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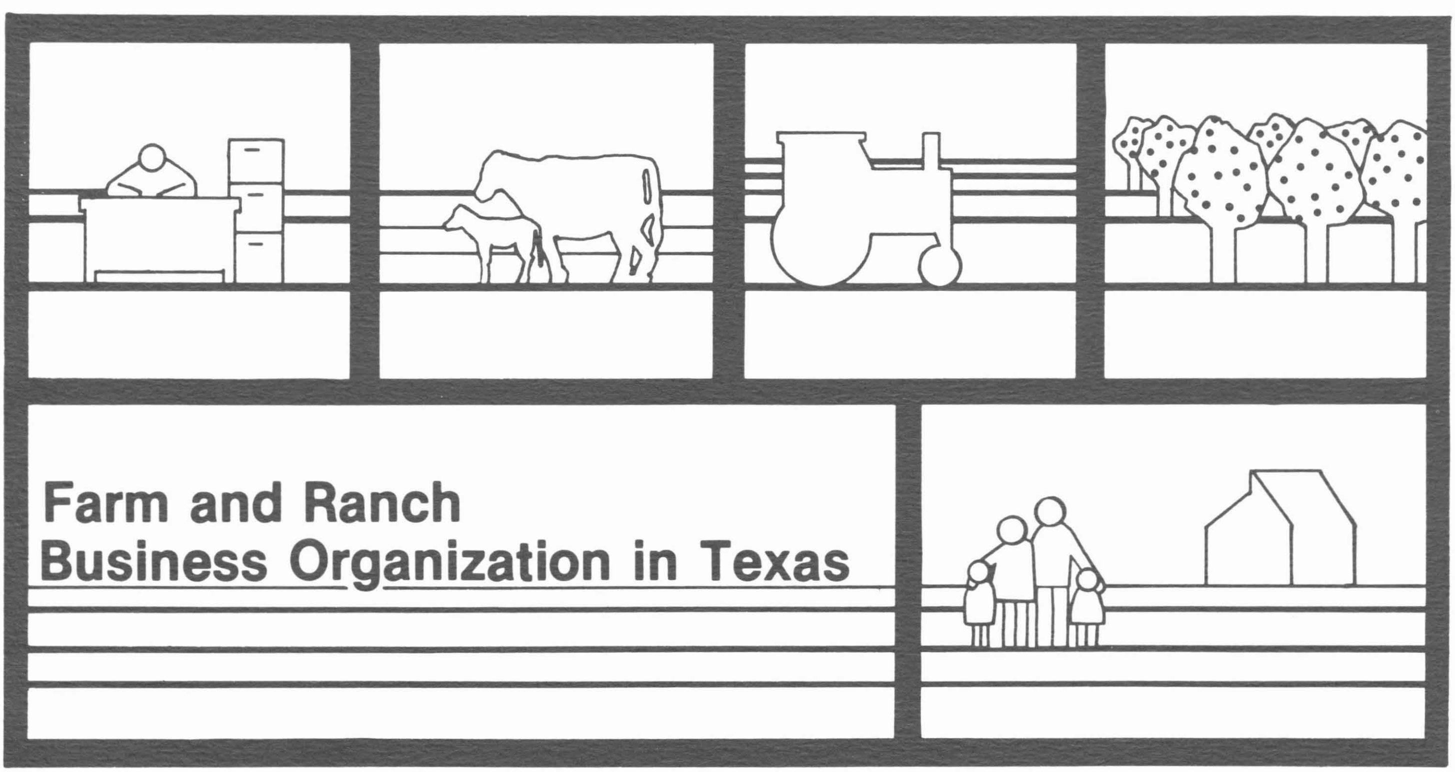
B-1333

