WINDING UP AND DISSOLUTION OF ENTITIES IN TROUBLED TIMES

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I. INTRODUCTION.

Periods of economic downtown, particularly those that are extended in nature, can put business entities in positions where they choose, or are required, to cease operations. In this regard, the factors that trigger a dissolution vary from entity to entity and can include: a substantial shift in the business' cash flow that leads to an inability to meet debt obligations; a marked drop in the value of the primary business asset in relation to the debt incurred to purchase the asset; and, a downturn that has a negative impact on the net worth and liquidity of the business' primary owners/financial contributors such that the business, although slowed but solvent, cannot find alternative financing and must close down.

This outline addresses specific tax (and, to a lesser extent, non-tax) issues that confront a business as it goes through the process of closing operations, paying off or negotiating the satisfaction of outstanding debts and liabilities, and distributing remaining assets to its owners. Section II of the outline addresses the tax consequences that arise when an entity faces the reduction or cancellation of indebtedness. This Section includes a discussion of the rules pertaining to discharge of indebtedness income under IRC §108 and, more specifically, the application of those rules in the context of entities operated as S corporations and partnerships. Section III of the outline covers dissolution and liquidation of an entity from a corporate standpoint. Finally, Section IV looks at the tax consequences of partnership distributions and focuses on the tax traps that can trigger the recognition of income upon distributions from a partnership.

Note, it is assumed for purposes of this outline that the troubled entity is either solvent or insolvent (as indicated in the subject text) but that it is not in bankruptcy, as a discussion of the bankruptcy rules is outside the scope of the outline. Note, however, that it is often the case that a bankrupt taxpayer will be treated in a manner similar to that of an insolvent taxpayer. Consequently, any discussion in this outline of the applicability of a Section of the IRC to an insolvent taxpayer should not be interpreted as an indication that the referenced IRC § has no application for a bankrupt taxpayer.

II. TAX CONSEQUENCES OF THE REDUCTION OR CANCELLATION OF OUTSTANDING INDEBTEDNESS.

A. Property Transferred in Conjunction With Debt Discharge. If property is voluntarily transferred by a debtor in conjunction with a reduction or cancellation of debt, the question is raised as to what extent that triggers a gain or loss from the sale or exchange of property [IRC §61(a)(3)] and the extent to which the transaction results in the recognition of income from discharge of indebtedness [IRC §61(a)(12)]. This will determine the character of the gain/loss (ordinary/capital gain) and, to the extent there is income from discharge of indebtedness, will trigger the myriad of rules under IRC §108 (including opportunities to exclude or defer such income).

Note, whether the debtor is solvent or insolvent and notwithstanding the recourse or nonrecourse nature of the debt, the character of the gain or loss from the sale of property recognized under the transaction will be determined under the same rules applicable to sales not involving discharge of debt, including capital gain/ordinary income distinction and the recapture of depreciation, amortization, and investment tax credit as ordinary income

1. Nonrecourse Debt Discharged In Conjunction With Debtor's Transfer of Property to Holder.

If property is transferred by the debtor in conjunction with the discharge of nonrecourse debt, the amount by which the discharged debt exceeds the transferred property's basis will be considered capital gain. Com'r. v. Tufts, 461 U.S. 300 (1983). No part of the cancelled nonrecourse debt is treated as income from discharge of indebtedness. The taxpayer in Tufts argued unsuccessfully that no gain should be realized to the extent the debt exceeded the property's fair market value.

> Example: Debtor transfers property worth $100,000 with a income tax basis of $50,000 to Creditor in discharge of $150,000 of nonrecourse debt. Debtor will realize $100,000 in capital gains in the process.

2. Recourse Debt Discharged In Conjunction With Debtor's Transfer of Property to Holder.

If property is transferred by the debtor in conjunction with the discharge of recourse debt, (i) capital gain will be realized to the extent the property's fair market value exceeds its basis and (ii) income from discharge of indebtedness will occur in the amount by which the discharged debt (if any) exceeds the property's fair market value. Treas. Reg. 1.1001-2(c); Gehl v. Com'r, 102 TC 784 (1994), aff'd, 50 F.3d 12 (8th Cir. 1995). See Section II.B below for a more detailed discussion of income from discharge of indebtedness, particularly a discussion of the circumstances in which part or all of that income may be excluded from gross income.

> Example: Debtor transfers property with a fair market value of $100,000 and an income tax basis of $40,000 to Creditor in discharge of $150,000 of recourse debt and Creditor agrees to not pursue the remaining debt. Debtor will realize $60,000 in capital gain in the process and will also have income from discharge of indebtedness in the amount of $50,000.

Note, under the regulations, income from discharge of indebtedness will still occur even if property is disposed of at a loss.

> Example: Debtor transfers property worth $60,000 with an income tax basis of $70,000 to Creditor in discharge of $100,000 of recourse debt and Creditor agrees to not pursue the remaining debt. Debtor will realize a $10,000 capital loss in the process and will also have income from discharge of indebtedness in the amount of $40,000.

3. Foreclosures.

Foreclosures are treated for income tax purposes just like any other sale or exchange of the subject property by the owner and can actually result in a taxable gain despite the typically less than ideal circumstances under which foreclosures commonly occur. Helvering v. Hammel, 311 U.S. 504 (1941); Electro-Chemical Engraving Co. v. Com'r, 311 U.S. 513 (1941). Note, any gain or loss realized in conjunction with a foreclosure will only occur when the debtor's right of redemption (if any) expires or is released by the debtor.

a. Nonrecourse Indebtedness.

The amount realized upon the foreclosure of property securing nonrecourse debt will equal the debt discharged, regardless of the property's fair market value. Com'r. v. Tufts, 461 U.S. 300 (1983).

> Example: Creditor foreclosures on property with a tax basis of $100,000 and a fair market value of $150,000. The property secured non-recourse debt of $200,000. Upon the foreclosure and discharge of the debt, Debtor will realize $100,000 of capital gain.

b. Recourse Indebtedness.

If a creditor forecloses on property subject to recourse indebtedness, the excess of the amount realized over the property's tax basis will be considered capital gain (correspondingly, if the amount realized is less than the property's tax basis, a capital loss will be realized with the foreclosure). The remaining amount of the debt (if any) will not be considered in calculating any capital gain or loss in connection with the foreclosure, though it may ultimately result in income from discharge of indebtedness if it is cancelled or reduced at a future date. Treas. Reg. 1.1001-2(a)(2); Rev. Rul. 90-16, 1990-1 C.B. 12. See Section II.B below for a more detailed discussion of income from discharge of indebtedness, particularly a discussion of the circumstances in which part or all of that income may be excluded from gross income.

In situations involving recourse indebtedness, it is sometimes difficult to determine the amount realized as the property's fair market value for purposes of calculating the resulting capital gain/loss. There is a presumption that the amount bid-in by the creditor at the foreclosure proceeding is the property's fair market value. However, that presumption may be rebutted with clear and convincing evidence to the contrary. Treas. Reg. 1.166-6(b)(2); Heath v. Com'r, TCM 1971-129.

Example: Creditor foreclosures on property with a tax basis of $100,000 and a fair market value of $200,000 (either established by the bid-in amount or otherwise by clear and convincing evidence). The property secured recourse debt of $300,000. Debtor continues to be responsible for the $100,000 of recourse debt remaining after the foreclosure. Debtor will have realized $100,000 in capital gain in conjunction with the foreclosure and may (but not as yet) ultimately have to recognize income in discharge of indebtedness if and when Debtor is discharged from the remaining $100,000 of debt (or recognize part as such, if the Debtor settles up with Creditor for less than the outstanding balance).

4. **Abandonment of Property**.

An individual cannot unilaterally abandon property securing recourse debt for tax purposes. An actual foreclosure must occur (and a taxpayer's right of redemption, if any, must expire) for a tax event to occur. Com'r v. Green, 126 F.2d 70 (3rd Cir. 1942).

In contrast, an individual can unilaterally abandon property subject to a nonrecourse debt, at which point a sale/exchange will be deemed to have occurred with the amount realized equal to the debt. Yarbro v. Com'r, 737 F.2d 479 (5th Cir. 1984).

B. **Income From Discharge of Indebtedness Pursuant to IRC §§ 61(a)(12)/Exclusions from Gross Income Pursuant to IRC 108**.

1. **General Rule**.

Generally, cancellation of indebtedness results in income to the debtor in an amount equal to the difference between the face amount of the debt discharged and the amount of cash/other property (if any) the debtor paid to the creditor in conjunction with the debt's discharge. Property provided to the creditor is valued at its fair market value. Specific rules apply in the event of a debt-for-debt exchange pursuant to IRC §108(e)(10) (generally, the debtor is treated as having satisfied the old debt with an amount equal to the new debt instrument's issue price). IRC §108(e) provides specific rules applicable with regard to obligations issued at a discount or premium.[1]

IRC §108(e)(2) provides that income will not be realized upon discharge of indebtedness to the extent the payment of the debt would have produced a tax deduction (e.g., payment of interest). With this in mind, debtors can negotiate for promissory notes to provide for note payments to be applied first to principal before being applied to interest. Correspondingly, as a general rule, the discharge of a liability that was previously deducted will give rise to income.

