



## Considering Alternatives to Liquidation

Shareholders might want to liquidate a corporation for several reasons including, among others, a division among the shareholders of the corporate assets, sale of the business operated within the corporation, a desire to operate the business as a sole proprietorship or partnership, avoidance of double tax on corporate earnings, and avoidance of personal holding company (PHC) status. In some cases, a plan of action other than liquidation might better meet these objectives.

### Determining Available Alternatives

All alternatives should be considered before deciding to liquidate. One option is a sale by the shareholder of the corporate stock to the corporation in a redemption transaction (assuming the shareholder is not the sole owner) or to another shareholder, rather than a sale by the corporation of its assets. A variation of this option is sale of the stock to an employee stock ownership plan (ESOP). Another option is a reorganization of the corporation.

### Alternatives for Avoiding Double Taxation

As an alternative to liquidating a C corporation, certain entities might be able to elect S corporation status or structure a tax-free divisive D reorganization.

### Electing S Corporation Status

Entities that can qualify as an S corporation can consider electing S status since, as passthrough entities, they generally would not be subject to entity-level taxes. However, to prevent the use of an S election as a method of avoiding corporate-level taxes on a liquidation, Sec. 1374 imposes a tax at the corporate level on the built-in gain of a C corporation that elects S corporation status. An S corporation that was formerly a C corporation will be subject to tax on gains from the disposition during a limited period of time (the recognition period) of appreciated assets on hand on the date the S election is effective (see Sec. 1374(a)).

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Therefore, this planning opportunity is only beneficial when there are no plans to liquidate the S corporation during the recognition period after electing S status.

S corporations are subject to numerous qualification requirements and restrictions that may preclude the C corporation from qualifying as an S corporation and retaining the S status.

### **Reorganizing the Corporation**

A corporate reorganization should be considered when the proposed liquidation is not due to a failed business but rather to disharmony among shareholders.

A divisive D reorganization results in the separation of a single corporation into two or more corporations. Thus, when there is shareholder dissent, the business can be split into separate lines of business rather than being liquidated (Secs. 368(a)(1)(D) and 355).

A divisive D reorganization may result in the distributing corporation's recognizing gain if there is a distribution of disqualified stock within five years ending on the date of the distribution. However, when gain recognition does not apply, a reorganization may represent an effective technique by allowing the distribution of appreciated property to the new business without adverse tax consequences.

### **Caution:**

There are several restrictions on divisive reorganizations and requirements for meeting Sec. 355 conditions, so it is important to structure the transaction carefully.

### **Selling Assets and Keeping the Corporation Intact**

Frequently, when an asset sale is used to transfer business ownership, the selling corporation is liquidated to provide cash to the business owner (or dependents, if the transfer is after his or her death). If the assets have appreciated, liquidating the corporation results in a large tax cost since the asset appreciation is taxed at the corporate level, and the sales proceeds are taxed when distributed to the shareholder. The high tax cost is a distinct disadvantage of using an asset sale (rather than a stock sale or redemption) to transfer business ownership when the business is a C corporation.

When assets are sold to transfer a business, the seller often takes a note. If a C corporation distributes installment notes in liquidation, it is taxed on all the deferred gain, even though cash is not yet collected. In addition, unless the note arose from a sale that occurred within 12 months of formally adopting a liquidation plan (and only if the corporation is actually liquidated in that 12-month period), the shareholder receiving the installment note is

taxed on its full fair market value (FMV) in the year the note is distributed.

Because of the tax costs associated with liquidating a C corporation (particularly if installment notes are distributed), business owners who can afford it should consider keeping the corporation intact. If the corporation is kept in existence until the owner's death, the owner's heirs will generally step up their basis in the stock to its FMV, generally allowing them to receive the corporate assets in liquidation without paying income tax (since the value of the stock should equal the liquidation proceeds).

One drawback to not liquidating is the potential for double taxation if assets in the corporation continue to appreciate and are not held by the corporation until the owner's death. This might result if the owner's financial situation deteriorates, forcing him or her to pull assets out of the corporation. Secondly, if the corporate stock is qualified small business stock (QSBS), the active business requirement of Sec. 1202(e) could be violated if corporate assets are held and not used in an active trade or business. Finally, there is the chance that the Sec. 541 PHC tax may be imposed, since the corporation is likely to own mostly cash or investment assets after selling its business assets.

#### **Avoiding the PHC Tax**

The purpose of the PHC tax is to tax currently the undistributed income of closely held C corporations that earn most of their income from investment or portfolio income and/or personal services income. The idea is to prevent the formation of corporations to receive and indefinitely hold investment income or compensation income of their individual shareholders. The PHC tax is really a penalty tax (paid at the rate of 20%) on such undistributed corporate income and is intended to force affected corporations to distribute income in the form of dividends, which are taxable income to the shareholders and nondeductible by the paying corporation.

A corporation is normally classified as a PHC, under Sec. 542(a), if:

1. More than 50% of its stock (measured by value) is owned directly or indirectly by five or fewer individuals at any time during the last half of the tax year; and
2. At least 60% of the corporation's adjusted ordinary gross income is from dividends, interest, and certain rents, royalties, and personal service contracts.

One way to avoid the PHC tax would be to reinvest cash sales proceeds in growth assets (e.g., mutual funds that do not pay dividends). Or, if the corporation is not liquidated until after the owner's death, the heirs would take a basis in the inherited stock

equal to its date of death (or alternate valuation date) FMV, so they should receive the liquidation proceeds and owe little or no tax.

Although leaving the corporation intact after selling the business assets to the successor can avoid double tax on the corporate assets, this plan should be undertaken only after considering the effect on the owner's financial planning and retirement planning, as well as the impact on the owner's estate planning goals. In addition, the other costs of keeping the corporation intact should be considered, such as the administrative costs of filing necessary corporate tax returns and the continued payment of any state franchise or income taxes that might be due.

### **Stock Purchases Treated as Asset Acquisitions (Sec. 338)**

In addition to complete liquidations under Secs. 331 and 336, a corporation may consider a stock purchase with a Sec. 338 election. Sec. 338 provides that certain stock purchases can be treated as asset acquisitions in which the target is deemed liquidated.

Sec. 338 allows a corporation that has purchased at least 80% (in value and voting power) of the stock of another corporation to make an election to step up the basis in the target corporation's assets, much as if the assets had been purchased instead of the stock. The deemed sale by the target of its assets at FMV is a taxable transaction. The target must recognize full gain or loss upon the deemed sale of its assets under Sec. 338(a). Therefore, for a purchasing corporation to achieve a step-up in basis of the target corporation's assets for future depreciation and amortization deductions, all gain must be recognized by the target as a result of the deemed sale of its assets.

Because the deemed sale that occurs under a Sec. 338 election causes full taxation to the target corporation as if it had sold its assets at FMV, most corporations do not benefit from incurring immediate taxation in exchange for an increase in basis.

However, in the following situations a Sec. 338 election can be advantageous:

1. The target has NOL carryovers that can be used to offset the gain and reduce or eliminate the tax liability by making a Sec. 338 election.
2. The gains and losses recognized in the deemed sale offset each other on an overall basis, and there is a net step-up in the basis of assets that can be depreciated or written off quickly and a step-down in the basis of assets that are non-depreciable or depreciable over an extended period.

3. A direct asset sale is impractical for nontax reasons (e.g., when the target has numerous assets for which the transfers of title after a direct acquisition would be expensive and time-consuming).

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