I.R.C. § 341(f).

71 I.R.C. § 341(f)(4).

72 I.R.C. § 332. This tax-free rule applies even if the corporate parent is an S corporation. I.R.C. § 1371(a), as amended by the Small Business Job Protection Act of 1996.

cancellation or redemption of all its stock . . .” in order for the tax-free rule of I.R.C. Section 332 to apply.[73] If the subsidiary is insolvent, Section 332 does not apply because there can be no distribution with respect to the subsidiary's "stock." If the parent corporation is a creditor, any distribution to the parent will be treated as a partial payment of the subsidiary's debt, with a capital loss for the balance of the debt and for the worthlessness of the stock.[74] If the parent corporation forgives the debt owing to it by its subsidiary, immediately prior to the liquidation, in order to make the subsidiary solvent, the prior forgiveness will be ignored, at least by the Service.[75]

If the subsidiary corporation has both common and preferred stock outstanding, the liquidating distributions must exceed the full preference of the preferred stock in order for the tax-free rule of Section 332 to apply.[76] This is so, according to the Tax Court, because the statute requires that the liquidating distributions must be in complete cancellation or redemption of "all its stock." If the preferred stock absorbs the full distribution, no distribution is made in cancellation or redemption of "all" of the subsidiary's stock.

[1A]—Parent corporation must have statutory 80-percent control. The parent corporation must, on the date of the adoption of the plan of liquidation and thereafter until the receipt of the liquidating distribution, be the owner of stock which possesses at least 80 percent of the total voting power of the outstanding stock, and which has a value equal to at least 80 percent of the outstanding stock.[77] For this purpose, however, the usual kind of preferred stock is not counted as stock at all.[78] Thus, preferred stock which is nonvoting, is limited and preferred as to dividends and does not participate in growth to any significant extent, has redemption and liquidation rights which do not exceed the paid-in capital or par value (except for a reasonable redemption premium), and is not convertible into another class of stock, is not counted. For example, if the subsidiary corporation has two classes of stock outstanding, one the usual voting common stock, and the other a typical kind of nonvoting preferred stock, this ownership requirement will be met if the parent corporation owns at least 80 percent of the common stock, even though it owns none of the preferred. On the other hand, if the second class of stock is a nonvoting common stock, then the corporate parent must own at least 80 percent of the voting common and a sufficient amount of the total outstanding stock to equal at least 80 percent in value of both classes.

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[73] I.R.C. § 332(b)(2).

[74] Treas. Reg. § 1.332-2(b); I.R.C. § 165(g). *See* Rev. Rul. 70-489, 1970-2 Cum. Bull. 53; and *Continental Grain Co. v. Commissioner,* 56 T.C.M. 900 (1988), *reconsideration denied,* 57 T.C.M. 57 (1989).

[75] Rev. Rul. 68-602, 1968-2 Cum. Bull. 135.

[76] *H.K. Porter Co. v. Commissioner, Inc.,* 87 T.C. 689 (1986).

[77] I.R.C. § 332(b)(1), as amended by the Tax Reform Act of 1986. A parent corporation which owns less than the required percentage of stock may acquire additional shares or cause its subsidiary to redeem some of its outstanding shares in order to bring its stock ownership to the required minimum, provided that the "plan" of liquidation is not adopted until the parent possesses that minimum. But sometimes a close question can be presented as to whether the plan of liquidation is adopted prior to the formal resolution of shareholders. See, for example, *George L. Riggs, Inc. v. Commissioner,*, 64 T.C. 474 (1975), acq. 1976–2 Cum. Bull. 2, which held favorably for the taxpayer.

[78] The ownership requirement, for this purpose, is defined in I.R.C. § 1504(a)(2). The type of preferred stock that is excluded is defined in I.R.C. § 1504(a)(4).

