

PROBLEM #II - Liquidations

II-1 X Corporation has 100 shares of common stock outstanding of which A, an individual, owns 80 shares, and B, an individual, owns 20 shares. A and B are not related. A has an adjusted basis of \$80,000 in his 80 shares of X stock..

On March 8, Year One, A transferred Whiteacre and Blackacre (unimproved lands) to X in exchange for which X issued 40 shares of its common stock to A. A had an adjusted basis of \$62,000 in Blackacre, and the fair market value of Blackacre at the time of the exchange was \$40,000. A had an adjusted basis of \$10,000 in Whiteacre which had a fair market value of \$35,000. After the exchange A held 120 of the 140 shares of X's outstanding stock – that is, A held over 85.7% of X's outstanding stock. For convenience of computation, we will treat A's percentage of X's stock as 85.7%, and we will treat B's percentage as 14.3% even though those figures are not quite accurate. A realized a loss of \$22,000 on the exchange of Blackacre and a \$25,000 gain on the exchange of Whiteacre, but none of that gain or loss was recognized because of § 351. X's basis in Blackacre is \$62,000 – the same basis that A had therein. § 362. A's basis in the 40 shares of X stock that he received in the exchange is \$72,000. § 358(a)(1). So, A's basis in the 120 shares of X stock that he holds is \$152,000 (i.e., \$80,000 + \$72,000).

On August 11, Year Three, X adopted a plan of liquidation and distributed its assets in complete liquidation. At that date, X owned Blackacre with a fair market value of \$40,000, and X has a basis of \$62,000 in Blackacre. In addition, X owned other assets having an aggregate fair market value of \$100,000, and X had a basis of \$100,000 in those assets. A still owned 120 shares of X's stock which comprised 85.7% of X's outstanding stock, and A's basis in those shares was unchanged.

X made liquidating distributions to A of 85.7% of Blackacre and 85.7% of its other assets. The fair market value of 85.7% of Blackacre was \$34,280 (i.e., 85.7% x \$40,000). The aggregate fair market value of the other assets distributed to A was \$85,700 (i.e., 85.7% of \$100,000). X realized no gain or loss on the distribution of the other assets to A, but X realized a loss of \$18,854 on the distribution of Blackacre (X had an adjusted basis of \$53,134 in 85.7% of Blackacre).

X made a liquidating distribution of 14.3% of Blackacre and 14.3% of its other assets to B. X realized no gain or loss on the distribution of the other assets to B, but X realized a loss of \$3,146 on the distribution of 14.3% of Blackacre to B.

- A. What amount of gain or loss did X recognize on making the liquidating distributions?
- B. What amount of gain or loss did A recognize as a consequence of receiving the liquidating distribution from X?

II-2 The same facts as those stated in **II-1** except: (1) that the adoption of a liquidating plan and the liquidation of X took place on August 11, Year Seven, and (2) the liquidating distribution that X made to A on that date constituted all of Blackacre (having a value of \$40,000) and other assets having a value of \$79,980. X distributed its remaining assets (having a value of \$20,020) to B.

- A. What amount of gain or loss did X recognize from making those liquidating distributions?
- B. What amount of gain or loss did A recognize from receiving the liquidating distribution?

II-3 The same facts as those stated in **II-2** except that by Year Seven, A was the sole shareholder of X (B's stock was redeemed for \$20,020 in Year Four). On August 11, Year Seven, X liquidated and distributed to A all of its assets, consisting of Blackacre (having a value of \$40,000) and other assets having a value of \$79,980.

What amount of gain or loss did X recognize from making the liquidating distribution?

II-4 Z Corporation was formed on July 10, Year One. From its inception, Z has had 100 shares of common stock outstanding of which 60 shares are owned by F, an individual, and 40 shares are owned by K, an unrelated individual. On July 10, Year One, F and K transferred various assets to Z in a § 351 exchange in which they received their stock interests in Z. One of the assets transferred by K was Greenacre (unimproved land). K had an adjusted basis of \$50,000 in Greenacre, and the fair market value of Greenacre at the date of exchange was \$55,000. K recognized no gain or loss on this exchange, and so Z's adjusted basis in Greenacre was \$50,000, the same as the basis that K had. On March 6, Year Three, less than two years after Z was formed, a plan of liquidation was adopted for Z. At that time, the value of Greenacre had fallen to \$30,000. Z's adjusted basis in Greenacre was still \$50,000 so Greenacre is a depreciated asset. Z has no other depreciated assets. In allocating its liquidating distributions between F and K, the value of property distributed to F and to K must be proportionate to their stock interests, but Z is not required to distribute each of its assets between the two shareholders. In distributing Greenacre as part of the liquidating distributions, would you advise that:

- (1) Z distribute a 60% interest in Greenacre to F and distribute a 40% interest to K?
- (2) Z distribute all of Greenacre to K?
- (3) Z distribute all of Greenacre to F?
- (4) Z sell Greenacre for \$30,000 and distribute the proceeds to F and K as liquidating distributions?
- (5) Z distribute a 50% interest in Greenacre to F and distribute a 50% interest to K?

