S CORPORATIONS
– BASIS AND DISTRIBUTIONS –
CASE STUDIES

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This outline should be viewed only as a summary of the law and not as a substitute for legal or tax consultation in a particular case. Your comments would be appreciated and are invited.

Law Office of William C. Staley

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This law office provides expert tax and legal advice and prepares documents for tax-related business transactions and nonprofit organizations. Core areas of practice are:

Business Entities

- *Choosing the right entity*
- *Organizing, reorganizing and dissolving entities*
- *Creating holding companies to isolate liabilities*

Business Transitions

- *Selling a business*
- *Mergers and acquisitions*
- *Buy-sell agreements among business owners*
- *Transferring a business to the next generation*
- *Giving stock to employees and family*

Nonprofit Organizations

- *Establishing new organizations*
- *Public charities, private foundations, trade associations*
- *Resolving difficult tax and board issues, including compensation*
- *Reorganizing and dissolving organizations*

Outside general counsel role

- *Ongoing legal representation for business owners and nonprofits*
- *Introducing owners and managers to other legal and tax specialists, investment bankers and consultants as needed (see www.californiataxattorney.com)*

Special Counsel Role

- *Providing tax advice about specific transactions*
- *Resolving complex situations requiring extensive analysis, business, law and tax experience, sometimes involving difficult people*

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1. S CORP STOCK BASIS – THE FUNDAMENTALS

1.1(a) *Increases* for capital contributions, expenses of defending title to the stock and aborted stock sales

1.1(b) *Increases* for S corp income.

1.1(c) *Decreases* for losses.

- Cannot decrease below zero.
- Losses in excess of a shareholder's stock basis reduce the basis of that shareholder's loans, if any, to the corporation.
  - o This raises the issues of paybacks and dispositions of low basis loans.
  - o Also the issue of restoring basis as a result of S corp income in later years.
- Losses in excess of a shareholder's basis in stock and loans are suspended.
  - o Other tax rules can also suspend losses -- the at risk and passive activity loss rules.
  - o Which leads to the issue of the order in which suspended losses are released, if they are suspended under more than one rule. (Basis, then at risk, then passive losses. Now you know.)

- It also raises the issue of what happens to the suspended loss when the stock changes hands with suspended losses.

  - Death
  - Divorce
  - Bankruptcy
  - Gifts
  - Sales

1.1(d) *Decreases* for distributions.

2. S CORP STOCK DISTRIBUTIONS – THE FUNDAMENTALS

Does the S corp have C corp e&p?

2.1(a) **No C Corp e&p**

- Tax-free distributions first reduce stock basis.
- Then taxable as capital gain to the extent that distributions exceed basis.

2.1(b) **Has C Corp e&p**

- Corporation maintains an "accumulated adjustment account" ("**AAA**").
  - *Increases* by S corp income
  - *Decreases* by S corp losses and distributions
  - Distributions cannot cause the AAA to be negative
  - Losses *can* cause the AAA to be negative.

- Tax-free distributions first reduce AAA.

- When AAA is reduced to zero, distributions become taxable and burn through the C corp e&p.

    - o The sole function of the AAA account is to determine which S corp distributions are tax free and which are taxable.

    - o A taxpayer can elect to take out the taxable e&p first. This can be done without even receiving an actual distribution.

        - A shareholder might want to do this while tax rates on dividends are low to avoid passive receipts problems, since excess passive receipts are troublesome only if the S corp has C corp e&p.

- If distributions exceed the AAA account and the C corp e&p, they become tax-free to the extent of the remaining stock basis.

- Distributions that exceed the AAA, the C corp e&p and the stock basis are taxable as capital gain.

3. CASE STUDY: INCOME, DISTRIBUTION, LOSS

Operating S Corporation ("**OPSC**") was a C corporation until it elected S corporation status as of January 1, 2005. OPSC has $1.5 million in undistributed C corp earnings and profits. It is engages in a manufacturing business. In 2005 OPSC has income of $300,000. On December 31, 2005 its AAA account is $300,000. On March 16, 2006 OPSC distributes $100,000 to its shareholder. In June, 2006 OPSC has a fire in the plant and loses its big customer. For 2006 OPSC has a $500,000 loss.

Old Law

Under the 1982 S corp law, distributions were tested at year end.

1-1-05 AAA	0
2005 income	$300,000
1-1-06 AAA	$300,000
2006 loss	($500,000)
1-1-07 AAA	($200,000)

Since there is no AAA at 12-31-06, *the 3-16-06 distribution is not tax-free from AAA, but taxable from C corporation e&p*. The 1996 law corrected this. Note – the $200,000 distribution does not reduce the AAA to ($300,000) because distributions cannot reduce AAA below zero.

After 1996

Under the 1996 S corp law, AAA is adjusted for distributions before it is adjusted for income or loss.

1-1-05 AAA	0
2005 income	$300,000
1-1-06 AAA	$300,000
3-16-06 distribution	($100,000)
3-17-06 AAA	$200,000
2006 loss	($500,000)
12-31-06 AAA	($300,000)

Since the 3-16-06 distribution comes out of positive AAA, it is tax-free. The bad news is that since it uses some AAA, the operating loss drives the AAA to ($300,000).

4. CASE STUDY: ZERO TAX LIQUIDATION OF AN S CORPORATION

See the 4 attached pages.

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.

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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*.

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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!

