

S CORPORATIONS





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This section covers the requirements that a corporation must meet in order to be subject to subchapter S tax status.

Basic Requirements

To be subject to subchapter S, a corporation must:

- ◆ Be an **eligible corporation**, and
- ◆ Make an **election** to be subject to subchapter S taxation.

What Is an Eligible Corporation?

An eligible corporation is one that meets all the following requirements.¹

- ◆ Has **100** or fewer **eligible shareholders**
- ◆ Has a **single class of stock**
- ◆ Is a **domestic corporation**

Eligible Shareholder

An S corporation may not have more than 100 shareholders, and each shareholder must be an eligible shareholder. Beginning in 2005, family members can elect to be treated as one shareholder for the purpose of determining number of shareholders. Eligible shareholders are limited to:

- ◆ Individuals, other than nonresident aliens²
- ◆ Estates³
- ◆ Certain trusts including voting trusts, grantor trusts, qualified subchapter S trusts (QSST), and electing small business trusts (ESBT)⁴
- ◆ Tax-exempt organizations described in IRC Sections 401(a) and 501(c)(3)⁵

¹IRC Sec. 1361(b)(1).

²IRC Secs. 1361(b)(1)(B), 1361(c)(1).

³IRC Secs. 1361 (b)(1)(B), 1361(c)(3).

⁴IRC Secs. 1361(c)(2), 1361(d), 1361(e)(1).

⁵IRC Sec. 1361(c)(6).



Single Class of Stock

An S corporation may have only one class of stock. Differences in economic rights such as a nonproportionate corporate distribution can result in the creation of an impermissible second class of stock. Provisions in business documents can create a second class of stock if not properly drafted. Mere differences in voting rights, however, will not create a second class of stock.⁶ Consequently, it is possible to have voting and nonvoting stock in an S corporation.

Subchapter S Elections

A corporation which has met the above requirements becomes an S corporation by making a tax election to be subject to subchapter S.⁷ (Form 2553)

All shareholders must consent to the election for it to be effective.⁸

The election must be made on or before the fifteenth day of the third month of the corporation's tax year (March 15 for calendar year corporations) to be retroactive to the beginning of the tax year. An election can be made at any time after this date for the following tax year. A late-filed S election can be treated as timely by the IRS if there is a finding of reasonable cause.

Effect on State Tax

The election is a federal tax election. Each state determines how to tax the S corporation for state tax purposes. While it is recognized under many state laws, this is not universally true.

Termination of the S Election

A corporation's S tax status is generally terminated by:

- ◆ A majority of all shareholders (voting and nonvoting) affirmatively **revoking** the election,⁹ or
- ◆ The **disqualification** of the corporation.¹⁰

⁶ IRC Sec. 1361(c)(4).

⁷ IRC Sec. 1362(a).

⁸ IRC Sec. 1362(a)(2).

⁹ IRC Sec. 1362(d)(1).

¹⁰ IRC Sec. 1362(d)(2).



Revocation

The revocation can specify an effective date. If no effective date is given, the revocation will be effective on the first day of the corporation's tax year provided the consents are filed on or before the 15th day of the third month. If filed after the above date, the revocation will be effective for the next tax year.

Disqualification

A corporation's S status terminates if the corporation ceases to satisfy the eligibility requirements. A corporation that "inadvertently" ceases to qualify may request re-election of the S status from the IRS.¹¹

Effect of Termination

If a corporation's S status terminates, the corporation cannot elect S status for five years except in the case where re-election is granted by the IRS.¹²

When a corporation's S status terminates, the tax year is divided into two parts.¹³ The portion of the year prior to termination is called the "**S short year**," and the balance of the year is called the "**C short year**." The corporation and its shareholders are taxed under the rules of subchapter S for the S short year and as a C corporation for the C short year.

¹¹ IRC Sec. 1362(f).

¹² IRC Sec. 1362(g).

¹³ IRC Sec. 1362(e).



This section provides an overview of the income tax rules governing the S corporation and its shareholders.

Case Study

For this section, the following example will be used to illustrate the impact of the S tax rules.

This past year, A and B decided to establish an S corporation for a new business venture. Each contributed \$35,000 and each received 35 shares. A and key employee C are the only employees of the business. During the year, the business earned \$100,000 of taxable income (before expenses) and \$10,000 of tax-exempt income, and paid compensation of \$20,000 to A and \$30,000 to C and medical benefits of \$5,000 (\$3,000 allocated to A).

Corporate Flow-Through

S corporate taxation is built on the principle that the shareholder, rather than the S corporation, is taxed on the income of the business after corporate-level deductions are taken into account.¹⁴ Consequently, the S corporation is often described as a “**flow-through**” entity or conduit for income tax purposes.

¹⁴ IRC Sec. 1363(a).



Corporate Flow-Through

Although the S corporation is generally not a separate tax entity, the rules governing income and deductions for the S corporation are similar to those governing C corporations.¹⁵ As a result, business expenses such as reasonable compensation and fringe benefits are deductible from the income of the business.

Example: In the case study, the \$50,000 compensation and \$5,000 medical benefits would reduce the income of the corporation from \$110,000 to \$55,000 as follows:

Corporate Income	Corporate Deductions	Shareholder's Flow-through Income
\$110,000	\$55,000	\$45,000 taxable \$10,000 tax-free

¹⁵ IRC Sec. 1371.



Corporate Level Taxes

Although the S corporation is generally a flow-through entity for tax purposes, there are situations where the S corporation is subject to taxation. In the following situations, corporate-level taxes may be imposed on the S corporation:

Built-in Gain

For S corporations that were C corporations in the past, a corporate-level tax is imposed on gain recognized on appreciated assets owned by the corporation when the S election became effective.¹⁶ The tax applies for a 10-year period beginning on the effective date of the S election.

Passive Investment Income

A corporate-level tax is imposed on passive income if an S corporation has accumulated earnings and profits from a period when it was a C corporation and has passive income which exceeds 25% of its gross receipts.¹⁷ The tax does not apply where the income is earned from a qualified subchapter S subsidiary.

LIFO Recapture

A C corporation that used the LIFO method of inventory accounting is required to include a "LIFO recapture amount" in income in the year it elects to be taxed as an S corporation.¹⁸

Employee Fringe Benefit Plan Limitations

Shareholder-employees of regular corporations may be covered by benefit programs that are deductible to the business and not taxable to the shareholder-employees. In contrast, for shareholder-employees of an S corporation, the Code provides that the more-than-2% voting S shareholder is treated the same as a partner, not an employee. Consequently, fringe benefits paid by the corporation are taxable to the shareholder.¹⁹ The corporation continues to receive a deduction.

¹⁶ IRC Sec. 1374.

¹⁷ IRC Sec. 1375.

¹⁸ IRC Sec. 1363(d).

¹⁹ IRC Sec. 1372.



What Fringe Benefits Are Affected?

The code does not define fringe benefit, but the committee report indicated the following are considered fringe benefits:

- ◆ The cost of \$50,000 group term life insurance.
- ◆ The amounts paid for accident and health plans.
- ◆ Although payments by the corporation for medical insurance are taxable to the more-than-2% S shareholder, the shareholder is entitled to take the same deduction as a self-employed individual on his or her personal tax return.²⁰
- ◆ The amounts paid for meals and lodging furnished for the convenience of the employer.

Items Pass Through to Shareholders

Items of income, losses, deductions, and credits received by the S corporation (after corporate-level deductions) are passed through and taxed to the shareholder whether or not the items are actually distributed.²¹ If the shareholder is also an employee of the corporation, he or she will also be taxed on compensation and certain fringe benefits received.

Generally, the character of the item (e.g., whether it is taxable or tax-exempt) is determined at the corporate level and is passed through to the shareholder.²²

How the income, loss, deductions, and credits are passed through to the shareholder is based on whether or not the item has tax significance to the shareholder.²³ Items of tax significance include items that can affect the tax treatment of an individual shareholder, such as losses, investment interest expenses, charitable contributions, and tax-exempt interest.

No Tax Significance	Tax Significance
Income and deductions are netted against each other and the net figure is passed through to the shareholder	Items of significance are passed through on an item-by-item basis to the shareholder.

²⁰ Rev. Rul. 91-26, 1991-15 IRB 23, IRC Sec. 162(1).

²¹ IRC Sec. 1366(a).

²² IRC Sec. 1366(b).

²³ IRC Sec. 1366(a)(1).



Loss Limitation

An S shareholder can claim a loss only to the extent of his or her stock basis.²⁴ Losses in excess of basis are carried forward until additional basis is created to support the loss.²⁵

Methods of Allocation

Generally, the income, losses, deductions, and credits of an S corporation must be allocated on a per share per day basis (per diem approach).²⁶ Under this approach, all the income for the entire tax year is allocated based on the following formula:

$$\text{Income} \times \frac{\text{Shares owned by shareholder}}{\text{Total shares}} \times \frac{\text{Number days shares owned}}{\text{Total days in year}} = \text{Amount allocated}$$

Notice that in this approach, the income for the entire year is allocated as if it were equally earned through all periods. As a result, a shareholder may have to report income earned during periods he or she was not a shareholder.

