CHAPTER 14

Redemptions and Purchases of S Corporation Stock

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§ 14.01 INTRODUCTION

Redemptions and purchases of stock, and in particular, S corporation stock, can raise a number of tax issues for the seller, the purchaser, the corporation itself and even the shareholders of the corporation not directly involved in the sale, purchase or redemption. Practitioners should be well versed in the rules applicable to redemptions and purchases of stock in order to take full advantage of planning opportunities and to avoid serious pitfalls for the uninformed.

§ 14.02 REDEMPTIONS

[1] In General

Income tax planning for a redemption is more complicated than that required for a cross-purchase,[1] as it involves consideration not only of the economics of the transaction, but also the character of the income or gain realized and recognized and the ability to offset such gain against the seller's adjusted basis in the shares which are sold or redeemed. The rules of Sections 302(b) and 303, by which "sale or exchange" treatment may be obtained, are complicated, and any redemption must be carefully designed to assure that the redemption of a shareholder's stock will qualify for sale or exchange treatment. The practitioner must consider the probable situations under which a redemption is likely to occur, and whether sale or exchange treatment is likely to be available. If it is clear to the practitioner that sale or exchange treatment will not be available and it is desirable for the redemption to qualify for sale or exchange treatment, a cross-purchase should be utilized.

[2] Impact on Redeemed Shareholder

[a] *C Corporation Shareholders*

Unless a redemption meets the requirements of Section 302(b) or 303, a corporate distribution in redemption of stock is taxed as a dividend to the redeemed shareholder: 15% dividend rate to the extent of the corporation's earnings and profits, without regard to the shareholder's basis.[2] Prior to the Jobs and Growth Tax Relief Reconciliation Act of 2003,[3] dividend treatment was even more disadvantageous since dividends were treated as ordinary income subject to a maximum marginal individual tax rate of 35%.

[i] *Dividend Treatment*

Dividend treatment can be particularly disastrous with respect to post-mortem redemptions, since the estate of a deceased

[1] I.R.C. § 3.01, *infra*, for a discussion of the tax issues relating to cross-purchase arrangements.

[2] I.R.C. §§ 302(d), 301 and 302. Such income, either dividend income or capital gain, constitutes portfolio income under I.R.C. § 469.

[3] Pub. L. No. 108–27 (2003).

shareholder would normally recognize no taxable gain on a sale or exchange of stock.

Example. A is a shareholder of the ABC Corporation, a C corporation. Pursuant to a redemption agreement, A's stock is to be redeemed after his death for $500,000 ($500 per share for his 1,000 shares). The corporation has substantial accumulated earnings and profits. If the redemption is taxed as a sale or exchange of the stock in accordance with Section 302(a) or 303, the estate recognizes no gain because its income tax basis is $500 per share pursuant to Section 1014 (the same as the sales price). If the redemption is taxed as a dividend under Section 302(d), however, the estate has $500,000 of dividend income, without regard to its basis and a corresponding $500,000 long-term capital loss.[4]

[ii] *Importance of Sale or Exchange Treatment*

Avoiding dividend equivalence in a redemption is critical because of the ability to benefit from a shareholder's basis in his or her shares. The primary reason for avoiding dividend treatment is the ability to receive basis tax-free in a redemption treated as an exchange, in contrast to a dividend equivalent redemption whereby basis is not recovered until (and unless) the corporation has distributed all of its earnings and profits. Any residual unrecovered basis constitutes long-term capital loss, which by virtue of the limitation contained in Section 1211(b)[5], may be of limited utility.

Practitioners must keep in mind that the 15% dividend tax rate of Section 1(h)(11) is scheduled to sunset for tax years beginning after December 31, 2008, although legislative proposals have been made to eliminate or defer the sunset date. If the dividend tax rate returns to a level higher than the capital gains tax rate, then achieving sale or exchange treatment on a redemption of stock will become even more important. because there will again be a significant differential between the tax rate applicable to dividends and the tax rate applicable to capital gains.

If the purchase price is to be paid over a period of years, sale or exchange treatment will also qualify the sale for installment

[4] I.R.C. § 1244(d)(4) (estate not eligible for I.R.C. § 1244 loss treatment).

[5] I.R.C. § 1211(b) provides that capital losses may only offset up to $3,000 of ordinary income for each tax year.

reporting under Section 453 provided the stock is not publicly traded.

[iii] *Sale or Exchange Treatment*

Section 302(a) provides that if a corporation redeems its stock and Section 302(b)(1), (2), (3) or (4) applies, such redemption will be treated as a distribution in part or full payment in exchange for the stock (i.e., "sale or exchange treatment"). A redemption is treated as a sale or exchange of a shareholder's stock under Section 302(b) if it: (1) is not essentially equivalent to a dividend;[6] (2) is substantially disproportionate;[7] (3) completely terminates the shareholder's interest in the corporation;[8] or (4) is of stock of a noncorporate shareholder in partial liquidation of the redeeming corporation.[9]

Of these four categories, the substantially disproportionate and complete termination exceptions are the most useful for advance planning purposes, since they operate with mathematical precision. However, in proper circumstances, a redemption can qualify as not essentially equivalent to a dividend. This determination, however, is made on a case-by-case basis, looking at all of the relevant facts and circumstances.[10] Thus, it is less useful for planning purposes than the substantially disproportionate redemption or the complete termination of interest categories.

[iv] *Substantially Disproportionate Redemption*

A redemption is substantially disproportionate for purposes of Section 302(b)(2) if it meets the following requirements:

1. Immediately after the redemption, the shareholder must own (directly or constructively) less than 50% of the total combined voting power of all classes of outstanding stock entitled to vote.
2. The shareholder's percentage of the total outstanding voting stock immediately after the redemption must be less than

[6] I.R.C. § 302(b)(1).

[7] I.R.C. § 302(b)(2).

[8] I.R.C. § 302(b)(3).

[9] I.R.C. §§ 302(b)(4) and 302(e).

[10] Reg. § 1.302-2(b).

80% of his percentage of ownership of such stock immediately before the redemption (i.e., the post-redemption ratio must be less than 80% of the pre-redemption ratio).

3. The shareholder's percentage of the total outstanding common stock immediately after the redemption must be less than 80% of his percentage of ownership of such stock immediately before the redemption.

Reg. Section 1.302-3(a) provides that if the corporation redeems only nonvoting stock, the redemption *cannot* qualify under Section 302(b)(2) because it will not reduce the shareholders' proportionate ownership of voting stock of the corporation. However, this regulation, known as the "piggyback regulation," also provides that a redemption of nonvoting stock can qualify if it is coupled with the redemption of voting stock that would qualify under Section 302(b)(2) if it stood alone.

Rev. Rul. 77–237[11] extended application of the piggyback regulation to a situation where the corporation redeemed nonvoting stock of one shareholder and voting stock of another shareholder, which redemption independently qualified under Section 302(b)(2), and such voting stock could be attributed under Section 318(a) to the shareholder whose nonvoting stock was being redeemed. In other words, Reg. Section 1.302-3(a) applies where the redemption of the voting stock is either actually owned or constructively owned by the shareholder whose nonvoting stock is being redeemed.

Rev. Rul. 81–41[12] provides that a redemption of voting preferred stock can qualify under Section 302(b)(2) even if the redeemed shareholder owns no common stock. Consequently, the requirement that in order to qualify as a substantially disproportionate redemption a shareholder's percentage of outstanding common stock after the redemption be less than 80% of his percentage of ownership of such stock before the redemption only applies if the shareholder owns some common stock of the corporation.

Section 302(b)(2)(D) provides that Section 302(b)(2) does *not* apply to any redemption made pursuant to a plan, the purpose or effect of which is a series of redemptions resulting in a distribution

[11] 1977–2 C.B. 88.

[12] 1981–1 C.B. 121.

which, in the aggregate, is not substantially disproportionate with respect to the shareholder.[13]

[v] *Complete Termination Redemptions*

Under Section 302(b)(3), sale or exchange treatment applies if a shareholder terminates his or her entire proprietary interest in the corporation as a result of the redemption. The simplest example of a complete termination redemption is where a corporation is owned by two unrelated shareholders and the corporation redeems all of the stock of one shareholder for cash. Although many Section 302(b)(3) redemptions will also qualify under Section 302(b)(2), the potential scope of Section 302(b)(3) is broader and could qualify a non-substantially disproportionate redemption of nonvoting stock or Section 306 stock.

[vi] *Attribution Rules*

Qualifying a redemption under either Section 302(b)(2) or 302(b)(3), especially in the context of a family corporation, may be difficult because of the application of the constructive ownership rules of Section 318. Section 302(c)(1) provides that Section 318(a) will apply in determining ownership of stock for purposes of Section 302. There are four major types of attribution under Section 318: family attribution, attribution from an entity, attribution to an entity and option attribution. Under Section 318(a)(5)(A), except as otherwise provided, stock constructively owned by a person by reason of the application of Sections 318(a)(1), (2), (3) or (4) will, for purposes of applying such sections, be considered as actually owned by such person.

Under the family attribution rule of Section 318(a)(1)(A), an individual is considered as owning the stock owned, directly or indirectly, by or for his spouse, children, grandchildren and parents. Section 318(a)(5)(B) provides that stock constructively owned by an individual by reason of application of the family attribution rules may *not* be considered as owned by him for purposes of again

[13] Rev. Rul. 85–14, 1985–1 C.B. 92 (a prohibited plan need be nothing more than a "design" by a single shareholder to arrange a redemption as part of a sequence of events that, ultimately, restores the control that was apparently lost in the redemption; a joint plan or agreement, between two or more shareholders, is not necessary).

applying the family attribution rules in order to make another the constructive owner of such stock (i.e., there is no double family attribution). Under Section 302(c)(2), under certain circumstances the family attribution rules may be waived in order to qualify a redemption as a complete termination of interest under Section 302(b)(3).[14] Additionally, Section 302(c)(2)(C) provides that under certain circumstances the family attribution rules may be waived by an entity.[15]

In general, under Section 318(a)(3), stock owned, directly or indirectly, by partners, beneficiaries, and shareholders is attributed to a partnership, estate, trust or corporation, respectively. Section 318(a)(3)(A) provides that stock owned, directly or indirectly, by or for a partner or a beneficiary of an estate shall be considered as owned by the partnership or estate. Reg. Section 1.318-3(a) provides that the term "beneficiary" includes any person entitled to receive property of a decedent pursuant to a will or pursuant to laws of descent and distribution. A remainderman is *not* considered a beneficiary of an estate since he has no direct present interest in the property nor in the income produced by such property. Section 318(a)(3)(B) provides that stock owned, directly or indirectly, by or for a beneficiary of a trust will be considered as owned by the trust, unless such beneficiary's interest in the trust is a remote contingent interest. A contingent interest of a beneficiary is remote if the value of such interest is 5% or less of the value of the trust property. Under Reg. Section 1.318-3(b), a remainderman ***is*** considered a beneficiary of a trust.[16] Section 318(a)(3)(C) provides that if 50% or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, such corporation shall be considered as owning the stock owned, directly or indirectly, by or for such person.

