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memorandum

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subject: Basis Adjustment in S Corporation Liquidations

This memorandum responds to your request for assistance. This advice may not be used or cited as precedent.

ISSUE

When an S corporation distributes encumbered assets to a shareholder in exchange for the shareholder's stock in the corporation upon complete liquidation, does the assumption of a liability associated with the distributed asset result in an increase in the shareholder's stock basis?

CONCLUSION

The liabilities associated with the distributed assets are accounted for in calculating the S corporation's gain or loss on the assets under § 336. There is, however, no adjustment to the shareholder's stock basis associated with the assumption of the liability on liquidation.

FACTS

An S corporation liquidates, distributing all of its assets to its shareholders. One or more shareholders form a new entity, either a single member disregarded LLC or an LLC taxable as a partnership, to continue the business previously conducted by the S corporation. The major reason for the conversion to a pass-through entity is to allow the S corporation to recognize any built-in loss associated with the asset under § 336. Recently, IRS field offices have seen these conversions in cases where the S corporation's primary business is property development or home building, because the current fair market value of the property is lower than the outstanding liability associated with the property.

LAW AND ANALYSIS

Section 1371(a) provides that, except as otherwise provided in the Code, and except to the extent inconsistent with subchapter S, the provisions of subchapter C apply to an S corporation and its shareholders.

Section 331(a) provides that amounts received by a shareholder in a distribution in complete liquidation of a corporation shall be treated as full payment in exchange for the stock.

Section 331(b) provides that § 301 (relating to the effects on shareholder distributions of property) shall not apply to any distribution of property (other than a distribution referred to in § 316(b)(2)(B), in complete liquidation.

Section 336(a) provides that, except as otherwise provided for in §§ 336 or 337, gain or loss shall be recognized to a liquidating corporation on the distribution of property in complete liquidation as if such property were sold to the distributee at its fair market value.

Section 336(b) provides if any property distributed in the liquidation is subject to a liability or the shareholder assumes a liability of the liquidating corporation in connection with the distribution, for purposes of § 336(a) and § 337, the fair market value of such property shall be treated as not less than the amount of such liability.

Section 334(a) provides that if property is received in a complete liquidation, and if gain or loss is recognized on receipt of such property, then the basis of the property in the hands of the distributee, shall be the fair market value of such property at the time of the distribution.

Section 336(d)(1)((A) provides that no loss shall be recognized to a liquidating corporation on the distribution of any property to a related person (within the meaning of § 267) if (i) such distribution is not pro rata, or (ii) such property is disqualified property. Section 336(d)(1)(B) defines, for purposes of § 336(d)(1)(A), disqualified property to mean any property which is acquired by the liquidating corporation in a § 351 transaction, or as a contribution to capital during the five-year period ending on the date of the distribution. Such term includes any property if the adjusted basis of such property is determined (in whole or in part) by reference to the adjusted basis of property described in the preceding sentence.

Section 1366(a) provides that in determining the shareholder's tax under Chapter 1 for the shareholder's taxable year in which the taxable year of the S corporation ends (or for the final taxable year of a shareholder who dies, or of a trust or estate which terminates, before the end of the corporation's taxable year), there shall be taken into account the shareholder's pro rata share of the corporation's (A) items of income (including tax-exempt income), loss, deduction, or credit the separate treatment of which could affect the liability for tax of any shareholder; and (B) nonseparately computed income or loss.

Section 1366(d)(3)(A) provides that if during the last taxable year of an S corporation, a loss or deduction is disallowed because it exceeds a shareholder's basis in the stock, then such loss or deduction shall be treated as incurred by the shareholder on the last day of the post-termination transition period.

Section 1367(a)(1) provides that the basis of each shareholder's stock in an S corporation shall be increased for any period by the sum of the following items determined with respect to that shareholder for such period: (A) the items of income described in § 1366(a)(1)(A); (B) any nonseparately computed income determined under § 1366(a)(1)(B); and (C) the excess of the deductions for depletion over the basis of the property subject to depletion.