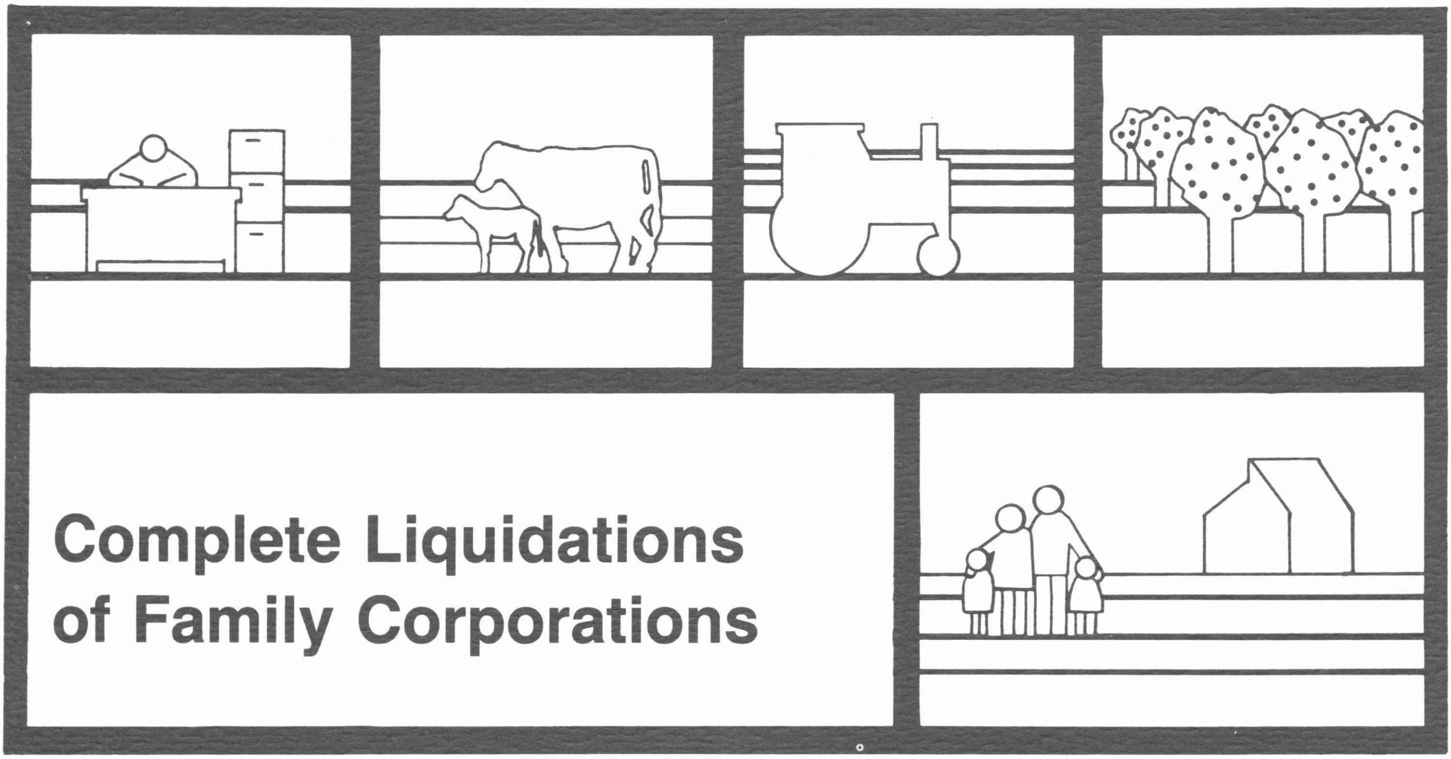
Complete Liquidations of Family Corporations



PREFACE

This publication is one of a series on the incorporation of farms and ranches and is intended for laymen who want to develop an understanding of basic tax issues encountered by incorporated businesses. The authors have attempted to interpret complex and technical tax law into understandable language and concepts. However, any dilution of the complexities of the law necessarily involve omission of some details and exceptions to general rules. This publication is intended to convey the type of information useful to businessmen who are considering the organization of a corporation or who currently are operating a corporation. It is not intended as legal advice nor should it be construed as an exhaustive treatment of tax implications.

While the authors have written in a manner understandable by most persons concerned with the incorporation of a business, certain terminology common in tax matters is used. While these terms may not be used in the everyday conversations of farmers and ranchers, a basic understanding of this terminology can help them communicate more effectively with professional advisors.



Complete Liquidations of Family Corporations

Marvin Sartin and Norman Brints*

Any business venture involves risks of failure and is subject to changing business conditions and personal objectives that can warrant termination of the business. Even though perpetual life is a characteristic of corporations, most incorporated businesses operate for only a finite period. Liquidation of an incorporated business usually involves tax consequences; therefore, an understanding of alternative liquidation techniques should be prerequisite to organizing a corporation.

