S Corporations: Lecture 3

I. Assignment of Income Concerns

A. Pre-Contribution Appreciation and Loss

1. The emphasis on simplicity underlying Subchapter S explains why built-in gain and loss in contributed property is shifted to other shareholders. Because this cannot be avoided, shareholders should attempt to adjust the value of the shares received upon formation to account for the shifting income and loss. Note that amount of built-in gain and loss, the character of such gain and loss, the shareholders‘ effective tax rates, and the timing of possible sales should be taken into account.

2. Problem 17-4 (p. 579): Because the contributed inventory is sold earlier than anticipated, any attempted accounting built-in gain will be imperfect. The shareholders could instead agree to account for the differential tax issues when the assets are sold by signing a tax receivable agreement that provides for direct cash or property payments when the assets are sold. However, such payments of cash and property will be taxable event.

B. Contribution of Services

1. Section 1366(e) attempts to protect the assignment of income doctrine as it applies to income from labor by ensuring that family members cannot shift value to other family members by providing free or under-compensated labor.

2. Problem 17-5

a. Part (a): The income is split equally.

b. Part (b): If A and B are members of the same family, §1366(e) is implicated.

c. Part (c): The deduction is shared equally.

II. The Elections Under §338(h)(10) and 336(e)

A. Hypos:

1. X Corp., and S Corporation, owns assets with adjusted basis of $1,200, fair market value of $1,500, and encumbered by a liability of $200. The shareholders have a combined adjusted basis in their shares of $1,000. Y Corp. wishes to acquire to all of the assets of X Corp., and is willing to pay $1,300 for those assets.

a. Purchase and Sale of Assets: If Y Corp. purchases the assets directly, it will pay $1,300 for the assets subject to the encumbrance of $1,500 if it gets the assets free of the liability. In either even, Y Corp. will take the assets with a cost basis of $1,500. X Corp. will recognize a gain of $300 that will flow through to and be includible by the shareholders, increasing their aggregate stock basis to $1,300. Accordingly, if X Corp. then liquidates, there will be no further gain or loss to the shareholders.

b. Purchase and Sale of Stock: If Y Corp. purchases the stock of X Corp. for $1,300, the X Corp. shareholders will recognize a gain of $300. This gain will be entirely capital gain while the gain from the asset sales could include an ordinary component. Nonetheless, the amount of the income recognition to the X Corp. shareholders remains the same. However, Y Corp. takes a cost basis in the shares of X Corp. but the assets retain their historic basis of $1,200. Thus, there will be a duplicate gain of $300 at the corporate level.

2. Charge the facts by assuming the X Corp. shareholders have an adjusted basis of only $900 in their shares. Now, an asset sale will increase their aggregate stock basis to only $1,200 so that the liquidating distribution will trigger an additional shareholder gain of $100, for net income of $400. A stock sale will yield the same $400 of income.

3. Change the facts by assuming the X Corp. shareholders have an adjusted basis of $1,00 in their shares. Now, an asset sale will increase their aggregate stock basis to $1,400, and they will recognize a taxable loss of $100 on the liquidating distribution, for net income of $200. A stock sale will also yield income of $200.

4. From these examples, we learn two things: (1) the aggregate shareholder stock basis determines the net gain or loss from a sale of shares or of a sale of assets followed by a complete liquidation; and (2) an asset sale is more tax-efficient from the perspective of the purchaser but may impose a cost on the X Corp. shareholders by converting some of their gain from capital to ordinary.

B. The Elections Under §338(h)(10) and 336(e): If a purchasing corporation makes a “qualified stock purchase,” the sellers and the purchaser can jointly file an election under §338(h)(10). A QSP requires acquisition of at least 80% of the target’s shares in a fully-taxable purchase and sale. If such an election is made, the actual stock purchase and sale is taxed as if the assets were purchased and sold and then the target corporation were liquidated.

1. The deemed sale price of the assets equals the sum of the actual stock sale price plus any liabilities assumed by the purchaser. Further, if the purchaser acquires less than 100% of the target’s shares, we much gross-up the price to fully capture the value of the assets. For example, if the purchaser only acquires 90% of the shares, we multiply the actual price paid for the 90% of the shares times 100/90, and then we add any liabilities assumed. If the purchaser acquired some of the target shares prior to the start of the QSP (a one-year period), then further adjustments have to be made.

2. The election under §336(e) is essentially the same as the election under §338(h)(10) except a QSP is replaced with a qualified stock sale, a minor change.

3. Problems (p. 582)

a. Problem 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).

b. Problem 17-7

i. Part (a): 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.

ii. Part (b): 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 –

AP < .21 times ($4,000,000 + AP)

AP < $840,000 + .21 AP

.79AP < $840,000

AP < $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.

III. Adaptability and Reversibility: When tax laws may change, it is important to consider the possible need to change or reverse a previously-implemented tax strategy. Here, we will consider the choice of entity – S Corporation or C Corporation – and the potential costs of reversing the decision. Of course, we also should consider other possible responses to changes in the law such as converting to a limited liability company.

A. Transition from C Corp. to S Corp.

1. Shareholder Taxation of Distributions

a. Distributions from S Corporations are tax-free to shareholders to the extent of stock basis and then generate gain. Distributions from C Corporations are dividend income to shareholders to the extent of e&P, then are tax-free to the extent of stock basis, then generate gain. Once a C Corporation converts to an S Corporation, an ordering rule is need to determine whether distributions should be taxed under the Subchapter S rules or the Subchapter C rules. The order rule is in §1368(c), and generally is pro-taxpayer.

b. An S Corporation with a C Corporation history must maintain as accumulated adjustments account (usually called its “AA” account). This plays the role for S Corporations that e&p plays for C Corporations. Unless an election is made reversing the default order, distributions are treated as made (1) out of the AA Account to the extent thereof, then (2) out of e&p to the extent thereof, then (3) again recovery of basis followed by gain. (Thus, tier 1 and tier 3 are taxed the same.) The only peculiar feature is that the AA account does not include an S Corporation’s tax-exempt income (if any). This has the effect of moving distributions out of tier 1 and into tier 3.

2. Corporate-Level Tax on Built in Gains

a. Overview: If a C Corporation converts to an S Corporation while holding appreciated assets, a subsequent taxable disposition of the assets during the “recognition period” will be taxable to the corporation under §1374 (the “BIG” tax). The amount taxed under §1374 during any taxable year in the recognition period is the net recognized built-in gain during the year, subject to the limitation that the maximum amount recognized under §1374 in any taxable year is the excess of the net unrealized built-in gain over the net recognized built-in gain for prior taxable years. §1374(c)(2). Thus, the maximum amount recognized under §1374 is the net unrealized gain (determined at the date of the conversion).

b. The recognition period is the 5 years following conversion from C Corporation to S Corporation. §1374(d)(7).

c. Any tax paid under §1374 is treated as a loss incurred in the year the tax is paid, §1366(f)(2), and so affects the S Corporation’s taxable income and AA Account.

B. Transition from S Corp. to C Corp.

1. Post-Termination Distributions: Post-termination distributions to the extent of the lesser of the corporation’s AA Account and the shareholder’s stock basis if made in cash and during the “post-termination transition period.” §1371(e)(1). The post-termination transition period generally is the one-year period ending one year after the S Corporation status terminates. §1377(b)(1).

2. Other than that, the corporation’s prior status as an S Corporation is disregarded. In particular, there is no equivalent to the BIG Tax in §1374.