[2]—Liquidation must be effected within the taxable year. The liquidating distributions must be effected "within the taxable year."[79] Although neither the Code nor the Regulations define what is meant by "the taxable year," a published ruling takes the position, probably correctly, that the taxable year in which the distributions must be made is the first taxable year in which the first liquidating distribution is made.[80] Thus, "the taxable year" is not necessarily the taxable year in which the plan of liquidation is adopted. If a valid reason exists for postponing all distributions to a later taxable year than the year in which the plan is adopted, the postponement will not make this special tax-free rule inapplicable. And, according to a later ruling, it is the liquidating subsidiary's taxable year, not the parent's, which is relevant.[81]

[3]—Alternative requirement for timing liquidation. As an alternative to the requirement set forth in [2]—above, the liquidating distributions may be made over a period ending no later than three years from the close of the taxable year during which the first of the series of distributions under the plan of liquidation is made.[82] If this three-year alternative is relied upon, however, care must be taken to make certain that the parent corporation continues to be qualified under the stockholding requirement set forth in [1]—above, throughout the period. In addition, the parent corporation is required to file a waiver of the statute of limitations, extending the period for the assessment of a deficiency if it develops that the liquidation is not tax-free.[83] Also, the Commissioner may require the parent corporation to file a bond assuring prompt payment of all additional income tax occasioned by a failure to meet the requirements of a tax-free liquidation.[84] Needless to say, it is generally preferable, if possible from a practical standpoint, to qualify under the "taxable year" requirement than to incur the added problems and difficulties of a three-year liquidation.

[4]—Tax-free treatment is mandatory if requirements are met. If the various requirements for the tax-free liquidation of a controlled subsidiary are met, the tax-free treatment automatically follows;[85] it is not elective with the taxpayer. If, however, it is desired for basis purposes or otherwise to effect a taxable liquidation, the parent corporation may be able to deliberately avoid qualifying under the requirements of a tax-free liquidation by selling a portion of its shares in the subsidiary prior to the adoption of the plan of liquidation or prior to the receipt of the subsidiary's property.[86]

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[79] I.R.C. § 332(b)(2). There is no provision in Section 332 permitting the liquidating corporation to retain assets to pay debts. See also Rev. Rul. 66–186, 1966–2 Cum. Bull. 112.

[80] Rev. Rul. 71–326, 1971–2 Cum. Bull. 177.

[81] Rev. Rul. 76–317, 1976–2 Cum. Bull. 98.

[82] I.R.C. § 332(b)(3).

[83] Treas. Reg. § 1.332–4(a)(2).

[84] Treas. Reg. § 1.332–4(a)(3).

[85] It is not likely that a business purpose requirement must be met for a tax-free liquidation of a subsidiary. See *Distributors Fin. Corp. v. Commissioner,* 20 T.C. 768 (1953), acq., 1954–2 Cum. Bull. 4. It is immaterial whether or not the parent corporation continues the business formerly conducted by the subsidiary. If the requirements of I.R.C. § 332 are met, the liquidation is tax free to the parent in either event. Rev. Rul. 70–357, 1970–2 Cum. Bull. 79.

[86] *Commissioner v. Day & Zimmermann, Inc.,* 151 F.2d 517 (3d Cir. 1945); *Granite Trust Co. v. United States,* 238 F.2d 670 (1st Cir. 1956).

§ 14.43—Basis of assets received in liquidation.

The tax basis of property acquired by a shareholder on the complete liquidation of a corporation depends upon the tax treatment properly accorded the shareholder.

[1]—When shareholders have received sale or exchange treatment. Under the usual kind of tax treatment of the recipient shareholder, the shareholder computes his gain or loss the same as though he had sold his shares to another for an amount equal to the cash and fair market value of assets received from the corporation.[87] Since the fair market value of the assets received is used in the computation of the shareholder's gain or loss, it follows that the same fair market value will be the tax basis attaching to the assets so received.[88]

[2]—When shareholders elected treatment under former Section 333. Before 1987 an elective tax treatment was often available to shareholders who received a liquidating distribution in a so-called "one-month liquidation."[89] Under this elective treatment a part or all of the gain realized by a shareholder was not recognized. Since this election has not been available for several years, it is no longer discussed in this treatise. As a corollary to that nonrecognition rule, however, the basis of the assets received by the shareholder was determined differently from the "fair market value" rule discussed in the preceding subdivision. Although that basis determination is no longer relevant to current transactions, its effect will linger on for many years for assets received before 1987 (or before 1989 in certain instances), and subject to this elective treatment. For that reason a brief discussion of the method of determining basis in a so-called "one-month liquidation" may be helpful.

