Purchase and Sale of LLC and S Corp Targets (PowerPoint)

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Purchase and Sale of LLC and S Corp Targets

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Assumed Facts

- LLC is a Virginia limited liability company taxable as a partnership.
- S Corp is a Virginia corporation taxable as an S corporation.
- P is an acquiring individual or entity, as indicated in the stated facts, and a U.S. person.
- All LLC members and all S Corp shareholders are U.S. persons.
- All acquisitions/dispositions of assets, membership interests, or stock are intended to be taxable transactions for federal income tax purposes.
- FMV means fair market value.
Sale/Purchase of 100% of LLC Membership Interests

Example 1

- Individuals A and B each own 50% of LLC’s membership interests. They have owned it since original formation several years ago.
- Individuals A and B share all of LLC’s profits and losses equally except as otherwise required by federal income tax law.
- Aside from some cash accounts, LLC’s assets consist of land, an office building, and related improvements that are Code § 1250 property, all of which LLC leases to third parties.
Sale/Purchase of 100% of LLC Membership Interests
Example 1 (Cont’d)

Facts
• Member A contributed asset (land) to LLC, with FMV of $100 and basis of $50.
• Member B contributed $100 cash.
• LLC used $100 cash to improve the property.
• Current values shown below.

Contributed Assets:
- Member A: Land
  - FMV: $100
  - Basis: $50
- Member B: Cash
  - FMV: $100

Assets at Sale
<table>
<thead>
<tr>
<th>Description</th>
<th>FMV</th>
<th>Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>$150</td>
<td>$50</td>
</tr>
<tr>
<td>Improvements</td>
<td>$110</td>
<td>$80</td>
</tr>
</tbody>
</table>

Diagram:
- Member A contributes Land (FMV $100, Basis $50)
- Member B contributes $100 Cash
- LLC uses $100 Cash for Improvements
- Current values:
  - Land: $150 FMV, $50 Basis
  - Improvements: $110 FMV, $80 Basis
Sale/Purchase of 100% of LLC Membership Interests
Example 1 (Cont’d)

Facts
- Members A and B sell 100% of LLC membership interests to P Corp for cash.
- Sale price is equal to the total FMV of LLC’s assets, minus the amount of its liabilities (all of which are accrued for federal income tax purposes and are allocated equally to A and B).

Contributed Assets - Land
FMV $100
Basis $50

Contributed Assets - Cash
$100

Assets at Sale
FMV
Basis
Land $150 $50
Improvements $110 $80
Sale/Purchase of 100% of LLC Membership Interests: Example 1 (Cont’d)

- What are the federal income tax consequences to A and B?
  - Per Rev. Rul. 99-6 *(Situation 2)*, A and B are treated as selling partnership interests.
  - Per Code § 752(d), amounts realized include their shares of the LLC’s liabilities.
  - Per Code § 741, gain is treated as capital gain except as otherwise provided in Code § 751.
Sale/Purchase of 100% of LLC Membership Interests
Example 1 (Cont’d)

• What are the federal income tax consequences to A and B (continued)?

  — None of LLC’s assets is an “unrealized receivable” or “inventory item” (essentially, assets that would produce ordinary income or loss if sold) under Code § 751, so it is inapplicable.

  — However, under the look-thru rules of Reg. § 1.1(h)-1, A and B each have $10 of gain characterized as unrecaptured Code § 1250 gain, taxable at a maximum rate of 25% (instead of 20%).

  — A’s $50 of Code § 704(c) built-in gain technically is not recognized, but it is reflected in A’s long-term capital gain on the sale of his LLC interest because his initial basis in the LLC interest was only $50, not $100.
Sale/Purchase of 100% of LLC Membership Interests  
Example 1 (Cont’d)

• What are the federal income tax consequences to P Corp?
  
  — Under Rev. Rul. 99-6 *(Situation 2)*, P Corp is treated as buying LLC’s assets, not partnership interests, for an amount equal to the amounts paid to A and B for their membership interests plus the amount of LLC’s liabilities.