Section 1367(a)(2) provides that the basis of each shareholder's stock in an S corporation shall be decreased for any period (but not below zero) by the sum of the following items determined with respect to the shareholder for such period: (A) distributions by the corporation which were not includible in the income of the shareholder by reason of § 1368; (B) the items of loss and deduction described in § 1366(a)(1)(A); (C) any nonseparately computed loss determined under § 1366(a)(1)(B); (D) any expense of the corporation not deductible in computing its taxable income and not properly chargeable to capital account; and (E) the amount of the shareholder's deduction for depletion for any oil and gas property held by the S corporation to the extent such deduction does not exceed the proportionate share of the adjusted basis of such property allocated to such shareholder under § 613A(c)(11)(B).

Section 1.1366-2(a)(5), of the Income Tax Regulations, states that, except as provided in § 1.1366-2(a)(5)(ii), any loss or deduction disallowed under § 1.1366-2(a)(1) is personal to the shareholder and cannot in any manner be transferred to another person. If a shareholder transfers some but not all of the shareholder's stock in the corporation, the amount of any disallowed loss or deduction under this section is not reduced and the transferee does not acquire any portion of the disallowed loss or deduction. If a shareholder transfers all of his stock in the S corporation any disallowed loss or deduction is permanently disallowed.

Section 1.1367-1(d)(1) states that the adjustments described in § 1367(a) to the basis of a shareholder's stock are determined as of the close of the corporation's taxable year, and the adjustments generally are effective as of that date. However, if a shareholder disposes of stock during the corporation's taxable year, the adjustments with respect to that stock are effective immediately prior to the disposition.

Section 1.1367-1(f) provides that, except as provided in § 1.1367-1(g), the adjustments required by section § 1367(a) are made in the following order: (1) any increase in basis attributable to income items described in § 1367(a)(1)(A) and (B), and the excess of the deductions for depletion described in § 1367(a)(1)(C); (2) any decrease in basis attributable to distributions by the corporation described in § 1367(a)(2)(A); (3) any decrease in basis attributable to noncapital, nondeductible expenses described in § 1367(a)(2)(D), and the oil and gas depletion deduction described in § 1367(a)(2)(E); and (4) any decrease in basis attributable to items of loss described in § 1367(a)(2)(B) and (C).

In a complete liquidation, an S corporation recognizes gain or loss on the distribution of property to its shareholders as if it sold that property for its fair market value. IRC § 336(a). To the extent any such property is subject to a liability or a shareholder assumes a liability of the liquidating corporation, fair market value is presumed to be not less than the amount of the outstanding liability. IRC § 336(b). Gain or loss associated with the liquidating sale is accounted for at the corporate level. IRC § 336. The S corporation, however, will not be entitled to recognize a loss if it distributes property to a related person (within the meaning of § 267) and the distribution is either not pro rata or the liquidating corporation acquired the property in a IRC § 351 transaction, or as a contribution to capital, within the five-year period ending on the date of distribution. IRC § 336(d). Any resulting corporate level gain or loss is then passed through to the shareholder. IRC § 1366.

Liquidating distributions received by an S corporation shareholder are treated as in full payment for the exchange of stock. IRC § 331(a). The shareholder will take into account its portion of the corporate level gain or loss to adjust his stock basis before calculating shareholder level gain or loss. In addition, the shareholder will reduce its amount realized by the amount of any liability assumed. Ford v. United States, 311 F.2d 951 (Ct. Cl. 1963); Rev. Rul. 58-228, 1959-2 C.B. 59. The shareholder's basis in the asset received in liquidation, however, is not affected by the assumption of a liability or receipt of property subject to a liability. IRC § 334(a), Ford at 955. To the extent the amount of the liability assumed exceeds the fair market value of the asset, the shareholder may recognize either a short-term or long-term capital loss on the complete liquidation of the S corporation. IRC §§ 331, 1222.

Prior to determining gain or loss from liquidating distributions, a shareholder's stock basis is first adjusted for current-year pass-through items. Treas. Reg. § 1.1367-1(d)(1). Pass-through losses suspended because of basis limitation rules that remain after the basis of the redeemed stock has been reduced to zero do not reduce gain or increase loss resulting from liquidation. If a shareholder is going to increase basis to use up suspended losses, this must be done before the final distribution through additional capital contributions or loans or the loss will be permanently disallowed under the general rule of § 1.1366-2(a)(5). There is no authority allowing a shareholder to restore basis after liquidation is completed as can be done under the post-termination transition period rules. IRC § 1366(d)(3).

Please call (202) 622-3060 if you have any further questions.