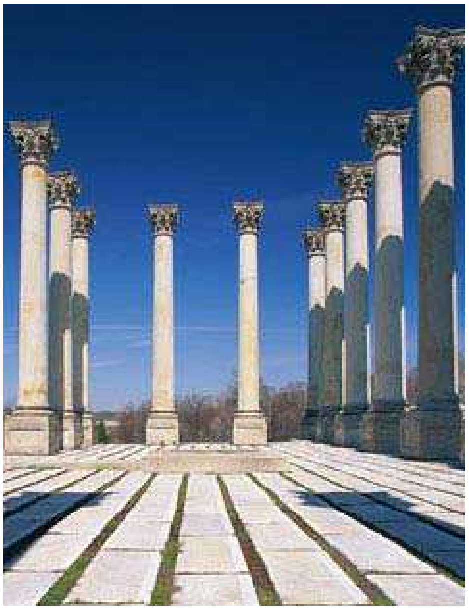

Monday, July 30, 2012

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The authors would like to thank Richard Yates, a former WNT Corporate group partner, for the groundwork for this article.

It's Only a Section 332 Liquidation—What *Possibly* Could Go Wrong?

The tax-free liquidation of a solvent, more-than-80-percent-controlled subsidiary into its parent is straightforward, right? Maybe not. This article identifies several factors that should be considered in connection with not-so-simple controlled subsidiary liquidations, illustrating some consequences that should be considered before these liquidations are complete.

"You did what?" This phrase is often heard from tax professionals when they are informed that a corporate entity was liquidated during the year. The speaker may be an external tax advisor getting the news from a client, or even a tax director getting the news from the legal department (often just before having to file the annual tax returns). In the spectrum of corporate organizational actions, liquidations may seem innocent enough—which may be why tax advisors so often hear about them after the fact. The purpose of this article is to highlight several potential ramifications of otherwise tax-free section 332 corporate liquidations.

We begin by acknowledging the different ways in which a corporate liquidation may be accomplished. A formal corporate liquidation typically involves an adoption of a plan of liquidation, necessary local law notifications to various interested parties, winding down of business operations, distributions of assets, and the eventual dissolution of the corporate law shell. As a practical matter, however, many corporate attorneys prefer to simply merge a corporate subsidiary into its parent as a means of eliminating the subsidiary because corporate law merger procedures are often less onerous than the more formal liquidation procedures. In addition to these corporate law mechanisms, for U.S. federal income tax purposes, corporate liquidations may be deemed to take place under a variety of different (tax-only) rules, such as:

- A section 338(h)(10) election,
- A section 856(i) election to obtain qualified real estate investment trust ("REIT") treatment,

- An election by an S corporation to give its subsidiaries qualified subchapter S subsidiary status,
- An election by an eligible corporate entity to change its classification under the "check-the-box regulations," and
- A "de facto" liquidation.[1]

Sections 332 and 337 generally govern liquidations of solvent, 80 percent (vote and value) controlled subsidiaries into their corporate shareholder. These rules are widely understood to allow a tax-free transaction in which neither the corporate shareholder nor the liquidating subsidiary recognizes any gain or loss in the liquidation.

This article considers some (but not all) of the special issues surrounding seemingly innocuous section 332 liquidations.

1. What happens to the parent's basis in the stock of a liquidated subsidiary?

Quite simply, the parent's basis in the stock of a subsidiary that is liquidated pursuant to section 332 permanently disappears.

> *Observation:* Taxpayers should think about disappearing basis when weighing the pros and cons of a liquidation (often the focus is limited to the immediate nonrecognition of gain or loss in the transaction). A parent corporation should consider whether it might be preferable to recognize a loss on the stock of its subsidiary, or whether a later sale of the subsidiary's distributed assets may result in more taxable gain (or possibly less loss) when the inside asset basis is less than the outside stock basis.

Unless otherwise indicated, references to "section" or "sections" in this article are to the Internal Revenue Code of 1986 (the "Code"), as most recently amended, or to the U.S. Treasury Department regulations, as most recently adopted or amended.