In general, under Section 318(a)(2), stock owned, directly or indirectly, by a partnership, estate, trust or corporation is attributed to such entity's partners, beneficiaries and stockholders, respectively. Section 318(a)(2)(A) provides that stock owned, directly or indirectly, by or for a partnership or estate shall be considered as owned proportionately by its partners or beneficiaries. Section 318(a)(2)(B) provides that stock owned, directly or indirectly, by or for a trust will be considered as owned by its beneficiaries in proportion to the actuarial interest of such beneficiaries in such trust. Section 318(a)(2)(C) provides that if 50% or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, such person will be considered as owning the stock owned, directly or indirectly, by or for such corporation, in that proportion which the value of the stock which such person owns bears the value of all the stock of the corporation.

Under Section 318(a)(4), a person who has an option to acquire stock is deemed to own such stock. Additionally, Section 318(a)(5)(D) provides that if stock may be considered as owned by an individual under either the family attribution rules of Section 318(a)(1) or under the option attribution rules of Section 318(a)(4), such stock will be considered as owned by such individual by reason of the option attribution rules (and not by reason of the family attribution rules). Consequently, such stock may be reattributed to a member of the option holder's family without being subject to the rule prohibiting double family attribution.

Section 318(a)(5)(C) provides that stock constructively owned by a partnership, estate, trust or corporation by reason of Section 318(a)(3) (attribution to the entity), will *not* be considered as owned by such entity for purposes of applying Section 318(a)(2) (attribution from the entity) in order to make another the constructive owner of such stock.

Clearly, the attribution rules discussed above are very complicated and should be carefully analyzed by the tax practitioner in any redemption scenario involving related parties. As a result of the attribution rules, a redemption of stock in a typical family corporation in which all of the stock is held by the parents and their children generally will not qualify as a substantially disproportionate redemption or as a complete termination of interest redemption.

Example. Father and Mother each own 1,000 shares of ABC Corporation stock; Son and Daughter each own 1,000 shares. Under a binding Redemption Agreement, the shares of any deceased shareholder must be redeemed by the corporation for $500 per share. Father dies in 1990, leaving all of his stock to

[14] See § 14.02[2][a][vii], *infra*.

[15] See § 14.02[2][a][viii], *infra*.

[16] When does an estate become a trust for purposes of the I.R.C. § 318 attribution rules? This question can impact whether I.R.C. § 318(a)(3)(A) or (B) applies in determining the tax consequences of a redemption transaction.

Mother. His estate submits the stock to the corporation, which redeems it for $500,000 in cash. The $500,000 is treated as a non-exchange distribution under Section 302(d), rather than a sale or exchange, because the estate is deemed to own 100% of the corporation's shares both before and after the redemption. Under the attribution rules, Mother is deemed to own the stock of her two children, as well as her own 1,000 shares. The estate is deemed to own the stock owned by its beneficiary (Mother), and as such, the estate is deemed to own 4,000 of the 4,000 outstanding shares before the redemption, and it is deemed to own 3,000 of the 3,000 outstanding shares after the redemption.

[vii] *Statutory Waiver of Family Attribution*

The distributee in a redemption can waive the family attribution rules under Section 318(a)(1) in order to have a complete termination of interest under Section 302(b)(3) if three requirements are met:[17]

1. "*The Look Back.*" During the 10-year period preceding the redemption, the distributee must not have transferred any stock to or received any stock from someone from whom it would have been attributed under Section 318 to the distributee (other than stock received by bequest or inheritance), unless the distributee satisfies the Service that the transfer did not have as one of its principal purposes the avoidance of federal income taxes.[18]
2. "*The Look Forward.*" Immediately after the redemption, the distributee must have no interest in the corporation (other than as a creditor), including interests as an employee, officer, or director, *and* the distributee must not acquire such an interest (other than by bequest or inheritance) for a period of 10 years following the date of the redemption.[19]

[17] I.R.C. § 302(c)(2).

[18] I.R.C. § 302(c)(2)(B). For examples of transfers without a tax avoidance purpose, *see* Rev. Rul. 56–556, 1956–2 C.B. 177; Rev. Rul. 56–584, 1956–2 C.B. 179; Rev. Rul. 77–455, 1977–2 C.B. 93; Rev. Rul. 77–293, 1977–2 C.B. 91; Rev. Rul. 79–67, 1979–1 C.B. 128; and Rev. Rul. 85–19, 1985–1 C.B. 94. The Service will not issue an advance ruling on a complete termination if there were transfers within the past 10 years and the facts are not materially identical to one of these rulings. Rev. Proc. 2005–3, 2005–1, I.R.B. 118; I.R.C. § 3.01(27).

[19] I.R.C. § 302(c)(2)(A)(i) and (ii).

3. *Notification.* The distributee must agree to notify the Service of the acquisition of any prohibited interest in the corporation and to retain records of the transaction.[20]

The Service takes an extremely expansive view on whether a shareholder-distributee has retained any interest in the corporation. Clearly, any retained stock interest as well as payments for services rendered as a director, officer or employee is not permitted. Furthermore, rendering services as an unpaid consultant is also prohibited.[21] Moreover, the Service has ruled that a former shareholder's right to have his counsel serve as a paid director of the corporation to protect his creditor interest on an installment redemption is not permitted despite the fact that the lawyer would be a minority director.[22] Similarly in Rev. Rul. 71–426,[23] the right to serve as a voting trustee to vote stock of the corporation was a prohibited retained interest where the beneficiaries of the trust were family members for purposes of Section 318(a)(1). Finally, the Service has taken the position that a redeemed shareholder has retained a prohibited interest in the redeeming corporation where the shareholder retained a debt instrument.[24]

However, the Tax Court in *Hurst v. Comm'r*,[25] overturned the Service's conclusion that it had reached in FSA 200203021 that a shareholder whose directly owned stock in a closely held corporation was completely redeemed failed to qualify (as a complete termination) under Section 302(b)(3) because he had retained an interest in the redeeming corporation greater than that of a creditor. In *Hurst*, the taxpayer was the 100% shareholder of Hurst Mechanical, Inc. ("Mechanical"), and the 50% shareholder, along with his wife who owned the other 50%, of R.H., Inc. ("RHI"). In order to allow Mr. Hurst to retire from his active involvement in Mechanical, Mechanical redeemed 90% of Hurst's shares in exchange for

[20] I.R.C. § 302(c)(2)(A)(iii). See Rev. Rul. 81–233, 1981–2 C.B. 83 (prohibited interest acquired when shareholder was named custodian under the Uniform Transfer to Minors Act to hold stock for minor child).

[21] Rev. Rul. 70–104, 1970–1. C.B. 66; Rev. Rul. 56–556, 1956–2 C.B. 177.

[22] Rev. Rul. 59–119, 1959–1 C.B. 68.

[23] 1971–2 C.B. 173.

[24] Rev. Rul. 77–467, 1977–2 C.B. 92 (a retained debt instrument may actually be a prohibited equity interest), unless it is not subordinated to the other corporate debts and its payments do not depend on earnings.

[25] 124 T.C. No 2 (February 3, 2005).

a promissory note. Hurst simultaneously sold the remaining 10% of Mechanical to his son and two key employees. After the sale/redemption transactions, Hurst's son owned 51% of Mechanical. Mr. and Mrs. Hurst simultaneously sold their RHI shares to Mechanical for a note and leased to Mechanical certain real property used by Mechanical in its business. Mrs. Hurst also signed an employment contract with Mechanical under which she and Hurst were covered by Mechanical's health plan. Whether Section 302(b)(3) was applicable to the redemption of his Mechanical stock turned on whether Hurst would be allowed to waive the family attribution rules because Hurst's son's shares in Mechanical would otherwise be attributed to Hurst.

The Service argued that Hurst retained a prohibited interest by retaining an interest in Mechanical greater than that of a creditor because a default with respect to any note issued in the transaction would entitle Hurst to seize the Mechanical stock (pledged as security for the notes) to satisfy the unpaid debt. The Tax Court disagreed and concluded that the retained security interest in the Mechanical stock did not give rise to a prohibited interest. In reaching its conclusion, the Tax Court found that the fixed payments due on the notes were not subordinate to claims of general creditors and that the amounts due were not dependent upon Mechanical's earnings. The Tax Court also disregarded the Service's argument that Mrs. Hurst's employment contract was a prohibited retained interest (mainly because it contained cross-default provisions relating to the promissory notes issued in the redemption transaction). The court simply found that such cross default provisions were consistent with Hurst's status as a creditor.

In *Lynch v. Comm'r*,[26] the Ninth Circuit held that post-redemption services either as an employee or independent contractor constituted a prohibited retained interest in the corporation within the meaning of Section 302(c)(2)(A)(i). The Court held that the Tax Court's position of looking at all relevant facts and circumstances to determine if a taxpayer has retained managerial control or a financial stake in the corporation after the redemption was inconsistent with Congressional intent to bring certainty into

[26] 801 F.2d 1176 (9th Cir 1986), *rev'g* 83 T.C. 597.

the area.[27] As an illustration of how narrow the court's focus in this area can be, in *Seda v. Comm'r*,[28] a father who had all of his stock redeemed terminated an employment relationship after being informed that his $1000 per month payments violated Section 302(c)(2)(A)(i). The Court held that such employment converted the redemption payments from capital gain into ordinary income.[29]

[viii] *Entity Waiver of Family Attribution Rules*

Stock constructively owned by a family member under the family attribution rules may be reattributed to any estate, trust, partnership or corporation in which he or she owns an interest. Such attribution of stock ownership can prevent a stock redemption from such entity qualifying for sale or exchange treatment. This is a particular problem with respect to estates and trusts, since a decedent's stock necessarily passes to either an estate or trust at his or her death. Entities can, however, waive family attribution, if both the entity and the related individual join in the waiver and agree not to acquire a prohibited interest, and if both agree to be jointly liable for any deficiency caused by the subsequent acquisition of a prohibited interest.[30]

The entity waiver rules are useful when an estate or trust beneficiary owns none of the redeeming corporation's stock personally, but is related to other shareholders. The entity waiver rules provide no benefit, however, if a beneficiary actually owns stock which he or she does not also submit for redemption.

