Liquidations and Dissolutions: Critical Tax Implications for Businesses
Proactive Steps to Minimize Negative Income Tax Consequences

A Live 110-Minute Teleconference/Webinar with Interactive Q&A

Today's panel features:
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Wednesday, January 6, 2010
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Liquidations And Dissolutions: Critical Tax Implications For Businesses Webinar

Jan. 6, 2010

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Today’s Program

• Important Background Concepts, slides 3 through 15 (Mark Schweighofer)
• Drill-Down On Entity Categories And Liquidations, slides 16 through 23 (Chris Lallo)
• Partnership-Taxed Entities, In Detail, slides 24 through 48 (Mark Schweighofer)
• S Corporations, slides 49 through 51 (Chris Lallo)
• Commercial And Legal Consequences Of Dissolutions, Liquidations, Conversions, slides 52 through 63 (Michael Cross)
• Issues That Cut Across Entity Categories, slides 64 through 71 (Michael Cross)
Important Background Concepts
Overview, Business Entities

• Basic entity classification
  – C corporation
  – S corporation
  – Limited liability company (LLC)
  – Partnerships (general and limited)
Overview, Business Entities (Cont.)

- C corporation
  - Tax considerations
    - Double-taxation
    - Potential entity level tax on liquidating distributions
  - Non-tax considerations
    - Significant formalities
    - Allows for multiple classes of stock with differing economic and voting rights
    - Liability protection
Overview, Business Entities (Cont.)

- **S corporation**
  - **Tax considerations**
    - Flow-through taxation (no entity level tax generally)
    - Deductions against debt are more complicated than in partnership structure
    - State-level taxation in some states
  - **Non-tax considerations**
    - Only one class of stock
    - Significant formalities
    - Liability protection
    - Shareholder restrictions (no more than 100 natural persons)
Overview, Business Entities (Cont.)

- Limited liability company (LLC)
  - Tax considerations
    - Flow-through taxation (no entity level tax)
    - Fewer complications in use of debt to utilize deductions
    - Flexibility — Can be taxed as a partnership, corporation or disregarded entity
    - With flexibility comes complexity
  - Non-tax considerations
    - Limited liability
    - Allows for multiple classes of ownership and priority returns
    - Fewer formalities
Overview, Business Entities (Cont.)

- Limited partnership
  - Tax considerations
    - Flow-through taxation (no entity level tax)
    - Allows for more efficient use of debt
    - Flexibility — Allows for priority return
    - With flexibility comes complexity
  - Non-tax considerations
    - Limited partners have limited liability
    - Limited partners unable to participate in day-to-day management
    - General partner faces unlimited liability
Liquidation Vs. Dissolution

- Liquidation vs. dissolution
  - “Liquidation” is generally a tax concept and results in distribution of assets and liabilities in termination of the entity for federal income tax purposes
  - “Dissolution” is generally a state law concept which terminates the legal existence of the entity
Liquidation Vs. Dissolution (Cont.)

- Liquidation vs. dissolution
  - Dissolution
    - Governed by state law, and each state has different requirements
    - Usually requires filing a certificate with the secretary of state in the state where entity is situated
    - Can be voluntary (election of shareholders) or involuntary (non-payment of state or franchise taxes)
Liquidation Vs. Dissolution (Cont.)

- Liquidation vs. dissolution
  - Adopt plan of dissolution and liquidation
    - Helps ensure orderly wind-up of business affairs and minimize disputes between parties
    - “Map out” the tax consequences on any liquidating distributions
Liquidation Vs. Dissolution (Cont.)

- Liquidation vs. dissolution
  - An entity can be liquidated but not dissolved
  - An entity can be dissolved but not liquidated
Liquidation Vs. Dissolution (Cont.)

- Liquidation vs. dissolution
  - Private Letter Ruling 200806006
    - Corporation’s administrative dissolution under state law did not, on its own, result in a liquidation for federal income tax purposes
  - Facts
    - Company was dissolved for state law purposes for its failure to pay state franchise taxes
    - Continued to file federal income tax return (unaware of state law dissolution)
Liquidation Vs. Dissolution (Cont.)

- Liquidation vs. dissolution
  - Private Letter Ruling 200806006
    - Facts (Cont.)
      - Corporation reincorporated upon learning of the administrative dissolution
    - Holding
      - Existence of corporation for federal income tax law is a matter of federal law. *Ochs. v. United States* 305 F.2d 844 (1962)
Liquidation Vs. Dissolution (Cont.)

