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Small Business: Liquidation of A Small Corporate Business

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In a recent issue of the *Woman CPA*, we discussed the pros and cons of incorporating a small business. We would do our clients a disservice if we did not point out to them that there may be some unexpected tax consequences when the corporate owner, some years down the road, decides that it is time to get out of business. He/she can, of course, sell the stock to a new corporate owner, and the tax result is usually long-term capital gain on the difference between the cost of the stock and the proceeds from the sale. This is sometimes done, but much more frequently by the owners of large corporations than by owners of small corporations with one or a few stockholders. There is often not a ready market for the stock of a small corporation, and the owner is faced with the necessity to liquidate the corporation.

Let's take a look at the tax cost of this procedure.

From the corporation's point of view, distribution of assets to shareholders results in no recognized gain, regardless of method of liquidation, with the following exceptions:

- (a) Recapture of depreciation on disposition of tangible and intangible personal property and of real property and leaseholds results in ordinary income to the distributing corporation.
- (b) Installment obligations received on the sale of corporate assets and their distribution in liquidation trigger taxable income to the corporation (Sec. 453 (d) Internal Revenue Code). The amount of the gain to the corporation is the unrealized profit on the installment obligation at the time of liquidation. This rule does not apply to corporate liquidations under Sec. 337 (sale of property during twelve-month-liquidation), but it does apply if the sale was made prior to the election under Sec. 337.

Investment credit must generally be recaptured by the corporation at time of liquidation if the investment credit has not yet been earned.

From the stockholders' point of view, the general method for liquidating a corporation — Section 331 IR Code — works as follows: The corporate assets are exchanged for the outstanding stock of the corporation. Under the general rule, the distribution in liquidation is treated, in effect, as a sale of stock from the stockholders to the corporation.

Small Business

Liquidation of A Small Corporate Business



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Gain or loss on distribution in complete liquidation is a capital gain or loss. The capital gain or loss is short-term or long-term depending on the holding period of the stock by the stockholder.

The recipient of the liquidating dividend will be taxed on the gain. Unless a substantial portion of the assets received are cash or other liquid assets, the recipient may have a problem in meeting his/her tax obligation. Often stockholders of closely-held corporations have most of their funds invested in their corporation and have few other resources for the payment of taxes. This situation points up the need for relief provisions.

Liquidation under Section 333 (One-month liquidation)

Section 333 of the IR Code provides relief as to the non-recognition of gain under certain conditions for one-month liquidations of corporations. Provisions of the Code and Regulations must be strictly followed or the relief will be denied and the provisions of Section 331 will be applied, normally at considerable tax cost to the stockholder.

A one-month liquidation under Sec-

tion 333 must be accomplished within one calendar month. It is, therefore, advisable to adopt the plan of liquidation on the first of any given calendar month or as soon thereafter as possible in order to complete the liquidation on or before the last day of the same calendar month. Do not elect on June 15 and complete the liquidations before July 15! It won't work. If you elect in June, you must complete the liquidation in the same month of June.

The one-month liquidation can be advantageous when the following conditions are met:

- (1) Liquidating corporation is holding appreciated property;
- (2) Liquidating corporation has little or no earnings and profits or cash and securities acquired after 12-31-53.

What is taxed to the recipient stockholders in the case of a one-month liquidation?

- (1) Retained Earnings are taxed as ordinary dividend.
- (2) Cash and securities acquired after 1953 are taxed as a long-term or short-term capital gain depending

upon the period of time the capital stock was held by the stockholders.

- (3) The other assets received in liquidation result in no recognition of gain to the stockholders upon receipt of the liquidating dividends.

The following is the balance sheet of a corporation prior to liquidation:

Cash and securities acquired after 1953	\$20,000
Unimproved real estate (FMV \$90,000)	<u>17,500</u>
	<u>\$37,500</u>
Capital stock outstanding	\$25,000
Retained Earnings	<u>12,500</u>
	<u>\$37,500</u>

Assuming that stockholders' basis in the stock is \$25,000, they will be taxed as follows under Sec. 333 for one-month liquidation:

Long-term capital gain on cash and securities one-half of \$20,000	\$10,000
Ordinary income on Retained Earnings	<u>\$12,500</u>
Total amount Taken into income	\$22,500

Under the regular method of Section 331, stockholders' gain would have to be computed as follows:

Assets received at FMV:	
Cash and securities	\$20,000
Unimproved real estate	<u>90,000</u>
	\$110,000

Less stockholders' basis in stock	<u>25,000</u>
Long-term capital gain	\$85,000
Taxed at one-half	\$42,500

This is \$20,000 more than under the one-month liquidation. For the purpose of this illustration, we are ignoring the minimum tax rules except to mention that they would make it even more advantageous to liquidate under Section 333, rather than Section 331.