The organization of a business as a corporation can differentiate between the individual owner(s) and the continuity of the business. However, in most family corporations this distinction is not material. The desire to liquidate a family corporation can stem from a variety of curcumstances, such as (1) the shareholders become disenchanted with the formalities of the corporate structure, (2) owners find that the major shareholders are not compatible, (3) an outside party is interested in buying the assets of the corporation but not the stock of the corporation, or (4) the corporation is losing money or has other business problems that a liquidation would eliminate.

LIQUIDATION OR DISSOLUTION?

Liquidation is a term used in the IRS Code with a specific meaning. The Federal Income Tax Code and state laws do not always use the same technical terminology or define concepts identically. The dissolution of a corporation under state law terminates the existence of this artificial person. A dissolution normally will be associated with a complete liquidation. However, a complete liquidation can occur without a formal dissolution of the corporation.

Corporate dissolutions entail the settling of all corporate debts, distributing all remaining assets, and relinquishment of the corporate charter and other credentials identifiable with the existence of the corporation. In general, liquidations can be effected when the corporation ceases to be a going concern by the distribution of corporate assets and obligations to shareholders in exchange for all outstanding shares of stock. Legal dissolution is not required and a nominal amount of assets may be retained by the corporation to protect its legal existence.

Since the term liquidation is a "term of art" developed by the IRS Code and the courts, discussion of this subject must be primarily concerned with income tax consequences. Tax consequences of liquidating a corporation will be discussed in

*Area Extension economist — management and CPA and area Extension economist — management, The Texas A&M University System detail in subsequent sections, both from the standpoints of the corporation and of the individual shareholders. However, one should realize from the outset that tax-free liquidations are much more difficult to achieve than are tax-free incorporations. As with other phases of corporate operations, a liquidation can best be accomplished with minimum tax consequences through proper advance planning. A close working relationship with an accountant and an attorney usually is required for farmers and ranchers who operate corporations. Continuous contact with these advisors and their understanding of business conditions and personal objectives are the keys to the drafting and the actual implementation of a plan of liquidation.

Although an informal liquidation may be recognized by the IRS and the courts, a formal plan should be adopted by the Board of Directors. This plan of liquidation can set forth the objectives of the liquidation and can avoid potential conflicts with the IRS as to when a status of liquidation exists and the character of any distributions to shareholders.

TAX CONSEQUENCES TO THE CORPORATION

The adoption of a plan of liquidation does not terminate the corporation's existence. As long as the liquidation process continues and the corporation operates, income tax returns must be filed and taxes paid on income.

The general rule for corporate distribution of assets to shareholders in a complete liquidation is that the corporation recognizes neither gain nor loss even though the fair market value of the assets exceeds the book value (adjusted basis). Recapture of depreciation on depreciable assets with fair market value in excess of book value and recapture of investment credit on assets that have not been used for the specified period of time are required of the corporation.

12-Month Liquidation

Distribution of corporate assets "in kind" is not always desirable. If the sale of the corporate assets and subsequent distribution of the proceeds to shareholders is preferable, a provision exists that will allow this approach without corporate recognition of any gains on the sale of assets. The requirements of this provision include the adoption of a formal plan of complete liquidation and the distribution of all assets (less those required to meet unsettled claims) to shareholders within a 12-month period beginning on the date of adoption of the plan. The corporation is not allowed to recognize gains or losses on property sold or exchanged within the 12-month period.

The sale of certain corporate assets does not qualify for the non-recognition provisions of the section. The sale of corporate inventory and stock in trade are excluded. The theory is that these provisions were intended to apply to the winding up sales of income-producing property rather than to sales in the regular course of business, even though the sales occurred during the final months of the corporation's life. However, an exception is provided for a bulk sale of "substantially all" of the inventory property to one person in one transaction.

Installment sales of the assets of a liquidating corporation are more attractive with recent changes in the law. In general, the sale of assets on an installment basis will escape tax at the corporate level only if the obligation arose from a sale of noninventory property not subject to the various recapture provisions or from the "bulk sale" of inventory after adoption of a 12-month plan of liquidation.

All assets sold by the corporation pursuant to a 12-month plan of liquidation are subject to recapture of depreciation, investment credit, soil and water conservation expenses and land clearing expenses that are normally incurred on sales or exchanges. These recapture provisions constitute tax liabilities to the corporation.

1-Month Liquidation

The IRS Code allows shareholders to receive liquidating distributions from a corporation in exchange for their stock without recognizing personal taxable gain (with exceptions) if the complete liquidating distribution is accomplished in one calendar month. The use of this 1-month liquidation by any shareholder bars the above described alternative 12-month provisions at the corporate level. Thus, if any shareholder elects the 1-month provisions, the sale of any assets by the corporation may result in a corporate tax. The sale also will likely increase the corporation's earnings and profits which, in turn, will affect the taxable gain to shareholders.

