

PRACTICE POINT

Avoiding an Adverse Tax Impact on Death of an S Corporation Shareholder

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I. Introduction

One of the main reasons to consider a partnership for owning a business rather than an S Corporation is the adverse impact upon death if the business is held by an S Corporation. Now there are solutions to this problem for S Corporation shareholders that tax advisers need to add to their toolbox. These solutions convert the tax status of the business from an S Corporation to a partnership for federal tax purposes, in a federal income tax-neutral manner. This can be accomplished through liquidation in the case of a deceased shareholder or reorganization prior to death of a shareholder.

A. Upon the Death of an S Corporation Owner

Specifically, upon the death of an S Corporation owner, the heirs are denied the benefits of receiving a step-up in bases in underlying corporate assets to fair market value. In a partnership, the heirs receive a full income tax-free step-up in basis for all of the underlying partnership assets and the benefits of obtaining the income tax shelter from new large depreciation deductions. However, in an S Corporation when the owner dies, the shareholder heirs only receive a step-up of basis in the corporate stock equal to the fair market value of the company at the date of death. The underlying S Corporation assets retain the same pre-death tax bases even though the decedent estates in both cases have the same federal estate tax implications and costs. Therefore, the S Corporation heirs should consider promptly liquidating the corporation to also achieve an income-tax neutral stepped-up basis for the company's assets. This same technique can also be considered if a surviving shareholder buys out the estate of a deceased shareholder.

B. Prior to Death of an S Corporation Owner

Alternatively, with proper tax and estate planning the S Corporation shareholders have reorganization options prior to death of an S Corporation shareholder to avoid heirs being denied the benefits of receiving a step-up in bases in underlying corporate assets to fair market value upon death. The reorganization options include, but are not limited to (i) a contribution by the S Corporation of its assets to a limited partnership or limited liability company in return for issuance of a preferred interest in such entity, or (ii) a sale of the assets of the S Corporation to a limited partnership or limited liability company in consideration of a note payable to the S Corporation. If the shareholder recently purchased the stock of an S Corporation without an IRC Section

338 Election, there is a statutory merger of the S Corporation into a limited partnership or limited liability company with such entity surviving the merger. This achieves the same result as the heirs of an estate who have a high stock basis without the underlying S Corporation assets having a stepped-up basis.

II. Achieving Step-up in Basis upon a Shareholder's Death Through Liquidation

For the estate of an S Corporation shareholder, one of the major problems is the inability of the estate, and thus the heirs as shareholders, to achieve a step-up in basis for the underlying corporate assets. Upon death, the shareholder's estate receives a stepped-up basis in the shareholder's stock only equal to the fair market value of the company on the date of death. In contrast, a tax partnership (including a limited liability company (LLC) taxed as a partnership) obtains a stepped-up basis for the decedent's partnership interest and for the decedent's proportional interest in the underlying partnership assets through an election under sections 736 and 754.

S corporations can consider the planning option of liquidating the S Corporation or liquidating the S Corporation through a merger. Because partnership status is generally preferable to the S Corporation structure for tax purposes, the estate or heirs can also use this event to convert from an S Corporation to a partnership without the usual tax consequences of such a conversion. Under this planning technique, estates and the heirs holding S corporation stock have a unique opportunity to achieve multiple tax benefits. This article describes how this conversion to partnership status and stepped-up basis in assets can be structured with little, if any, tax cost to the estate and heirs. When an S Corporation liquidates, the corporation is treated as having sold all of its assets for their fair market value, typically resulting in taxable S Corporation gain. Likewise, the estate is treated as having sold its S Corporation stock for an amount equal to the fair market value of the assets it receives in the liquidation distribution from the S Corporation.

Fortunately, when the S Corporation recognizes taxable gain, that gain increases the estate's basis in the stock in an amount equal to the taxable gain recognized by the S Corporation. This taxable gain is reported to the estate on the corporation's final Schedule K-1 (Form 1020S). The estate's tax basis in its S Corporation stock is increased to the fair market value of the S Corporation stock upon the death of the shareholder and further increased as a result of the deemed sale of the S Corporation stock upon the liquidation.

Simultaneous with the increase in basis from the liquidation, the estate recognizes a taxable loss equal to the taxable gain reported to the estate on the corporation's final Schedule K-1. The loss on the deemed sale of the S Corporation stock in the liquidation is reported on the estate's or heirs' Schedule D (Form 1040 or 1041). Typically, the S Corporation gain on the Schedule K-1 (Form 1020S) reported on Schedule E (Form 1040 or 141) and the loss on the Schedule D (Form 1040 or 1041) will net out with no tax due by the estate or its heirs for the S Corporation gain on liquidation. Remarkably, the business will have a new step-up in basis in all of its assets which the heirs can contribute tax-free to a new partnership.