Example 1. Mother bequeathed her 1,000 shares of ABC Corporation stock to Father. Their children, Son and Daughter, each already own 1,000 shares of ABC Corporation stock and plan to run the business after Mother's death. Father owns none of the stock himself. After Mother's death, the corporation redeems her estate's 1,000 shares for $500,000. The estate can waive the

[27] See also *Michael N. Cerone v. Commissioner*, 87 T.C. 1 (1986); *Jack O. Chertkof v. U.S.*, 649 F.2d 264 (4th Cir. 1981) (management contract with controlled affiliate disqualified family waiver).

[28] 82 T.C. 484 (1984).

[29] But see *Estate of Lennard v. Commissioner*, 61 T.C. 554 (1974), *acq.* in result only, 1974–2 C.B. 3, *nonacq.* 1978–2 C.B. 3.

[30] I.R.C. § 302(c)(2)(C). See Willens, Redemption of Stock Held by Entities, Tax Notes, March 28, 2005, at 1585.

attribution of Son's and Daughter's stock to Father, from whom it would be attributed to the estate, in order to have a complete termination of interest.

Example 2. Assume the same facts as above, except that Father owns 1,000 shares of ABC Corporation stock and plans to continue to own these shares. Mother's estate cannot file a valid waiver of attribution, since the waiver will only sever family attribution and not entity attribution. Thus, while such a waiver could prevent the estate from being deemed to own the shares of Son and Daughter, it could not prevent the estate from being deemed to own Father's 1,000 shares.

[b] *S Corporations Shareholders*

[i] *Applicability of Section 302 to S Corporation Shareholders*

The same rules governing shareholders in C corporations under Section 302 (and 303) also apply to distributions in redemption of stock of an S corporation, including the stock attribution rules in Section 318.[31] However, the characterization of a distribution as a redemption under Section 302(a) or as a distribution under Section 1368(a) may make little difference to the redeemed S corporation shareholder because of the distribution rules governing S corporations having no earnings and profits.

[ii] *General Distribution Rules for S Corporations With No Earnings and Profits*

Distributions of cash or property made by an S corporation having no accumulated Subchapter C earnings and profits are received tax-free by shareholders to the extent of their basis in the S corporation stock.[32] To the extent distributions exceed basis, however, the excess is treated as gain from the sale or exchange of property.[33] Thus, unless the purchase price is to be paid over a period of years (where the shareholder will need exchange treatment to qualify for the installment sales rules), it essentially

[31] I.R.C. §§ 1371(a)(1) and 318(a)(5)(E) (S corporation treated as a partnership for entity attribution rules).

[32] I.R.C. § 1368(b)(1).

[33] I.R.C. § 1368(b)(2).

makes no difference to the redeemed S corporation shareholder whether the transaction is a redemption under Section 302(a) or a distribution under Section 1368. A separate block rule will apply to non-sale or exchange redemptions in mirroring the results under distributions to shareholders in C corporations.[34]

[iii] *General Distribution Rules for S Corporations With Earnings and Profits*

This indifference as to whether a distribution is characterized as a Section 302 redemption or a Section 1368 distribution *may* also apply to shareholders of S corporations having earnings and profits. Distributions made by S corporations having accumulated Subchapter C earnings and profits are subject to a 5-tier system of taxation. This system utilizes the corporation's accumulated adjustment account (AAA) in determining the taxability of distributions. AAA generally consists of the accumulated gross income of the S corporation less deductible expenses and prior distributions. The AAA is essentially a running total of the S corporation's income, losses, deductions and distributions. The 5-tier system of taxation may be summarized as follows:

1. That portion of the distribution that does not exceed AAA is tax-free to the extent of the shareholder's stock basis;[35]
2. That portion of the distribution that does not exceed AAA, but that does exceed the shareholder's stock basis, is capital gain;[36]
3. That portion of the distribution that exceeds AAA is a dividend to the extent of the S corporation's accumulated Subchapter C earnings and profits;[37]
4. That portion of the distribution that exceeds AAA and the accumulated Subchapter C earnings and profits of the S corporation is tax-free to the extent of the shareholder's residual stock basis (the shareholder's adjusted basis in his or her S corporation stock less any reductions made in his or her stock basis for any first-tier distributions);[38] and

[34] See Reg. §§ 1.1367-1(c)(3) and (f).

[35] I.R.C. §§ 1368(c)(1) and 1368(b)(1).

[36] I.R.C. §§ 1368(c)(1) and 1368(b)(2).

[37] I.R.C. §§ 1368(c)(2) and 301.

[38] I.R.C. §§ 1368(c)(3) and 1368(b)(1).

5. That portion of the distribution that exceeds AAA, the accumulated Subchapter C earnings and profits of the S corporation, and the shareholder's residual stock basis, is capital gain.[39]

Thus, even if the redemption is not treated as an exchange, the same result will apply (i.e., return of capital to the extent of basis, gain from the sale of stock to the extent that the amount of the distribution exceeds basis), if the amount received by the shareholder is *not* in excess of the corporation's accumulated adjustments account (AAA) as of the close of the taxable year and is allocated among all dividend distributions made during the same period. Where the distribution exceeds AAA as of the close of the taxable year, however, such excess will be a distribution of earnings and profits and taxed as a dividend. The dividend distribution will be allocated pro-rata to all distributions made during the year.

[iv] *Ordering of Adjustments to Basis*

Before determining the tax treatment of distributions to S corporation shareholders, the basis of the distributee shareholder in his S corporation stock will be increased by items of S corporation income described in Section 1367(a)(1), but will *not* be decreased by items of S corporation loss and deduction described in Section 1367(a)(2) until after the tax treatment of the distribution has been determined. Additionally, Section 1368(e) provides that in determining the corporation's AAA available to cover distributions made during the taxable year, the amount of AAA as of the close of the taxable year will be determined without regard to any "net negative adjustment" (the excess of reductions to AAA for the taxable year over increases to AAA for the taxable year).

[v] *AAA Bypass Election*

Under Section 1368(e)(3), an S corporation which has Subchapter C earnings and profits can make an election to change the ordinary distribution rules discussed above. If a Section 1368(e)(3) election (which is referred to as a "AAA bypass election") is made, the distributions from the corporation to its shareholders will first be treated as coming out of the corporation's accumulated Subchapter

[39] I.R.C. §§ 1368(c)(3) and 1368(b)(2).

C earnings and profits to the extent thereof, then out of the corporation's AAA.

A Section 1368(e)(3) election is useful for an S corporation with subchapter C earnings and profits that wishes to purge such earnings and profits to avoid the "sting" tax of Section 1375 (which applies where the passive investment income of an S corporation having accumulated earnings and profits exceeds 25% of gross receipts) and the possible termination of S corporation status under Section 1362(d)(3) (which applies where passive investment income of an S corporation with accumulated earnings and profits exceeds 25% of gross receipts for three (3) consecutive years). Because of the 15% tax rate now applicable to dividend distributions, the distribution of earnings and profits to purge subchapter C earnings and profits is more palatable to taxpayers than prior to the 2003 Act.[40]

Additionally, because of the 15% tax rate now applicable to dividend distributions, in some situations it may make sense in order to free up suspended losses to offset other ordinary income of the shareholder for the corporation to make a Section 1368(e)(3) election since such distributions will be taxed at the 15% tax rate and will not reduce the shareholders' stock basis, and as such, allow losses that might otherwise be suspended to flow through and offset other ordinary income of the shareholder which would otherwise be subject to a maximum marginal income tax rate of 35%.

Example — No Section 1368(e)(3) Election

Facts:

S is an S corporation with a single shareholder, B. As of 1/1/2005, S has accumulated E&P of $1,000 and AAA of $2,000. On 4/1/2005, S makes a $2,000 distribution to B. For 2005, S has $2,000 of income and $3,500 of deductions. As of 1/1/2005, B owned 100 shares of S stock with a basis of $20 in each share. S does *not* make an election under Section 1368(e)(3) and Reg. Section 1.1368-1(f)(2).[41]

Analysis:

[40] Even where an S corporation does not have available funds to make an actual distribution of its earnings and profits, Reg. § 1.1368-1(f)(3) provides that an S corporation may make a "deemed distribution" of its earnings and profits.

[41] Reg. § 1.1368-3 Example (5).

Under Section 1368(e)(1)(C) and Reg. Section 1.1368-2(a)(5), in applying adjustments to AAA to determine the taxability of distributions, AAA is determined without regard to any net negative adjustment (excess of reductions in AAA (other than for distributions) over increases in AAA). For purposes of the distribution, the AAA of S is $2,000 ($2,000 + $2,000 (income) − $2,000 loss (not to exceed the 2005 income). Therefore, the $2,000 distribution to B is out of AAA. The AAA is further reduced by the remaining $1,500 loss to a negative ($1,500). For purposes of determining taxability of the distribution, B's beginning basis of $2,000 is increased by $2,000 income. Section 1368(d). The $2,000 distribution reduces the basis of B's S stock to $2,000 ($2,000 + $2,000 − $2,000). The basis of B's S stock is further reduced by $2,000 of loss. The remaining $1,500 loss in excess of B's basis in his shares is suspended and will be treated as incurred by S in the succeeding taxable year with respect to B.

Summary:

The $2,000 distribution is not taxable to B. B has a pass-through of $2,000 of income and $2,000 of loss (a "wash"). Additionally, B has $1,500 of suspended losses.

Example — Section 1368(e)(3) Election

Facts:

Same as previous example except that S elects under Section 1368(e)(3) and Reg. Section 1.1368-1(f)(2) to distribute E&P first.

Analysis:

The $2,000 distribution by S is deemed to be made first out of accumulated E&P of $1,000 and is a dividend to B. *See* Reg. Section 1.1368-3 Example (7). The remaining $1,000 distribution is made out of AAA and constitutes a tax-free return of basis. Under Reg. Section 1.1367-1(f):

Beginning basis	$2,000
Increase for income items	2,000
Decrease for distribution not includable in shareholder's income ($2,000 distribution − $1,000 portion treated as dividend)	1,000
Decrease for noncapital, nondeductible expense	-0-
Decrease for items of loss or deduction described in Sections 1367(a)(2)(B) and (C) (but not in excess of basis)	(3,000)
Remaining Basis	-0-

The remaining $500 of loss in excess of B's basis in his shares of S stock is suspended and will be treated as incurred by S in the succeeding taxable year with respect to B.

