

15.0 S CORPORATION LIQUIDATIONS

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15.1 OVERVIEW

There are several reasons that an S corporation may choose to liquidate. The S corporation may choose to liquidate because of a sale of substantially all its assets, a change in the form of entity (other than conversion to C corporation status), or a winding down of its business affairs. Whatever the reasons are, the liquidation of the S corporation will almost always have some tax consequences. In order to determine if self-compliance is met when an S corporation liquidates, an auditor must consider all of the other issues in this manual.

The most common circumstances in which corporate liquidation issues will arise for an S corporation and its shareholders are from the sale of the S corporation's business assets and or a sale of all of the S corporation's stock when both the seller and the buyer elect to apply Internal Revenue Code (IRC) Section 338(h)(10).

Applicable to income years beginning on or after January 1, 1993, pursuant to California Revenue and Taxation Code (R&TC) Section 24451, California generally conforms to subchapter C of the Internal Revenue Code, including IRC Section 338. Once an IRC Section 338(h)(10) election is made with respect to a stock sale, the sale is recast in the form of the sale of the S corporation's assets for income tax purposes.

The primary difference between a sale of an S corporation's assets and a sale of the S corporation's stock with an IRC Section 338(h)(10) election is that the latter is treated as a stock sale for purposes of the sales and use tax, while both are treated as an asset sale for income tax purposes. This allows the buyer in a stock sale with an IRC Section 338(h)(10) election to avoid paying sales and use tax on the tangible assets that were acquired.

The question then is why would a buyer buy the assets of an S corporation instead of completing a stock sale with an IRC Section 338(h)(10) election if the benefits are the same under both approaches (that is, a stepped-up basis in the assets acquired) and the sales and use tax burden is greater with regard to the asset sale. Perhaps the reason for not choosing the IRC Section 338(h)(10) method is the complexity of the computations that are involved, the corporation may not have any tangible assets or they may want to avoid the assumption of liabilities or contingent liabilities of the corporation. In either case, the income tax ramifications of both of these transactions are very similar.

In this section, we will primarily focus on the sale of the business assets of the S corporation and Section 16.0 will discuss the sale of stock and the election of IRC Section 338(h)(10). Keep in mind that similar issues will arise when an S corporation ceases doing business and distributes all of its assets to the shareholders, or if an S corporation decides to convert to another entity, such as an LLC.

15.2 LIQUIDATION-ASSET SALE

- 15.2.1 In General
- 15.2.2 Gain or Loss from Sale of Assets
- 15.2.3 Gain or Loss on Liquidation

15.2.1 In General

The most common form of liquidation is by way of selling all of the business assets of an S corporation. Generally, the selling corporation will cease doing business and liquidate after it sells all the assets. This creates a two-step process for computing tax. First, the S corporation seller must compute its gain or loss from the sale of its assets. Secondly, the shareholder(s) must compute gain or loss from the liquidation.

15.2.2 Gain or Loss from Sale of Assets

The first step in the S corporation asset sale is to determine the appropriate gain or loss on the sale itself. Secondly, determine if there are built-in gain considerations (See S Corporation Manual Section 5.0 Built-In Gains Tax). Third, determine the amount of flow through gain or loss to the shareholder(s) and make appropriate stock and/or debt basis adjustments. (Refer to the S Corporation Manual Section 9.0 Shareholder Basis.)

To determine the gain or loss on the sale of assets, the auditor should compare the sales price to the adjusted basis of the properties sold in the hands of the S corporation. (IRC Section 1001, IRC Section 1011, IRC Section 1012, and IRC Section 1016)

Example A

Seller Corporation, an S corporation from its inception, is in the business of leasing office space in the building it owns. Seller Corporation sold its business for \$15 million to Buyer Corporation on December 30, 2015. The assets sold included a building, land, and goodwill. The purchase price allocated \$5 million to goodwill and \$10 million to the building and land. Seller Corporation's adjusted basis in the building and land was \$9 million (the building has accumulated depreciation of \$2 million) and goodwill was accrued ratably from the inception of the corporation. Seller Corporation will recognize a total gain of \$6 million, \$1 million as ordinary income as a result of IRC Section 1250 recapture and \$5 million capital gain from goodwill. The \$6 million gain will all be taxed at 1.5% for a total tax of \$90,000, computed as follows:

	Building and Land	Goodwill
Sales Price	\$10,000,000	\$5,000,000
Less: Adjusted Basis	(9,000,000)	(0)
Total Gain on Sale	\$1,000,000	\$5,000,000
Tax @ 1.5%	\$15,000	\$75,000

Since the taxpayer has been an S corporation from inception, there are no built-in gains considerations. However, if Seller Corporation had been a C corporation prior to becoming an S corporation or if they had acquired C corporation assets by way of merger, then there would be built-in gains considerations. (See S Corporation Manual Section 5.0 Built-In Gains Tax.)

This next example considers the built-in gains tax.

Example B

In addition to the same facts as in Example A, assume that Seller Corporation incorporated on January 1, 2001. Seller Corporation has a 100 percent shareholder, Mr. Seller. Seller Corporation elected S status effective on January 1, 2006, 5 years after incorporating. On the date of their S corporation election, the fair market value (FMV) of the building and land was \$9 million and the FMV of the goodwill was \$2 million. Thus, when Seller Corporation sold all its assets on December 30, 2015, for \$15 million, they should still report the same \$6 million in gains as determined in Example A.

However, since the taxpayer had a net unrealized built-in gain from the goodwill, \$2 million of the \$5 million dollar gain will be taxed at the C corporation tax rate of 8.84%. The remaining gain on goodwill of \$3 million dollars and the \$1 million dollar gain on the building will be taxed at the S corporation tax rate of 1.5%.

Thus, the total tax for Seller Corporation from the sale of its business is \$236,800, which is made up of the following:

	Building and Land	Goodwill	Tax
Gain subject to 1.5% tax	\$1,000,000	\$3,000,000	
Tax @ 1.5%	\$15,000	\$45,000	\$60,000
Gain subject to built-in gains tax	\$0	\$2,000,000	
Tax @ 8.84%	\$0	\$176,800	\$176,800
Total Tax			\$236,800

Once the appropriate tax is determined at the S corporation level, the next step is to analyze the amount of gain/loss that flows-through to the shareholder(s) of the S corporation.

Any gain recognized by the corporation is passed-through to the shareholder and included in the shareholder's taxable income. In order to avoid double taxation on the income recognized by the shareholder(s), the shareholder's basis is increased by the amount of flow-through gain received from the corporation. Also, if built-in gains tax was assessed at the corporate level, then the amount of built-in gains tax paid by the corporation is treated as a capital loss that flows through to the shareholder(s). This loss reduces the flow-through gain to the shareholder(s), and reduces the shareholder's basis in the corporation.

The information provided in this manual does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the last update.

Example C

Continuing the fact pattern in Example B, Mr. Seller reports \$1 million as ordinary income as a result of the IRC Section 1250 recapture. However, Mr. Seller only reports a capital gain of \$4,823,200 instead of the \$5,000,000 capital gain recognized by the corporation. This is because R&TC Section 23803(b)(1) allows for a reduction in the amount of gain passed through to the shareholder by the amount of built-in gains tax paid by the S corporation. Thus, the \$5,000,000 gain on sale of goodwill of is reduced by the built-in gains tax of \$176,800, which results in a net flow through capital gain of \$4,823,000.

15.2.3 Gain or Loss on Liquidation

a. In General

When an S corporation is being liquidated, the subchapter C rules are applied. (R&TC Section 17321)

Under IRC Section 331(a), amounts received by a shareholder in a complete liquidation of their corporation are treated as full payment in exchange for their stock. In other words, the liquidation is treated as a sale by the shareholder to the S corporation of their stock by comparing the total liquidating distribution with the shareholders adjusted stock basis to determine the gain or loss on the liquidation. (Treasury Regulation (Treas. Reg.) Section 1.331-1(b))

Therefore, it is critical that the shareholders basis is appropriately adjusted before the exchange.