[1] IRC §102 excludes amounts received as a gift or bequest from gross income. Consequently, if debt is forgiven by a creditor with a donative intent (e.g., a family member), gross income will not occur (although the holder of the debt may have gross income if the debt is an installment obligation). Of course, the holder may be required to use up gift tax exemption and/or owe gift taxes as a result of forgiving the debt. The IRS' tendency to presume donative intent in family situations may be advantageous in this regard, if the dissolving entity owes indebtedness to a family member who is willing to forgive the debt.

However, IRC §111 provides an exception to this rule if the prior deduction did not result in a reduction of the taxpayer's tax.

Related parties (as defined in IRC §108(e)(4)) cannot be used as a means to circumvent the rules of IRC §108. IRC §108(e)(4)(A) provides that if a party related to the debtor acquires the subject debt from an unrelated creditor at a discount, the debtor is deemed to have acquired the debt also at a discount, resulting in discharge-of-indebtedness. Treas. Reg. 1.108-2.

Note, there are methods to restructure debt without triggering discharge of indebtedness income, provided the principal amount of the debt is not reduced in the process. For example, it is possible to extend the maturity date, modify the interest rate, or substitute new collateral without realizing such income. Rev. Rul. 73-160, 1973-1 C.B. 365; Rev. Rul. 68-419, 1968-2 C.B. 196. However, though these actions may not trigger income from discharge of indebtedness, they may trigger income under other rules applicable to debt instruments (i.e., imputed interest rules).

2. Timing of Income Recognition.

Generally, income from the discharge of indebtedness is realized when debt is satisfied for less than the full amount. If no payment is made with regard to the debt, the realization of income will occur when (and to the extent) it is clear the debt will not be repaid, either by the agreement of the parties or otherwise. In these cases, the Court will look to the substance of the transaction, not the form, to determine when the debt was discharged. U.S. v. Ingalls, 399 F.2d 143 (5th Cir. 1968); Salva v. Commissioner, T.C. Memo 1993-90; Cozzi v. Commissioner, 88 T.C. 435 (1987); Bear Manufacturing Co. v. U.S., 430 F. 2d 152 (7th Cir. 1970).

Note, the American Recovery and Reinvestment Act of 2009 provides certain taxpayers with the ability to defer recognizing income from discharge of indebtedness realized in 2009 and 2010 in conjunction with a "reacquisition" by the taxpayer (or a related party) of an "applicable debt instrument." See IRC §108(i). An "applicable debt instrument" is any debt instrument issued by a C corp or any other person in connection with the conduct of a trade or business by that person. See IRC §108(i)(3). A "reacquisition" includes the acquisition of the instrument for cash, another debt instrument, stock, or partnership interest, or a contribution of the debt instrument to capital. See IRC §108(i)(4). A "reacquisition" also includes a partial or complete forgiveness of debt.

If elected, a taxpayer can defer the (i) recognition of income from discharge of indebtedness realized in 2009 until the fifth taxable year following the taxable year in which the reacquisition occurs and (ii) recognition of income realized in 2010 until the fourth taxable year following the taxable year in which the reacquisition occurs. Subsequent to the deferral period, the taxpayer is required to recognize the deferred income ratably over a 5-year period.

For pass-through entities, the election is made at the entity level. The debtor must include an election statement with the tax return for the year in which the debt is reacquired clearly identifying the debt instrument and the amount of income deferred. See IRC §108(i)(5)(B). Special rules apply to trigger recognition of the deferred income in the event the entity makes the election and during the deferral period subsequently liquidates, sells substantially all of its assets,

ceases operations, or is affected by an event of similar nature. The deferred income recognition rule also applies if the owner of an interest in the electing entity sells or redeems that ownership interest.

Businesses making the election cannot exclude (either for the year of the election or any subsequent year) the income from the cancellation of the debt pursuant to IRC §108(a)(1)(A), IRC §108(a)(1)(B), IRC §108(a)(1)(C), or IRC §108(a)(1)(D).

3. **Exclusions from Gross Income Under 108**.

a. **Exclusion from Gross Income For Insolvent Debtors**.[2]

i. **General Rule**.

If a debtor is insolvent at the time a debt is discharged, the taxpayer must exclude the resulting income from discharge of indebtedness up to the amount of the taxpayer's insolvency. See IRC §108(a)(1)(B). The application of the insolvency exclusion is not elective. The insolvency exclusion will not apply with regard to a discharge that occurs during a bankruptcy.

IRC §108(d)(3) provides that the taxpayer is "insolvent" to the extent the taxpayer's liabilities exceed the fair market value of the taxpayer's assets, as determined immediately prior to the discharge (thus, liabilities to be discharged in a transaction are counted as liabilities in determining whether the taxpayer is "insolvent" for purposes of the transaction). The income excluded under IRC §108(a)(1)(A) as a result will reduce the taxpayer's tax attributes pursuant to IRC §108(b) (see Section II.B.3.a.iii below for a more detailed description of IRC §108(b)). Any income from the discharge of indebtedness not so excluded will be included in the taxpayer's gross income for the year in which the discharge occurs.

> Example: Debtor owns property with a fair market value of \$100,000 and has liabilities of \$200,000 (i.e., Debtor is insolvent to the extent of \$100,000), of which \$150,000 is recourse debt owed to Creditor. If Debtor and Creditor settle that debt in exchange for Debtor's transfer to Creditor of the property worth \$100,000, the transaction will be bifurcated into two transactions: a sale of the property for \$100,000; and, \$50,000 of income from discharge of debt. However, Debtor will not realize any discharge of indebtedness income because the \$50,000 of debt forgiven is less than the insolvency amount of \$100,000. However, had the property transferred to Creditor been worth only \$40,000, then Debtor would have realized \$40,000 from the sale of the property and \$110,000 of income from the discharge of debt. Debtor would have to recognize \$10,000 of income from discharge of indebtedness, as that is the amount by which the discharged debt (\$110,000) exceeds the insolvency amount (\$100,000).

[2] Note, a separate exclusion is available pursuant to IRC §108(a)(1)(A) for a bankrupt debtor. However, a discussion of that exclusion is outside the scope of this outline.

Prior to the codification of the insolvency exception, it was accepted by the courts and the IRS that a taxpayer was not required to take into account assets exempt from the bankruptcy estate in determining the taxpayer's "insolvency"amount. However, subsequent to the codification of the insolvency exception, the Tax Court issued two controversial rulings in which the Court concluded those exempt assets were to be taken into account in determining the taxpayer's "insolvency." Carlson v. Com'r, 116 T.C. 87 (2001) and Quartemont v. Com'r, 93 TCM 711 (2007). These cases have been widely criticized and are thought to be unlikely to withstand a future challenge.

ii. Determination of Insolvency.

Contingent liabilities should only be taken into account in determining the insolvency amount to the extent the taxpayer can prove by the preponderance of the evidence that the taxpayer will be called upon to pay the liability. Merkel v. Com'r, 192 F.3d 844 (9th Cir. 1999).

The Service has ruled that in determining a spouse's insolvency for purposes of §108 the other spouse's assets are not to be considered. PLR 8920019.

Nonrecourse debt is taken into account in determining the insolvency amount at least to the extent of the fair market value of the property securing the debt. To the extent the debt amount exceeds the property's value, the excess amount is taken into account in the insolvency determination only to the extent of the amount of the excess nonrecourse debt that will be discharged. Rev. Rul. 92-53, 1992-2 C.B. 48.

Example: Debtor owes Creditor #1 $2,000,000 in nonrecourse debt secured by a building now worth $1,600,000 that was purchased from a third party with the money Creditor #1 provided.[3] Creditor now agrees to reduce the note to $1,650,000. Debtor's other assets are worth $200,000 immediately prior to the debt discharge, and Debtor has other recourse debt owed to Creditor #2 of $100,000 at that time. Of the $400,000 of the nonrecourse debt owed to Creditor #1 in excess of the building's fair market value, $350,000 is to be discharged, so that amount is counted in determining Debtor's insolvency amount, along with the $100,000 owed to another third party and the $1,600,000 of the debt owed to Creditor #1 equal to the building's fair market value. Consequently, Debtor's liabilities for purposes of the insolvency exclusion total to $2,050,000. Debtor's assets are $1,800,000. Consequently, the insolvency amount is $250,000 immediately prior to the debt discharge. As a result, Debtor may exclude $250,000 of the $350,000 debt discharged by Creditor #1, but will have $100,000 in discharge of indebtedness income. Note, recognition of that income may be deferred in accordance with IRC §108(i) (as

[3]In other words, the purchase-money debt reduction exclusion set forth in IRC §108(e)(5) will not apply.

described in Section II.B.2 above, if such discharge occurs in 2009 or 2010).