If the shareholder realized a loss on the liquidation, the basis of the assets is determined under the usual fair market value rule. If, however, the shareholder realized a gain, the basis is determined under the so-called "substituted basis" rule. That is, the basis of the assets received is the same as the basis of the stock surrendered.[90] Further adjustments are then made as follows in order to determine the basis of noncash assets:

(1) The amount of cash received by him is subtracted from his stock basis.

(2) The amount of any gain taxed to him on account of the liquidation is added to his stock basis.

(3) Any unsecured liabilities assumed, or taken subject to, by the shareholder are added to his stock basis.

(4) The stock basis, adjusted in this manner, is then allocated to the various noncash assets received by him in proportion to the fair market value of each such asset, net of any encumbrance on any asset. Thus, if encumbered

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[87] See § 14.41 *above*.

[88] I.R.C. § 334(a).

[89] Former I.R.C. § 333, repealed by T.R.A. 1986. For certain small, closely held corporations, a transitional rule made this elective treatment available through 1988.

[90] Former I.R.C. § 334(c), repealed by T.R.A. 1986.

property is received by the shareholder, it is only the fair market value of his equity which is relevant at this point.

(5) To an asset on which there is an encumbrance there is then added the amount of the encumbrance whether it is assumed by the shareholder or whether the property is taken merely subject to the encumbrance.

[3]—When controlled subsidiary has been liquidated. When a controlled subsidiary is liquidated into the parent corporation,[91] the parent corporation takes over the same tax basis in the acquired assets as the subsidiary had immediately prior to the liquidating distribution (a "carry-through basis").[92] This basis rule can give rise to some interesting possibilities. Suppose, for example, that a parent corporation owns all of the stock of a subsidiary corporation. The parent's cost basis of the stock is $100,000, but the subsidiary has net assets with a basis to it of $200,000. The parent corporation has an opportunity to sell for $300,000 either the subsidiary's stock or the subsidiary's assets. If the parent corporation sells the subsidiary's stock, it will realize a taxable gain of $200,000. If, however, it causes the subsidiary to sell its assets, the subsidiary will realize a gain of only $100,000, and a subsequent liquidation of the subsidiary will pass its assets (being the proceeds of sale) up to the parent tax-free. Similarly, if the parent corporation liquidates the subsidiary in a tax-free transaction prior to the sale, the tax basis of the subsidiary's assets will carry through to the parent; the subsequent sale by the parent of those assets will give rise to the same taxable gain of only $100,000.[93]

§ 14.5—Tax Effect to Liquidating Corporation of Complete Liquidation.

Prior to 1987, some of the more intricate problems in the entire field of corporate tax planning were presented when corporate management contemplated a complete liquidation. This was largely attributable to the varying tax treatment to the liquidating corporation when it sold its assets in the process of winding up, or distributed its assets in kind to its shareholders. Since 1987, however, the rules are more simple, the choices are more restricted, and the need for imaginative planning has been lessened. We shall pause for a moment in order to recall, briefly, the past.

§ 14.51—Introduction: a brief history.

Before 1954, the applicable rules were also fairly simple. If a corporation distributed its assets to its shareholders in complete liquidation, the corporation did not recognize gain or loss with respect to those assets.[1] That is, if the fair market value of an asset

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[91] See § 14.43 *above,* for a description of the "controlled subsidiary" liquidation.

[92] I.R.C. § 334(b).

[93] Actually, since 1987, this same tax result can be achieved if the parent corporation sells the stock of the subsidiary and an election is filed under Regulations yet to be issued, to treat the transaction as a sale of the subsidiary's assets. I.R.C. § 336(e), added by the Tax Reform Act of 1986.

§ 14.5

[1] This is the so-called *"General Utilities* rule," a term that acquired notoriety during the debate attending the progress of the bill which became the Tax Reform Act of 1986. It is named after *General Utilities & Operating Co. v. Helvering,*, 296 U.S. 200, 56 S.Ct. 185 (1935).

was greater or less than its adjusted basis to the corporation, that unrealized gain or loss was not recognized on account of its mere distribution to shareholders. If, however, the corporation sold its assets prior to liquidating, any gain or loss that it realized on the sale was fully recognized for tax purposes even though the sale was incident to a complete liquidation. This different tax treatment for distributions and sales led to imaginative tax planning. When a corporation's assets were to be sold incident to a complete liquidation, sophisticated tax planning dictated that the corporation be liquidated first, followed by a sale of assets by the shareholders. The shareholders would pay a tax on account of the receipt of the assets,[2] and would obtain a stepped-up basis for the assets.[3] They would then sell the assets to the intended purchaser without any further gain. By thus reversing the normal order of sale followed by a liquidation, a double-taxed transaction would be converted into a single-taxed transaction.[4] Ingenuity would triumph.

