CHAPTER 17 – S CORPORATIONS: SELECTED TOPICS

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17-1a. In general, buy-sell agreements between shareholders are disregarded in determining whether an S corporation has more than one class of stock unless (1) a principal purpose of the agreement is to circumvent the one class of stock requirement and (2) the buy-sell agreement established a purchase price that, at the time the agreement was entered into, is significantly above or below fair market value. Treas. Reg. §1.1361-1(*l*)(2)(iii)(A). (Note that the regulations also state that agreements that provide for the purchase or redemption of stock at book value or at a price between book value and fair market value will not be considered as establishing a price significantly in excess of or below the fair market value of the stock. *Id).* More specifically, "[b]ona fide agreements to redeem or purchase stock at the time of death, divorce, disability, or termination of employment are disregarded" in determining whether an S corporation has more than one class of stock outstanding. Treas. Reg. §1.1361-1(l)(2)(iii)(B). Accordingly, this provision will not cause a problem so long as it is "bona fide."

17-1b. Under Treas. Reg. §1.1361-1(*l*)(2)(iii)(B), this agreement should be irrelevant to the one class of stock determination, assuming that the agreement is "bona fide."

17-1c. This provision should not cause a problem, because its purpose is to ensure that holders of debt get paid, not to avoid the one class of stock requirement. Of course, if this provision is ever triggered and the debt holders actually receive preferred stock, the corporation will then have more than one class of stock outstanding.

17-1d. This phantom stock should not be treated as a second class of stock because it is a deferred compensation plan as described in Treas. Reg. §1.1361-1(b)(4); see Treas. Reg. §1.1361-1(*l*)(4)(i). If these provisions did not apply, the phantom stock arrangement might be treated as a second class of stock, particularly if the phantom stock was created to circumvent the maximum number of shareholders limitation in §1361(b)(1)(A). See Treas. Reg. §1.1361-1(l)(4)(ii). Note, however, that the phantom stock must not be properly treated as equity under general debt/equity principles.

17-1e. Even if the sale price established in the agreement is "significantly above or below" fair market value, because the purpose of the agreement is not to circumvent the one class of stock requirement, this agreement will be disregarded in making the one class of stock determination. Treas. Reg. §1.1361-1(*l*)(2)(iii)(B); see also Treas. Reg. §1.1361-1(*l*)(2)(iii)(A).

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17-2. Because S Corp. files a QSub election for Brother and Sister, those two corporations become disregarded entities and their assets are deemed to be owned directly by S Corp. Thus, S Corp. is treated as the direct owner of all the stock of Child Corp. As a result, S Corp. can make a QSub election for Child as well. Once all three elections are made, S Corp. is the deemed owner of all the assets held by Brother, Sister and Child. Once all

three elections are made, S Corp. is deemed for federal income tax purposes to own all the assets formerly treated as owned by Brother, Sister and Child.

Note that under the default ordering rule, these liquidations are deemed to occur up the chain. Thus, Child would first be deemed to liquidate into Brother and Sister. Because neither Brother nor Sister owns an affiliated interest in the Child stock, the liquidation cannot be described in §332, and the shareholders will recognize gain or loss on the deemed liquidation under §331(a). Further, Child will recognize gain (and generally) loss on property distributed in liquidation. §336(a).

To avoid those consequences, Brother and Sister should liquidate into S Corp. first. Because S Corp. owns all of their stock, §332 and §337 will apply to the deemed liquidations. Thus, neither Parent nor Brother or Sister will recognize gain or loss on the deemed liquidation. Following the deemed liquidations, S Corp. will be deemed to own all Child stock, so its liquidation will also be described in §332 and §337, and neither S Corp. nor Child will recognize gain or loss. (These conclusions assume that S Corp. does not have Brother, Sister, or Child debt.)

Note that the one disadvantage of this approach is that there would be three separate §1374 pools, instead of just two. To avoid that problem, Parent could contribute the Brother stock to Sister, make the elections, and have Brother first liquidate, then Child, and finally Sister. The contribution and deemed liquidation of Brother would be treated as a D reorganization (*see* Rev. Rul. 67-274), Child would be treated as liquidating into Sister, and Sister as a combined entity with the Brother and Child assets would liquidate into S, and there would be only one §1374 pool. Note that the Child and Sister liquidations would be described in §332 and §337.

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17-3. X has equity basis of $10,000 and debt basis of $15,000. Pass-thru of loss comes after accounting for distributions. §1368(d)(1). The distribution can be absorbed by equity basis only, §1368(b)(1), so the $20,000 distribution is half tax-free and half taxable, and stock basis goes to $0, §1367(a)(2)(A). Because pass-thru of loss can be absorbed by both equity and debt basis, §1366(d)(1), the pass-thru loss is fully allowed and reduces X's debt basis to $3,000, §1367(b)(2)(A). The guarantee does not affect the transaction.