If, however, Debtor provides Creditor #2 with assets valued at $80,000 in settlement of the $100,000 debt Debtor owes to Creditor #2, and the debt to Creditor #1 is not reduced, then the $400,000 in excess nonrecourse debt will not be considered in determining whether Debtor is insolvent prior to the discharge of debt Debtor owed to Creditor #2. As a result, Debtor is deemed to have been solvent immediately prior to the discharge of the debt owed to Creditor #2 since Debtor's assets ($1,600,000 for the building and $200,000 in other assets) exceeded Debtor's liabilities ($1,600,000 of nonrecourse debt owed to Creditor #1 equal to the building's fair market value plus the $100,000 owed to Creditor #2). Consequently, Debtor must include the entire $20,000 in discharge of indebtedness income pursuant to IRC §61(a)(12). Note, recognition of that income may be deferred in accordance with IRC §108(i) (as described in Section II.B.2 above, if such occurred in 2009 or 2010).

iii. <u>Reduction of Tax Attributes</u>.

If discharged indebtedness is excluded from gross income under the bankruptcy exclusion, the insolvency exclusion, or the qualified farm indebtedness exclusion (not discussed in this outline due to its scope), then IRC §108(b) requires that the excluded amount be applied to reduce certain tax attributes.

Unless the taxpayer elects first to reduce the basis of depreciable property pursuant to IRC §108(b)(5) (as discussed below), IRC §108(b)(2) provides that the following tax attributes be reduced in the order listed:

- Any net operating loss for the taxable year of the discharge of the indebtedness, and then any net operating loss carryover to that taxable year (if more than one carryover is involved, they will be reduced in the order of the taxable years from which the carryovers occurred);
- any carryover to or from the taxable year of the discharge of the indebtedness of an amount for purposes of determining the amount allowable as a credit under IRC §38 (relating to general business credit);
- the minimum tax credit amount available under IRC §53(b) as of the beginning of the taxable year immediately following the taxable year of the discharge of the indebtedness;

- any net capital loss for the taxable year of the discharge of the indebtedness, and then any capital loss carryover to such taxable year under IRC §1212 (if more than one carryover is involved, they will be reduced in the order of the taxable years from which the carryovers occurred);
- basis of the taxpayer's property, as provided in IRC §1017;
- any passive activity loss or credit carryover of the taxpayer under IRC §469(b) from the taxable year of the discharge of the indebtedness; and
- any carryover to or from the taxable year of the discharge of the indebtedness for purposes of determining the amount of the credit allowable per IRC §27.

Pursuant to IRC §108(b)(3), the reduction of the specified tax attributes is to be made on a dollar-for-dollar basis in conjunction with the amount excluded from income pursuant to IRC §108(a), except with respect to credit carryovers, the reduction of which is to be made on the basis of 33 1/3 cents for each dollar excluded from gross income pursuant to IRC §108(a).

IRC §108(b)(4)(C) provides that the reduction in credit carryovers under IRC §108(b)(2)(B) and (G) is to be made in the same order in which the carryovers are taken into consideration for the taxable year of the debt discharge.

Pursuant to IRC §108(b)(4)(A), the reduction of the tax attributes is to be made subsequent to the determination of tax for the taxable year in which the discharge occurs. Consequently, the tax attributes arising in or carried over to the taxable year in which the discharge occurs can be used to reduce income for the taxable year of the discharge before being reduced pursuant to IRC §108(b).

Example: An insolvent taxpayer has a discharge of debt of $200,000 in Year 1, and under IRC §108(a)(1)(B), the entire $200,000 of discharged debt is excluded from the taxpayer's gross income. The taxpayer has taxable income of $100,000 for Year 1 before the use of a NOL carryover in the amount of $150,000. Under IRC(b)(4)(A), the $150,000 carryover is first applied to eliminate the taxpayer's taxable income of $100,000. Under IRC §108(b)(2)(A), the $200,000 of discharged debt is then applied to eliminate the remaining $50,000 of the carryover.

The theory of the ordering rules is that (for example) NOL and NOL carryovers should be reduced in the same manner as they would be had the discharged debt created taxable income.

iv. Basis Reduction.

Under the insolvency exclusion, a basis reduction is required pursuant to IRC §108(b)(2)(E) (to the extent that the excluded discharge of indebtedness income is not applied to reduce tax attributes as discussed above).

(A) Affected Property.

IRC §1017(a) requires that the amount excluded under IRC §108(a) and therefore the amount of the basis reduction pursuant to IRC §108(b)(2)(E), IRC §108(b)(5) (discussed below) or IRC §108(c)(1) (regarding the exclusion for discharge of qualified real property business indebtedness, discussed in Section II.B.3.b below), as applicable, is applied to reduce the basis of property held by the taxpayer at the beginning of the taxable year subsequent to the year in which the debt discharge occurred. See IRC §1017(c). This presents certain planning opportunities in that assets disposed of during the year of the debt discharge will not be subject to the basis adjustment. Additionally, if the proceeds from such a disposition are reinvested after the first of the following taxable year (the point at which the basis reduction is undertaken), the basis reduction is avoided altogether (barring a finding of a sham transaction to have occurred).

(B) Ordering Rules.

The basis reduction rules under IRC §108(b)(2)(E) are to be applied in accordance with the ordering rules of Treas. Reg. 1.1017-1, so that the taxpayer reduces (in the order indicated) the bases of the following assets held on the first day of the taxable year following the year in which the exclusion of discharged indebtedness income occurred, with the total amount of the bases reduction to be equal to the amount of the excluded income, reduced by discharged debt income applied to reduce tax attributes under IRC §§108(b)(2)(A) through (D), and IRC §108(b)(5), if applicable (if there is more than one asset in an indicated category, the reduction of those assets' bases is to occur on a pro rata basis based upon the assets' adjusted bases):

- Real property used in a trade or business or held for investment (other than IRC §1221(1) real property) that secured the discharged indebtedness immediately before the discharge;
- Personal property used in a trade or business or held for investment, (but not inventory, accounts receivable, or notes receivable) that secured the indebtedness immediately before the discharge;
- Remaining property used in a trade or business or held for investment (but not inventory, accounts receivable, notes receivable, or IRC §1221(1) real property);
- Inventory, accounts receivable, notes receivable, and IRC §1221(1) real property; and
- Property not used in a trade or business nor held for investment.

If a taxpayer has discharge of indebtedness income attributable to more than one discharged debt resulting in a reduction of tax attributes under IRC §§108(b)(2)(A) through (D) and, if applicable, IRC §108(b)(5), the tax-attribute reductions must be allocated among all the indebtednesses in proportion to the amount of discharge of indebtedness income attributable to each discharged debt.

IRC §1017(b)(2) provides that the basis reduction resulting from the application of IRC §108(a)(1)(B) cannot exceed the amount by which the aggregate bases of the property held by the taxpayer immediately after the discharge exceeds the aggregate liabilities then held by the taxpayer. This limitation on basis reduction does not apply with regard to any reduction in basis resulting from the election pursuant to IRC §108(b)(5).

IRC §1017(c)(2) provides that a reduction in basis pursuant to IRC §1017 is not be treated as a disposition in accordance with the IRC. As a result, this prevents the recapture of the investment credit as a consequence of the basis reduction. While the IRC does not expressly provide as such, it is likely the case that the basis reduction will not trigger recapture income under any of the recapture provisions (e.g., IRC §1245 and IRC §1250).

IRC §1017(d) provides that for purposes of IRC §1245 and IRC §1250 any reduction in basis is treated as a deduction allowed for depreciation, and property that is not IRC §1245 or IRC §1250 property is treated as IRC §1245 property. As such, ordinary income will be realized to the extent of gain attributable to basis reduction when any depreciable or nondepreciable property previously subject to a basis reduction under IRC §1017 is then disposed of in a transaction that would trigger recapture under IRC §1245 or IRC §1250 (were the property described in either IRC Section). In effect, a taxpayer is prevented from trading a capital gain or reduction in capital loss resulting from an elective basis reduction pursuant to 108(b)(5) for an increased ordinary loss arising because an NOL or NOL carryover not being reduced. This recapture rule also prevents a taxpayer from using the rules of IRC §1031 to the extent of the gain subject to recapture under IRC §1017(d).

(C) IRC §108(b)(5) Election.

Note, the taxpayer may elect to initially reduce the basis of the depreciable property (as defined in IRC §1017(b)(3)(B)) pursuant to IRC §108(b)(5) before reducing the other tax attributes. That election is made by filing Form 982 with the return for the year of the related debt discharge. The IRC §108(b)(5) election would be made by a taxpayer willing to sacrifice future depreciation deduction (and/or incur capital gain) to preserve NOLs, carryover NOLs, etc. The election can result in the basis of depreciable property being reduced below the amount of the taxpayer's undischarged liabilities, a result not possible absent the IRC §108(b)(5) election having been made. Note, if the IRC §108(b)(5) election is made, the taxpayer can also elect pursuant to IRC §1017(b)(3)(E) to treat real property described in IRC §1221(a)(1) as "depreciable property."

b. Discharge of Qualified Real Property Business Indebtedness.[4]

Alternatively, income from the discharge of qualified real property business indebtedness (as defined in IRC §108(c)(3)) can be excluded from gross income in accordance with IRC §108(a)(1)(D). In return, the bases of depreciable real property must be reduced by an equivalent amount.

i. Limitations on Exclusion Amount.

