

LIQUIDATING OR SELLING THE CORPORATION

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In this final article of a series of articles on business and corporate development and planning, we will address the issues and concerns involved in selling or liquidating the corporate structure. At some stage in a corporation's life it is very likely that consideration must be given to its sale or liquidation. Retirement, disagreements with owners, or an attractive offer may all trigger the desire to sell or liquidate the business. Regardless of the reason certain issues must be addressed when considering selling or liquidating the business.

A **complete liquidation** occurs when the corporation distributes all of its assets in exchange for all of its outstanding stock. This may occur in one of two ways: the corporation may sell its assets and then liquidate or it may liquidate first, distributing its assets to its shareholders, who will then dispose of them.

A distribution in complete liquidation of a corporation is treated as full payment for the shareholder's stock. The **shareholder** will report a gain or loss measured by the difference between the value of the assets (cash and property) received in the liquidation distribution and the basis of the stock surrendered. If the shareholder has held the stock for at least six months or one year if acquired after 1987, the capital gain or loss will be considered long term. Where a shareholder has acquired different blocks of stock at different times and at different prices, each particular block of stock must have its own calculation of gain or loss. The shareholder's basis for property received as part of the liquidation distribution is its fair market value at the time of distribution for purposes of determining gain or loss.

As a general rule, a **corporation** must report gain or loss on a distribution of assets other than cash in a complete liquidation. The liquidating corporation is treated as if it sold the assets at their fair market value to its shareholders. Since the Tax Reform Act of 1986, corporations no longer have the tax benefit of nonrecognition of income or loss. Where an asset is subject to a liability or the shareholder has assumed the liability and the liability exceeds the asset's fair market value, the value is deemed to be the amount of liability. The corporation will recognize a gain to the extent that the liability is more than the asset's basis.

Although losses are generally recognized on a distribution of assets in a complete liquidation, there are restrictions which prevent companies and their shareholders from creating or inflating losses. A loss may not be recognized by a liquidating corporation when it distributes property to a more-than-50 percent shareholder unless (1) the property is distributed pro rata to all shareholders; and (2) the property was not acquired in a tax-free transaction or as a contribution to capital during the five years preceding the distribution.

Caution should be taken in order to avoid the possibility of having the **liquidation-reincorporation** doctrine applied to your business liquidation. A liquidation-

reincorporation occurs where a corporation has been liquidated, but essentially the same corporation has thereafter continued to conduct the business that was purportedly the subject of the liquidation. The liquidation-reincorporation doctrine seeks to prevent this kind of behavior. The measure is not whether the same corporation was "revived", but whether essentially the same business with the same shareholders continued in operation following the liquidation of the existing corporation. Factors tending to show that the liquidation-reincorporation is actually a reorganization and thereby possibly triggering an Internal Revenue Service investigation include:

- 1) The transactions are part of a prearranged plan.
- 2) The business of the old corporation is continued by the new corporation.
- 3) Substantially all of the operating assets of the old corporation are transferred to the new corporation.
- 4) There is no business purpose for the liquidation.
- 5) The shareholders of the old corporation own a substantial percentage of the new corporation's stock.

One alternative to the business owner is to sell all of the corporate assets to one or more purchasers. Once the sale of assets is complete, the owners are left with a corporate shell that can be liquidated, with a distribution of the sale's cash proceeds. The sale of assets is taxable to the corporation with gain or loss recognized by comparing the asset's sales price to their tax basis. Depreciation and investment tax credit recapture must also be recognized on the asset sales. The tax associated with the recognition of gain or recapture is paid by the corporation in the year of the sale.

The distribution of the cash proceeds to the shareholders triggers a second-tier tax to be paid by the owners. The distribution may take the form of a dividend or a liquidation and yield the same impact in terms of tax rate. The two-tier taxability of an asset sale makes this alternative less attractive to the owners than a sale of stock.

The sale of the corporate stock by its owners is one way to avoid the negative aspects of an asset sale although such stock sale has its own difficulties particularly in finding a buyer and fixing a value on the stock. However, the tax effect is such that only a tax on the shareholder's gain on the sale occurs. The corporation remains unaffected, with all of its assets and liabilities intact.

The valuation of corporate stock can be most perplexing to an owner of a closely held corporation as there is typically no market for the such stock, yet the owners may be called upon by lenders or prospective buyers to set a stock value. On the other hand, it is highly likely that a market exists or is readily determinable for the sale of most assets making the business owners decision whether to sell the stock or the assets even more difficult.

As you can see, considerable thought must go into planning and organizing the sale or liquidation of a business especially in the areas of tax considerations and the valuation of stock and assets. Before taking any action in this area always consult your attorney and accountant. For more information on selling or liquidating your business

contact Reager & Adler at (717) 763-1383.