

Dissolving Business Entities and Corporate Housekeeping

Presenter:

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Westlake Village Hyatt

Law Office of William C. Staley

This presentation should be viewed only as a summary of the law and not as a substitute for tax or legal consultation in a particular case. Your comments and questions are always welcome.

Key Dissolution Concepts

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- “Liquidation”
 - Business sense – turning assets into cash
 - Tax sense – a process of ending the life of an entity
 - “Liquidating distributions” are made during the liquidation process
 - There can be a “de facto” liquidation

Key Dissolution Concepts

- “Dissolution”
 - A corporate law term meaning the formal end of the life of an entity
 - No such thing as a “de facto” dissolution
 - Tied to obligation to pay a franchise tax for the privilege of having a corporation, whether or not it is used.

Overview of the Dissolution Process

Overview of the Dissolution Process

1. Board adopts plan of liquidation
2. Shareholders approve it – **liquidation process starts**
3. Corporation files Form 966 with IRS
4. Corporation pays its debts and makes liquidating distributions to shareholders
5. Corporation dissolves and files final tax returns – **generally liquidation process ends**
6. Corporation can be sued for four years

Dissolution and Taxes

Dissolution and Taxes

- “Inside” tax
 - Tax on gain on the corporation’s assets deemed sold when distributed to the shareholders
 - Exception: Section 332/337 liquidation of a subsidiary
 - Cash method receivables are realized if distributed in liquidation

Dissolution and Taxes

- “Outside” tax
 - Liquidating distributions are taxed as if the shares were sold for a price equal to the value of the distributed assets
 - Basis reduces gain; low long-term capital gain rates can apply
 - Shareholders take a fair market value basis in the distributed property

Dissolution and Taxes

- “Outside” tax
 - File Form 966 with the IRS to evidence that a plan of liquidation has been adopted by the shareholders and that subsequent distributions will be “liquidating distributions”

Dissolution and Taxes

- “Outside” tax
 - “Open transaction” treatment allows a shareholder to apply all basis to the first gain, if total gain on liquidation is uncertain
 - If it’s really a “liquidation-reincorporation,” the distributions are taxable as ordinary dividends

Dissolution and Taxes

- “Outside” tax
 - No outside gain to corporate parent in a Section 332 liquidation of a subsidiary
 - Carryover basis in the distributed assets
 - Attribute carry over, too
 - *Minority shareholders in the sub DO recognize gain on their liquidating distributions*

Dissolution and Taxes

- S corporations
 - Non-liquidating distributions might be tax-free distribution of corporate earnings – so defer the liquidation?
 - The inside gain can be subject to the “built-in gain” tax
 - Key concept - Outside share basis increases for every dollar of inside gain

Dissolution and Taxes

- Installment receivables
 - Defer liquidation until they are collected to avoid accelerating deferred *inside* gain
 - Exception: Section 332 liquidation
 - Exception: S corporation with no built-in gain
 - Outside gain *can* be deferred

Dissolution and Taxes

- Personal holding company
 - Liquidate to avoid double tax on forced dividends?
 - Gain recognized sooner, but basis applies to reduce gain
 - Ordinary dividends will be taxed later, but without reduction for basis
 - Consider S corporation election

Dissolution and Taxes

- *Arrowsmith* and capital loss
 - “Inverse” of capital gain on liquidating distribution is capital loss on pay-back by shareholder to (or for) the corporation
 - Capital loss is not very useful
 - Consider instead deferring final liquidating distribution – until the claim is resolved

Dissolution and Taxes

- Section 1244 stock
 - Capital loss becomes more useful ordinary loss
 - No need to adopt a “section 1244 plan”
 - Do need a formal liquidation
 - Not “de facto” liquidation
 - File Form 966 *before* making liquidating distributions

Dissolution and Taxes

- California sales tax
 - No sales tax on liquidating distributions
 - Unless:
 - The shareholders assume debt of the corporation, or
 - The distributions are not made in proportion to share ownership
 - The “occasional sale” rule can apply

Dissolution and Taxes

- California property tax
 - No reassessment if property is distributed in *exact* proportion to share ownership
 - Concerns:
 - *Share* transfers just *before* the distribution
 - *Property* transfers just *after* the distribution

The Zero Tax Liquidation of an S Corporation

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The Zero Tax Liquidation of an S Corporation

Situation: Sole shareholder of S corp dies. Heir wants to *sell* asset. The S corp's asset would create long-term capital gain when sold. S corp has zero basis in asset.

