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S Corporations Redemptions and Divisions

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I. DIVIDENDS.

A. Internal Revenue Code ("Code") § 301. Code § 301 provides that, except as otherwise provided, a distribution of property made by a corporation to a shareholder with respect to its stock shall be treated as follows:

1. First, as a dividend (as defined in Code § 316) to the extent of the corporation’s earnings and profits;
2. Second, as a return of basis; and
3. Third, as gain from the sale or exchange of property.

B. Dividends to the Extent of Earnings and Profits. The shareholder receiving the distribution, therefore, includes the full amount of the corporation’s distribution in gross income, to the extent of the shareholder’s allocable portion of the corporation’s earnings and profits. This amount is taxable to the shareholder as dividend income.

C. Qualified Dividends and JGTRRA. Prior to the Jobs and Growth Tax Relief Reconciliation Act of 2003 ("JGTRRA"), dividends were treated as ordinary income subject to a maximum marginal individual tax rate of 35%. JGTRRA reduced the tax rate on “qualified dividends” from ordinary income tax rates to a maximum federal tax rate of 15%. The 15% dividend tax rate of Code § 1(h)(11) is scheduled to sunset for tax years beginning after December 31, 2008. 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.

1 This outline includes excerpts from F. Aghdami, M. A. Mancini, & H. M. Zaritsky, Buy-Sell Agreements: Tax and Business Planning (Warren, Gorham, & Lamont, Inc., 2d ed) and a draft version of Aghdami and Zaritsky, "The Blount True-th About The F-Amlie Business: Tax And Nontax Considerations In Drafting Buy-Sell Agreements", an outline that will be presented at the 41st Annual University of Miami Philip E. Heckerling Estate Planning Institute in January 2007. I thank my co-authors, the University of Miami, Warren, Gorham & Lamont, Inc., RIA Group, and Thomson Corporation for the use of these materials.
D. Qualified Dividends.

1. **Maximum Tax Rate.** The maximum income tax rate for qualifying dividends is reduced to 15% for individuals, estates and trusts. Code § 1(h)(11).

2. **Maximum Income Tax Rate For Certain Long-Term Capital Gains.** The maximum tax rate for long-term capital gains property (property held for more than one year) that qualified for the 20% rate under prior law is reduced to 15% for individuals, estates, and trusts. Code § 1(h)(1)(B). The new rates apply to sales on or after May 6, 2003. Pre-May 6, 2003 installment sales qualify for new rates for payments received after that date. The lower rates for certain long-term capital gains also apply for AMT. The 15% capital gains rate is scheduled to expire after 2008. Installment sales and other deferral techniques may not prove beneficial in the long run.

3. **Definition of Qualified Dividend.**
   a. The term "qualifying dividend income" means dividends received during the taxable year from domestic corporations and qualified foreign corporations received by a non-corporate taxpayer (i.e., a taxpayer whose capital gains income is subject to Code § 1(h). Code § 1(h)(11)(B)(i)(I) and (II).

   b. The following dividends are not “qualified dividends”:
      i. Any dividend from a tax-exempt corporation.
      ii. Any tax deductible dividend paid by mutual savings bank.
      iii. Any deductible dividend paid by a C corporation with respect to employer securities in a qualified plan that is paid to the plan participants.
      iv. Any dividend paid with respect to stock held by the shareholder for less than 60 days during the 120-day period beginning 60 days before and ending 60 days after the ex-dividend date.
      v. Any dividend paid by a RIC or REIT to the extent deductible in computing the table income of such entity.
      vi. If the taxpayer receives any dividend that constitutes an extraordinary dividend under Code § 1059(c), any loss on
the sale or exchange of such share shall, to the extent of such dividends, be treated as long-term capital loss. Generally, an extraordinary dividend on preferred stock exceeding 5% of the shareholder's adjusted basis, and on common stock, 10% of the shareholder's stock basis.

vii. Qualifying dividend income shall not include any amount that the taxpayer takes into account as investment income under Code §163(d)(4)(B). See Prop. Reg. §1.163(d)-1 for the election to treat qualified dividends as investment income.


E. Why Does Exchange Treatment Still Matter? By now, some of you may be thinking, “If the dividend rate is at 15% and the capital gains rate is 15%, why are we so concerned with avoiding dividend treatment and obtaining exchange treatment?” The following example illustrates that point.

Example Adam is a stockholder of the ABC Corporation, a regular corporation. Pursuant to a redemption buy-sell agreement, Adam's stock is to be redeemed after his death for $500,000 ($500 per share for his 1,000 shares). The agreement is designed so that the $500 per share price also establishes the estate tax value of the stock. The corporation has substantial accumulated earnings and profits.

If the redemption is taxed as a sale or exchange of the stock in accordance with Code §§302(a) or 303, the estate recognizes no gain because its income tax basis is $500 per share—the same as the sales price.

If the redemption is taxed as a dividend under Code §302(d), the estate has $500,000 of dividend income, without regard to its basis and a corresponding $500,000 long term capital loss. See Code §1244(d)(4).

If the purchase price in the redemption is to be paid with a note, the redemption will not qualify for installment reporting under Code §453.
F. In Announcement 2006-30, 2006-19 IRB 879, the IRS announced the withdrawal of proposed regulations on redemptions of stock in which the redemption proceeds are treated as dividend distributions, citing concerns that the proposed approach departs from current law and could create two levels of tax in certain transactions.

II. EXCHANGE TREATMENT – CODE §§ 302 AND 303.

A. General.

1. A corporate redemption is treated as a sale or exchange of a shareholder’s stock, rather than a distribution, if the redemption meets any of the special exceptions under Code § 302(b) which include exceptions for:

   a. Distributions “not essentially equivalent to a dividend” under Code § 302(b)(1)

   b. Distributions that are “substantially disproportionate” under Code § 302(b)(2);

   c. Distributions that completely terminate the shareholder’s interest in the corporation under Code § 302(b)(3); and


2. 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.

3. Code § 303 provides a fifth exception for distributions made after the shareholder’s death, in order to pay death taxes and administrative expenses.

B. Redemption Not Essentially Equivalent to a Dividend – Code § 302(b)(1).

1. A distribution in redemption of a shareholder’s stock is treated as a sale or exchange if it is not “essentially equivalent to a dividend.” Code § 302(b)(1); Treas. Regs. §§ 1.302-2(a), 1.302-2(b). This is perhaps the most logical of the statutory exceptions to distribution treatment of a redemption, because the purpose of distribution treatment is to prevent a shareholder from withdrawing corporate earnings and profits as capital gains rather than as ordinary dividend income. The “not essentially equivalent to a dividend” standard was first adopted during the 1954 codification of the federal tax laws. See, e.g., S. Rep. No. 1622, 83d Cong., 2d Sess. 42 (1954).
2. This exception raises the fundamental question of whether the redemption results in a meaningful reduction in the shareholder's proportionate interest in the corporation. The IRS makes this determination on a case-by-case basis, looking at all of the relevant facts and circumstances. Treas. Reg. § 1.302-2(b).

3. The uncertainty and sensitivity to individual facts and circumstances makes this exception somewhat less useful for planning purposes than the other exceptions, all of which tend to work with a certain arithmetic precision.


C. **Substantially Disproportionate Redemption – Code § 302(b)(2).**

1. A redemption is substantially disproportionate for purposes of Code § 302(b)(2) if the stockholder's interest in outstanding common stock (both voting and non-voting) after the redemption is less than 80 percent of his or her interest before the redemption, and if, after the redemption, the stockholder owns less than 50 percent of the total combined voting power of all shares.

2. Assuming a corporation has only voting common stock outstanding, the amount of stock which must be redeemed to satisfy the requirement of substantial disproportionality may be determined by the following formula:

\[
X = \frac{NT}{5T - 4N} + 1
\]

- \(N\) = Stockholder's number of shares before redemption
- \(X\) = Number of shares which must be redeemed
- \(T\) = Total number of shares outstanding before the redemption
3. If only non-voting common stock is redeemed the redemption can not qualify under Code § 302(b)(2) since there must be a reduction in the stockholder’s voting stock. A redemption of non-voting common can qualify, however, if piggy-backed with a qualifying redemption of common stock. Treas. Reg. § 1.302-3(a). See Rev. Rul. 77-237, 1977-2 C.B. 88.