But the technique was not universally understood, and always involved an element of risk. So Congress enacted former I.R.C. Section 337 in 1954 in order to remove the inordinate premium on sophisticated and successful tax planning. Section 337 was intended to establish a relatively simple rule whereby the straightforward sale of assets by the corporation itself, followed by a liquidation, would have the same tax effect as the liquidation of the corporation first, followed by a sale of assets. And it was largely successful. Section 337 quickly became one of the most important and beneficial factors involved in planning and executing a sale of corporate assets.

Gradually, however, in the years between 1954 and 1987, the pendulum began swinging in the opposite direction. Both Congress and the courts evidenced an increasing concern for the deep inroads that the nonrecognition rules incident to a liquidation, and sales incident to a liquidation, made in the double tax pattern of corporate taxation. This concern was particularly directed at the opportunities created for a corporation to obtain tax deductions at ordinary income tax rates on account of its normal operations, and then, by liquidating, to transfer its assets to a purchaser who would again obtain ordinary income tax deductions, with only the price of a single, favorably taxed capital gain to the shareholders. Thus, Congress chipped away at these favorable rules by subjecting liquidating distributions and sales to the recognition of depreciation recapture income. And the courts chipped away at these favorable rules by requiring the recognition of income when previously expensed assets (for example, small tools and supplies) were distributed or sold,[5] and when an asset that represented income earned but not yet recognized was distributed or sold.[6] These, and other, exceptions to the nonrecognition rule incident to distributions and sales in complete liquidation brought the law more into a philosophical accord with the double tax pattern of corporate taxation. But the opportunity available on the complete liquidation of a

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[2] See § 14.41 *above*.

[3] See § 14.44[1]*above*.

[4] *United States v. Cumberland Public Service Co.,*, 338 U.S. 451, 70 S. Ct. 280 (1950).

[5] See *Commissioner v. Anders,* 414 F.2d 1283 (10th Cir. 1969), holding that the sale of expensed assets give rise to recognized income notwithstanding the applicability of former I.R.C. § 337; and *Hillsboro Nat'l Bank. v. Commissioner,* 460 U.S. 370, 103 S. Ct. 1134 (1983), holding that the liquidating distribution to shareholders of expensed assets gave rise to recognized income.

[6] See, simply as an example, *Midland-Ross Corp. v. United States,* 335 F.2d 561 (6th Cir. 1964).

corporation to avoid the corporate tax remained a powerful planning tool. This was especially true with respect to appreciated inventory and to depreciable real and personal property to the extent that the depreciation recapture rules did not apply.[7]

In 1986, Congress was driven by a zeal to eliminate tax inconsistencies (sometimes referred to as "loopholes") in order to help pay for sharply reduced individual and corporate tax rates. In this zeal, the double tax pattern of corporate operation was imbued with a purity it had never previously had. The basic rule of former I.R.C. Section 337 was revoked. Beginning in 1987, generally, the fundamental rule is that a liquidating corporation recognizes gain or loss on either the sale or the distribution of assets just as though it had sold those assets for their fair market value.

§ 14.52—The general rule: gain or loss is recognized.

If a corporation sells an asset in the process of liquidating, the gain or loss is recognized as it is with any sale. The exception to that usual treatment which was once provided by former I.R.C. Section 337 does not apply after 1986.[8] Similarly, if a corporation distributes an asset to a shareholder in the process of liquidating, it recognizes gain or loss just as though it had sold the asset to the distributee for an amount equal to its fair market value.[9] The character of the gain or loss, whether ordinary or capital, is determined by the nature of the asset. Thus, gain or loss on inventory assets will be ordinary. So, also, will any gain that is attributable to depreciation recapture.[10] Similarly, if the distributee owns directly or by attribution more than 50 percent in value of the corporation's outstanding stock, all of the gain (not simply the amount attributable to depreciation recapture) recognized by the corporation will be characterized as ordinary income.[11] If any asset that is distributed is encumbered by a liability, it is treated as having a fair market value not less than the amount of the liability. Accordingly, if the liability is greater than the adjusted basis of the asset, the corporation will recognize taxable gain to the extent of the difference even though the asset may have a lower value.[12]

