Succession and Planning Topics for Corporations

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Tax Considerations for C and S Corporations

Considerations in succession planning include continuity of the business, concerns over financing the withdrawal of a shareholder, and attracting talented successors to manage and run the firm.

The departing shareholder is looking to provide adequate financial resources during his lifetime and for the surviving spouse. Shifting ownership to other family members or to key employees for the corporation may be a strategy especially if the shareholder holds a controlling interest in the corporation.

Tax minimization techniques for C corporation shareholders often include: (1) lifetime transfers of stock (either to achieve income tax savings by shifting income to family members in lower income tax brackets, or estate tax savings by shifting future appreciation in stock to a younger generation); (2) using estate “freeze” techniques to reduce the potential appreciation of assets which an individual plans to retain during his or her life; and (3) (transferring stock at death to utilize the decedent’s unified gift and estate tax credit to take advantage of the estate tax marital deduction.

The issues are whether the stock changes hands during the shareholder’s lifetime or whether it passes at the death of the shareholder. Also an S corporation has its own unique framework. Stock can be transferred by sales, gift, or inheritance.

The first factor to consider is the price of the stock. This may require an outside valuation performed by specialists on both sides of the sale. IRS Revenue Ruling 59-60, 1959-1 CB 237 has been the guide to business valuation of closely held corporations. The ruling discusses the following factors:

- The nature of the business and the history of the enterprise
- The general economic outlook and the outlook for the particular industry
- The book value of the stock and the financial condition of the business
- The earning capacity of the company
- The dividend-paying capacity
- Whether or not the business has goodwill or other intangibles
- Sales of the stock and the size of the block to be valued
- The market price of stocks of corporations engaged in the same line of business

The most common approach is Capitalization of Earnings which is based on the assumption that the value of the stock lies in the earnings the business is expected to produce. The following are the steps involved:

1. Determine the estimated future annual earnings
2. Determine an acceptable rate of return on the investment in the business, given the risks associated with the future earnings.
3. Divide the earnings from Step 1 by the rate of return in Step 2

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\text{Value of stock} = \frac{\text{Estimated future earnings}}{\text{rate of return}}
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1. **Sale of Stock**
   A buyer will often bargain for seller financing because the transaction costs are often lower than dealing with a financial institution or other third-party lender. If the sale qualifies for the installment method, the seller can report the gain as the sale proceeds are received. Interest is earned on the portion of the note that represents the deferred gain as well as on the cost of the asset. A seller may want to seek additional security for the debt. For example, the seller could require a guarantee of the debt by a party with substantial resources or require that additional assets serve as security for the debt. The basis of the stock for the purchaser is equal to its cost.

*Borrowing to buy stock* – When an individual investor borrows funds to purchase stock in a C Corporation, the interest is investment interest. This is true if the investor is also a full-time employee of the corporation and even if the stock was purchased to protect a job. In fact, interest related to services as an employee cannot be trade or business interest. Therefore, the interest on the debt to finance the C corporation stock must be investment interest if any deduction is to be attained. (IRC §163(h)(2)) The significance of the investment interest lies in the fact that such interest can be deducted only to the extent of net investment income (interest, dividends, and royalties, but not capital gains).

*Example* – T worked for the same company (a C Corporation) for 25 years. When the sole shareholder in the corporation died, T purchased all the stock from the estate. T financed the acquisition by selling all of his investments and borrowing additional amounts from the bank. T’s primary reason for acquiring the stock was to assure that he would have a job until retirement. Although T considers his purchase business motivated, under the tax law, the interest is related to an investment in common stock.

T receives a substantial salary, much of which is used to pay the bank note. The corporation does not pay any dividends, and because T sold his investments to purchase the employer’s stock, T has no investment income. Therefore, the interest paid to the bank is not currently deductible.

T could have reduced his tax liability by taking less salary from the corporation and causing the corporation to pay a dividend. The dividend income could be offset by the investment interest, and taxable income would be reduced by the amount of the decrease in salary. The corporation’s taxable income, however, would increase by the amount of the reduction is salary.