Instead of the per diem approach, a short-year election can be made, but only upon a shareholder's **complete termination** of his or her stock interest in the S corporation, and only if all the affected shareholders consent. Under this approach, the allocation is made based on the corporation's income as of the date of termination (books and records allocation).²⁷

Example: For this example only, assume the \$10,000 of tax-exempt income received by the corporation was all realized in the second half of the year. Assume from January 1 until June 30, A was the only shareholder and on July 1, B acquired A's interest. The allocation of the tax-exempt income on a per share per day basis (per diem method) would be as follows:

Shareholder	Shares	Days	Tax-Exempt Allocation
A	35/35	181/365	49.6%
B	35/35	184/365	50.4%

If, instead of using the per diem approach, the short-year election is made, no part of the tax-exempt income would be allocated to A, and B would report 100% of the tax-exempt income.

²⁴ IRC Sec. 1366(d)(1).

²⁵ IRC Sec. 1366(d)(2).

²⁶ IRC Secs. 1366(a)(1), 1377(a)(1).

²⁷ IRC Sec. 1377(a)(2).



Items Taxed to Shareholder Whether or Not Distributed

Consistent with the conduit system of S corporate taxation, profits of an S corporation are taxed to the shareholder in proportion to stock ownership whether or not the income is actually distributed.

Example: *The shareholders in our example would report as taxable income both their pro rata share of the corporation's earnings \$45,000 (\$100,000 taxable income minus \$55,000 compensation and benefits) and their personal compensation as follows:*

Shareholder	Interest	Benefits and Compensation	Pro Rata Share	Total Taxable Income
A	50%	\$23,000	\$22,500	\$45,500
B	50%	0	\$22,500	\$22,500

In the above example, notice how the money received by the shareholder-employee (A) is different. Corporate distributions must be in proportion to stock ownership, whereas compensation can be made without regard to ownership but must be reasonable in relation to the services performed.

Characterization as Compensation or an S Distribution

S shareholder-employees are taxed on both compensation and distributions of S corporate earnings. Consequently, unreasonably high compensation is generally not a critical issue in an S corporation. (An owner's concern about unreasonable compensation in a C corporation may be a reason to elect S status.) In contrast to a C corporation where the usual compensation strategy is to increase compensation to avoid dividend payment and double taxation, shareholder-employees of an S corporation may attempt to have a large portion of a distribution characterized as an S distribution in an attempt to avoid the cost of FICA and FUTA. However, as indicated above, to be classified as a distribution, the shareholder must be able to prove the distribution was based on proportionate ownership and not on services rendered.



S Corporate Distributions

An S shareholder is also taxed on actual corporate distributions received. The taxation of a corporate distribution is dependent on the shareholder's **adjusted basis** in his or her stock and whether the corporation has any accumulated **earnings and profits**.

Earnings & Profits Account (E & P)

As indicated on the previous page, current earnings are taxed to the S shareholder even if they are retained by the business. When these retained earnings are subsequently distributed to the shareholder, they are tax-free since they have already been taxed. In contrast, in a C corporation, earnings retained by the business are not taxed. Consequently, when these earnings are distributed to the shareholder, they need to be taxed. It's possible for an S corporation to have both types of earnings. To distinguish between the types of earnings, the concept of earnings and profits (E & P) was developed to provide a method for determining which corporate distributions to shareholders should be taxed.

The following S corporations may have E & P:

- ◆ S or C corporations in operation prior to 1983
- ◆ S corporations which previously operated as, or that acquired, a C corporation

In enacting subchapter S, Congress did not intend to have S corporation distributions of E & P avoid taxation. As a result, S corporations with prior E & P must maintain an E & P account so that these distributions will continue to be taxed.

Accumulated Adjustment Account (AAA)

At the same time, Congress did not intend that previously taxed retained earnings of an S corporation should be subject to tax at distribution. Consequently, the Accumulated Adjustment Account (AAA) was created to distinguish between distributions of previously taxed S earnings (earnings which generally may be distributed tax-free) and distributions of E & P (which are taxable).



Basis & AAA Adjustments

In an S corporation, a shareholder's stock basis and the corporation's AAA are adjusted to reflect the operations of the business as follows:

On Pro Rata Share

	Initial	Increase By:	Decrease By:
Basis ²⁸	Purchase price and notes assumed	<ul style="list-style-type: none"> • Taxable income • Tax-exempt income • Shareholder contribution to capital 	<ul style="list-style-type: none"> • Deductions and losses (other than related tax-exempt income) • Nondeductible expenses not charged to capital account (except related to tax-exempt income) • Nontaxable corporate distributions to shareholders
AAA ²⁹	Zero	<ul style="list-style-type: none"> • Taxable income 	<ul style="list-style-type: none"> • Deductions and losses (other than related tax-exempt income) • Nondeductible expenses (except related to tax-exempt income) • Nontaxable corporate distributions to shareholders

1. Basis cannot fall below zero. AAA can be reduced below zero.
2. Basis is personal to a shareholder while AAA is a corporate account.

²⁸ IRC Sec. 1367(a).

²⁹ IRC Sec. 1368(e)(1).



Example: Continuing the previous example, the following table shows the impact of the S corporation's operation on basis and AAA. Note that the assumption is made that \$55,000 earned from operations is not held by the S corporation but is actually distributed to A and B.

Adjustments	Basis		AAA
	A	B	
Initial Balance	\$35,000	\$35,000	0
Increase for corporate income \$100,000 taxable	\$50,000	\$50,000	\$100,000
\$10,000 tax-exempt	\$5,000	\$5,000	0
Decrease for compensation and benefits paid			
\$20,000 A	(\$10,000)	(\$10,000)	(\$20,000)
\$30,000 C	(\$15,000)	(\$15,000)	(\$30,000)
\$5,000 Benefit	(\$2,500)	(\$2,500)	(\$5,000)
Balance before distribution	\$62,500	\$62,500	\$45,000
Decrease for dividend paid			
\$45,000 taxable	(\$22,500)	(\$22,500)	\$45,000
\$10,000 tax-exempt	(\$5,000)	(\$5,000)	0
Balance after distribution	\$35,000	\$35,000	0

In the above example, the balance before the S corporation distribution represents basis and AAA balances, assuming not all profits are distributed to the shareholders. The balance after the S corporation distribution assumes all the profits for the year are distributed to the shareholders. Notice that basis and AAA are higher before the distribution.

Earlier we indicated that shareholders of an S corporation are taxed on the income of the business in proportion to their stock ownership whether or not the income is actually distributed. The illustration above shows that, where income is retained by the business, basis and AAA accounts are increased. Maintaining a high basis is a significant consideration for an S shareholder because basis shelters distributions from taxation. Consequently, the harsh rule of taxation without distribution is balanced by the rule governing the calculation of an S Shareholder's basis.



Taxation of S Corporation Distributions

S corporation distributions are treated as occurring on the last day of the taxable year, after all adjustments reflecting the operations of the business have been made to basis and AAA.

Where Corporation Has No E & P ³⁰

When an S corporation does not have any accumulated E & P, distributions are taxed as follows:

Distribution Amount	Tax Character	Basis
1. Extent of basis	Tax-free	Eliminate
2. Excess of basis	Capital gain	

Example: If A and B each had a basis of \$35,000 and the corporation distributes \$50,000 to each, the first \$35,000 would be a tax-free distribution while \$15,000 would be subject to capital gains tax. Their basis would be reduced to zero.

Where Corporation Has E & P ³¹

If an S corporation has accumulated E & P, distributions are taxed as follows:

Distribution Amount	Tax Character	AAA	Basis
1. AAA (extent of basis)	Tax-free	Reduce/Eliminate	Reduce
2. Remaining AAA (if any)	Capital gain	Eliminate	—
3. Extent E & P	Taxable dividend	—	—
4. Remaining basis (if any)	Tax-free	—	Eliminate balance
5. Excess basis	Capital gain	—	—

Importance of Basis

The charts above indicate that basis determines how much of a corporate distribution can be made tax-free. Having a greater basis that can absorb corporate distributions is an advantage to an S shareholder who anticipates major corporate distributions or the lifetime sale of the business. Consequently, S shareholders frequently seek ways to maintain or increase their basis.

³⁰ IRC Sec. 1368(b).

³¹ IRC Sec. 1368(c).



The purpose of this section is to highlight the impact that S corporation taxation has on specific insurance arrangements. Since the tax implications for a corporate-owned policy are different from those of a personally owned policy, this section has been divided along these lines. The tax impact of life insurance in a buy-sell agreement is treated in a separate section.