Tip: Sell the asset *and distribute the sale proceeds in the same year*. There will be no income tax on the sale or distribution.

Zero tax *sale* of S corp asset

- Heir gets a basis step-up in stock to FMV – to \$100.
- S corp sells asset for \$100 cash
 - Inside gain of \$100 flows through to heir.
 - ☆ Heir's stock basis jumps from \$100 to \$200.
- *Same year:* Heir receives cash in liquidation of S corp.
 - Amount realized on distribution = \$100 cash
 - Basis in stock = \$200
 - ☺ \$100 *outside* capital loss on *distribution* offsets \$100 *inside* capital gain on *sale*.

Botched zero tax sale of S corp asset

- Heir gets a basis step-up in stock to FMV – to \$100.
- S corp sells asset.
 - Inside gain of \$100 flows through to heir.
 - Heir pays tax on capital gain.
 - Heir's stock basis jumps from \$100 to \$200.
- ***Next year:*** Heir receives cash in liquidation of S corp.
 - Amount realized on distribution = \$100 cash
 - Basis in stock = \$200
 - ☆ ***\$100 outside capital loss on distribution.***
 - ☹ **No offset or carry back!**

Preserving NOLs in a Sub-into-Parent Liquidation

Sub-into-Parent Liquidation

Situation: Parent Corp has pumped cash into its subsidiary but Sub's business failed. Sub is indebted to Parent for more than Sub's assets are worth. Sub has lots of unexpired NOLs.

Issue: How to dispose of Sub?

Intuitive: Merge Sub into Parent?

Not so fast....

Sub-into-Parent Liquidation

How to dispose of an insolvent Sub with NOLs?

- The Sub => Parent merger is a failed Section 332 liquidation
 - The NOLs won't survive
- Better: Merge Parent => Sub and re-name Sub with Parent's name
 - This is a good Type A reorg
 - The NOLs will survive

Sub-into-Parent Liquidation

- California property tax issue
 - The sub must be 100% owned to avoid a reassessment
 - vs. 80% or more owned to qualify for IRC Sections 332/337

Dissolutions and Corporate Law

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Dissolutions and Corporate Law

- Directors adopt a “plan of liquidation”
- Shareholders approve the plan
 - At least 50% for a voluntary dissolution
 - Other 50% can buy “dissolver” out for appraised value in cash
 - Or court orders it, when at least 1/3 of the shares ask for it and show good cause
 - Or any shareholder of a “close corporation”

Dissolutions and Corporate Law

- Officers must advise known creditors that the corporation has adopted a plan of liquidation
 - It is the duty of the officers and directors to assure that creditors are paid before shareholders receive liquidating distributions
 - Officers should do a UCC-1 and lien search
 - Chapter 500 limitations on distributions do not apply to liquidating distributions
 - No need for positive retained earnings after the liquidating distributions

Dissolutions and Corporate Law

- All known corporate debts must be paid or provided for
 - Consider tax for final year
 - Consider buying “tail” insurance
 - Directors must swear that this has been done

Dissolutions and Corporate Law

- Certificate of Dissolution
 - When this is filed with the California Secretary of State, the corporation is dissolved
 - The final tax returns are due 2 full months and 15 days later. For a 1-6-05 dissolution, the due date is 4-15-05.

[REDACTED]

CERTIFICATE OF DISSOLUTION
OF

ENDORSED - FILED
In the office of the Secretary of State
of the State of California

JAN - 6 2005

[REDACTED]
a California corporation

KEVIN SHELLEY
Secretary of State

[REDACTED], [REDACTED] and [REDACTED]
certify that:

1. They are all of the directors of [REDACTED] Inc., a California corporation.
2. The corporation has been completely wound up.
3. The corporation's known debts and liabilities have been actually paid.
4. The known assets have been distributed to the persons entitled to them.
5. The election to dissolve was made by the vote of all of the outstanding shares of the corporation.
6. The corporation is dissolved.