4. In testing for substantial disproportionality under Code § 302, the attribution rules in Code § 318 are applicable. See Rickey v. U.S., 592 F.2d 1251 (5th Cir.), rehe’g denied, 599 F.2d 1054 (5th Cir. 1979) (integrated set of sales and gifts of stock resulted in disproportionate redemption). The IRS will not issue rulings under Code § 302(b)(2) where payments are contingent on the future earnings of the corporation or are subordinate to general creditors.

D. Complete Termination of Interest – Code § 302(b)(3).

1. Under Code § 302(b)(3), sale or exchange treatment will result if a stockholder terminates his 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 in equal shares by two unrelated stockholders and the corporation redeems all of the stock of one stockholder for cash.

2. Although many Code § 302(b)(3) redemptions will also qualify under Code § 302(b)(2), the potential scope of Code § 302(b)(3) is broader and could qualify a redemption of nonvoting stock or Code § 306 stock that is not substantially disproportionate.

E. Code § 318 – Family Attribution Rules. Qualifying a redemption under either Code §§ 302(b)(2) or 302(b)(3) in the context of a family corporation is extremely difficult, because of the application of the constructive ownership rules in Code § 318.

1. Introduction. Stock is owned constructively if it is owned by certain family members, or entities in which the stockholder is interested. Thus, in the typical family corporation, in which all stock is held by parents and their children, the redemption of all of the stock owned directly by any stockholder will be neither substantially disproportionate nor a complete termination of the stockholder’s interest.

2. 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 stockholder must be redeemed by the corporation for $500 per share. Father dies in 1990, leaving all of his stock to 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 Code § 302(d), rather than a sale or exchange, because the estate is deemed to own 100 percent 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, so before the redemption the estate is deemed to own 4,000 of the 4,000 outstanding shares, and after the redemption it is deemed to own 3,000 of 3,000 outstanding shares.

3. **Family Hostility.** The First Circuit has held that the family attribution rules do not apply if the taxpayer can show that there is such a degree of family hostility that their use is inappropriate in testing for dividend equivalence under Code § 302(b)(1). *Haft Trust v. Comm'r*, 510 F.2d 43 (1975), *rem'g* 61 T.C. 398 (1973), *supplemental opinion*, 62 T.C. 145 (1974). The opinion relies on *U.S. v. Davis*, 397 U.S. 301 (1970), *reh. denied* 397 U.S. 1071 (1970), *rev'g* 408 F.2d 1139 (6th Cir. 1969), as rejecting only the narrow proposition that the attribution rules are to be completely disregarded under Code § 302(b)(1). The First Circuit then remanded the case back to the Tax Court for consideration of the family hostility issue but the case was then settled by the parties. Despite *Haft Trust*, the Service has continued to take the position that the family attribution rules continue to apply in testing for dividend equivalence under Code §§ 302(b)(1), (b)(2) and (b)(3).

4. **Specific Attribution Rules.** Code § 302(c)(1) provides that Code § 318(a) will apply in determining ownership of stock for purposes of Code § 302. There are four major types of attribution under Code § 318: (i) family attribution, (ii) attribution from an entity, (iii) attribution to an entity, and (iv) option attribution. Under Code § 318(a)(5)(A), except as otherwise provided, stock constructively owned by a person by reason of the application of Code §§ 318(a)(1), (2), (3) or (4) will, for purposes of applying such sections, be considered as actually owned by such person.

5. **Family Attribution.** Under Code § 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.

   a. Code § 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 applying the family attribution rules in order to make another the constructive owner of such stock (no double family attribution).

   b. Under Code § 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 Code § 302(b)(3). Additionally, Code § 302(c)(2)(C) provides that under certain circumstances the family attribution rules may be waived by an entity.

6. **Attribution to the Entity.** In general, under Code § 318(a)(3), stock owned, directly or indirectly, by partners, beneficiaries, and shareholders is attributed to a partnership, estate, trust or corporation, respectively.

   a. Code § 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. Treas. Regs. § 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.

   b. Code § 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 Treas. Reg. § 1.318-3(b), a remainderman is considered a beneficiary of a trust. Query: When does an estate become a trust for purposes of the Code § 318 attribution rules? This question can impact whether Code § 318(a)(3)(A) or (B) applies in determining the tax consequences of a redemption transaction.

   c. Code § 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.


7. **Attribution from the Entity.** In general, under Code § 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.

   a. Code § 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.
b. Code § 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.

c. Code § 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.

8. **Option Attribution.** Under Code § 318(a)(4), a person who has an option to acquire stock is deemed to own such stock. Additionally, Code § 318(a)(5)(D) provides that if stock may be considered as owned by an individual under either the family attribution rules of Code § 318(a)(1) or under the option attribution rules of Code § 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 re-attributed to a member of the option holder's family without being subject to the rule prohibiting double family attribution.

9. **Prohibition on Attribution of Stock to an Entity and then from Such Entity.** Code § 318(a)(5)(C) provides that stock constructively owned by a partnership, estate, trust or corporation by reason of Code § 318(a)(3) (attribution to the entity), will not be considered as owned by such entity for purposes of applying Code § 318(a)(2) (attribution from the entity) in order to make another the constructive owner of such stock.

10. **Statutory Waiver of Family Attribution.** The distributee in a redemption can waive the family attribution rules under Code § 318(a)(1) in order to have a complete termination of interest under Code § 302(b)(3) if the three require-ments set forth in i, ii, and iii below are met. Code § 302(c)(2).

a. **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 Code § 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. Code § 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 CB 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. 2006-3; 2006-1 IRB 122 Section 3.01(27).

b. 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. Code § 302(c)(2)(A)(i).


d. Retained Interest. The Service takes an extremely expansive view on whether a shareholder-distributee has retained any interest in the corporation.

i. 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. Rev. Rul. 70-104, 1970-1 C.B. 66; Rev. Rul. 56-556, 1956-2 C.B. 177.

ii. 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. Rev. Rul. 59-119, 1959-1 C.B. 68.

iii. Similarly in Rev. Rul. 71-426, 1971-2 C.B. 173, 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 Code § 318(a)(1).

iv. Finally, the IRS has taken the position that a redeemed shareholder has retained a prohibited interest in the redeeming corporation where the shareholder retained a
debt instrument. See 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.

v. However, the Tax Court in Hurst v. Comm’r, 124 T.C. No 2 (February 3, 2005), overturned the IRS’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 Code § 302(b)(3) because he had retained a prohibited interest in the redeeming corporation in that it was an interest 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 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 Code § 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 IRS argued that Hurst retained a prohibited interest by retaining an interest in Mechanical which is 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 IRS’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 the Hurst's status as creditors.

e. Retained Services. In Lynch v. Comm'r, 801 F.2d 1176 (9th Cir 1986), rev'g 83 T.C. 597, 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 Code § 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 is inconsistent with Congressional intent to bring certainty into the area. See also Michael N. Cerone, 87 T.C. 1 (1986); Jack O. Chertkof, 649 F.2d 264 (4th Cir. 1981) (management contract with controlled affiliate disqualified family waiver). As an illustration of how narrow the court's focus in this area can be, in Seda v. Comm'r, 82 T.C. 484 (1984), a father who had all of his stock redeemed terminated an employment relationship after being informed that his $1000 per month payments violated Code § 302(c)(2)(A)(i). The Court held that such employment converted the redemption payments from capital gain into ordinary income. But See Estate of Lennard v. Comm'r, 61 T.C. 554 (1974), acq. in result only, 1974-2 C.B. 3, nonacq. 1978-2 C.B.3.

11. Entity Waiver of Family Attribution Rules. The stock constructively owned by a family member is 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 an entity qualifying as a sale or exchange. 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. Code § 302(c)(2)(C). See Willens, Redemption of Stock Held by Entities, Tax Notes, March 28, 2005 and Willens, Stock Transfer May Prevent Attribution Waiver, Tax Notes, August 8, 2006.

a. The entity waiver rules can be useful when an estate or trust beneficiary owns none of the redeeming corporation's stock
personally, but is related to other shareholders.

b The entity waiver rules provide no benefit, however, if a beneficiary owns stock which he or she does not also submit for redemption.

c. Example. 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 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.

d. Example. 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.


