Closing Down the Shop: Pitfalls and Opportunities in a Liquidation

by Vadim Mahmoudov

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In this report, Mahmoudov examines fact patterns involving the liquidation or wind-down of a corporation or a disregarded entity owned by a corporation.

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Businesses fail or shut down for many reasons, in good times and bad. Recessions and market disruptions tend to accelerate the collapse of companies that were already in distress and sometimes can push healthy companies into difficulty. The global economy has seen a wave of business shutdowns caused by the COVID-19 pandemic; the real estate, leisure, travel, and hospitality industries have been hit particularly hard. Also, many companies that have several lines of business are looking to divest or wind down unprofitable subsidiaries or divisions to improve their liquidity position. The form and timing of a wind-down can sometimes produce surprising tax results, and a well-advised taxpayer should carefully consider the hidden tax pitfalls and opportunities.

In this report, I will examine a few common fact patterns involving the liquidation or wind-down of a corporation or, alternatively, a disregarded entity owned by a corporation. In the examples that follow, assume that a stock sale is not feasible except where otherwise noted and that the purchaser wants to obtain a step-up in the tax basis of acquired assets (which rules out a tax-free asset reorganization). Accordingly, the exit must take the form of a taxable asset sale followed by a liquidation.

I. The Final Fire Sale

A taxable liquidation of a corporation may appear deceptively simple at first blush. But as factual nuances pop up, it does not take long for tax complexities to arise.

Example 1. Albert owns 100 percent of the stock of ABC Corp., which operates a

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restaurant. Albert decides to retire and wind down the business. ABC Corp. has assets with a fair market value of $100, basis of $80, and accrued liabilities of $40. ABC Corp. sells its assets to a third-party buyer for $60 of cash and assumption of $40 of liabilities, recognizing $20 of taxable gain. ABC Corp. has no net operating loss carryovers or other attributes to absorb the gain.

Can Albert cause ABC Corp. to distribute the cash proceeds of $60 to him and retire happily? Not before having ABC Corp. take care of paying its corporate tax bill on the sale first. The sale has generated a tax liability at the level of ABC Corp., and pulling out all proceeds without paying that liability would render ABC Corp. insolvent and amount to a fraudulent conveyance, which can be legally undone.[1] To the extent a shareholder receives a liquidating distribution from a corporation that fails to pay its corporate taxes, the IRS can pursue the shareholder for the unpaid tax bill in its capacity as a transferee of the corporation's assets.[2]

Example 2. Same facts as Example 1, except now ABC Corp. has liabilities of $130 and is insolvent. The liabilities consist of $110 of secured bank debt and $20 of unsecured accounts payable (that is, trade creditors). ABC Corp. files a chapter 11 bankruptcy petition and soon thereafter sells all its assets to a buyer in a transaction governed by section 363 of the Bankruptcy Code. The buyer pays $100 cash for the assets and assumes none of ABC Corp.'s liabilities.

Now things get more interesting. Albert, the distraught shareholder, is holding underwater equity and will not receive any of the sale proceeds. But once again, the sale has generated $20 of taxable gain. Does the IRS still need to get paid? Yes and no.

Generally, post-petition taxes of the debtor arising after the filing of the bankruptcy case are treated as administrative claims entitled to high priority under section 503(b)(1)(B) of the Bankruptcy Code. They must be paid in full upon confirmation of a chapter 11 plan.[3]

However, secured claims trump unsecured claims, and the secured creditors of ABC Corp. in this example have a secured claim (and a previously perfected lien) on all its assets. The amount owed to secured creditors ($110) exceeds the proceeds of the asset sale ($100). Therefore, the secured debt is the "fulcrum security" in the bankruptcy whose vote is essential to confirm any bankruptcy plan of reorganization — and the first on the totem pole if the proceeding converts into a chapter 7 liquidation. The entirety of the cash here will likely be used to satisfy the secured claims, and a subsequent IRS lien for unpaid taxes would not prime the secured bank debt claims whose liens arose earlier.[4] The IRS and other taxing authorities, and the unsecured trade

[1] *See generally* 11 U.S.C. section 548. Hereinafter, references to 11 U.S.C. may alternatively refer to the Bankruptcy Code.

[2] *See* section 6901 of the IRC of 1986, as amended. Unless otherwise indicated, references to section in this article are to the IRC, and references to Treasury regulations are to regulations (or proposed regulations) issued under the IRC.

[3] *See* 11 U.S.C. sections 507(a)(2) and 1129(a)(9)(A); and *In re Molycorp Inc.*, 562 B.R. 67, 78 (Bankr. D. Del. 2017) ("Section 1129(a)(9)(A) of the Bankruptcy Code requires that, unless agreed otherwise, each holder of an administrative claim will receive cash equal to the allowed amount of such claim on the effective date of the plan; this is true regardless to the existence of unencumbered assets."). Note that, if a chapter 11 plan cannot be confirmed, *e.g.*, because the estate is "administratively insolvent" and is unable to pay all administrative claims in full, it does not mean that the bankruptcy cannot end. Rather, the proceeding would likely convert into a chapter 7 liquidation. *See* 11 U.S.C. sections 1112(b)(1). This has nontax ramifications beyond the scope of this article, *e.g.*, professional advisers not receiving releases that are customary in a chapter 11 reorganization.

[4] *See generally* section 6323; and *United States v. Estate of Romani*, 523 U.S. 517 (1998). For a detailed discussion of the interplay between the Federal Tax Lien Act and applicable laws governing the rights of secured creditors, see Gordon D. Henderson and Stuart J. Goldring, *Tax Planning for Troubled Corporations* para. 1017 (2020).

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creditors, may not receive a dime unless the secured creditors feel generous and want to share their loot.[5]

In several bankruptcy cases, the IRS attempted to prevent a taxable asset sale that could result in an unpaid tax bill. The IRS generally has not been successful, with courts authorizing the sale to go forward, typically concluding that the asset sale was the only viable alternative (for example, because no purchaser was willing to buy stock of the debtor) and offered the highest and best value for the debtor's assets, thus maximizing recovery for the estate.[6]

While the result is curious, it is no different from what would have happened outside bankruptcy if the creditors had simply foreclosed on their collateral — the assets of ABC Corp. The foreclosure would be treated as a taxable sale of such assets for their FMV ($100) in addition to triggering cancellation of indebtedness income (CODI) of $10 regarding the portion of the secured debt that was left unpaid. Once again, gain of $20 would be triggered, and tax would be due. However, ABC Corp. would now be an insolvent empty shell, having surrendered all its assets to the secured creditors, and would be unable to pay the IRS. The IRS would have no luck chasing the creditors, which merely collected an old debt owed to them by enforcing their preexisting lien and seizing the collateral. The same result would often arise in an insurance company receivership, which is governed by applicable state law that often gives first priority to claims of policyholders.[7]

Can the IRS at least deny the basis step-up of $20 for those assets in the hands of their new owners? Under current law, there seems to be no basis (no pun intended) for doing so. The buyer acquired assets in a taxable transaction, and its ability to enjoy a step-up does not depend on whether the seller paid any tax. Indeed, the seller could have been tax exempt or foreign.

Can the IRS chase the buyer of the assets for the substantive tax liability? Generally, even outside bankruptcy, the answer is no if the buyer is a bona fide purchaser and did not assume the seller's tax liabilities in the asset sale.[8] Section 6901 does not create a separate federal transferee liability for federal income tax claims beyond what the applicable state law (or federal bankruptcy law) would provide, so the IRS would have to rely on common law principles of transferee liability, which typically requires some type of fraudulent conveyance. Notably, the answer regarding transferee liability may be different for state and local taxes — in particular, sales and use taxes — because the relevant state statutes often include broad principles of transferee liability, which may apply even for a bona fide purchaser acting in good faith.[9]

Because fraudulent conveyance could be a legitimate concern for an insolvent seller, the buyer would be well advised to execute the transaction in a way that cuts off any potential transferee liability. For a sale under Bankruptcy

[5] *See, e.g., Official Committee of Unsecured Creditors v. Stern (In re SPM Mfg. Corp.)*, 984 F.2d 1305, 1313 (1st Cir. 1993) (allowing secured creditors to "gift" a portion of its recovery to unsecured creditors skipping the priority tax claim of the IRS); *In re Nuverra Environmental Solutions Inc.*, 590 B.R. 75 (D. Del. 2018) (permitting secured creditors to voluntarily gift portion of recovery to some, but not all, unsecured creditors); *Exide Holdings Inc.*, Case No. 20-11157 (CSS) (Bankr. D. Del. Oct. 19, 2020), Docket No. 1003 (court overruling objection by California seeking payment for environmental obligations by noting that "there is simply no available money to do so. Under the governing law, any money available is subject to senior, secured liens that are superior to Exide's environmental obligations. I lack the power to override that law."). *See also* Norman L. Pernick, David R. Hurst, and Therese A. Scheuer, "Beware of Creditors Bearing Gifts: A Primer on Sharing Property in Chapter 11," *Norton Journal of Bankruptcy*, Vol. 22, No. 6 at 723 (2013) ("Senior claimholders seeking to promote cooperation may attempt to share or 'gift' property to junior stakeholders in order to improve the confirmability of a proposed plan."). Taxing authorities may have claims against "responsible persons," such as officers of ABC Corp. who permit payments to creditors while taxes remain unpaid. *See, e.g.,* 31 U.S.C. section 3173; Colo. Rev. Stat. section 39-21.116.5; 35 Ill. Comp. Stat. 5/1002(d); and Va. Code Ann. section 58.1-1813.