- Liquidation vs. dissolution
  - Private Letter Ruling 200806006
- Holding (Cont.)
  - Administrative dissolution and subsequent reincorporation did not, by itself result, in distribution or transfer of property to the shareholders or cause a liquidation
  - Shareholders’ bases and holding periods unaffected
  - Corporation can continue to use same employer identification number
Drill-Down On Entity Categories And Liquidations
Tax Consequences Of Liquidations

- C corporations
  - Liquidations
    - Taxable
    - Non-taxable
      - Tax attributes and considerations
- S corporations
  - Liquidations
- Recent developments
- Planning opportunities
C Corporation Liquidations

- Taxable
  - Requirements
  - Consequences to liquidating corporation – § 331
  - Consequences to shareholders of liquidating corporation – § 336

- Non-taxable
  - Requirements
  - Consequences to liquidating corporation – § 332
  - Consequences to parent (P) of liquidating corporation – § 337
C Corporation Liquidations: Taxable § 331

- Requirements
  - Must cease to be a going concern
  - Full payment for stock from the corporation to the shareholder
  - Usually occurs if the shareholder is not a corporation, or shareholder fails to meet 80% ownership requirement
    - Example: Subsidiary is owned less than 80%, or another § 332 requirement is not met (i.e., solvency requirement)
  - Note: A series of distributions can qualify as a liquidating distribution
C Corporation Liquidations: Taxable § 331 (Cont.)

- Consequences
  - Shareholder
    - Gain (usually capital gain, long- or short-term), reduced by amount of liabilities assumed by the shareholder
    - FMV basis in the property received at the time of the distribution
  - Corporation
    - Gain recognized as if property was sold at FMV
    - Ability to utilize losses can be limited
C Corporation Liquidations: Non-Taxable § 332

- Requirements
  - Corporate shareholder (parent)
  - Adoption of a plan of liquidation – formal or informal
  - Ownership requirement – 80% of vote and value of all classes
  - Distribution(s) of property must be in complete cancellation/redemption of all subsidiary (S) stock, and:
    - The transfer must occur within one taxable year, OR
    - If distribution is one of a series of distributions, the transfer of property must be completed within 3 years from close of the taxable year in which the first liquidating distribution is made
  - Liquidated assets are not reincorporated
  - S cannot be insolvent
C Corporation Liquidations: Non-Taxable § 332 (Cont.)

- Consequences to parent (P)
  - No gain or loss recognized by P on the receipt of the subsidiary’s (S’) property with respect to stock *(Note: need to look out for deferred inter-company gains and debt-related issues)*
  - Carryover basis for P in S’ assets (§ 334)
  - Carryover to P of S’ tax attributes (e.g. NOLs, capital loss carryovers) - (§ 381)
  - P’s basis in S stock is permanently eliminated

- Consequences to subsidiary (S)
  - No gain or loss recognized by S (§ 337)
  - *Note: Under a § 332 liquidation, a S recognizes gain, but not loss, on distributions to minority shareholders*
C Corporation: Tax Attributes And Considerations

- Specified tax attributes carry over to P in a § 332 liquidation (§ 381(a)), such as:
  - Net operating losses
  - Earnings and profits
  - Capital loss carryovers
  - Methods of accounting/business history
- Considerations
  - Note: If S is insolvent, § 332 and § 381 do not apply
  - Note: § 382 may limit amount of NOL carryover and built-in loss if there has been a greater than 50% change in ownership
  - Note: § 482 authorizes IRS to reallocate income, deductions and credits in certain circumstances
Partnership-Taxed Entities, In Detail
Partnership Entities

- State law dissolution and liquidation will not necessarily trigger termination of partnership entity for federal income tax purposes
  - State law determinations have no impact on termination of partnership, for federal income tax purposes
  - Partnership agreement or LLC operating agreement also is not controlling
Partnership Entities: Terminations

- Termination for federal income tax purposes
  - Governed by IRC Sect. 708
    - No part of any business of the partnership continues to be carried on; or
    - Within a 12-month period, there is a sale or exchange of 50% or more of the total interest in partnership capital and profits; or
    - Only one partner/member remains
Partnership Entities: Terminations (Cont.)

- Tax consequences on termination
  - If partnership is continuing, termination will close the partnership’s taxable year as of the termination date
  - If continuing, new elections (e.g. Sect. 754 elections, etc.) will need to be filed
Partnership Entities: Income Recognition

• Income recognition generally is governed by Sect. 731
  – Non-recognition of gain or loss by the partners, except to the extent money distributed is in excess of the distributee partner’s (member’s) outside basis. IRC Sect. 731(a)
  – No gain or loss to partnership upon distribution. IRC Sect. 731(b)
Partnership Entities: Income Recognition (Cont.)

