PLANNING TO REALIZE CAPITAL LOSS UPON LIQUIDATION? BETTER HURRY UP AS CHANGE IS IN THE AIR

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INTRODUCTION

Incurring economic losses is rarely a good thing. On the other hand, harvesting a capital loss in the same tax period an unrelated capital gain is recognized has its advantages – the loss may be utilized as a deduction to reduce tax liability arising from the capital gain.[1] While this statement is generally true for all types of losses, this article will focus on capital losses incurred by a corporation from the divestiture of subsidiary stock.

In general, a corporation can deduct losses recognized on the sale or exchange of capital assets.[2] Those losses may be used only to reduce capital gains such as those recognized from the sale of subsidiary stock.[3] Consequently, a corporation that suffers a book loss due to a drop in the value of subsidiary stock may recognize the loss by selling the shares of the subsidiary. Where the sale of the subsidiary is not possible because of the absence of a buyer, the shareholder may realize the loss pursuant to the complete liquidation of the subsidiary where the tax consequences of the liquidation are governed by Code §331.

Regrettably, not every liquidation has its tax consequences governed by Code §331. Where 80% or more of the stock of the liquidating corporation is owned by a single corporate shareholder, the tax consequences of a complete liquidation are governed by Code §332. Under Code §332, no gain or loss is recognized in connection with the complete liquidation of the subsidiary. However, corporate shareholders have been taking the position that certain steps may be taken to intentionally shut down Code §332 and bring back Code §331 into play.

Over the years, courts have allowed intentional avoidance of Code §332, rejecting counter arguments by the I.R.S. However, legislation proposed in late 2021 suggests that Congress may now look to put an end to this planning opportunity in order to raise revenue.

THE ELECTIVE FEATURE OF CODE §332

Code §331 Liquidation or Code §332 Liquidation?

From a corporate law standpoint, a complete liquidation of a corporation usually involves winding down of the business of the liquidating corporation, making

[1] Provided certain conditions are met. See Code §1211 and the regulations promulgated thereunder.

[2] Code §1211(a).

[3] Code §1221 allows the loss to offset the gain, provided the stock is not held by the taxpayer primarily for the sale in the ordinary course of trade or business.

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payments to creditors, and distributing remaining assets to shareholders. From a tax perspective, however, the last step of a complete liquidation – the distribution of remaining assets – is not treated as an ordinary dividend distribution. Instead, Code §331 generally provides that the amounts received by a shareholder as part of a distribution that is part of a complete liquidation of a corporation is treated as full payment in exchange for the relinquishment of stock. In other words, Code §331 creates a fiction, under which the liquidation is treated as the transfer of the shares of the liquidating corporation by its shareholders to the liquidating corporation in exchange for the liquidating corporation's assets. An exchange of property (including shares) generally results in a recognition of gain or loss under Code §1001(c). Therefore, under Code §§331 and 1001, the deemed exchange of shares of the liquidating corporation triggers recognition of gain or loss.[4]

In contrast to Code §331, Code §332 provides that no gain or loss is recognized by a corporation that is a shareholder upon complete liquidation of a subsidiary, provided that certain conditions are met.[5] While this is a desirable outcome when a built-in gain exists in the shares, nonrecognition treatment produces an unfavorable result when a built-in loss exists in the shares. If no loss is recognized for tax purposes, no loss may be utilized to offset taxable capital gains.

Code §332 is not drafted as an elective provision. Therefore, a simple read of the section would suggest that a taxpayer is not entitled to choose whether the section applies. However, Code §332 applies to a liquidation only if several conditions are met. If any of the conditions are not met, Code §331 governs the tax treatment of the liquidation.