1. General. If the value of stock that the decedent owned at the date of death exceeds 35% of the value of his adjusted gross estate, the estate is entitled to treat the amount received in redemption of the stock as payment in exchange for the stock, but only to the extent of the amount of the death taxes (including interest) and the allowable funeral and administration expenses of the estate. Code § 303.

2. Requirements. In order to qualify for Code § 303 “exchange” treatment, the following requirements must be met:

   a. The value of the stock redeemed must be included in the decedents gross estate;

   b. The value of all the stock of the distributing corporation included in the decedent’s gross estate must exceed 35% of the value of the decedent’s total gross estate less certain expenses deductible for
federal estate tax purposes. The stock of two or more corporations can be aggregated, in order to satisfy this 35 percent test, if the estate includes 20 percent or more of the stock of each corporation, including the full value of stock owned jointly with the surviving spouse. Code § 303(b)(3);

c. The exchange treatment is only available to the extent the amount received in redemption of the stock does not exceed the death taxes (plus interest) imposed on the estate and the allowable funeral and administrative expenses;

d. The interest of the shareholder must be reduced by the payment of the estate tax, funeral or administrative expenses, and

e. The redemption must occur within three years from the date the estate tax return is filed; but if a Code § 6166 election has been made, the redemption period includes the deferral period.

3. Treatment of Amounts Received. To the extent the amount received by the estate in redemption of stock qualifies under Code § 303, such amount is treated as follows:

a. First, the amount distributed is treated as a tax-free recovery of the estate’s basis in the stock, to the extent thereof. The estate’s basis in the stock is the value of the stock on the date of the decedent’s death or on the alternate valuation date. Code § 1014. Accordingly, the estate often will not realize any gain, unless the value of the stock appreciates between the date of the decedent’s death (or alternate valuation date) and the date of redemption.

b. Second, to the extent the amount distributed exceeds the estate’s basis in the stock, the amount distributed is treated as gain from the sale of stock, normally capital gain.

4. Practical Limits. In practice, Code § 303 is of only modest utility. 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 Code § 303 applies only to the extent that the redeemed stockholder’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 share of the estate is rarely going to be eligible for redemption under Code § 303. See Zaritsky, “How Estate Planning is Affected by the Tax Equity and Fiscal Responsibility Act of 1982,” 1983-1 Tax Mgmt. Estates, Gifts & Tr. J. 4 (1983); and on Code § 303 generally, See also Blum and Trier, “Planning for maximum benefits of 303 redemptions with estate tax deferral,” 53 J.
G. Impact on Other Stockholders.

1. **Code § 305.** Under Code § 305(b)(2), if a distribution (or series of distributions) has the result of having some stockholders receiving property while the remaining stockholders increase their proportionate interest in the corporation, the latter are treated as in receipt of a dividend to the extent of the corporation's earnings and profits.

2. Under the regulations, isolated redemptions of stock will not constitute prohibited property distributions even if the redeemed stockholders do not qualify under Code § 302(a) for exchange treatment. Treas. Regs. §§ 1.305-3(b)(3) (last sentence), 1.302-3(e), Ex. 10. See Rev. Rul. 77-19, 1977-1 C.B. 83 (20 isolated redemptions during prior 3 years from deceased or retiring stockholders, plus redemptions from stockholders in going private redemptions held not a periodic redemption plan).

3. **Dividend Treatment.** Aside from Code § 305(b)(2), as long as the corporation redeeming the shares of stock is not relieving the other stockholders of any primary obligation to make the purchase themselves there is no dividend treatment to the remaining stockholders. Wall v. U.S., 164 F.2d 462 (4th Cir. 1947); Holsey v. Comm'r, 258 F.2d 865 (3rd Cir. 1958).

H. Impact on the Corporation.

1. **E&P.** 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 non-exchange redemption. For an exchange redemption, earnings and profits are reduced in direct proportion with the percentage of shares redeemed. Code § 312(n)(7).

2. If as a result of the redemption (or even a cross purchase) the corporation has five or fewer stockholders owning more than 50 percent (value) of its stock on any day during the last half of its taxable year, then the corporation will be subject to the at-risk and passive activity loss rules for its entire taxable year.
3. In general, the distribution of appreciated property by a corporation to a stockholder in an exchange or non-exchange redemption will result in gain to the corporation. Code § 311. The distribution of depreciated property will not be recognized by the corporation and also results in disappearing basis at the stockholder level.

III. S CORPORATION REDEMPTIONS.

A. General Distribution Rules for S Corporations Without Earnings and Profits.

1. The same rules governing shareholders in C corporations under Code § 302 (and Code § 303) also apply to distributions in redemption of stock of an S corporation, including the stock attribution rules in Code § 318. See Code §§ 1371(a)(1) and 318(a)(5)(E) (S corporation treated as a partnership for entity attribution rules).

2. Characterization of a distribution as a redemption under Code § 302(a) or as a distribution under Code § 1368(a) may make little difference to the redeeming shareholder because of the distribution rules governing S corporations having 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. Code § 1368(b)(1).

3. To the extent distributions exceed basis, however, the excess is treated as gain from the sale or exchange of property. Code § 1368(b)(2).

4. 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 makes no difference to the redeeming shareholder whether the transaction is a redemption under Code § 302(a) or a distribution under Code § 1368. A separate block rule will apply to non-sale or exchange redemptions in mirroring the results under distributions to shareholders in C corporations. See Treas. Regs. §§ 1.1367-1(c)(3) and (f).

B. General Distribution Rules for S Corporations With Earnings and Profits.

1. This indifference as to whether a distribution is characterized as a Code § 302 redemption or a Code § 1368 distribution may also apply to S corporations having earnings and profits.

2. 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.

3. 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:

a. That portion of the distribution that does not exceed AAA is tax-
free to the extent of the shareholder's stock basis - Code §§
1368(c)(1) and 1368(b)(1);

b. That portion of the distribution that does not exceed AAA, but that
does exceed the shareholder's stock basis, is capital gain - Code §§
1368(c)(1) and 1368(b)(2);

c. 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 - Code §§ 1368(c)(2) and 301;

d. 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) - Code §§ 1368(c)(3) and
1368(b)(1); and

e. 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 - Code §§
1368(c)(3) and 1368(b)(2).

4. Thus, even if the redemption is not treated as an exchange, the same result
will apply, e.g., 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.
5. **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 Code § 1367(a)(1), but will not be decreased by items of S corporation loss and deduction described in Code § 1367(a)(2) until after the tax treatment of the distribution has been determined. Additionally, Code § 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).

6. **AAA Bypass Election.** Under Code § 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 Code § 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 corporations accumulated Subchapter C earnings and profits to the extent thereof, then out of the corporation’s AAA.

   a. A Code § 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 Code § 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 Code § 1362(d)(3) (which applies where passive investment income of an S corporation with accumulated earnings and profits exceeds 25% of gross receipts from 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.

   b. 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 Code § 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%.

C. **Redemptions That Qualify for Exchange Treatment.**
1. **Effect on Corporation.** If a redemption results in exchange treatment to the shareholder under Code §§ 302 or 303, there is no immediate tax effect to the S corporation. If the S corporation distributes appreciated property as consideration in the redemption, gain will be recognized on the distribution, pursuant to Code § 311(b). The Code § 311(b) gain flows through and is taxed to all shareholders, not just the shareholder receiving the distribution.

2. **AAA Reduction.** Code § 1368(e)(1)(B) and Treas. Regs. § 1.1368-2(d)(1) provide that a redemption under Code §§ 302 or 303 requires a reduction in the corporation’s AAA by an amount determined as of the redemption date reflecting the proportionate shares redeemed. In this instance, AAA is multiplied by the fraction equal to the number of redeemed shares divided by the number of outstanding shares immediately before the redemption. For example, if the S corporation’s AAA as of the redemption date is $200,000, and 40% of the S corporation’s shares are redeemed, the AAA is reduced by $80,000.