The life insurance needs of an S shareholder are no different than those of the owners of a C corporation. In both situations, the insurance techniques used to address the needs of the business owners are affected by the tax rules governing the business. The tax rules governing S corporations can have unique effects on life insurance arrangements when compared to the same arrangements in C corporations. In some cases, the tax impact in an S corporation may require that a different approach be used than would be used in a C corporation.

Employer-Owned Life Insurance Issued After August 17, 2006

For **employer-owned contracts** issued after August 17, 2006, IRC § 101(j) provides that death proceeds will be subject to income tax; however, where specific employee notice and consent requirements are met and certain exceptions apply, death proceeds can be received income tax-free under IRC § 101(a).

What Is an Employer-Owned Contract?

The starting point to understanding the impact of the legislation is to recognize what it calls an **employer-owned contract**. An employer-owned contract is defined as a life insurance contract

- ◆ That is owned by a person engaged in a trade or business (**applicable policyholder**, as defined by the law)
- ◆ Under which such person, or related person (as defined by the law), is directly or indirectly a beneficiary, and
- ◆ That covers an insured that is an employee of the trade or business of the applicable policyholder on the date the contract is issued.



Clearly, this definition includes policies where a business is the owner and beneficiary. What's not so obvious is that, under the **applicable policyholder** and related party definitions, the legislation expands its reach to a broad group of individuals and entities such as family members, trusts, and estates.³²

Notice and Consent Required Prior to Issue

Congress apparently was aware that this broad definition could negatively impact many valid business uses, so it included a number of exceptions in the legislation. However, the exceptions only apply where the employee receives **notice of, and consents to, the following in writing prior to policy issue:**

- ◆ The applicable policyholder intends to insure the employee's life and specifies the maximum face amount for which the employee will be insured at time of issue;
- ◆ The employee consents to being insured and agrees that such coverage may continue after he/she terminates employment; and
- ◆ The applicable policyholder will be the beneficiary of the death proceeds paid.

Meeting the notice and consent requirements is a critical first step to avoiding taxation of death benefits applicable to employer-owned contracts. However, notice and consent is not the only requirement imposed by the legislation. Employer-owned contracts must also fall within one of the following exceptions.

³²*The applicable policyholder includes a trade or business that owns the contract, but also includes any individual who bears a relationship described under the following related party rules: IRC §267(b), 707 (b)(1) and 52(a),(b).*



Exception: Based on Insured's Status

This exception provides that the income inclusion rule will not apply to employer-owned contracts provided the insured was either:

- ◆ An employee at any time during the 12-month period prior to death, or
- ◆ A director, a highly compensated employee³³, or a highly compensated individual³⁴ at the time the contract was issued.

Exception: Based on Who Receives the Death Benefit Proceeds

This exception states that the income inclusion rule will not apply to an amount received at the death of insured to the extent the amount is paid;

- ◆ To a family member of the insured;
- ◆ To an individual, other than an applicable policyholder, who is the designated beneficiary of the insured;
- ◆ To a trust established for the benefit of a family member or designated beneficiary;
- ◆ To the estate of the insured; or
- ◆ Where the policy proceeds are used to purchase an interest in the applicable policyholder from such family member, beneficiary, trust, or estate.

Reporting & Record Keeping Requirements

The legislation also mandates annual reporting of employer-owned contracts for each year the contracts are owned. The report must include the following;

- ◆ The number of employees at the end of the year;
- ◆ The number of employees insured under such contracts;
- ◆ The total amount of insurance in force under such contracts;
- ◆ The name, address, and taxpayer identification number of the applicable policyholder as well as the type of business; and
- ◆ An attestation that valid consent has been obtained from each insured, or where all consents have not been obtained, the number of insureds for whom such consent was not obtained.

In light of these reporting rules, it's extremely important that businesses maintain documentation that proves that they have met the notice and consent requirements in a timely manner.

³³ **Highly compensated employees** include employees who were 5% owners of the business at any time during the preceding year or who received compensation in excess of a specific amount during the preceding year (\$105,000 if the look-back year is 2008, \$110,000 if the look-back year is 2009, indexed for inflation in future years).

³⁴ **Highly compensated individuals** include the five highest-paid officers or individuals who are among the highest-paid 35% of all employees.



Corporate Ownership

The first half of this section focuses on the tax implications of life insurance owned by and payable to an S corporation. It first highlights how the basic S corporation tax rules affect the payment of premiums and receipt of death proceeds for term and permanent insurance. Next, it illustrates how these rules impact specific corporate-owned insurance planning techniques.

Term Insurance Premium Payment

Like the C corporation, the S corporation is not allowed an income tax deduction for premiums paid on corporate-owned policies where the corporation is directly or indirectly the beneficiary.³⁵ As a result, premium payments do not reduce the taxable income of the business. In a C corporation, this would make the income used for premium payments subject to corporate-level income taxes. In contrast, in an S corporation, the income is passed through to the shareholders in proportion to stock ownership and is taxed at the shareholder level.³⁶ Consequently, one of the principal effects of corporate-owned insurance is that S shareholders are taxed on income not available for distribution, with the largest shareholders bearing the greatest tax burden.

In addition to the tax burden, the basis rules provide that a shareholder's basis is reduced in proportion to stock ownership by any nondeductible expenses of the corporation.

³⁵ IRC Sec. 264(a)(1).

³⁶ IRC Secs. 1363(a), 1366.



Consequently, premium expense will reduce the basis of the S shareholder, with the largest shareholders having the greatest decrease.³⁷

Example: Assume that equal shareholders A & B purchased a \$200,000 term policy on a 40-year-old key employee. Premiums of \$1874 are paid annually. The following illustration shows the impact of premium payments on each shareholder's basis. (50% of the premium is allocated to each shareholder.)

Male, age 40, Preferred Non-Tobacco		
\$200,000 20-year Level Term Year	Annual Premium	Annual Basis Reduction
1	\$937	\$937
2	\$937	\$937
3	\$937	\$937
4	\$937	\$937
5	\$937	\$937
10	\$937	\$937
15	\$937	\$937
20	\$937	\$937
20-Year Cumulative Premiums:		\$18,740
20-Year Cumulative Basis Reduction:		\$18,740

The AAA account, on the other hand, is not decreased by expenses related to tax-exempt income.³⁸ Since the proceeds of insurance are tax-exempt, the AAA is not reduced by the payment of premiums.

Death Proceeds

At the death of the insured, assuming the previously discussed requirements of IRC § 101(j) have been met, the proceeds paid to the S corporation are not subject to income taxation to either the S corporation or its shareholders.³⁹ Furthermore, unlike the C corporation, the S corporation is not subject to the alternative minimum tax (AMT).⁴⁰

As previously indicated, an S shareholder's basis is increased by income, including tax-exempt income.⁴¹ As a result, at the death of an insured S shareholder, the proceeds paid to the corporation will generally increase the basis of all the shareholders, including the deceased shareholder, in proportion to stock ownership.⁴² Of course, the deceased shareholder will have already received a step-up in basis to fair market value as a result of death.⁴³

³⁷ IRC Sec. 1367(a)(2).

³⁸ IRC Sec. 1368(e)(1).

³⁹ IRC Secs. 101(a)(1) and 101(j).

⁴⁰ IRC Sec. 1363(a).

⁴¹ IRC Secs. 1367(a)(1), 1366(a)(1)(A).

⁴² IRC Secs. 1367(a)(1), 1377(a)(1).

⁴³ IRC Sec. 1014(a)(1).



Finally, since AAA is not affected by tax-exempt income, the AAA is not increased by the receipt of death proceeds.⁴⁴

Example: Assume that equal shareholders A & B purchased a \$200,000 term policy on a 40-year-old key employee as described in the previous example. Premiums of \$1,874 are paid annually. In this example, assume that the key employee dies in the 20th year after the insurance premium is paid. The following illustration shows the impact of premium payments and death proceeds on the business and the basis of the shareholders.

Cumulative Year 1–20	Basis		
	A	B	AAA
Beginning Balance	\$35,000	\$35,000	0
Decrease for Premium	\$9,370	\$9,370	—
Ending Balance	\$25,630	\$25,630	0
Increase for Life Insurance Proceeds	\$100,000	\$100,000	0
Ending Balance	\$125,630	\$125,630	0

Permanent Insurance

Where the life insurance is a permanent policy with cash value, the exact effect of the premium payments on S corporation stock basis is less clear.

At present there does not appear to be a clear answer to this basis reduction question. As a result, there are differences of opinion on the practical application of this capitalization theory and the actual effect it has on the shareholder's basis when premiums are paid (could be annually) or when death benefit proceeds are received. There appear to be at least three interpretative approaches.

⁴⁴ IRC Sec. 1368(e)(1).



The chart that follows summarizes each approach:

Premium Payment Reduces Basis

Proceeds Increase Basis

Method I:

Full Premium

Full Proceeds

Method II:

To the extent premium exceeds cash value increase. No basis impact when cash value increase exceeds premium. ("lost basis")*

Full proceeds, less cash value, plus "lost basis."

Method III:

To the extent premium exceeds cash value increase. Basis is increased by the amount the cash value increase exceeds premium.