The first condition requires that 80% or more of the voting power and value of all shares of stock of the liquidating corporation must be owned by the corporate parent receiving the property. Moreover, the required level of ownership must exist at all times, beginning on the date of the adoption of the plan of liquidation until all property is received.[6] This 80% ownership requirement is in fact the differentiating factor between Code §332 and Code §331, since all the other conditions that apply to Code §332 apply also to Code §331.[7]

Since the 80%-ownership requirement can be controlled by a shareholder, a sole corporate parent can prevent Code §332 from applying by disposing enough shares of the liquidating subsidiary prior to the adoption of the plan of liquidation. Once there are at least two shareholders and the parent corporation holds less than 80% of the liquidating corporation, the two shareholders may adopt a plan of liquidation. That liquidation would be outside the realm of Code §332 and, instead, would trigger loss recognition under Code §331.[8]

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[4] Note that gain or loss may be recognized by the shareholder upon the deemed sale of the subsidiary shares and potentially by the liquidating subsidiary upon the deemed sale of its property to the shareholder.

[5] See Code §332(b) and the regulations promulgated thereunder for the conditions of Code §332(a).

[6] Code §§332(b)(1) and 1504(a)(2).

[7] The other conditions for Code §332 to apply are outside the scope of this article.

[8] Provided the underlying conditions for Code §331 are met.

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The Granite Trust Case

In *Granite Trust Co. v. U.S.*,[9] the I.R.S. was unsuccessful in challenging the effect of a disposition of shares in a wholly owned subsidiary immediately before the adoption of a plan of liquidation.

The taxpayer owned 100% of a subsidiary corporation. Over the course of several years, the value of the subsidiary's shares dropped significantly. Wishing to assure recognition of the loss on a purported liquidation of the subsidiary and to avoid nonrecognition treatment, the taxpayer sold or otherwise transferred enough shares to reduce its ownership in the subsidiary corporation to less than 80%. The transferee was a friendly party in relation to the taxpayer and was well aware of the subsidiary's situation and the taxpayer's intention to have the subsidiary liquidated. It is fair to say that the transferee acted as an accommodation party for the taxpayer, enabling the taxpayer to recognize a capital loss.

The I.R.S. challenged the application of the predecessor of Code §331. It argued that the sale of shares should be ignored in light of the step transaction doctrine. Under that doctrine, a series of transactions may be collapsed into mere steps of a single integrated transaction for income tax purposes because each individual step is meaningless or unnecessary to achieve the end-result.[10] Here, the I.R.S. argued that the end result was the complete liquidation of a wholly owned subsidiary of the taxpayer. The disposition of shares that preceded the adoption of the plan of liquidation had no purpose other than to move the governing tax law provision from the predecessor of Code §332 to the predecessor of Code §331. Consequently, it should be ignored. In addition, the I.R.S. argued that the sale should be ignored because it was transitory and meaningless, within the meaning of *Gregory v. Helvering*.[11]

The court rejected the I.R.S. challenge, finding that the taxpayer's loss was properly recognized. The court expressed the view that the rigid requirements of the predecessor of Code §332 suggested that it is not an "end-result provision" but rather one which prescribes specific conditions for the application of a nonrecognition provision of the Code. The Court relied on the decision in *Commr. v. Day & Zimmerman, Inc.*,[12] where a shareholder sold a sufficient number of shares to avoid the same nonrecognition provision. Despite the tax motive for the transaction, the sale was upheld as *bona fide*.[13]

In addition, the court reviewed the legislative history of Code §332 in 1954 to show that Congress was aware of the possibility that taxpayers could take preliminary steps to avoid the provision by reducing the stock ownership to less than 80%.[14]

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[9] 238 F.2d 670 (1956).

[10] See, for example, *King Enterprises, Inc. v. U.S.,* 418 F.2d 511, 516 (Cl. Ct. 1969).

[11] 293 U.S. 465 (1935).

[12] 151 F.2d 517 (3rd Cir., 1945).

[13] In *Day & Zimmerman*, the Court found that there was no agreement between the seller and purchaser for the seller to retain any interest in the transferred stock.

[14] In 1954, Code §112(b)(6) was reenacted as Code §332. According to the Report of the Senate Finance Committee (report No. 2543), Congress was aware of the 3rd Circuit's ruling in *Day & Zimmerman* and of the elective nature of Code §332 and did not change the provision to disallow it. It follows that Congress took into account that taxpayers may, by taking appropriate steps, render Code §332 inapplicable as they choose.