Pursuant to IRC §108(c)(2), there are two limitations on the amount of discharged qualified real property business indebtedness excluded from gross income under IRC §108(a)(1)(D).

First, the amount of discharged qualified real property business indebtedness excluded cannot exceed the excess of (i) the outstanding principal amount of such debt (immediately prior to the discharge) over (ii) the fair market value of the real property securing the indebtedness (immediately prior to the discharge), as reduced by the outstanding principal amount of any other qualified real property business indebtedness secured by the property immediately prior to the discharge.

Second, the amount excluded from gross income cannot exceed the aggregate adjusted bases of all depreciable real property held by the taxpayer immediately before the discharge (reduced by the sum of (i) deprecation claimed for the taxable year the taxpayer excluded the discharge of indebtedness from gross income pursuant to Code Section §108(a)(1)(D) and (ii) reductions to the adjusted bases of the depreciable real property required pursuant to IRC §108(b) or §108(g) for the same taxable year). Depreciable real property acquired in contemplation of the discharge is not to be taken into account in determining the amount of the second limitation.

This exclusion is not available for C corporations and is unavailable if the bankruptcy or insolvency exclusions of IRC §108 apply. Unlike the bankruptcy and insolvency exclusions under IRC §108(a)(1), this exclusion is elective by filing Form 982 with the return for the taxable year of the debt discharge.

ii. Timing of Basis Reduction.

The basis reduction is applied to reduce the basis of property held by the taxpayer at the beginning of the taxable year following the year of the debt discharge, unless the property is disposed of prior to that point (in which event the basis adjustment will take place immediately prior to the disposition).

iii. Ordering of Basis Reduction.

The basis reduction is applied first to the property securing the debt that is discharged before reducing the bases of other depreciable real property.

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[4]Note, an exclusion for qualified farm indebtedness is also available pursuant to IRC §108(a)(1)(C), but a discussion of such IRC Section is beyond the scope of this outline.

c. **Purchase-Money Debt Reduction**.

A solvent debtor may avoid recognition of discharge of indebtedness income if the seller of the property reduces the purchase-money debt in connection with a purchase price adjustment. See IRC §108(e)(5). However, the price/debt reduction must be undertaken with the original seller of the property, or the amount of the reduction can constitute discharge of indebtedness income. Rev. Rul. 91-31, 1991-1 C.B. 19. Presumably, for §108(e)(5) to apply the debtor must still own the property subject to the debt to be adjusted, although the statute does not require that on its face (whereas the Committee Reports indicate the latter would be required as well). See IRC §108(e)(5).

Arguably, the debt cancellation should be reflected in a basis adjustment. However, the statute does not expressly require such an adjustment to basis.

4. **Reporting Requirements**.

Debtors who exclude amounts from gross income or reduce tax attributes under IRC §108 are required to attach a "Reduction of Tax Attributes Due to Discharge of Indebtedness and §1082 Basis Adjustment" to their returns. Certain other reporting requirements apply with regard to discharge of indebtedness income (particularly with regard to creditors). See IRC §6050P and the related Regulations.

C. **Specific Application of IRC §108 For Entities**.

1. **S Corporations**.

Pursuant to IRC §108(d)(7)(A), the exclusion provisions of IRC §108(a), attribution reduction provisions of IRC §108(b), qualified real property business indebtedness provisions of IRC §108(c), and discharge of qualified farm indebtedness provisions of IRC §108(g) are all applied at the corporate level.

Prior to the amendment of IRC §108 in 2002 (amending IRC §108(d)(7)(A)), cancellation of debt income for an S corporation (even if excluded from shareholder income under IRC §108(a)) increased the shareholders' stock basis under IRC §1366(a) before any tax attribute reduction pursuant to IRC §108(b). Gitlitz v. Com'r, 531 U.S. 206 (2001). Congress reversed this holding by amending IRC §108 to provide that any cancellation of debt income is not to be taken into account in establishing the shareholders' bases. Instead, the S corporation must reduce its tax attributes, as discussed in Section II.B.3.a.iii above.

IRC §108(d)(7)(B) provides that for an S corporation, for purposes of IRC §108(b)(2)(A), any loss or deduction disallowed for the taxable year of the discharge under IRC §1366(d)(1) will be treated as a NOL for that taxable year, except to the extent that IRC §108(a)(1)(D) applies (the exclusion for discharge of qualified real property business indebtedness). The effect of IRC §108(d)(7)(B) is to treat the carryover amount pursuant to IRC §1366(d)(2) as an amount subject to reduction under IRC §108(b)(2)(A) by discharged indebtedness.

IRC §108(d)(7) provides specific guidelines for the interaction of IRC §108 with IRC §1366 and IRC §1367.

2. **Partnerships**.

a. **General Application of IRC §108 At Partner Level**.

Pursuant to IRC §108(d)(6), the exclusion provisions of IRC §108(a), attribution reduction provisions of IRC §108(b), qualified real property business indebtedness provisions of IRC §108(c), and discharge of qualified farm indebtedness provisions of IRC §108(g) are all applied at the partner level, not at the partnership level. Generally, the effect of IRC §108(d)(6) is that discharge of indebtedness income is recognized at the partnership level (with the resulting income allocated in accordance with IRC §702(a)), and the provisions of 108 are applied at the partner level.[5]

b. **IRC §108(e)(5)/Purchase-Money Debt Reduction Applied at Partnership Level**.

The purchase-money debt reduction exclusion provided by IRC §108(e)(5) has been applied by the IRS at the partnership level without regard to the solvency of the partners. TAM 8429001. This can be problematic in that it requires a determination of the partnership's insolvency, which may (but does not clearly) require taking into account the general partner's net worth. (Note that on its face, IRC §108(e)(5) is unavailable to an insolvent purchaser, however see the discussion below of the IRS' departure from enforcement of this provision for certain partnerships.)

Despite IRC §108(e)(5)(B)(ii) being seemingly to the contrary, the IRS announced that it will not challenge a bankrupt/insolvent partnership's treatment of a reduction (in whole or in part) in debt as a purchase-money debt reduction if the transaction would qualify for treatment under IRC §108(e)(5) but for the bankruptcy/insolvency. However, the IRS requires that the partners adopt a reporting position with regard to the debt discharge consistent with the partnership's income tax treatment of the debt discharge. See Rev. Proc. 92-92, 1992-2 CB 505.

Additionally, since there is no debt-discharge income for the partners, their bases will not be increased. However, the deemed distribution rules of IRC §752 will still apply, creating the possibility of generating taxable income for the partners.

c. **Impact for Partners**.

i. **General Application of IRC §108**.

Since the provisions of IRC §108 are generally applied at the partner level, unless a partner is bankrupt or insolvent, the bankruptcy and insolvency exclusions will not apply even though the partnership itself is in bankruptcy or is insolvent. While it would certainly be "safe" to determine a partner's insolvency by valuing his/her partnership interest at its fair market value, arguably a partner with a economic risk of loss with regard to a debt owed by an insolvent partnership should be able to include that partner's share of the debt in the insolvency determination.

[5] There are exceptions to this general rule. See the House Ways and Means Committee Report No. 103-11, H.R. 2141 for more details.

ii. Impact on Tax Basis.

Income from the discharge of indebtedness of the partnership will be allocated to the partners under IRC §702(a). Pursuant to IRC §704(a) and (b), each partner's share of the income is determined pursuant to the partnership agreement, or on the basis of each partner's interest in the partnership (if the partnership does not provide for an allocation, or if the allocation provided lacks "substantial economic effect").

Pursuant to IRC §705(a), each partner's basis in that partner's partnership interest is increased by his/her distributive share of the discharge income.[6] Pursuant to IRC §752(b), a decrease in partnership debt is treated as a distribution of money to the partners and thus reduces their bases in their partnership interests in the amount of the cancelled debt. This could result in gain under IRC §731 for a partner to the extent a deemed distribution exceeds basis, a result that would occur if there is a difference in profit and loss allocations in the partnership agreement.

If an insolvent partner excludes his/her share of income from the discharge of indebtedness at the partner level in accordance with IRC §108(a)(1)(B), he/she may increase his/her basis in the partnership interest by an equivalent amount under IRC §705(a)(1)(A), provided the allocation of income from the discharge of indebtedness has substantial economic effect. Rev. Rul. 92-97, 1992-2 CB 124. Note, this result differs from that applicable with regard to S corporations pursuant to IRC §108(d)(7)(A), because the failure to increase the basis in S corporation stock in a like situation cannot give rise to capital gain income, as would be the case for a partner under IRC §731(a) absent the basis increase.

d. Specific Impact of IRC §108(i).