We further declare under penalty of perjury under the laws of the State of California that the matters set forth in this certificate are true and correct of our own knowledge.

SIGNED at Valencia, California on December 30, 2004.

[REDACTED]
[REDACTED], Director

[REDACTED]
[REDACTED], Director

[REDACTED]
[REDACTED], Director





SECRETARY OF STATE

I, *Kevin Shelley*, Secretary of State of the State of California, hereby certify:

That the attached transcript of ... *1* ... page(s) has been compared with the record on file in this office, of which it purports to be a copy, and that it is full, true and correct.

IN WITNESS WHEREOF, I execute this certificate and affix the Great Seal of the State of California this day of

JAN 14 2005



Kevin Shelley
Secretary of State

Dissolutions and Corporate Law

- Tax Clearance Certificate
 - The dissolution is conditioned on receiving a Tax Clearance Certificate from the California Franchise Tax Board
 - A request for the TCC must be filed with the Certificate of Dissolution (for for-profit corporations)
 - The California taxes must be assumed, or a bond must be filed, or the certificate may be requested on a “taxes paid” basis (that is, issued after the final return is filed and the FTB decides whether to audit the corporation).



STATE OF CALIFORNIA
FRANCHISE TAX BOARD
PO BOX 1468
SACRAMENTO CA 95812-1468

TAX CLEARANCE CERTIFICATE

September 27, 2005

WILLIAM C STALEY
6303 OWENSMOUTH AVE 18TH FLR
WOODLAND HILLS CA 91367

ISSUED TO : [REDACTED]
ENTITY ID : [REDACTED]

Our records show that the Secretary of State established a conditional dissolution date for your business entity. Once the Secretary of State receives and files a copy of this Tax Clearance Certificate, your business entity will be officially closed as of the conditional dissolution date.

If you provided an assumer with your request for tax clearance, the assumer must ensure that the state income tax returns for your business entity are (or have been) filed with the Franchise Tax Board through the dissolution date established by the Secretary of State. Additionally, the assumer must ensure that all state income tax liabilities are paid in full.

By issuing this Tax Clearance Certificate, we certify that you have either paid all taxes imposed on your business entity or that you have secured them by providing an assumer, bond, or cash deposit. However, the business entity, its assumers, or transferees still remain liable for any subsequent assessments during the applicable statute of limitations.

We sent a copy of this certificate to the California Secretary of State. Please keep this original for your records.

Tax Clearance Unit
Taxpayer Services Center
Telephone (800) 852-5711

Dissolutions and Corporate Law

- Nonprofit Public Benefit Corporations
 - The Attorney General must approve the distribution of assets *before* the Secretary of State will file the Certificate of Dissolution
 - The Attorney General checks to see that the distribution is consistent with the dissolution clause in the articles of incorporation
 - For all California nonprofit corporations, it also is necessary to get a TCC *before* filing the Certificate of Dissolution

BILL LOCKYER
Attorney General

State of California
DEPARTMENT OF JUSTICE



1300 I STREET
P.O. BOX 903447
SACRAMENTO, CA 94203-4470
Public: (916) 445-2121
Facsimile: (916) 444-2651
email: dissolution@doj.ca.gov

██████████, 2005
WILLIAM C STALEY
██████████
██████████
██████████

RECEIVED

JUL 17 2005

WILLIAM C STALEY

RE: Dissolution of ██████████
Our File Number ██████████

Dear Ma./Mr.:

We have reviewed your dissolution notice or request and we note incomplete financial records or data.

However, based on your representations in the "Certificate to the California Attorney General," the Attorney General's office waives notice of the dissolution and the disposition of the corporation's assets upon dissolution pursuant to California Corporations Code section 6716 (section 8716 for mutual benefit corporations).

The corporation may proceed to complete its dissolution through procedures with the California Secretary of State.

AFTER the Secretary of State has endorsed the corporation's Certificate of Dissolution, please submit a copy of it to this office.