Full proceeds, less cash value, plus "lost basis."

* *This option appears to have the most support.*⁴⁵

⁴⁵ Reardon, Dennis C., *Working with S Corporations*, 3rd ed., National Underwriter; Klein, William D. and David C. Bahls, *S Corporations and Life Insurance*, 2nd ed., American Bar Association.



An argument can be made that the portion of the premium corresponding to the cash value increase reflects the conversion of cash into another asset of equal value and therefore is more **properly charged to the capital account** and should not reduce stock basis. Under this thought process, the remainder of the premium would then represent the **nondeductible expense** of the insurance coverage and should reduce stock basis.⁴⁶

Example: Continuing our previous example, lets now assume that, rather than term insurance, \$200,000 of permanent insurance is purchased on the same 40-year-old key employee. Premiums are \$9,244 annually and illustrated to be paid for 7 years. The death benefit is illustrated to increase to \$254,041 in year 20.

**Male, age 40, Preferred Non-Tobacco
\$200,000 7-pay Non-MEC**

Year	Premium	Cash Value Increases	Basis	Death Benefit
1	\$9244	\$6,696	(2,548)	\$200,000
2	\$9244	\$8,745	(499)	\$200,000
3	\$9244	\$9,310	+ 66	\$200,000
4	\$9244	\$9,782	+ 538	\$200,000
5	\$9244	\$10,325	+1,081	\$200,000
10	0	\$3,558	+3,558	\$209,575
15	0	\$4,885	+4,885	\$229,092
20	0	\$6,157	+6,157	\$254,041
20-Year Cumulative Totals				
	Premium	Cash Value	Lost Basis	
	\$64,708	\$128,243	\$66,582	

⁴⁶ IRC Sec. 1367(a)(2)D).



If the Method II accounting method were used, the following would be the impact on basis:

Cumulative Year 1–20	Basis		
	A	B	AAA
Beginning Balance	\$35,000	\$35,000	0
Decrease for Premiums	\$ 1,523	\$ 1,523	—
Ending Balance	\$33,477	\$33,477	—
Increase for Proceeds*	\$96,180	\$96,180	—
Ending Balance	\$129,677	\$129,677	0

*\$254,041 life insurance proceeds less cash value of \$128,243, plus “lost basis” of \$66,582 = \$192,380; then \$192,380 ÷ 2 (shareholders) = \$96,180.

Should Term or Permanent Be Used?

The example above illustrates reduction in basis can be less over a period of years with a permanent policy than with a term policy. As previously indicated, an S shareholder’s basis is significant because it shields the shareholder from incurring taxable income on corporate distributions. Consequently, if, after considering the usual factors in deciding the type of coverage, the decision is on the border between term and permanent insurance, then keeping basis at a higher level provides a reason for using permanent coverage.

Marketing Application

Funding Nonqualified Deferred Compensation and Death Benefit Only Plans

A deferred compensation plan is an agreement under which the receipt of earnings is postponed until a later date. At that time, the payments become taxable to the employee (or his or her beneficiary) and deductible to the employer.⁴⁷ A death benefit only plan (DBO) is an agreement between an employer and employee that provides a lump-sum death benefit or salary continuation payments to an employee’s beneficiary in the event of the employee’s death prior to retirement. Like deferred compensation, the benefit payments are taxable to the employee’s beneficiary and deductible to the employer. In both of these arrangements, a corporate employer will often informally fund its obligation by purchasing a life insurance policy.

⁴⁷ Rev. Rul. 60-31, 1960-1 CB 174, IRC. Sec. 404(a)(5).



Where insurance is used to informally fund the plans, the standard view is that a deferred compensation/DBO plan is not workable in an S corporation where the plan is for the sole or majority shareholder. This is a result of the fact that the shareholder is first taxed on the income earned by the S corporation to pay the nondeductible premium expenses and taxed a second time when the shareholder (or beneficiary) receives the benefits. Consequently, the plan results in double taxation.

In contrast, if the plan is established for a key employee or minority shareholder, the plan remains a viable option when the employer wants to retain control over the policy and create **golden handcuffs** on the key employee. The shareholders are still in the position of having to reduce basis and support the tax cost of the premium payment; however, when benefits are paid, the deduction shelters the taxable income of the shareholders. Thus, the shareholders receive a deferred deduction.

Key Employee Insurance and Debt Liquidation Funding

The tax and basis considerations for premium payment and receipt of death proceeds when life insurance is used to provide key employee protection or to secure outstanding loans are the same as those highlighted in the general discussion.

In an S corporation where insurance is used to provide key employee protection or to secure outstanding loans, the focus is on how the policy proceeds are used. The use of the proceeds can create favorable results for the S shareholder. If the S corporation uses the proceeds to pay deductible expenses, such as compensation of a new employee, the shareholders obtain a direct benefit because the deductible expense shelters taxable income. However, if the proceeds are used to repay a loan, there is no sheltering of taxable income since loan repayment is not a deductible expense.

Despite the lack of sheltering when insurance is used to repay a loan, insurance funding of corporate obligations in an S corporation offers clear benefits to S shareholders. First, without the proceeds, the S shareholders would need to use taxable income to repay the loan. Second, the tax-free basis increase resulting from the receipt of proceeds is not reduced by loan repayment since repayment of principal is not an expense. Consequently, this may allow for greater amounts of subsequent tax-favored S distributions.



Personal Income

Instead of corporate-owned insurance, the corporation can assist in the payment of a personally owned policy. The balance of this section addresses the tax implications of two commonly used premium payment techniques, the bonus plan and the split dollar plan.

Bonus Plan

In a bonus plan, the insurance premium is furnished as additional employee compensation, deductible to the corporation and taxable to the employee.⁴⁸ In a C corporation where the employee is also a shareholder, this arrangement can, in the appropriate mix of corporate and personal tax brackets, offer tax leverage.

Example: *The example below illustrates the impact of taxes on a bonus plan in a C corporation. Notice that, where the corporation is in a higher tax bracket than the employee, the corporate tax deduction is greater than the employee's total cost.*

On the other hand, where the corporation is in a lower tax bracket, the employee's cost is greater than the corporation's deduction, resulting in a greater overall cost to a shareholder-employee.

Employee Compensation	Personal Tax Bracket	Tax Cost	After-Tax Benefit
\$13,889	28%	\$3,889	\$10,000

Compensation Paid	Corporate Tax Bracket	Tax Deduction	After-Tax Cost
\$13,889	34%	\$4,722	\$9,167

Compensation Paid	Corporate Tax Bracket	Tax Deduction	After-Tax Cost
\$13,889	15%	\$2,083	\$11,806

⁴⁸ IRC Secs. 162(a), 61.



As can be seen from the examples on the previous page, the comparison of corporate to personal tax brackets is an important factor in deciding whether the bonus technique is appropriate for the owners of a C corporation.

In contrast, since the S corporation is generally not a taxable entity, the payment of life insurance by an S corporation for a shareholder-employee does not offer tax leverage. Despite the lack of tax leverage, the bonus plan remains an attractive method of paying life insurance premiums because of its simplicity. The impact of the bonus plan will vary depending on whether the employee is a sole shareholder, a minority or majority shareholder, or simply a key employee who is not a shareholder.

Shareholder

In the situation where the employee is also a shareholder, the bonus plan could be structured as either additional compensation (subject to FICA and FUTA if the employee is below the social security wage base) or as a distribution in proportion to stock ownership (not subject to FICA or FUTA). The additional compensation or distribution is taxable to the employee, but it may or may not increase the shareholder-employee's overall taxable income. In the sole shareholder situation, the bonus plan will not increase taxable income since the sole shareholder will report all the income of the business regardless of whether it is distributed. Where there are a number of shareholders, the taxable income of the shareholder receiving the bonus may or may not increase, depending on the existence of other similar arrangements. Where the bonus is structured as additional compensation, the other shareholders will not bear any of the tax costs for the premium payment since compensation (unlike premium payments on a corporate-owned policy) is a deductible expense. Finally, unlike deferred compensation or death benefit only (DBO) plans, the beneficiaries in a bonus plan receive the proceeds free of income tax.

While the income tax results of a bonus plan appear to be generally favorable, the impact on basis and AAA is mixed. Whether the bonus is structured as compensation or as a distribution, the amount paid out reduces basis and AAA of the shareholders in proportion to ownership. In the sole shareholder situation, the bonus may or may not change the overall basis or AAA of the shareholder, depending on whether the income of the business is normally distributed or retained. If the business income is normally distributed, the bonus plan will not change the overall basis or AAA of the sole shareholder.



Where there are multiple shareholders, basis and AAA are reduced in proportion to ownership by the amount of the bonus. However, with a bonus plan, basis and AAA are not reduced by the proceeds received by the beneficiary as they are with a deferred compensation or DBO plan.