Investment interest issue generally disappears if one of the following conditions exists:
- An individual purchases the stock and the corporation makes an S election
- The purchaser is a C corporation
In the case of the S election, the interest on the debt is viewed as incurred to purchase the underlying assets of the business, rather than to acquire the stock. Therefore, interest will either be business interest or investment interest, depending upon the assets owned by the corporation.

Example – T purchased 100% of the common stock of his employer and the corporation immediately made an S election. T financed the acquisition with $50,000 of his funds and a $150,000, 8% loan from the bank. The corporation had operating assets with a value of $175,000 and investments with a value of $25,000. The corporation had no liabilities other than noninterest-bearing payables to trade creditors. A portion of the interest T pays on the $150,000 loan must be allocated to the investments. Part of the $12,000 interest paid on the loan will be deemed investment interest determined as follows:

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$12,000 \times \left[ \frac{25,000}{175,000+25,000} \right] = 1,500
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If the activity is passive, the loss from an activity for the year can be deducted only to the extent of the income from other passive activities. If the activity is sold or otherwise disposed of before its losses have been used, the previously unused loss can be used in the year of disposition.

C corporations are not subject to the investment interest rules. The investment interest rules, therefore, would not come into play if either of the following situations exists:

- A C corporation uses borrowed funds to purchase the target corporation’s stock from the exiting shareholder (and thus creates a parent-subsidiary group).
- The target corporation purchases the stock from its own shareholder (the corporation redeems its stock).

When the seller partially finances the transaction, the financing can take the form of either of the following:

- A note payable by T to the former shareholder where the stock serves as security for the debt.
- A note payable by the target corporation to the former shareholder where the new shareholder may guarantee the debt.

Stock Received as Compensation for Services – If stock is received in exchange for services rendered to the corporation, the value of the stock received (less any amount paid for the stock) is taxable as compensation to the service provider. The corporation is entitled to a deduction equal to the amount includible in the service provider’s income. The basis of the stock received in exchange for services is equal to the amount paid for the stock plus the amount included in gross income by the service provider.

Stock Received as a Gift – If stock is received as a gift, the donee’s basis is generally the same as the donor’s basis. However, if a gift tax is paid on the transfer, the donee’s basis
is increased (but not above fair market value) by the amount of the tax paid by the donor
that is attributable to the excess of the value over the donor’s basis in the stock.

**Example** – D gifts 1,000 shares of the stock of Z, an S corporation, to his daughter B. The stock is worth $50,000 and D’s basis is $5,000. D pays a $20,000 gift tax on the gift. B’s basis in the shares is $23,000, D’s basis of $5,000 plus $18,000 of gift taxes attributable to the appreciation of the stock on the date of the gift.

Under §1015(d)(6), the amount of D’s tax attributable to the net appreciation in the Z stock is equal to the gift tax paid ($20,000) multiplied by a fraction the numerator of which is the net appreciation of $45,000 and the denominator in the amount of the gift $50,000.

**Stock Received as an Inheritance** – If stock is received by reason of a shareholder’s death, the recipient’s basis in the stock equals its value at the date of the decedent’s death (or on the valuation date). This stepped up basis in the S corporation stock acquired from a decedent is reduced to the extent the value of the stock is attributable to items consisting of income in respect of a decedent.

**Example** – B inherited all of his father’s (F) shares in corporation Z. For estate tax purposes F’s shares in Z were valued at $10,000. B’s basis in the Z stock is $10,000. However, if $2,000 of the date of death value of F’s stock was attributable to items consisting of income in respect of a decedent (e.g. accounts receivable of a cash basis taxpayer), B’s stock basis would be $8,000.

2. **Basis Adjustments for S Corporation Shareholders Disposing of a Significant Amount of Stock**

Basis adjustments in an S Corporation are made as of the close of the corporation’s taxable year, and the adjustments are generally effective as of that date. However, if a shareholder disposes of stock during the corporation’s taxable year, the adjustments with respect to that stock are effective immediately before the disposition, based on the per-share, per-day year-end numbers.