1 See sections 338(h)(10), 856(i), 1361(b)(3)(B), and 301.7701-2. A de facto liquidation is when a corporation is deemed liquidated for U.S. federal income tax purposes even though the legal entity continues to exist. The determination of whether a de facto liquidation has occurred is based on the surrounding facts and circumstances such as: (1) a manifest intent to liquidate, (2) a continuing plan to wind up the corporate affairs and dissolve, and (3) the corporate activities directed and limited to the act of terminating the corporate affairs. *See* Rev. Rul. 61-191, 1961-2 C.B. 21; Omsted v. Commissioner, 48 T.C.M. 594 (1984).

2. What if either the liquidating subsidiary or the parent is a foreign corporation?

If a foreign subsidiary liquidates into a U.S. parent corporation in what would otherwise qualify as a section 332 liquidation, the U.S. parent is taxed on all the earnings and profits of the liquidated subsidiary.[2] Note also that under section 334(b), if there is an aggregate built-in loss in the assets, the U.S. parent must take a fair market value ("FMV") basis in the assets (rather than the normal carryover basis).

If a U.S. subsidiary liquidates into a foreign parent in what would otherwise qualify as a section 332 liquidation, the U.S. subsidiary generally is taxed on the distribution of appreciated property (there are limited exceptions for distributions of U.S. trade or business property, U.S. real property interests, and stock of an 80-percent-owned U.S. subsidiary).[3]

In addition, a distribution to a foreign corporation in complete liquidation of an "applicable holding company" may be subject to U.S. withholding tax under section 332(d) because the distribution may be treated as a section 301 distribution. An "applicable holding company" is defined as any U.S. corporation (1) that is the common parent of an affiliated group, (2) whose stock is directly owned by a foreign distributee corporation,
(3) substantially all the assets of which consist of stock in other members of such affiliated group, and (4) which has not been in existence at all times during the five years immediately preceding the date of the liquidation.

Finally, taxpayers also should consider whether foreign exchange gain or loss could be triggered as a result of a section 332 liquidation.[4]

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2 Section 1.367(b)-3.

3 Section 1.367(e)-2(b)(2).

4 Section 1.367(b)-2(j) paragraph 1 as to foreign exchange gain or loss of a change in a qualified business unit ("QBU") as a result of any section 381 exchange subject to section 367(b) through the application of the section 985(b) QBU determination rules and paragraph 2, which deals with previously taxed income in section 1.367(b)-3 (inbound section 332 and inbound 368(a)(1) transactions) that are discussed in section 1.367(e)-2(c)(1) and section 988(c)(1)(B). The final 367(b) regulations are reserved as to recognition of exchange gain or loss with respect to capital. Section 1.367(b)-3(b)(3)(iii).

3. What happens to the liquidating subsidiary's earnings and profits ("E&P") and net operating losses ("NOLs")?

Following certain tax-free transactions, including section 332 liquidations, section 381 preserves certain tax attributes (e.g., E&P, NOLs, etc.) with the acquiring corporation as successor. E&P that was generated by the subsidiary while it was a member of the parent's consolidated group is already reflected in the E&P of the parent such that no further adjustment to parent's E&P is necessary upon liquidation of a subsidiary pursuant to section 332.[5] However, if the subsidiary has E&P earned prior to joining parent's consolidated group (pre-affiliated E&P), the parent will only succeed to the subsidiary's pre-affiliated E&P upon merger or liquidation.[6]

> *Observation:* Following a consolidated group section 332 liquidation, the parent will have more E&P only if the subsidiary had pre-affiliated E&P.

4. What if the subsidiary is owned by more than one consolidated group member?

In determining ownership for purposes of the 80-percent-control test,[7] stock owned by all other consolidated group members is aggregated.[8] Although the owning members generally will not recognize gain or loss on their liquidating subsidiary shares, the liquidating subsidiary will recognize gain (but not loss) on any asset it distributes to a shareholder member that does not own, by itself, at least 80 percent of the subsidiary.[9] If the liquidating subsidiary is a member of the consolidated group, any gain recognized by the liquidating subsidiary should be deferred and its deferred gain should be inherited by its 80-percent-controlling shareholder, if it has one.[10] When there are two less-than-80-percent shareholders, the deferred asset gains are attributed to the shareholder that did not receive the asset to which the gain was attributable (e.g., shareholder S becomes

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5 Section 1.1502-33(a)(2).
6 Section 381(c)(2).
7 Section 332(b)(1).
8 Section 1.1502-34.
9 Section 337(c). Any less-than-80-percent shareholder will take a fair market value basis in the assets distributed to it. Section 334(a).
10 Section 1.1502-13(j)(9), example 6.

a successor to the deferred gains associated with the assets distributed to shareholder B).[11]

> *Observation:* To avoid creating deferred gains on assets, it may be better to distribute non-appreciated assets to any member that does not own, by itself, at least 80 percent of the liquidating subsidiary.