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Nonetheless, no anti-abuse provision was adopted mandating the disregard of a sale that immediately preceded a liquidation. Therefore, the step transaction doctrine was found to be inapplicable in the context of a liquidation.

As to the second argument of the I.R.S., that the transferee's ownership was transitory, the court found the sale of shares to be genuine. The transferee acquired all the rights of a minority shareholder in the subsidiary. Provided the transaction was truly consummated as it was purported to be, the accompanying intent of the taxpayer to minimize taxes was irrelevant.

The Court's decision in *Granite Trust* effectively made Code §332 an elective provision in most circumstances.[15] Code §331 applies as long as the share transfer transaction provides the transferee with all the benefits and burdens of ownership.

The decision has been followed by several other circuit courts of appeal[16] and by the I.R.S.[17] With limited exception, Code §332 has been interpreted and implemented as an elective provision for many years. A parent corporation owning 80% or more of the shares of a subsidiary may decide to defer gain when liquidating a subsidiary that is profitable or recognize loss by disposing more than 20% of the shares in an unprofitable subsidiary prior to adopting a plan of liquidation.

A *GRANITE TRUST* TRANSACTION BETWEEN RELATED PARTIES

The Granite Trust Case Has Been Taken One Step Further

In *Granite Trust*, the taxpayer sold the shares in its subsidiary to an unrelated party. Even though the purchaser accommodated the taxpayer, it neither owned shares in the taxpayer or its affiliates, nor was owned by the taxpayer or affiliates. In the

[15] For example, where the transferee is a member of the same consolidated group – see further detail below.

[16] See, for example, *Riggs, Inc. v. Commr.,* 64 T.C. 474, 489 (1975). See also *Avco Mfg Corp. v. Commr*., 25 T.C. 975 (1956); Note, however, that under certain circumstances the step transaction doctrine will be applied to treat the transaction as a liquidation of the subsidiary under §332. For example, in *Associated Wholesale Grocers, Inc. v. U.S.,* 927 F.2d 1517 (10th Cir. 1991), the court disallowed a claimed capital loss on the sale of a subsidiary's stock, in a cash merger of the subsidiary into an unrelated corporation, where the parent corporation used most of the proceeds of the merger to repurchase about 97% of the subsidiary's assets.

[17] See, for example, Technical Tax Memorandum ("T.A.M.") 8428006; Field Service Advice ("F.S.A.") 200148004; The elective nature of Code §332 is also reflected in Rev. Rul. 75-521, where a 50% shareholder took preliminary steps to increase its stock ownership to 80% in order to achieve tax-free liquidation under Code §332. However, in 2014 the I.R.S. announced it will no longer issue private letter rulings ("P.L.R.'s") to taxpayers in connection with the intentional avoidance of Code §332. See Rev. Proc. 2014-3. Note that an I.R.S. written determination in the form of a P.L.R., a T.A.M. or an F.S.A. may not be cited as precedential authority by any person other than the taxpayer involved. Code §6110(k)(3). However, those determinations tend to demonstrate the view of the I.R.S. at the time issue and may be cited as authority for the limited purpose of avoiding certain penalties.

absence of a friendly third-party buyer, a transaction between the shareholder and a related party[18] may be considered.

As mentioned in n. 17, F.S.A. 200148004 concludes that a transfer to a related party immediately prior to a liquidation will be recognized as valid as long as it is a *bona fide* transfer reflecting a permanent realignment of ownership interests. Put differently, if the transferor has not retained any interest in the stock transferred and the transferee continues to hold the subsidiary's stock after the transfer has been completed, the I.R.S. will not disregard the transfer of shares.

The I.R.S. further provided in FSA 200148004 that, in lieu of actually liquidating the subsidiary, U.S. shareholders of an eligible entity[19] may instead elect to treat the entity as a partnership for U.S. Federal tax purposes. Under the Check-the-Box regulations, an eligible entity that has two or more members and is treated as an association taxable as a corporation may elect to be classified as a partnership for U.S. Federal tax purposes. As a result of making an election, the eligible entity is deemed to distribute all of its assets and liabilities to its shareholders in liquidation and immediately thereafter the shareholders are deemed to contribute all of the distributed assets and liabilities to a newly formed partnership.[20] Since an election made under the Check-the-Box Regulations is treated as a deemed liquidation, a taxpayer can trigger the recognition of a loss under Code §331 by making Check-the-Box election without having the subsidiary undergo an actual liquidation.