The basis of property received in a one-month liquidation is computed as follows:

Basis of capital stock redeemed or canceled in liquidation	\$25,000
Less cash received	<u>20,000</u>
Plus total amount of gain:	\$5,000
Ordinary	12,500
Capital	<u>20,000</u>
	\$37,500

The procedure to qualify for a one-month liquidation is, briefly, as follows:

- (1) Form 964 must be filed with IRS by each qualifying electing shareholder

within thirty days after the adoption of the plan of liquidation.

- (2) Form 966 must be filed with the IRS by the corporation within thirty days after adoption of the proposed plan of liquidation.

(3) Forms 1099L (with transmittal form 1096) must be filed with the IRS for each shareholder receiving a liquidating dividend or distribution of \$600 or more. The due date for these forms is February 28 of the year following the calendar year in which the distribution in liquidation occurred.

- (4) Legally dissolve the corporation under the laws of the state of incorporation for the firm.

Liquidation under Section 337 (twelve-month liquidation)

Prior to the enactment of the IR Code of 1954, if a corporation sold its asset at a gain and then distributed the proceeds to the shareholders in complete liquidation, the sale and the distribution would result in a double tax. The corporation would first pay a tax on the recognized gain on the sale, and then the stockholders, upon receipt of the proceeds in the liquidation of the corporation, would be liable for a tax on the difference between the amount received in liquidation and the basis of the capital stock investment.

The procedures under Section 337 are as follows:

- Adopt Plan of complete liquidation;
- Within 30 days after the adoption, file Form 966 with the IRS;
- Within the twelve-month period beginning on the date of the adoption, all of the assets of the corporation are distributed in complete liquidation (less assets retained to meet payables).

If these conditions are met, no gain or loss will be recognized to the corporation from the sale or exchange by the corporation of its property within the twelve-month period. However, under the depreciation recapture provisions of Sections 1245 and 1250, if these sections are applicable to the sale and liquidation under Section 337, they will result in ordinary income taxable to the corporation equal to the depreciation recapture.

Let's again use the balance sheet previously shown and work out the tax consequences.

The corporation is to be liquidated after the sale of real estate for \$90,000 cash. Without the relief provisions of Section 337, the corporation has a long-term capital gain of \$72,500 which

results in tax liability of 30 percent.

Subsequently, assets distributed to stockholders would be as follows:

Cash on hand prior to sale of real estate	\$20,000
Proceeds from sale of real estate	<u>90,000</u>
	<u>\$110,000</u>
Less Federal income tax	<u>21,750</u>
	\$ 88,250

Assuming again that the basis of the stock to the stockholder is 25,000 the long-term capital gain \$63,250

The tax on one-half of \$63,250, or \$31,625, is \$8,514 if we assume that the stockholder is married, files a joint return and the \$31,625 is his/her taxable income. After the liquidation of the corporation and the payment of the personal income tax, the former stockholder has \$79,736 left, the \$88,250 which came to him from the corporation, minus the \$8,514 income tax paid on the disposition of his stock.

Under Section 337, the corporation does not recognize the gain on the sale of real estate, and the stockholder would, therefore, receive the following amounts:

Cash on hand prior to sale of real estate	\$ 20,000
Proceeds from sale of real estate	<u>90,000</u>
	<u>\$110,000</u>

The taxpayer would be taxed on the long-term capital gain of \$85,000 — the difference between \$110,000 cash received and \$25,000 basis of stock. The tax on one-half of \$85,000, or \$42,500, would be \$13,340 for a married taxpayer filing a joint return.

Thus, after paying the income tax, the former stockholder would still have \$96,600 — \$110,000 received in liquidation minus tax of \$13,340.

The \$96,600 retained under a Section 337 liquidation is \$16,864 more than the \$79,736 retained under the regular method of liquidating. Again, for the sake of simplification, we have ignored the rules of minimum tax.

To summarize: when stockholders of a small corporation want to retire from business or get out of business for some other reason, they may find it difficult to find a ready market for their stock. They may then decide to liquidate their corporation. If they do this, it is advisable that they obtain expert advice regarding the method of liquidation. The method chosen and the proper procedure of liquidating may make a great deal of difference in the amount of after-tax dollars retained by them.