- Exception to non-recognition
  - Anti-mixing bowl rules under Sect. 737 for distributions of Sect. 704(c) property contributed within the past seven years
Partnership Entities: Basis Consequences

- Basis consequences are governed by Sect. 732
  - In complete liquidation, basis of property distributed to a partner is equal to the partner’s basis in his/her/its partnership interest. IRC Sect. 732(b)
  - May necessitate basis allocations to partnership property on distribution under Sect. 732(c)
Partnership Entities: Liabilities

• Impact of liabilities
  – Relief from liability is treated as distribution of money to the partner/member

• Use of suspended losses
Partnership Entities: Conversions

• Conversions
  – Traditionally, are three different forms
    • “Assets up”
    • “Assets over”
    • “Interests over”
Partnership Entities: Conversions (Cont.)

• Conversions
  – “Assets Up”
    • Assets of partnership or LLC are distributed to the partners/members in liquidation of entity
    • Partners contribute assets to new entity
    • Assets need to be re-titled in name of partners; this leads to administrative challenges
Partnership Entities: Conversions (Cont.)

- Conversions
  - “Assets over”
    - Assets of partnership or LLC are contributed to a new entity in exchange of equity interests (stock, membership interests or partnership interests)
    - Partnership or LLC distributes equity interests received in the exchange to the partners/members in liquidation
Partnership Entities: Conversions (Cont.)

- Conversions
  - “Interests over”
    - Interest of existing partnership or LLC are contributed to new entity in exchange for equity interests
    - Old entity is liquidated
Partnership Entities: Conversions (Cont.)

- Partnership converting to LLC; LLC converting to partnership
  - Usually is not a taxable event
    - See Rev. Rul. 95-37
  - Assumes no change in allocation of liabilities and percentage interest post-conversion
Partnership Entities: Conversions (Cont.)

- Partnership/LLC conversion to corporation
  - Can be structured to be free
  - Must meet requirements under Sect. 351
    - Liabilities in excess of basis
    - No “control” within meaning of the statute
  - See Rev. Rul. 84-111
Partnership Entities: Conversions (Cont.)

- State conversion statutes
  - Treated as an “assets over” transaction
    - Rev. Rul. 84-111 does not apply
Partnership Entities: Conversions (Cont.)

- State conversion statutes
  - Generally treated as a continuation of the previous entity in a different form for state law purposes (not the case in change of form via merger)
  - Example: Del. Code Ann. tit 6 Sect. 266(h)
    - When a corporation has been converted to another entity or business form pursuant to this section, the other entity or business form shall, for all purposes of the laws of the State of Delaware, be deemed to be the same entity as the corporation
Partnership Entities: Conversions (Cont.)

- Corporation conversion to LLC or partnership
  - Usually is a taxable transaction
  - If a C corporation, transaction usually results in two levels of tax; S corporations usually only one level of tax
  - Net operating losses may be utilized to offset some of the corporate level gain on liquidation
Partnership Entities: Conversions (Cont.)

- Conversion coupled with rescission
  - PLR 200952036
    - Partnership which converts from partnership to corporation and then to limited liability company in the same year will not be treated as corporate liquidation on conversion from corporation to LLC
      - Must occur in same year
      - Must restore parties to same economic position as before initial conversion from partnership to corporation
Partnership Entities: Conversions (Cont.)

- Single-member LLC becomes multi-member LLC (taxed as partnership)
  - Rev. Rul. 99-5
    - Tax consequences depend on form of transaction
    - Facts
      - In both situations 1 and 2, a single-member LLC converts to a multi-member LLC
Partnership Entities: Conversions (Cont.)

- Single-member LLC becomes multi-member LLC (taxed as partnership), Cont.
  - Rev. Rul. 99-5
- Situation 1
  - Transaction structured as a purchase of 50% of the single member’s interest in the entity (B purchases A’s 50% interest)
    » Treated as if B purchased 50% of the entity’s assets, and both A and B contribute assets to new entity
    » A recognizes gain or loss
    » Basis of assets equal to basis in hands of contributors
    » A’s holding period includes time as single member; B’s holding period begins on date of transaction
Partnership Entities, Conversions (Cont.)

• Single-member LLC becomes multi-member LLC (taxed as partnership), Cont.
• Situation 2
  – Transaction structured as a contribution by B in exchange for 50% interest
    » Treated as though A contributed assets and B contributed cash
    » No gain or loss to either party
    » A’s outside basis equal to basis in assets contributed (704(c) issues)
    » A’s holding period is tacked onto prior period
Partnership Entities, Conversions (Cont.)