Example D

Continuing with the same fact pattern from Example B above, Mr. Seller (100% shareholder) had stock basis of \$9 million prior to the sale. In addition, the corporation made a liquidating distribution of \$16 million cash in exchange for his stock. Mr. Seller will report a liquidating capital gain of \$1,236,700 that is computed as follows:

Beginning Stock Basis	\$9,000,000
Ordinary Income - Section 1250 Recapture – Gain on sale of Building	1,000,000
Capital Gain -Sale of Goodwill Less BIGs Tax Paid by S Corporation	4,823,300
Non-Capital / Non-Deductible Items	(60,000)
Adjusted Stock Basis Prior to Liquidating Distribution	\$14,763,300
 Liquidating Distribution	 \$16,000,000
Adjusted Stock Basis	(14,763,300)
Liquidating Gain	\$1,236,700

b. Accumulated Earnings and Profit

An S corporation may have accumulated earnings and profits (E&P) from prior C corporation years. Normally, distributions made from E&P are considered dividends to the shareholder. (IRC Sections 301 and 316) However, in a complete liquidation, E&P are treated as part of the exchange for stock, and thus becomes a capital item instead of an ordinary dividend. (IRC Section 331(b))

Therefore, in Example A, the result is the same even if the S corporation had E&P. Generally, this is the case when you have a liquidating gain.

c. Complete Liquidation

To determine whether or not distributions are made pursuant to complete liquidation, the auditor should request a copy of the corporation's plan of liquidation, which should be filed with the Internal Revenue Service (IRS) (Form 966). The plan provides the details on the distribution or series of distributions. If there is no formal plan of liquidation, the auditor should use their judgment and review the facts and circumstances of the case to determine if the distribution(s) is made pursuant to a plan of complete liquidation.

In the above examples, there should be no question that the distribution is made pursuant to a complete liquidation because the S corporation sold all of its assets and liquidated shortly after. Issues arise when the S corporation does not liquidate immediately and/or it continues to conduct part of its trade or business.

According to IRC Section 346(a), for the purpose of IRC Section 301, a distribution shall be treated as in complete liquidation of a corporation if the distribution is one of a series of distributions in redemption of all of the stock of the corporation pursuant to a plan.

d. Built-In Gains Tax and Shareholder Basis

The built-in gains tax and shareholder basis issues work in tandem. This is because the built-in gains tax paid by the S corporation reduces the amount of flow-through gain to the shareholder(s) by the amount of the tax paid, which in turn, will decrease the shareholder(s) basis. (IRC Section 1366(f)(2))

As much as this adjustment provides some relief to shareholder(s), the relief is only a tax deferral. Like most tax deferrals, liquidation is an event that requires the deferred tax to be paid. Thus, when auditors identify a built-in gains issue in a liquidation year, it is important to keep in mind that any adjustment that was previously made for built-in gains tax at the shareholder level will likewise reduce the shareholder's basis. The effect of this is to offset or wash the loss deduction given to the shareholder(s). Thus, the liquidating distribution for full payment in exchange for the shareholder's stock will create a larger liquidating gain or a smaller liquidating loss by the amount of the built-in gains tax that the auditor has assessed.

See S Corporation Manual Section 5.0, Built-In Gains Tax, for issues regarding the built-in gains tax in the year that the S corporation liquidates.

15.3 INSTALLMENT INCOME REPORTING UPON CESSATION OF BUSINESS

- 15.3.1 In General
- 15.3.2 Liquidating Distributions of Installment Obligations to S Shareholders
- 15.3.3 Contingent Payment Obligations

15.3.1 In General

In some instances, an S corporation will sell some or all of its assets under the installment method. Thus, the S corporation will have a note receivable, which may be distributed as part of the liquidating distribution. One reason an S corporation may not want to distribute the note receivable is to avoid acceleration of gain on the installment note at the entity level. This can be a large tax burden to an S corporation if the installment note is a built-in gain item. However, if the S corporation does not liquidate and distribute the note receivable, it may encounter an excess net passive income issue, since interest income on the receivable is considered passive in this context. (See S Corporation Manual Section 7.0 Excess Net Passive Income.)