3. **Calculation of AAA Reduction.** Although the amount of the redemption is determined based on the balance in the AAA as of the redemption date, the balance of the AAA, and therefore the redemption reduction, is not actually calculated until the close of the taxable year. Calculating the AAA balance and the amount of the redemption adjustment is relatively simple in a year when there are no ordinary distributions. Income and loss items for the year are allocated ratably up through the redemption date and then added to the balance of the AAA from the previous year. To determine the redemption adjustment, this balance is then multiplied by the fraction reflecting the proportion of shares redeemed. Treas. Regs. § 1.1368-2(a)(2) and Treas.1.1368-2(a) Regs. § 1.1368-2(d)(1)(i).

   **Example:** XYZ is an S corporation owned equally by B and C. XYZ’s AAA balance at the beginning of the year is $40,000. During that year, the corporation has net earnings of $100,000, none of which is distributed to the shareholders. On June 30, XYZ redeems all of B’s stock. XYZ’s AAA is first increased to $90,000 ($40,000 + (6/12 × $100,000)) to reflect the balance in the AAA at the date of redemption. Then it is decreased to $45,000 ($90,000 × 1/2) to reflect the redemption adjustment. XYZ’s AAA balance at the end of the year would be $95,000 ($45,000 AAA post redemption + pro rata AAA for the remainder of the year).

4. **Mixed Distributions – Ordinary and Redemption.** When both ordinary and redemption distributions are made in the same year, however, the calculation can become more complex. In such cases, the AAA must be adjusted, at the end of the taxable year, for ordinary distributions before it is adjusted for redemption distributions, but the redemption adjustment
amount must be determined as of the redemption date, which could be before one or more ordinary distributions are made. Under the final regulations, it is not clear how the redemption adjustment amount is calculated. The final regulations, however, provide only that the AAA is adjusted first for ordinary distributions and then for any redemption distributions, without specifically describing how the adjustment is calculated. Treas. Regs. § 1.1368-2(d)(1)(ii).

5. **Closing of Books.** Alternatively, if a shareholder’s interest is terminated, or if the redemption is of 20% or more of the outstanding stock of the corporation from a shareholder in one or more transactions during any 30-day period during the corporation’s taxable year, the corporation may elect with the consent of all affected shareholders to close the corporation’s books and treat the year as two independent tax years for allocation purposes; one year ending at the close of the termination date, and the second ending at the normal year end. Code § 1377(a)(2); Treas. Regs. §§ 1.1368-1(g)(1), 1.1368-1(g)(2), - 1.1368-12(e). Such an election eliminates the AAA ordering uncertainty identified above.

i. The daily allocation rule of Code § 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.

ii. Under Code § 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. Code § 1377(a)(2)(B) and Treas. Regs. § 1.1377-1(b)(2). 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 Code § 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.

iii. 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 Code § 1367, and in determining the tax effect of a distribution to the S corporation’s shareholders under Code § 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 Code
§§ 1367 and 1368. An S corporation making a terminating
election under Code § 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 Code §
446(a).

iv. A terminating election does not, however, affect the due date of the
S corporation’s tax return, nor does a terminating election under
Code § 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
Code § 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,
y 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.

v. 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 Treas. Regs. § 1.1368-1(g)(2) (as discussed in iv
below), the regulations provide that the election under Treas. Regs.
§ 1.1368-1(g)(2) cannot be made by the S corporation. In other
words, the Code § 1377(a)(2) allocation rules take precedence over
the allocation rules set forth in Treas. Regs. § 1.1368-1(g)(2)
relating to qualifying dispositions.

vi. Additionally, an S corporation may not make a terminating
election under Code § 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 Code § 1362(d).
Rather, the rules of Code § 1362(e)(2) and (3) (see iii below) take
precedence over the allocation rules of Code § 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 Code §§ 1362(e)(3) and 1377(a)(2) differ in one
important respect. An election under Code § 1362(e)(3) closes the
books on the day before the termination of S status, whereas a terminating election under Code § 1377(a)(2) closes the books on the day of the termination of the shareholder's entire interest in the S corporation.

vii. A terminating election under Code § 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 share-holder’s entire interest in an S corporation:

(A) A sale, exchange, or other disposition of all of the stock held by the shareholder;

(B) A gift under Code § 102(a) of all of the shareholder’s stock;

(C) A spousal transfer under Code § 1041(a) of all of the shareholder’s stock;

(D) A redemption under Code § 317(b) of all of the shareholder’s stock, regardless of the tax treatment of the redemption under Code § 302 as a sale or exchange or as a dividend; and

(E) The death of a shareholder.

(F) 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 Code § 1362(a)(2).

(G) 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 Treas. Regs. § 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 Code § 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.
viii. The terminating election under Code § 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. All “affected shareholders” (see ii above) must consent to the terminating election.

ix. The shareholders required to consent to the terminating election are the shareholders described under Code § 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 Code § 1377(a)(2). If 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 Code § 1361(c)(2)(A) owns shares of stock of an S corporation, the person treated as the shareholder under Code § 1361(b)(1) must consent to the terminating election.

x. 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.

xi. 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 Code § 1362(e)(4), Treas. Regs. § 1.1362-3(a). 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, Code § 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. Code § 1362(e)(3)(B) and Treas. Regs. § 1.1362-3(b)(1). Also note that under Code § 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 with respect to any items resulting from the application of Code § 338.

xii. 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. Treas. Regs. § 1.1368-1(g)(2). Moreover, the regulations provide that a redemption treated as an exchange under Code § 302(a) or Code § 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.

xiii. For dispositions of stock in an S corporation, Temporary Regulation Code § 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.

6. **Reduction of E&P.** A capital gain redemption under Code §§ 302 or 303 also has the favorable effect of concurrently reducing accumulated E&P under Code § 1371(c)(2), without the recipient’s receiving ordinary dividend income. Under the final regulations, E&P is reduced under Code § 312, independently of any adjustments made to the AAA. Treas. Regs. § 1.1368-2(d)(1)(iii).

7. **Withdraw AAA Prior to Redemption.** A shareholder who is about to have stock redeemed on the installment basis might be inclined to take a distribution out of AAA before the sale in an attempt to defer any installment gain; the AAA distribution would be tax free but put cash in the shareholder’s hands as if part of the redemption distribution, while the gain recognized over the term of the installment payments would be the same, but initial payments would be tax free and would not include any installment gain. However, under *Waterman S.S. Corp. v. Comr.*, 430 F.2d
1185 (5th Cir. 1970), the distribution may be treated as part of the sale proceeds in a collapsed transaction.


D. **S Corporation Redemptions That Do Not Qualify for Exchange Treatment.**

1. If the redemption does not qualify for capital gain treatment, it is instead considered to be a Code § 301 distribution. Therefore, under Code § 1368, the recipient shareholders first treat the distribution as nontaxable to the extent of the corporation’s AAA balance (which also serves to reduce basis in stock), then as a taxable dividend to the extent of the S corporation’s accumulated E&P, next as a nontaxable reduction in any remaining shareholder stock basis, and finally as a capital gain distribution.

2. In some cases, consideration might be given to not qualifying the redemption for exchange treatment. If there is both an adequate AAA balance and shareholder basis, the distribution would be deemed to be from the AAA in any event, and thus would be tax free to the recipient shareholder.

3. The shareholder in Rev. Rul. 95-14 was similarly able to receive a distribution tax free. In that ruling, the S corporation, which had earnings and profits, redeemed a portion of the shareholder’s stock for cash in a noncapital gain redemption. Because the corporation had AAA in excess of the distribution and the shareholder’s stock basis also exceeded the amount of the distribution, the entire amount of the distribution reduced the corporation’s AAA under Treas. Regs. § 1.1368-2(a)(3)(iii) and the shareholder could exclude the distribution from income under Code § 1368(c).


E. **Basis Adjustments.**

1. The adjustments to stock basis are generally determined as of the close of the corporation’s taxable year. However, when a shareholder disposes of stock during the year, the adjustments are effective immediately before the disposition. Treas. Regs. § 1.1367-1(d)(1).