For shareholders disposing of a significant amount of stock, the full tax consequences of the disposition will not be known until year-end. However, a special election is available to treat the tax year as separate pre-and post-disposition tax years for the purposes of calculating stock basis. Under the election, the tax year of the S corporation is treated as if it consists of separate taxable years, the first of which is terminated at the close of the day on which the shareholder terminates his interest or there is a qualifying disposition. (Regs. §1.1368-1(g)(3)(i)). Therefore, shareholders may calculate the increase or decrease in stock basis at the date of termination or qualifying disposition instead of waiting until year-end to allocate income and deductions for the year. In addition, adjustments of nontaxable items are now included with respect to the taxable year. (Regs. §1.1367-1(d)(2))
Qualifying disposition means redemptions or dispositions of 20% or more of the outstanding stock of the corporation or the issuance of 25% or more of the outstanding stock to one or more new shareholders during the taxable year.

Increases and decreases in the basis of shareholder stock are made in the following order:

- First, any increase in basis attributable to separately stated items of income and gain; non-separately computed items, and the excess of depletion deductions.
- Second, any decrease in basis attributable to a distribution.
- Third, any decrease in basis attributable to nondeductible, noncapital expenses and the oil and gas depletion deduction.
- Fourth, any decrease in basis attributable to separately stated items of loss or deduction and any non-separately computed loss items.

Adjustments to a shareholder’s Debt Basis – An S corporation shareholder has basis created from any loans made by him/her directly to the corporation.

In two circumstances a shareholder’s basis in the corporation’s indebtedness is adjusted for items passed through from an S corporation.

1. Corporate items of loss and deduction and other items that reduce a shareholder stock basis to zero will then reduce the loan basis.
2. A shareholder’s loan basis is reduced for repayments of the loan by the corporation. The amount of basis reduction is equal to the amount of the repayment. If the stock basis is zero, the shareholder may have a taxable gain upon repayment of the loan.

Example – B owns all of the stock of X, an S corporation. B’s basis in the stock is zero. Two years ago, B lent $20,000 to X. Subsequently, X incurred $18,000 of losses, which passed through to B and reduced his debt basis to $2,000. If X repays the full amount of the debt, B’s debt basis is reduced to zero, and B recognizes an $18,000 gain.

If a shareholder terminates his or her interest in the corporation, the loan basis, just as the stock basis, is terminated immediately before the date the shareholder’s interest is terminated. If a debt is disposed of or repaid in whole or in part before the close of the taxable year, the basis in that debt is restored, effectively immediately before the disposition or the first repayment on the debt during the taxable year.

Suspended Losses of a Terminating Shareholder – suspended losses and deductions of a shareholder are specific to that shareholder and cannot be transferred to another shareholder except, where the S corporation stock is transferred to the shareholder’s spouse, or to a former spouse incident to a divorce. If a shareholder disposes of all of his/her stock whether by gift, sale, or otherwise, the suspended losses vanish. Losses are also eliminated when the shareholder dies. They do not carry over to the shareholder’s estate or beneficiaries.
However, suspended losses do not attach to specific shares held by the shareholder. Shareholders who dispose of less than all of their stock may continue to use suspended losses. Alternatively, in order to take advantage of suspended losses, the shareholder could contribute additional capital or make additional loans to the corporation before transferring all of the stock.

3. Redemption Versus Distribution

*C Corporation* – It is usually more advantageous to qualify a distribution to an individual shareholder as a redemption rather than a distribution. If a redemption qualifies for exchange treatment, the shareholder recognizes gain or loss equal to the difference between the redemption proceeds and the basis of the stock redeemed. In contrast, a nonliquidating distribution not qualifying as an exchange is taxable as a dividend to the extent of the corporation’s current and accumulated earnings and profits. Although long term capital gain and qualified dividends are taxed at the same rate, redemption treatment is still preferable because capital gains may be offset by the basis of the stock redeemed and by capital loss carryovers.