  — P Corp obtains a new cost basis in the LLC assets, allocated as required by Code § 1060 and the Section 1060 Regulations.

  — LLC (which continues to exist under state law) becomes a disregarded entity owned 100% by P Corp per Treas. Reg. § 301.7701-3 for federal and, by conformity, Virginia income tax purposes, unless an election is made for LLC to be taxable as a corporation (which would result in a deemed Code § 351 transaction between P Corp and LLC).
Sale/Purchase of 100% of S Corp Stock
Example 2

- The facts are the same as in Example 1 except that A and B own stock in S Corp, not membership interests in LLC.
- How is this transaction treated for federal income tax purposes?
Sale/Purchase of 100% of S Corp Stock
Example 2 (Cont’d)

Same as Example 1, Except Target is an S Corp
Sale/Purchase of 100% of S Corp Stock
Example 2 (Cont’d)

- Unless a Code § 338(h)(10) election is made (assume it is not), A and B are treated as selling their stock and recognizing long-term capital gain.

- Subchapter S does not contain a provision like Code § 751, so none of their gain would be treated as ordinary income even if S Corp held assets that would produce ordinary income if sold.

- In addition, Reg. § 1.1(h)-1 does not treat any gain from a sale of S Corp stock as Code § 1250 gain.

- P Corp is treated as buying S Corp’s stock, not S Corp’s assets.

- P Corp acquires a cost basis in stock and, unless a Code § 338 election is made, the tax basis of S Corp’s assets do not change.

- S Corp does not become a disregarded entity but becomes a C corporation, unless P Corp is an S corporation and elects for S Corp to become a qualified subchapter S subsidiary under Code § 1361 (b)(5).
Sale/Purchase of LLC’s Subsidiary LLC
Example 3

The facts are the same as in Example 1 except that:

• LLC’s only asset is the sole membership interest in LLC Sub, which owns the assets and has the liabilities described as LLC’s assets and liabilities in Example 1.

• LLC Sub is a disregarded entity for federal and Virginia income tax purposes.

• LLC sells its membership interest in LLC Sub to P Corp for the price paid to A and B in Example 1 and distributes the proceeds (cash) to A and B in liquidation of their LLC interests.
Sale/Purchase of LLC's Subsidiary LLC

Example 3 (Cont'd)

Same as Example 1, Except Target is a Subsidiary LLC

**Facts**
- Parent LLC contributes all assets and liabilities to wholly-owned Subsidiary LLC.
- Values and tax basis remain the same.

**Contributed Assets - Land**
- FMV: $100
- Basis: $50

**Contributed Assets - Cash**
- FMV: $100

- 50% to Member A
- 50% to Member B

- 100% to LLC Sub

- Sale of Membership Interests

**Current Assets**
- Land: $150, $50
- Improvements: $110, $80
Sale/Purchase of LLC’s Subsidiary LLC
Example 3 (Cont’d)

What are the federal income tax consequences to LLC, A, and B?

• Because LLC Sub is a disregarded entity, LLC is treated as selling the assets actually owned by LLC Sub.

• The gain (including Code § 1250 gain) is recognized and characterized at the LLC level.

• All the gain is allocated equally to A and B, except that all $50 of the Code § 704(c) built-in gain is allocated to A.
Sale/Purchase of LLC’s Subsidiary LLC
Example 3 (Cont’d)

• A and B are taxable on their shares of LLC’s gain (Code § 1250 gain and other capital gain) and increase their basis in their LLC interests by the amounts included in income under Code §§ 702 and 705.

• Under Code §§ 731(a)(1) and 741, the liquidating distributions reduce the basis of A and B’s LLC interests, and any excess over basis is recognized as capital gain.
  — Because LLC sold all of its assets and, under the facts, there was no difference between the total asset basis and the total basis in the LLC interests, A and B should not realize any gain on the liquidating distributions.

• The overall consequences to A and B should be the same as in Example 1.
What are the federal income tax consequences to P Corp?