5. Was the subsidiary stock acquired within the two years prior to the liquidation?

When a subsidiary is liquidated pursuant to section 332, the parent should generally succeed to the liquidated subsidiary's tax attributes.[12] However, if the subsidiary was acquired in a qualified stock purchase within two years of the liquidation[13] and an election was not made under section 338, then the IRS may assert its authority pursuant to section 269(b) to disallow the parent's use of the subsidiary's pre-acquisition tax attributes. The provisions of section 269(b) generally apply when *the* principal purpose for the liquidation is the evasion or avoidance of federal income tax.

6. What will happen to any deferred intercompany gains or losses generated (but not yet taken into account) by the liquidated subsidiary?

In a section 332 liquidation, any deferred intercompany gains or losses of the liquidated subsidiary should be inherited by the parent corporation.[14]

7. What if there is a deferred intercompany gain on the consolidated liquidating subsidiary's shares?

A section 332 liquidation will cause a deferred intercompany gain on the stock of a liquidating subsidiary to be triggered—and the resulting gain

[11] Section 1.1502-13(j)(9), example 7; section 1.1502-13(d)(1)(i)(A). If there are more than two distributees, it is less clear which shareholders become successors to which deferred gains. Therefore, it will be difficult to identify with certainty the future triggering events for those deferred gains.

[12] Section 381.

[13] As defined in section 338(h)(3).

[14] Section 1.1502-13(j)(2) for intercompany items from post-July 11, 1995 tax years; sections 1.1502-13T(c), (f)(1), and (f)(2) for intercompany items after calendar year 1987 through pre-July 12, 1995 tax years; and former sections 1.1502-13(c)(6) and (f)(2)(ii)(a) for intercompany items from calendar year 1987 and earlier years.

generally will be fully taxable. However, final regulations ("2011 Final Regulations") effective beginning March 4, 2011,[15] permit the intercompany gain to be permanently excluded from gross income following certain stock basis elimination transactions, such as section 332 liquidations, but only if each of the following criteria is met:

- One member is treated as both the "buyer" and the "seller" (the buyer/seller member) as to the deferred gain on stock,[16]
- The buyer/seller member directly owns the deferred gain member stock,
- The buyer/seller member's basis in the deferred gain stock is eliminated without the recognition of gain or loss (and the basis is not further reflected in the basis of any successor asset),
- The effects of the intercompany transaction have not previously been reflected—directly or indirectly—on the group's consolidated return, and
- The group has not derived (and will not derive) any federal income tax benefit from the intercompany transaction that gave rise to the intercompany gain or the redetermination of intercompany gain.[17]

If a taxpayer fails to qualify for the permanent exclusion under the rules described above, elective relief is available for the consolidated group to continue to defer the gain on member stock, if the group is willing to transfer the subsidiary's assets to a newly created company within the time (and subject to the conditions) specified in the regulations.[18] This relief effectively returns the gain on the member shares to deferred status

[15] The 2011 Final Regulations are based, with some modifications, on slightly more restrictive temporary regulations that were originally proposed in 2008 ("2008 Temporary Regulations"). Under the 2008 Temporary Regulations, the gain exclusion criteria were similar to the 2011 Final Regulations, except that common parent was the only member that could satisfy the first two criteria in the text associated with this footnote (i.e., the consolidated group's common parent had to be the buyer/seller member associated with the deferred gain on stock and parent had to directly own such deferred gain shares). The 2008 Temporary Regulations were effective for transactions occurring after March 7, 2008, and before March 4, 2011.

[16] This likely would be the case if the prior buyer or seller merged into one another or into another member of the group.

[17] Section 1.1502-13(c)(6)(ii)(C).

[18] Section 1.1502-13T(f)(5)(ii)(B).