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Zero tax *distribution (not sale)* of S corp asset

- Distribution of the appreciated asset (vs. sale and distribution of proceeds)

  ☆ The timing can't be botched, because the inside gain and outside loss result from the same event – the distribution of the asset

  ☺ So the inside gain and outside loss occur at the same time

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5. CASE STUDY: ENTITY PURCHASE VS. CROSS PURCHASE BUY-SELL AGREEMENT FOR AN S CORPORATION

When life insurance is used to fund the buy-sell agreement, the "entity purchase vs. cross purchase" issue must be addressed when the agreement is drafted. This case study considers this issue.[1]

Scenario

Five shareholders: B, C, D, E and F, each with 20 shares of S Corp.

Tax basis of each shareholder in his 20 shares at the end of 2003: $20,000.

Value of a block of 20 shares in 2004: $400,000

Value of S Corp. at the end of 2004: $3 million[2]

Variation 1: Entity Purchase

S Corp. owns a $400,000 life insurance policy on each shareholder.

F dies in 2004. F's estate gets a new basis of $400,000 in the 20 shares.

S Corp. receives life insurance proceeds of $400,000, which increases the basis of each of the *five* shareholders by $80,000 each.[3] So the new basis of B, C, D and E's 20 shares each is $100,000 each ($20,000 initial basis + $80,000 from the life insurance proceeds). The new basis of F's estate is $480,000 ($400,000 stepped-up basis + $80,000 from the life insurance proceeds).

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[1] If the buy-sell agreement is not funded by life and/or disability insurance, the agreement can be drafted to defer the issue until a triggering event occurs.

[2] In valuing each block of shares, they used a 20% discount for lack of a liquid market for the shares and a 16% discount because no block controlled S Corp.

[3] Note that S Corp.'s accumulated adjustment account does *not* increase.

S Corp. buys the 20 shares from F's estate for $400,000 (their value), so the estate has a capital *loss* of $80,000 (the amount realized is $400,000, the basis is $480,000). Because all of the estate's assets were adjusted to their value at the date of death, the estate has no capital gain to offset the capital loss, and the loss is *permanently wasted*.

Observation: *Entity purchases always waste basis.*

B, C, D and E then sell all of their shares to BigCo for $3 million, or $750,000 each. They each have a $650,000 gain and, at a combined federal and California 24% tax rate, pay tax of $156,000 each.

B and C each buys from S Corp. the policies on his life, taking it as separate property, not community property, to avoid "transfer for value" problems. D and E do not need additional life insurance, so S Corp. surrenders their policies to the insurance company and receives their cash value.

Variation 2: Cross Purchase

B, C, D, E and F each owns a $100,000 policy on each other. So B owns four $100,000 policies: on C, D, E and F. There are 20 policies,[4] providing $2 million in coverage (20 x $100,000). S Corp. does not own any life insurance.

F dies in 2004. F's estate gets a new basis of $400,000 in the 20 shares.

B, C, D and E each receives insurance proceeds of $100,000.

B, C, D and E each uses the proceeds to buy a block of five shares from F's estate for $100,000 per block. F's estate receives $400,000 for the 20 shares, so it has *no gain or loss*.

B, C, D and E each now has his original 20-share block with a basis of $20,000 and a new five-share block with a basis of $100,000.

4 N x (N-1), where N = number of shareholders.

B, C, D and E then sell all of their shares to BigCo for $3 million, or $750,000 each. They each have a $630,000 gain ($750,000 - $120,000) and, at a 24% tax rate, pay tax of $151,000.

Observations:

B, C, D and E *each* saves $5,000 on the sale of their S Corp. stock as a result of using the cross-purchase arrangement rather than the entity purchase. They save taxes because the $80,000 tax basis allocated to F's estate in Variation 1 is *wasted* in the entity purchase, but there is *no wasted basis* in Variation 2.

In Variation 1 S Corp. was 100% insured. (That is, it expects to pay $400,000 to buy out a shareholder and it carries life insurance with a face value of $400,000 on each shareholder.) The lower the portion of the purchase price that S Corp. insures, the greater the relative benefit of the cross purchase. This is because the less insurance S Corp. carries, the less basis the shareholders receive when S Corp. gets the insurance proceeds, so the greater the shareholder's tax on an eventual sale of the company.

Insurance	**Additional tax**	
	Total	**Per shareholder**
$ 400,000	$ 19,200	$4,800
$ 300,000	$ 38,400	$9,600
$ 200,000	$ 57,600	$14,400
$ 100,000	$ 76,800	$19,200
$ -	$ 96,000	$24,000

The difference between cross-purchase and entity purchase is even more dramatic for C corporations:

- The shareholders do not get any basis increase when the C corporation receives the policy proceeds.

- The C corporation is subject to alternative minimum tax on its receipt of the life insurance proceeds (and on increases in the cash value of the policy over the cumulative premiums paid). Neither S corporations nor individuals are subject to the adjustment that triggers this tax.

The above results are the same whether the policy is term or permanent life insurance.

[End of outline.]

ADDITIONAL INFORMATION

If you would like to receive additional information about these issues, please check the appropriate box(es) below, provide your address (or attach your business card) and return this sheet to the speaker -- or FAX it to Susan Rognlie at (818) 936-2990.

1. ☐ **Buy-Sell Agreements for Owners of a Closely-Held Business**
2. ☐ **Disregarded Entities: Working with Single-Member Limited Liability Companies and Qualified Subchapter S Subsidiaries***
3. ☐ **Five Expensive Mistakes Business Owners Should Avoid***
4. ☐ **Hot Tax Planning Tips and Strategies***
5. ☐ **Limited Liability Companies: An Introduction***
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* Available on www.staleylaw.com