- Because LLC Sub is a disregarded entity, P Corp is treated as buying LLC Sub's assets from LLC for a total consideration equal to the amount paid for the LLC Sub membership interest plus the amount of LLC Sub's liabilities.

- P Corp obtains a cost basis in the assets, just as in Example 1.

- LLC Sub remains a disregarded entity for federal and Virginia income tax purposes, unless an election is made for it to become taxable as a corporation.
Sale/Purchase of S Corp’s Subsidiary LLC
Example 4

- The facts are the same as in Example 3 except that S Corp sells LLC Sub and distributes the proceeds to A and B in a complete liquidation of S Corp.

- What are the federal income tax consequences to S Corp, A, and B?
Sale/Purchase of S Corp’s Subsidiary LLC
Example 4 (Cont’d)

Same as Example 3, Except Target is Owned by an S Corp

Facts
- S Corp contributes all assets and liabilities to wholly-owned Subsidiary LLC.
- Values and tax basis remain the same.

<table>
<thead>
<tr>
<th>Current Assets</th>
<th>FMV</th>
<th>Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>$150</td>
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</tr>
<tr>
<td>Improvements</td>
<td>$110</td>
<td>$80</td>
</tr>
</tbody>
</table>

Shareholder A
Contributed Assets - Land
FMV $100
Basis $50

Shareholder B
Contributed Assets - Cash
$100

S Corp
50%
50%

P Corp
Sale of Membership Interests

LLC Sub
Drop Down of all Contributed Assets

50%
100%
Sale/Purchase of S Corp’s Subsidiary LLC
Example 4 (Cont’d)

- Because LLC Sub is a disregarded entity, S Corp is treated as selling the assets actually owned by LLC Sub.
- The gain (including Code § 1250 gain) is recognized and characterized at the S Corp level.
- All the gain is allocated equally to A and B under Code §§ 1366(a) and 1377(a); subchapter S does not contain a provision like Code § 704(c).
- A and B are taxable on their shares of S Corp’s gain (Code § 1250 gain and other capital gain) and increase their stock basis accordingly.
- Under Code § 331, the liquidating distributions reduce the basis of A and B’s stock, and any difference between a shareholder's stock basis and the amount of the shareholder's liquidating distribution is recognized as capital gain or loss.
- Because the $50 of built-in gain cannot be specially allocated to A, half of it was allocated to each of A and B. Thus, A’s stock basis is $25 less than his liquidating distribution and B’s stock basis is $25 more than his liquidating distribution.
Sale/Purchase of S Corp’s Subsidiary LLC
Example 4 (Cont’d)

• What are the federal income tax consequences to P Corp?
  — Because LLC Sub is a disregarded entity, P Corp is treated as buying LLC Sub’s assets from S Corp for a total consideration equal to the amount paid for the LLC Sub membership interest plus the amount of LLC Sub’s liabilities.
  — P Corp obtains a cost basis in the assets, just as in Examples 1 and 3, but unlike Example 2.
  — LLC Sub remains a disregarded entity for federal and Virginia income tax purposes, unless an election is made for it to become taxable as a corporation.

• Additional issues arise with installment sales. See additional slides in presentation.
Sale of LLC Interests Between Members
Example 5

Facts:
- A and B each own 50% of LLC. B purchases A's 50% interest.
- After the purchase, B owns 100% of LLC.
Sale of LLC Interests Between Members  
Example 5 (Cont’d)  

BEFORE  

Rev. Rul. 99-6: Situation 1  

AFTER  

Result:  

- After sale, LLC becomes a disregarded entity (it has one owner and it has not elected to be taxed as an association). Rev. Rul. 99-6 treats transaction differently as to A and B.  
- LLC (as a tax partnership) is deemed to terminate under Code § 708(b)(1)(A) when B purchases A's 50% interest.
Sale of LLC Interests Between Members
Example 5 (Cont’d)

Tax Consequences to A:

- A must treat the transaction as a sale of a partnership interest. (Rev. Rul. 99-6) Results are the same as under Example 1.

