

SUPPLEMENT: Liquidation of Flow-Through Entities for LLCs and Partnerships

Example 1

Susan Smith owns 20 shares of Power Corporation, a domestic corporation, 10 of which were acquired in 20x1 at a cost of \$1,500, and the other 10 shares in December, 20x2, at a cost of \$2,900. In April, 20x3, Susan received a liquidating distribution from Power Corporation of \$250 per share.

Total Amount Realized \$5,000

Amount allocated to the 20x1 shares = $10 \times \$250 = \$2,500$

Amount allocated to the 20x2 shares = $10 \times \$250 = \$2,500$

	SHARES ACQUIRED IN 20x1	SHARES ACQUIRED IN 20x2
AMOUNT REALIZED	\$2,500	\$2,500
ADJUSTED BASIS	\$1,500	\$2,900
GAIN/LOSS REALIZED/RECOGNIZED	\$1,000 LTCL	(\$400) STCL

Example 2

Susan Smith purchases 50 shares of Petco stock for \$50,000 in 20x1 and an additional 25 shares of Petco on December 31, 20x3 for \$10,000. Susan receives her first installment payout on July 1, 20x6, of \$30,000, her second payment on July 1, 20x7 of \$60,000, and her third payment on July 1, 20x8, of \$6,000.

	20x1 STOCK PURCHASE 50 SHARES	20x3 STOCK PURCHASE 25 SHARES
20x6 PAYMENT	\$20,000	\$10,000
BASIS	\$50,000	\$10,000
GAIN/LOSS REALIZED	(\$30,000)	0
20x7 PAYMENT	\$40,000	\$20,000
REMAINING BASIS	\$30,000	0
GAIN/LOSS REALIZED	\$10,000	\$20,000
GAIN/LOSS RECOGNIZED	\$10,000	\$20,000
20x8 PAYMENT	\$4,000	\$2,000
REMAINING BASIS	0	0
GAIN/LOSS REALIZED	\$4,000	\$2,000
GAIN/LOSS RECOGNIZED	\$4,000	\$2,000

Example 3

Shareholder Mary Smith receives a liquidating distribution of a building worth \$1 million in the current year. Attached to the building is a mortgage of \$800,000, which Mary assumes. Mary's basis in her shares is \$50,000. Mary's gain will be computed as follows:

AMOUNT REALIZED	\$1,000,000
MORTGAGE	(\$800,000)
AMOUNT REALIZED REDUCED BY THE ASSUMED MORTGAGE	\$200,000
BASIS IN SHARES	\$50,000
GAIN RECOGNIZED	\$150,000

Example 4

George Adams dies owning 100% of the stock of M Corporation, an S corporation, with an adjusted basis of \$100,000 and an FMV of \$1 million. M Corporation's basis and FMV of its assets are the same as that of George's stock. George's grandson, Tad, inherits his stock, but has no intention of continuing the business. M Corporation sells its assets to a third party at a \$900,000 gain.

Tad's stock basis will be \$1.9 million. When he receives the \$1 million in sales proceeds, he will have a capital loss of \$900,000 to offset against his pass-through gain. The net result is:

- \$1 million cash;
- No tax liability to Tad from the sale of the business; and
- A step-up in the basis of M Corporation's assets for the buyer.

Example 5

In the current year, Essex Corporation made a liquidating distribution of its two properties: Property A and Property B. The tax characteristics of both properties are as follows:

	PROPERTY A	PROPERTY B
FAIR MARKET VALUE	\$10,000	\$10,000
BASIS	\$5,000	\$5,000
LIABILITY	\$15,000	None

Essex Corporation will recognize the following gains if it distributes these properties in a liquidating distribution:

	PROPERTY A	PROPERTY B
DEEMED SALES PRICE	\$15,000	\$10,000
BASIS	\$5,000	\$5,000
GAIN REALIZED	\$10,000	\$5,000

Example 6

Mary and Stephen own 60% and 40% of Simpson Corporation’s stock, respectively. During the current year, Simpson makes a liquidating distribution of its assets, which consist of the following properties:

	BASIS	FAIR MARKET VALUE
CASH	\$500,000	\$500,000
REAL ESTATE	\$2,000,000	\$500,000
INVENTORY	\$600,000	\$1,000,000

Mary received all of the real estate and \$700,000 worth of inventory. Stephen received all the cash and \$300,000 worth of inventory.

The corporation must recognize \$400,000 of gain on the distribution of the appreciated inventory but cannot recognize any of the loss on the distribution of the real estate. The related party, Mary, did not receive her share of each type of property. Thus the distribution was not pro rata with respect to a related party.

Assume: The loss generating property was not 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.

Example 7

Assume the same facts as above except that Mary received all the inventory and \$200,000 in cash and Stephen received the real estate and \$300,000 in cash. In this case, the corporation would recognize both the gain on the inventory as well as the loss on the real estate. The loss property was not distributed to a related party, but rather to an unrelated party and hence the loss restriction under §336(d)(1) did not apply.

Example 8

During the current year, Partner Z, with a basis of \$20,000, receives cash of \$8,000 and unrealized receivables of \$17,000 in a liquidating distribution. Because the unrealized receivables have a zero basis to the partnership, Z takes a zero basis in them as well. Consequently, Z will recognize a \$12,000 capital loss on the liquidation.

If, on the other hand, Z had received land (a capital asset) instead of the unrealized receivables, no gain would be recognized because something other than cash or §751 assets had been received. The \$12,000 disallowed loss would be reflected in an adjustment to the basis of the land.

Example 9

John Smith is a 20% general partner in the ABCDE Partnership. John retired from the partnership business during the current year. As of the date of John's retirement, John's basis in his partnership interest is \$230,000 and the partnership's balance sheet is as follows:

ACCOUNT	INSIDE BASIS	FAIR MARKET VALUE
CASH	\$500,000	\$500,000
BUSINESS ASSETS	\$650,000	\$900,000
TOTAL ASSETS	<u>\$1,150,000</u>	<u>\$1,400,000</u>
LIABILITIES	\$50,000	\$50,000
CAPITAL, JOHN SMITH	\$220,000	\$270,000
CAPITAL, OTHER PARTNERS	\$880,000	\$1,080,000
TOTAL LIABILITIES AND OWNERS' CAPITAL	<u>\$1,150,000</u>	<u>\$1,400,000</u>

Assume that even though John Smith's capital account is only \$270,000, the other partners agree to pay him \$400,000 for a complete liquidation of his interest. The total liquidating distribution to John is as follows:

Cash distribution to John:	\$400,000
Deemed cash distribution to John (his share of liabilities)	<u>\$10,000</u>
Total cash distributed	<u>\$410,000</u>

Assuming that John's 20% interest in the value of the partnership assets is \$280,000 (i.e., 20% X \$1,400,000 = \$280,000) only \$280,000 of the liquidating payment is treated under the regular partnership distribution rules. The gain recognized is thus:

Total distribution attributable to the fair market value of John's proportionate share of the partnership's assets	\$280,000
John's basis in his partnership interest	<u>\$230,000</u>
Gain recognized	<u>\$50,000</u>

The remaining part of the distribution – i.e., \$410,000 - \$280,000 = \$130,000 – is a §736(a) payment which is treated as a guaranteed payment. John will recognize the \$130,000 as ordinary income and the partnership will deduct the payment as a current expense.