



Liquidation of Flow-Through Entities for LLCs and Partnerships



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Today's Presenter

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Bill is an Associate Professor in the Bryan School of Business and Economics at the University of North Carolina at Greensboro where he teaches tax courses on flow-through entities, individual and corporate tax, tax research, IRS practices, and ethics. Bill has thirty years of experience in taxation. He began his public accounting career in 1990 in the Dallas office of one of the Big Six accounting firms. In addition to his university teaching, Bill consults on tax and financial planning issues and maintains a sole practice in North Carolina, focusing on taxation and financial consulting for small businesses and individuals.

Bill has testified before the House Ways and Means Oversight Sub-Committee on Internet taxation issues. He was the recipient of a Lybrand Certificate of Merit in 2002. Bill has been involved in CPE instruction for over a decade. He received NCACPA outstanding instructor awards in 2009, 2010, 2011, and 2013. In 2015, he received the Surgent Outstanding Discussion Leader Award because of his consistently high evaluations for knowledge and presentation skills. In 2016, Bill was awarded the R. Donald Farmer discussion leader award by the NCACPA.

Bill has authored over 30 publications in tax accounting and financial planning journals, including the *Journal of Financial Service Professionals*, *Strategic Finance*, *National Tax Journal*, *Journal of Business Finance and Accounting*, *Tax Notes*, *Tax Advisor*, and *Journal of the American Society of CLU and ChFC*. Mr. Harden is currently a member of the American Accounting Association, the American Taxation Association, the National Tax Association, and the North Carolina Association of CPAs.



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Corporate Liquidation

- The liquidation of a corporation takes place when the corporation ceases to be a going concern, and its activities involve winding the corporation down
- The liquidation may be completed prior to the actual legal dissolution of the corporation
- Neither legal dissolution nor retention of nominal amounts of property for the sole purpose of preserving the corporation's legal existence disqualifies the transaction from being a liquidation
- Whether or not local law describes the distribution as a liquidation has no bearing for federal tax purposes



Corporate Liquidation

- The IRC does not mandate a time period within which a corporate liquidation must take place
- State legal formalities are important and must be complied with
- Legal documentation related to the transaction generally incorporates the federal tax requirements with state law rules
- Lengthy asset distribution cycles and unwritten plans of liquidation may result in the IRS characterizing the distribution as a dividend distribution under § 301 rather than a corporate liquidation



Treatment of the Corporation Shareholder When the Corporation Is Liquidated

- Section 331(a)(1) provides that amounts distributed in complete liquidation of a corporation are treated as in full payment in exchange for the shareholder's stock
- The gain or loss will be the difference between the amount realized and the basis of the stock
- The result is a capital gain or loss to the shareholder
- Section 334(a) provides that shareholders take as their bases in the properties received in the liquidating distribution the properties' FMVs at the time property is distributed to them



Calculating Gain or Loss

- In the event the shareholder has acquired his or her shares at various times, the gain or loss is to be computed on a per share basis
- The amount realized will be allocated to the blocks in accordance with the number of shares in each block of shares
- **See Example 1**



Installment Distributions

- In the event the shareholder receives a liquidating distribution on the installment basis, he or she is allowed to recover his or her basis and gain is then recognized thereafter
- The taxpayer's gain or loss is computed for each distribution on a per share basis
- Amount realized is allocated in accordance with the number of shares in the block



Installment Distributions

- Gain is recognized as soon as basis is recovered but loss is not recognized until the liquidation is complete
- Whether the gain is long-term or short-term is determined by the shareholder's holding period in the stock
- **See Example 2**



Receipt of Corporate Liabilities

- If a shareholder distributee receives liabilities of the corporation as part of a corporation's liquidating distribution, in addition to the corporation's assets, the amount of the liability will reduce the amount realized by the shareholder
- **See Example 3**