Tax Consequences to B:

- First, LLC is deemed to make a liquidating distribution of its assets to A and B.
- B recognizes gain or loss, if any, on any deemed distribution of cash to B in excess of B's basis in its "old" 50% membership interest under Code § 731. (This includes deemed distributions of cash under Code § 752.)
- B's basis in 50% of LLC assets deemed distributed to B is determined under Code § 732(b) (generally, substituted basis), and the holding period for these assets is determined under Code § 735(b).
- Second, B is treated as having purchased from A those assets that are deemed to have been distributed to A in the liquidating distribution. Therefore, B will have a $130 basis in 50% of the assets under Code § 1012, and its holding period will begin on the day following A's sale of its 50% interest to B. (Rev. Rul. 99-6)
Sale of S Corp Stock Between Shareholders
Example 6

- The facts are similar to Example 5, except sale of S Corp stock occurs solely between Shareholder A and Shareholder B, which is similar to Example 5.

- What are the federal income tax consequences to S Corp, A, and B?
Sale of S Corp Stock Between Shareholders
Example 6 (Cont’d)

Same as Example 5, Except Target is an S Corp

**BEFORE**

- Shareholder A
- Shareholder B
- S Corp

$130 cash

50% Stock

**AFTER**

- Shareholder B
- S Corp

100%

**Facts:**
- A and B each own 50% of S Corp. B purchases A’s 50% interest.
- After the purchase, B owns 100% of S Corp.
Sale of S Corp Stock Between Shareholders
Example 6 (Cont’d)

General:
Not eligible for a Code § 336(e) or Code § 338(h)(10) election. (See following slides.)

Tax Consequences to A:
• A must treat the transaction as a sale of S Corp stock. Tax results are the same as under Example 2.

Tax Consequences to B:
• B purchased 50% of S Corp’s stock, and obtains a cost basis in the purchased stock.
• Absent a Code § 336(e) or Code § 338 election, the tax basis of S Corp’s assets do not change. Thus, 100% of any built-in gain or loss in S Corp’s assets may be taxable to B in the future.
• Did purchase price reflect the PV of this deferred tax liability?
Taxable Stock Sale With Section 338(h)(10) Election or Disposition With Section 336(e) Election

- Provides Buyer with a SUB equal to purchase price + Target liabilities deemed assumed + acquisition costs.
- Seller taxed as if Target sold its assets and then liquidated, distributing the sale proceeds to its shareholders in redemption of their Target stock.
- No gain or loss is recognized by Seller on the actual transfer of Target stock to Buyer.
Sale of S Corp Stock:
Requirements for Code § 338(h)(10) Election

• Buyer must be a corporation (C or S).
  — Individual(s) and/or partnership(s) may form a non-transitory corporate Buyer to acquire and thereafter hold Target.

• Triggering Event: Buyer must acquire 80% or more of Target stock in a taxable purchase in a 12 month period. This is a "qualified stock purchase" ("QSP").
  — Acquisition via Code § 351, 354, 355, or 356 is not a QSP, even if taxable.

• Buyer and all shareholders of Target S Corp must make Code § 338(h)(10) election.
  — Election made on IRS Form 8023 by the 15th day of 9th month beginning after the QSP date. See, Reg. § 1.338(h)(10)-1(c).
Sale of S Corp Stock: Requirements for Code § 336(e) Election

- Buyer must be one or more persons, including corporations, partnerships, individuals, trusts and estates.

- Triggering Event: S corporation shareholders must dispose of 80% or more of Target’s stock in a taxable disposition in a 12 month period. This is a qualified stock disposition (“QSD”).
  - Disposition via Code § 351, 354, 355, or 356 is not a QSD, even if taxable.

- If what would be a QSD also qualifies as a QSP, it is not a QSD.