Employee

Where the employee is not a shareholder, the employee's tax results from a bonus plan in an S corporation are the same as in a C corporation. That is, the bonus is taxable to the employee and the beneficiaries receive the proceeds income tax-free. From the standpoint of the S shareholder, the employee bonus plan has both positive and negative tax consequences. On the positive side, as long as the employee compensation is deemed to be reasonable, the payments will be a deductible expense, thus not creating the tax burden that exists in the deferred compensation or DBO plan. On the negative side, unlike with deferred compensation plans, bonus payments reduce shareholder basis and AAA in proportion to stock ownership. Furthermore, unlike with employee deferred compensation and DBO plans, shareholders do not receive the benefit of the "delayed deduction" when using an employee bonus plan since the payments to the beneficiaries are not made by the corporation.



Split Dollar Plan*

Split dollar is an arrangement between two parties in which the rights and responsibilities to premium payment, interest in cash value, and death proceeds on a permanent life insurance policy are divided between two parties. Typically, the two parties involved in the split dollar arrangement are an employer and employee.

In an S corporation, the premium payment might be structured as an employer-pay-all non-equity collateral assignment split dollar plan. Under this approach, the S corporation advances the entire premium. The shareholder-employee is the owner of the policy but is given no interest in the policy cash values. If the split dollar plan is terminated during the life of the shareholder-employee, the S corporation generally must be repaid an amount equal to the greater of premiums paid or the policy cash value. Similarly, at the death of the employee, the S corporation generally recovers the greater of premiums paid or the cash value of the policy with the balance of the proceeds payable to the employee's designated beneficiary.

Premiums paid by the S corporation are not tax-deductible. Each year the split dollar agreement is in place, the shareholder-employee has imputed income equal to the economic benefit value of his/her share of the death benefit. The value of the economic benefit is the "life insurance premium factor" multiplied by the amount of the shareholder-employee's death benefit.⁴⁹

When split dollar taxation is combined with the flow-through taxation of an S corporation, the effects of the plan on the participant-insured will depend on whether the employee is a sole shareholder, a minority or majority shareholder, or a nonowner key person. In addition, a number of variables that do not apply to a C corporation must be considered in the S corporation.

**The assumption is made that the split dollar plan is implemented after September 17, 2003, and is taxed under the economic benefit regime as outlined in the IRS final regulations addressing split dollar taxation.*

⁴⁹Reg. Sec. 1.61-22(d)(3)(ii)



Sole Shareholder

The premiums paid by the S corporation in a split dollar plan are not deductible. Consequently, in an employer-pay-all plan, the full premium paid by the corporation will flow through as taxable income to the shareholder. Furthermore, in the employer-pay-all plan, the value of the economic benefit will be taxable to the shareholder-employee. The result is that in a sole shareholder employee-pay-all plan the shareholder will be taxed twice on a portion of the premium.

This is illustrated as follows:

Assumptions: Employer-Pay-All Split Dollar Plan	
Premiums paid by S corporation	\$10,000
<i>Taxable Income:</i>	
As shareholder (income resulting from nondeductible premium)	\$10,000
As employee (economic benefit)	\$1,000
Total Taxable Income	\$11,000

Assumptions: Bonus Plan	
Premiums bonused by S corporation	\$10,000
<i>Taxable Income:</i>	
As a shareholder (\$10,000 income decreased by \$10,000 deductible compensation)	0
As employee (taxable bonus)	\$10,000
Total Taxable Income	\$10,000

Obviously, the bonus plan results in less taxable income to the sole shareholder-employee. You might think that the solution is to make the split dollar plan contributory in order to reduce the economic benefit effect. This is not tax efficient since, under the final regulations issued by the IRS, this would result in taxable income to the S corporation for the amount contributed by the employee. Thus, where the entity is an S corporation with a sole shareholder, a simple bonus plan is the most tax-efficient solution.



Multiple Shareholders

When an S corporation is owned by more than one shareholder, the tax costs of the premium payment provided by the business is allocated in direct proportion to stock interest. Consequently, the shareholder with the largest interest will bear the greatest tax burden. In addition, in an employer-pay-all split dollar plan, the shareholder-employee who benefits from the plan will have economic benefit costs. When the two costs are combined, the tax benefits of the split dollar plan decrease as the percentage of stock ownership increases.

In addition to the tax considerations, there is a danger that a split dollar plan in a multi-shareholder situation could create a second class of stock. When an S corporation relieves a shareholder from paying the economic benefit term cost (as in the case of an employer-pay-all plan), the IRS may view the economic benefit paid by the S corporation as an alteration of the rights to corporate distribution, resulting in a second class of stock.

Key Employee

Where the employee is not a shareholder, the employee's tax results for a split dollar plan in an S corporation are the same as in a C corporation. From the standpoint of the S shareholder(s), the nondeductible premiums paid by the business will result in a tax burden to the shareholders, with the largest shareholders bearing the greatest cost. As with the bonus plan and the deferred compensation/DBO plans, this shareholder cost may be viewed as sensible when compared to alternative methods of retaining key employees.



The purpose of this section is to examine aspects of buy-sell planning that occur at the death of a shareholder that are especially relevant when a corporation is subject to the S election. The first portion of this section examines selected provisions of the buy-sell agreement. This is followed by a discussion of the tax considerations involved in selecting either a cross purchase or a stock redemption agreement.

The ability to remain an S corporation depends on several factors including the number and type of shareholders. For this reason, business continuation planning may be more important in an S corporation than in a C corporation. Many of the issues that apply to business continuation planning for a C corporation apply to the S corporation. The unique tax attributes of the S corporation, however, influence the income tax treatment of the shareholders in several respects that are significantly different from a C corporation. Life insurance funding, while serving the same purpose in an S corporation as a C corporation, has implications which require consideration.

Agreement Provisions

A buy-sell agreement for an S corporation should contain provisions that address the unique features of an S corporation. The following are some of the unique issues that need to be addressed by the shareholder's legal advisors.

Preservation of S Election

The agreement should acknowledge that the corporation has elected to be taxed as an S corporation. If the parties desire to continue the election, the agreement should provide that the parties and the corporation agree to take action needed to avoid termination and, in the event of inadvertent termination, that the corporation may request the IRS to waive the termination under Section 1362(g). The agreement should also address situations under which termination or revocation of the S election is possible (e.g., where more than half of the outstanding shareholders consent).



Distributions to Satisfy Income Tax Liabilities

Shareholders of an S corporation must report their proportionate share of the corporation's income for tax purposes.⁵⁰ If the shareholder is a minority shareholder, nonvoting shareholder, or passive shareholder, he or she may not have any influence over the distribution policy. As a result, the shareholder could be forced into a position of having to fund a tax obligation from other sources. The agreement could provide that cash distributions be made to shareholders to satisfy the income taxes on the income from the S corporation. Of course, the distributions would still have to be in proportion to ownership without regard to varying individual tax rates in order to avoid the violation of the single class of stock requirement.

Valuation and Second Class of Stock

Under IRS regulations, buy-sell agreements restricting the transferability of stock at the death, disability, or termination of employment of an S shareholder can be disregarded in determining whether an S corporation's stock has identical distribution and liquidation rates unless:

- ◆ The agreement is entered into in order to circumvent the one class of stock requirement, and
- ◆ It establishes a purchase price that is significantly above or below the fair market value of the stock.⁵¹

Consequently, the buy-sell agreement should be drafted to avoid creating a second class of stock.

Allocation of Tax Items

The income, losses, deductions, and credits of an S corporation are normally allocated on a per diem basis. It may be advisable to draft the agreement so that all the shareholders agree to the election under Section 1377(a)(2) to depart from the per diem approach and allocate the tax items based on the books and records for the separate tax periods at the termination of a shareholder's stock interest.

The agreement could also require that, in certain circumstances, distributions be first made from accumulated E & P instead of AAA.⁵²

⁵⁰ IRC Sec. 1366(a)(1).

⁵¹ Reg. Sec. 1.1361-1(l)(2).

⁵² IRC Sec. 1368(e)(3).



Adjustment to Purchase Price to Reflect Tax Factors

Shareholders of an S corporation are taxed pro rata on corporate earnings, including the income earned in the year of death. It may be appropriate to adjust the purchase price to reflect the value of this income.

Cross Purchase Plan

A cross purchase buy-sell plan operates basically the same in an S corporation as it does in a C corporation.

Arrangement

In a cross purchase plan, the buy-sell agreement is between the shareholders. Where the buyout is funded with insurance, each shareholder is the owner and beneficiary of a policy on the life of every other shareholder. One of the benefits of the cross purchase buy-sell is that, through the agreement, it is possible to restructure the percentage of ownership among the surviving shareholders.

Premium Payments

When insurance is used to fund a cross purchase buy-sell, the premiums are paid by the shareholders with after-tax nondeductible dollars.⁵³ Since the corporation is not involved, basis and AAA are not affected.