Consider the following hypothetical facts. Sam has two heirs and he owns 100% of Hardware Corporation (taxed as an S Corporation) with a basis in his stock of \$5,000. When Sam dies, Hardware Corporation is worth \$10 million and has a basis in its assets of \$10,000. As a result of Sam's death, Sam's estate now has a stepped-up tax basis in the Hardware Corporation stock of \$10 million (the fair market value of the stock on Sam's death).

If Sam's two heirs liquidate the corporation, Hardware Corporation will recognize gain in the amount of \$9,990,000 from the deemed sale of its assets (\$10 million value minus \$10,000 basis). Hardware Corporation will report a gain of \$9,990,000 to Sam's estate on a Schedule K-1 (Form 1020S). Upon

recognition of this gain by Hardware Corporation, Sam's estate basis in the stock will increase by \$9,900,000 because of the deemed sale gain, giving Sam's estate an aggregate tax basis in the stock of \$19,990,000 (\$9,990,000 deemed sale gain + \$10,000,000 step up to fair market value on death). The liquidation of Hardware Corporation on the Schedule D of Sam's heirs will be reported as a loss of \$9,990,000, calculated as the difference between the fair market value of the Hardware Corporation assets received by Sam's heirs of \$10 million and Sam's estate's stock basis of \$19,990,000.

It is anticipated that the Schedule K-1 gain recognized by Sam's estate of \$9,990,000 on Schedule E of the Form 1041 and the Schedule D loss on the Form 1041 recognized by Sam's estate of \$9,990,000 will mostly off-set each other even though they are reported on different Schedules. Some difference may occur because the Schedule D loss will be a capital loss but some of the gain on the Schedule K-1 may be ordinary income recapture. The benefit of the large depreciation or amortization deductions for the assets with stepped-up basis will far exceed the modest tax cost. To utilize the depreciation, Sam's heirs can contribute the \$10 million in assets tax-free to a new partnership (or LLC taxed as a partnership) under section 721. The benefit to the new partnership is the ability to depreciate \$10 million of asset basis in the partnership compared to the \$10,000 of asset basis in an unliquidated Hardware Corporation.

III. Reorganization Prior to Death Through Contribution to a Partnership for a Preferred Return

Another tax planning strategy available prior to the death of the S Corporation shareholder is a reorganization involving the contribution by the S Corporation of its assets to an entity electing to be taxed as a partnership in return for issuance of a preferred interest in the newly formed entity.

This type of reorganization can be illustrated by a case study and diagram in which the S Corporation (Hardware Inc.) forms an LLC taxed as a partnership (Hardware LLC) into which it transfers all of its operating assets. After the reorganization the S Corporation owner Fred Smoot, through his revocable living trust, continues to hold 100% of the outstanding shares of Hardware Inc., and directly and indirectly, owns all of the interests in Hardware LLC.

The steps to complete the reorganization are as follows. First, Hardware LLC issues a preferred membership interest to Hardware Inc. equal to the estimated value of the business (\$14.0 million). The preferred interest has a liquidation preference and could also have a cumulative dividend. The preferred interest holder may also have the option to claim all or some of a distribution of profits or permit all or some of a distribution of profits to be allocated to the holders of common interests. Hardware LLC also issues a majority of Hardware LLC common interests to Fred Smoot: those common interests have a value of zero (assuming the preferred interest equals the value of the entire business). As part of Hardware's reorganization plans, Hardware LLC's key officers and executives may receive a grant and award of restricted common interests to enable them to share in the value creation going forward while isolating the existing business value with the preferred interest holder.

Other than the company designation as an LLC as opposed to a corporation and a contingent unvested restricted grant and award to key management to enable them to share in value creation going forward, nothing has changed. The staff, location, emails, phone numbers and all other details of Hardware as well as current contracts and other agreements remain unchanged. As a result of the reorganization, Mr. Smoot is able to remain in control of his business, isolate his prior accretion of wealth and provide valuable equity incentive grants to his key employees.