Pursuant to IRC §108(i)(6), any income deferred is to be allocated to the partners immediately before the discharge in the same manner as such amounts would have been included in their distributive shares under IRC §704 if such income were to be recognized at that time. Any reduction in a partner's share of partnership liabilities as a result of the discharge is not to be taken into account in accordance with IRC §752 at the time of the discharge to the extent it would result in the partner having to recognize gain under IRC §731. Any deemed distribution deferred as a result is to be taken into account by the partner at the same time, and to the extent remaining in the same amount, as income deferred in accordance with IRC §108(i) is recognized.

III. CORPORATE DISSOLUTION AND LIQUIDATION.

A. Overview. A corporate liquidation is a transfer of assets out to all of its shareholders, whether in cash or in-kind. Simultaneously, the shareholders assume the corporation's remaining

[6] Note, the IRS may challenge any attempt by the partners to provide in the partnership agreement for a special allocation of debt discharge income to insolvent or bankrupt partners pursuant to IRC §704(b) as an allocation lacking "substantial economic effect." Any such allocations must also take into account any minimum-gain chargeback provided for in the partnership agreement. This is often a hard sell with limited partners with regard to nonrecourse debt. However, in the absence of this requirement, tax allocations will not be respected unless deductions arising from nonrecourse debt are allocated among the partners in the same manner as allocations (with substantial economic effect) of other items attributable to the debt encumbered property, and the partnership agreement contains a minimum-gain chargeback.

liabilities, regardless of whether a formal dissolution occurs under state law, though it is typical for a corporate dissolution to be accompanied by a true liquidation of the corporation's assets.

A corporate liquidation should be considered at two levels, the shareholder level and the corporate level. On the shareholder level, a complete liquidation can be thought of as a sale of all outstanding corporate stock held by the shareholders in exchange for all of the assets in that corporation. Like any sale of stock, the shareholder receives capital gain treatment on the difference between the amount received by the shareholder in the distribution and the cost or other basis of the stock. At the corporate level, the corporation recognizes gain or loss on the liquidation in an amount equal to the difference between the fair market value and the adjusted basis of the assets distributed.

B. Timing of the Liquidation. Generally, a complete liquidation transaction is a recognition event to both the corporation and its shareholders, versus a pass through event as with partnerships and S corporations. While neither the Code nor the regulations under Section 331 define the term "complete liquidation," the following portion of the regulations under Section 322 (concerning subsidiary liquidations) probably applies to Section 331 as well:

> A status of liquidation exists when the corporation ceases to be a going concern and its activities are merely for the purposes of winding up its affairs after paying its debts, and distributing any remaining balance to its shareholders. A liquidation may be completed prior to the actual dissolution of the liquidating corporation. However, legal dissolution of the corporation is not required. Nor will the mere retention of a nominal amount of assets for the sole purpose of preserving the corporation's legal existence disqualify the transaction.[7]

The courts also support this approach concerning the triggering of a complete liquidation. The courts have not found that a dissolution under state law is required to effectuate a complete liquidation.[8] The following is an excerpt from a Fifth Circuit case concerning a cash liquidation, but the same can be applied to a liquidation in-kind as well:

> It is not material that the distribution was not specifically designated as a liquidating dividend or that no formal resolution to liquidate or dissolve the corporation had been adopted when the distribution was made. An intention to liquidate was fairly implied from the sale of all the assets and the act of distributing the cash to the stockholders. Permitting the forfeiture of this right to do business was an additional circumstance which the [Tax Court] properly considered with the other facts and evidence. The determining element was the intention to liquidate the business, coupled with the actual distribution of the cash to the stockholders.[9]

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[7] Regs. 1.332-2(c).

[8] The Tax Court generally applies a three-pronged test to determine if a distribution is considered part of a liquidation: (1) Was there a manifest intent to liquidate? (2) Was there a continuing purpose to terminate corporate affairs and dissolve? and (3) Were the corporate activities directed and confined to that purpose? *Estate of Charles Fearon*, 16 TC 385 (1951).

[9] Kennermer v. CIR, 96 F2d 177 (5th Cir. 1938).

While it is not a requirement for a corporation to adopt a formal plan of liquidation, and the courts and the regulations are willing to observe an informal liquidation, it would be wise for the shareholders to document the formal action of the corporation prior to distributions of corporate assets.

C. Liquidating Distributions under Section 331. Section 331(a) provides that amounts received by a shareholder in complete liquidation of a corporation shall be treated as "full payment in exchange for the stock." Section 331(b) reinforces this treatment by rendering Section 301, relating to dividends, inapplicable to amounts received in a complete liquidation. The shareholder computes gain or loss by subtracting the adjusted basis of the stock from the amount realized (the money, if any, plus the fair market value of any other property received, less any debt assumed or to which the distributed property is subject) and reports the difference as capital gain or loss if the stock is a capital asset in the shareholder's hands.

The principal advantages accorded to liquidating distributions over ordinary dividends are threefold:

> (1) the capital gains rate preference allowed for liquidating distributions (unlike ordinary dividends which are taxed at regular rates);
> (2) a shareholder is allowed to set off his or her stock basis against the liquidation distribution proceeds (unlike the case of ordinary dividends) and;
> (3) a taxpayer with capital losses can use those losses to offset any capital gain on a Section 331 liquidating distribution without dollar limit but can apply such losses annually against only $3,000 of ordinary income (including dividends).

Even when the rate differential for long-term capital gains and ordinary income and losses is not extreme, capital gains and losses are not equal in treatment because of the limitation associated with capital losses.

For a simplistic example: Sam owns all of Corporation XYZ. The adjusted basis of the stock is $200,000. XYZ has accumulated earnings and profits of $50,000, and the company is worth $200,000. XYZ would pay an ordinary cash dividend of $50,000 to Sam, thus reducing XYZ's net worth to $150,000. XYZ would then distribute the remaining assets to Sam in a complete liquidation. Unfortunately for Sam, this transaction created $50,000 in ordinary income on the dividend and a capital loss of $50,000. The loss cannot offset the ordinary income from the dividend and can only be used to offset $3,000 of ordinary income per year.

D. Shareholder Gain or Loss on a Liquidating Distribution. Section 331(a) provides that payments received by a shareholder in complete liquidation of a corporation shall be treated as full payment in exchange for the shareholder's stock so that the shareholder will recognize any gain or loss inherent in that stock. This confirms that the disposition of the stock has occurred which triggers that the related gain or loss should be calculated based on Section 1001, and Section 331(a) establishes the exchange element that is needed for capital gain or loss treatment of the stock under Section 1222.

The amount of the gain or loss and its character as long-term or short-term capital gain or loss depends on the shareholder's adjusted basis and the holding period for the stock and the value of the liquidating distribution. If there is shareholder debt to the corporation that is cancelled when the liquidation occurs, the amount of the debt is treated as part of the liquidating distribution.

However, if the shareholder acts in another capacity (such as a creditor) in receiving a liquidating distribution, then the distribution will be taxed in accordance with that capacity.

1. Calculating Gain or Loss. The regulations state that the shareholder's gain or loss on liquidating distributions be calculated on a per-share basis, so that the gain or loss is separately calculated for blocks of stock obtained at different instances and for different prices.[10] If a shareholder receives a series of liquidating distributions over a period of time, the shareholder will apply all receipts to recover stock basis first, before reporting gain or loss on the distribution.

2. Issues Concerning Valuation and Timing. Section 1001(a) calculates a shareholder's gain or loss upon liquidation as the fair market value of the liquidating distribution less the adjusted basis of the shareholder's stock.[11] The determination of when the shareholder should realize a receipt of the liquidation for purposes of computing that gain or loss is made under the general tests of Section 1001 which outlines the general rules concerning amount of and realization of gains and losses. When a shareholder receives a series of liquidating distributions, he recognizes gain after all basis is recovered, but does not recognize a loss until the final distribution is received.[12]

Calculating the value of distributed assets can be done through appraisals or reasonable estimates for most assets. Some assets, such as disputed claims, contingent rights, royalties from mineral interests, and goodwill related to a business, may be extremely difficult to value accurately. When the value of some of the assets received in a liquidating distribution cannot be ascertained with reasonable accuracy, the computation concerning these assets can be held "open" until an ascertainable value is determined by a sale, collection or otherwise. The theory behind delaying the recognition of gain or loss and leaving the assets "open" until an ascertainable value is determined will affect the year in which the shareholder recognizes the gain or loss as well having the potential for affecting the characterization of the gain or loss.

This concept was initially explained by the Supreme Court in *Burnet v. Logan.* In *Burnet*, the shareholders were to be paid $2.2 million dollars initially and 60 cents annually thereafter for each ton of ore apportioned to their shares.[13] Mrs. Logan received payments yearly, but claimed no taxable receipt was made because her capital had not yet been returned to her. The IRS claimed her anticipated future earnings to be $2 million dollars and she should then pay tax on this amount. The Supreme Court agreed with Mrs. Logan and provided that only when the profit of a transaction is actually realized will the taxpayer be required to respond.[14]

The Court reasoned that in order to determine whether there is a gain or loss, the initial capital at the beginning of the period in consideration must first be recovered. As annual payments from extracted ore are paid, they can be apportioned as return of capital and later profit. Only then

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[10]Regs. Section 1.331-1(e).