Receipt of Installment Obligations

- A shareholder-distributee may receive a liquidating distribution which includes installment obligations belonging to the liquidating corporation
- Section 453(h) provides that installment obligations which meet certain requirements are not taxed to the shareholders until the installment obligations are paid
- The liquidating corporation will always recognize gain



Receipt of Installment Obligations

- These installment obligations:
 - Must have been acquired in connection with the sale or exchange of property by the distributing corporation which took place during the 12-month period beginning on the date the plan of liquidation was adopted; and
 - The liquidation must have taken place during this 12-month period



Receipt of Installment Obligations

- Installment obligations arising from the sale of inventory do not qualify unless:
 - The sale of the inventory is to one person, and
 - The sale is a bulk sale of inventory
- In all other circumstances the taxpayer includes the FMV of the installment obligation in his amount realized when received



Liquidation of an S Corporation

- The general corporate liquidation rules apply to both S and C corporations
- A liquidating S corporation recognizes gain or loss on the distribution of assets to its shareholders under § 336(a)
- The same deemed sale provision applies to liquidations of C corporations
- If the built in gains tax under § 1374 does not apply, no corporate-level tax will be due – gain is allocated to the shareholders



Liquidation of an S Corporation

- Sections 336(d)(1) and (2) (discussed shortly) may disallow losses if the corporation incurs losses on the liquidation or sale of its assets
- When an S corporation liquidates, all of its tax attributes (AAA, PTI, C corporation NOLs, suspended PALs, and AE&P) disappear



Liquidation of an S Corporation

- Under § 331, an S shareholder computes gain or loss on the corporation's liquidation by comparing his or her adjusted basis in his or her S stock to the FMV of property received in the liquidation
- The shareholder's adjusted basis in his or her stock includes the corporation's gain or loss recognized on the liquidation
- The shareholder's basis in the property he or she receives in the liquidating distribution is its FMV, unreduced by liabilities



Liquidation of an S Corporation

- Because of the step-up to FMV, the holding period in the shareholder's hands starts anew
- Thus, there is no tacking of holding period
- Section 453 (h)(1)(A) provides that if, as part of the liquidation, the S corporation sells its assets on an installment basis to third parties, the shareholders step into the corporation's shoes and postpone their gain until payments on the notes are received
- If the shareholder inherited the stock, the tax result may very well be favorable – little or no gain and a step-up in basis of the assets to fair market value
- **See Example 4**



Treatment of the Liquidating Corporation

- Section 336(a) provides that 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 FMV
- When the shareholder assumes a liability of the liquidating corporation in connection with the distribution or where the property itself is subject to a liability, the FMV of such property in the deemed sale is no less than the amount of such liability



Treatment of the Liquidating Corporation

- In such a case, gain will be recognized by the corporation to the extent the liability assumed or acquired is in excess of the property's basis
- **See Example 5**



Treatment of the Liquidating Corporation

- The character of the gain or loss resulting from the deemed sale is determined by the character of the property deemed sold



Compliance Requirements

- A corporation adopting a plan of complete liquidation must file Form 966 Corporate Dissolution or Liquidation
- File Form 966 within 30 days after the resolution or plan is adopted to dissolve the corporation or liquidate any of its stock
- If the resolution or plan is amended or supplemented after Form 966 is filed, file another Form 966 within 30 days after the amendment or supplement is adopted
- The return must be signed and dated by the president, vice president, treasurer, assistant treasurer, chief accounting officer, or any other corporate officer (such as tax officer) authorized to sign
- If a return is filed on behalf of a corporation by a receiver, trustee, or assignee, the fiduciary must sign the return, instead of the corporate officer



Compliance Requirements

- The additional form will be sufficient if the date the earlier form was filed is entered on line 11 and a certified copy of the amendment or supplement is attached
- Include all information required by Form 966 that was not given in the earlier form
- If the corporation pays \$600 or more to any shareholder in a liquidation other than a liquidation of a subsidiary, the corporation is required to send a Form 1099-DIV to such shareholder, indicating the amount distributed in a liquidating distribution
- Form 1099-DIV must be sent by January 31 of the year following the calendar year in which the distribution occurs
- File Form 966 with the IRS Center at the address where the corporation files its income tax return