"As a result of making an election, the eligible entity is deemed to distribute all of its assets and liabilities to its shareholders in liquidation and immediately thereafter the shareholders are deemed to contribute all of the distributed assets and liabilities to a newly formed partnership."

As a technical matter, using a Check-the-Box election as an alternative to a Code §331 liquidation is available for subsidiaries that are eligible entities. In the domestic context, only L.L.C.'s and partnerships that previously elected to be treated as corporations for U.S. income tax purposes can make an "Uncheck-the-Box" election, and can do so only at times permitted by the regulations.[21] It is not available for an entity formed under the domestic corporation law of any state of the U.S. or the District of Columbia. In comparison, a Check-the-Box election can be used for foreign eligible entities that defaulted into association status because no member is personally liable for the obligations of the entity or that were partnerships or partnership-equivalent entities for U.S. income tax purposes that elected association status for U.S. tax purposes because at least one member is personally liable for the obligations of the entity.

Tax Implications to be Considered

Some important tax consequences should be considered when consummating a *Granite Trust* transaction between related parties:

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18 The term "related party" is defined in Code §267(b). However, different definitions may apply for different purposes.

19 An "eligible entity" is defined under Treas. Reg. §301.7701-3(a) as an entity that is not classified as a corporation under Treas. Reg. §301.7701-2(b), meaning that it does not include an association having two or more members.

20 Treas. Reg. §301.7701-3(g)(1)(ii).

21 Under Treas. Reg. §301.7701-3(c)(1)(iv), once an election is made that is effective on any date other than the date of formation, it cannot be changed for 60 months except where a substantial change has taken place in the ownership of the company.

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- The stock ownership requirement triggering the application of Code §332 to a liquidation of a subsidiary looks to stock that is directly owned and stock that is indirectly owned through a member of the same consolidated group.[22] Where both shareholders of a corporation about to undergo a liquidation are members of the same consolidated group, each shareholder is deemed to own all shares owned by all other group members for purposes of applying Code §332(b)(1).[23] Consequently, a sale that is the precursor to a *Granite Trust* liquidation does not reduce the selling shareholder's interest to below 80% once the indirect ownership rules are taken into account. This rule strongly suggests that a precursor sale must take place with purchasers that are not members of the same consolidated group.

- Even where the seller and purchaser are not members of the same consolidated group, they may be members of same controlled group.[24] Where a member of a controlled group sells shares to another member at an arm's length price which triggers a loss, Code §267(f) applies, preventing the selling member from claiming a loss in the taxable year of the sale. The loss is deferred until the purchasing member of the group sells the asset to an unrelated purchaser that is not a member of the group.[25] Therefore, although pursuing a Granite Trust liquidation between members of the same controlled group is possible, the shareholder must take into account that the loss attributed to the shares sold immediately before the liquidation, will be deferred.

- If, instead of selling the shares of one subsidiary to another, the common shareholder contributes the shares to another member of a consolidated group, the transaction may qualify as a Code §351 transaction. Under Code §351, no gain or loss is recognized on the transfer of shares. Therefore, the common parent would not be able to utilize the loss realized on the transfer. As mentioned above regarding the liquidation of the loss corporation, where the transferor and transferee are members of the same consolidated group, Code §332 would continue to apply because the common shareholder would be deemed to own all shares owned by all other group members. Hence, the balance of the loss would not be recognized for U.S. income tax purposes. However, where the transferee is a not a member of the same consolidated group, as would be the case where the transferee is a foreign corporation, Code §331 is expected to apply and the parent corporation is expected to recognize loss on the shares of the liquidating subsidiary. Note that the entirety of the loss will not be recognized. The deduction is limited to the portion of the loss attributed to the shares of the subsidiary that remained in the shareholder's possession after the initial transfer of shares to the related party.