[7] This same opportunity to avoid corporate tax on appreciation in value accruing during the corporate life was available to corporate purchasers of stock of the target corporation. This was true, under pre-1987 law, because the corporate purchaser could file a basis election under I.R.C. § 338, and the taxability of the hypothetical sale by the target corporation of its assets was governed by former I.R.C. § 337. The basis election is still available to a corporate purchaser under I.R.C. § 338, but the repeal of I.R.C. § 337 makes such an election more costly to the purchaser. See § 12.53 *above*.

[8] With a few transitional exceptions which are no longer relevant for planning purposes. See Tax Reform Act of 1986, § 633(c) and (d).

[9] I.R.C. § 336. This same rule applies with respect to installment obligations that are reported on the installment method; that is, the distribution in liquidation accelerates the recognition of gain to the corporation just as though the corporation sold the installment obligation for an amount equal to its fair market value. I.R.C. § 453B(a). If, however, the liquidating corporation is an S corporation and the installment obligation arose on account of a sale by the corporation after it adopted a plan of liquidation, an exception to acceleration may apply. See § 12.22[6]*above*.

[10] See § 12.22[7]—*above,* for a brief summary of depreciation recapture.

[11] I.R.C. § 1239. The attribution of ownership rules are those that are set forth in I.R.C. § 267, with certain modifications. See I.R.C. § 1239(c)(2), as amended by the Tax Reform Act of 1986.

[12] I.R.C. § 336(b).

Gain or loss is recognized on the distribution of "property." Although the statute does not define "property" for this purpose, it almost certainly means any asset, whether tangible or intangible. Clearly, this broad definition of "property" applies in the computation of gain or loss to the shareholder who receives a liquidating distribution,[13] and there is no reason why the definition should be any different in determining the corporation's gain or loss. Thus, if a going business is transferred intact to its shareholders, any intangible value in the nature of goodwill, or going concern value, will give rise to taxable gain to the corporation to the extent that value exceeds the corporation's cost, if any. Similarly, if the corporation distributes contract rights, or uncompleted work, or rights to income that has already been earned, the fair market value of these intangible rights will give rise to taxable income.[14]

§ 14.53—Exceptions to the general rule.

The current law relating to liquidating sales and distributions is more simple than pre-1987 law. But there are still exceptions to the general rule. Some distributions in liquidation do not give rise to recognized gain or loss. Unlike the case with respect to pre-1986 law, however, these exceptions are limited and narrow.

[1]—Nonrecognition of certain losses. If all losses incident to a liquidating distribution were recognized, the rule could be abused. Artificial losses could be created, or a single loss at the shareholder level could be converted into a double loss at both the corporation and shareholder level. Accordingly, there are two general limitations on the recognition of loss.

[a]—Distribution to Related Party. If a liquidating distribution is to a shareholder who owns, actually and/or constructively, more than 50 percent in value of the corporation's stock,[15] the distribution will not give rise to recognized loss at the corporate level unless (i) it is pro-rata to all shareholders, and (ii) the distributed property was not acquired by the corporation during the preceding five years as a contribution to capital or in a transaction which was tax-free to the transferor under I.R.C. Section 351.[16] Unless both of these conditions are met, the distribution does not give rise to recognized loss to the distributing corporation.[17]

[b]—Sale or distribution of certain recently acquired property. Irrespective of the amount of stock owned by any of the shareholders, the recognized loss to the corporation on account of either the sale or the distribution incident to a liquidation will be reduced in certain circumstances. Thus, if the sold or distributed property was acquired by the corporation as a contribution to capital or in a transaction to which I.R.C. Section 351 applied, and the acquisition was part of a plan a principal purpose of which was to recognize loss by the liquidating corporation with respect to

[13] See § 14.41 *above*.

[14] This was true under the old law by virtue of judicial inroads on the "*General Utilities* rule." See n.6 *above*. Under current law, I.R.C. § 336 requires the same result.