II-5 On September 4 Year One, as part of a section 351 exchange, B transferred to Y Corporation Blackacre (unimproved land in Arizona) and 100 shares of stock of the Z Corporation, a publicly held corporation. Blackacre's fair market value was \$12,000, and B had an adjusted basis of \$50,000 in the land. The 100 shares of Z stock had a fair market value of \$50,000, and B had a basis of \$10,000 in those shares. In exchange for Blackacre and the 100 shares of Z stock, B received 10% of Y's stock. The exchange did not cause the recognition of any gain or loss because it qualified for nonrecognition under section 351. At the time of the exchange, Y was in the business of owning and operating a radio repair shop in Charlotte, North Carolina, and Y had been in that business for over 10 years.

On July 15, Year Two, Y sold Blackacre to an unrelated person for its then value of \$4,000. At that time, Y's basis in Blackacre was \$50,000. On May 12, Year Three, Y adopted a plan of liquidation, and the liquidation was completed within two months. What was the tax consequence to Y of the sale of Blackacre in Year Two? In what taxable year should Y report that consequence?

II-6 The same facts as those stated in **Question II-5** except that Y first adopted a plan of liquidation on November 5, Year Three and liquidated within two months thereafter. What was the tax consequence to Y of selling Blackacre?

II-7 The same facts as those stated in **Question II-5** except that Y was incorporated on September 1, Year One. What was the tax consequence to Y of selling the Blackacre in Year Two?

II-8 For more than 10 years, Corporation P has owned all 100 shares of outstanding common stock of Corporation S, which owns and operates an art gallery. S has suffered financial reverses in recent years and has liquidated most of its assets in order to pay its creditors. S borrowed \$40,000 from P several years ago, and that debt is still outstanding. P's loan to S was bona fide. S has no other debts. The only asset that S now owns is a painting, the fair market value of which is \$25,000. S has a basis of \$42,000 in that painting (the painting was one of the art works that S held for sale to its customers). The directors and shareholders of S have resolved to terminate S and to transfer its only asset, the painting, to P. If S makes this transfer, will S be granted an ordinary deduction of \$17,000 (the difference between the basis that S has in the painting and its value)? If S had no gross income in the taxable year in which it distributed the painting to P, would the granting of a \$17,000 deduction to S be of any significance in determining its tax liability? Did the liquidation of S cause it to recognize \$15,000 income because of the forgiveness of that amount of its debt to P? What were the tax consequences to P?

II-9 In Year One, S Corporation was formed as a wholly-owned subsidiary of X Corporation. On January 5, Year Eight, S borrowed \$30,000 from the Friendly National Bank and gave the bank its note payable in full on January 5, Year Fifteen, bearing adequate interest which is payable monthly. No principal was payable on the note until January 5, Year Fifteen. On June 4, Year Nine, P Corporation purchased S's note from the bank for \$20,000. At that time, P was not related to S or to X. On December 8, Year Eleven, P purchased for cash all of the outstanding stock of S, which thereby became a wholly-owned subsidiary of P. At that time, the value of S's note constituted less than 5% of the value of all of P's assets (exclusive of cash, stocks and other liquid assets). On August 24, Year Thirteen, S adopted a plan of complete liquidation and within two months distributed all of its assets to P in complete liquidation. No interest was owing on the note of S that P held. In answering the questions below, you will ignore the market discount rules of §§ 1276– 1278. Consider the tax consequences to P and S in each of the following alternative circumstances.

- (a) The aggregate value of the assets distributed by S to P in liquidation was \$35,000. S had a basis of \$25,000 in those assets. What were the tax consequences to S and to P? What basis did P acquire in the assets distributed to P?
- (b) The aggregate value of the assets distributed by S to P was \$28,000. S had a basis of \$22,000 therein. What were the tax consequences to S and to P? What basis did P acquire in the assets so distributed to P?
- (c) The same facts as those stated in (b) except that one month prior to the date on which the liquidating distributions of S were made, P forgave \$3,000 of the \$30,000 debt that S owed on the note in P's possession. Thus, at the time of liquidation, S owed only \$27,000 on that note. What were the tax consequences to P and to S of the cancellation of \$3,000 of the debt and of the liquidation of S? See, Rev. Rul. 68-602, 1968-2 Cum. Bull. 135, where the Commissioner ruled that a parent's cancellation of a debt owed by its subsidiary to it was to be disregarded (under the step transaction doctrine) where the cancellation was effected immediately before the subsidiary was liquidated and for the purpose of qualifying the liquidation under § 332. Do you agree that the step transaction doctrine should be applied here? Cf., Rev. Rul. 78-330, 1978-2 Cum. Bull. 147, where a parent's cancellation of the debt of a wholly-owned subsidiary immediately prior to the merger of that subsidiary into another wholly-owned subsidiary of the parent was given effect by the Commissioner. The reason that the parent corporation in Rev. Rul. 68-602 wished to qualify the liquidation under § 332 was that only then could the parent succeed to the net operating loss carryovers of the subsidiary under § 381. See also, Rev. Rul. 68-359, 1968-2 Cum. Bull. 161. Even if such a cancellation of a subsidiary's debt would be effective for this purpose, before the parent forgives any of the subsidiary's debt, the parent should consider the extent (if any) to which the subsidiary will be required to recognize income under § 108(e)(6).
- (d) The same facts as those stated in (b) except that one month prior to the liquidation of S, P contributed \$3,000 cash to S; and so, on its liquidation, S distributed assets having an aggregate value of \$31,000 to P. What were the tax consequences of the liquidation to S and to P?