- As to the remainder of the shares of the subsidiary, the related-party transferee will not be able to recognize any loss on those shares. Loss is measured by the excess of the adjusted basis over the amount realized.[26] Since the transferee's basis in the shares received will be equal to the shares' fair

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[22] See Code §§332(b)(1) and 1504(a)(2) and Treas. Reg. §1-1502-34.

[23] Treas. Reg. §1.1502-34.

[24] "Controlled Group" is defined in Code §267(f)(1).

[25] Code §267(f)(2).

[26] See Code §1001(a).

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market value as of the day of their receipt,[27] the adjusted basis is not expected to exceed the amount realized upon liquidation of the subsidiary.

The loss that is attributed to the transferred shares will not be completely lost. The high basis that the transferor had in the transferred shares, will be transferred to new shares in the transferee corporation that the transferor will receive as a result of the Code §351 transaction.[28] At such time as the transferee corporation is sold by the transferor, the high basis will be taken into account and could result in a loss.

- Finally, when structuring a *Granite Trust* liquidation between related parties care must be taken to confirm that the transaction does not fall within the four walls of a reorganization under Code §368. If the transaction is recharacterized by the I.R.S. as a reorganization under Code §368,[29] nonrecognition treatment will follow. Once more, the *Granite Trust* liquidation will be ineffective. No loss will be recognized and no deduction will be allowed.

"For over 60 years, Granite Trust liquidations have been allowed, and corporations have been able to avoid nonrecognition treatment for losses when a liquidation would otherwise be governed by Code §332 if carried out in a straightforward way."

ALL GOOD THINGS MUST COME TO AN END

As mentioned throughout this article, Code §267 governs the tax treatment of losses from transactions involving related parties and provides rules that either disallow or defer such losses. Under current law, the rules of Code §267 do not apply to losses recognized under Code §331.[30] Therefore, a shareholder that has recognized a loss pursuant to a *Granite Trust* liquidation enjoys the full benefit of the loss.

In late 2021, the House of Representatives voted to approve a bill, referred to as "Build Back Better Bill," that proposed certain tax increases for corporations and upper-income individuals. As part of the House Bill, a new Code §267(h) was introduced. Proposed Code §267(h) would have deferred the loss realized on a complete liquidation under Code §331, until all members of the controlled group that receive property pursuant to the liquidation dispose all property received in subsequent transactions with unrelated persons.[31] Specifically, proposed Code §267(h) would apply to any corporation that is a member of a controlled group, within the meaning of Code §267(f), that realizes losses with respect to stock of a subsidiary pursuant to a specified controlled group liquidation. This would include distributions in complete liquidation under Code §331.

The House never voted for the final adoption of the Build Back Better Bill and the initiative to add new Code §267(h) was paused. However, it is not uncommon for unenacted revenue raising provisions to be reproposed in future tax legislation as a "pay-for" to offset revenue loss provisions. Like Lazarus in the bible, Code §267(h) may come back again and again until it is finally enacted.

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[27] See Code §362(e)(2).

[28] See Code §358(a).

[29] For example, by using the Step Transaction Doctrine as described in Rev. Rul. 2004-83.

[30] However, as mentioned above, the rules of Code §267(f) may apply to losses recognized on a sale to a related party that precedes a Code §331 liquidation.

[31] See Section 138142 of the Build Back Better bill.

CONCLUSION

For over 60 years, *Granite Trust* liquidations have been allowed, and corporations have been able to avoid nonrecognition treatment for losses when a liquidation would otherwise be governed by Code §332 if carried out in a straightforward way. To date, the I.R.S. follows court decisions that favor a two-step liquidation. The first step is a sale of shares that generate a loss while reducing ownership to below the 80% level.[32] The second step is to pursue a wind-up of the company's business and a complete liquidation.

In 2021, the House of Representatives voted to approve a provision to eliminate this planning device. Although not enacted in 2021, revenue raising provisions often are reproposed to offset revenue losses in future legislations. Only time will tell whether that will happen here.

[32] However, if the shares are not sold but transferred under a Code §351 transaction, the loss attributed to the transferred shares will be deferred, as explained above.

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