In a cross purchase plan, an amount approximately equal to the premium is often bonused by the S corporation to assist the shareholder. In this case, shareholder basis and AAA are reduced with the majority owner bearing the greatest reduction.⁵⁴ However, since the payments are made as a deductible compensation expense, the basis reduction is accompanied by a tax deduction, most of which benefits the majority owner.

⁵³ IRC Sec. 2651(a)(1).

⁵⁴ IRC Secs. 1367(a)(2), 1368(e)(1)(a).



Death Proceeds

The death proceeds in a cross purchase plan are received by the shareholders income tax-free assuming the requirements of IRC 101(i) previously discussed are fulfilled.⁵⁵ Again, the receipt of the proceeds does not affect basis and AAA.

Sale of Stock Interest

From the purchaser's perspective, the purchase price paid by the surviving shareholder increases his or her basis.⁵⁶ The AAA is not increased or decreased by the purchase of stock from a deceased shareholder; however, since the AAA is a corporate account, the purchaser acquires the AAA allocated to the selling shareholder. This allows the purchasing shareholder to receive a greater withdrawal of S distributions income tax-free.

Example: *A and B, as equal shareholders, each have an equal interest in the corporation's AAA. If we assume the AAA of the corporation is \$40,000, each shareholder is allocated \$20,000 of AAA. If A purchases B's shares, A also acquires B's \$20,000 of AAA interest.*

From the viewpoint of the deceased shareholder, his/her basis is stepped up to fair market value.⁵⁷ If the stock is sold for this fair market value, the estate of the deceased shareholder will not recognize gain or loss for income tax purposes.

It is important to remember, however, that shareholders of an S corporation are taxed pro rata on corporate earnings, including the income earned in the year of death. Since the allocation occurs whether or not there are distributions, it will prove costly to the selling shareholder if no distributions occur and the allocations are not taken into consideration in the purchase price. To the extent the allocations relate to the post death period, they will increase or decrease the basis established by the date of death value. If the purchase price established in the agreement does not adjust to reflect the post death income allocation, the sale will produce income or loss and the basis increase or decrease will produce a capital gain or loss to the seller.

⁵⁵ IRC Secs. 101(a), 101(j).

⁵⁶ IRC Sec. 1012.

⁵⁷ IRC Sec. 1014(a), Under the Economic Growth and Tax Relief Reconciliation Act of 2001, the estate tax is repealed for the year 2010. For deaths occurring in that year only, a modified step-up in basis will be available. This is limited to a step-up of \$1.3 million in total for all beneficiaries and an additional \$3 million step-up available for property passing to a surviving spouse.



Stock Redemption Plan

A stock redemption buy-sell plan in an S corporation offers a number of advantages not available to the shareholders of a C corporation.

Arrangement

In a stock redemption plan, the corporation agrees to purchase the deceased owner's shares. Where the buyout is funded by insurance, the corporation is the owner and beneficiary of a policy on each shareholder. Following the completion of a stock redemption, the surviving shareholders continue to maintain the same percentage of ownership as they had prior to the redemption. Consequently, the stock redemption buy-sell arrangement lacks the structural flexibility of the cross purchase plan. On the other hand, the redemption plan offers simplicity and generally provides a greater sense of security that the agreement will be completed.

Premium Payments

When insurance is used to fund a stock redemption agreement, the premiums paid by the corporation are not a deductible expense.⁵⁸ As a result, the payment of premiums will have the same consequences as discussed in the section on corporate-owned life insurance. The impact is as follows:

- ◆ Income earned by a business used to pay premiums is taxed pro rata to shareholders.⁵⁹
- ◆ Income increases basis, premium payment decreases basis (the amount of basis decrease will depend on whether term or permanent insurance is used to fund the buy-sell).⁶⁰
- ◆ Since only taxable income and related expenses affect AAA, premium expenses do not decrease AAA.⁶¹

⁵⁸ IRC Sec. 264(a)(1).

⁵⁹ IRC Sec. 136(a)(1).

⁶⁰ IRC Sec. 1367(a).

⁶¹ IRC Secs. 101(a), 1363(a).



Notice that the payment of premium reduces basis and increases taxable income. Since these costs are allocated in proportion to stock ownership, a majority shareholder will have the greatest basis burden. In contrast, in a cross purchase plan where the premiums are bonused to the shareholders, the tax deduction provides the greatest benefit to the majority shareholder. Since the cost to the corporation is the same in either situation, from a majority shareholder's viewpoint, a significant issue in choosing between the cross purchase and redemption formats may be whether the above-noted personal tax disadvantages of corporate paid premiums under the redemption format can be mitigated by other benefits.

Death Benefits

Unlike the death proceeds received by a C corporation, proceeds received by an S corporation are not subject to the corporate alternative minimum tax.⁶² Assuming the requirements of IRC § 101(j) previously discussed are fulfilled the proceeds will be received income-tax free under IRC § 101(a).

Unlike a cross purchase plan, a redemption, by itself, does not affect the basis of the remaining shareholders. The absence of a direct increase in stock basis does not, however, mean there will be no basis increase where the agreement is funded with life insurance. As has been noted several times, basis in an S corporation is increased by both taxable and tax-exempt income. Thus, the insurance proceeds will produce an indirect increase in the basis of all the shareholders in proportion to stock interest.⁶³ Consequently, where insurance is used to fund a stock redemption buy-sell in an S corporation, the S shareholders benefit by receiving a basis increase that is not available to shareholders in a redemption in a C corporation.

However, a problem arises when the per diem allocation method is used since the basis increase applies not only to the stock owned by the remaining shareholders, but also to the shares redeemed from the estate of the deceased shareholder.⁶⁴ As a result, there is only a partial increase in basis for the surviving shareholder. Since the shares owned by the deceased will have already received a step-up as a result of death, part of the basis increase will have been "wasted."⁶⁵

⁶² IRC Secs. 101(a), 1363(a).

⁶³ IRC Sec. 1367(a)(1).

⁶⁴ IRC Sec. 1377(a)(1).

⁶⁵ IRC Sec. 1014.



Example: *Assumptions: Several years have passed since the 50/50 shareholders A and B established the business. The business has been successful and is now valued at \$2,000,000. A and B established a stock redemption buy-sell funded with a corporate-owned policy of \$1,000,000 on each shareholder. Assuming B dies on April 1, the impact on basis and AAA when per diem allocation is used is shown below. Note that only \$125,000 of the life insurance proceeds is allocated to B's basis due to the death occurring one-fourth of the way through the year and that this increase is "wasted" due to the step-up in basis as a result of his death.*

Year 1	Basis		AAA
	A	B	
<i>Beginning Balance</i>	\$250,000	\$250,000	\$100,000
<i>Receive Life Ins. Proceeds</i>	\$875,000	\$125,000	—
<i>Balance Prior to Redemption</i>	\$1,125,000	\$375,000	
<i>Stock Redeemed</i>			(\$50,000)
<i>Basis after Step-up at Death</i>		\$1,000,000	
<i>Ending Balance After Redemption</i>	\$1,125,000	0	\$ 50,000

As noted earlier, when you have a shareholder terminating his or her interest in the business and where all the affected shareholders have consented, it is possible to depart from the per diem allocation substituting the books and records method.⁶⁶ If the corporation uses the cash basis method of accounting so that "income" from the insurance is not recognized and allocated until it is actually received, the redemption can be structured so that the basis increase is allocated only to the surviving shareholders. This will result in the surviving shareholders receiving a basis increase similar to the results of a cross purchase arrangement.

⁶⁶ IRC Sec. 1377(a)(2).



To allocate the full basis increase to the surviving shareholders, the following steps must occur:

Step	Action
1	The corporation must use the cash method of accounting.
2	All the shareholders in the corporation in the tax year must agree to the short-year election. (This may be included as a provision in the buy-sell agreement.)
3	Corporation redeems the deceased shareholder's interest. In exchange, the estate receives a promissory note. This terminates the deceased shareholder's interest in the corporation.
4	Short-year election is made, ending the tax year.
5	Insurance claim is filed and proceeds are received by the S corporation. Since the deceased is no longer a shareholder, the "income" is totally allocated to the surviving shareholder's basis.
6	The corporation transfers cash to the estate in cancellation of the promissory notes.

Finally, as noted earlier, the receipt of tax-exempt insurance proceeds will not increase the accumulated adjustments account (AAA).⁶⁷

	Basis		AAA
	A	B	
Year 1			
Beginning Balance	\$250,000	\$250,000	\$100,000
Death Occurs, stepped-up basis	—	\$1,000,000	—
Sale of Decreased Interest, note	—	(\$1,000,000)	(\$50,000)
Ending Balance	\$250,000	\$0	\$50,000
Year 2			
Beginning Balance	\$250,000		
Receiving Proceeds	\$1,000,000		\$50,000
Ending Balance	\$1,250,000		\$50,000

⁶⁷ IRC Sec. 1368(e)(1).