[6] *See, e.g., In re MSR Resort Golf Course LLC*, No. 11-10372, 2013 WL 5716897 (Bankr. S.D.N.Y. Feb. 22, 2013) (order authorizing taxable asset sale despite government objections); *In re Inner City Media Corp.*, No. 11-13967 (Bankr. S.D.N.Y. Feb. 23, 2012) (authorizing section 363 asset sale despite government objections noting the debtors' admission that an unpaid tax bill is likely); *In re LCI Holding Co. Inc.*, No. 12-13319 (Bankr. D. Del. Apr. 4, 2013) (section 363 "credit bid" asset purchase by secured creditors). For a detailed discussion of these cases, see Colleen E. Laduzinski, "IRS Challenges to Chapter 11 Plans and Section 363 Sales," *Tax Review* No. 325 (Dec. 14, 2015).

[7] *See United States Department of Treasury v. Fabe*, 508 U.S. 491 (1993). Similarly, depositors of a failing bank have priority over tax claims under section 7507.

[8] *See, e.g., In Matter of Motors Liquidation Co.*, 829 F.3d 135, 156 (2d Cir. 2016) ("A bankruptcy court may approve a section 363 sale 'free and clear' of successor liability claims if those claims flow from the debtor's ownership of the sold assets."); and *In re General Motors Corp.*, 407 B.R. 463, 500 (Bankr. S.D.N.Y. 2009) ("As a general rule, a purchaser of assets does not assume the liabilities of the seller unless the purchaser expressly agrees to do so or an exception to the rule exists.").

[9] *See, e.g.,* Janette M. Lohman, "A Business Planning Guide to Successor Liability Laws, Part 1," *State Tax Notes*, Oct. 13, 2008, p. 87.

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Code section 363, it is customary for the buyer to obtain a "free and clear" order[10] from the bankruptcy court, cleansing the assets of the debtor's historic liabilities.

But even the magic wand of bankruptcy cannot turn off transfer taxes. As a general matter, under applicable state tax laws, both buyer and seller can be liable for transfer, sales, and similar taxes. Bankruptcy Code section 1146(a) states:

> The issuance, transfer, or exchange of a security, or the making or delivery of an instrument of transfer *under a plan confirmed* under Section 1129 or 1191 of this title, may not be taxed under any law imposing a stamp tax or similar tax.[11]

However, because of its reference to "a plan confirmed," this provision has been found to be inapplicable for a section 363 sale that *precedes* the confirmation of a bankruptcy plan of reorganization.[12] And even in the context of an asset sale that is an integral part of a confirmed plan and occurs on the date of the debtor's emergence from bankruptcy, significant doubt exists about the scope of section 1146's exemption. Since true stamp taxes hardly exist anymore in the United States, what is a "stamp or similar tax"? For example, some courts have held that this provision does not turn off real property gains taxes[13] or sales and use taxes.[14] While the bankruptcy court order often states that the transactions shall be exempt from transfer, sales, and similar taxes "to the fullest extent permitted by Section 1146 [of the Bankruptcy Code]," that merely begs the question of what kind of taxes are truly turned off by that provision.

What about Albert, the hapless shareholder who got wiped out in the bankruptcy? Does the IRS have any recourse against him? Again, the answer is no. Unlike Example 1, here Albert is not receiving any proceeds in the liquidation of ABC Corp. So unless the IRS can succeed in piercing the corporate veil and hold Albert liable for ABC Corp.'s taxes or can claim fraudulent conveyance regarding prior distributions or transfers that Albert received from ABC Corp., the corporate tax bill remains at the level of ABC Corp. and does not reach its shareholders.

But Albert does have some tax consequences from ABC Corp.'s demise. Since his equity investment was eliminated in the bankruptcy, he should be able to claim a worthless stock deduction. Thus, the asset fire sale and liquidation, in addition to triggering an unpaid corporate tax bill, may also produce a tax benefit at the shareholder level.

II. The Worthless Stock Deduction

Much has been written about the worthless stock deduction — in particular, the timing of it — that is, when is the right tax year to claim the deduction?[15] One aspect of the worthless stock deduction that is sometimes overlooked, for a consolidated group in which some or all members are in bankruptcy or insolvent, is the ability to offset taxable gain from an asset sale triggered at (or below) the member of the group whose equity is worthless.

> **Example 3.** Parent owns 100 percent of Sub and files a consolidated group return with Sub. Sub has $125 of liabilities (secured bank debt, which is also guaranteed by Parent), assets with FMV of $100, and inside asset basis of $80. Parent has $80 stock basis in Sub. Sub sells all its assets to Buyer for $100 in cash, which will be used to partially repay its creditors. Parent has no other assets.

At first blush, this seems to be another case of a stranded corporate income tax liability at the parent level. As discussed above, while it may be possible to leave the IRS and other taxing authorities holding the bag, that may have

[10] *See generally* Bankruptcy Code section 363(f). *See, e.g.*, *In re Chrysler LLC*, 576 F.3d 108, 115 (2d Cir. 2009) (section 363 sales "assets are typically burnished (or 'cleansed') because (with certain limited exceptions) they are sold free and clear of liens, claims and liabilities.").

[11] 11 U.S.C. section 1146(a) (emphasis added) (formerly Bankruptcy Code section 1146(c)).

[12] *See Florida Department of Revenue v. Piccadilly Cafeterias Inc.*, 554 U.S. 33 (2008).

[13] *See, e.g.*, *In re 995 Fifth Avenue Associates LP*, 963 F.2d 503 (2d Cir. 1992), *cert. denied*, 506 U.S. 947 (1992).

[14] *See, e.g.*, *In re GST Telecom Inc.*, No. 00-1982, 2002 U.S. Dist. LEXIS 4662 (D. Del. 2002). For a detailed discussion of case law under Bankruptcy Code section 1146, see Henderson and Goldring, *supra* note 4, at para. 1102.15.

[15] *See, e.g.*, Jerred G. Blanchard Jr. and David C. Garlock, "Worthless Stock and Debt Losses," 83 *Taxes* 205 (Mar. 2005).

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undesirable collateral consequences (for example, administrative insolvency and inability to confirm a chapter 11 plan, if the transaction occurs in a bankruptcy case). Alternatively, suppose that some of the creditors are unsecured, in which case their claims will likely be trumped by the tax claim. But is there really a tax due here at all?

On a stand-alone basis, Sub has $20 of taxable gain on the asset sale. (This may be the end of the story for some state and local tax purposes in jurisdictions in which Parent and Sub are not filing consolidated, combined, or unitary returns, as discussed in more detail *infra*.) However, at the Parent level, a worthless stock deduction of $80 regarding its investment in Sub may be available. In computing the consolidated income tax liability for the year, this deduction may soak up Sub's gain on the asset sale, resulting in zero tax due — and perhaps even a net loss carryback to prior tax years, in a world in which carrybacks are permitted.

Parent would need to get comfortable that the deduction and the asset sale gain do not produce a character mismatch, for example, if some of the gain is ordinary because of depreciation recapture under section 1245, as opposed to being section 1231 gain that is generally capital in nature. If character matters, further analysis would be needed to confirm that the offsetting deduction is also ordinary under section 165(g)(3). In practice, this typically requires an exhaustive review of Sub's cumulative historic gross receipts to establish that more than 90 percent of them were from non-passive sources. This can become a treacherous exercise if historic records are incomplete or if significant receipts were attributable to intercompany transactions. Generally, the provisions of section 165(g)(3) do not fit well within the context of a consolidated group, especially regarding intercompany payments, forcing practitioners to rely on a hodgepodge of private letter rulings or to craft pragmatic interpretations.[16]

Putting aside character issues, the requirements for claiming a worthless stock deduction under section 165's general tax principles are clearly satisfied in Example 3. Parent's investment in Sub is hopelessly lost. All of Sub's assets have been disposed of and the proceeds used to pay off creditors. However, the deduction must still pass the gantlet of consolidated return rules before we can safely conclude that it is available to offset Sub's gain.

