

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.

If you have questions about this or any other legal matter, please feel free to contact Herb Fineburg at 267.338.1376 or Charles McCauley, III at 484.531.1712.

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