[11]See also Regs. 1.331-(b).

[12]See Rev. Rul. 85-48, 1985-1 CB 126.

[13]*Burnet v. Logan*, 283 U.S. 404, 410.

[14]*Id*. at 411.

can the liability for income tax can be fairly determined without resort to conjecture. The initial promise has no ascertainable fair market value, so the transaction was not closed. Mrs. Logan may never have recouped her initial investments from payments that were promised to her. The Court concluded that based on the facts, there is no way to fairly evaluate the promise of 60 cents a ton for an undisclosed portion of time, and that income should only be included after the basis has been recovered.

For a more common and simplistic example: Sam is the sole shareholder of ABC. ABC completely liquidates the company and distributes to Sam $100,000 cash, assets valued at $25,000, and a contingent claim against company XYZ for $200,000 (which may or may not have value because it is not ascertainable at this time). Sam has a basis of $150,000 for his ABC stock. Under *Burnet*, the calculation would be held "open" until the claim against XYZ was reduced to an ascertainable value. If the claim against XYZ is later settled for $100,000 the amount of the liquidating distribution to Sam would be $225,000. Sam would then have a gain of $75,000. If, instead of the claim being valued at $100,000, the claim had failed and been deemed worthless, Sam would have a loss of $25,000.

3. <u>Impact of Liabilities for a Liquidating Distribution</u>. Each state's laws differ on the specifics concerning legal obligations to corporate creditors, but the laws typically require that a liquidating corporation either pay its debts or cause third parties (such as those receiving assets from the distribution) to assume the related debt. If shareholders take property subject to the corporate liabilities (i.e. assume the debt), the shareholder's gain on the transfer must be reduced (or their loss increased) by the amount of the assumed debt.

For example: Company XYZ distributes property in a complete liquidation to Sam with a fair market value of $150,000, but the property is subject to a $50,000 debt. Sam has a basis of $20,000 in his XYZ stock. Sam will realize a gain of $80,000 on the distribution.

If the amount of the liability is unknown, speculative, or contingent at the time of the distribution, the principles described above do not apply. If the debt is later paid by the shareholder, the amount paid will typically be deducted in the year of payment and the gain or loss will not be recalculated. This loss will typically be a capital loss and not a deduction from ordinary income on the theory that the shareholder's prior capital gain or loss on the liquidation was over or understated respectively.[15]

If the amount of the debt associated with a distributed asset is greater than the value of the asset, the value of the property does not increase to the amount of the debt as it would if Section 7701(g) applied. This is because when an insolvent corporation liquidates, the shareholder receives nothing, but is not liable for the corporate debts in excess of the corporation's assets.

The result is different then the scenario described above if the shareholder was already liable for the obligation. If a shareholder is a co-signor on the note, or is some other form of obigor, the liability associated with the distributed property will not reduce the amount realized on the distribution. If the shareholder pays the debt on which the shareholder was already liable, he or she may be able to deduct a loss. When a shareholder pays an assumed debt that reduced the amount received in the liquidation, as described above, the shareholder may not deduct the payment.

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[15] See Arrowsmith v. CIR, 69 TC 697, 709 (1952).

E. **Property Distributed Related to a Liquidating Distribution**.

1. Basis of Property Received in a Liquidating Distribution. According to Section 334(a), the basis of property received in a complete liquidation is the property's fair market value at the time of the distribution if the shareholder recognized gain or loss on its receipt. If no gain or loss was recognized, the basis would have already equaled the fair market value.

Section 334(a) ensures that the profits and loss related to a liquidating distribution is measured in two steps: (1) the difference between the shareholder's basis in the stock and the value of the distributed assets is taxed at the time of liquidation; and (2) the difference between the value of the distributed assets and the proceeds from an ultimate sale or disposition of the distributed assets is taxed when the property is sold by the shareholder.

If shareholders assume or take property subject to liabilities, their basis is the unencumbered fair market value of the assets, and that amount is not further increased by the amount of these liabilities.[16]

2. Liquidating Corporation's Gain or Loss on Distributions of Property. Since Congress amended Section 336(a) in 1986, corporations recognize gain or loss on the distribution of its property in complete liquidation "as if such property were sold to the distributee at its fair market value."[17] The complete liquidation of corporate assets produces the same general tax result at the corporate level and the shareholder levels as if the corporation had sold its assets to third parties and distributed the proceeds, less its tax liability, to the shareholders. If gains are assumed at both levels, Section 336(a) enforces the two tiered tax system.

3. Computation of Corporate Gain or Loss. Generally, gain and loss must be calculated separately on each corporate asset, even if assets functionally interrelate with the conduct of an ongoing business. Debt which encumbers distributed property does not affect the computation of corporate gain or loss unless it exceeds the property's fair market value. If the debt is in excess of the fair market value, Section 336(b) requires that the property's fair market value be treated as at least equal to any liability to which it is subject or any liability assumed by the shareholders in connection with the distribution.

Unlike Section 311, which requires corporate gains but not losses to be recognized on nonliquidating distributions in kind, the general rule of Section 336(a) requires corporate recognition of both gain and loss on distributions in complete liquidations.[18] There are restrictions to this general rule which prevent companies and their shareholders for creating or inflating losses. A loss may not be recognized by a liquidating corporation when it distributes property to a more-than-50 percent shareholder unless: (1) the property is distributed pro rata to all shareholders; and (2) the

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[16]This prevents a shareholder from benefitting from the assumption of the debt twice since the shareholder's gain was already reduced by the amount of the debt assumed at the time assets were distributed to the shareholder.

[17]See IRC Section 336.

[18]IRC Section 311(a) specifically exempts complete liquidations from its coverage.

property was not acquired in a tax-free transaction or as a contribution to capital during the five years preceding the distribution.[19]

F. S Corporation Dissolution and Liquidation. When an S corporation is being liquidated the Subchapter C rules are applied.[20] Therefore, under section 336(a), an S corporation will recognize gain upon a distribution of appreciated assets in liquidation in the same manner as a C corporation. As a pass-through entity, this gain is taxed on the shareholder's return and the shareholder's stock basis receives a step-up for the gain.

Gain (or loss) is reported by the shareholder to the extent the value of the property received in liquidation exceeds (or is less than) his or her stock basis in the corporation (adjusted for any gain or loss recognized by the corporation upon the liquidation and passed through to the shareholders). Generally, the income recognized at the distribution of the assets will increase the shareholder's basis, and therefore should eliminate the recognition of gain with respect to the property distributed in the liquidation.

If a corporation has always elected S corporation status, there is generally little or no Section 331 gain or loss at the shareholder level. On the other hand, if the corporation was formerly a C corporation, there may be a built-in gains tax to the S corporation on the assets while the C corporation was in existence[21] and there could be Section 331 gain or loss on the liquidation.[22]

IV. LIQUIDATION OF A PARTNERSHIP - THE TAX TRAPS.

There is a perception that a limited partnership may be liquidated without income tax recognition. However, the truth is that many distributions of property from a partnership do, in fact, trigger gain, and thus, require further examination. Specifically, three major income tax traps exist under the Code, which can prevent a tax-free liquidation. Such tax traps will be explored in the following paragraphs.

When a partnership wishes to unwind or dissolve, it has two basic options for effecting such a change: (a) sell the entity's assets and distribute the cash proceeds after paying all partnership debts; or (b) distribute the assets in kind to the partners.

A. Sale of Partnership Assets. If the partnership wishes to sell the assets and distribute cash to the partners, Section 704(c)(1)(A) requires any gain from the sale of appreciated property contributed to the partnership to be allocated among the partners in a manner that takes into account

[19]See IRC Section 267(a)(1).

[20]Pursuant to IRC Section 1371, except to the extent inconsistent with Subchapter S, all provisions of Subchapter C (dealing with C corporations) will apply to S corporations. Thus, IRC Sections 331 and 1001 apply to S corporation distributions in liquidation.

[21]See IRC Section 1374.

[22]See also IRC Section 1245 to consider if there is a Section 1245 recapture at the time of conversion as another possible source of built-in gain.

the property's built-in gain at contribution.[23] Therefore, if any partner contributes property to a partnership ("contributed property") with a fair market value in excess of its adjusted basis ("built-in gain"), and the partnership sells the contributed property, the built-in gain must be allocated to the contributing partner and any excess gain may be allocated as determined by the partnership agreement.[24] Generally, the partnership agreement will allocate excess gain to the partners in proportion to their partnership interests. An individual or entity that succeeds to all or a portion of a contributing partner's partnership interest (the "contributing partner's assignee") will inherit that partner's share of the built-in gain attributable to the interest received.[25] Following the recognition and pass-through of gains and losses from the sale of the assets and required adjustments to a partner's basis in the partnership interest (the "outside basis"), a distribution of cash is taxable only to the extent that the distributed cash exceeds the partner's outside basis.[26] A partner's outside basis must be increased by the partner's share of partnership income and gain items and reduced by the partner's share of partnership losses and expenditures.