• Multi-member LLC (taxed as partnership) becoming a single-member LLC (taxed as a disregarded entity)
  – Rev. Rul. 99-6 still controls
• Situation 1
  – A and B are 50-50 members
  – Member B buys out Member A
Partnership Entities, Conversions (Cont.)

- Rev. Rul. 99-6 (Cont.)
  - Situation 1
    - Partnership terminates when Member B purchases Member A’s interest
    - Treated as a sale of partnership interest by Member A
    - B’s tax consequences
      - LLC deemed to make liquidating distributions to both A and B, and then B deemed to purchase the assets distributed to A
      - B’s holding period with respect to assets received from partnership attributable to B’s interest carries over
      - B’s holding period with respect to assets “purchased” from A begins on day following the purchase (no tacking)
Partnership Entities, Conversions (Cont.)

- State tax consideration with conversions
  - Conformity with federal income tax treatment?
    - Carry-over of tax attributes
    - Sales and use tax, property tax considerations
Partnership Entities, Conversions (Cont.)

- Non-tax considerations of conversions
  - Consents to assignments
  - Default/acceleration clauses
S Corporations
S Corporations

- S corporations overview
  - Pass-through treatment, but Subchapter C rules apply
  - Distributions that do not exceed shareholder’s basis in stock are not taxed to shareholder
  - Must recognize gain on distributions of appreciated property (i.e., pro rata portion of gain (§ 311(b) taxed to each shareholder)
- Liquidations
  - § 332 generally cannot apply to an S corporation liquidation
  - To qualify for a § 332 liquidation, P has to have at least 80% control of S. An S corporation cannot generally have a corporate shareholder (exception for qualified Subchapter S subsidiaries)
S Corporations (Cont.)

- Liquidations
  - § 331 generally applies to an S corporation liquidation
  - S corporation liquidation consequences
    - Gain or loss on distribution of property is generally recognized as if property was sold at FMV
    - Gain or loss on distributions of appreciated assets is generally recognized, but the S corporation generally pays no tax on the gain (the corporation’s gain passes through to shareholders and increases their basis), except in situations where built-in gains tax under Sect. 1374 applies
Commercial And Legal Consequences Of Dissolutions, Liquidations, Conversions
Recent Developments

- **PLR 200949031**
  - **Facts:** Parent (P), a real estate investment trust (REIT), partially owned a limited partnership (LP). LP owns all the stock of a taxable REIT subsidiary (TRS). LP forms a single-member disregarded limited liability company (TRS LLC), into which TRS will merge.
  - **Ruling:** Service ruled that the merger of TRS into TRS LLC will be treated as a corporate liquidation of TRS under §§ 331 and 336.
  - **Significance:** Illustrates (1) the flexibility that can be used to accomplish a liquidation/merger, and (2) that the loss disallowance or deferral provisions of § 267 do not apply, by virtue of § 267(a)(1) to a complete liquidation.
Planning Opportunities

• C corporations
  – Increased use of conversions to LLCs within consolidated groups to take advantage of potential state tax planning opportunities
  – Can use liquidations/mergers within consolidated groups to plan around tax attribute limitation rules (i.e., SRLY)
Commercial And Legal Consequences: Dissolution

Dissolution of a corporation

• Voluntary dissolution (possible to revive corporation after dissolution)

• Administrative dissolution (possible to reinstate corporation after administrative dissolution; five-year period in some states)

• Judicial dissolution
Commercial And Legal Consequences: Dissolution (Cont.)

(Voluntary) dissolution of a corporation

- Accomplished through filing articles of dissolution with Corporations Division of state government (Sec. of State, Dept. of State, etc.)
- Typically must be approved by board of directors and shareholders
- Many states require publication of notice of intent to dissolve
- Legal impact: Corporation should no longer continue doing business, but should commence “winding up” its operations
- Practical impact: This shows the world the corporation is ceasing to do business
Commercial And Legal Consequences: Dissolution (Cont.)

Dissolution of a limited liability company

- Accomplished by filing articles of dissolution with Corporations Division of state government (Sec. of State, Dept. of State, etc.)

- Legal impact: Corporation should no longer continue doing business, but should commence “winding up” its operations

- Practical impact: This shows the world the corporation is ceasing to do business
Commercial And Legal Consequences: Liquidation

Liquidation of a corporation

• Identifying assets, accounts receivable, etc.
• Identifying liabilities, accounts payable, etc.
• Satisfying “outside” creditors
• Satisfying “inside” creditors
• Distributing dividends to shareholders (consider type/class of shares)
• For smaller companies, consider whether personal guarantees exist for principals
Commercial And Legal Consequences: Liquidation (Cont.)