Restrictions on Losses

- Section 336(d)(1) restricts corporate loss recognition when property is distributed to related parties in a liquidating distribution
- There are two types of distributions subject to this loss disallowance rule:
 - Distributions to related parties, and
 - Distributions of disqualified property
- The first restriction relates to distributions to related parties that are not pro rata
- **See Examples 6 and 7**



Restrictions on Losses

- The second restriction under § 336(d)(2) prevents a corporation from recognizing losses on distributions to related parties if the distributed property was acquired by the corporation during the five-year period prior to the distribution in either a nontaxable transfer under § 351 or a contribution to capital
- A transaction involving § 351 is a straightforward means for an individual to transfer property to a corporation in exchange for stock without recognizing a gain or loss
- The transfer of property must be made in exchange for stock in the corporation



Liquidation of a Subsidiary

- Under § 332, the complete liquidation of a subsidiary is a nonrecognition event for tax purposes
- Section 337(a) provides that no gain or loss is recognized on the receipt by a corporation of property distributed in complete liquidation of another corporation
- The owner must possess the following ownership interest in the corporate subsidiary:
 - At least 80% of the total combined voting power of all classes of stock entitled to vote, and
 - At least 80% of the total number of all other classes of stock



Liquidation of a Subsidiary

- The nonrecognition of gain or loss under § 332 is limited to the receipt of property by a corporation that is the actual owner of stock (in the liquidating corporation), meeting the requirements of § 1504(a)(2)
- The recipient corporation must have been the owner of the specified amount of such stock on the date of the adoption of the plan of liquidation and have continued so to be at all times until the receipt of the property
- If the recipient corporation does not continue to be qualified with respect to the ownership of stock of the liquidating corporation and if the failure to continue to be qualified occurs at any time prior to the completion of the transfer of all the property, the provisions for the nonrecognition of gain or loss do not apply to any distribution received under the plan



Liquidation of a Subsidiary

- To constitute a distribution in complete liquidation within the meaning of § 332, the distribution must be:
 - (1) Made by the liquidating corporation in complete cancellation or redemption of all of its stock in accordance with a plan of liquidation, or
 - (2) One of a series of distributions in complete cancellation or redemption of all its stock in accordance with a plan of liquidation
- Where there is more than one distribution, it is essential that a status of liquidation exist at the time the first distribution is made under the plan and that such status continue until the liquidation is completed



Liquidation of a Subsidiary

- Liquidation is completed when the liquidating corporation and the receiver or trustees in liquidation are finally divested of all the property (both tangible and intangible)
- A status of liquidation exists when the corporation ceases to be a going concern and its activities are merely for the purpose of winding up its affairs, paying its debts, and distributing any remaining balance to its shareholders
- A liquidation may be completed prior to the actual dissolution of the liquidating corporation
- However, legal dissolution of the corporation is not required
- Nor will the mere retention of a nominal amount of assets for the sole purpose of preserving the corporation's legal existence disqualify the transaction



Liquidation of a Subsidiary

- Section 332 applies only to those cases in which the recipient corporation receives at least partial payment for the stock that it owns in the liquidating corporation
- If § 332 is not applicable, § 165(g), relating to allowance of losses on worthless securities may apply
- Nonvoting shares limited and preferred as to dividends do not count as stock for purposes of this test
- The general nonrecognition rule of § 332 does not apply to any minority shareholders, i.e., the non-80% or greater shareholder



Section 332 and S Corporations

- S corporations may own any percentage of any other corporation
- An S corporation that wholly owns another domestic corporation can elect to treat such subsidiary as a QSub, allowing flow through treatment of the Qsub's tax items
- The QSub is a disregarded entity similar to an SMLLC
- The QSub is a disregarded entity for federal tax purposes, but is recognized as a corporation for state law purposes