B. <u>Distributions of Partnership Assets In-Kind</u>. The remaining paragraphs in this section will focus on distributing assets in-kind to the partners since the majority of tax traps surrounding partnership dissolution result from this particular dissolution option. Once a partnership has made the decision to liquidate by distributing its assets in-kind to the partners, such distributions can either by done (a) proportionately so that each partner receives a share of every asset owned by the partnership according to the partner's interest or (b) selectively (a.k.a. "cherry picking") so that entire assets are distributed to one partner to the extent possible.

A distribution from a partnership to a partner is not taxable to the partner <u>except</u> to the extent that: (a) Section 704(c)(1)(B) applies; (b) the amount of "money" distributed exceeds the partner's basis in the partnership (*see* Section 731(c)); or (c) Section 737 applies. In exploring these tax traps, it is important to note the ordering rules for their application. If a distribution results in the application of Section 731(c) and one or both of Sections 704(c)(1)(B) and 737, the Treasury Regulations provide that the effect of the distribution is determined by applying Section 704(c)(1)(B) first, Section 731(c) second and finally Section 737.

1. <u>Section 704(c)(1)(B)</u>. Under Section 704(c)(1)(B), if contributed property is distributed to another partner ***within seven (7) years*** of being contributed, the contributing partner must recognize the built-in gain (or loss) on the contributed property at the time of the distribution. If a contributing partner transfers his or her partnership interest, the transferee partner steps into the contributing partner's shoes for purposes of Section 704(c)(1)(B).[27] Thus, any transferee partner would be required to recognize the built-in gain (or loss) on contributed property that the contributing partner would have had to recognize at the time of distribution to another partner. There is a "return-to-sender" exception so that recognition of built-in gain (or loss) is avoided if the

[23] Section 704(c)(1)(A).

[24] *Id.*

[25] Treas. Reg. 1.704-3(a)(7).

[26] Section 731(a)(1).

[27] Treas. Reg. 1.704-3(a)(7).

distribution of the contributed property is back to the contributing partner.[28] This "return to sender" exception also applies to the contributing partner's assignee so that such partner is treated as the contributing partner to the extent of the built-in gain (or loss) allocable to the transferee partner's interest.[29]

There are two easy solutions to avoid 704(c)(1)(B) gain. The partnership can either (a) distribute the built-in gain property back to the contributing partner (or such partner's assignee), or (b) wait seven (7) years after the contribution before making distributions of property with built-in gain. Of course, such solutions are not always an available option especially when a partnership must liquidate immediately. There are few other options available for avoiding the application of Section 704(c)(1)(B) for property with built-in gain.

2. <u>Section 731(c)</u>. If the partnership distributes money (which includes marketable securities as explained below), Section 731(a)(1) generally provides that partners do not recognize gain upon such a distribution except to the extent that any money distributed exceeds the adjusted basis of the partner's interest in the partnership immediately prior to the distribution. This rule is applicable to both current distributions and distributions in liquidation of the partner's entire partnership interest.[30] On the other hand, loss will only be recognized to a partner under Section 731(a) upon liquidation of his entire partnership interest and only if the property distributed to him consists solely of money, unrealized receivables (as defined in Section 751(c)) and inventory items (as defined in Section 751(d)).[31]

Under Section 731(c), the term "money" includes marketable securities for purposes of Section 731(a)(1) and such securities are valued at fair market value as of the date of distribution. The term "marketable securities" is defined as financial instruments and foreign currencies which are, as of the date of the distribution, actively traded (within the meaning of Section 1092(d)). Thus, if a partnership distributes marketable securities, Section 731(c) works to require the distributee partner to recognize gain on such a distribution if the fair market value of the securities on the date of distribution exceeds the basis of the distributee partner's interest in the partnership.

In the event marketable securities are distributed and Section 731(c) applies, the amount of the deemed cash distribution is reduced by the recipient partner's share of gain on the distributed securities as determined by the formula set forth below:

Fair Market Value of the Distributed Marketable Securities

LESS

Distributee's Share of Net Gain on Sale of All of the Partnership's Marketable Securities

PLUS

[28] Section 704(c)(1)(B).

[29] Treas. Reg. 1.704-4(d)(2).

[30] Treas. Reg. 1.731-1(a)(1).

[31] Treas. Reg. 1.731-1(a)(2).

Distributee's Share of Net Gain on Sale of Retained Partnership's Marketable Securities

EQUALS

***Amount of Deemed Cash Distribution*.**[32]

Thus, once you know the "amount of deemed cash distribution", you can calculate the Section 731 gain (if any) to be attributable to such partner upon the distribution of marketable securities.

The provisions of Section 731(c) provide four exceptions to its application to a distribution of marketable securities. Section 731(c) will not apply to distributions of a marketable security if: (a) the security was distributed to the contributing partner (another "return to sender" exception); (b) subject to certain limitations, the securities were acquired by the partnership in a nonrecognition transaction; (c) the securities were not marketable when first acquired by the partnership (e.g. investment in a company prior to it becoming publicly traded), did not become marketable for at least six (6) months, and were distributed within five (5) years of the date upon which they became marketable; or (d) the partnership is an "investment partnership" and the recipient of the distribution is an "eligible partner".[33] An "investment partnership" is a partnership that has never been engaged in a trade or business and ninety percent (90%) or more of its assets have always consisted of portfolio assets. An "eligible partner" is any partner that contributed nothing but such portfolio assets to the partnership.[34]

Under Section 731(c)'s "return to sender" exception, marketable securities will not be treated as cash so long as they are distributed to the contributing partner, which is consistent with the "return to sender" exception available under Section 704(c)(1)(B). Provided, however, that unlike the exception under Section 704(c)(1)(B), no Treasury Regulation has been issued extending this exception to a distribution of marketable securities to a contributing partner's assignee. Accordingly, those who receive a partnership interest by gift may be required to recognize gain upon distribution of marketable securities even if those securities were contributed by the transferee partner's respective donor.[35]

3. <u>Section 737</u>. Congress intended Section 737 to complement Section 704(c)(1)(B) so that together the two provisions deter the use of a partnership to effect tax-free exchanges of built-in gain property.[36] Section 737(a) applies when a partner contributes appreciated property to the partnership and ***within seven years*** of such contribution, receives a distribution of property (other than money). Under Section 737(a), the contributing partner must recognize either the Section 704(c) built-in gain, or, if less, the excess of the distributed property's value over the

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[32]Section 731(c)(3)(B).

[33]Section 731(c)(3)(A) and Treas. Reg. 1.731-2(d).

[34]Section 731(c)(3)(C). It is important to note that while the formation of a partnership is generally not a taxable event, Section 721(b) requires recognition of gain where more than eighty percent (80%) of the value of the partnership assets is made up of portfolio assets held for investment.

[35]Donaldson, *supra* 4.

[36]*Id.*

partner's outside basis immediately prior to the distribution minus any cash received in the same distribution. Section 737 does not allow for the recognition of built-in loss, so that upon distribution of property with built-in loss, such loss will be preserved in the basis of the distributed property.[37]

The following expresses the amount of gain to be recognized by the contributing partner under Section 737(a) in formula form:

The contributing partner must recognize the **lesser of** these two amounts:

1. *Fair Market Value of Property (Other Than Money)*[38] *Distributed to Contributing Partner*

LESS

Contributing Partner's Outside Basis LESS Cash in Same Distribution

EQUALS

Excess Distribution (737(a)(1)); OR

2. *Amount of Section 704(c)(1)(B) Gain Allocable to Contributing Partner if All Contributing Partner's Section 704(c) Assets Distributed to Other Partners*

EQUALS

Net Precontribution Gain (737(a)(2)).

In summary, upon a partnership distribution of property (other than money) to a contributing partner (within seven (7) years of such partner's contribution), such partner will be required to recognize the lesser of "excess distribution" or "net precontribution gain."

A transferee partner is treated as the contributing partner for purposes of Section 737's general gain recognition rule, so that the transferee partner would be required to recognize the same built-in gain (or a proportionate amount if the transferred interest is less than all of the contributing partner's interest) as the contributing partner would have had to recognize.[39] As is the case under Section 704(c)(1)(B) and Section 731(c), Treasury Regulations provide that if the contributing partner receives the property he or she originally contributed to the partnership, Section 737 does not apply (another "return to sender" exception).[40] Provided, however, that similar to Section 731(c), there is no Treasury Regulation extending this "return to sender" exception to the contributing partner's assignee. Accordingly, those who receive a partnership interest by gift may

[37]Donaldson, *supra* 4.

[38]It is important to note that under Section 731(c), the term "money" also includes marketable securities for purposes of Section 737.

[39]Treas. Reg. 1.731-1(c)(2)(iii).

[40]Treas. Reg. 1.731-2(d)(1).

be required to recognize gain under Section 737 even if the property distributed was contributed by the transferee partner's respective donor.[41]

As is the case with Section 704(c)(1)(B), there are two easy solutions to avoid 737 gain. The partnership can either (a) distribute the built-in gain property back to the contributing partner (although it is unclear whether such exception applies to such partner's assignee), or (b) wait seven (7) years after the contributing partner makes a contribution before making distributions of property with built-in gain to such partner.