TAX CONSEQUENCES TO SHAREHOLDERS

Generally, complete liquidating distributions are considered as full payment in exchange for the shareholders' stock. Stock is a capital asset in the hand of most individuals. Thus, the amount distributed in excess of the stockholder's basis (cost) would be a capital gain (loss). The character of the gain (loss), long-term or short-term, depends upon the holding period of the stock.

The gain (loss) in liquidation must be computed on a "per-share basis." Thus, if blocks of stock were obtained at different times and at different costs, the gain (loss) is calculated separately for each block. For example, if 100 shares of stock in a corporation were acquired in 1975 at $50 per share and another 100 shares were acquired in February

1980 at $100 per share, a liquidating distribution of $80 per share in June 1980 would create a long-term gain of $3,000 [($80 − $50) × 100] and a short-term loss of $2,000 [($80 − $100) × 100].

If the shareholders of a corporation assume corporate liabilities or take property subject to liabilities in a liquidation, the liabilities must be considered in calculating gain (loss). Assets distributed "in kind" to shareholders are valued at their fair market value as a liquidating distribution. The amount of liability assumed by the shareholder reduces the value of the distribution. For example, assume that a corporation distributed farm machinery valued at $100,000, but subject to a $40,000 liability, to a shareholder who had a basis (cost) in his stock of $45,000. The gain that must be recognized by the shareholder is $15,000 ($100,000 − $40,000 = $60,000 − $45,000). The basis (cost) of any asset received in a liquidating distribution is its fair market value.

If an installment obligation is distributed to the shareholder in exchange for stock, the shareholder does not have to value the obligation at its current fair market value for immediate tax reporting purposes. Instead, the shareholder's receipt of payments under the obligation is treated as payment for his stock. Thus, the opportunity exists to sell the corporate assets under a 12-month plan of liquidation on an installment note and distribute the note to the shareholder(s) without undue adverse tax consequences.

1-Month Liquidation

A section of the IRS Code provides a mechanism, under certain circumstances, for the distribution of corporate assets to shareholders without the shareholders recognizing taxable gains. This section applies only to *gains* of qualified electing shareholders. Thus, if a shareholder suffers losses (on all or on a block of stock), the losses can be recognized. To qualify for the election, an individual must own stock when the plan of liquidation is adopted, must file a written election within 30 days of the adoption and shareholders owning at least 80 percent of the combined voting power of the non-corporate-owned stock must elect this alternative.

The transfer of all of the corporation's property must occur within one calendar month and it must be in exchange for the complete cancellation of all of the corporation's stock. The basis of property received in such a distribution is computed with reference to the shareholders' basis in the stock. Specifically, the basis of the assets received is the basis of the stock, less any money received and plus any gain recognized.

Shareholders will incur tax liabilities on distributions under this section to the extent of the greater of earnings and profits of the corporation or the value of the cash, stocks and securities distributed by the corporation. Note that the amount of earnings and profits is ordinary income to shareholders and does not benefit from the 60 percent exclusion of long-term capital gains. If the value of cash, stock and securities exceeds the earnings and profits, the excess is taxable as capital gain.

The income tax term *earnings and profits* involves several adjustments to corporate taxable income. To avoid becoming bogged down with the details of earnings and profits computations, earnings and profits may be roughly approximated by subtracting from cumulative corporate taxable income both income taxes paid and dividends paid to shareholders. Because most profitable operating corporations retain substantial quantities of after-tax profits, this alternative may be of limited usefulness. The 1-month liquidation best applies to corporations with substantially appreciated assets and little or no accumulated earnings and profits.

SUMMARY

The tax consequences of liquidating a corporation can be substantial. The difficulties of accomplishing a completely tax-free liquidation must be recognized and can influence an individual's decisions on whether to incorporate and which assets should be included in the corporation.

Assuming that an operating profit is expected and the income tax advantages of splitting income with the corporation are used, a subsequent 1-month liquidation can create a substantial lumping of income into a particular year for shareholders. Farm and ranch businesses are comprised largely of land which has been inflating rapidly. A traditional liquidation will create a tax liability for the inflation in land values to the shareholders.