Section 332 and S Corporations

- An S corporation may acquire a C corporation in a taxable stock acquisition and can make a QSub election – result is a deemed liquidation of the target into the parent S corporation



Section 332 and S Corporations

- There are advantages and disadvantages to electing QSub status for a newly acquired C corporation:
 - Only one Form 1120S need be filed
 - Each QSub is recognized as a corporation for state law purposes, hence it serves to protect the assets in other entities from creditors
 - Parent S corporation will inherit the Qsub's earnings and profits (E&P) under § 381(a)
 - Thus, if more than 25% of the Qsub's gross receipts are from passive investments, the parent will incur § 1375 tax on its excess PII
 - Parent's S status will terminate under § 1362(d)(3) if it has accumulated E&P and excess PII for 3 consecutive years
 - On the other hand, if the parent's gross receipts are large relative to passive income, this might shelter the Qsub's passive activities
 - The reverse is also true — a large Qsub's gross receipts could shelter the parent's vulnerability to S status termination



QSub Election

- S corporation can elect to treat its wholly owned domestic subsidiary as a QSub on Form 8869
- The election is treated as a deemed liquidation of the subsidiary into the S parent for federal tax purposes
- For state law purposes, the subsidiary remains in existence



QSub Election

- Once the QSub election is made, the subsidiary is treated as an integrated division of the S parent
- Because the QSub-election requirements mandate a 100% stock ownership in the domestic subsidiary, the liquidation will generally be tax free for the S parent under § 332, and tax-free for the subsidiary under § 337



QSub Election

- Under § 332, the “parent” S corporation is treated as exchanging its subsidiary’s shares for the liquidation proceeds (the subsidiary’s assets) in a tax-free exchange
- “Parent” S corporation takes a carryover basis in these assets under § 334(b)
- Parent S corporation’s stock basis disappears
- Any C corporation E&P the subsidiary had immediately before the liquidation would carry over to the parent S corporation



QSub Election and BIG Tax

- The built-in-gains (BIG) tax can be triggered on disposition of an asset that had unrealized appreciation when it was transferred from a C corporation to an S corporation in a carryover-basis transaction
- If the target was a C corporation and had appreciated assets, the QSub election would create a BIG tax liability for the S corporation purchaser if it sells 100% of the QSub assets within 5 years of the effective date of the QSub election



QSub Election and BIG Tax

- Even if the acquiring S corporation always has been an S corporation, the acquisition of 100% of the C stock coupled with a QSub election taints the S corporation for BIG tax purposes for the assets of the former C corporation for the 5-year recognition period
- **See Example 8**



Liquidation of a Partnership or MMLLC Treated as a Partnership

- The terms LLC (limited liability company), MMLLC (multiple member limited liability) and partnership are used interchangeably throughout these materials
- The terms partner and member are used interchangeably throughout these materials
- These materials presume that the LLC or the MMLLC is treated as a partnership for federal tax purposes and accordingly the partnership tax rules apply



Partnership Distributions Generally

- Distributions of LLC assets are either current distributions or liquidating distributions
- Distributions are current when the member(s) receiving the distributions retain all or part of his/her/their LLC interest
- Distributions are liquidating only when a member's entire interest in the LLC is liquidated at the end of the distribution



Partnership Distributions Generally

- LLC distributions can be further divided into distributions that do not change the member's proportionate interests in the "hot assets" of the LLC and distributions that do change the member's proportionate interest in the "hot assets" of the LLC (disproportionate)
- Hot assets or § 751 assets are generally unrealized receivables and substantially appreciated inventory items
- In order to be substantially appreciated, the fair market value of the assets must be at least 120% of the basis of the assets



