A Tax-Free Corporate Liquidation?

by Robert W. Wood • San Francisco

Ever since the repeal of the *General Utilities* doctrine in 1986, practitioners have struggled mightily with the double-level tax incident to most corporate liquidations. Today, twelve years after the liquidation provisions of Subchapter C were radically altered, clients still occasionally ask questions that are very clearly based on their old understanding of how the liquidation rules used to work.

If a C corporation (whether it is a professional corporation or otherwise) seeks to convert to partnership or LLC status, the transaction is treated as if the corporation had distributed its assets in liquidation and the shareholder recipients had conveyed the assets they receive into a new partnership. Whether the business is to be converted into another type of entity, the liquidation can be expensive, but it is particularly costly if intangibles are involved. The liquidation can be expensive because, under Section 336, a liquidating corporation is treated as if it sold the distributed assets to its shareholders for an amount equal to the fair market value of those assets. That gain is fully taxable.

Moreover, the shareholders are treated as receiving the assets in full payment in exchange for their stock in the liquidating corporation under Section 331. If the assets have a value in excess of the basis of the stock surrendered, that excess constitutes gain which is recognized to the shareholder at the time of the liquidation.

Traditionally, one of the greatest dangers, especially a problem in the professional service corporation context, is the C corporation's intangible assets, including its goodwill and going concern value. If the IRS ascribes a high value to these intangibles, then the gain at both the corporate and the shareholder level may be unanticipated and may be quite high.

Hope and Glory?

There is a recent indication, however, that tax-free corporate liquidations (apart form parent subsidiary liquidations under Section 332), may not entirely be a thing of the past. The Tax Court recently decided *William Norwalk, et al. v. Commissioner*, T.C. Memo 1998-279 (1998), in which it considered the liquidation of an unprofitable professional corporation. The court held that the liquidation did not result in depreciation recapture, transferee liability, or a taxable distribution of goodwill.

The facts arose out of the incorporation of a CPA practice in 1985, the two principals (Mr. Norwalk and Mr. DeMarta) executed five year employment agreements with the corporation. The employment agreements included noncompetition clauses. In addition to being paid their salaries, in 1992 the corporation paid the two shareholders amounts denominated as "consulting fees." Norwalk reporting his consulting fees as business income. DeMarta did not report it.

Liquidation

In the same year (1992), the two shareholders liquidated the corporation, distributing its assets and liabilities. They left outstanding shareholder loans of $96,000. Thereafter, they became partners in another accounting firm, contributing the distributive assets and liabilities in exchange for opening partnership capital account balances in the new firm. The tangible assets were contributed to the new partnership using a carryover adjusted basis of $59,000. The partnership did not assume the professional corporation's tax liabilities or shareholder loans.

The two shareholders' noncompetition agreements

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had lapsed by 1992, and other employees of the corporation had never executed noncompetition agreements. Interestingly, both Mr. DeMarta and Mr. Norwalk were required to sign noncompetition agreements with the partnership, even though many of the liquidated corporation's other employees were also hired by the partnership, but not required to sign noncompete agreements. Within several months, two of the employees of the partnership left to start their own accounting practices, and clients followed them. Within five years of the liquidation, only approximately 10% of the professional corporation's clients remained with the partnership.

No Gain on Intangibles

On audit, the Service determined that the professional corporation realized a $588,000 gain on the liquidation of its goodwill; that Norwalk and DeMarta realized capital gains from the distribution of the goodwill; that the corporation had $15,600 in depreciation recapture income; that the corporation was not entitled to deduct $40,000 in consulting fees; that both Norwalk and DeMarta had dividend income from the consulting fees; and that Norwalk and DeMarta were liable under the transferee liability rules for the liquidated corporation's taxes.

In a significant blow to the Service, the Tax Court held that at the time of liquidation, any "customer-based intangibles" belonged to the accountants, and not to the corporation. The court even said that it was sure that most, if not all, of the professional corporation's clients would have followed the client who serviced the client, rather than staying with the corporation if the accountant departed. The court agreed that the client lists and goodwill had no meaningful value absent an effective noncompetition agreement. Neither the professional corporation nor its shareholders, it said, could realize any gain on the liquidation of a zero value asset.

Furthermore, the court held that the professional corporation did not realize Section 1245(a)(1) recapture income from the distribution of the tangible assets, finding the corporation's basis was less than or equal to the fair market value of the assets. The contribution of the assets to the partnership, the court concluded, was undisputedly an arms' length transaction. In a slight victory for the Service, the court did agree with the IRS that the corporation failed to substantiate its deduction of the $40,000 in consulting fees.

However, the court ruled that neither DeMarta nor Norwalk were transferees of the corporation under Section 6901. The court found that the distribution to them was made in partial repayment of shareholder loans. Furthermore, the court found that the IRS failed to show any intent to defraud the IRS or any receipt of assets for less than full and adequate consideration.

The lesson of the *Norwalk* case seems to be that not only can goodwill be held not to exist where there is only one professional (see, for example, *Howard B. Lawton*, 6 T.C. 1093 (1946), *acq.*, 1946-2 C.B. 3, *rev'd on other grounds*, 164 F.2d 380 (6th Cir. 1947)). Arguably, as in *Nowalk*, the same situation can apply where there are several shareholder/professionals. Given the rather draconian result that can apply on a liquidation of a professional corporation (or other types of corporations for that matter), this is a case that should be filed away by many corporate tax practitioners for use against the service at a later date. ■