2. Thus, the shareholder’s basis in stock reflects earnings up to the date of redemption so that the redeemed shareholder can take these earnings into account in computing gain on his or her stock exchange. Note also that
under Treas. Regs. § 1.1367-1(b)(2) and 1.1367-1(c)(3), stock basis is computed on a share-by-share basis in the same manner as stock of a C corporation. Thus, in a redemption transaction, a shareholder can select high basis stock to be redeemed to minimize gain on the transaction. This differs from a partnership where an aggregate basis is used.

3. In Priv. Ltr. Rul. 8613040, the IRS ruled that in a liquidation where a shareholder had several blocks of stock with different bases, the distribution was allocated ratably among the separate blocks of stock in proportion to the number of shares in a particular block over the total number of shares held by that shareholder. See Rev. Rul. 68-348, 1968-2 C.B. 141, amplified by Rev. Rul. 85-48, 1985-16 C.B. 126, and Rev. Rul. 69-334, 1969-1 C.B. 98.

4. The method for computing the amount includible in the redeemed shareholder’s basis should parallel the method used to compute the AAA up to the redemption date. Thus, earnings may either be ratably allocated throughout the year, or, if the shareholder either completely terminates his interest or redeems at least 20% of the corporation’s outstanding stock in a capital gain redemption, the shareholders and the corporation may elect to close its books and treat the taxable year as two separate years for purposes of allocating its earnings.

5. See, Starr and Sobol, 731 T.M., S Corporations: Operations, Section VI.B.

F. Tax Treatment Compared.

1. If the redeeming S corporation has no accumulated E&P, a complete redemption of a shareholder’s interest produces essentially the same tax results whether it is treated as a distribution of property under Code § 1368 or as a capital gain redemption under Code § 302 or Code § 303. Under Code § 1368(b), the taxation of distributions depends on the shareholders’ stock basis when there is no corporate E&P. As a result, the AAA balance is effectively irrelevant.

2. Example: XYZ is an S corporation with no accumulated E&P. B owns stock in XYZ with a value of $100,000 and a basis of $60,000. XYZ redeems all of B’s stock for $100,000. If treated as a capital gain redemption, B has a capital gain of $40,000 ($100,000 less $60,000). If regarded as a Code § 1368(b) distribution, B would again recognize a $40,000 capital gain ($100,000 distribution in excess of $60,000).

3. As a result of the enactment of JGTRRA, “qualified dividend income” is taxed at the capital gains rates. Under Code § 1(h)(11)(B), qualified dividend income is dividend income received from domestic corporations
and qualified foreign corporations. As a result, the tax rate imposed on distributions from an S corporation sourced from accumulated E&P has been reduced. A failed redemption will first be sourced from the AAA and then from accumulated E&P.

4. Example: XYZ is an S corporation with accumulated E&P of $50,000. B owns stock with a value of $100,000 and a basis of $60,000. XYZ’s AAA balance is $90,000. Assume XYZ redeems all of B’s stock for $100,000. If treated as a capital gain redemption, B has capital gain of $40,000 ($100,000 less $60,000). However, if regarded as a Code § 1368 distribution, B would recognize a $30,000 gain ($90,000 less $60,000), which is the amount by which the corporation’s AAA exceeds B’s stock basis. In addition, B would have $10,000 of dividend income out of the corporation’s E&P because the $100,000 distribution exceeds the AAA balance by $10,000. Assuming the stock had been held for at least one year, B would have $40,000 of income taxed at 15% in either scenario.

5. The benefit of achieving redemption treatment is the ability to utilize stock basis against the amount received in the transaction; however, in certain circumstances, distribution treatment may be more beneficial.

6. Example: XYZ corporation has $50,000 of AAA and $75,000 of accumulated E&P. Shareholder B has owned 40% of XYZ stock for 10 years. The fair market value of B’s stock is $400,000 and B’s stock has a tax basis of $16,000. Shareholder B would like to have 10% of the stock redeemed. If the redemption were treated as an exchange under Code § 302(a), then B would recognize capital gain of $96,000 ($100,000 fair market value less $4,000 basis). If the redemption were treated as a distribution pursuant to Code § 302(d), B would recover $16,000 of basis tax free under Code § 1368(c)(1), have dividend treatment of $75,000 (treated as net capital gain under current law), and the remaining $9,000 would be treated as gain from the sale or exchange of property (taxed at 15% under current law). Had there been no AAA, the amount taxed on the failed redemption would be also be $96,000 ($75,000 as a dividend of E&P, $4,000 recovery of basis and $21,000 treated as gain from the sale or exchange of property). As illustrated in the above example, in the case of a failed redemption, where only some of a shareholder’s stock is redeemed, Treas. Regs. § 1.1367-1(c)(3) allows basis of shares not redeemed to be applied against the distributions in order to defer ultimate taxation with respect to the redemption.

7. See, Starr and Sobol, 731 T.M., S Corporations: Operations, Section VI.B.

G. Tax Consequences to Other Shareholders. In an S corporation redemption, the other stockholders effectively are taxed on the redemption payments, which are
nondeductible (except to the extent of interest). On the other hand, and if properly structured, stockholders in C corporations are not charged with taxable income on their corporation’s purchase of stock under a buy-sell agreement. Again, however, principal payments are nondeductible. Consideration should thus be given to achieving deductible payments through allocating a portion of the total consideration to consulting or non-compete arrangements.

H. Situations Where S Corporation Qualified Dividends Might Make Sense.

1. Strip Prior C Corporation E&P. The 15% tax rate for qualified dividends has created a unique opportunity to strip out C corporation earnings and profits from an S corporation. The existence of C Corporation E&P creates two problems for an S corporation.

   a. First, if an S corporation has both C Corporation E&P and passive investment income in excess of 25% of its gross receipts, then its excess passive investment income will be subject to a 35% penalty tax. See Code § 1375.

   b. And, second, if this situation continues for three consecutive years, the S corporation’s S election will terminate. See Code § 1362(d).

   c. Thus, one strategy to avoid these problems is to cause the S corporation to pay a dividend that will eliminate all of its C Corporation E&P.

   d. If an S corporation has C Corporation E&P, S distributions in excess of the corporation’s AAA are taxed as dividends to the extent of C Corporation E&P. Distributions not in excess of AAA are taxed as a return of basis, then capital gain.

   e. Distributions in excess of C Corporation E&P are taxed as a return of basis and capital gain. Code §§ 1368(c)(1), (2), and (3). Elimination of the S corporation C Corporation E&P will avoid both the passive investment income termination rule (Code § 1362(d)) and the passive investment income penalty tax (Code § 1375). Consider distributions with property or promissory notes if the S corporation doesn’t have sufficient cash.

   f. Consider paying dividends with property or with promissory notes bearing interest at the AFR if the corporation doesn’t have sufficient cash. See PLRs. 9149030 and 8917025. Warning: Distribution of appreciated property causes gain recognition to the corporation. See Code § 311(b), Pope & Talbot, Inc., 104 T.C. 574 (1995), aff’d 162 F.3d 1236 (9th Cir. 1999), and TAM 200443032 (7/13/04).
g. Any gain recognized as a result of the distribution creates additional earnings and profits. Stripping out E&P is a good strategy to set the stage for an S election.

IV. ANCILLARY ISSUES.

A. One Class of Stock Considerations.

1. A redemption that does not qualify for exchange treatment is not generally considered a disproportionate distribution that creates a second class of stock in violation of the S corporation eligibility rules.

2. The final single-class-of-stock regulations generally disregard such distributions in determining whether the corporation’s outstanding shares of stock confer identical distribution and liquidation rights, unless the redemption agreement is entered into to circumvent the single-class-of-stock requirement and the purchase price, when the agreement is entered into, is significantly above or below the fair market value of the stock. Treas. Regs. § 1.1361-1(l)(2)(iii). See also, Priv. Ltr. Ruls. 9810020, 9404020

3. Thus, noncapital gain redemptions will not generally trigger an S corporation termination.

B. Effect of Life Insurance.

1. For purposes of addressing the potential death of a shareholder, insurance is generally preferred as a funding vehicle because the event that triggers the need for funds also triggers the payment of funds. Under either a cross-purchase or stock redemption arrangement, the life insurance premiums are not deductible for federal income tax purposes, and correspondingly, the insurance proceeds are not taxable. Code §§264, 101(a)(1).