Sale of Stock Interest

From the surviving shareholder's viewpoint, the redemption plan offers a number of benefits not available to C shareholders. First, as stated above, depending on how the insurance allocation occurs, the surviving shareholders receive either a partial or full increase in basis as a result of receipt of the insurance proceeds by the corporation. When the proceeds are used to redeem the stock, the redemption will not decrease the survivor's basis.⁶⁸ Thus, except to the extent the insurance proceeds are allocated to the decedent's shares, the basis increase from the insurance gains will be available to the remaining shareholders to offset future distributions.

Secondly, when the redemption occurs, the AAA and any E & P must be reduced by an amount equal to the balance in the account multiplied by the percentage of shares redeemed.⁶⁹ Compared to the cross purchase plan, the decrease in AAA is a disadvantage of the redemption approach since less can be distributed to shareholders before triggering taxable dividends out of E & P. (Recall that in the cross purchase plan, surviving shareholders acquire the terminating S shareholder's AAA.) At the same time, the reduction in E & P means there is less potential for taxable dividends if distributions later exceed the AAA balance.

From the standpoint of the estate of the deceased shareholder, the income tax consequences are similar to those of a C corporation. Like with a C corporation, the tax consequences depend on whether the redemption qualifies as a "sale or exchange" under Section 302 (i.e., the person or entity whose stock is being redeemed receives capital gains treatment).

To receive capital gains treatment, the redemption must qualify as one of the following:

- ◆ Not essentially equivalent to a dividend
- ◆ A substantially disproportionate redemption of stock
- ◆ A complete termination of the shareholder's interest in the corporation
- ◆ Redemption made in partial liquidation of the corporation⁷⁰
- ◆ Partial redemption that qualifies under Section 303 to pay estate taxes and administrative expenses

⁶⁸ IRC Sec. 1367(a)(2).

⁶⁹ IRC Sec. 1368(e)(1)(B).

⁷⁰ IRC Sec. 302(b).



The usual method of qualifying a redemption as a “sale or exchange” is to have the estate of the deceased shareholder completely terminate the interest in the business. In a closely held family business, the attribution rules under Section 318 must be considered in order to determine whether a complete redemption has occurred. Basically, the attribution rules cause stock owned by certain family members (spouse, children, grandchildren and parents) and certain entities (trusts, business entities or estates) to be deemed owned by the redeeming shareholder. Consequently, to qualify as a complete redemption, both the interest of the decedent and the deemed interests actually owned by certain family members and entities must be terminated.

At the decedent’s death, if the redemption qualifies as a sale or exchange and the step-up in basis rules are applicable, the decedent’s estate will not have a taxable gain provided the redemption occurs quickly after death and the sales price is equal to the fair market value at the date of death.⁷¹ Like with a cross purchase plan for an S shareholder, it is important to remember that the redeeming shareholder is taxed pro rata on earnings of the business. To the extent that there are earnings related to the post-death period, they will increase or decrease the basis established by the date-of-death value. If the purchase price established in the agreement does not adjust for the post-death income allocation, the redemption will produce income or loss and the basis increase or decrease will produce a capital gain or loss to the redeeming shareholder’s estate.

⁷¹ IRC Sec. 1014(a), Under the Economic Growth and Tax Relief Reconciliation Act of 2001, the estate tax is repealed for the year 2010. For deaths occurring in that year only, a modified step-up in basis will be available. This is limited to a step-up of \$1.3 million in total for all beneficiaries and an additional \$3 million step-up available for property passing to a surviving spouse.



If the redemption does not qualify as a sale, the distribution rules discussed earlier under Section 1368 govern the tax consequences to the redeeming shareholder. As previously indicated, the consequences depend on whether the business has prior E & P.

Where No E & P

Where an S corporation has no earnings and profits, distributions when made are

- ◆ Income tax-free to the extent of the shareholder's adjusted basis,
- ◆ With any excess basis taxed as capital gain.

Notice that this is the same as the tax result received under Section 302 where the redemption qualifies as a sale. Consequently, in an S corporation that lacks E & P, the amount and character of the gain will be taxed the same whether or not the redemption qualifies for sales treatment. Therefore, the application of the attribution rules should not be a concern where an S corporation has always been an S corporation and has no E & P.

Where Corporation has E & P

Where an S corporation has earnings and profits (generally from prior years as a C corporation), the Internal Revenue Code establishes a system ordering the tax treatment as follows:

- ◆ First, any distribution reduces AAA and is income tax-free to the extent of the shareholder's basis; the remaining AAA balance, if any, is taxed as capital gain, then,
- ◆ Any distribution in excess of AAA is a taxable dividend to the extent of E & P, next,
- ◆ Any distribution in excess of E & P is tax-free to the extent of remaining basis, and
- ◆ Any remaining distribution in excess of basis is treated as capital gain.

Where the buy-sell does not qualify as a sale and the corporation has E & P, if the redemption exceeds the AAA allocated to the distribution, the redeeming shareholder will recognize taxable income.

Summary

The consequences of a redemption plan funded with insurance that qualifies as a sale under Section 302 in an S corporation do not differ significantly from those of an insured cross purchase approach. Consequently, except where the S corporation has prior E & P and is family owned so that the attribution rules prohibit the redemption from qualifying as a sale, the redemption approach may be favored in an S corporation because of its administrative simplicity.



This section will first provide an overview of the special eligibility requirements that must be met for an estate or trust to own S stock where maintenance of the S election is desired. Next, it will examine how those rules influence estate planning techniques. Finally, it will provide an overview of the special liquidity considerations of an estate that owns S stock.

The owners of a closely held business interest who engage in estate planning are typically confronted with a number of personal and tax planning dilemmas concerning the distribution of their business interest. In addition to the typical estate issues which face a business owner, the S shareholder must be attentive to the special eligibility requirements and the liquidity problems that can be created when an estate owns S stock.

Maintenance of S Election

Where continuation of the S election is important, care must be taken to assure the S stock is distributed to eligible shareholders. The failure to pass S stock to eligible shareholders in an estate plan will generally terminate the S election for all shareholders even if a majority want the election to continue. Consequently, to maintain the S election, it is necessary that all the shareholders' estate plans are drafted so that stock is only transferred to qualified individuals and/or entities and that all S corporation restrictions are met (e.g., one class of stock, restrictions on number of shareholders).



Estates as Shareholders

An estate is a permissible S shareholder during its administration, even if all of the beneficiaries of the estate are not eligible S shareholders.⁷² Once administration is complete, the estate ceases to qualify as an eligible shareholder. If the administration is considered unreasonably long, the estate is considered terminated for tax purposes and the S stock is considered to be held individually by each beneficiary.⁷³ If the estate elects to defer payments of tax attributable to the stock under the fourteen-year installment provision, the estate will be permitted to continue as an eligible shareholder for the duration.⁷⁴

Eligible Trust Shareholders

A gift or bequest of S stock to a trust will terminate the S election except where the trust is a grantor trust, a Section 678 beneficiary owned trust, a qualified subchapter S trust (QSST), or an electing small business trust (ESBT). If a transfer is made to a non-qualifying trust, the trust can be a shareholder for two years.⁷⁵

Grantor Trust

A grantor trust will qualify as an eligible shareholder as long as:⁷⁶

- ◆ The grantor is considered the owner of the entire trust for income tax purposes
- ◆ The grantor is a citizen or resident of the U.S.

A trust is described as a grantor trust if the person who creates the trust (the grantor) is taxed as the owner on the trust's income. Powers which cause the grantor to be taxed on the income of the trust include:

- ◆ Reversionary interests
- ◆ The power to revoke the trust
- ◆ The power to control the beneficial enjoyment of the trust

⁷² IRC Sec. 1361(b)(1)(B).

⁷³ Tres. Reg. 1.641(b)-3(a).

⁷⁴ Rev. Rul. 76-23, 1976-1CB 264.

⁷⁵ IRC Sec. 1361(c)(2)(A)(ii).

⁷⁶ IRC Sec. 1361(c)(2)(A)(i).



- ◆ Certain administrative powers
- ◆ The ability to receive distributions from the trust

The grantor is treated as the shareholder in determining whether the shareholder limit is satisfied. Once the grantor of the trust dies, the trust cannot be a grantor trust. As a result, to maintain the S election at the death of the grantor, the trust must provide that the trust assets pass to an eligible individual or a trust which qualifies as either a Section 678 nongrantor owned trust, QSST, or an electing small-business trust.

Section 678 Trust/Beneficiary Owned Trust

A Section 678 trust will qualify as an eligible S shareholder as long as:⁷⁷

- ◆ The nongrantor owner is considered the owner for income tax purposes, and
- ◆ The nongrantor owner is a citizen or resident of the U. S.

A Section 678 trust is one where a nongrantor is taxed as the owner on any portion of the trust's income because he or she has the power to distribute trust income or principal to himself or herself.

The beneficiary nongrantor owner is treated as the shareholder in determining whether the shareholder limit is satisfied.

⁷⁷ IRC Sec. 1361(c)(2)(A)(i).