Under regulation section 1.1502-80(c), Parent would be permitted to treat Sub stock as worthless under section 165 upon the earlier of (i) Sub ceasing to be a member of the group or (ii) its stock becoming treated as disposed of under regulation section 1.1502-19(c)(1)(iii). That regulation treats a member as disposing of a share of subsidiary stock upon one of three identifiable events:

1. All the subsidiary member's assets are treated as disposed of, abandoned, or destroyed for federal income tax purposes. An asset would not be considered as disposed of to the extent the disposition is in complete liquidation under section 332 or is in exchange for consideration (other than relief from indebtedness). In our example, Sub has sold assets for cash to a third party and is still holding the cash, so the literal requirements of this prong are not met. The subsequent distribution of cash to creditors might do the trick, but what if the final distribution does not occur until the following tax year?
2. An indebtedness of the subsidiary member is discharged, if any part of the discharged amount is not included in gross income and is not treated as tax exempt income under regulation section 1.1502-32(b)(3)(ii)(C) (that is, does not give rise to attribute reduction under section 108(b) and becomes "black hole CODI").
3. A member takes into account a deduction or loss for the uncollectibility of an indebtedness of the subsidiary member, and the deduction or loss is not matched in the same tax year by the subsidiary member taking into account a corresponding amount of income or gain from the indebtedness in determining consolidated taxable income.

[16] *See generally* New York State Bar Association Tax Section, "Report on the Gross Receipts Test of Section 165(g)(3)(B)," Report No. 1315 (2015); and NYSBA Tax Section, "Claiming Worthlessness for a Failed Subsidiary Within a Consolidated Group," Report No. 1230 (2011).

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Assuming the last two prongs are not applicable, the easiest path toward unlocking the worthless stock deduction in the same tax year in which the asset sale occurred appears to be a complete liquidation of Sub, which should satisfy the alternative test above: cessation of Sub's membership in the consolidated group. Given the facts of Example 3, a strong position exists that Sub will have de facto liquidated upon transferring all its assets to creditors.[17] But, once again, what if there is a gap of time between the asset sale and the transfer of the cash proceeds to creditors? This often occurs in a bankruptcy case when a debtor sits on the proceeds from a completed section 363 sale while competing constituencies of creditors argue over how the proceeds shall be distributed or various objections to the confirmation of a chapter 11 plan are being addressed. Alternatively, suppose some amount of cash is left behind to help pay wind-down costs, for example, the filing of transfer tax returns for which Sub is responsible? In a world without loss carrybacks, it is crucial that the liquidation — which unlocks the worthless stock deduction for consolidated return purposes — occur in the same tax year as the asset sale.

The question of when is a corporation really gone for tax purposes is a fascinating one, to which I will return at the end of this article. Fortunately, tax practitioners have tools at their disposal to make most corporations disappear for tax purposes, thus accelerating the timing of a corporation's deemed liquidation and related tax effects. For a domestic corporation, the technique commonly used is a conversion to a limited liability company under state law or a forward merger of the corporation into an LLC if the entity is incorporated in a state whose corporate law does not permit such a conversion. In either case, the entity's default classification for federal income tax purposes would switch from a corporation to a disregarded entity (or a partnership, if it has more than one regarded shareholder), producing a deemed liquidation of the corporation. For a foreign corporation, a check-the-box election can achieve the same purpose, assuming the entity is not on the per se list.[18] The IRS has confirmed that such techniques are acceptable ways of triggering a worthless stock deduction.[19] In Example 3, Parent should convert Sub into an LLC as a prophylactic measure promptly after the asset sale to ensure that Sub is really dead for tax purposes and the worthless stock deduction can now be claimed.

III. Don't Let Section 332 Ruin the Party

Anytime a corporate parent seeks to liquidate a corporate subsidiary, whether to accelerate a worthless stock deduction or for another reason, the threshold question is whether the liquidation may be a taxfree transaction governed by section 332. If so, no loss would be allowed to the parent shareholder, and its stock basis in the subsidiary will be permanently eliminated, with the parent generally inheriting carryover basis in the liquidated subsidiary's assets.[20]

Fortunately for Parent in Example 3, section 332 should not be an issue because Sub is clearly insolvent (bank debt of $125 and asset sale cash proceeds of $100) at the time of its liquidation, and Parent does not receive any distribution regarding its equity. The sale proceeds leave Sub via the side door (to pay Sub's creditors) instead of moving up to Parent. Treasury regulations under section 332 require that the recipient corporation receive at least partial payment for the stock that it owns in the liquidating corporation. The IRS has consistently ruled that an insolvent corporation cannot liquidate tax free under section 332 because the corporation's shareholders would receive nothing in the distribution. For example, in Rev. Rul. 59-296,[21] the IRS ruled that an upstream merger of an insolvent subsidiary was neither a nontaxable liquidation under section 332 nor a section 368(a)(1)(A) reorganization. In Rev. Rul. 2003-125,[22] the IRS ruled that section 332 was applicable upon an entity's election to convert to a disregarded entity only in situations in which the FMV of the entity's assets (both tangible and

[17] *See, e.g., Kennemer v. Commissioner*, 96 F.2d 177 (5th Cir. 1938); and *Shore v. Commissioner*, 286 F.2d 742 (5th Cir. 1961).

[18] *See* reg. section 301.7701-3(g)(1)(ii) and (iii). For a list of entities ineligible to make a check-the-box election, see reg. section 301.7701-2(b).

[19] *See* Rev. Rul. 2003-125, 2003-2 C.B. 1243.

[20] *See* sections 332(a), 334(b), and 337(a).

[21] 1959-2 C.B. 87.

[22] *See supra* note 19.

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intangible) exceeded the sum of the entity's liabilities. By contrast, when the FMV of all the assets did not exceed liabilities, a worthless stock deduction was available.

> **Example 4.** Same facts as Example 3, except the obligor on the bank debt is Parent, not Sub. However, Sub is a guarantor on the debt, and all its assets are pledged as collateral to support the guarantee. Upon selling its assets, Sub is directed by Parent to remit all proceeds to creditors.

Now things get more interesting. Is Sub insolvent? Should Parent be treated as receiving a liquidating distribution from its equity interest in Sub, which may result in section 332 applying and no worthless stock deduction being available?

One potential theory for Parent to achieve the same tax treatment as Example 3 would be to argue that, notwithstanding the legal form, Sub was the true borrower (or a co-borrower) of the bank debt. That may require proving that the bank lenders were in substance relying on Sub's guarantee and the FMV of its assets when they extended credit to Parent, like in *Plantation Patterns v. Commissioner*.[23] This may be a stretch. Presumably, the FMV of Sub's assets comfortably exceeded the amount of the bank loan when it was originally made to Parent, which suggests that Parent itself had the wherewithal to service the debt by virtue of owning 100 percent of Sub's equity. Unlike the *Plantation Patterns* case, in which the borrower was a thinly capitalized subsidiary relying on a parent guarantee, here the fact pattern is reversed: Borrower is a parent whose only asset is an equity interest in a subsidiary, so (absent other liabilities at Parent) it's hard to see Parent being the weaker borrower than Sub would have been.

A more promising theory would be to say that, even if Parent was the true borrower, the Sub's guarantee is a contingent liability that made Sub insolvent at the time of liquidation. *Merkel v. Commissioner*[24] stands for the proposition that, if the facts are right, a guarantee can be treated as a liability for purposes of measuring solvency under section 108(d)(3). The key question is whether the guarantee is more likely than not to be triggered, forcing the guarantor to pay the lenders. In *Merkel*, the court concluded that because the taxpayer was unable to establish that, at the time of the debt discharge, the guarantors "would be called upon" to pay their obligation under the guaranty, the guarantee had not ripened to a true liability and therefore was not counted in determining the debtor's solvency.

In other contexts, courts have ruled that a guarantee is ignored for tax purposes until the guarantor is called upon to make a payment. For example, in *Landreth v. Commissioner*,[25] the court rejected the IRS's suggestion that a taxpayer constructively received income as a guarantor because the debtor made payments to the creditor on the guaranteed debt.