Summary:

B has $1,000 dividend income taxed at maximum rate of 15% under Section 1(h). B has $2,000 of pass-through income and $3,000 of pass-through loss. Assuming B is taxed at maximum marginal rate of 35% and loss items are fully deductible by B, he has a net savings of $200 [Excess of ($1,000 x .35) over ($1,000 x .15)] as compared to the result where no Section 1368(e)(3) election was made.

[vi] *Allocations of Tax Items*

Under Sections 1366 and 1377(a)(1), the redeemed shareholder will be allocated his or her daily pro rata share of the S corporation's items of income, deduction, loss or credit for the year of the redemption. Unless one of the elections discussed below is made, the S corporation's items are allocated to the shareholders on a per share, per day basis. The daily allocation rule of Section 1377(a)(1) results in the redeemed shareholder of an S corporation being allocated an amount of the corporation's tax items even *after* the stock is sold.

Under Section 1377(a)(2), where a shareholder in an S corporation completely terminates his or her stock interest in the corporation, the corporation and all of the "affected shareholders" may elect hypothetically to close the taxable year of the corporation as of the

date of sale in allocating tax items. The "affected shareholders" are the shareholders whose interest ends and all shareholders to whom such shareholder transferred shares during the taxable year.[42] If a shareholder's interest in an S corporation is redeemed by the S corporation, all the shareholders during the taxable year of the redemption are "affected shareholders." If Section 1377(a)(2) applies, the pro rata shares of the affected shareholders are determined as if the corporation's taxable year consisted of two taxable years, the first of which ends on the date as of the termination of the shareholder's interest.[43]

An S corporation that makes a terminating election for a taxable year must treat the taxable year as separate taxable years for purposes of allocating income (including tax-exempt income), loss, deduction and credit, making adjustments to the accumulated adjustments account, earnings and profits and basis under Section 1367, and in determining the tax effect of a distribution to the S corporation's shareholders under Section 1368. This comprehensive treatment ensures that full effect is given to treating the taxable year as two separate taxable years, and is consistent with the basis and distribution regulations promulgated under Sections 1367 and 1368. An S corporation making a terminating election under Section 1377(a)(2) must assign items of income, loss, deduction and credit to each deemed separate taxable year using its normal method of accounting as determined under Section 446(a).

A terminating election does *not*, however, affect the due date of the S corporation's tax return, nor does a terminating election under Section 1377(a)(2) generally affect the taxable year in which a shareholder must take into account his pro rata share of the S corporation's items of income, loss, deduction and credit. If a terminating election is made by an S corporation that is a partner in a partnership, the election will be treated as a sale or exchange of the corporation's entire interest in the partnership for purposes of Section 706(c), relating to closing the partnership taxable year, if the taxable year of the partnership ends *after* the shareholder's interest is terminated and *within* the full taxable year of the S corporation for which the terminating election is made. As such,

[42] I.R.C. § 1377(a)(2)(B) and Reg. § 1.1377-1(b)(2).

[43] See § 14.04, *infra*, for a discussion of the planning opportunities and pitfalls associated with making or not making the I.R.C. § 1377(a)(2) election.

any partnership income earned by an S corporation partner through the date that a shareholder completely terminates his interest in the S corporation will be allocated to the deemed taxable year ending on the date of the shareholder's disposition of his stock rather than to the deemed taxable year following the date of such disposition.

In the event that the termination of a shareholder's entire interest in an S corporation also constitutes a "qualifying disposition" within the meaning of Reg. Section 1.1368-1(g)(2) (discussed below), the regulations provide that the election under Reg. Section 1.1368-1(g)(2) cannot be made by the S corporation. In other words, the Section 1377(a)(2) allocation rules take precedence over the allocation rules set forth in Reg. Section 1.1368-1(g)(2) relating to qualifying dispositions.

Additionally, an S corporation may *not* make a terminating election under Section 1377(a)(2) if the termination of the shareholder's interest occurs in a transaction which also results in a termination of the corporation's S election under Section 1362(d). Rather, the rules of Section 1362(e)(2) and (3) (discussed below) take precedence over the allocation rules of Section 1377 and will determine the allocation of S corporation items where a corporation's S election has been terminated. Note that the allocation rules of Sections 1362(e)(3) and 1377(a)(2) differ in one important respect. An election under Section 1362(e)(3) closes the books on the day *before* the termination of S status, whereas a terminating election under Section 1377(a)(2) closes the books on the day of the termination of the shareholder's entire interest in the S corporation.

A terminating election under Section 1377(a)(2) can be made only if a shareholder's entire interest as a shareholder in the S corporation is terminated. A shareholder's entire interest in an S corporation is considered terminated on the occurrence of any event through which a shareholder's entire stock ownership in the S corporation ceases. The following are examples of events resulting in termination of a shareholder's entire interest in an S corporation:

1. A sale, exchange, or other disposition of all of the stock held by the shareholder;
2. A gift under Section 102(a) of all of the shareholder's stock;
3. A spousal transfer under Section 1041(a) of all of the shareholder's stock;

4. A redemption under Section 317(b) of all of the shareholder's stock, regardless of the tax treatment of the redemption under Section 302 as a sale or exchange or as a dividend; and
5. The death of a shareholder.

A shareholder's entire interest in an S corporation will *not* be considered as terminated, however, if the shareholder retains ownership of any stock that would result in the shareholder being treated as a shareholder of the corporation under Section 1362(a)(2).

In determining whether a shareholder's entire interest in an S corporation has been terminated, any options held by the shareholder (other than options that are treated as stock under Reg. Section 1.1361-1(l)(4)(iii)), and any interest held by the shareholder as a creditor, employee, director, or in any other non-shareholder capacity, will be disregarded. As such, a Section 1377(a)(2) terminating election can be made when a shareholder sells all of his stock even though the shareholder remains an employee, officer and/or director of the S corporation.[44]

The terminating election under Section 1377(a)(2) is made by attaching a statement to the S corporation's *timely* filed original or *amended* return for the taxable year during which the shareholder's entire interest is terminated. A terminating election may be made on an amended return as well as on an original return, but a terminating election only can be made on a *timely* filed return, and not on a late return. Additionally, the regulations set forth what information must be included in the election statement and provide that a single election statement may be filed by the S corporation for *all* terminating elections with respect to the taxable year.

As discussed above, all "affected shareholders" must consent to the terminating election. The shareholders required to consent to the terminating election are the shareholders described under Section 1362(a)(2) that must consent to a corporation's S election. For example, if stock of an S corporation is owned by a husband and wife as community property, both husband and wife must consent to the terminating election under Section 1377(a)(2). If

[44] This is a completely different standard than the standard for determining whether there has been a complete termination of interest for purposes of waiving the family attribution rules discussed above. See § 14.02[2][a][vii], *supra*.

shares of stock of an S corporation are owned by a minor, the consent to the terminating election must be made by the minor (or by the legal representative of the minor); if shares of stock of an S corporation are owned by an estate, the consent of the estate must be made by an executor or administrator of the estate; and if a trust described under Section 1361(c)(2)(A) owns shares of stock of an S corporation, the person treated as the shareholder under Section 1361(b)(1) must consent to the terminating election.

In the event a terminating election is made with respect to a shareholder who terminates his entire interest in an S corporation, that shareholder will *not*, however, be required to consent to a terminating election made with respect to the subsequent termination of another shareholder's entire interest in the S corporation during the same taxable year.

If a sale of S corporation stock results in the termination of the corporation's S status, the taxable year of the termination is considered an "S termination year" as defined in Section 1362(e)(4).[45] The S termination year is divided into two short taxable years, with Subchapter S governing the first short year (which ends on the day *before* the effective date of termination and is known as the "S short year") and with Subchapter C governing the balance of the year (the "C short year"). While the corporation generally allocates its items of income, loss, deduction and credit between the two short years based on the number of days in each year, Section 1362(e)(3) allows the corporation to elect to close its books on the day before the termination date, provided that all persons who own stock during the S short year and on the first day of the C short year consent to such election.[46] Also note that under Section 1362(e)(6)(D), the books will close automatically if there is a sale or exchange of 50% or more of an S corporation's stock in an S termination year, and will also close automatically with respect to any items resulting from the application of Section 338.

If a shareholder disposes of 20% or more of the corporation's stock during a 30-day period, the corporation may also elect to close the books hypothetically as of the date of disposition, for purposes of allocating items of income and loss.[47] Moreover, the regulations

[45] Reg. § 1.1362-3(a).

[46] I.R.C. § 1362(e)(3)(B) and Reg. § 1.1362-3(b)(1).

[47] Reg. § 1.1368-1(g)(2).

provide that a redemption *treated as an exchange under Section 302(a) or Section 303(a)* of 20% or more of the outstanding stock of the corporation from a shareholder in one or more transactions over a 30-day period during the S year will constitute a "qualifying disposition" for which the hypothetical closing of the books election may be made.

For dispositions of stock in an S corporation, Temporary Regulation Section 1.469-2T(e)(3) requires that the resulting gain or loss be allocated among the various activities of the S corporation as if the entity had sold all of its interests (assets) in such activities, including activities conducted by ownership of a pass-through entity such as a partnership, as of a prescribed valuation date, for purposes of applying the passive activity loss limitation rules.

[vii] *Structuring Non-Exchange Redemptions*

Where the selling shareholder has low basis stock, deliberately avoiding Section 302(a) or 303 may be an effective tax planning technique, especially where the selling shareholder may have an incentive to help out the remaining shareholder group by significantly reducing the corporation's earnings and profits account.

[3] Impact on the Corporation

[a] *C Corporations*

Earnings and profits of the corporation are reduced dollar for dollar from current earnings and profits and then from the most recently acquired accumulated earnings and profits in a redemption not qualifying for sale or exchange treatment under Section 302(b). For a redemption qualifying for sale or exchange treatment, earnings and profits of the corporation are reduced in direct proportion with the percentage of shares redeemed.[48]

In general, the distribution of appreciated property by a corporation to a shareholder in an exchange or non-exchange redemption will result in gain to the corporation.[49] The distribution of depreciated property (resulting in a loss) will not be recognized by the

[48] I.R.C. § 312(n)(7).