Qualified Subchapter S Trust (QSST)

A trust will qualify as a QSST if it meets the following three requirements:⁷⁸

1. All the trust's accounting income must be distributed currently to one individual. If the trust does not require the distribution of income currently but does distribute all the income to one individual, the trust will qualify. On the other hand, if the trust does not require distribution of income and the trust does not distribute all the income, the trust will be disqualified as of the first day of the following year.
2. The terms of the trust must provides that:
 - ◆ There be one income beneficiary during the life of the current income beneficiary,
 - ◆ Any principal of the trust distributed during the life of the current income beneficiary must be distributed to such beneficiary,
 - ◆ The income interest must terminate on the earlier of the death of the beneficiary or the termination of the trust, and
 - ◆ The trust must distribute all of its assets to the beneficiary upon termination of the trust during the life of the current income beneficiary.
3. The income beneficiary of the QSST must file an election with the IRS within 2 months and 15 days of the transfer of the shares to the trust.

A trust classified as a grantor trust or Section 678 trust is precluded from qualifying as a QSST.⁷⁹

⁷⁸ IRC Sec. 1361(d).

⁷⁹ Reg. Sec. 1.1361-1.



Voting Trust

A trust created to exercise the voting rights of the stock transferred to it will qualify as an eligible shareholder if the primary purpose of the trust is to exercise the voting rights of the stock and the written trust document provides:

- ◆ The right to vote to one or more trustees
- ◆ That all distributions of the corporation be paid to, or on behalf of, the beneficial owners of the stock
- ◆ That title and possession of the stock is to be delivered to the beneficial owners upon termination of the trust
- ◆ That the trust terminates by its terms on or before a specific date or event⁸⁰

Each beneficiary of a voting trust is counted as a shareholder in determining whether the 100-shareholder limit is satisfied.

Electing Small Business Trust (ESBT)

A trust will qualify as a ESBT if it meets the following requirements:

- ◆ It must not have a beneficiary other than an individual, estate, or certain charities eligible to be an S shareholder.
- ◆ No interest in the trust may be acquired by purchase.
- ◆ The trust must file an election to be an ESBT. Once elected, it can be revoked only with the consent of the IRS.⁸¹

The ESBT will permit many types of discretionary or accumulation trusts to own S stock, but the cost of this flexibility is that the trust will be subject to federal income tax at the highest individual marginal federal income tax rate on its pro rata share of S corporation income.

Each current beneficiary of an ESBT is treated as a shareholder for purposes of counting shareholders. The determination of whether a person is a potential beneficiary is made without regard to any power of appointment to the extent the power remains unexercised.

⁸⁰ IRC Sec. 1361(c)(2)(A)(iv).

⁸¹ IRC Sec. 1361(e).



Common Estate Techniques

Gifts of S Stock

One way to reduce a client's taxable estate is by lifetime transfers that do not generate gift tax liability. An ideal asset for gifting is stock that is expected to appreciate in value during the client's lifetime.

Gifts of S stock can reduce a shareholder's taxable estate. A gift of S stock also shifts the income attributable to the interest in the business. As a result, the income is also removed from the client's estate.

One hurdle to gifting S stock is that business owners frequently want to retain control of the business. As indicated earlier, differences in voting rights will not in itself create a second class of stock. Consequently, an S shareholder can recapitalize stock into voting and nonvoting. The shareholder can make gifts of the nonvoting stock and retain the voting stock. This transfer does not come within the valuation rules of Chapter 14 since the retained interest is of the same class as the transferred interest.⁸² Thus, the gift of nonvoting stock effectively allows the shareholder to retain control of the business while reducing the value of his or her estate for estate tax purposes.

Marital and Family Trust

A common estate technique for the married client involves the use of the marital trust for property passing to the surviving spouse and the credit shelter or family trust for amounts qualifying for the estate tax applicable exclusion amount.

The two most popular trusts that qualify for the marital deduction are the qualified terminated interest trust (QTIP) and the general power of appointment trust.⁸³ Both the QTIP and testamentary power of appointment trusts can be, and usually are, drafted to qualify as a QSST during the lifetime of the surviving spouse since these can only have one income beneficiary (the spouse) and all the income must be distributed to the spouse during his or her lifetime.⁸⁴ The general power-of-appointment marital trust that gives the spouse lifetime power of appointment, in contrast to a testamentary power, can also qualify as a Section 678 trust.

⁸² *IRC Sec. 2701(a)(2).*

⁸³ *IRC Sec. 2056.*

⁸⁴ *PLRs 8336069, 8415025, 8607044.*



While the marital trust is usually drafted to qualify as an eligible S shareholder during the lifetime of the spouse, the conventional family trust with sprinkling provisions for multiple beneficiaries will not qualify to hold S corporation stock. The family trust, however, can be drafted to meet the QSST or Section 678 trust requirements for holding S stock, or an election can be made to qualify as an electing small-business trust.

At the death of the spouse, if either the family or credit shelter trust continues to own S stock for the benefit of children, the trusts will need to contain provisions to qualify as either a QSST or a Section 678 trust, or to make an election to qualify as an electing small-business trust.

Transfers to Children

S shareholders may not be willing to make a gift or bequest outright to children. Accordingly, such transfers are often made in trust.

A QSST can be structured to own S stock that is either gifted or passed at death to a child. The drawback to the QSST holding a child's interest is that the trust cannot accumulate income, or sprinkle income or corpus to multiple beneficiaries.

Unlike the QSST, the Section 678 trust can accumulate income and provide distributions to multiple beneficiaries.⁸⁵ Like the QSST, the Section 678 trust can be established during the lifetime of the shareholder or at the shareholder's death. The drawback to the Section 678 trust is that to qualify as an eligible shareholder, the child(ren) must be given the unrestricted right to withdraw the income and corpus of the trust. Because of the unrestricted power, the Section 678 trust may not be an effective form for transfers to minors.

A grantor trust can be an effective form for holding S stock for children because it is not subject to the limitations of the QSST and Section 678 trusts. For example, the grantor trust can have multiple beneficiaries and the trustee can accumulate, sprinkle, or pay income. The drawback to the grantor trust is that it is only effective as a form to pass property during the grantor's life. And, in most

⁸⁵ PLR 9037011.



instances, the powers that cause the trust to be considered a grantor trust also cause the trust to be included in the grantor's estate for estate tax purposes. At the grantor's death, the grantor trust will no longer exist. At that time, the S stock must either be distributed outright to the children or continued under a QSST or Section 678 trust.

S stock can be transferred to a Uniform Gifts to Minors Account (UGMA) or a Uniform Transfer to Minors Account (UTMA). S stock transferred to a UGMA or UTMA is considered owned by the individual rather than owned by a trust.⁸⁶

Irrevocable Life Insurance Trust

The terms of an irrevocable trust should take into consideration the possibility that S corporation stock may be transferred or purchased by the trust after the insured's death, even if the only asset owned by the trust during the insured's lifetime is life insurance.

If S stock is to be transferred to a life insurance trust with Crummey provisions during the shareholder's life, care must be exercised in drafting the trust to qualify it as an eligible shareholder. A trust with Crummey withdrawal provisions will not qualify as a QSST since a QSST cannot provide distributions to anyone other than the current income beneficiary. Likewise, since the grantor in a grantor trust must be treated as owning the entire trust, a trust with a Crummey power held by another will not qualify. It may be possible for the sole beneficiary of a Section 678 trust to have a Crummey withdrawal power.⁸⁷ However, there are private letter rulings that have held to the contrary.

Liquidity Considerations

The fact that an estate holds S stock may cause additional liquidity problems.

Since S corporation shareholders are taxed on their pro rata share of the S corporation's income, the estate, as shareholder during the administration process, would receive a proportionate pass-through of the income of the corporation, whether or not actual cash distributions are made. If the corporation does not make any actual distributions, the estate may not have enough liquidity to pay the income taxes on its proportionate share of the corporation's income.

⁸⁶ *Rev. Rul. 71-287, 1971-2 CB 317.*

⁸⁷ *PLRs 8613054, 8809043, 900910.*



Another problem that frequently occurs in an S corporation is that the beneficiary responsible for the payment of the income tax is not the beneficiary who inherits the stock. The conventional tax appointment clause usually provides that all taxes are paid out of the residuary of the estate. If the residuary beneficiary is different from the beneficiary who inherits the S stock, the residuary beneficiary will be required to pay taxes on income he or she never receives.

There are a number of ways to address these liquidity problems. To deal with the liquidity problem caused by the pass-through of corporate income, the shareholders could enter into an agreement that provides that the corporation will pay sufficient dividends during administration to pay income taxes. Another approach would be to enter into a buy-sell agreement where the proceeds from the sale could provide the liquidity. It may be possible to allocate liquid assets to the beneficiary responsible for the tax. Where liquid assets are not available, they could be created by insurance proceeds.

Finally, after the source of liquidity is addressed, the tax apportionment clause should be structured to provide that the beneficiary who receives the stock is responsible for the payment of the income tax.



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