Sincerely,

Gena Ensey
Staff Services Analyst

For **BILL LOCKYER**
Attorney General

Dissolutions and Corporate Law

- The Four-Year Rule
 - Claims can be made against the corporation for up to four years after the certificate of dissolution is filed
 - The they are barred
 - Creditors of the dissolved corporation can get up to the amount distributed to a shareholder in liquidation – *any* shareholder
 - There is a right of contribution from the other shareholders

Dissolutions and Corporate Law

- The Four-Year Rule
 - Note the tension between:
 - The four-year rule (Dissolve now!) and
 - The *Arrowsmith tax* rule (Never dissolve! Never distribute all of the assets, to avoid later capital loss)

Dissolutions and Corporate Law

- Liquidating trusts and LLCs
 - Sometimes the directors do not want to (or cannot) distribute the assets to the shareholders, but they want the four-year clock to start
 - It is possible to distribute some of the assets to a trust or LLC, if the shareholders approve it
 - The trust or LLC generally dissolves when it sells its assets or, if later, when the four years end

Dissolutions and Corporate Law

- Stock certificates
 - When the corporation dissolves, it is a good idea to mark “CANCELLED” across the face of the outstanding stock certificates, collect them and insert them in the stock book
 - Otherwise, an heir might find the certificate and waste time and money looking for the corporation

Dissolutions and Corporate Law

- Let it die on the vine? No.
 - Too many loose ends
 - Too many letters from the Secretary of State and Franchise Tax Board
 - Minimum taxes accrue, with interest and penalties
 - The corporation cannot defend lawsuits or enforce contracts or protect its name while it is suspended
 - Heirs and executors will fret about it
 - Better: decide to dissolve and JUST DO IT

Dissolving Partnerships

- General partners
 - Any **negative capital accounts** to pay back?
 - File Form GP-4 for a general partnership, or for LP-3 for a limited partnership to dissolve it
 - There is no “dying on the vine” for LPs because the GP is liable for all of the minimum tax, interest and penalties

Dissolving Partnerships

- General partners
 - If there is a statement of partnership recorded in a county, record the file-stamped GP-4 or LP-3 there, or a notice that the partnership has dissolved
 - If there is a fictitious business name filing in effect, file a notice abandoning the name

Dissolving LLCs, PCs and LLPs

Dissolving LLCs, PCs and LLPs

- LLCs
 - The process is similar to a limited partnership, but there is no GP with unlimited liability
- PCs and LLPs must also file with their licensing authorities
- Partnerships and LLCs – read the partnership or operating agreement
- “Close corporations” – read the shareholders agreement

The Merger Alternative

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The Merger Alternative

- Rather than dissolve, consider merging into another entity
 - Easy asset transfer and liability assumption
 - No need to advise creditors (but consider whether the merger is an event of default)
 - NOLs can survive (if done right)
 - No four-year rule to limit liability
 - Corporation => partnership or LLC merger (or conversion) is a *taxable* liquidation of the corporation

Keeping the Name

Keeping the Name

- Unless there is another related entity that will survive and should use the corporate name, a unrelated entity cannot be prevented from using the name of the dissolved entity
- Customer confusion can be prevented under trademark law
 - The best way to protect the name is a federal trademark registration
 - A “fictitious business name” (or “dba”) filing provides much weaker protection

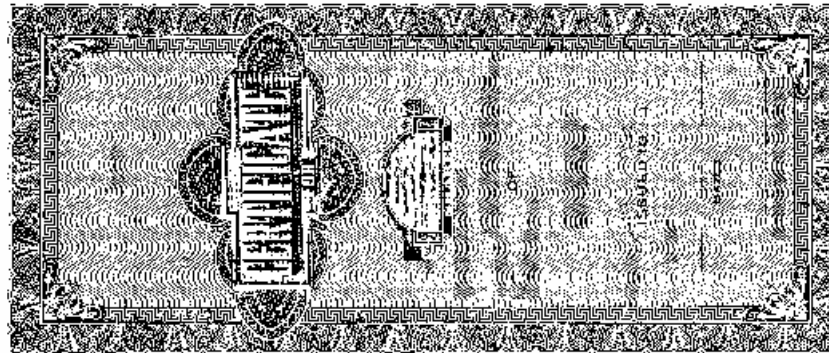
Corporate Housekeeping – Stock Certificates