[49] I.R.C. § 311(b).

corporation and also results in disappearing basis at the shareholder level.[50]

Also note that if a buy-out is funded by corporate owned life insurance, the proceeds of the life insurance received by the corporation may be subject to the alternative minimum tax to which C corporations are subject.

[b] *S Corporations*

Non-exchange redemptions will reduce the corporation's AAA account first and then the corporation's earnings and profits account unless the corporation and its shareholders file a AAA bypass election for the same year, in which case distributions are deemed to be made first from accumulated earnings and profits and then from AAA.[51] Exchange redemptions are charged to both the AAA and accumulated earnings and profits account in direct proportion to the percentage of stock redeemed.[52]

In general, the distribution of appreciated property by an S corporation to a shareholder in an exchange or non-exchange redemption will result in gain to the corporation.[53] Moreover, gain from a distribution of appreciated property has the potential for triggering the corporate level built-in gains tax imposed under Section 1374, or, if the property distributed constitutes stocks or securities, a possible tax on passive investment income under Section 1375. The distribution of depreciated property (resulting

[50] I.R.C. §§ 311(a) and 301(d).

[51] I.R.C. § 1368(e)(3).

[52] I.R.C. § 1368(e)(1)(B); Reg. § 1.1368-2(d)(1); I.R.C. § 312(n)(7); Reg. § 1.1368-2(d)(1)(iii). See Rev. Rul. 95–14, 1995–1 C.B. 169 (when an S corporation shareholder receives proceeds in a redemption that does *not* qualify as a sale or exchange under either § 302(a) or § 303(a), the corporation's AAA must be reduced by the full amount of the distribution to the extent the distribution is not included in the shareholder's income under the distribution rules of I.R.C. § 1368). Thus, although there may be no tax difference between an exchange and non-exchange redemption to the redeemed S corporation shareholder, the remaining shareholders have an interest in the redemption qualifying as an exchange so that the AAA is only reduced proportionately and not by the full amount of the distribution. On the other hand, an S corporation can use these rules to make a non-pro rata tax-free operating distribution to one of its shareholders.

[53] I.R.C. § 311.

in a loss) will not be recognized by the corporation and also results in disappearing basis.[54]

In PLR 9116008, the Service applied the interest allocation rules of Temporary Regulations Section 1.163-8T and Notice 89–35,[55] to a redemption by an S corporation of its stock from some of its shareholders. The corporation issued promissory notes to the shareholders in payment for their stock. The Service found that since the redemptions would qualify under Section 302(a) for sale or exchange treatment rather than being treated as distributions under Section 302(d), the interest allocation rules for debt financed distributions set forth in Notice 89–35 would be inapplicable.[56] The Service additionally found that since the remaining shareholders' ownership interests in the S corporation would be increased as a result of the corporate redemptions, such redemptions should be characterized under Notice 89–35 as debt financed purchases. Consequently, the Service ruled that the debt and related interest expense incurred in connection with the redemptions could be allocated among all the assets of the corporation using any reasonable method. The Service concluded that allocating the debt and related interest expense incurred in connection with the redemptions among the assets on the basis of the book value of the company's assets, averaged monthly, constituted a reasonable method of interest allocation for purposes of Notice 89–35.

[4] Distributions Under Section 303

Section 303 grants sale or exchange treatment on the redemption of closely-held stock, to the extent of the estate's death taxes, administrative expenses, and generation-skipping transfer taxes.

[a] *Qualification*

An estate qualifies under Section 303 if the stock, either owned by the estate or otherwise required to be included in the decedent's gross estate, represents at least 35% of the decedent's adjusted gross

[54] I.R.C. §§ 311(a) and 301(d).

[55] 1989–1 C.B. 675.

[56] Presumably, if the redemption did not qualify for sale or exchange treatment, it would have been characterized as a debt-financed distribution, and the deductibility of the interest on the promissory note would have depended on the redeemed shareholder's use of the funds received by him in the redemption.

estate (gross estate less deductible losses and expenses).[57] The stock of two or more corporations can be aggregated in order to satisfy this 35% test, if the estate includes 20% or more of the stock of each corporation, including the full value of stock owned jointly with the surviving spouse.[58]

[b] *Utility*

In practice, Section 303 is of limited use. The unlimited estate tax marital deduction and the larger unified credit reduce both the estate tax liability and the amount of stock which can be redeemed. Furthermore, since Section 303 applies only to the extent that the redeemed shareholder's interest is reduced "directly (or through a binding obligation to contribute) by any payment" of estate taxes or expenses, stock passing to a marital or charitable trust of the estate is rarely going to be eligible for redemption under Section 303.

§ 14.03 CROSS-PURCHASE

A cross-purchase (i.e., the purchase of the existing shareholder's stock by another shareholder rather than the corporation) raises significantly fewer income tax issues than does a redemption.

[1] Impact on Selling Shareholder

Corporate stock is typically a capital asset, so unless the shareholder is a dealer in stock, any gain on the sale is generally capital gain, regardless of the character of the corporation's underlying assets.[59] Thus, a cross-purchase will be more advisable than a redemption where a redemption may not qualify for sale or exchange treatment under Section 302(a).[60] Although there is no longer a tax rate preference between capital gains and dividends, it is important that the gain be characterized as a sale or exchange, rather than as a dividend, since the seller will be allowed to recover basis without tax and if payments are to be made over a period of years, the seller will be allowed to use the installment sales method under Section 453.

[57] I.R.C. § 303(b)(2)(A).

[58] I.R.C. § 303(b)(2)(B).

[59] I.R.C. § 1221.

[60] See § 14.02[2][a], *supra*, for a discussion of the § 302 redemption rules.

Generally, a selling shareholder's basis in his or her stock will equal the amount paid for the shares plus the amount of cash and adjusted basis of property contributed to the corporation in exchange for stock or as a capital contribution.[61] In the case of the death of a shareholder, the shareholder's estate generally will receive a basis under Section 1014 equal to the fair market value of the stock as of the date of the shareholder's death.[62] However, the estate of a deceased S shareholder will *not* receive a step-up in stock basis to date of death value to the extent of the shareholder's interest in unrealized receivables of the corporation.[63] This may have a dramatic impact on the tax cost of the sale, especially in service based S corporations.

For shareholders owning stock in an S corporation, adjustments to basis are made for the pass through of tax items in accordance with Section 1367. If a shareholder disposes of stock during the taxable year, the basis adjustments with respect to such stock are effective immediately prior to the disposition.[64] Such adjustments will affect the computation of gain or loss on the sale of stock.

[61] I.R.C. §§ 1012, 351, 358 and 118.

[62] Pursuant to applicable provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 ("TRA 2001"), beginning in 2001 the federal estate tax rates are being reduced and the applicable exclusion amount is being increased, until the year 2010, when both the estate and generation skipping transfer taxes are repealed. Also in 2010, current rules under Section 1014, providing for a fair market value basis for property acquired from a decedent, also will be repealed and replaced with a significantly more complicated set of basis adjustment rules. Under these new rules, a receipt of property received upon a decedent's death will no longer be entitled to an automatic step-up in basis. Instead, recipients of a decedent's property at death will be entitled to an adjusted basis in such property equal to the lesser of (i) the decedent's adjusted basis in the property received or (ii) the fair market value of such property. In addition, recipients of property "owned by the decedent" at his or her death will be entitled to an aggregate basis increase of $1,300,000 (increased by certain carryovers and losses), plus an additional aggregate basis increase of $3,000,000 for qualified spousal property owned by the decedent at his or her death (both the $1,300,000 and $3,000,000 basis increase amounts will be adjusted for inflation after 2010). To ensure compliance with the Congressional Budget Act of 1974, all these changes are inapplicable for taxable years beginning after December 31, 2010. Whether such new rules will actually go into effect in 2010 is not certain and how practitioners will plan for such uncertain changes is also problematic.

[63] I.R.C. § 1367(b)(4).

[64] Reg. § 1.1367-1(d)(1).

Under Sections 1366 and 1377(a)(1), the selling shareholder will be allocated his or her daily pro rata share of the S corporation's items of income, deduction, loss or credit for the year of the redemption. Where a shareholder completely terminates his or her stock interest, a hypothetical closing of the books rule for allocation purposes can be elected in accordance with Section 1377(a)(2). Additionally, where the shareholder makes a "qualifying disposition" of stock as provided in Reg. Section 1.1368-1(g)(2), the corporation may elect to close the books hypothetically as of the date of disposition for purposes of allocating items of income and loss.[65]

[2] Impact on Cross-Purchase Buyers

The buying shareholders will receive a cost basis in the shares of stock purchased, even if the purchase is funded with tax-free life insurance proceeds. To the extent that life insurance cannot be used to fully fund the purchase price, a disadvantage of a cross-purchase is that the purchasing shareholders are acquiring the stock with after-tax dollars.

[a] *Cross-Purchase Buyers of C Corporation Stock*

This basis increase may actually be of only modest utility for shareholders in a C corporation, especially one which has significant earnings and profits. This is due to the fact that post-purchase distributions will frequently represent dividend income (instead of a tax-free return of capital) and their shares, including the newly purchased stock, will frequently be retained until their death, at which time the stock will receive a basis equal to date of death fair market value.[66] A debt financed acquisition of stock in a C corporation will generate investment interest expense subject to limitations on deductibility under Section 163(d).

[b] *Cross-Purchase Buyers of S Corporation Stock*

A cross-purchase may be more desirable to the purchasing shareholders in an S corporation with a prior (and profitable) C year history since the cost basis for the acquired stock will not only

[65] For a detailed discussion of these provisions, see § 14.02[2][b][vi], *supra*.

[66] See Note 62, *supra*.

reduce gain (or increase a loss) in the event of a subsequent sale, but will facilitate the tax-free receipt from the corporation's accumulated adjustment account (AAA) under Section 1368(c)(1) or recovery of basis under Section 1368(c)(3) for distributions made by the corporation. This is primarily attributable to the fact that a cross purchase will *not* result in a reduction in the S corporation's AAA.

Having the purchasing shareholders obtain a cost basis in the acquired shares may also be important to absorb losses for those who are faced with a basis limitation problem under Section 1366(d)(1)(A) or have already accumulated suspended losses from prior years due to insufficient stock (and debt) basis.