- Target S corporation and all shareholders of Target S corporation must enter into binding, written agreement to make Code § 336(e) election.
  - Election statement must be attached to Target S corporation’s timely filed income tax return for the taxable year that includes the QSD date. See, Reg. § 1.336-1, -2(h)(3).
Sale of S Corp Stock Between Shareholders
Example 7

Similar to Example 6, Except A owns 80% of S Corp

BEFORE

Shareholder A

$208 cash

80%

Shareholder B

80% Stock

20%

S Corp

AFTER

Shareholder B

100%

S Corp

Result: Transaction qualifies for Code § 336(e) election.
Sale of S Corp Stock Between Shareholders
Example 7 (Cont’d)

Tax Consequences to A and B:

• With a Code § 336(e) election, transaction treated as a taxable sale of 100% of “Old S Corp’s” assets at FMV to “New S Corp” followed by a deemed taxable liquidation of Old S Corp. See, Code §§ 331 and 336.

• For this purposes, FMV is calculated by grossing up the amount paid by B for 80% of S Corp’s stock, including cash paid, liabilities assumed and transaction costs.

• Transaction is fully taxable to both A and B. Thus, B (the purchaser) pays current tax on its 20% share of S Corp’s built-in gain.

Tax Consequences to S Corp:

• S Corp (post-closing) is treated as having purchased 100% of its predecessor’s assets at deemed FMV, with a cost basis post-closing.
Code § 351 Rollover Trap
Example 8

Effect of Code § 351 on QSP Requirement:

- Code § 338(h)(10) requires a QSP by a Buyer corporation.
- A QSP requires that 80% or more of Target’s stock must be received by Buyer via a taxable purchase.
- Acquisitions of stock via Code § 351 do not qualify as a QSP.
- Applies even if the Code § 351 transaction is taxable to the seller.
- Example: cash received in a Code § 351 transaction is taxable to the contributing shareholder – despite the shareholder’s receipt of stock.
- A similar conclusion could be reached if target shareholders purchase Buyer Corporation shares for cash under the step transaction doctrine.
Corporate Rollover Using Code § 351
Example 8 (Cont’d)

Result:
- Each Target shareholder transfers to Buyer Corporation:
  - 90% of Target stock for cash; remaining 10% for New Buyer Corporation stock.
- Code § 351 applies to the transaction.
- Even though the contributed stock represented ≤20% of Target’s total shares outstanding, the transaction is not a QSP.
Corporate Rollover Using Code § 351
Example 8 (Cont’d)

- Buyer Corporation forms a Merger Subsidiary which merges into Target S Corp.
- Transaction is treated as if Target shareholders contributed Target stock to Buyer Corp for cash plus stock under Code § 351.
- Even if rollover stock represented ≤20% of Target’s total shares outstanding, stock acquired from contributing Target shareholders Code § 351 exchange does not qualify.
Double Holding Company Structure to Obtain QSP with Rollover Equity: Example 8 (Cont’d)

- Buyer Corporation forms a merger subsidiary which issues debt and merges into Target S Corp.
- Rollover shareholders reinvest transaction proceeds in Holding Company to avoid a deemed Code § 351 acquisition of Target S Corp stock.

• Rev. Rul. 99-6 refers to Rev. Rul. 84-111, which specifies 3 methods for converting a state law partnership into a corporation.
• Result: Transaction tested under Code § 351, including recognition of gain under Code § 351(b).
• Acquisition Corp’s basis determined under Code § 362(a), subject to net built-in loss limitation per Code § 362(e). Basis will reflect a step-up to extent of gain recognized by LLC Members.
Issues with Rev. Rul. 99-6: Acquisition by Buyer LLC – Example 10

What are the federal income tax consequences to the LLC Members and the PE Fund?
Two Possible Characterizations of Transaction:

1. Acquisition of 100% of the LLC membership interests by Acquisition LLC, or

2. Purchase of 90% of the LLC membership interests by PE Fund, with Acquisition LLC being treated as a disregarded entity until the acquisition has occurred and then a successor to LLC.
Issues with Rev. Rul. 99-6: Acquisition by Buyer LLC – Example 10 (Cont’d)

Tax Treatment under First Characterization:

- Per Reg. § 1.707-3, LLC members are treated as selling a 90% undivided interest in LLC membership interests for cash, and contributing a 10% undivided interest in LLC membership interests to Acquisition LLC in exchange for partnership interests in a Code § 721 transaction.