2. Life insurance death benefit gains increase stock basis (as does all tax-exempt income). Death proceeds encompass both amounts that represents recovery of the corporation’s “basis” in the policy, i.e., the premiums that were capitalized rather than expensed under the rules set forth earlier, and the death benefit “gain,” i.e., the amount received in excess of that policy basis.

3. Although the insurance death benefit gains will increase basis, they will not increase the corporation’s accumulated adjustments account, because AAA does not reflect tax-exempt income and related expenses. Code § 1368(e)(1)(A)
4. If the corporation does not have pre-existing earnings and profits, the AAA would not limit distributions, so the life insurance proceeds normally could be distributed tax free to the shareholders because of the basis increases. If there are earnings and profits, the AAA may limit how much of the death proceeds can be distributed without triggering taxable dividend treatment.

5. The deceased shareholder will be allocated a share of income, gain, deductions, and loss for the portion of the corporation's tax year ending with the date of death. The estate or other successor will receive a similar allocation for the period following the date of death until the stock is sold. Thereafter, allocations will be made only to the surviving shareholders according to their post-purchase stock ownership. Depending on when the two transfers (death and the buy-out) occur, these allocations could all occur in one tax year or could be spread over several years.

6. Because there will be a complete termination of a shareholder's interest on death and on the closing of the purchase of stock from the decedent's successor, tax items may be allocated either by treating all items as earned or incurred ratably over the tax year or, if all affected shareholders consent, by a closing-of-the-books.

C. The Problem of "Wasted Basis."

1. To the extent that basis increases attributable to life insurance proceeds are allocated to the shares to be redeemed for the period prior to the deceased shareholder's death, their effect will be eliminated by the basis adjustment on death under Code § 1014 (the step-up or step-down to market value). To the extent the basis increase is allocated to the shares to be redeemed with respect to the post-death/pre-redemption period, it is unlikely to be of much benefit. The most likely result will be a capital loss of little or no use to the estate. See, William D. Klein, "Use of Life Insurance by S Corporations and Their Shareholders," ABA Tax Section Meeting, January 2004 (Kissimmee, Florida).

2. Issues That Can Affect the Wasted Basis Problem.

   a. Cash basis. If the corporation uses the cash basis method of accounting, the "income" from the insurance is not recognized and allocated until it is actually received. This provides some opportunity for post-mortem planning.

   b. Accrual basis. If the corporation uses the accrual basis method of accounting, the "income" from the insurance accrues and is recognized upon the decedent's death. This provides far less opportunity for post-mortem planning.
c. Income allocation method -- per share/per day vs. closing-of-the-books.

3. **Timing Of Death And Redemption Following Death.**

   a. Generally the later a death occurs in the S corporation’s tax year, the more limited are the post-death planning possibilities. This may not be quite so true for a cash basis S corporation if the life insurance proceeds are received after the close of the year of death.

   b. Wasted basis will generally be minimized the closer the redemption is to the date of death. For this reason, it is usually best to close the redemption as soon as possible, regardless of when the proceeds may be received. Use a short term note or other promise to pay the redemption price when the proceeds are actually received.

4. **Examples.**

   a. In the case of an accrual basis S corporation, if the death occurs late in the tax year, there will be a great deal of unavoidable wasted basis. For example, if a 50% shareholder dies on December 16 of a calendar tax year, at least 47.95% (50% x 350/365) of the basis increase will be allocated to the redeemed shares. If the redemption is not completed before year end, these shares, in the hands of the decedent and then the estate, will receive a full 50% of the increase.

   b. If a death occurs early in an accrual basis S corporation’s year, the opportunities increase, especially if the redemption is completed shortly thereafter. For example, if a 50% shareholder dies on March 1, the redemption is closed on March 16, and there is no closing-of-the-books, 10.27% (50% x 75/365) of the basis increase will be allocated to the redeemed shares. If the redemption is delayed until April 15, these shares will receive 14.38% (50% x 75/365) of the increase.

   c. In the case of a cash basis S corporation, the “gains” and basis increase will not be accounted for until the proceeds are actually received. For this reason, if the redemption can be completed before the proceeds are received, and a closing-of-the-books election is made as of the date of the redemption, the “gains” and basis increases will be allocated solely to the post-redemption period, and solely to the survivors’ shares, thereby eliminating “wasted basis.”
d. If the corporation is cash basis and the redemption cannot be completed before the proceeds are received, it generally would be best to make a closing-of-the-books election as of the date of death, but not as of the redemption date. This would exclude any allocation of the basis increase to the pre-death period. For example, if a 50% shareholder dies on March 1, the insurance proceeds are received on April 1, the redemption is closed on May 1, and a closing-of-the-books election is made as of the date of death, but not as of the redemption date, the basis increase will be allocated solely to the 305-day post-death period. Of this, 10% (50% x 61/305) will be allocated to the redeemed shares.

5. 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.

a. The Service, citing Rev. Rul. 98-39, 1998-2 C.B. 198, Frank's Casing Crew and Rental Tools, Inc. v. Comm'r, T.C. Memo 1996-413, Continental Tie & Lumber Co. v. United States, 286 U.S. 290 (1932) and Charles Schwab v. Comm'r, 107 T.C. 282 (1996), 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 will be allocated proportionately to all of the shareholders (including the deceased shareholder's estate), and could not be allocated solely to the remaining shareholders.

b. 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 shareholder 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).
c. 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.

D. **Pension Protection Act of 2006.**

1. The Pension Protection Act of 2006 includes new rules taxing as ordinary income certain life insurance proceeds received by a company on insurance policies owned on the lives of certain of its employees. Code § 101(j).

2. The new rule applies to any policy issued after the date of enactment, that is owned by and names as beneficiary (directly or indirectly) a person engaged in a trade or business, and that insures the life of an employee, officer, or director of the business. Code § 101(j)(3)(A). The new law makes two significant exceptions to new rule taxing the proceeds of a company-owned life insurance policy.

3. First, the new law also excludes from gross income any amount received because of the death of an insured, that is paid to a member of the family of the insured, to an individual designated beneficiary of the insured under the contract (other than the applicable policyholder, of course), or to a trust created for the benefit of any member of the family of the insured or any individual who is the designated beneficiary under the contract (other than the applicable policyholder). Code § 101(j)(2)(B)(i). The new rules also exclude from gross income any amount received because of the death of an insured, if the insured was employed by the policyholder within the year ending on the date of death, or was, when the contract was issued, a director, highly-compensated employee, or highly-compensated individual with respect to the policyholder. Code § 101(j)(4).

4. This second exception, however, applies only, before the contract is issued, the insured: (a) is notified in writing that the applicable policyholder intends to insure the employee’s life and the maximum face amount for which the employee could be insured; (b) is notified in writing that an applicable policyholder will be the beneficiary of the death benefits; and (c) consents in writing to being insured on such terms and that such coverage may continue after the insured’s employment terminates. Code § 101(j)(4).

5. This new rule is designed to discourage corporations from buying a large number of policies of insurance on the lives of rank-and-file employees,
without their notice, and retaining these policies after the employment relationship had terminated. It may, however, create serious problems for certain insurance-funded corporate buy-sell agreements.

6. A corporate redemption buy-sell agreement is often funded by having the corporation buy insurance on the lives of the stockholders to whom the agreement applies, to provide cash with which the corporation can purchase the stock of a deceased stockholder. The business owners are most often also employees, officers, or directors of the corporation. The policies on their lives will produce ordinary income under this rule, however, unless the notice and consent requirements have also been met.

7. It is unsettling that very few corporations whose insurance is used to fund a redemption buy-sell agreement will be able to meet these rules. The business owners are likely to know before the policy is bought that the policy will be purchased, that it will insure their lives, and that it will be payable to the corporation. They may even have this information in writing, though often they do not receive a formal notice and sometimes the documents that provide that notice are executed after the policies have been bought.