Liquidation of a limited liability company

- Voluntary dissolution (possible to revive LLC after dissolution)
- Administrative dissolution (possible to reinstate LLC after administrative dissolution; five-year period in some states)
- Judicial dissolution
Commercial And Legal Consequences: Conversions To Other Entities

Conversion from an LLC to a corporation

- It is possible in many states for the members (or managers) of the LLC to elect to convert the LLC into a corporation.

- This typically is done by filing a certificate of election AND articles of incorporation.

- For tax purposes, the conversion *often* (but not always) is not a taxable event.
Conversion from an LLC to a corporation (Cont.)

- If the LLC is taxable as an S corporation, may convert to state corporation taxable as an S corp. without a taxable event. IRC Sect. 368(a)(1)(F)

- If the LLC is taxable as a C corporation, may convert to state corporation taxable as a C corp. without a taxable event. IRC Sect. 368(a)(1)(F)

- Need to have written plan of reorganization
Commercial And Legal Consequences: Conversions To Other Entities (Cont.)

Conversion from a C corporation to an LLC

- If LLC is NOT also taxable as a C corp., then this is a taxable event

- Although it is possible to convert from a corporation to an LLC, it’s not always beneficial
Commercial And Legal Consequences: Conversions To Other Entities (Cont.)

Conversion from an S corporation to an LLC

- If LLC is NOT also taxable as an S corp., then this is a taxable event
Issues That Cut Across Entity Categories
Commercial And Legal Consequences:  
Broader Issues

UCC and bulk sale issues

• U.S. law typically recognizes an individual’s absolute power over his or her property to make any disposition that does not interfere with the rights of others. Sexton vs. Wheaton, 8 Wheat., US, 229

• Some obligations apply with respect to a “bulk sale” (a/k/a “bulk transfer”), which is a transfer or sale of goods by a business that represents all or substantially all of the businesses assets and inventory to a single buyer, unless in the ordinary course of business
Commercial And Legal Consequences: Broader Issues (Cont.)

UCC and bulk sale issues (Cont.)

• If there is a bulk sale, then the purchaser may be liable to creditors of the seller
• Procedures involve: (i) Seller must complete an affidavit identifying secured and unsecured creditors, (ii) Affidavit must be filed with a government authority (i.e., clerk of county court or a state department or agency)
• It’s often possible for the purchaser and seller to elect out of the application of the UCC Bulk Sales Act
• See Article VI of the UCC (http://www.law.cornell.edu/ucc/6/)
Commercial And Legal Consequences: Broader Issues (Cont.)

State tax clearance certificate processes

- Many states require that companies obtain some form of state tax clearance prior to significant transactions or corporate acts, including:
  - Participating in a merger that involves filing articles of merger with the state
  - Electing to convert one form of entity to another
  - Withdrawing a certificate of authority to transact business, or
  - Obtaining a certificate of authority to transact business for a new company that is affiliated with another
Commercial And Legal Consequences: Broader Issues (Cont.)

State tax clearance certificate processes (Cont.)

• If taxes are not current, the state may not allow the transaction or corporate act to be effective or may hold one entity responsible for taxes owed by a predecessor or affiliated entity

• The taxes covered by the clearance process may include state income taxes, state sales and use taxes, and various other taxes

• Make sure to allow time to obtain the tax clearance certificate (and follow up as needed)
Commercial And Legal Consequences: Broader Issues (Cont.)

The series LLC

- First authorized by Delaware in 1996
- Allows a corporate structure similar to having a holding company and various operating subsidiaries in a single LLC structure
- Allows assets, liabilities, operations, etc., to be separated among individual cells or series of the series LLC
- In theory, the debts and obligations of the various individual series are enforceable only against that series
Commercial And Legal Consequences: Broader Issues (Cont.)

The series LLC (Cont.)

- In theory, each individual series may enter into, enforce and be sued pursuant to the contracts into which each individual series enters.

- Seven states have state statutes authorizing series LLCs (DE, IL, IA, NV, OK, TN, UT), as does Puerto Rico.

- Other states recognize series LLCs formed in other states. All but IL closely track the DE provision.
Commercial And Legal Consequences: Broader Issues (Cont.)

The series LLC (Cont.) – Formal guidance and authority

• 2006 Revised Uniform Limited Liability Company Act does not include series LLC provision

• Private Letter Ruling 200803004

• GxG Management, LLC vs. Young Brothers and CO., Inc., 2007 WL 551761 (D.Me.) (Feb. 21, 2007)

• GxG Management, LLC vs. Young Brothers and CO., Inc., 2007 WL 1702872 (D.Me.) (June 11, 2007)