However, in the context of a holding company whose debt is underwater, the guarantee by a subsidiary whose assets serve as the ultimate collateral securing the debt becomes more meaningful. Since Parent will look to Sub's assets (or proceeds from its sale) to satisfy its debt obligations, the guarantee may be viewed as a contingent liability that is more likely than not to be called upon, thus deserving recognition as a liability that counts toward a determination of the guarantor's (in)solvency under the *Merkel* standard. Arguably, what is happening in Example 4 when Sub uses sale proceeds to pay the creditors is de facto performance by Sub on its guarantee (whether or not it has been formally called upon). If so, Sub's direct payment to creditors is not deemed a liquidating distribution to Parent. Put another way, the liability has economically shifted down to Sub, rendering it insolvent and precluding any recovery by Parent in its shareholder capacity.

If the *Merkel* theory carries the day, the liquidation is still ineligible for section 332 treatment, and Parent's worthless stock deduction can be claimed. As is often the case with tax planning, timing and sequencing is important. As discussed above, converting Sub into an LLC (or making a check-the-box election, if applicable) is

[23] 462 F.2d 712 (5th Cir. 1972).

[24] 109 T.C. 463 (1997), *aff'd*, 192 F.3d 844 (9th Cir. 1999).

[25] 50. T.C. 803, 812-813 (1968).

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advisable to ensure its liquidation is complete for tax purposes and reg. section 1.1502-80(c) can no longer prevent the recognition of Parent's worthless stock deduction. In Example 4, if the transaction takes place as part of a bankruptcy, the conversion should be made before the effective date of the bankruptcy plan of reorganization and ideally even before the confirmation of such plan. The risk of waiting too long, until the creditors get paid and the debt is officially discharged in bankruptcy, is that at that point, Sub is no longer on the hook for the guarantee, the *Merkel* contingency has resolved itself, and Sub may no longer be viewed as insolvent.

Example 5. Same facts as Example 3 (debt is at Sub level, guaranteed by Parent), except no third-party buyer shows up. Instead, in accordance with a chapter 11 plan, the creditors will acquire Sub in a taxable "Bruno's transaction" on the effective date of the plan. Because the creditors desire to obtain an asset basis stepup and plan to hold Sub's business in a flowthrough structure going forward, Sub is converted into an LLC one day before the effective date.

As discussed earlier in Example 3, Parent should be able to get a worthless stock deduction here. The liquidation is not eligible for section 332 treatment and is therefore fully taxable. How much "inside gain" does Sub recognize on the deemed sale of its assets?

Recall that basis was $80, FMV of assets was $100, and Sub's recourse liability on the bank debt was $125. If, before liquidating, Sub had transferred the assets to creditors in satisfaction of the liability, the tax treatment is clear: deemed asset sale for FMV (triggering gain of $20) and CODI of $25 on the portion of the debt left unpaid.[26] The results should be the same if Sub had liquidated first, but there is uncertainty whether Sub's amount realized on the deemed sale might be the full $125 of liabilities, resulting in $45 of inside gain.[27] Nevertheless, debt restructuring tax practitioners often take the view that the correct measure of amount realized in this case is capped by the FMV of Sub's assets.

In a consolidated group, the difference may be academic: If the higher amount realized applies, Parent should also obtain a stepup in the basis of Sub's assets to $125. Upon the subsequent disposition of the assets to creditors at FMV of $100, Parent's loss of $25 should offset the inflated "gain" of $25 from the liquidation. However, a character mismatch could arise if some of the asset gain is ordinary. Aside from recapture rules, section 1239 may apply because of Sub's liquidation being treated as a sale of depreciable property to a related party (Parent) and gain attributable to the property being characterized as ordinary. Further, even if inflated gain is ultimately a wash for federal tax purposes, the inside gain at Sub and the loss at Parent may not wash for all state and local tax purposes, as discussed *infra*.

IV. Don't Let the Unified Loss Rules Ruin the Party

Having run through the gantlet of worthless stock deduction rules, including the consolidated reg. section 1.1502-80(c) and -19 overlay and section 332 traps, is it safe to conclude that the worthless stock deduction can be taken? As Lieutenant Columbo would say, "just one more thing" stands in the way: the unified loss rules (ULR) of reg. section 1.1502-36. The ULR is a byzantine web of rules designed to eliminate or reduce losses recognized regarding stock of consolidated subsidiaries in situations that the government finds abusive, for example, duplication of outside loss on the stock and built-in loss in assets, or loss on the stock being driven by inflated stock basis resulting from positive investment adjustments (PIAs) under reg. section 1.1502-32.

[26] *See* reg. section 1.1001-2(a)(2) and (c), Example (8). As discussed *infra*, the result would be different for *nonrecourse* debt: no CODI and taxable gain measured by reference to $125 of liabilities. *See Commissioner v. Tufts*, 461 U.S. 300 (1983); reg. section 1.1001-2(a)(1) and (c), Example (7); and section 7701(g).

[27] Section 336(b), which governs taxable section 331 liquidations, states that "if any property distributed in a liquidation is subject to a liability . . . the [FMV] of such property shall be treated as not less than the amount of such liability." The counterargument would be that the liquidation of an insolvent corporation is not covered by section 331 (because of lack of distribution to shareholders) but rather by the catchall principles of section 1001, which, for recourse debt, limit the amount realized to actual FMV of the property regardless of the amount of the associated liability. *See supra* note 26.

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A complete analysis of potential ULR applicability is beyond the scope of this article. In practice, the most relevant portion of those rules that could impair the ability to claim a worthless stock deduction for a distressed subsidiary is reg. section 1.1502-36(c). Briefly, this rule reduces Parent's stock basis in Sub (thus reducing the potential loss) by the lesser of (i) net PIAs and (ii) the "disconformity amount," defined as the excess of (x) stock basis over (y) Sub's net inside attribute amount (NIAA). The NIAA, in turn, is the sum of Sub's basis in assets, NOLs, and similar attributes reduced by the amount of Sub's liabilities.

Assuming some amount of PIAs exists, the struggle in examples 3 and 5 would be that NIAA is a negative number: inside basis of $100 (after the assets are sold for cash or their basis is stepped up in the taxable liquidation) minus liabilities of $125, that is ($25). This creates a disconformity amount of $105 (the excess of $80 stock basis over negative $25), which exceeds the potential worthless stock deduction. Fortunately, the ULR reduction is the lesser of the disconformity amount and the net PIAs, so the key variable in determining the allowable deduction is the amount of PIAs. In practice, this means a detailed stock basis study is in order.

In Example 4, in which the direct obligor on the debt is Parent, not Sub, query how the NIAA is computed? Recall that we were hoping to get a worthless stock deduction by arguing that Sub is insolvent because of its guarantee obligation. Once we go down that path and posit that Sub is a de facto obligor on the bank debt, it is hard to claim this liability is nevertheless not on its books for purposes of computing the NIAA and the disconformity amount. While there may be a technical way to thread that needle, it seems too cute to be true.

V. Don't Ignore State and Local Taxes

After navigating the maze of rules discussed above, suppose we conclude that the worthless stock deduction is available to offset the asset sale gain. Note that all this analysis so far has been limited to federal income taxes. What about state and local taxes?

The SALT answer may be less cheerful. First, in some states, Parent and Sub are not filing consolidated, combined, or unitary returns — each is treated as a stand-alone corporate taxpayer for SALT purposes. Further, in some states, it may be the case that Sub has nexus and files SALT returns, but Parent does not. If so, Sub's tax liability on the asset sale gain is not offset with Parent's worthless stock deduction.

Moreover, the stock basis in Sub may be different for SALT purposes. For example, even in states that allow consolidated, combined, or unitary filings, there may be no analog to the federal rules of reg. section 1.1502-32, for example, stock basis might not be increased on account of PIAs.[28] Thus, stock basis for SALT purposes may be much lower than federal stock basis. On the other hand, it is still possible to have a SALT equivalent of an excess loss account (that is, negative stock basis) if distributions have been made by Sub historically, for example, a deferred intercompany stock account for California tax purposes.[29] Thus, while the federal analysis may produce a robust worthless stock deduction (and a net loss in the consolidated group), the SALT analysis may yield zero or a limited offsetting deduction, and perhaps even an income inclusion, at the Parent level.

The flip side is that, in the absence of perfect consolidation, some opportunities may exist in the SALT space that would be unthinkable for federal tax purposes.