Consideration should also be given to the possible application of the passive activity loss rules in Section 469, as well as the at-risk limitations in Section 465, in determining whether a cross-purchase is more favorable. Where the S corporation does not have earnings and profits from prior C years, the cross purchase arrangement will generally be more favorable since the shareholders will get a basis increase in their stock and achieve only a single level of taxation on the use of corporate level profits to pay for the shares.

Just like the selling shareholder, the purchasing shareholder will also be allocated a pro rata share of the S corporation's items of income, loss, deduction and credit for the tax year of the purchase. Absent a terminating election under Section 1377(a)(2) or a qualifying disposition election under Reg. Section 1.1368-1(g) to close the books of the S corporation, the allocation will be made on a per share, per day basis.[67]

The use of a promissory note to acquire stock in an S corporation will be treated under Notice 89–35,[68] as a debt financed purchase. Consequently, the debt and related interest expense incurred in connection with the stock purchase can be allocated among all the assets of the corporation using any reasonable method (i.e., average monthly book value of company's assets). Accordingly, assuming the S corporation is engaged in a trade or business activity (as opposed to a rental activity) and the purchasing shareholder materially participates therein, the deductibility of the interest expense

[67] See § 14.02[2][b][vi], *supra*, and § 14.04, *infra*, for a discussion of the availability and effect of such elections.

[68] 1989–1 C.B. 675.

incurred by the shareholder on the debt financed stock purchase will not be subject to limitation under Section 163(d) or 469.

[3] Impact on Corporation

There are few real tax effects of a cross-purchase on the corporation. The shift in stock ownership does not affect earnings and profits or, as to an S corporation, either its earnings and profits or accumulated adjustments account. A cross-purchase also removes from direct consideration whether the corporation has adequate surplus with which to redeem the shares of the withdrawing shareholder under state law.

Unlike the rules governing purchases and redemptions of partnership interests, there is no mechanism for the buying shareholder to adjust his or her allocable portion of the corporation's inside basis in its assets to correspond to such shareholder's outside basis in the corporation's stock.[69] Furthermore, unlike Section 708 which provides for the termination of the partnership's taxable year in the event there is a sale or exchange of more than 50% of the interests (capital and profits) during a 12-month period, no similar rule applies to accelerate income (or the reporting of loss) by a C corporation or an S corporation.

§ 14.04 PLANNING OPPORTUNITIES AND PITFALLS IN CONNECTION WITH TERMINATING ELECTIONS

Because of the elective nature of Section 1377(a)(2) (as well as Reg. Section 1.1368-1(g)(2)), it can be a useful planning tool for the practitioner. Depending upon the facts and circumstances of a particular situation, and the party being represented (the selling shareholder, the buying shareholder or the other shareholders), the failure to make a terminating election under Section 1377(a)(2) (or under Reg. Section 1.1368-1(g)(2)), can either be advantageous from a tax standpoint or a major blunder resulting in disastrous tax consequences to the taxpayer. In particular, a terminating election can have a dramatic effect on the *time* when income will be recognized by the shareholders as well as on the *character* of the income recognized by the shareholders. The following examples illustrate some of the planning opportunities and pitfalls associated with the Section 1377(a)(2) terminating election.

[69] I.R.C. §§ 754, 755, 743(b) and 1060(d).

[1] Example 1

X incorporates, elects S corporation status, and issues 100 shares of stock to A and 100 shares of stock to B on January 2, 2005. Exactly half way through the taxable year, B sells all of his stock to C. During its 2005 taxable year, X has a profit of $100,000 through the date of B's sale of his X stock to C, and a loss of $200,000 for the period after the date of such sale. If no terminating election under Section 1377(a)(2) is made, X's non-separately computed loss of $100,000 ($100,000 profit through the date of the sale less $200,000 loss following the date of the sale) will be allocated on a per-share, per-day basis. As such, $50,000 of loss will be allocated to A since he owned 50% of the stock of X for the entire taxable year ($100,000 loss ÷ 364 days x 50% × 364 days), $25,000 of loss will be allocated to B since he owned 50% of the stock of X for one-half of the taxable year ($100,000 loss ÷ 364 days × 50% x 182 days), and the remaining $25,000 of loss will be allocated to C since he owned 50% of the stock of X for the last half of the taxable year ($100,000 loss ÷ 364 days x 50% × 182 days).

If, however, a terminating election is made under Section 1377(a)(2), X will close its books on the date of B's sale of his stock to C for purposes of allocating all of X's items of income, loss, deduction and credit for the taxable year. As such, $50,000 of loss will be allocated to A (50% of the $100,000 income of X through the date of the sale of B's stock to C, less 50% of the $200,000 loss of X following the date of the sale of B's stock to C). B will be allocated $50,000 of income (50% of the $100,000 income of X through the date of the sale), and C will be allocated $100,000 of loss (50% of the $200,000 loss of X following the date of B's sale of his stock to C). Although the Section 1377(a)(2) terminating election has no effect on the net amount allocated to A, the effect of the terminating election on B and C is significant. B's ordinary income is *increased* by $75,000 as a result of the terminating election (allocation of $50,000 of income if terminating election is made as compared to an allocation of $25,000 of loss if no terminating election is made). Likewise, C's ordinary income is *decreased* by $75,000 as a result of the terminating election (allocation of $100,000 of loss if terminating election is made as compared to an allocation of $25,000 of loss if no terminating election is made).

[2] Example 2

Assume the same facts as above, except that instead of B selling his shares to C, B sells all of his stock to A exactly half way through the 2005 taxable year for a sales price of $200,000 to be received over a period of five years. B's basis in his stock is $100,000, and B intends to report the $100,000 gain realized by him on the sale of his stock to A on the installment sales method under Section 453. Through the date of B's sale of his stock to A, X has no income or loss, but following the sale of B's stock to A, X sells substantially all of its assets to a third party resulting in a gain to X of $1,000,000. If no terminating election under Section 1377(a)(2) is made, $750,000 of gain will be allocated to A since he owned 50% of the stock of X for one-half of the taxable year and 100% of the stock of X for the remaining one-half of the taxable year. B will be allocated $250,000 of gain since he owned one-half of the shares of X for one-half of the taxable year. Even if the entire gain on the sale of X's assets is capital gain (so that there is no rate differential between the gain allocated to B attributable to the sale of X's assets and the gain realized by B on the sale of his stock to A), B will nevertheless have to report the $250,000 gain on his 2005 income tax return. In turn, the $250,000 of gain allocated to B will increase B's basis in his X stock under Section 1367 to $350,000 ($100,000 original basis plus $250,000 gain), which will cause B to recognize a capital loss on the sale of his stock to A of $150,000 ($350,000 basis less $200,000 sales price). This $150,000 capital loss can be used by B to offset the $250,000 of capital gain allocated to him, so that the net amount of gain that must be recognized by B on his 2005 income tax return will be $100,000.

If, on the other hand, a terminating election under Section 1377(a)(2) was made in connection with the sale of B's stock to A, *none* of the gain on X's sale of its assets would be allocated to B, and B would be permitted to recognize the $100,000 of gain realized by him on the sale of his stock to A under the installment sales method over a period of five years, rather than recognizing the entire $100,000 gain in 2005. Additionally, A would be allocated the entire $1,000,000 of gain recognized by X on the sale of its assets.

[3] Example 3

Alternatively, assume the same facts as in above, except that instead of X selling its assets for a gain of $1,000,000, A contributes assets to X following the date of the sale of B's stock to A and those contributed assets produce $1,000,000 of ordinary income. Assuming no terminating election is made under Section 1377(a)(2), $750,000 of ordinary income will be allocated to A since he owned 50% of the stock of X for one-half of the taxable year, and 100% of the stock of X for the remaining one-half of the taxable year. B will be allocated $250,000 of ordinary income since he owned 50% of the stock of X for one-half of the taxable year. B will be required to include the $250,000 of ordinary income on his 2005 income tax return, which will also result in an increase in the basis of his X stock to $350,000 ($100,000 original basis plus $250,000 income). Again, this will result in a capital loss of $150,000 ($350,000 basis less $200,000 sales price) on the sale of B's stock to A, but because the $250,000 allocated to B is *ordinary income* rather than capital gain, B will *not* be permitted to offset the $150,000 capital loss against the $250,000 of ordinary income allocated to him except to the extent of $3,000 per year. Additionally, B will be subject to the substantially higher tax rates imposed on ordinary income with respect to the $250,000 of ordinary income allocated to him.

If, however, a terminating election under Section 1377(a)(2) is made with respect to B's sale of all of his stock to A, B will be allocated no portion of the $1,000,000 of ordinary income of X following the date of B's sale of his X stock to A, and will therefore receive capital gain treatment on the entire $100,000 of gain realized by him on the sale of his stock to A. A, on the other hand, will be allocated the full $1,000,000 of ordinary income of X following the date of B's sale of his stock to A.

[4] Importance of Terminating Election — Timing and Characterization of Income

Quite clearly, the Section 1377(a)(2) terminating election can have a significant impact both on the timing and characterization of income to both the seller and the buyer of S corporation stock. The seller can avoid having his or her tax consequences affected by the actions of the buyer after the date of the sale only by having

the S corporation make a terminating election under Section 1377(a)(2).

Because of the varying tax consequences that can result from making, or failing to make, a Section 1377(a)(2) terminating election to the seller and buyer of S corporation stock, as well as to the other shareholders of the S corporation, the tax practitioner must be fully informed of the income or loss of the S corporation through the date of a sale of stock which terminates a shareholder's entire interest in the S corporation, the estimated income or loss of the S corporation following the date of such sale, the amount of any distributions made by the S corporation to its shareholders prior to the date of the sale, and the likelihood that the S corporation will sell its assets following the date of the sale.

At a minimum, the stock purchase agreement between the selling shareholder and the purchasing shareholder should address whether a Section 1377(a)(2) terminating election will be made, and if so, the S corporation should join in the execution of the stock purchase agreement for purposes of agreeing to consent to the terminating election. The most equitable solution may be to provide in a Shareholder Agreement between the corporation and all of its shareholders that a Section 1377(a)(2) terminating election *must* be made in the event a shareholder terminates his or her entire interest in the corporation (without knowing whether such an election will be favorable or detrimental to the respective shareholders). Although this may be the most equitable solution, such a provision eliminates the planning opportunities available to the knowledgeable practitioner under Section 1377.