[15] In other words, the shareholder is a related party within the meaning of I.R.C. § 267.

[16] For a discussion of I.R.C. § 351 transactions, see § 2.22[2]*above*.

[17] I.R.C. § 336(d)(1).

the property in connection with the liquidation, the recognized loss will be reduced.[18] The reduction in loss will be the excess of the basis of the property immediately after its acquisition over the fair market value at that time.

> **Example:** A owns all of the stock of X corporation which manufactures and sells widgets in New Jersey. A had purchased unimproved land in Arizona in 1980 for $100,000, which is worth only $10,000 on June 1, 1987. The land has no relationship to X's business. A wishes to sell the land. If he sells it personally, he will have a capital loss of $90,000. Instead, A contributes the land on June 1, 1987 to X with the thought that he can thereby double the loss by liquidating X. That is, he intends that X will acquire his basis of $100,000 by virtue of the tax-free contribution, and A's basis in his stock will be increased by $100,000, so that by liquidating X the corporation will have a $90,000 capital loss and A will still have the $90,000 loss at the personal level. Six months later, X adopts a plan of liquidation and sells the land for $10,000. Contrary to A's expectations, X's loss will be reduced by $90,000 to zero.[19]

[2]—Liquidation of controlled subsidiary. The liquidation of a controlled subsidiary is tax-free to the parent corporation.[20] As a corollary to that rule, the basis of the subsidiary's assets carries through to the parent.[21] The transaction is treated at the parent level for what it really is; namely, the retention of the subsidiary's assets in the same corporate solution as before. This same realistic analysis applies at the subsidiary level. The subsidiary's assets have not been disposed of outside the same corporation, and there is therefore no recognition of gain or loss to the liquidating subsidiary.[22] If the subsidiary is indebted to the parent, and some of its assets are distributed to the parent in satisfaction of the debt, the same nonrecognition rule applies.[23] If, however, the subsidiary has minority shareholders, any distribution to them of an appreciated asset will give rise to recognition of gain to the liquidating corporation, but a distribution to minority shareholders of a depreciated asset will not give rise to recognition of loss.[24]

[3]—Part of tax-free reorganization or split-up. A corporate liquidation might be a part of a larger transaction that qualifies as a tax-free reorganization or tax-free split-up. Thus, in a tax-free asset sale, the selling corporation will sell substantially all of its assets solely for voting stock of the purchasing corporation or

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[18] I.R.C. § 336(d)(2). If the property was so acquired within two years prior to the adoption of the plan of liquidation, it will be presumed to be acquired pursuant to a tax-avoidance plan. Treasury Regulations to be issued will set standards for rebutting this presumption. See I.R.C. § 336(d)(2)(B)(ii).

[19] This example is taken substantially from the Conference Committee Report accompanying the enactment of the Tax Reform Act of 1986.

[20] See § 14.43 *above*.

[21] See § 14.44[3]*above*.

[22] I.R.C. § 337(a). Also, any gain inherent in an installment obligation that is distributed to the parent in the liquidation is not accelerated and taxed to the liquidating subsidiary. I.R.C. § 453B(d).

[23] I.R.C. § 337(b).

[24] I.R.C. § 336(d)(3). This is the same rule that would apply if the distribution of property to the minority shareholders were a distribution in redemption of their stock, not a complete liquidating distribution. See § 9.36 *above*.

its parent.[25] As a part of the plan, the selling corporation will liquidate and distribute the purchaser's stock and any retained asset to its shareholders. If the transaction is wholly tax-free to the shareholders of the selling corporation, the liquidating distribution will be wholly tax-free to the selling corporation.[26] If the retained asset constitutes boot, taxable as such to the shareholders,[27] the liquidating corporation will recognize gain or loss with respect to that asset. Similarly, one method of dividing a corporation is the complete liquidation of a corporation that owns only the stock of one or more controlled subsidiaries, a so-called "split-up."[28] If the split-up is wholly tax-free to the shareholders of the liquidating corporation, the liquidating distribution will be wholly tax-free to the liquidating corporation. If the split-up is partly taxable, the liquidating corporation will have recognized gain or loss with respect to the distribution of boot.

