

# CaseStudy

## UNDERSTANDING THE EFFECTS OF NONLIQUIDATING DISTRIBUTIONS ON CORPORATIONS



NONLIQUIDATING CORPORATE DISTRIBUTIONS are distributions of cash and/or property by a continuing corporation to its shareholders. At the shareholder level, a nonliquidating corporate distribution can produce a variety of tax consequences, including taxable dividend treatment, capital gain or loss, or a reduction in stock basis.

At the corporate level, a nonliquidating corporate distribution can also have varying tax consequences. The distribution may have no tax effect, or it may trigger corporate-level capital gain and/or ordinary income. The corporate-level tax consequences of a nonliquidating corporate distribution depend on whether the distribution consists of cash or property (other than cash). The corporation does not recognize gain or loss when it distributes cash to shareholders or when it redeems stock in exchange for cash payments (Sec. 311(a)).

### Avoiding Corporate-Level Gain

When a corporation makes a nonliquidating distribution of corporate property other than cash (including a distribution to redeem stock), the corporation recognizes gain if the property's fair market value (FMV) exceeds its adjusted tax basis in the corporation's hands (Sec. 311(b)(1)). Specifically, the corporation recognizes gain as if it had sold the appreciated property for FMV to the recipient shareholder. When multiple properties are distributed, the corporation computes gain on an asset-by-asset basis (Rev. Rul. 80-283). The portion of the corporation's gain attributable to recapture items (e.g., depreciation recapture) is ordinary

income, as is gain attributable to the distribution of inventory and unrealized receivables. Gain attributable to capital assets and certain property used in a trade or business (Sec. 1231 property) is capital gain.

**Practice tip:** Corporations generally report nonliquidating distributions to shareholders on Form 1099-DIV, Dividends and Distributions (Sec. 6042(c); Regs. Sec. 1.6042-4). The form breaks total distributions down into taxable and nontaxable categories. Form 5452, Corporate Report of Nondividend Distributions, is used to report nondividend distributions to shareholders.

**Example 1:** A, B, C, and D each own 2,500 shares of J Corp., a C corporation real estate development company. A disagrees with the other shareholders and wants the corporation to redeem his stock for \$60,000. A has held his stock for three years, and his stock basis is \$59,000. A is not related to the other shareholders. The corporation cannot afford to redeem the stock entirely for cash because its cash balance of \$75,000 must be used primarily to service real estate debt. However, the shareholders agree that J can distribute one of the tracts of land to A (see the exhibit). A does not care which tract of land he receives in redemption of his stock because he plans to sell the land immediately. The other shareholders feel that the tracts will appreciate at about the same rate, so they are willing to distribute any of the tracts. However, they want to avoid corporate-level gain.

This case study has been adapted from *PPC's Tax Planning Guide—Closely Held Corporations*, 21st Edition, by Albert L. Grasso, Joan Wilson Gray, R. Barry Johnson, Lewis A. Siegel, Richard L. Burris, Mary C. Danylak, Timothy Fontenot, James A. Keller, and Michael E. Mares, published by Thomson Tax & Accounting, Ft. Worth, TX, 2008 ((800) 323-8724; [ppc.thomson.com](http://ppc.thomson.com)).

### Exhibit: Tracts of land owned by J Corp.

	Basis	FMV	Debt	Net Equity
Tract 1	\$700,000	\$750,000	\$690,000	\$60,000
Tract 2	300,000	350,000	300,000	50,000
Tract 3	600,000	600,000	545,000	55,000

If *J* distributes Tract 1 or Tract 2 to *A* to redeem his stock, the corporation must recognize a \$50,000 gain. However, if the corporation distributes Tract 3, it will not recognize any gain.

*J* could distribute \$5,000 in cash and Tract 3 to redeem *A*'s stock without recognizing any corporate-level gain. This strategy would provide *A* with the \$60,000 he wants in exchange for his stock (\$5,000 cash + \$55,000 net equity in Tract 3). Since all of *A*'s shares would be redeemed, and because he is unrelated to the remaining shareholders, the redemption would qualify for stock sale (capital gain) treatment as a complete termination of a shareholder's interest under Sec. 302(b)(3).

*A*'s basis in the stock is \$59,000, so he would recognize a \$1,000 long-term capital gain from the redemption. His basis in the land would equal its FMV on the date of distribution, or \$600,000. *A*'s holding period would also begin on that date.

### Recognizing Corporate-Level Loss

Unfortunately, a corporation cannot recognize a tax loss on a nonliquidating distribution of depreciated property (i.e., where the property's FMV is less than the adjusted basis). A corporation is generally allowed to recognize tax losses when depreciated property is distributed to shareholders in complete liquidation of the corporation (Sec. 311(a)).

**Example 2:** Assume that *H*, Inc., is a C corporation that is equally owned by *E*, *F*, and *G*, who are not related in any way. *F* and *G* actively manage *H*. Because of disputes regarding *F*'s and *G*'s salaries, *E* wants the corporation to redeem her stock (which has a basis of \$150,000). *E* does not care what assets she receives as long as they have a total value of \$195,000.

*H* does not have enough cash to redeem the stock. However, the shareholders have agreed to distribute a parcel of land held for investment purposes and stock in a publicly traded company, *I*, Inc., to redeem *E*'s shares. The land has an FMV of \$175,000 and basis of \$150,000, while the stock has an FMV of \$20,000 and basis of \$40,000.

*H* cannot deduct a loss on a nonliquidating distribution of depreciated property. Conversely, if it distributes appreciated property it must recognize gain as if it had sold the property to the shareholder for its FMV. Since the corporation must compute its gains and losses on an asset-by-asset basis, *H* would have a recognized gain of \$25,000 from the land and an unrecognized loss of \$20,000 from the *I* stock, if those assets were transferred to redeem *E*'s shares.

Instead of distributing the *I* stock, the corporation should sell it and distribute the resulting sales proceeds to *E*. This would allow *H* to recognize a \$20,000 tax loss that would mostly offset the \$25,000 taxable gain from distributing the appreciated land. Structuring the redemption in this fashion would not cause any adverse tax effects for *E*. She would recognize a gain of \$45,000 (\$195,000 FMV of assets distributed to her less \$150,000 basis in her redeemed shares) regardless of which corporate assets she receives.

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### EditorNotes

Albert B. Ellentuck is of counsel with King & Nordlinger, L.L.P., in Arlington, VA.