§ 14.05 OTHER SPECIAL CONSIDERATIONS APPLYING TO THE REDEMPTION AND PURCHASE OF S CORPORATION STOCK

[1] Single Class of Stock Rule

Under Section 1361(b)(1)(D) and Reg. Section 1.1361-1(l)(1), a corporation that has more than one class of stock will not qualify as a small business corporation, and as such, cannot be an S corporation. A corporation is treated as having only one class of stock if all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds.

[a] *Voting Rights*

Reg. Section 1.1361-1(l)(1) provides that differences in voting rights among shares of stock of the corporation will be disregarded in determining whether a corporation has more than one class of stock. Consequently, an S corporation may have voting and nonvoting common stock, a class of stock that may vote only on certain issues, irrevocable proxy agreements, or groups of shares that differ with respect to rights to elect members to the board of directors, as long as such shares confer identical rights to distribution and liquidation proceeds.

[b] *Non-conforming Distributions*

The original proposed second class of stock regulations provided that even where all outstanding shares of stock conferred identical rights to distribution and liquidation proceeds, the corporation still would be treated as having more than one class of stock if the corporation made "non-conforming distributions." Non-confirming distributions were defined as distributions which differed with respect to timing or amount as to each outstanding share of stock, with certain limited exceptions. Thus, under the original proposed regulations, excessive or inadequate compensation from an S corporation to a shareholder, shareholder loans, fringe benefits to shareholders, and other constructive distributions such as excessive rental payments between a shareholder and an S corporation could cause the inadvertent termination of an S corporation's election under the non-conforming distribution rule. Under the final second class of stock regulations, however, non-conforming distributions do *not* cause a corporation to be treated as having more than one class of stock but such distributions (including actual, constructive or deemed distributions) that differ in timing or amount will be given appropriate tax effect in accordance with the facts and circumstances. Thus, the Service has the power to recharacterize such distributions.[70]

[c] *Stock Taken Into Account*

Under Reg. Section 1.1361-1(l)(3), in determining whether all outstanding shares of stock confer identical rights to distribution

[70] Reg. § 1.1361-1(l)(2)(i).

and liquidation proceeds, all outstanding shares of stock of a corporation are taken into account, except for: (i) restricted stock within the meaning of Reg. Section 1.1361-1(l)(b)(3) with respect to which no Section 83(b) election has been made; (ii) deferred compensation plans within the meaning of Reg. Section 1.1361-1(b)(4); and (iii) straight debt under Reg. Section 1.1361-1(b)(5).

[d] *Governing Provisions*

Reg. Section 1.1361-1(l)(2) provides that the determination of whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds is based upon the corporate charter, articles of incorporation, bylaws, applicable state law, and "binding agreements relating to distribution and liquidation proceeds" (the "Governing Provisions"). Thus, with respect to an S corporation's outstanding shares of stock, only governing provisions can cause the corporation to be treated as having a second class of stock.

[e] *Routine Commercial Contractual Arrangements*

Reg. Section 1.1361-1(l)(2) provides that routine commercial contractual arrangements, such as leases, employment agreements and loan agreements, will not be considered binding agreements relating to distribution and liquidation proceeds, and consequently will not be considered Governing Provisions, *unless such agreements are entered into to circumvent the one class of stock requirement.*

[f] *State Law Requirements for Payment and Withholding of Income Tax*

Reg. Section 1.1361-1(l)(2)(ii) provides that state laws requiring a corporation to pay or withhold state income taxes on behalf of some or all of its shareholders will be disregarded in determining whether all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds if, when the constructive distributions resulting from the payment of such taxes by the corporation are taken into account, the outstanding shares otherwise confer identical rights to distribution and liquidation proceeds. Consequently, a difference in timing between constructive distributions attributable to withholding and payment of taxes with

respect to some of an S corporation's shareholders and actual distributions to its shareholders will not cause the corporation to be treated as having more than one class of stock.

[g] *Distributions that Take Into Account Varying Interests*

Reg. Section 1.1361-1(l)(2)(iv) provides that an agreement will not be treated as affecting the shareholders' rights to liquidation and distribution proceeds conferred by an S corporation's stock if the agreement merely provides that, as a result of a change in stock ownership, distributions in one taxable year will be made on the basis of the shareholders' varying interests in the S corporation's income during the immediately preceding taxable year. If, however, such distributions are not made within a "reasonable time" after the close of the taxable year in which the varying interests occur, such distributions may be re-characterized depending upon the facts and circumstances, but still will not result in the corporation being treated as having a second class of stock.

[h] *Buy-Sell, Redemption and Other Stock Restriction Agreements*

Reg. Section 1.1361-1(l)(2)(iii) sets forth rules regarding when buy-sell, redemption and other stock restriction agreements will be disregarded in making the determination as to whether a corporation's shares of stock confer identical rights to distribution and liquidation proceeds.

[i] *Agreements Triggered by Death, Divorce, Disability or Termination of Employment*

A bona fide agreement to redeem or purchase stock at the time of death, divorce, disability or termination of employment will be disregarded in determining whether a corporation's shares of stock confer identical rights to distribution and liquidation proceeds.[71]

[ii] *Buy-Sell Agreements, Stock Restriction Agreements and Redemption Agreements*

Buy-sell agreements among shareholders, agreements restricting the transferability of stock, and redemption agreements will be

[71] Reg. § 1.1361-1(l)(2)(iii)(B). If stock that is substantially non-vested is treated as outstanding, the forfeiture provisions that cause the stock to be substantially non-vested will be disregarded.

disregarded in determining whether a corporation's outstanding shares of stock confer identical distribution and liquidation rights unless: (1) a principal purpose of the agreement is to circumvent the one class of stock requirement; *and* (2) the agreement establishes a purchase price that, at the time the agreement is entered into, is significantly in excess of or below the fair market value of the stock.

Reg. Section 1.1361-l(l)(2)(iii) provides that a price established at book value or at a price between fair market value and book value will not be considered to establish a price significantly in excess of or below the fair market value of the stock. A determination of book value will be respected if the book value is determined in accordance with GAAP, or the book value is used for any substantial non-tax purpose. Additionally, the regulations provide that a good faith determination of fair market value will be respected unless it can be shown that the value was substantially in error *and* the determination of value was not performed with reasonable diligence.

[i] *Special Rule for Section 338(h)(10) Elections*

Reg. Section 1.1361-1(l)(2)(v) provides that if the shareholders of an S corporation sell their stock in a transaction for which an election under Section 338(h)(10) is made, the receipt of varying amounts per share by the shareholders will *not* cause the S corporation to have more than one class of stock, provided that the varying amounts are determined in arm's-length negotiations with the purchaser. This provision is important because the amount a shareholder is paid per share of stock (and the timing of the payment) often will vary among the shareholders (for example, due to control premiums and minority discounts), which could create a second class of stock concern if the shareholders were viewed as receiving different amounts in the fictional liquidation of the S corporation resulting from the Section 338(h)(10) election.[72]

[2] Pricing Considerations

In addition to the other methods and considerations used in determining the value of stock in a corporation, some special pricing

[72] See also PLRs 9821006 and 199918050.

considerations may be necessary in valuing stock in an S corporation for buy-sell purposes.

A shareholder having his or her stock purchased/redeemed may want credit for his or her allocable share of the corporation's AAA, especially where a cross purchase is the selected buy-sell method. On the other hand, it could be argued that since AAA is a corporate level account and is already reflected in the selling shareholder's stock basis, a selling shareholder's imputed share of AAA should not be treated as a positive adjustment to the purchase price. Still, it may be an issue which the selling shareholder can use to negotiate the receipt of more cash at closing and less in the way of a deferred payment.

Where an S corporation has accumulated earnings and profits (from C years) and the selling shareholder is receiving capital gain and/or a full basis recovery by structuring the transaction as a sale or exchange, the remaining shareholders may wish to reduce the price paid to account for the subsequent income tax burden they will recognize on the receipt of ordinary income dividends from the corporation's accumulated earnings and profits.

Projected corporate level taxes on an S corporation should also be considered. For example, if the corporation is subject to the built-in gains tax under Section 1374, a shareholder selling out before the end of the 10-year recognition period will be avoiding his or her share of the double tax to which the corporation would be subject if it sold its assets or liquidated. Thus, it may be contended that a downward price adjustment should be made with respect to such shareholder's pro rata share of the potential corporate level tax. A similar adjustment could arise for anticipated corporate level taxes under the passive investment income rules of Section 1375. As to the passive investment income tax, a ceiling could be placed on the required adjustment based on the amount of accumulated earnings and profits from C years that must be distributed to avoid application of Section 1375.[73]

[73] See August, "The 'BIG' Tax Under Section 1374: Blocking the Erosion of Corporate Level Taxation in a Post-General Utilities World (Part I & Part II)", Corporate Tax and Business Planning Review (March, 1996 and April, 1996); Starr, 731 T.M., S Corporations: Operations, ¶ VII(E). See also *Eisenberg v. CIR*, 155 F.3d 50, *acq.* 1999 — C.B. xix (AOD 1999-001), *vacg* and *remg* T.C. Memo 1997-483; *Estate of Artemus Davis*, 110 T.C. 530 (1998).

As an alternative to resolving the complex issues concerning adjustments for corporate level taxes, it may be preferable to use a formula price based on pretax earnings and not include any adjustment for corporate level taxes. Moreover, federal income taxes generally are not relevant in determining net asset values if asset values are the primary method of valuation.

[3] Redemptions Funded With Life Insurance Proceeds

S corporations are not subject to the corporate alternative minimum tax, and as such, may receive life insurance proceeds tax-free. Where a redemption buy-sell method is used, a group policy may be purchased by the corporation. However, the proceeds will increase the stock basis of *all* shareholders, including a deceased shareholder whose stock is being redeemed. Since Section 1014 applies to increase basis at death, the added pass through of the insurance proceeds (assuming such adjustment is nontaxable under Section 101(a)), will largely be wasted or will result in a capital loss to the redeeming shareholder. To avoid this problem, the shares of a deceased S shareholder should be purchased prior to the time that the insurance proceeds are received and the agreement should require that all shareholders and the corporation file an election under Section 1377(a)(2) to close the books of the corporation as of the date of the shareholder's death.