§ 14.6—The Reincorporation Pitfall.

Occasionally a complete liquidation will be utilized by taxpayers as a step in a plan whereby the operating assets of the business nevertheless end up still in corporate solution. In some such instances, particularly where the tax treatment of a complete liquidation is favorable to the taxpayers, the Internal Revenue Service may successfully contend that no complete liquidation occurred at all, with adverse tax consequences to the taxpayers.

Suppose, for example, that a corporation has assets having a total value of $200,000, of which $100,000 represents assets essential to the business, and $100,000 represents cash and marketable securities. The corporation has over $100,000 of earnings and profits.[1] The sole shareholder has a cost basis of $160,000 for his shares. The shareholder would like, not surprisingly, to withdraw from the corporation as a dividend distribution to him the $100,000 of unneeded assets were it not for the income tax which would be occasioned thereby. After being apprised of the usual tax treatment of complete liquidations,[2] he concludes that his corporation should be completely liquidated. He will have a gain of $40,000 (the difference between his share basis of $160,000 and the $200,000 value of the corporate assets), and his tax is likely to be approximately $11,200, a reasonable price to pay for placing the unneeded liquid assets in his pocket. If, however, it is important that the working assets be operated in corporate form, and the shareholder therefore contemporaneously transfers the working assets to a newly formed corporation, the transaction will almost certainly be characterized either as a tax-free reorganization[3] or as a dividend distribution by a

[25] For a discussion of the tax-free asset deal, see § 12.4 *above*.

[26] I.R.C. § 336(c).

[27] For an explanation and discussion of boot, see § 12.8 *above*.

[28] For a discussion of the tax-free split-up, see ch. 11 *above*.

§ 14.6

[1] See § 7.22 *above,* for the definition of "earnings and profits" and § 7.21 *above,* for the relevance of the term.

[2] See § 14.41 *above*.

[3] I.R.C. § 368(a)(1)(D).

continuing corporation.[4] In the latter event, the $100,000 of assets retained by the shareholder will be fully taxed to him.[5]

The reincorporation problem is not limited to those situations where working assets are retransferred to a corporation contemporaneously with, or subsequent to, a liquidating distribution. The same effect and the same disadvantageous tax treatment can result where the corporation donates or sells its working assets to another corporation owned by substantially the same shareholder and then liquidates.[6] Whether the working assets are transferred to a different, but related, corporation before or after the liquidation, the net effect is the same: the business assets are still operated in corporate form and unneeded assets are in the shareholders' pockets.

Although the withdrawal of assets from the corporation is the objective most often associated with the reincorporation problem, there are other possible objectives as well. Thus, the shareholders may be motivated by a desire to step up the depreciation base for the corporation's depreciable property. Or the shareholders may wish to realize a tax loss by virtue of their share basis being higher than the value of the corporate assets. In these events, little or no assets may be retained by the shareholders, but if the revenues would be increased by a characterization of the transaction as something other than a complete liquidation, the IRS may be expected to make the attack.

There is no longer any question but that in appropriate cases, a transaction cast in the form of a complete liquidation will be characterized and taxed in a manner different from that anticipated by the taxpayers.[7] The difficult problem that remains is to determine in which instances a recasting of the transaction is "appropriate." In this connection, two questions are most often suggested: (1) Is there a "safe" time interval between the liquidation and reincorporation? (2) Is there a reincorporation problem if the shareholders of the continuing corporation are somewhat different from those of the liquidated corporation? Unfortunately, the answer to neither question is relatively certain.

If the subsequent reincorporation is not a planned step in a series of transactions which begins with the liquidation, the reincorporation doctrine will not apply. In one case, the Tax Court held that a complete liquidation was, in fact, a complete liquidation when the reincorporation did not occur until nine months later.[8] Although the IRS promptly acquiesced in that decision, it is by no means safe to assume that a time

[4] Treas. Reg. §§ 1.301–1(1) and 1.331–1(c).