4. Summary of Major Tax Traps. As noted above, if a distribution results in the application of Sections 731(c) and one or both of Sections 704(c)(1)(B) and 737, the Treasury Regulations provide that the effect of the distribution is determined by applying Section 704(c)(1)(B) first, Section 731(c) second and finally Section 737.

In applying Section 704(c)(1)(B) first, a contributing partner must recognize built-in gain (or loss) from the contributed property if it is ***distributed to another partner*** within seven (7) years of contribution. The "return to sender" exception keeps the contributing partner or the contributing partner's assignee from recognizing any built-in gain (or loss) upon a distribution of the contributed property back to the contributing partner or his or her assignee.

Next, in applying Section 731(c), this section requires ***marketable securities*** distributed to a partner to be treated as a distribution of cash. Accordingly, under Section 731(a), a distribution of cash or marketable securities will be taxable to the extent such distribution exceeds the recipient's outside basis in the partnership. Similar to that of Section 704(c)(1)(B), a "return to sender" exception to Section 731(c) keeps marketable securities from being treated as cash so long as they are distributed to the contributing partner, but it is unclear whether such exception is applicable to the contributing partner's assignee.

Lastly, in applying Section 737, a contributing partner must recognize built-in gain (but not loss) from the contributed property if such partner ***receives non-cash property*** within seven (7) years of contributing property to the partnership. As is the case with Section 704(c)(1)(B) and Section 731(c), a "return to sender" exception keeps the contributing partner from recognizing any built-in gain upon a distribution of the contributed property back to the contributing partner, but it is unclear whether such exception is available to the contributing partner's assignee. Note, as discussed above, Section 704(c)(1)(B) and Section 737 are symbiotic and work together to prevent partnerships from effecting tax-free exchanges of property with built-in gain. Thus, it can be argued that such sections would also work together to provide the same "return to sender" exception to a contributing partner's assignee.

As the forgoing paragraphs indicate, partners may have a preference between a pro-rata or non-pro-rata liquidation of the partnership from a purely tax perspective. In contrast, non-tax factors (e.g. the desire to own a particular asset because of future growth or income possibilities) may play as big a role to some individuals as the tax implications. Thus, some or all of the partners may wish to overlook the tax implications in determining how to distribute assets in liquidation of the partnership.

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[41] Donaldson, *supra* 4.

V. ZONE OF INSOLVENCY.

Another consideration to be aware of during the dissolution process of an entity with creditors is the shift in roles for the directors and officers which may arise when a corporation enters the "zone of insolvency". A fundamental tenet of corporate law is that directors and officers owe fiduciary duties of care, loyalty, disclosure, and good faith to the corporation and its shareholders.[42] In contrast, such roles change when the corporation becomes insolvent and may change when a corporation enters the "zone" or "vicinity" of insolvency, so that directors and officers fiduciary duties are extended to include creditors. If a fiduciary duty is owed to a corporation's creditors, the officers and directors may discharge such a duty by preserving sufficient assets to repay the creditors' claims.[43]

A. General Rule and Its Exception. As explained above, the general rule is that officers and directors of a solvent corporation owe their fiduciary duties to the corporation and its shareholders, and generally owe no fiduciary duty to the corporation's creditors.[44] However, when a corporation becomes insolvent, the fiduciary duties of its officers and directors can arguably expand to include not only the corporation and its shareholders but also its creditors as well.[45] In the insolvency setting, the shareholders' equity interest in the company is small and perhaps non-existent so that shareholders may have little to lose by a risky strategy that could lead to a business failure or liquidation (although they may have much to gain if the company can turn itself around).[46] Creditors, on the other hand, have more to lose if the company fails but share less in the gains of the corporation's future success in the event the company becomes profitable again.[47] Obviously, in the setting of insolvency, the shareholders and the creditors may have completely different views on the best direction for the company moving forward.

B. Zone of Insolvency. While it is clear that at one end of the spectrum (solvency), fiduciary duties run only to the corporation and its shareholders, and at the other end of the spectrum (insolvency), fiduciary duties run not only to the corporation and its shareholders, but also to creditors, it is not clear what duties run to creditors within the "zone of insolvency" and when such duties (if any) commence. The answer to these questions differ depending on the test used to determine insolvency (so that in turn a determination can be made as to when the entity has entered the "zone of insolvency") and depending on which state's law is applicable.

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[42] *Slip-Sliding Away: Breaching Fiduciary Duties in the Zone of Insolvency*, by Joseph D. Martinec (2004).

[43] *Voluntary Dissolution and Termination of Texas Entities*, by John T. Palter, (2008).

[44] *Fiduciary Duties of Officers and Directors in Troubled Company Situations*, by Kenrick D. Kattner, Doug H. Edwards and James Brashear (2009).

[45] *Carrieri v. Jobs.com,* 393 F.3d 508 (5th Cir. 2004)*; Weaver v. Kellogg,* 216 B.R. 563 (S.D. Tex. 1997) (holding that under Delaware and Texas law, corporate insiders may have a fiduciary duty to the corporation's creditors when the corporation is in the "zone of insolvency"); *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*, 930 A.2d 92 (Del. 2007).

[46] *Director and Officer Fiduciary Duties in the Context of Insolvency*, by Thad Behrens and John Tancabel (2009).

[47] *Id.*

1. Insolvency Test. As a practical matter, determining insolvency at a given point in time can be a very difficult endeavor for officers and directors, as well as being a difficult evidentiary burden for a litigant to meet.[48] There are many potential tests for evaluating insolvency including the following three tests: (a) the Bankruptcy Code Standard; (b) the Balance Sheet Test; and (c) Retrojection Analysis.[49] The Bankruptcy Code Standard provides that insolvency exists when an entity's financial condition is such that the sum of its debts is greater than all of its assets using a fair valuation and excluding any property that may be exempted under Section 522 of the Bankruptcy Code.[50] The Balance Sheet Test is a going concern test and provides that a corporation reaches insolvency if its liabilities are greater than its assets and the corporation is unable to pay its debts as they become due in the ordinary course of business.[51] A test of Retrojection allows insolvency to be proven at an earlier period through a showing that the company is insolvent at a later time. In using Retrojection, an inference of insolvency is assumed where the condition of such insolvency would not have changed materially during a brief lapse of time.[52] Regardless of the test used, the issue of whether a company is insolvent or whether a company has entered the zone of insolvency is a question of fact.

2. State Law. While it is clear that at the point of actual insolvency, fiduciary duties of officers and directors of a corporation are extended to include creditors, Delaware courts have struggled for many years with the question of to what extent are fiduciary duties owed to creditors within the "zone of insolvency". However, the Delaware Supreme Court in *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*[53] brought some clarity to this area of Delaware law.[54] In *Gheewalla*, the Delaware Supreme Court held that *when a solvent corporation is navigating in the zone of insolvency, the focus for Delaware directors does not change: directors must continue to discharge their fiduciary duties to the corporation and its shareholders by exercising their business judgment in the best interests of the corporation for the benefit of its shareholder owners*, strongly suggesting that creditors may not assert a claim against the officers or directors if the company is not yet insolvent.[55]

While a certain amount of clarity now exists under Delaware law regarding when a creditor may bring a claim for breach of fiduciary duty, such is not the case in other jurisdictions, such as Texas, where courts have adopted widely differing positions on when a creditor may seek redress for breach of fiduciary duty.[56] Some courts restrict a creditor's claim for breach of fiduciary duty

[48] Martinec, *supra* 23.

[49] *Id.*

[50] 11 U.S.C. Section 101.

[51] Martinec, *supra* 23.

[52] *Snider v. England*, 374 F.2d 717 (9th Cir. 1967); Martinec, *supra* 23.

[53] *Gheewalla*, 930 A.2d at 92 (decided after *Weaver v. Kellogg*, supra 26).

[54] Behrens, *supra* 27.

[55] *Gheewalla*, 930 A.2d at 101.

[56] Behrens, *supra* 28.

to those situations where the company is ***both*** actually insolvent and has ceased business operations.[57] On the other hand, some courts allow creditors to seek redress for breach of fiduciary duty when the company has merely entered the "zone of insolvency" (although still solvent).[58] Accordingly, if a corporation enters the "zone of insolvency", officers and directors of Delaware corporations may now feel confident that their legal responsibilities are to manage the corporation solely for the benefit of the corporation and its shareholders until the corporation is actually insolvent, while officers and directors of corporations in other jurisdictions may be wise to check the current status of the law in that jurisdiction and be aware that they may have a legal duty to perform their duties as though creditors may seek redress against them for failing to preserve sufficient assets to pay the corporation's debts.

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[57] *See Floyd v. Hefner*, 2006 WL 2844245 (S.D. Tex. 2006).

[58] *See In re Vartec Telecom, Inc., et. al,* Case No. 04-81694-HDH-7 (Bankr. N.D. Tex. 2007); *Kellogg,* 216 B.R. at 563.