(subject to later triggering events), provided the new company to which the assets are transferred continues the liquidated subsidiary's business. If the liquidation is triggered as a result of a section 338(h)(10) election, then the elective relief mechanism is different—rather than allowing continued deferral in the new company's stock, the mechanism is the allowance of a loss that should mitigate some or all of the triggered intercompany stock gain.[19]

> *Observation:* Liquidations occurring prior to July 12, 1995, were subject to treatment under former section 1.1502-13 ("pre-1995 regulations"), which required the stock gain to be triggered and to be fully taxable.
>
> Any deferred intercompany stock gain created (but not triggered) under the pre-1995 regulations generally will be triggered and reportable in the liquidation year.[20] However, if the group made the one-time election under section 1.1502-13(l)(3) with its 1995 tax return to apply the 1995 regulations instead of the pre-1995 regulations, the post-July 11, 1995 regulations (including any of the relief provisions) generally should apply to these older transactions.

8. What will happen if the parent has an excess loss account ("ELA") in the liquidating subsidiary shares?

Very simply, the ELA too should permanently disappear like any positive tax basis in Question 1.[21] Under the consolidated return regime, an ELA is the term describing when one member has a negative tax basis in the stock of another member of the consolidated group. ELAs generally arise in debt-financed distributions, when debt-financed losses are absorbed by other members, or when the parent transfers property subject to liabilities in excess of the basis of the property transferred to the subsidiary.

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19 Section 1.1502-13(f)(5)(ii)(C)

20 Former section 1.1502-13(f)(1)(vi). See, e.g., P.L.R. 9644003, P.L.R. 9643002, and P.L.R. 9627002.

21 Section 1.1502-19(b)(2).

> *Observation:* Even a deemed section 332 liquidation, such as one made pursuant to a section 338(h)(10) election, will be treated as a liquidation resulting in the elimination of the ELA.[22]

9. What if the liquidated subsidiary stock basis was reduced under sections 108 and 1017 due to its parent's past excluded cancellation of debt income?

Section 1017(d) treats subsidiary stock as section 1245 property to the extent the subsidiary's parent was required to reduce its basis in the subsidiary stock due to prior excluded cancellation of debt income. Further, the section 108(b) and section 1017 basis reduction is treated, solely for purposes of future section 1245 recapture, as a depreciation deduction. Although section 332 generally provides for nonrecognition treatment to the parent shareholder, section 1245(a)(1) nonetheless requires the parent to recognize taxable income equal to the lesser of the amount realized (i.e., built-in gain on the subsidiary stock at the time of liquidation) or the section 108(b) and section 1017 basis reduction. A key exception to this rule applies if the stock basis reduction occurs under the consolidated return cancellation of debt rules of section 1.1502-28, and then only to the extent the subsidiary reduces its own tax attributes.[23]

10. How are section 332 liquidating distributions made by regulated investment companies ("RICs") or real estate investment trusts ("REITs") treated?

Under section 332(c), section 332 liquidating distributions made by a RIC or REIT are treated as a dividend to the corporate distributee in an amount equal to the dividends-paid deduction allowable to the RIC or REIT on such distribution.

11. Can a taxpayer intentionally structure into a section 332 liquidation?

The answer depends on which requirement of section 332 is lacking to cause the liquidation to fail to qualify as a 332 liquidation. If the shareholder simply lacks the requisite 80 percent vote and value, then it is

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[22] Rev. Rul. 89-98, 1989-2 C.B. 219.
[23] Section 1.1502-28(b)(4).

generally possible to purchase additional shares (at least from unrelated parties) in order to satisfy the ownership threshold.[24]

> *Observation:* Favorable guidance of buying into 80 percent ownership involves cash purchases from unrelated parties. Any time stock is purchased followed by a planned liquidation, the overall transaction may be recharacterized as a section 368 reorganization depending on whether the buyer and seller are related and on the consideration paid (cash versus shares).[25]
>
> Further, redeeming some shareholders in order to be left with an 80-percent-controlling parent should be avoided. In Revenue Ruling 70-106, such a redemption was treated as part of an overall plan of a section 331 fully taxable liquidation with the 75 percent parent corporation.[26]
>
> If, however, the parent corporation already owns 80 percent of a subsidiary, but the subsidiary is insolvent due to debt owed to the parent corporation, structuring into a section 332 liquidation may be more difficult. In Revenue Ruling 68-602, a subsidiary was indebted to its 80 percent parent corporation. In order to qualify for section 332 treatment, the parent corporation first cancelled its receivable from the subsidiary to make the subsidiary solvent. Second and immediately thereafter, the subsidiary liquidated into its parent corporation. The ruling concluded that the cancellation of debt was transitory and, therefore, disregarded, which meant the liquidation did not qualify for section 332 treatment.