15.3.2 Liquidating Distributions of Installment Obligations to S Shareholders

a. Tax Treatment to the S Corporation

If the S corporation ceases to be subject to tax and if the income from installment transactions has not been fully reported before the year of cessation, the unreported income must be included in the measure of tax for the last year the S corporation is subject to a tax measured by net income. (R&TC Section 24672) (*Appeal of Kavanaugh* (April 20, 2007) Cal. St. Bd. of Equal. Case No. 348937, not to be cited as precedent)

Also, any built-in gains tax or excess net passive income tax imposed pursuant to IRC Section 1374 or IRC Section 1375 due to a liquidating distribution of an installment obligation to a shareholder is not precluded pursuant to IRC Section 453B(h).

b. Tax Treatment to the S Corporation Shareholders

While the S corporation must accelerate the gain from an installment obligation in a liquidating distribution, the shareholder(s) may not have to, if they meet certain criteria.

IRC Section 453(h)(1)(A) states – If, in a liquidation to which IRC Section 331 applies, the shareholder receives (in exchange for the shareholders stock) an installment obligation acquired in respect of a sale or exchange by the corporation during the 12-month period beginning on the date a plan of complete liquidation is adopted (and the liquidation is completed during such 12-month period), then, for purposes of this section, the receipt of payments under such obligation (but not the receipt of such obligation) by the shareholder shall be treated as the receipt of payment for the stock.

This section places a 12-month time limit, starting from the date the S corporation adopts a plan of complete liquidation, for the S corporation to distribute the installment note, which must be satisfied in order for the S corporation shareholder(s) to use the installment method to report the gain from the complete liquidation. The 12-month period is unique because IRC Section 346(a) does not place a similar time constraint on other liquidating distributions, not involving installment notes. Therefore, where an S corporation shareholder wants to use the installment method to report gain from the complete liquidation of an S corporation, the auditor should verify that the installment note was acquired by the S corporation and distributed to the S corporation shareholder within 12-months of the date the S corporation adopted a plan of complete liquidation.

When an S corporation distributes an installment obligation to its shareholder in complete liquidation and IRC Section 453(h)(1)(A) applies, the effect on the shareholder must be determined by recasting all of the liquidating distributions to the particular shareholder as a sale of the shareholder's stock in return for all of the property received in the liquidating distributions.

First, the liquidating distribution of the installment note is recast in the form of a transaction whereby the shareholder sold his or her stock to the original issuer of the installment obligation (Treas. Reg. Section 1.453-11(a)(2)(i)) for a newly issued installment note, issued on the date of the liquidating distribution. (Treas. Reg. Section 1.453-11(a)(2)(ii)(A)) Second, the issue price for the installment obligation is recalculated as the sum of the adjusted issue price of the installment obligation on the date of the distribution and the amount of any qualified stated interest (as defined in Treas. Reg. Section 1.1273-1(c)) that has accrued prior to the distribution but that is not payable until after the distribution. (See Treas. Reg. Section 1.453-11(a)(2)(ii)(A) for this rule and rules governing the treatment of unstated interest.)

Third, all of the amounts distributed to the shareholder in complete liquidation, including cash, the issue price of the distributed installment obligation as recalculated above, and the fair market value of other property, are treated as received by the shareholder in exchange for the shareholder's stock in the S corporation. (Treas. Reg. Section 1.453-11(a)(3))

Fourth, any corporate debt (recourse or nonrecourse) assumed by the shareholder with regard to the liquidation is added to the shareholder's basis in the stock of the S corporation. (Treas. Reg. Section 1.453-11(a)(4))

Fifth, the gross profit ratio for the entire transaction must be re-determined using the amount received (as determined in the third step discussed above) and the shareholder's adjusted basis in the stock (as increased by the assumption of corporate debt). (Treas. Reg. Section 1.453-11(a)(5) Example (2))

Once the gross profit ratio is re-determined, all of the payments received on the installment obligation and all of the other property, including cash, received from the S corporation in liquidating distributions, will be taxable to the S corporation shareholder based upon the re-determined gross profit ratio. The end result of these computations is to treat the S corporation shareholder as if he or she were reporting all of the liquidating distributions under the installment method.