> **Example 6.** Grandparent owns Parent, which owns Sub, and all three are corporations filing a consolidated tax return. The entire group is in bankruptcy. Aside from its liabilities owed to unrelated third parties, Parent owes $30 to Sub, and Sub owes $70 to Grandparent. Sub sells its assets, triggering $20 of taxable gain. The entire group liquidates, with all proceeds from the asset sale remitted to third-party creditors and no recovery for intercompany liabilities. Assume no material worthless stock deductions are available.

[28] *See, e.g.,* Cal. Code Regs. tit. 18, section 25106.5-1(d)(3); Mich. Comp. Laws Ann. section 208.1511; and 34 Tex. Admin. Code section 3.587(c)(3).

[29] *See, e.g.,* Cal. Code Regs. tit. 18, section 25106.5-1(f)(1)(B); and W. Va. Code R. section 110-24-13d.6.a.2.B.

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Typically, intercompany liabilities either get wiped out at the conclusion of a bankruptcy or may survive intact if the group survives. Here, we are positing a liquidation, so the intercompany liabilities must be eliminated, and corresponding items of CODI (for borrower) and bad debt deduction (for lender) must be taken into account in the final tax year of the group. From a federal tax perspective, these items should add up to a wash on the consolidated group return. The bankruptcy exclusion of CODI from gross income under section 108(a) does not apply to an extinguishment of intercompany debt.[30]

For SALT purposes, the answer may be different. On a stand-alone basis, Sub may be entitled to a bad debt deduction of $30 because of the cancellation of its receivable from Parent. On the other hand, Sub may also be able to exclude its CODI from the cancellation of its $70 liability to Grandparent under section 108(a), to which most states conform for purposes of their own income tax laws. (Ditto for Parent regarding its CODI on the $30 owed to Sub.) As a result, Sub may be able to offset the entirety of its asset sale gain with the bad debt deduction. Meanwhile, none of the CODI is taxed for SALT purposes, and Grandparent may enjoy a separate $70 bad debt deduction to boot.

VI. Now Let's Imagine a Disregarded Sub

How would the examples examined above play out in a scenario in which Sub is a disregarded entity? Let's start with a variant of Example 3.

> **Example 7.** Parent owns 100 percent of Sub, which is a disregarded entity. Sub has $125 of liabilities (secured bank debt, which is also guaranteed by Parent), assets with FMV of $100, and inside basis of $80. Sub sells all its assets to Buyer for $100 cash, which it promptly uses to partially repay its creditors. Parent has no other assets.

Now we are essentially back to Example 2. There is no stock basis in Sub and thus no possibility of a worthless stock deduction to save the day. Parent owes tax on $20 of gain, which may be left unpaid if the secured creditors do not want to share their proceeds with the IRS. Parent also has CODI of $25 on the portion of the debt that was left unpaid but should be able to exclude it under section 108(a)(1)(B) because it is insolvent by the same amount.

Suppose that Sub's creditors were unsecured instead. Does the IRS have a better shot at grabbing some of the proceeds to satisfy the tax liability? Curiously, the taxpayer that owes the tax is not Sub (because it doesn't exist for tax purposes) but rather Parent. But Parent never gets its hands on the cash, which is intercepted by Sub's creditors to satisfy their claims. Parent's creditors are structurally subordinated to Sub's creditors. The IRS has acknowledged that, absent reverse veil piercing or similar arguments under applicable state law, it may not have a claim against a disregarded entity for taxes owed by its owner, even if the tax arises from income earned at the disregarded entity level.[31]

> **Example 8.** Same facts as Example 7, except Parent is not a guarantor on the debt. Instead of a sale for cash, Parent's equity interest in Sub is canceled, and new equity in Sub is issued to the bank lenders. Parent liquidates. Since Sub is disregarded, the transaction is treated for tax purposes as an asset transfer by Parent in partial satisfaction of the debt.

This twist raises a question like the one we considered earlier in Example 5: How much gain on the asset sale? Is the amount realized still $100 (the FMV of Sub's assets)? Or is Sub's debt (which, for federal income tax purposes, is deemed owed by Parent, since Sub doesn't exist for such purposes) treated as a nonrecourse liability of Parent, resulting in amount realized of $125 and taxable gain of $45 under *Tufts*? This would be an inferior result to Example 7 ($20 of taxable gain and $25 of excluded CODI).

The notion of debt being "nonrecourse" to Parent, when in substance all of Parent's assets are subject to the debt in this case, feels odd. Nevertheless, legally, Parent is not directly on the

[30] *See* reg. section 1.1502-13(g)(4)(i)(C).

[31] *See, e.g.*, IRS GCM 200338012 (Sept. 19, 2003); IRS Chief CCA Mem. 200235023 (Aug. 30, 2002); and IRS CCA 199930013 (Apr. 18, 1999).

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hook for the debt, and the IRS appears to endorse the view that the debt is nonrecourse here.[32] Accordingly, there is some risk that Parent's amount realized would be the full amount of the debt.[33]

Now let's think back to examples 3 and 5, in which Sub was regarded as a corporate subsidiary. We concluded that we can trigger a worthless stock deduction for Parent by converting Sub into an LLC. Inflated *Tufts* gain was not an issue in those examples because Parent was a guarantor on the debt. Parent's guarantee should make the debt recourse to it after Sub becomes disregarded. Would you still advocate for the LLC conversion if the Parent is not a guarantor, and there is a risk that the disappearance of Sub for tax purposes may turn Parent into an obligor on (arguably) nonrecourse debt?

Timing is everything. If the LLC conversion happens after the asset sale and the debt discharge (but before the end of the tax year, so that the worthless stock deduction is still in the same year as the asset sale gain), this should allow the Parent to sidestep *Tufts* and limit Sub's amount realized on the asset sale to FMV.

In a scenario in which a corporate Sub's equity needs to be transferred (for example, because Sub holds valuable licenses or contracts that cannot be easily assigned), the parties may be tempted to have Sub engage in an F reorganization immediately before the transfer of its equity by having Parent drop Sub's equity into a corporate Newco, then having Sub convert into a disregarded LLC.[34] This would facilitate a transfer of Sub's equity that is still treated as a taxable asset sale for tax purposes. However, it may again raise the specter of Sub's recourse debt morphing into nonrecourse debt if Newco does not become a guarantor or the transitory guarantee is ignored. A safer course of action would be to maintain Sub's corporate status for tax purposes and structure the transfer of its equity as a transaction eligible for a section 338(h)(10) or section 336(e) election.

> **Example 9.** Same facts as Example 8 (Parent is not a guarantor), but Parent has other assets besides its equity interest in Sub and is neither in bankruptcy nor insolvent. Lenders take over Sub's equity. Parent does not liquidate.

Once again, we are faced with a dilemma of how to characterize the debt (nonrecourse vs. recourse) and the potential difference in tax results ($45 gain vs. $20 gain and $25 CODI). Unlike prior examples in which CODI was excluded from income, here Parent will recognize $45 of taxable income either way. However, character may vary if some or all the gain is capital, whereas CODI is ordinary. If capital gain is preferred, Parent may well opt for the "all gain" treatment. The argument for treating Sub's debt as nonrecourse to Parent is also more robust here, when the location of the debt at the Sub level and the lack of Parent guarantee actually makes an economic difference: Parent's other assets are shielded from Sub's lenders, and this limits their recovery to the $100 of assets inside Sub.

VII. Zombie Company: The Unbearable Agony of Remaining in Existence

Sometimes, liquidating is not so simple. Instead of being forced into liquidation or bankruptcy by debt with a fixed due date, a business may be facing contingent liabilities of an unknown amount or a maturity date that may linger for years, if not decades. This is common with mass tort claims, e.g., environmental pollution exposures in the oil industry, litigation claims against tobacco or gun manufacturers, or the opioid crisis for big pharma. In these cases, the company may well remain viable and continue operating for a long time after the exposure is discovered. However, the ominous cloud of the

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[32] *See* LTR 201644018 (Oct. 28, 2016), Ruling no. 11; LTR 202050014 (Dec. 11, 2020), Ruling no. 4; Guidance Concerning the Exclusion of Discharge of Indebtedness Income of a Grantor Trust or a Disregarded Entity, 81 F.R. 37,504 (May 25, 2016) (to be codified at 26 C.F.R. pt. 1) (assuming owner has not guaranteed disregarded entity's debt and is not otherwise liable under applicable law, such debt should generally be treated as nonrecourse debt of the owner for purposes of applying the insolvency exclusion of section 108(a)(1)(B)).