- LLC Members recognize gain or loss on the sale portion of the transaction in an amount equal to the cash received (including deemed relief from liabilities) and 90% of their basis in the transferred LLC interests.

- LLC Members generally recognize no gain or loss on the Code § 721 exchange.
Issues with Rev. Rul. 99-6: Acquisition by Buyer LLC – Example 10 (Cont’d)

Tax Treatment under First Characterization (Cont’d):

- Per Code § 722, the basis in the Acquisition LLC interests received is the same as 10% of the basis in the transferred LLC interests, subject to adjustment (including possible gain recognition) for the net deemed relief/assumption of liabilities per Code § 752.

- Acquisition LLC obtains a cost basis in 90% and, under Code § 723, a transferred basis in 10% of the LLC membership interests.

- LLC terminates as a partnership under Code § 708(b)(1) and is deemed to be liquidated into Acquisition LLC as the sole member.

- Under Code § 732(b), Acquisition LLC’s aggregate basis in the assets deemed received from LLC will equal its total basis in the LLC membership interests.
Issues with Rev. Rul. 99-6: Acquisition by Buyer LLC – Example 10 (Cont’d)

Tax Treatment under Second Characterization:

- The LLC members are treated as selling 90% of the LLC membership interests (same as above, except the sale is to PE Fund) and retaining 10%.

- PE Fund obtains a cost basis in the 90% LLC membership interest.

- There is a technical tax termination of the LLC partnership under Code § 708(b)(1)(B).

- Per Reg. § 1.708-1(b)(4), “old” LLC is treated as contributing its assets to “new” LLC for new partnership interests in a Code § 721 nonrecognition transaction and then distributing those interests to all its members, including PE Fund, in liquidating distributions under Code § 731.
Issues with Rev. Rul. 99-6: Acquisition by Buyer LLC – Example 10 (Cont’d)

Tax Treatment under Second Characterization (Cont’d):

- The Members’ basis in their “new” partnership interests will be the same as in their “old” interests. See Code § 732(b).

- The basis of the new partnership’s assets will be the same as before the transaction, unless LLC has made (or makes for its final tax year as the old partnership) an election under Code § 754 to adjust the basis of its assets with respect to PE Fund to reflect the purchase price paid by PE Fund. See Reg. § 1.708-1(b)(5).
Sale of LLC Assets: Installment Note Example 11

**Facts**
- LLC sells its assets for $4M cash and $4M note.
- LLC liquidates and distributes cash and note to its Members.

**Result:**
- $3M taxable gain in Year 1
- $3M taxable gain in Year 3

**Membership Interests:**
- FMV $8M
- Basis $2M

**Membership of LLC:**
- $4M Cash
- $4M P Note

**LLC Assets:**
- FMV $8M
- Basis $2M

**P Corp:**
- $4M cash
- $4M P Note (3 yr. term)

**Assets:**
- $4M Cash
- $4M P Note
Sale of LLC Assets: Installment Note Example 11 (Cont'd)

Tax Consequences of Sale:

- LLC computes its gain under IRC § 453 (selling price is $8M, gross profit is $6M, and gross profit ratio is therefore 75%).
- LLC has received $4M cash in year of sale and 75% of that payment is recognized ($3M).
- $3M gain passes through to Members per Code § 702.
- Members' tax basis in their LLC interests increased to $5M per Code § 705 (i.e., $2M pre-sale basis + $3M gain on sale).
Sale of LLC Assets: Installment Note
Example 11 (Cont'd)

Tax Consequences on Distribution of $4M of Cash and $4M P Note in Liquidation:

• Members' tax basis in their LLC interests will be allocated first to the $4M cash (Code § 732(b)) and then to the $4M P note.

• Result: Members' tax basis in the P note will be $1M (Code § 732(b)).