Example E

Seller Corporation, an S corporation, sold all tangible assets for their book value and goodwill for a \$4 million note on November 30, 2015, with an adequate stated interest rate. Mr. Seller, 100 percent shareholder, had a stock basis of \$1,060,000 prior to the sale. Seller Corporation, pursuant to a plan of liquidation, makes a final liquidating distribution to Mr. Seller on December 30, 2015 of \$1 million cash and the \$4 million installment note. Assume that there is no built-in gain.

At the corporate level, the distribution of the installment note triggers an acceleration of the unrecognized gain in accordance with R&TC Section 24672. Therefore, Seller Corporation will pay tax of \$60,000. (\$4 million gain income X 1.5% tax rate.) This reduces Mr. Seller's stock basis to \$1 million (\$1,060,000 minus \$60,000).

Note: There is no gain or loss on the tangible assets because they were sold for book value.

Then, in order to determine the gain at the shareholder level, the liquidating distribution (cash and note) needs to be recast as if the whole amount was a new installment sale as follows:

Sale Price (\$1 million cash plus \$4 million note)	\$5 million
Less: Shareholder Basis	(1 million)
Realized Gain on Liquidation	\$4 million
Gross Profit Percentage (\$4 M / \$5 M)	80%

Therefore, the shareholder will report a capital gain of \$800,000 on receipt of the \$1 million cash liquidating distribution. Then as he receives payment on the installment note, he will report a capital gain equal to 80 percent of the payment(s) received.

Example E indicates the difference in the gross profit percentage between maintaining the installment note within the S corporation versus distributing the note to shareholder in a complete liquidation. If the S corporation did not liquidate, it would report collection of the installment note as 100 percent income; whereas, the shareholder, who received the note pursuant to a complete liquidation, reports income at 80 percent of the installment collection.

The effect of this treatment is to allocate the shareholder stock basis to all assets distributed, including the installment note, thus causing the distribution of \$1 million cash to be taxable. Typically, taxpayers will take the \$1 million cash, tax free, as a return of basis and continue to report the installment collection as 100 percent income when the payments are collected. This is a common error that is made in accounting for liquidations of S corporations involving installment notes.

Sometimes, a shareholder will assume the liabilities of the S corporation or receive a property distribution subject to liabilities in a complete liquidating distribution. In both these cases, the amount of the liability assumed by the shareholder(s) increases his/her stock basis. (Treas. Reg. Section 1.453-11(a)(4)) This ultimately will reduce the amount of the gross profit percentage on the installment note distribution.

Further, there are special rules for installment sales of inventory items. To have the installment method apply to inventory items, they must be sold in a bulk sale to one person in one transaction and also involve a sale of substantially all of such property attributable to the trade or business of the corporation. (IRC Section 453(h)(1)(B))

Finally, recapture income from IRC Section 1245 or IRC Section 1250 property is not subject to installment method reporting. Therefore, the S corporation and the shareholder(s) will recognize the recapture income in the year of disposition. (IRC Section 453(i))

15.3.3 Contingent Payment Obligations

Frequently, an S corporation will sell its business with the precise amount of part of the total payments that could be made being contingent on certain future events. For example, a sales contract might include a clause that if a certain milestone (for example, in terms of gross receipts) is met with the business over the next three years, the buyer will pay additional amounts ranging from \$100,000 to \$1 million per year to the seller corporation or its shareholder(s). In such a case, the S corporation has two options. One is not to liquidate until the 3-year time period is up and the S corporation can determine the amount of the contingent payment actually received and the other is to liquidate and follow the guidance provided in Treas. Reg. Section 15a.453-1(c), which provides that contingent payment sales are to be reported using the installment method. (IRC Section 453(j))

If the S corporation chooses to liquidate within the 12-month period from the adoption of the plan of complete liquidation, Treas. Reg. Section 15a.453-1(c)(2) provides that the issue price of the distributed installment obligation will be increased to include the maximum possible contingent payment provided for in the sales contract, which is referred to in the regulations as the "stated maximum selling price." Therefore, it is assumed that the maximum amount stated on the contract will be collected at the earliest possible time to determine the sales price and gross profit percentage.