[33] If taxable gain is problematic, it may be possible to restructure this transaction as a tax-free reorganization under section 368(a)(1)(G) by having Sub elect to be treated as a corporation for tax purposes if all requirements for a G reorganization can be met (*e.g.*, are any creditors that receive Sub's equity treated as holders of securities?). If the transaction qualifies as a G reorganization and the debt is treated as nonrecourse debt, there is no CODI, and the *Tufts* gain is realized but not recognized. LTR 202050014 (Dec. 11, 2020), Rulings nos. 4-5. However, this would also mean that the creditors do not obtain a step-up in the basis of Sub's assets.

[34] *See, e.g.*, LTR 200750009 (Dec. 14, 2007), Ruling no. 1.

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contingent liability makes it hard to attract new capital or sell the business. If the present value (PV) of the liability could be accurately measured and accounted for, the company may well be insolvent, even though the final reckoning may be many years away.

To add insult to injury, the liability has not yet ripened enough to give rise to a tax deduction, even for an accrual method taxpayer. This could produce distortive results, especially if the business is sold in whole or in part, with no deduction available to offset any gain. As Lenin would say: "What is to be done?"

Example 10. ABC Corp. owns two lines of business: Winner and Dog. FMV of Winner is $450, and its basis is $50. Dog has ceased operating several years ago. Its only remaining asset is Warehouse with basis of $10 and FMV of $50. In the past, Dog engaged in the production and distribution of opioids. This activity caused many addiction-related illnesses and deaths. Lawsuits by potential victims are in progress, and additional lawsuits are expected. The total potential liability exposure of ABC Corp. has been estimated at $400. Because lawsuits will take many years to resolve and damage payments are not imminently due, the PV of this contingent liability is $200. ABC Corp. wants to sell the assets of Winner for $450, triggering taxable gain of $400 and net federal, state, and local corporate income taxes of $100.

Can the happy owners cause ABC Corp. to distribute the after-tax proceeds of $300 from the sale of Winner to themselves, either as a dividend or a liquidating distribution, and leave the carcass of Dog behind to rot? As noted back in Example 1, this could be a fraudulent conveyance because it would leave ABC Corp. unable to pay plaintiffs in the pending and future lawsuits.

The key tax issue here is that the $400 gain on Winner is balanced by an unrealized loss on Dog. Depending on whether you count the liability at its PV or its gross amount, this unrealized loss is either $360 ($40 gain on Warehouse, less the gross amount of future liability of $400) or $160 (if we only consider the PV of $200 for the future liability). Because the liability has not yet been accrued for tax purposes, ABC Corp. is taxed on "too much" gain when it sells Winner.

Is there any way to accelerate the deduction for Dog's liability? The general rule for tort liabilities is that a deduction can only be accrued when economic performance occurs, e.g., when ABC Corp. pays the tort victim or a special fund is set up for the benefit of the victim.[35] Merely losing a lawsuit that fixes the amount of a liability is not good enough. And if the liability is truly contingent, e.g., the lawsuit is still ongoing or has not even been filed yet, there is nothing to accrue for tax purposes because the all-events test has not been met.[36]

What if the Winner's Buyer could be persuaded to take on Dog's liability? The simplest case would be an outright sale of ABC Corp. stock, warts and all, for a reduced purchase price that reflects the potential liability. Of course, there are many reasons for Buyer to resist this structure. Buyer wants to get a step-up in the basis of Winner's assets and may want to cherry-pick (or cap) the amount of Dog's liabilities that it is assuming.

Suppose the transaction is still structured as an asset sale by ABC Corp., but now Dog and its contingent liabilities are included in the deal. Alternatively, if ABC were a partnership, the sale of 100 percent of its equity should produce the same tax results as a sale of all its assets under Rev. Rul. 99-6.[37] Can this structure accelerate the offsetting deduction?

Example 11. Same facts as Example 10, except Buyer agrees to purchase all of ABC Corp.'s assets and assume all its liabilities for a cash payment of $300, reducing the purchase price from $500 (the gross FMV of assets unencumbered by the liability) by the $200 PV of the contingent liability.

[35] *See* section 461(h)(2)(C); and reg. section 1.461-4(g)(2). The potential use of a "qualified settlement fund" under section 468B is discussed *infra*.

[36] *See* reg. section 1.446-1(c)(1)(ii).

[37] 19991 C.B. 432.

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The desired tax outcome here for ABC Corp. would be (i) amount realized of $500 ($300 cash plus $200 assumption of liabilities) and (ii) deduction of $200 for the deemed satisfaction of the contingent liability because ABC Corp. in effect paid Buyer for taking on the liability by accepting a $200 purchase price reduction. In that case, ABC Corp. would end up with a net gain of $240 ($500 amount realized, less asset basis of $60 and deduction of $200), compared to the outcome in Example 10 ($400 gain on Winner) in which Dog and its liability were left behind.

Notably, regulations under section 461 would allow this treatment for a liability assumed in connection with an acquisition of a trade or business if the all-events test were met for the liability (for example, the lawsuit has concluded with a verdict or a binding settlement), and the only bar to claiming the deduction is the "economic performance" requirement (that is, paying the plaintiff). In that case, the assumption of the ripe liability by Buyer is deemed to constitute economic performance by ABC Corp., triggering the deduction.[38] However, the same regulations reserve regarding contingent liabilities.[39]

Nevertheless, many practitioners believe that a deduction should be available to ABC Corp. even if the liability is contingent because of the theory that the economics of the transaction are comparable to those involving a ripe liability, and case law permitting the offsetting deduction can be extended to contingent liabilities.[40] But what is the amount of the deduction? It is unclear whether the contingent liability would be taken at its face amount ($400) or its PV ($200) here, although on these facts, it should be a wash either way: Presumably, the deduction should equal the amount treated as liabilities assumed for purposes of increasing the amount realized.[41]

In some other cases, the amount of available deduction becomes more important. If Buyer refuses to assume Dog's liability, life becomes more complicated.

> **Example 12.** Same facts as Example 10. Buyer purchases Winner's assets for $450 but refuses to buy Warehouse or assume Dog's contingent liability. Instead, ABC Corp. finds Vulture Fund, which agrees to assume Dog's liability in exchange for Warehouse and a cash payment of $250. Promptly after the sale of Winner, ABC Corp. transfers Warehouse and $250 of cash proceeds into Newco LLC, causes Newco LLC to assume the contingent liability, and then sells the membership interests of Newco LLC to Vulture Fund for nominal consideration. To backstop Newco LLC's liability assumption, Vulture Fund agrees to indemnify ABC Corp. for any claims related to Dog's liabilities.

Bifurcating the exit into two separate transactions puts more pressure on the deductibility of the contingent liability and the amounts to be recognized. Regulation section 1.461-4(d)(5) applies to liabilities assumed in connection with an acquisition of a trade or business. Here, Vulture Fund is merely acquiring cash and Warehouse. Similarly, *Pierce* and other friendly case law involved acquisitions of a trade or business. From a policy perspective, it is unclear why the result should be any different if the transaction is a simple liability assumption, but the absence of a trade or business muddies the water. It would be helpful if the Dog transaction is contingent on the closing of the sale of Winner — which may be required in practice because Buyer's cash purchase price must be in hand to

[38] *See* reg. section 1.461-4(d)(5) and (g)(1)(ii)(C).

[39] *See* reg. section 1.461-4(j).

[40] *See* Martin D. Ginsburg, Jack S. Levin, and Donald E. Rocap, *Mergers, Acquisitions and Buyouts* para. 304.1 (2019) for a thorough discussion of the issue; *see also Commercial Security Bank v. Commissioner*, 77 T.C. 145 (1981), *acq.*, 1986-2 C.B. 1; *James M. Pierce Corp. v. Commissioner*, 326 F.2d 67 (8th Cir. 1964); and Rev. Rul. 68-112, 1968-1 C.B. 62.

[41] *Cf.* prop. reg. section 1.382-7(c)(3)(iii)(A), which provides that "if [a contingent] liability . . . is reflected on the face of the most recently issued applicable financial statement . . . then the estimated value of a liability is the amount of such liability reflected on the most current applicable financial statement as of the change date. The estimated value of any liability described in paragraph (c)(3)(i)(C) of this section is not adjusted to reflect the actual amount of liability that is established on removal of the contingency."

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enable ABC Corp. to fund Newco LLC — and occurs immediately thereafter, facilitating the argument that the liability assumption was an integral part of a larger transaction that included a sale of a trade or business.