Stock Certificates

- Critical record of ownership, like a deed to a home
 - There is no title insurance for shares of closely-held businesses
- When a business sells, the buyer's attorneys will review the seller's stock records in the due diligence process
 - They might ask the seller's attorney for a legal opinion that the shares are "duly issued"
 - Sometimes that is tough

OWNERSHIP OF THIS CERTIFICATE AND THE SHARES EVIDENCED BY IT ARE SUBJECT TO RESTRICTIONS ON TRANSFER AND MAY NOT BE SOLD, TRANSFERRED, ASSIGNED, PLEDGED, HYPOTHECATED OR OTHERWISE DISPOSED OF, EXCEPT AS PROVIDED IN THE 2005 BUY-SELL AGREEMENT FOR WIDGET CORPORATION DATED APRIL 13, 2005, A COPY OF WHICH AGREEMENT IS ON FILE AT THE CORPORATION'S PRINCIPAL OFFICE AND ALL OF THE TERMS OF WHICH ARE MADE A PART OF THIS CERTIFICATE BY THIS REFERENCE.

OWNERSHIP OF THIS CERTIFICATE AND THE SHARES EVIDENCED BY IT ARE SUBJECT TO RESTRICTIONS ON TRANSFER AND MAY NOT BE SOLD, TRANSFERRED, ASSIGNED, PLEDGED, HYPOTHECATED OR OTHERWISE DISPOSED OF, EXCEPT AS PROVIDED IN THE 2005 BUY-SELL AGREEMENT FOR WIDGET CORPORATION DATED APRIL 13, 2005, A COPY OF WHICH AGREEMENT IS ON FILE AT THE CORPORATION'S PRINCIPAL OFFICE AND ALL OF THE TERMS OF WHICH ARE MADE A PART OF THIS CERTIFICATE BY THIS REFERENCE.



*The Value Received, _____ hereby well, assign, and transfer
unto _____
represented by the within Certificate, and do hereby
irrevocably constitute and appoint _____ Attorney
to transfer the said Shares, in the books of the within named
Corporation, with full power of substitution, in the premises.
Dated _____
In presence of _____*

WILLIAMSON & COMPANY, INC. 1000 W. 10TH AVENUE, SUITE 1000, DENVER, CO 80202
TELEPHONE: 303.733.1000 FAX: 303.733.1001
WWW.WILLIAMSONANDCOMPANY.COM

STOCK ASSIGNMENT SEPARATE FROM CERTIFICATE

WIDGET CORPORATION

From Stock Certificate Number 1

FOR VALUE RECEIVED, Bill Staley ("Transferor") hereby sells, assigns and transfers to Cecelia Staley 100 shares of the capital stock of Widget Corporation, a California corporation ("Issuer"), standing in the name of Transferor on the books of Issuer and represented by Issuer's stock certificate number 1.

SIGNED at Woodland Hills, California.

Dated: April 14, 2005

BILL STALEY

See legend on reverse.

THE TRANSFER OF SECURITIES EVIDENCED HEREBY IS RESTRICTED AS SET FORTH ON THE REVERSE HEREOF

CERTIFICATE
WITH GUARANTEE OF AUTHENTICITY

100 SHARES

For 100 Shares
Issued to
Cecelia Staley

Dated April 14, 2005
FROM WHOM TRANSFERRED

Bill Staley

Dated April 13, 2005

No. ORIGINAL CERTIFICATE	No. ORIGINAL SHARES	No. OF SHARES TRANSFERRED
1	1,000	100

Received Certificate No. 2
For 100 Shares
this 14th day of April, 2005

CECELIA STALEY



See legend on reverse.