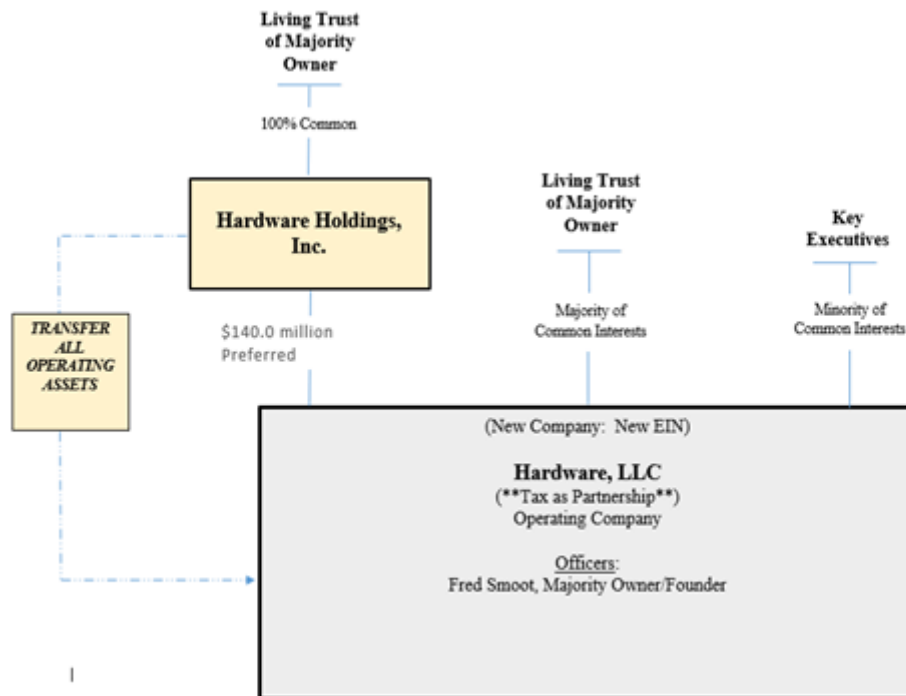


Fig. 1: Ownership of Hardware Holdings, Inc., A Delaware Limited Liability Company

IV. Reorganization Prior to Death: A Sale of Assets for a Note

Another tax and estate planning strategy to consider is the sale of the assets of an S Corporation (or C Corporation) to a limited partnership (or LLC taxed as a partnership) for a note payable to the S Corporation. (After the reorganization, the C Corporation can make an S Corporation election).

The following case study and diagram illustrates this tax and estate planning strategy. On December 18, 2019, Hardware Inc. (a C Corporation) changed its name to Hardware Holdings Inc. and formed Hardware Holdings LLC as a subsidiary. On December 31, 2019, Hardware Holdings Inc. sold all of its assets (except cash) to Hardware Holdings LLC, based upon the appraised value of the assets as determined by outside accountants. The sale was represented by a 121-month promissory note for tangible assets and a separate 121-month promissory note for section 197 intangibles. In addition, the LLC executed a line-of-credit note payable to the corporation so that cash would be available to the LLC. The sale of assets also included the corporation's marketable securities, which the LLC required to secure its loan. Immediately after the sale on December 31, 2019, the LLC membership interests were distributed to all of the shareholders pro-rata. Because the LLC's assets were encumbered by promissory notes for 100% of their fair market value, the net value of the LLC interests was reported to be zero dollars. Effective January 1, 2020, Hardware Holdings Inc. elected to be taxed as an S corporation. The foregoing transactions were approved by all of the shareholders and directors of Hardware Holdings Inc. at annual and special meetings held on December 11, 2019.

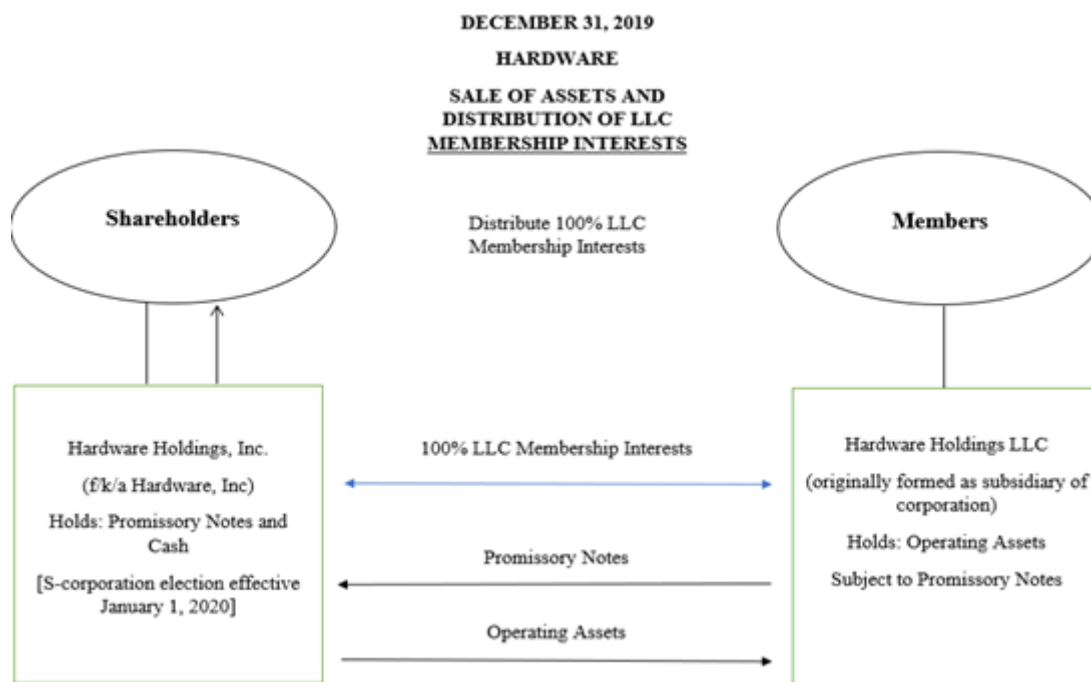


Fig. 2: Sale of Assets and Distribution of LLC Membership Interests

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