In PLR 200409010, the Service ruled that the life insurance proceeds on an S corporation's insurance policy on one of its shareholders would be required to be recognized as of the date of the shareholder's death, since the shareholder's death established the S corporation's rights to the proceeds as a beneficiary of the insurance policy. Under the facts of the ruling, the minority shareholders of an S corporation using the accrual method of accounting, acquired a life insurance policy on one of the shareholders to provide funds for the redemption of the shares owned by such shareholder upon his death. Upon the death of the shareholder, the S corporation planned to immediately redeem the S corporation's stock held by the shareholder at the time of his death by issuance of a promissory note to the shareholder's estate. Following the redemption, the remaining shareholders of the S corporation intended to make an election pursuant to Section 1377(a)(2), to terminate the S corporation's taxable year. By terminating the S

corporation's taxable year after the redemption of the shareholder's stock but prior to the submission of the claim on the life insurance policy on the deceased shareholder's life, the remaining shareholders attempted to have all of the insurance proceeds allocated to their S corporation stock.

The Service, citing Rev. Rul. 98–39,[74] *Frank's Casing Crew and Rental Tools, Inc. v. Commissioner*,[75] *Continental Tie & Lumber Co. v. U.S.*,[76] and *Charles Schwab v. Commissioner*,[77] ruled that because the submission of a claim on the insurance policy held by the S corporation was simply a ministerial act, the life insurance proceeds on the insurance policy would be required to be recognized as of the date of the shareholder's death. Consequently, the basis increases resulting from the S corporation's receipt of the proceeds from the life insurance policy on the deceased shareholder's death were required to be allocated proportionately to all of the shareholders (including the deceased shareholder's estate), and could *not* be allocated solely to the remaining shareholders.

This situation should be contrasted to an S corporation using the cash method of accounting. In that situation, if the shares of a deceased S shareholder are purchased prior to the time that the insurance proceeds are actually received by the S corporation, and a Section 1377(a)(2) terminating election is made by all of the shareholders to treat the tax year as if it consisted of two tax years (the first ending as of the date of death of the deceased shareholder), the shareholders should be successful in allocating the increase in basis resulting from the S corporation's receipt of the life insurance proceeds solely to the remaining shareholders (and not to the deceased shareholder's estate).

Additionally, this ruling seems to indicate that if certain circumstances are present, such as death within the contestable period, suicide within the policy's first two years, fraudulent claims, or claims by competing adverse beneficiaries, the life insurance proceeds may *not* be accruable as of the date of death of the deceased shareholder, and as such, the basis increase could be allocated solely to the remaining shareholders in those situations.

[74] Rev. Rul. 98–39, 1998–2 C.B. 198.

[75] T.C. Memo 1996–413.

[76] 286 U.S. 290 (1932).

[77] 107 T.C. 282 (1996).

It has been suggested that insurance proceeds may fall within the meaning of "annuities" for passive investment income purposes. For an S corporation having subchapter C earnings and profits, funding redemption payments with life insurance could subject the corporation to a tax on otherwise non-taxable insurance proceeds under Section 1375.[78]

§ 14.06 SALES AND REDEMPTIONS OF PARTNERSHIP INTERESTS

While the primary focus of this article is on the tax consequences of redemptions and purchases of S corporation stock, with a secondary focus on the tax consequences of redemptions and purchases of C corporation stock, it is also beneficial to briefly address the tax consequences relating to redemptions and purchases of partnership interests. Such rules are found in Subchapter K, which normally applies the "aggregate" theory of partnership taxation in an effort to tax each partner as though he were directly conducting his proportionate share of the partnership's business, unless for tax policy purposes, the entity theory is more appropriate (as determined by Congress). The application of aggregate or entity taxation rules in the partnership context can affect the character, timing and allocation of a partnership's items of income, loss, deduction and credit.

Comparing the sale or redemption of a partnership interest to the sale or redemption of shares of a corporation (C or S) is almost a *non sequitor* because of the complexity of the rules governing such transactions under Subchapter K, which affects the parties in ways dramatically different from the application of Subchapter S and Subchapter C to similar corporate transactions.

Accordingly, the remainder of this article will only *generally* describe the *basic* issues to be considered in analyzing sales or redemptions of partnership interests and will not attempt to directly compare these rules to the rules applicable to the sale or redemption of corporate stock.

[78] See (former) Reg. § 1.1372-4(b)(5)(ix). Reg. § 1.1362-3(d)(5)(ii)(E) ("amount(s) received as an annuity under an annuity, endowment, or life insurance contract, if any part of the amount would be includable in gross income under Section 72").

[1] General Rules Governing Sales of Partnership Interest

The sale of a partnership interest is normally governed by Section 741, which provides that gains and losses from sales of partnership interests are treated as capital gains and losses, limited by the application of Section 751(a), which will cause some or all of the amount realized in such a sale to be re-allocated among the capital and non-capital assets of the subject partnership whenever the selling partner receives payments attributable to that partner's share of the partnership's unrealized receivables or inventory items, otherwise known as Section 751 property or "hot" assets. In addition to Section 751/741 considerations, the selling partner must consider how Section 752 will impact his or her amount realized in the sale transaction.

[2] Purchaser's Basis in Partnership Interest

The purchaser of a partnership interest will take a cost basis in his purchased interest under Section 1012, and will also increase his basis under Section 752 to take into consideration his share of the partnership liabilities for which he becomes liable as the result of the sale transaction. The buyer must also consider how the allocation of purchase price rules under Section 754 will affect his share of the inside basis in the assets of the partnership.

[3] Rules Governing Redemptions of Partnership Interest

If the rules governing sales of partnership interest are not complex enough, to compare the consequences of a sale of a partnership interest to a redemption, the practitioner must master a myriad of rules governing the partial or complete liquidation of a partnership interest. Since such transactions are, in effect, distribution transactions, the rules governing partnership distributions determine the tax consequences of partnership redemptions. Set forth below is a brief summary of the basic rules governing the federal tax treatment of partnership distributions.

[a] *Non-Recognition of Gain or Loss on Current Distributions*

Under Section 731(a), the recipient of a current (i.e., nonliquidating) partnership distribution generally recognizes neither gain nor loss. There are two exceptions to this rule. The first occurs when

the distribution includes an amount of money or marketable securities which have a fair market value in excess of the distributee's basis in his partnership interest. The second exception occurs when Section 737 is triggered.

[b] *Basis and Holding Period of Currently Distributed Property*

The basis to the distributee of property included in a current distribution is generally equal to the partnership's basis immediately prior to the distribution under Section 732(a)(1), and the distributee is permitted to "tack" the partnership's holding period onto his own holding period under Section 735(b). Again, there is a significant exception to this rule if the partnership's basis in distributed property exceeds the recipient's pre-distribution basis in his partnership interest. In this case, the recipient's basis in distributed assets is limited under Section 732(a)(2) to the pre-distribution basis of his partnership interest.

[c] *Reduction in Basis of Partnership Interest Resulting from Distributions*

On a current distribution, the recipient's basis in his partnership interest is reduced (but not below zero), pursuant to Section 733, by the amount of money and the adjusted basis (to the distributee) of other property received in the distribution.

[d] *Non-recognition of Gain or Loss on Liquidating Distributions*

Distributions by a continuing partnership in complete liquidation of a partner's interest are governed by Section 736. Under Section 736, most distributions with respect to a partner's interest in partnership property are taxed under the general distribution rules of Sections 731 through 735 and Section 737. If a liquidating distribution is received in connection with the liquidation and termination of the partnership itself (as distinguished from the liquidation of a single partner's interest), all distributions are taxed under Sections 731 through 735, Section 737 and Section 751(b), without reference to Section 736.

As is the case with respect to current distributions, the distributee recognizes gain only to the extent the amount of money and the fair market value of marketable securities (subject to various

exceptions) distributed exceeds the pre-distribution basis of his partnership interest.

The recipient of a liquidating distribution may recognize a loss, but only if (1) the liquidating distribution consists solely of money, unrealized receivables, and inventory, and (2) the amount of money and the basis to the distributee of the unrealized receivables and inventory is less than the pre-distribution basis of his partnership interest.

[e] *Basis of Property Received in a Liquidating Distribution*

The basis of property received in a liquidating distribution is generally computed with reference to the distributee's basis in his partnership interest under Section 732(b). Again, a significant exception to this general rule, Section 732(c), prohibits any increase in the basis of unrealized receivables and inventory.

[f] *Non-Recognition of Gain or Loss by, and Effect on Basis to, Distributing Partnership*

Section 731(b) generally prohibits the recognition of gain or loss by the distributing partnership, and the basis of remaining partnership assets is generally unchanged under Section 734(a). However, an adjustment may be made to the basis of remaining partnership assets pursuant to Section 734(b) under certain circumstances if the partnership files a timely Section 754 election.

[g] *Section 737*

If a partnership makes a distribution to a partner who contributed property to the partnership within seven years of such contribution, the distribution triggers gain (but not loss) to the extent of the lesser of: (a) the excess of the fair market value of the distributed property over the distributee's basis in his partnership interest (reduced, but not below zero, by any distributed money); or (b) the amount of gain which would be recognized under Section 704(c)(1)(B) if the contributed property were distributed to another partner.

[h] *Marketable Securities*

Distributions of marketable securities (and certain similar items deemed to be marketable securities) are treated as distributions of money.

[i] *Special Basis Adjustments*

If the recipient of a partnership distribution acquired his interest by sale or exchange or upon the death of a former partner, and a Section 754 election was not in effect with respect to the acquisition, he may nevertheless be entitled (or, in some cases, required), under Section 732(d), to treat the basis of property distributed to him as if it had been adjusted under the optional basis adjustment provisions of Section 743(b) upon the acquisition of his interest.

[j] *Characterization of Post-Distribution Gain or Loss to Distributee-Partner*

Section 735(a) sets forth special rules under which post-distribution gain or loss realized by a distributee on a subsequent sale of distributed unrealized receivables or inventory must be characterized as ordinary income or loss regardless of the character of the property in the hands of the distributee. If the property distributed is subject to one of the many statutory recapture provisions (e.g., Sections 617, 995, 1245, 1248, 1250, 12542, 1253, and 1254), special rules are generally provided for the computation of the distributee's income on a subsequent sale of the property.

[k] *Post-Distribution Depreciation or Cost Recovery Deductions*

Section 168(i)(7) provides that a partner receiving a Section 731 distribution of recovery property generally must compute his accelerated cost recovery system (ACRS) deductions as if he were the transferor to the extent his basis in the property does not exceed the partnership's basis. Thus, the distributee-partner steps into the shoes of, and is bound by, all ACRS elections made by the distributing partnership.