Partnership Distributions Generally

- There is no advantage to the partnership or to the partners in making disproportionate distributions
- Recommendation: Have the partnership sell the properties and distribute cash to the partners rather than make a disproportionate distribution of non-cash property
- This discussion concerns only proportionate distributions, and accordingly the rules for disproportionate distributions are not covered



Partnership Distributions Generally

- An LLC distribution can consist of cash, property, or a combination of both
- Under § 752(b), all decreases in a member's share of LLC liabilities are treated as distributions of cash to the member from the LLC
- All increases in a member's share of LLC liabilities are treated as contributions of cash to the LLC by the member
- A constructive cash distribution triggered by § 752(b) is equivalent in its impact on a member's basis to an actual distribution of cash



Partnership Distributions Generally

- For purposes of determining gain or loss on LLC distributions, all members' interests are aggregated into a single interest
- Neither gain nor loss is ever recognized by the LLC (as opposed to individual members) on the distribution of property, including money, from the LLC
- This is one of the many significant differences between partnership liquidation rules and both C and S corporate liquidation rules
- Generally, a current distribution of cash or property is not taxable to the recipient member if that member's basis is equal to or greater than the cash distributed



Partnership Distributions Generally

- The partner recipient of a non-liquidating partnership distribution will never recognize a loss as a result of a current distribution
- It is possible to recognize a loss on a liquidating distribution – but not a nonliquidating distribution
- The recipient member recognizes gain only to the extent that cash distributed to him/her exceeds the basis of his or her interest in the LLC immediately before the distribution, regardless of the other types of property distributed, as long as the distribution is not disproportionate



Partnership Distributions Generally

- Gain is not recognized by the recipient member if only property other than cash is distributed, regardless of the value of the distributed property in relation to the member's basis in his or her interest in the LLC or the FMV of his or her interest in the entity
- In determining whether cash distributions exceed a member's basis, all advances and drawings against a member's distributive share are deemed to be current distributions made on the last day of the LLC's taxable year



Partnership Distributions Generally

- Generally, the basis of the partner in his or her partnership interest carries over to the property distributed
- The general carryover-basis rule of § 732(a) is limited when the recipient member's basis in his or her interest in the LLC is less than the LLC's adjusted basis for the distributed property in a current distribution
- In such case, the recipient member's basis for the distributed property is limited to his or her basis in his or her interest in the LLC reduced by any cash distributed to him or her



Partnership Distributions Generally

- The distribution of property could result in the distributee member having a zero basis in his or her interest in the LLC
- In such a case if there were a § 754 election in effect, the partnership could take the “lost basis” and positively adjust similar property by the excess of the partnership’s basis in the distributed property over the partner’s basis in his or her partnership interest
- If there were no § 754 election – hence no possibility of making a § 734(b) adjustment – the excess basis of the partnership in the property over the partner’s basis would be lost



Partnership Liquidations – Loss Recognition

- Tier one assets: Cash and marketable securities
- Tier two assets: Unrealized receivables and inventory
- Tier three assets: § 1231 and capital gain assets
- Losses may be recognized upon complete liquidation of a partner's interest only if money, unrealized receivables, and inventory are distributed
- If any tier 3 assets are distributed, no loss can be recognized until such time as the distributed assets are sold



Partnership Liquidations

- The loss, if any, would be the excess of the recipient member's basis in his or her interest in the LLC over the sum of any money distributed and the LLC's basis for the unrealized receivables and inventory distributed (tier one and tier two assets)



Partnership Liquidations

- Suggestions
 - Have the partnership sell the tier three assets and distribute only cash or tier two assets
 - Distribute only cash and have the partnership sell all noncash property
- The recipient member's basis for property distributed to him or her in liquidation of his or her interest in the LLC is equal to the member's basis in his or her interest in the LLC immediately before the distribution, reduced by any cash received