8. It is rare, however, that the employee-business owner will know the maximum face amount for which his or her life can be insured, because there is often no such maximum. The insurance coverage is often periodically adjusted to reflect the increased values of the stockholdings of the insureds.

9. Also, it is unlikely that most of the insureds will have consented in writing to being insured on these terms and that the coverage may continue after the insured's employment terminates. Practitioners should now include such notice and consent provisions as part of their buy-sell agreement forms.

10. Such a buy-sell clause could resemble the following:

Section 5. Life Insurance

5.1. Required Policies. The Corporation shall apply for, own, maintain, and be the beneficiary of life insurance policies on the life of each Shareholder, in amounts listed on Schedule.
5.2. Added Policies. The Corporation may acquire any additional policies of life insurance that it deems appropriate to carry out this Agreement, and each Shareholder shall cooperate fully in any such acquisitions, including submitting to any physical examinations and providing any medical information required by the insurer. All additional policies shall be listed on Schedule.

5.3. Premiums. The Corporation shall pay every premium on any life insurance policies that it is required or permitted to maintain under this Section, and give each Shareholder proof of such payment within fifteen (15) days of the date the premium was due. If the Corporation fails to supply such proof, any Shareholder may pay the premium and be reimbursed for his or her payment by the Corporation. All dividends on any such policies shall be applied to the payment of premiums.

5.4. Notice and Consent. This Section 5 shall constitute written notice to each Shareholder that the Corporation intends to insure the Shareholder's life and the maximum face amount for which the Shareholder could be insured, and that the Corporation shall be the beneficiary of the death benefits under all such insurance policies. The signature of each Shareholder to this Agreement shall constitute a written consent to being insured on such terms and that such coverage may continue even if any employment of the Shareholder with the Corporation shall have hereafter been terminated, regardless of cause and regardless of whether the termination shall have been by the unilateral decision of the Corporation, the unilateral decision of the Shareholder, or by mutual consent of the Corporation and the Shareholder.

V. DIVISIONS.

A. General.

1. Corporate divisions will typically occur pursuant to the provisions of Code §§ 355 and, in many cases, Code § 368(a)(1)(D).

2. Code § 1371(a) provides that subchapter C applies to an S corporation except to the extent of any inconsistency with subchapter S. Thus, Code §§ 355 and 368(a)(1)(D) should apply to a transaction involving an S corporation.
3. A substantial portion of this Section is derived from Eustice & Kuntz, Federal Income Taxation of S Corporations, Section 12.10 (WG&L, 4th Ed).


1. A divisive Type D reorganization occurs under Code § 368(a)(1)(D) when:
   a. A corporation transfers part of its assets to another corporation;
   b. Immediately after that transfer, the transferor corporation (or its shareholders or both) controls the transferee corporation; and
   c. The transferor corporation distributes stock or securities of the controlled transferee corporation under Code § 355 or Code § 356.

2. Thus, by the terms of Code § 368(a)(1)(D), a divisive Type D reorganization can occur only in conjunction with a qualified distribution of stock or securities under Code § 355 or Code § 356.

C. Code § 355 Division.

1. Code § 355 provides that, under certain conditions, a shareholder or security holder does not recognize gain or loss upon the receipt from a controlling corporation of stock or securities of a controlled corporation.

2. Thus, if a corporation has control of a subsidiary, and if the transaction otherwise meets the requirements of Code § 355, the controlling corporation can simply distribute the stock of that subsidiary.

3. Because the controlling corporation need not transfer any additional assets to its subsidiary prior to the distribution of stock or securities under Code § 355, the Code § 355 division can occur on a stand-alone basis without the need for a Type D reorganization. This may occur, for example, when the controlling corporation is a mere holding company for two or more operating subsidiaries.

4. When an S corporation is involved in a Code § 355 division, however, a Type D reorganization commonly will precede the division. A Code § 355 division must involve a distributing corporation and one or more controlled subsidiaries. No subsidiary can be an S corporation because the existence of a corporate shareholder will prevent qualification. Code § 1361(b)(1)(B). Thus, only the distributing corporation in a Code § 355 division can potentially be an S corporation. Although an S corporation may have controlled subsidiaries, that pattern was not common prior to the
repeal of Code § 1371(a)(2) in 1996, because the C corporation status of the subsidiary does not provide pass-through tax treatment.

5. If the S corporation owns all the stock of a subsidiary that is treated as a "disregarded" qualified subchapter S subsidiary (defined in Code § 1361(b)(3)(B)), regulations allow a parent S corporation to distribute the stock of a qualified subchapter S subsidiary in a transaction that qualifies under Code § 355. See, Treas. Regs. § 1.1361-5(b)(3), Example 4.

D. Control.

1. To qualify under Code § 355, a distributing corporation must have "control" of its subsidiary immediately prior to the distribution of the subsidiary's stock or securities. Control is defined as 80% of voting power and of each class of nonvoting stock of the transferee. Code § 355(a)(1)(D).

2. Before Congress changed the law in 1996, an S corporation normally would lose its S status if it had such control of another corporation. Former Code § 1361(b)(2)(A). However, the Service ruled publicly (and in many private letter rulings) that "momentary" control of a subsidiary before a divisive distribution of stock under Code § 355 would not terminate the S status of the distributing corporation. Rev. Rul. 72-230, 1972-1 CB 270. Congress eliminated this issue in 1996 by allowing an S corporation to own any amount of the stock of a subsidiary. Thus, engaging in a Code § 355 transaction should not end the S status of the parent S corporation.

E. Business Purpose.

1. If a corporation engages in a tax-free separation under Code § 355 of one or more of its existing businesses, it must establish, in whole or substantial part, one or more corporate business purposes.

2. The Service has made clear that a corporate separation undertaken solely to allow a resulting subsidiary to elect S corporation status will not meet the business requirement. However, where any tax motivations to the business separation are secondary, and the taxpayer can show under the facts and circumstances that a corporate business purpose predominates, then the potential avoidance of federal taxes with an S corporation election can be surmounted. Treas. Regs. § 1.355-2(b), Examples 6, 7, and 8.

lessen the concern about business purpose, the revenue procedure suggests certain representations be made when S corporation elections are possible. For example, if a C corporation were to spin-off an S corporation, the IRS might be concerned that obtaining S status was the real business purpose for the transaction. Therefore, the IRS requested representations that parity in tax status between the distributing and controlled corporations, would continue after the spin; i.e., if distributing were a C corporation, neither distributing nor controlled will elect S status, or both will elect S status, and when distributing is an S corporation, controlled will elect S status immediately following the spin. The IRS has issued several recent private letter rulings that appear to be taking a less restrictive stance on the ability for either the distributing or controlled corporation to elect or not elect S status after the spin-off.

F. Allocation Among Shareholders of Income or Loss in Year of Division.

1. If the distributing corporation is an S corporation, the Type D reorganization and the divisive transaction under Code § 355 ordinarily will not terminate that status. Thus, the distributing parent corporation's income or loss for its entire taxable year will pass through to its shareholders under subchapter S.

2. The parent's shareholders may change as a result of a non-pro rata "split-off" distribution (i.e., a division in which some shareholders surrender all or part of their stock in the distributing parent corporation in return for all or part of the stock of the controlled subsidiary corporation).

3. Those shareholders of the distributing parent corporation who continue to own its stock will share in its income and loss for its entire taxable year.

4. However, those shareholders whose stock ownership in the parent ends in the Code § 355 exchange will share in the parent's income and loss apportioned on a daily basis up to the time of the exchange. Code §§ 1366 and 1377(a).

5. A Type D reorganization, and a later distribution of stock under Code § 355, generally will not terminate the taxable year of the distributing corporation.

6. However, a complete liquidation of the distributing corporation in a "split-up" transaction (i.e., a division in which the distributing parent corporation completely liquidates and distributes the stock of two or more controlled subsidiary corporations) will terminate the taxable year of the distributing corporation and accelerate the pass-through of its income or loss under subchapter S. Code § 1366.
G. **S Election by Formerly Controlled Corporation.**

1. After a divisive reorganization under Code §§ 368(a)(1)(D) and 355, a formerly controlled corporation may generally elect under subchapter S, assuming that the corporation meets all the requirements of Code § 1361. Although a former subsidiary should be able to elect under subchapter S in general, an issue may arise if the former subsidiary wishes to elect immediately after the division. The results may differ depending on whether the subsidiary is an existing or a newly formed corporation.