[5] See *Bard-Parker Co. v. Commissioner,* 218 F.2d 52 (2d Cir. 1954), *cert. denied* 349 U.S. 906; and *Survaunt v. Commissioner,* 162 F.2d 753 (8th Cir. 1947); but cf. *United States v. Arcade Co.,* 203 F.2d 230 (6th Cir.), *cert. denied* 346 U.S. 828 (1953). If the transaction is characterized as a reorganization, the retained assets will be treated as boot, taxable as ordinary income to the extent of the corporation's earnings and profits or the amount of gain realized by the shareholder, *whichever is less.* See ch. 12, *Purchase and Sale of a Corporate Business*. If the transaction is characterized as a garden-variety dividend distribution, the only limitation on the amount of the dividend is the corporation's earnings and profits. In appropriate cases, the difference can be substantial. See *Adams v. Commissioner,* and *Bazley v. Commissioner,* 331 U.S. 737, 67 S. Ct. 1489 (1947).

[6] *Liddon v. Commissioner,* 230 F.2d 304 (6th Cir. 1956); *Commissioner v. Morgan,* 288 F.2d 676 (3d Cir. 1961); *Lewis v. Commissioner,* 176 F.2d 646 (1st Cir. 1949).

[7] See cases cited in nn. 5 and 6, *above.*

[8] *Mathis v. Commissioner,* 19 T.C. 1123 (1953), acq., 1953–2 C.B. 5.

interval of several months will, in itself, assure treatment as a complete liquidation. Similarly, if the later of the liquidation or the reincorporation is occasioned by events which were unanticipated at the time of the earlier transaction, the reincorporation doctrine is not likely to apply.[9] Thus, where the two transactions are not parts of a single plan, that fact is a good defense to the attempted application by the IRS of the reincorporation doctrine. But, obviously, for planning purposes it is impossible to rely on the subsequent occurrence of an unanticipated event.

Even where the liquidation and incorporation are parts of a single plan, adverse tax characterization should not be applicable where the corporation which acquires the assets of the liquidated corporation is more than 50 percent owned by persons who were not shareholders in the old corporation. That is, where new shareholders owning more than 50 percent of the shares of the new corporation are brought in, an attempt to characterize the entire transaction as a tax-free reorganization is made much more difficult. This is so because the IRS's victories in this area have usually been predicted on the ground that the entire integrated transaction constitutes a "D" reorganization.[10] In this type of transaction, a "D" reorganization is effected only when some or all of the shareholders of the old corporation continue to own at least 50 percent of the stock of the new corporation.[11] In determining stock ownership for this purpose, broad attribution of ownership rules are applied.[12] Thus, if new shareholders, not related to the old shareholders within the meaning of the applicable attribution of ownership rules, are brought into the new corporation to the extent of more than 50 percent, the transaction cannot be characterized as a "D" reorganization.

It should be noted, however, that for advance ruling purposes, the IRS's position is more restrictive than the statutory language. Under the IRS's current ruling policy (October, 1994), it will not "ordinarily" grant a favorable ruling on a reincorporation transaction when more than 20 percent in value of the stock of the ongoing corporation is owned by persons who owned more than 20 percent in value of the stock of the liquidated corporation.[13]

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[9] *Simon v. United States,* 402 F.2d 272 (Ct. Cl. 1968); *Kind v. Commissioner,* 54 T.C. 600 (1970), acq., 1970–2 C.B. __ *Swanson v. United States,* 479 F.2d 539 (9th Cir. 1973).

[10] That is, a reorganization as defined in I.R.C. §§ 368(a)(1)(D), 354(b)(1), and 368(a)(2)(H). See, for example, *Moffatt v. Commissioner,* 363 F.2d 262 (9th Cir. 1966), and *Mark E. Degroff,* 54 T.C. 59 (1970.)

[11] With respect to transactions prior to July 19, 1984, the definition of a "D" reorganization, for this purpose, required that some or all of the old shareholders end up with at least 80 percent of the stock of the ongoing corporation. As of this date (the end of 1985), all of the relevant cases dealt with this prior definition. The current law, requiring only a 50 percent continuity of shareholder interest, will make it much easier for the IRS to characterize a purported liquidation as a reorganization.

[12] I.R.C. § 368(a)(2)(H) defines "control" for this purpose by cross reference to I.R.C. § 304(c) which, in turn, brings into play the attribution of ownership rules of I.R.C. § 318(a), with some modifications.

[13] Rev. Proc. 85-22, 1985-1 C.B. 550 and Rev. Proc. 84-75, 1984-2 C.B. 751.

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