Revisiting Liquidation Reincorporation

By Robert W. Wood • Wood & Porter • San Francisco

This topic makes me feel young again, or at least causes me to peer over the precipice into my youth, an era when liquidation reincorporation was a big concern for tax practitioners. There may be a whole generation of tax professionals who've never experienced the delight of worrying about liquidation-reincorporation problems, at least not to the degree we old-timers did. As its name suggests, liquidation reincorporation directs its focus on a business that does one and then the other in an arguably seamless way.

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Why should the IRS (or anyone else) care if a business does that? Mostly we don't, it turns out, or at least that's what many corporate tax practitioners have thought for the last few decades. At a minimum, the incentives and landscape for liquidation-reincorporation transactions have changed, as have the typical tax costs. But it was not always so.

The sea change occurred in 1986 with the repeal of the so-called *General Utilities* doctrine. Corporate tax history buffs will remember *General Utilities & Operating Co.*, SCt, 36-1 USTC ¶9012, 296 US 200 (1935), the seminal Supreme Court case establishing the notion (later embodied in the Code) that one could sell corporate assets and liquidate, distributing money to shareholders and pay only a single level of tax. That was a really good deal.

In fact, more modern practitioners may marvel that such a thing was ever possible. But it was. The repeal of that vaunted doctrine in 1986 made holding assets in corporate solution (at least without an S election in effect) considerably more expensive. Because of that sea change, pass-through entities—partnerships and then-nascent but now omnipresent limited liability companies—became popular in the extreme.

In its heyday—and its heyday covered many decades—the liquidation-reincorporation phenomenon was frightening. It basically involved the IRS denying the liquidation transaction and stepping together the liquidation and reincorporation. The result was to saddle you with reorganization treatment. This was positive proof you didn't always aspire to reorganization treatment. Despite not wanting it, it could be thrust upon you.

Reorganization treatment was based on a long-standing IRS position that a liquidation of a corporation preceded or followed by a transfer to another corporation of all or part of the assets of the liquidating corporation could be recharacterized in accordance with its substance. [*See, e.g.*, Reg. §1.331-1(c). *See also* T.D. 9361, 2007-47 IRB, Oct. 24, 2007.]

Part Deux?

What does this trip down memory lane have to do with revisiting liquidation reincorporation? There may be differing views about just how much we've exaggerated the death of the liquidation-reincorporation doctrine. After all, consider the following simple example:

> Smallco is a closely held C corporation with an enormous expiring NOL. To make use of its NOL while there's still time, Smallco liquidates, triggering a large corporate level gain that can—one assumes—be offset by the expiring NOL. Could the IRS invoke liquidation incorporation? This kind of very simple example was recently used by a Treasury Department attorney who was noting the potential continued vitality of the liquidation-reincorporation doctrine. Of course, the example doesn't mention the critical other shoe falling—the "reincorporation" part of the pattern. As in all things, the details will be terribly important.

The liquidation-reincorporation doctrine is rarely discussed these days. Nevertheless, it was the focus of a District of Columbia Bar Association Tax Section panel in November in which practitioners and government officials discussed the state of liquidation reincorporation. Much isn't clear, and there is disagreement about just how vital the doctrine remains in this post–*General Utilities* world. Yet the fact there is even disagreement about how vital it is suggests that it has much more life left in it than some of us thought.

In fact, it seems clear that considerable pitfalls remain. That seems especially so if you read Reg. §1.368-2(k), something that ostensibly tells you not to worry about liquidation reincorporation. That provision makes the liquidation-reincorporation doctrine inapplicable to some transactions, but decidedly not to all. That may make you worry that if your transaction doesn't expressly qualify under this exclusionary rule, you could face the often amorphous liquidation-reincorporation gauntlet.

More Later

To some practitioners, it may be oddly comforting that the IRS is still thinking about the potential application of the liquidation-reincorporation doctrine. Back in 2007, the government even solicited comments about the continued vitality of these rules. [*See* REG-125632-06, 2007-5 IRB, Jan. 29, 2007.] To others, though, it may seem like a stranger from a strange land.

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