The creation or the liquidation of a corporation is not a simple business decision.An individual must use his best judgment in forseeing future circumstances and obtain professional counsel in selecting alternative courses of action. While no one can predict the future with certainty, proper planning can minimize adverse tax effects when unexpected events occur.

APPENDIX

To aid readers in understanding the complex rules discussed in this publication, the following examples of corporate liquidations are presented. These examples are simplified to emphasize the results of the various alternatives without the confusion that may be associated with detailed computations.

Below is the Balance Sheet for X Farm Corporation. M owns 150 shares with a basis of $175,000. S owns 50 shares with a basis of $40,000. Assume that the cumulative earnings and profits of the corporation are $70,000.

X Farm Corporation Balance Sheet, December 31, 19XX

Assets	Basis	Fair Market Value	Liabilities and Capital	Basis	Fair Market Value
Cash	$ 30,000	$ 30,000	Liabilities	$ 50,000	$ 50,000
Equipment	125,000	200,000			
Less accumulated depreciation	(50,000)	(50,000)	Stock	215,000	215,000
			Retained Earnings	90,000	90,000
Land	250,000	400,000	Appreciation of Assets		225,000
Total Assets	**$355,000**	**$580,000**	**Total Liabilities and Capital**	**$355,000**	**$580,000**

Situation 1. Corporation distributes all assets and liabilities to M and S. Not a "1-month liquidation." (Investment credit recapture is ignored.)

Tax Consequences to X Farm Corporation

$50,000 recapture of depreciation	
Total Assets distributed:	$580,000*
Assets/share	$ 2,900
Liabilities distributed	$ 50,000
Liabilities/share	$ 250

*Excludes consideration of at least $9,250 of corporate tax liability.

Tax Consequences — Shareholders

Shareholder M		Shareholder S	
Distribution of 150 shares @ $2,900	$435,000	50 shares @ $2,900	$145,000
Liabilities of 150 shares @ $250	37,500	50 shares @ $250	12,500
Net to shareholder	$397,500	Net to shareholder	$132,500
Less basis of stock	175,000	Less basis of stock	40,000
Capital Gain	$222,500	Capital Gain	$ 92,500

*Corporate tax liability on recapture of depreciation of at least $9,250 not considered.

Situation 2: Corporation sells all assets without a plan of complete liquidation and distributes proceeds to shareholders. (Not a 12-month liquidation. Recapture of investment credit is ignored.)

Tax Consequences to X Farm Corporation

Proceeds from Sale of Assets		$550,000
Basis in Assets: Equipment	$125,000	
Land	250,000	375,000
Capital Gain		$175,000
Recapture of Depreciation		$ 50,000
Estimated Corporate Tax		$ 58,250
Available for Distribution to Shareholders		$580,000
Less: Liabilities	$ 50,000	
Corporate Taxes	58,250	108,250
		$471,750

Tax Consequences — Shareholders

	Shareholder M	Shareholder S
Cash Distribution $2,359/share	$353,850	$117,950
Less Basis in Stock	175,000	40,000
Capital Gain	$178,850	$ 77,950

Situation 3: Corporation sells all assets pursuant to a plan of liquidation and subsequently distributes all proceeds to shareholders in exchange for their stock within a 12-month period. (Recapture of investment credit is ignored.)

Tax Consequences to Corporation

$50,000 recapture of depreciation	
Assets available for distribution	$580,000
Less liabilities	50,000
Net distribution	$530,000
Net distribution/share	$ 2,650

Tax Consequences to Shareholders

	Shareholder M	Shareholder S
Cash Distribution	$397,500	$132,500
Less basis in stock	175,000	40,000
Capital Gain	$222,500	$ 92,500

Situation 4: Corporation distributes assets to M and S within 1 calender month. Shareholders properly elect special 1-month provisions. (Recapture of investment credit ignored.) Since earnings and profits exceed cash, each shareholder has ordinary income equal to their pro rata share of earnings and profits.

Tax Consequences — X Farm Corporation

Recapture of depreciation — $50,000

Tax Consequences — Shareholders

	Shareholder M	Shareholder S
Earnings and Profits $350/share	$52,500	$17,500
Cash $150/share	22,500	7,500

Cooperative Extension Work in Agriculture and Home Economics, The Texas A&M University System and the United States Department of Agriculture cooperating. Distributed in furtherance of the Acts of Congress of May 8, 1914, as amended, and June 30, 1914.
5M — 1-81, New ECO 7-2