2. Code § 1362(b)(2)(B)(i) may create a problem for a subsidiary that wishes to elect immediately. If a corporation has a corporate shareholder on any day of its taxable year before it elects, its election will not take effect until the next taxable year. Of course, the new subsidiary begins life with a corporate shareholder. Despite the language of Code § 1362(b)(2)(B), the Service has ruled privately (and frequently) that it will ignore momentary corporate ownership and allow a former subsidiary to elect immediately under subchapter S. See, e.g., Priv. Ltr. Ruls. 9441011, 200029053, and 200036036. The former corporate parent should not have to consent to that election.

H. **Post-Division Distributions.**

1. If the parent corporation has accumulated earnings and profits, Code § 1371(c)(2) requires “proper adjustment” to the earnings to reflect various subchapter C transactions (including reorganizations and divisions). Some of the parent corporation's accumulated earnings account will shift to the newly created subsidiary under certain conditions. Code § 312(h)(1). Treas. Regs. § 1.312-10(a).

2. Treas. Regs. § 1.1368-2(d)(3) divides the accumulated adjustments account of a distributing corporation between that corporation and the controlled corporation under certain conditions. When the regulation applies, it divides the accumulated adjustments account of the distributing corporation in a manner similar to the manner in which the earnings and profits are divided.

3. The regulation applies by its terms only if the distributing S corporation has accumulated earnings and profits. Further, the regulation applies by its terms only if the distributing S corporation transfers an active trade or business to another corporation in a Type D reorganization. Finally, the regulation applies only if an immediate distribution of the stock and securities of the controlled subsidiary occurs.
I. Distributions Pursuant to the Division

1. During the course of and pursuant to a division, an S corporation may distribute cash as well as the stock of a controlled subsidiary. Code § 356(b) may treat those distributions of boot as subject to Code § 301. The basic question raised by a boot distribution from an S corporation is whether the rules of Code § 1368 can prevent dividend treatment where Code § 356(b) would otherwise require it.

2. Code § 1368 applies to distributions with respect to stock to which Code § 301(c) would otherwise apply. Code § 355(a)(1)(A)(i) helps in part by stating that a corporation's distribution in a Code § 355 transaction is "with respect to its stock." Because Code § 356(b) provides that a boot distribution is subject to Code § 301, this distribution clearly seems to qualify for treatment under Code § 1368. Moreover, Code § 1371(a) gives primacy to subchapter S in any case of conflict with subchapter C.

3. Boot dividends in Code § 355 exchanges that are subject to Code § 356(a)(2) pose more difficult issues. Because such distributions are not literally subject to Code § 301(c), Code § 1368 may not apply. On the other hand, an ambiguous regulation under Code § 1368 may cause Code § 1368 to apply. Further, Code § 1368 may prevent the boot from having "the effect of the distribution of a dividend," within the meaning of Code § 356(a)(2). Thus, gain, rather than a dividend, may result under Code § 356(a)(2).

4. If an S corporation distributes property before a division, the rules of subchapter S ordinarily will control the tax results. However, if the distributions bear a close connection in time or planning to the division, the Service may attempt to apply the boot rules of Code § 356 to the distributions.

J. Built in Gains Tax Under Code § 1374

1. A former subsidiary is potentially subject to corporate-level tax on built-in gains under Code § 1374.

2. If the former subsidiary is a new corporation that elects under subchapter S from the very beginning, it may qualify for exemption under Code § 1374(c)(1) which provides that the built in gains tax does not apply to a corporation which has always been an S corporation.

3. In one situation, the Service has ruled that a former subsidiary will not be subject to tax under Code § 1374. That ruling held that Code § 1374 will not apply if (1) a former subsidiary elects under subchapter S effective on the first day of its existence and (2) assets received from the former parent.
would not have been subject to the tax in the hands of the former parent because it elected under subchapter S before 1987. See, Priv. Ltr. Ruls. 9030020, 9030053, 9510043. Thus, it may be a major blunder for a former subsidiary that is a new corporation not to elect immediately under subchapter S.

4. Suppose that a distributing S corporation is subject to Code § 1374 on only certain assets. For example, a corporation that elected after 1986 and before 1989 may not be subject to Code § 1374 on long-term capital gains. Rev. Rul 86-141. The former subsidiary should be subject to Code § 1374 only on assets that were subject to that Code § in the hands of the former parent (e.g., the assets with built-in ordinary gains).

5. Suppose that a distributing corporation is subject to Code § 1374 but that some of the years in the gain recognition period have elapsed. The new subsidiary that is spun off should be subject to Code § 1374 only for the remaining balance of the distributing corporation's gain recognition period. Priv. Ltr. Ruls. 9321006, 9414016, and 200036036. Further, if the entire gain recognition period has expired for the distributing corporation, then the new subsidiary should not be subject to tax under Code § 1374 on the assets it receives from the distributing corporation. Priv. Ltr. Rul. 9645016.

K. Miscellaneous Effects.

1. Earnings and Profits. Under Code § 312(h), earnings and profits of the distributing parent may shift to the distributed subsidiary. In that case, the distributed subsidiary may be subject to the passive investment income rules if it elects under subchapter S. Further, the more complex distribution rules of Code § 1368(c) may apply.

2. End of Grandfather Rules. The Subchapter S Revision Act of 1982 contained several grandfather rules that end when more than 50 percent of a corporation's stock is newly owned. See, e.g., Priv. Ltr. Rul. 8518034 (fiscal year).

3. Corporate Preference Items. Under Code § 1363(b)(4), an S corporation is subject to Code § 291 if a predecessor was a C corporation in any of the three preceding taxable years. Code § 1363(b)(4) does not define "predecessor."

4. Recapture of Investment Credits. Under certain conditions, a Code § 355 division involving an S corporation may result in the recapture of investment credits for shareholders. Priv. Ltr. Ruls. 9319018, 9627008, and 200022039.
5. **Recapture of LIFO Benefits for Distributing C Corporation.** Suppose that a C corporation transfers assets including inventory to a subsidiary, the stock of which is distributed under Code § 355. If the subsidiary immediately elects under subchapter S, regulations adopted in 1994 appear to require that the C corporation recapture any LIFO benefit. Treas. Regs. § 1.1363-2(a)(2). If they apply, the regulations divide the liability for the resulting tax between the transferor C corporation and the transferee S corporation. A different result will apply if the distributing corporation is an S corporation, not a C corporation, when the division occurs. In that case, Code § 1363(d) will not require any LIFO recapture.

6. **Use of Suspended Losses.**

   a. Suppose that one or more of the shareholders of an S corporation has losses that have been suspended under Code § 1366(d) due to a lack of basis. Suppose further that the S corporation then transfers part of its assets that constitute an active trade or business to a subsidiary in a Type D reorganization and immediately distributes the subsidiary’s stock under Code § 355. In that case, that the regulations require the shareholder with the suspended loss allocate the loss between the distributing corporation and the former subsidiary. The shareholder may use any reasonable method for this allocation. Treas. Regs. § 1.1366-2(c)(2).

   b. Allocation of part of a shareholder's suspended loss to the formerly controlled subsidiary may produce a good result if that corporation elects under subchapter S. In that case, the shareholder can increase stock basis in the future and deduct the loss. Suppose, however, that the former subsidiary does not elect under subchapter S. A good result will occur only if a post-termination transition period arises. Under the regulations, however, it is not at all clear that the former subsidiary will have a post-termination transition period. Treas. Regs. § 1.1377-2(b).

   c. Suppose the parent S corporation distributes the stock of a “qualified subchapter S subsidiary” in a Code § 355 division. What happens in that case to the shareholder’s suspended losses? Regulations allocate the shareholder’s suspended losses between the S corporation and the former qualified subchapter S subsidiary. Treas. Regs. § 1.1361-5(b)(2) and Treas. Regs. § 1.1366-2(c)(2).