Example F

Seller Corporation, an S corporation, sold all the tangible assets of its business for \$1,000,000 book value on November 30, 2015. On that date the \$1,000,000 was paid in cash. Further, it was agreed that the buyer would pay between \$250,000 to \$1 million per year over the next four years, depending on the amount of the gross receipts in each of the next four years as follows:

- \$250,000 if gross receipts are between \$0 and \$4,999,999;
- \$500,000 if gross receipts are between \$5 million and \$9,999,999; and
- \$1 million if gross receipts are \$10 million and above.

The contingent payments are payable on December 31 of each year together with adequate stated interest.

Mr. Seller, the 100 percent shareholder, had a stock basis of \$1,060,000 prior to the sale. Pursuant to a plan of liquidation, Seller Corporation makes a final liquidating distribution

to Mr. Seller on December 30, 2015, of \$1 million cash and the contingent payment sales agreement. Assume no Built-in Gain.

At the corporate level – the distribution of the installment note triggers and acceleration of the unrecognized gain in accordance with R&TC Section 24672. Therefore, Seller Corporation will pay tax of \$60,000. (\$4 million gain income X 1.5% tax rate). This reduces Mr. Seller's stock basis to \$1 million (\$1,060,000 minus \$60,000).

Note: There is no gain or loss on the tangible assets because they were sold for book value.

Then, in order to determine the gain at the shareholder level, the liquidating distribution (cash and contingent payment note) needs to be recast as if the whole amount was a new contingent payment as follows:

Sale Price (\$1 million cash plus \$4 million max. contingent note)	\$5 million
Less: Shareholder Basis	(1 million)
Gain on Liquidation	\$4 million
Gross Profit Percentage (\$4 million / \$5 million)	80%

Therefore, the shareholder will report a capital gain of \$800,000 on receipt of the \$1 million cash liquidating distribution. Then as he receives the contingent payments, he will report a capital gain equal to 80 percent of the payment(s) received.

Contingent payment sales can be arranged in many different ways. Contingent payments may be dependent upon the buyer achieving specified amounts of gross receipts (see Example F), net receipts, or the occurrence or non-occurrence of any other event agreed to by the buyer and seller. However, the sales contract must specify the maximum selling price or provide for a fixed period of payments, in order to prevent the sales contract from being scrutinized and possibly re-characterized as a lease or license, rather than a sale. (Treas. Reg. Section 15a.453-1(c)(4))

For liquidation purposes, the maximum selling price is the most important factor. If the stated maximum selling price is certain, then like Example F, the computation is certain, especially with the acceleration of the 1.5 percent tax at the corporate level when the S corporation liquidates. At the shareholder level, the recalculated gross profit percentage will apply until all contingent payments are collected.

The more difficult question arises when there is neither a maximum selling price nor a fixed period for the contingent payment sales. In this situation, the auditor should evaluate all facts surrounding the transaction to determine if in fact a sale rather than a lease or license has occurred. If the auditor concludes that a sale did occur and that the S corporation made a distribution in complete liquidation within the 12-month period (IRC Section 453(h)(1)(A)), then the shareholder's basis shall be recovered equally over a 15-year period commencing with the date of the sale. (Treas. Reg. Section 15a.453-1(c)(4))

However, the shareholder may use an alternative method for allocating basis if the shareholder can demonstrate that the 15-year method will substantially and inappropriately defer the shareholders recovery of basis and the IRS or the Franchise Tax Board (FTB) may

use an alternative method for allocating basis if either agency determines that the 15-year method will substantially and inappropriately accelerate the shareholder's recovery of basis. (Treas. Reg. Section 15a.453-1(c)(7)) For purposes of determining the S corporation's gain on the liquidating distributions, the installment obligation can be valued using any reasonable method.