*Types of Qualifying Redemptions* – Four types of distributions in redemption of stock qualify for exchange treatment at the shareholder level. These are:

1. A redemption that is not equivalent to a dividend. This depends on the circumstances such as the effect on the shareholder’s voting rights, participation in earnings, and liquidation rights.
2. A redemption that is substantially disproportionate meaning that immediately after the redemption the shareholder’s stock interest in less than 80% of the pre-redemption ownership level and the shareholder owns less than 50% of the voting company of the company.
3. A redemption that completely terminates the shareholder’s stock interest in the company.
4. A redemption of a noncorporate shareholder’s stock in partial liquidation of the company.

*S Corporation with No Accumulated Earnings and Profits* – A shareholder of an S corporation with no accumulated earnings and profits may prefer to have a distribution not qualify for exchange treatment. The distribution would then be treated as a nonliquidating distribution subject to the S corporation distribution rules. Under these rules, distributions are tax-free to the extent of the shareholder’s adjusted stock basis, with any excess being capital gain. In contrast, if the distribution qualifies for exchange treatment, only the basis allocated to the shares redeemed reduces the amount of gain recognized.
**Example** – A and B each own 50 of the total 100 outstanding shares of the stock of X, an S corporation with no AE & P. A and B each have a basis in their stock of $2,000. X redeems 10 shares of B’s stock for $5,000. If the distribution qualifies for exchange treatment, B recognizes a capital gain of $4,600 ($5,000 amount realized - (10/50 X $2,000 stock basis)). If the redemption is treated as a distribution, B’s gain would be only $3,000 ($5,000 distribution - $2,000 stock basis).

If all the stock held by a shareholder is redeemed, the tax consequences to the shareholder generally are the same whether or not exchange treatment applies.

*S Corporation with Accumulated Earnings and Profits* – If an S corporation has AE & P, a shareholder’s preference for exchange or distribution treatment depends on the size of the corporation’s AAA. If the AAA exceeds the amount distributed, the results to the shareholder parallel those of a redemption by an S corporation without AE & P. If the distribution exceeds the AAA, failure to qualify the distribution as an exchange results in dividend income to the shareholder.

**4. Amount of Gain or Loss**

If a distribution in redemption of stock qualifies for exchange treatment, the shareholder recognizes gain or loss equal to the difference between the amount realized and the adjusted basis of the stock. The shareholder adjusted stock basis is computed immediately before the exchange so that the basis of the shares are adjusted for its pro rata share of any corporate items for the portion of the year the shares are outstanding.

**Example** – On Jan. 1 of the current year A & B, unrelated individuals, each own 50 of the 100 outstanding shares of the stock of X, an S corporation. On June 30, X redeems 40 shares from B for $5,000. B’s basis in the 40 shares at the beginning of the year is $1,000 ($25 per share). X earns $4,000 of income for the current year. B’s gain on the redemption is $3,207 computed as follows:

<table>
<thead>
<tr>
<th>Amount realized</th>
<th>$5,000</th>
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<tbody>
<tr>
<td>Beginning basis in shares redeemed</td>
<td>$1,000</td>
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<tr>
<td>(40 shares X $25)</td>
<td></td>
</tr>
<tr>
<td>Add: pro rata share of income</td>
<td>793</td>
</tr>
<tr>
<td>($4,000 X 40% X 181/365)</td>
<td>(1,793)</td>
</tr>
<tr>
<td>Gain</td>
<td>$3,207</td>
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</tbody>
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**Effect on the Corporation** – No gain or loss is recognized by an S corporation that redeems its stock for cash. Similarly, no gain or loss is recognized if stock is redeemed for the corporation’s own obligations. The corporation will not obtain any basis or other tax benefit from the funds used to purchase the stock. If stock is redeemed with depreciated property, no loss is recognized. The loss decreases the corporation’s AAA balance, and shareholders must reduce their stock basis. If stock is redeemed with appreciated property, however, the corporation recognizes gain as if the property were
sold at its fair market value to the shareholder. The gain increases the corporation’s AAA and passes through to all shareholders on a daily pro rata basis.