To improve her position, X could have invested the $15,000 in additional stock, rather than debt and borrowed the $75,000 directly, re-lending the that money to the corporation. (X's $15,000 debt is likely subordinate to the bank's debt in any case, so that X acquiring stock rather than $15,000 debt may put X in no worse position.) To minimize the gain on the distribution, only a contribution would suffice, because only equity basis can absorb distributions. See §1368. Note that if S Corp. paid the principal and interest on X's debt, those payments would be constructive dividends, but X should be able to deduct the interest (since it was paid on X's behalf), subject to §163. Note that the constructive distribution would not create a second class of stock, because it would be paid entirely to X, the sole S shareholder.

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17-4. Fred should demand more stock (or other consideration) than Mary because of gain associated with the inventory contributed by Mary, half of which he will take into account when the inventory is sold. The amount that he would ask for would depend on the present-value tax cost of taking that gain into account (as well as the amount that Mary would be willing to offer Fred). Note that Mary would take into account the present-value cost to her of the tax on her allocable share of the built-in gain in the land, and Mary should discount the extra amount that Fred receives by that present-value cost. Note as well that even if Mary makes Fred whole, she should come out ahead, because Fred is taxed at only a 15% rate (and should be compensated based on that rate) but Mary avoids a 35% tax on half of the gain because of the §351 contribution.

17-5a. The gain is allocated $1,000 each to A and B because each owns half the stock. Cf. §704(c)(1)(A).

17-5b. The gain is allocated pro rata again, unless B is treated as contributing additional services to the corporation in exchange for additional stock. Here, the facts do not indicate that additional stock was received by B. However, if A and B are members of the same family, the Commissioner might reallocate some of the gain to B under §1366(e).

17-5c. The depreciation deduction is allocated pro rata also.

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17-6. If B joins with the Acquiring Corporation to make a §338(h)(10) election for her sale of the S Corp. stock, S Corp. will be treated as if it sold its assets for consideration equal to $1,000,000 (assuming that the corporation has no liabilities), and B is treated as if she received the sales consideration in liquidation of S Corp. Treas. Reg. §1.338(h)(10)-1(d)(3)-(5). Further, assuming that the installment obligation is from Acquiring Corporation and B does not elect out of the installment method under §453(d), that method applies to S Corp.'s deemed asset sale and B's receipt of the note in the deemed liquidating distribution. On the deemed asset sale, S Corp. recognizes one-half or $300,000 of its gain (since half of the consideration is the installment note). See §453; Treas. Reg. §1.338(h)(1)-1(d)(8)(i). Under §1366, B takes that gain into account, and under §1367, B increases her S stock basis from $400,000 to $700,000 to account for that gain. On the deemed liquidation, S Corp. does *not* recognize gain on its deemed distribution of the installment note. §453B(h). Further, under Treas. Reg. §1.338(h)(10)-1(d)(8)(ii), S Corp. is treated as distributing an acquiring corporation installment note plus cash in liquidation, and B is treated as receiving that consideration. Under §453(h), B can account for the payments under that note using the installment method. Thus, although B realizes a $300,000 gain (the excess of $1,000,000 amount realized over $700,000 basis) on the deemed liquidation, only half or $150,000 of that gain is recognized at the time of the stock sale. The other $150,000 gain is recognized when Acquiring Corp. pays off the note in two years. See Treas. Reg. §1.338(h)(10)-1(e) (*ex.* 10) (for a comparable illustration).

17-7. To determine the additional price that A Corp. (or A) should pay, it is necessary to determine the benefit to A Corp. (or A) of the §338(h)(10) (or §336(e) election). That benefit may be measured by comparing the tax cost to A Corp. (or A) with and without the election. The buyer would also take into account any detriment to T of making the election. Note that the analysis in this problem disregards the time value of money.

17-7a. If no §338(h)(10) (or §336(e)) election is made, A Corp. (or A) is willing to buy the X stock, and T is willing to sell that stock, for $5,000,000. If neither election were made, T would recognize a $4,000,000 long-term capital gain on her sale of the X stock (assuming that she had held it for more than one year), paying an $800,000 tax (20% of $4,000,000). Thus, at a minimum, T must net $4,200,000 after tax. Note that if no election was made and X Corp. later sold the inventory, it would also recognize a $4,000,000 gain, triggering an $840,000 tax (21% of $4,000,000) if X Corp. was owned by A Corp. or a $1,600,000 tax (40% of $4,000,000) if X Corp. was owned by A.