15.4 MISCELLANEOUS ISSUES

- 15.4.1 Liquidating Distribution of Appreciated/Depreciated Property
- 15.4.2 Suspended Losses
- 15.4.3 Loans to Shareholders
- 15.4.4 Loans from Shareholders

15.4.1 Liquidating Distribution of Appreciated/Depreciated Property

When a shareholder receives appreciated property as part of a liquidating distribution, the transaction is treated as a sale from the S corporation to the shareholder(s). (IRC Section 336(a)) Therefore gain is reported by the S corporation (either 1.5 percent or 8.84 percent for built-in gain tax) and to the shareholder(s) as a flow-through item. In addition, the shareholder(s)'s basis is adjusted to reflect the gain with the distribution amount being the fair market value of the appreciated property.

Losses are not allowed in the case of loss property distributed in a liquidation to a related party as defined in IRC Section 267, if the distribution is either non pro-rata or the property is "disqualified property." (IRC Section 336(d)) Disqualified property is defined as property acquired by the corporation in an IRC Section 351 transaction or as a contribution to capital within the 5-year period ending on the date of the distribution. (IRC Section 336(d)(1)(B)) The purpose of this limitation is to prevent shareholders from infusing the corporation with loss property prior to liquidating.

Further, there is a second limitation for losses on property distributions as well as for property sales if the purpose for acquiring the property prior to distribution or sale was for the liquidating corporation to recognize loss. (IRC Section 336(d)(2)) Unlike the first limitation above, the second limitation can apply to minority shareholders as well as majority shareholders if the built-in loss property was contributed as capital or the corporation acquired the property in an IRC Section 351 transaction within two years of filing the plan of liquidation. If this limitation applies, the adjusted basis of the distributed property for purposes of computing the loss is reduced by the amount of the built-in loss that existed on the date the property was contributed to the corporation.

Example G

Seller Corporation liquidated on November 30, 2015. Seller Corporation distributed land to the minority shareholder. The majority shareholder contributed the land to Seller Corporation just a year earlier. The majority shareholder's basis in the land at the time on contribution was \$1 million and the FMV was \$750,000. (If the majority shareholder had sold the land for its FMV, he would have had a loss of \$250,000.)

At the time of the distribution, the basis of the land remained the same, but the FMV had dropped to \$650,000.

Assuming Seller Corporation can't rebut the presumption that the contribution was for tax avoidance, Seller Corporation will realize a \$350,000 loss but will only recognize a \$100,000 loss, the difference in the loss contributed (\$250,000) and the loss at distribution (\$350,000).

15.4.2 Suspended Losses

In a complete liquidation, flow-through losses that were suspended because of basis limitations are lost forever unless the shareholder(s) contributes additional capital to free-up suspended losses. (IRC Section 1366(d)(1)) Otherwise, the suspended losses do not decrease a liquidating capital gain or increase a liquidating capital loss.

15.4.3 Loans to Shareholders

If a loan from an S corporation to its shareholder is still outstanding at the time the S corporation completes its liquidation, the outstanding balance is treated as a deemed distribution or payment in exchange for the shareholder's stock. (IRC Section 331(a) and Treas. Reg. Section 1.1001-1(a) and 1.1001-2(a)(1)) Therefore, if the note exceeds the shareholder's stock basis, then the excess becomes a capital gain to the shareholder. Notes receivable from shareholders are not subject to installment reporting on a liquidating distribution. (Treas. Reg. Section 1.453-11(c)(2))

Example H

Seller Corporation made a loan to the shareholder on January 1, 2014, in the amount of \$1 million. On December 30, 2015, Seller Corporation liquidates and distributes the note, which is its only asset, to the sole shareholder, Mr. Seller. Mr. Seller had stock basis of \$750,000 prior to the liquidating distribution. Mr. Seller would recognize a liquidating capital gain of \$250,000.

15.4.4 Loans from Shareholders

Loans from shareholder that are forgiven by the shareholder after filing a plan of liquidation are not treated as forgiveness of indebtedness. Instead, they are re-classified as paid-in capital prior to liquidation. (Treas. Reg. Section 1.61-12(a))

The amount of the debt that is re-classified will depend on whether or not the shareholder used the debt to deduct pass-through losses. (IRC Section 1366(d)(1)) If the debt was used to deduct losses, then only the adjusted basis in the debt will be re-classified as paid-in capital and not the face amount of the debt.

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