THE TRANSFER OF SECURITIES EVIDENCED HEREBY IS RESTRICTED AS SET FORTH ON THE REVERSE HEREOF

CERTIFICATE
NO. 10000001

For 900 Shares
 Issued to
 Bill Staley

Dated April 14, 2005
 FROM WHOM TRANSFERRED

Bill Staley

Dated April 13, 2005

No. ORIGINAL CERTIFICATE	No. ORIGINAL SHARES	No. OF SHARES TO APPROPRIATE
1	1,000	900

Received Certificate No. 3
 For 900 Shares
 this 14th day of April, 2005

BILL STALEY



FORM NO. 10000001

ATTORNEYS: CUMMINGS & STRONG, INC., SAN FRANCISCO

Share Register

Certificate No.	Date	Shares	Outstanding Shares	Issue	Status of Cert.	Transfer Date	Transferee
	4/12/2005			Incorp			
1	4/13/2005	1,000		Bill Staley	CANCELLED	4/14/2005	to Cecelia
2	4/14/2005	100	100	Cecelia Staley (from #1)	OUTSTANDING		
3	4/14/2005	900	900	Bill (balance from #1)	OUTSTANDING		
			1,000	now outstanding			

Stock Certificates

- There must be assignments to reflect each transfer
 - An assignment form separate from the certificate is best because once the certificate is signed, it is forever
- All of the stock certificates back to the first issuance should be reflected in the stock book, in which should be:
 - All of the signed receipt stubs
 - All of the cancelled stock certificates
 - All of the blank stock certificates

Stock Certificates

- When a stock certificate is lost, the owner of it should sign an affidavit of lost stock certificate, which should be placed in the stock book where the certificate would have gone
 - A replacement certificate should be issued immediately

Stock Certificates

- If there are gaps in the stock records, it is best to get declarations from everyone living who has ever been an officer or director of the corporation, to state their knowledge of the share history
 - Without this, it is difficult to opine that all of the current shareholders can be identified
 - The sooner this is done, the better.
 - The declarations should be kept in the minute book, unless those that address a specific certificate, which should be kept in the stock book in that certificate's place

Corporate Housekeeping – Minutes

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Minutes

- The Board of Directors is charged with supervising the officers of the corporation
- The officers manage the day-to-day activities of the corporation
- The shareholders elect the directors
- The directors elect the officers, who hire the employees

Minutes

- Generally, boards should meet at least annually, but seldom more frequently than quarterly
 - Minutes of each meeting should be prepared, signed by the corporate secretary and the president, and kept in the minute book
 - Notices of the meeting, or written waiver of notice should also be kept in the minute book
 - The corporate secretary should sign an affidavit of sending notice and insert it in the minute book, unless all of the directors attend or provide waivers of notice of the meeting

Minutes

- Minutes should cover the election of officers and the approval of major contracts and borrowings
- Minutes should reflect that the president or CFO reported on the corporation's finances and that the president or a VP reported on operations and growth plans
- Minutes should tread lightly on subjects on which the corporation or the board could be sued
- Each and every distribution should be approved by the board, to minimize the risk of "piercing the corporate veil"

Minutes

- Minutes should also be prepared for shareholders meetings
 - Generally, the shareholders elect directors and not much else ...
 - Unless the bylaws or articles are amended, the corporation merges, sells substantially all of its assets or dissolves
 - Shareholders sometimes approve transactions between an officer or director and the corporation, but not compensation arrangements

Minutes

- It is a good practice to have “outside directors” who are not employees of the business or related to the principal shareholders
 - It is a good practice for the outside directors to sit on a compensation committee to set the compensation packages of the officers
 - This is now required for publicly held corporations and many nonprofit corporations
 - Outside directors can be very helpful in a transition from one generation of management to the next

A thought ...

- It would not be a bad idea to work with a law firm that is familiar with these things and can help you get them done right

Thank you

Bill Staley

Attorney

Woodland Hills, California

818 936-3490

www.staley.com

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2/06	Transferring a Business to the Next Generation *Van Nuys*
4/06	Selling a Business *Torrance*
6/06	Private Foundations and Community Foundations
8/06	Giving Stock to Employees – and Other Incentive Programs
10/06 and 2/07	Reorganizing a Business for Growth
4/07	Selling a Business
6/07	Selling the Business to a Family Member
8/07	Effective Boards of Directors for Nonprofit Organizations