Vulture Fund may also worry about its tax treatment. Does the receipt of $250 result in immediate day 1 income inclusion for Vulture Fund, without an offsetting deduction? The assumption of the liability, at most, would give it basis in the cash and Warehouse. If the transaction had been simply a transfer of Warehouse for a $50 liability assumption, the result would have been more certain: no tax for Buyer upfront, and basis of $50 in Warehouse obtained upon payment of the liability by Vulture Fund.[42] But the concept of cash with initial zero basis, or cash received tax free, seems awkward — even though economically it is still an asset being acquired in exchange for a liability assumption, just like Warehouse. Can this concern be remedied by packaging the cash inside a corporation?

> **Example 13.** Same facts as Example 12, except Newco is a corporation, and the transaction with Vulture Fund takes place one year after the sale of Winner. Assume that Newco was formed well in advance, and the liability, cash, and Warehouse were contributed to it in a transaction respected as a section 351 transfer unrelated to the subsequent transaction with Vulture Fund.[43]

This should buttress Vulture Fund's tax position. It is acquiring stock of a corporation, stuffed with a contingent liability, cash, and Warehouse. Economically, this seems like a bargain purchase ($300 of total FMV of assets inside Newco offset by a liability with a PV of $200, albeit a potential total amount of $400), but we don't tax buyers simply for striking a good deal and buying an asset on the cheap.[44] If Vulture Fund causes Newco to invest the cash wisely until it is needed to settle the liability, it should make a profit in the aggregate. Newco may also be able to deduct future payments on the liability, subject to ULR as discussed *infra*.[45]

The problem here is the potential loss of the offsetting deduction or loss for ABC Corp. First, suppose the contingent liability is ignored at the time of the section 351 dropdown into Newco, so that ABC Corp. could have obtained $260 of basis in Newco stock upon contributing the cash and Warehouse. The subsequent sale of Newco stock for a few pennies could give rise to a big capital loss. Fortunately, corporate taxpayers can carry back capital losses, which could permit a refund of taxes paid on the gain from the sale of Winner in the prior year. To the extent the gain was ordinary, the capital loss would not help offset that income. But did ABC Corp. really get $260 of basis in Newco stock?

Under section 358(d)(1), assumption of liabilities is generally treated as cash boot and reduces stock basis in a transferee corporation under section 358(a)(1)(A)(ii). However, section 358(d)(2) helpfully carves out from this treatment any liabilities that are excluded from boot treatment under section 357(c)(3) — for example,

[42] *See, e.g.*, reg. section 1.338-7(e), Example 1 (adjustment of adjusted grossedup basis in a section 338 transaction upon the accrual of a liability that was contingent at the time of closing).

[43] Notably, if all steps can be integrated into a single transaction, there is a significant risk that section 351 treatment is not respected. If so, the initial dropdown into Newco is either a taxable section 1001 transfer (raising the same doubts about the contingent liability being deductible for ABC Corp. that we discussed in Example 12 above, exacerbated by the "counterparty" here being a related party) or could even be resequenced as a direct transfer to Vulture Fund, which then drops the assets and liabilities into Newco. *See, e.g.*, Rev. Rul. 70-140, 1970-1 C.B. 73.

[44] *See, e.g.*, *Palmer v. Commissioner*, 302 U.S. 63 (1937).

[45] The availability of postclosing deductions for payments on the contingent liability may also be affected by section 382(h) built-in loss limitations. Under current law, the section 1374 method does not capture these deductions as recognized built-in losses (RBILs) within its definition of built-in deductions under section 382(h)(6) because the definition is limited to items for which "an accrual method taxpayer would have . . . been allowed a deduction for the item before the change date" (modified to remove the requirement of economic performance). *See* Notice 2003-65, 2003-2 C.B. 747, Part III.B.2.a. (These deductions are treated as RBILs under the notice's section 338 method, however, to the extent of the estimated value of the liability on the ownership change date. *See id.*, Part IV.C.) Proposed regulations would change this result by sweeping into the universe of RBIL any deductions for liabilities that were contingent on the change date, to the extent of their estimated value on the financial statements as of that date. *See* prop. reg. section 1.382-7(c)(3)(iii)(A) and (d)(3)(v).

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liabilities that would give rise to a future deduction. At first blush, Dog's contingent liability seems to fit that description. Under Rev. Rul. 95-74,[46] an assumption of a contingent liability for environmental remediation is excluded from boot treatment under section 357(c), and future payments would be deductible for transferee under a "step in the shoes" theory. But the facts of that ruling again assume a transfer of the entire trade or business to a transferee, so query if our facts in Example 13 would fit the bill.

Even if we get comfortable that section 358(d)(1) does not ruin the party, the next challenge is section 358(h), which would reduce stock basis in Newco by the amount of the contingent liability to the extent basis of assets transferred to Newco exceeds their FMV. This is clearly the case here, with basis of $260 and net value transferred of $100 (or negative $100 if the liability is taken into account at its face value rather than PV). While section 358(h)(2)(A) gives a glimmer of hope, it again requires the associated trade or business to be transferred in the exchange.[47] To put the final nail in the coffin, the transaction we are contemplating appears quite similar to the "contingent liability tax shelter" listed transaction described in Notice 2001-17.[48] In sum, a dropdown into a newly created Newco does not seem like a workable solution for triggering the loss associated with the contingent liability. We will discuss other potential solutions in a bit, but first let's reimagine the basic fact pattern of Example 10 in a consolidated group in which all the assets and liabilities already reside in a corporate subsidiary.

VIII. The Consolidated Zombie Group: A Different Outcome?

Example 14. Parent is pure holding company that owns Sub. Sub has all the assets and liabilities described in Example 10. Parent has stock basis of $60 in Sub, equal to Sub's inside basis in its assets. Sub sells Winner's assets to Buyer for $450 and distributes $200 of proceeds to Parent. Immediately thereafter, Parent sells stock of Sub (holding Warehouse, $250 of remaining proceeds, and the contingent Dog liability) to Vulture Fund for nominal consideration.

Contrast this scenario to Example 13, in which we were trying to stuff the liability and cash into a newly formed corporate box and ran into section 358(h) and other obstacles. Here, everything is already held in an old and cold corporate sub. Can the consolidated stock basis adjustment rules of reg. section 1.1502-32 produce the right outcome?

The gain on the sale of Winner tiers up to Parent and should give rise to a PIA, increasing Parent's stock basis in Sub from $60 to $460. The subsequent cash distribution to Parent reduces it to $260. This still leaves a sizable capital loss to be triggered on the subsequent sale of Sub's stock to Vulture Fund for a few pennies. Can the ULR ruin the party?

Recall that the reduction of stock basis under reg. section 1.1502-36(c) is the lesser of net PIAs or the disconformity amount. We clearly have enough PIAs to wipe out the entire stock loss, but what is the disconformity amount? Stock basis is $260, while the NIAA is also $260 (remaining cash of $250 plus basis in Warehouse of $10). What about liabilities? Reg. section 1.1502-36(f)(5), with one exception not applicable for purposes of -36(c) rules that we will consider below, defines a liability as a "liability incurred within the meaning of section 461(h)." As discussed earlier, Dog's contingent liabilities have not yet met either the all-events test or the economic performance requirement and therefore do not count for this purpose. Accordingly, Parent has an allowable capital loss on the sale of Sub stock, which should help offset the gain from the sale of Winner's assets, except for any portion treated as ordinary income. This makes sense, because Parent has suffered a true economic loss, which the ULR is not supposed to disallow.

The last relevant prong of the ULR concerns the buyer of Sub, that is, Vulture Fund. To the extent all other ULR rules have not produced a stock basis reduction, reg. section 1.1502-36(d) attempts to shut down duplication of the stock loss in the hands of Sub and its new owner by reducing tax attributes inside Sub by the lesser of

[46] 1995-2 C.B. 36.

[47] The other potential exception (transfer of substantially all related assets) under section 358(h)(2)(B) is turned off by reg. section 1.358-5(a).

[48] 2001-1 C.B. 730.

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the stock loss or the "aggregate inside loss."[49] The aggregate inside loss is the excess of the NIAA (that is, $260) over the value of Sub's stock, which was just sold for pennies. Once again, the stock loss and the inside loss are equal, and a reduction of inside attributes is in order.