If either election is made, X Corp. would take a basis in its assets equal to the price paid for the T stock. *See* Treas. Regs. §1.338-5(b); Treas. Regs. §1.336-4(a). If the buyer paid $5,000,000 for that stock, disregarding the time value of money, that benefit would equal the tax saved on the later sale of the inventory, or $840,000 for A Corp. or $1,600,000 for A. Note that if the buyer increased its or his purchase price by that amount, X's asset bases would also increase by the same amount, producing an additional tax benefit, which would allow another possible increase in price, produce added tax benefit, and so on. Computing the total possible benefit (and maximum increase in price) would require an iterative computation (and assumptions about the timing of that benefit, the applicable tax rates at the relevant times, and an appropriate discount rate). In any case, disregarding the time value of money, A Corp. or A should be willing to increase the price by $840,000 or $1,600,000, respectively. If the buyer offers that increased price, should A accept the deal and join in making the §338(h)(10) or §336(e) election?

If T sells the X stock to A Corp. for $5,840,000 and T and A Corp. join in filing a §338(h)(10) election, X Corp. will be deemed to sell its inventory for $5,840,000 recognizing a $4,840,000 of ordinary income, which is passed thru to T. §1366(a)(1); Treas. Regs. §1.338(h)(10)-1(d)(5)(i). Assuming that T has no losses available to offset that income, her tax on the sale is $1,936,000 (40% of $4,840,000). T increases her basis in the X stock by the allocated income, from $1,000,000 to $5,840,000. §1367(a)(1)(A). T is deemed to receive the sales proceeds for the X stock in liquidation of X, recognizing no gain or loss because her basis in that stock ($5,840,000) equals the sales proceeds (also $5,840,000). §331(a); Treas. Regs. §1.338(h)(10)-1(d)(5)(i). Overall, T nets $3,904,000, or $296,000 less than if the election is not made and T sells the stock for $5,000,000. Thus, T should not accept the deal.

You might ask students how the reduction in corporate tax rates affected the determination of whether to make a §338(h)(10) election. It turns out that the reduction in corporate rates (from 35% to 21%) made the election unwise, because the buyer was willing to pay less after the corporate rate reduction since the reduction made the added basis less valuable. If A Corp. were taxed at a 35% rate, it would be willing to pay an

additional $1,400,000 (or 35% of $4,000,000), T would incur a tax of $2,160,000 (40% of $5,400,000), and T would net $4,240,000, or $40,000 more than if the election were not made.

Suppose, instead, that T sells the X stock to A for $6,600,000 and T and A join in filing a §336(e) election, the analysis is substantially the same as in the preceding paragraph, although the results differ. *See* Treas. Regs. §1.336-2(b)(1)(iii)(A). X Corp. will be deemed to sell its inventory for $6,600,000 recognizing a $5,600,000 of ordinary income, which is passed thru to T. §1366(a)(1). Assuming that T has no losses available to offset that income, her tax on the sale is $2,240,000 (40% of $5,600,000). T increases her basis in the X stock by the allocated income, from $1,000,000 to $6,600,000. §1367(a)(1)(A). T is deemed to receive the sales proceeds for the X stock in liquidation of X, recognizing no gain or loss because her basis in that stock ($6,600,000) equals the sales proceeds (also $6,600,000). §331(a). Overall, T nets $4,360,000, or $160,000 more than if the election is not made and T sells the stock for $5,000,000. Thus, again T should accept the deal.

17-7b. This part of the problem illustrates the potential tax benefit of the extra payment. Assume that X Corp. could use any extra deduction and that the deduction's benefit would equal 21% of any added basis. That added basis would equal $4,000,000 plus the additional payment ("AP") that A Corp. would pay. Disregarding the time value of money, that benefit would therefore equal 21% of the sum of $4,000,000 plus AP. AP (*i.e.*, the additional amount that X Corp. pays) should not exceed that benefit. Stated as a formula –

$$\text{AP} \leq .21 \text{ times } (\$4{,}000{,}000 + \text{AP})$$
$$\text{AP} \leq \$840{,}000 + .21\ \text{AP}$$
$$.79\text{AP} \leq \$840{,}000$$
$$\text{AP} \leq \$1{,}063{,}291.14$$

Thus, A Corp. should pay no more than $1,063,291.14 for the additional benefit.

Note that if the time value of money were taken into account, the tax benefits over four years would have to be stated to present value using an appropriate discount rate. If the discount rate were 6%, A Corp.'s maximum additional payment would be $889,485.7, while if the discount rate were 10%, A Corp.'s maximum additional payment would be $798,562.80.