Tax Consequences on Future Payment of $4M P Note:

• Upon receipt of $4M in payment on the P note, Members recognize the $3M of deferred gain (i.e., $4M cash on payment of P note less $1M basis).
Sale of S Corp Assets: Installment Note
Example 12

Stock:
FMV $8M
Basis $2M

$4M Cash
$4M P Note

S Corp

Shareholders

$4M cash
$4M P Note (3 yr. term)

S Corp Assets:
FMV $8M
Basis $2M

Facts
Same facts as Example 11, except Seller is an S Corp.

Result:
• $4.5M taxable gain in Year 1
• $1.5M taxable gain in Year 3
Sale of S Corp Assets: Installment Note
Example 12 (Cont'd)

Tax Consequences of Sale:

• S Corp’s gross profit is the same as Example 11 ($6M), and its gross profit ratio is the same as Example 11 (75%).
• S Corp recognizes $3M on the $4M cash payment received in the year of sale (same as Example 11).
• $3M gain passes through to the Shareholders per Code § 1366.
• Shareholders' tax basis in their stock increased to $5M per Code § 1367.
Sale of S Corp Assets: Installment Note
Example 12 (Cont'd)

Tax Consequences on Distribution of $4M of Cash and $4M P Note in Liquidation:

- Shareholders’ $5M tax basis (original $2M + $3M gain) apportioned between the $4M cash and the $4M P note. Code § 453(h)
- Shareholders allocate 50% of their $5M basis (or $2.5M) to the $4M cash and the remaining 50% to the P note. Treas. Reg. § 1.453-11(a)(3)
- Result: $4.5M gain in year of sale (i.e., $3M on sale + $1.5M on cash distribution). Code § 453B(h)

Tax Consequences on Future Payment of $4M P Note:

- Upon receipt of $4M in payment on the P note, Shareholders recognize the $1.5M of deferred gain (i.e., $4M cash on payment of P Note less $2.5M basis).
Sale of S Corp Assets: Installment Note
Example 13

**Facts**
- Same facts as Example 14, except S Corp does not liquidate.
- S Corp distributes $4M cash to Shareholders but retains P note.

**Result:**
- $3M taxable gain in Year 1
- $3M taxable gain in Year 3

**Stock:**
- FMV $8M
- Basis $2M

**Shareholders**

**S Corp**
- FMV $8M
- Basis $2M

**P Corp**
- $4M P Note (3 yr. term)
- $4M cash

**S Corp Assets:**

**Facts**

**Result:**

<table>
<thead>
<tr>
<th>Year 1</th>
<th>Year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>$3M taxable gain</td>
<td>$3M taxable gain</td>
</tr>
</tbody>
</table>
Sale of S Corp Assets: Installment Note
Example 13 (Cont'd)

Tax Consequences of Sale: Same as Example 12.

Tax Consequences on Distribution of $4M of Cash:

- No tax payable upon distribution of $4M cash.
- Cash distributed in a transaction otherwise subject to Code § 301(c) applied first against outside basis. (Code § 1368(b)(1)).
- Shareholders’ outside basis $5M (original $2M + $3M gain) exceeds $4M cash distribution, thus no additional tax on distribution.
- Shareholders outside basis reduced to $1M per Code § 1368.
Sale of S Corp Assets: Installment Note
Example 13 (Cont'd)

Tax Consequences on Future Payment of $4M P Note:

• S Corp recognizes $3M of gain when the $4M P note is paid (based on a 75% gross profit ratio).

• $3M of gain will be taxable to the Shareholders and increase stock basis from $1M to $4M (per Code §§ 1366 and 1367).

Tax Consequences on Future Liquidation of S Corp:

• On liquidation, S Corp distributes $4M in cash to the Shareholders.

• Shareholders recognize no additional gain or loss on liquidation, because the $4M cash received equals their $4M stock basis (as adjusted above).

Caveat:

• If S Corp has any E&P, it must plan to avoid application of Code §§ 1375 and 1362(d)(3).
Questions or Comments?