But are there any attributes to reduce? Category D, basis in assets, seems like the only candidate. So we reduce Sub's basis in Warehouse ($10), but then the buck stops here because basis in cash ($250) is untouchable.[50] Because the attribute reduction amount exceeds attributes available for reduction, the excess is suspended "to the extent of any liabilities of [Sub] not taken into account for tax purposes before the transfer." The suspended amount reduces any amounts that would be deductible or capitalizable by Sub because of such liabilities. And solely for this purpose, liability means "any liability or obligation the satisfaction of which would be required to be capitalized as an assumed liability by a person that purchased all of [Sub's] assets and assumed all of [Sub's] liabilities in a single transaction."[51] This seems to capture the contingent Dog liabilities and would prevent Sub from deducting payments of these liabilities made post-closing. There may be some room to argue that the relevant amount is $200, not the full $400 gross amount before the PV discount was applied.

In sum, this is a good outcome for Parent and a potential trap for Vulture Fund if it was counting on deducting the future payments. Once again, as we saw in the bankruptcy and debt workout examples earlier, tax results may be much better in the context of a preexisting consolidated group, when Parent is able to offset Sub's inside gain with the outside loss on Sub's stock, compared to scenarios in which the relevant taxpayer is a stand-alone corporation.

This begs the question: If a stand-alone corporation sees a train wreck coming, can a consolidated group be created in advance of the final fire sale? As discussed earlier, a dropdown of assets and liabilities into a corporate Newco formed below the existing corporate taxpayer may not work for a variety of reasons. But can a Newco be inserted *above* the existing corporate taxpayer by having the shareholders contribute their ABC Corp. stock into a new corporate Holdco? Food for thought for another day. As a cautionary note, one would need to consider the business purpose for forming the new Holdco, assess any hurdles to tax-free reorganization treatment (to the extent it matters), and pause briefly on the ULR antiabuse rules of reg. section 1.1502-36(g).

IX. A Couple More Ideas

The examples above show some possibilities (and pitfalls) of crystallizing the pregnant loss lurking inside the zombie company to offset the gain on its final asset sale. However, all these scenarios required a transaction with a third party (or multiple third parties) that would be willing to take on the contingent liability. What if such a counterparty cannot be found? Are any selfhelp remedies available?

One solution often used by businesses with long tail contingent liabilities is a transfer of cash or other property to a qualified settlement fund (QSF) that meets the requirements of section 468B and related regulations. A transfer to a QSF is generally treated as economic performance regarding the liabilities that the QSF was established to resolve or satisfy.[52] Accordingly, the transfer can trigger an immediate deduction equal to the FMV of the cash or property that was transferred to the QSF.

A complete analysis of the applicable QSF rules is beyond the scope of this article. However, the key requirement that will need to be addressed is that the QSF be (i) established in accordance with an order of, or approved by, the federal government, a U.S. state or possession, the District of Columbia, a political subdivision of any of the foregoing, or any agency or instrumentality thereof, including a court of law, and (ii) subject to the "continuing jurisdiction" of that governmental authority. Thus, while a commercial third party is not needed, the QSF needs to be set up under the auspices of a governmental agency or a court that retains

[49] *See* reg. section 1.1502-36(d)(3).

[50] *See* reg. section 1.1502-36(d)(4)(i)(D).

[51] *See id.* at (d)(4)(ii)(C)(1).

[52] *See* reg. section 1.468B-3(c)(1).

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continuing oversight over the QSF because the agency is tasked with adjudicating, prosecuting, or resolving the claims giving rise to the liability being addressed by the QSF. In practice, this typically happens in a bankruptcy, class action litigation, or an administrative proceeding involving a regulatory agency. Thus, if an appropriate proceeding is not already underway, ABC Corp. would need to trigger one. A bankruptcy filing could be one option, and this route has been used recently by several pharmaceutical companies struggling with opioid-related litigation claims. However, the filing of a bankruptcy petition is a serious step that could result in the company's shareholders losing control over the outcome.

Another alternative is to purchase an insurance policy to cover the latent Dog exposures. But now we again need a third party — an insurance company — to play along. The tax objective, once again, would be to claim a deduction for the premium paid upfront so that the gain from the Winner asset sale would be offset. The pricing of an insurance policy for such a risk would need to be carefully structured to ensure that the product qualifies as insurance for tax purposes. Generally, to be respected as insurance, the policy needs to transfer some risk of loss to the insurer. In cases in which the event being insured (in our example, the sales of opioids causing damages to the plaintiffs) has already occurred, a higher level of IRS scrutiny applies. The potential challenge would be that the purported insurance contract represents only investment risk if the exposure under the policy is capped at an amount at which the economic benefits of the premiums received, investment income from the premiums, and tax savings from the insurer's loss reserve deductions would exceed the insurer's maximum liability.[53]

Another challenge would be to ensure that the premium can be deducted immediately, as opposed to being capitalized and amortized over the life of the insurance contract (which, given the protracted nature of the exposure, would need to provide coverage for multiple future years). A payment for a multiyear insurance policy is a prepaid expense subject to the general requirements of capitalization and amortization.[54]

X. Be Sure to Turn the Lights Out

As the corporate enterprise nears the end of its journey, closing the books on its tax history is important. The completion of a liquidation triggers gains and losses on any remaining assets, achieves finality for tax reporting purposes, and limits further expenses on tax return preparation. The final year of a corporation is also an opportunity to unlock deductions that were previously unavailable, for example, capitalized costs attributable to past M&A transactions or bankruptcy restructurings.[55] As discussed above, it may also be a way to unlock a worthless stock deduction for the shareholders.

In a bankruptcy, it is usually feasible to terminate a corporation's existence for tax purposes by having the corporation transfer its remaining assets into a liquidating trust for the benefit of creditors. This is treated as (i) a fully taxable transfer of assets directly to creditors, followed by (ii) a dropdown of the assets by the creditors into a liquidating trust, a separate flow-through entity for tax purposes that is not a successor to the liquidating corporation.[56]

Outside bankruptcy, while there is plenty of guidance on adopting and maintaining a liquidation plan, it is sometimes difficult to discern when a corporation becomes truly dead for tax purposes.[57] As discussed above, this can be challenging for zombie companies that have ceased active operations but retain long-term contingent liabilities, particularly insurance companies in runoff that are obligated to continue servicing their existing insurance policies. (The trick of converting into an LLC or another flow-through entity would not work for an insurance company — a per se corporation for tax purposes.) Once again, finding a helpful third

[53] *See, e.g.*, Rev. Rul. 89-96, 1989-2 C.B. 114; and Rev. Rul. 2007-47, 2007-30, IRB 127.

[54] *See* reg. section 1.263(a)-4(d)(3)(ii), Example 1.

[55] *See* LTR 201138022 (Sept. 23, 2011) (allowing deduction under section 165 for capitalized costs of the bankruptcy restructuring in the year of the corporation's liquidation).

[56] *See generally* Rev. Proc. 94-45, 1994-2 C.B. 684.

[57] *See generally* Boris I. Bittker and James S. Eustice, *Federal Income Taxation of Corporations and Shareholders* para. 10.02 (2020) (discussing uncertainties of when complete liquidation occurs).

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party willing to take on the remaining assets and liabilities (for an insurance business, by engaging in assumption reinsurance or a similar transaction) is usually the best way to mark the end of the corporation's life.

Often, there is a tail period during which some hard-to-transfer assets (in particular, regulatory licenses) remain on the books of the liquidating corporation while the transferee is working on getting the transfer approved. Sometimes, even a few employees may stay behind on the payroll to service the wind-down process. (For a midyear asset sale, it may make sense not to switch employers for some employee benefits reasons, e.g., to avoid a restart of FICA withholding.) Before concluding that the corporate taxpayer is still alive, it's useful to ask: Who is paying their salaries? Who economically owns the "benefits and burdens" of the straggler assets? It may well be the case that ownership of the remaining assets has already changed hands for tax purposes,[58] with the zombie holding mere title but not the economics. If so, one may be able to conclude that the corporate taxpayer's existence has ended, even if the shingle is still hanging on the door:

> 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.[59]

Finally, as the last employees head for the exits, it is a good idea to put in place procedures (and set aside a cash reserve for adviser fees) for filing the corporation's final tax returns on a post-mortem basis. This is particularly important if any tax refunds are expected, and of course there is always a chance of an audit of prior tax years for which the statute of limitations remains open. Even after the corporate taxpayer is officially dead, its tax legacy will linger for some time, just like the Cheshire cat's mischievous grin. ■

[58] *See, e.g., Grodt and McKay Realty Inc. v. Commissioner*, 77 T.C. 1221 (1981).

[59] Reg. section 1.332-2(c).

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