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24 In Revenue Ruling 75-521, 1975-2 C.B. 120, a 50 percent corporate shareholder purchased the remaining subsidiary stock from the other shareholders, and then adopted a plan to completely liquidate the subsidiary under section 332. The steps were respected because there was no official corporate action approving the liquidation at the time of the stock purchase. Similarly, Revenue Ruling 90-95, 1990-2 C.B. 67, permitted the purchase of 100 percent of the target stock from an unrelated party followed by a complete liquidation under section 332.

25 In Revenue Ruling 2004-83, 2004-2 C.B. 157, the IRS held that the sale of one subsidiary to a related corporation followed by the liquidation of the purchased subsidiary was part of an integrated plan qualifying as a section 368(a)(1)(D) reorganization. *See also* Rev. Rul. 2001-46, 2001-2 C.B. 321; Rev. Rul. 67-274, 1967-2 C.B. 141; section 1.368-2(l).

26 1970-1 C.B. 70.

Thus, making a subsidiary solvent in contemplation of liquidation may not be respected if viewed as part of an integrated plan with a liquidation.

12. Can a taxpayer intentionally structure out of a section 332 liquidation?

Yes. Although section 332 treatment is not elective, it may be possible to avoid section 332 treatment by reducing stock ownership below the 80 percent threshold prior to liquidation.[27]

Observation: Taxpayers that structure subsidiary ownership to avoid section 332 treatment should be careful of stock sales to related parties. First, such stock sales may have their own taxable income and gain implications. Second, if the divested stock is sold to a related party, section 267(f) may defer such loss until a time when the buyer and seller are no longer related to one another—even though the liquidated company stock is gone for tax purposes.[28]

13. Will the liquidation compromise state tax planning?

Regardless of the taxability of a subsidiary liquidation, the combination of two separate corporations into one may have a significant impact on prior state tax planning. For example, if the two companies historically have been operating in and mitigating taxation of profits in a high-tax state and low-tax state (e.g., perhaps through required royalty payments), the post-liquidation structure likely would lose that prior benefit. Further, any separate-return state apportionment factors for the parent would likely change as a result of the liquidation.

Most states follow the federal treatment of section 332. Not all states, however, adopt the aggregation of ownership rules found in section

[27] In Commissioner v. Day & Zimmerman, Inc., 151 F.2d 517 (3d Cir. 1945), parent did not want nonrecognition treatment. In order to fall below the 80 percent threshold, parent sold a portion of the common stock of two of its wholly owned subsidiaries prior to liquidating those subsidiaries. The court held that parent's capital losses in the stock of its two subsidiaries were allowed. In Granite Trust Co. v. United States, 238 F.2d 670 (1st Cir. 1956), parent sold and donated a portion of the stock of its wholly owned subsidiary to unrelated parties, reducing parent's ownership interest in the subsidiaries below 80 percent prior to liquidating the subsidiaries. The court held that the liquidation was a taxable event.

[28] Section 1.267(f)-1(c)(1)(iv).

1.1502-34, which may cause a state-level gain to a minority shareholder member of the consolidated group. Even if a state follows section 332, it may not follow all of the corollary provisions, such as section 381.[29]

Other state taxes, such as sales, transfer, and property taxes, should also be considered whenever there is a movement of assets. Generally, a liquidation is not subject to sales tax, but relying on specific exemptions may be necessary.[30] And, even if no specific exemption applies, further inquiry into whether a casual or isolated sale exemption applies should be undertaken. In states where transfer or property taxes apply, additional inquiry into whether an exception exists should be considered.

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[29] For example, in New Jersey, when a legal entity is merged, liquidated, or otherwise ceases to exist, the tax attributes for New Jersey purposes are extinguished (N.J.A.C. 18:7-5.13). Further, Mississippi does not conform to section 338(h)(10). Rather, the transaction is governed under section 338(g), so no deemed liquidation takes place for Mississippi purposes (MISS Reg. 35.III.8.01).

[30] For example, liquidations in New York are specifically exempt; liquidations in California are not expressly exempt, but should nevertheless escape sales tax because no consideration is paid. N.Y. Comp. R & Regs. Tit. 20 § 526.6(d)(1)(ii); Sales Tax Counsel Ruling 395.2280; Cal. Admin. Code tit. 18 § 1595(b)(5).