Basis in Distributed Property

- If the member's basis in his or her interest in the LLC (reduced for any cash received) is less than or equal to the LLC's basis in unrealized receivables and inventory distributed, the basis is entirely allocated to these assets in proportion to their basis in the hands of the LLC
- If the member's basis in his interest in the LLC (reduced for any cash received) exceeds the LLC's basis in unrealized receivables and inventory distributed, these assets are allocated equal to their basis in the hands of the LLC
- The remaining basis of the member's interest is allocated to other distributed assets in proportion to their basis to the LLC



Basis in Distributed Property

- Mechanically, these allocation rules are the same as those applicable to current distributions when the LLC's basis for the distributed property exceeds the recipient member's basis for his or her interest in the partnership
- However, in the case of a liquidating distribution, the effect of these rules may be to give the member a basis in the distributed property (other than unrealized receivables and inventory) that is greater than the LLC's basis for the same assets
- **See Example 8**



Partnership Retirement Payments

- Section 736 treats payments to a retiring partner as either § 736(a) ordinary income payments or § 736(b) capital gain payments
- The subsection of § 736 that applies to a partnership distribution to a retiring partner depends upon whether hot assets are present in the partnership, whether the retirement payments are made in cash or noncash property, whether a § 754 election to adjust the inside basis of entity assets is present and whether the partnership is primarily a service provider where capital is not a material income-producing factor



Partnership Retirement Payments

- The retiring partner and those partners remaining in the partnership have different interests at stake with regard to the tax characteristics of distributions to a retiring partner
- The retiring partner would like the general distribution rules under § 731 to apply to his or her retirement payments since normally such rules provide for a recovery of basis and capital gain treatment for any excess distribution when only cash is distributed
- If the general partnership distributions rules apply, the remaining partners would prefer to treat retirement payments as deductible expenditures since they receive no benefit from these payments in the form of a tax deduction



Partnership Retirement Payments

- The amount of a liquidating distribution paid to a retiring partner should, at least in theory, equal the partner's proportionate interest in the value of the partnership assets; though, the actual amount of the distribution may be different since a retiring partner may receive a distribution in excess of his proportionate interest in the value of the partnership's assets
- Section 736 provides that only the portion of the total distribution attributable to the partner's ownership interest in partnership assets is subject to the ordinary tax rules governing partnership distributions



Partnership Retirement Payments

- Those rules provide that when a partner's entire interest in a partnership is extinguished upon receipt of a liquidating cash distribution, the partner will recognize capital gain only to the extent the cash distributed exceeds the outside basis in his partnership interest



Partnership Retirement Payments

- Assuming that the distribution is proportionate with respect to hot assets, liquidating distributions of property do not result in gain or loss recognition to either the partnership or the partner
- When a partnership distributes property as a liquidating distribution, the recipient partner's outside basis, reduced by any amount of cash included in the distribution, is allocated to the distributed property
- In the vast majority of cases, this substituted basis rule defers the recognition of any economic gain or loss realized by the partner upon liquidation



Partnership Retirement Payments

- A § 736(b) payment is the portion of the partner's interest in the partnership assets that is distributed to him or her and subject to the general rules dealing with partnership distributions
- The remaining part of the distribution, a § 736(a) payment, is not subject to the general partnership distribution rules



Partnership Retirement Payments

- A § 736(a) payment is not subject to the normal partnership distribution rules
- A § 736(a) payment is a payment not related to the partner's proportionate interest in the value of the partnership assets and is classified as a guaranteed payment
- A guaranteed payment is deductible by the partnership and accordingly provides a tax benefit to the partners remaining in the partnership
- **See Example 9**



Partnership Retirement Payments

- Section 736 contains a special rule concerning liquidating payments made with respect to a partner's interest in certain partnership assets
- Payments made with respect to unrealized receivables must be considered § 736(a) payments rather than distributions
- Payments made with respect to goodwill are also classified as § 736(a) payments unless the partnership agreement specifies that a withdrawing partner will be paid for his or her share of goodwill

Thank you!

