Advanced Markets

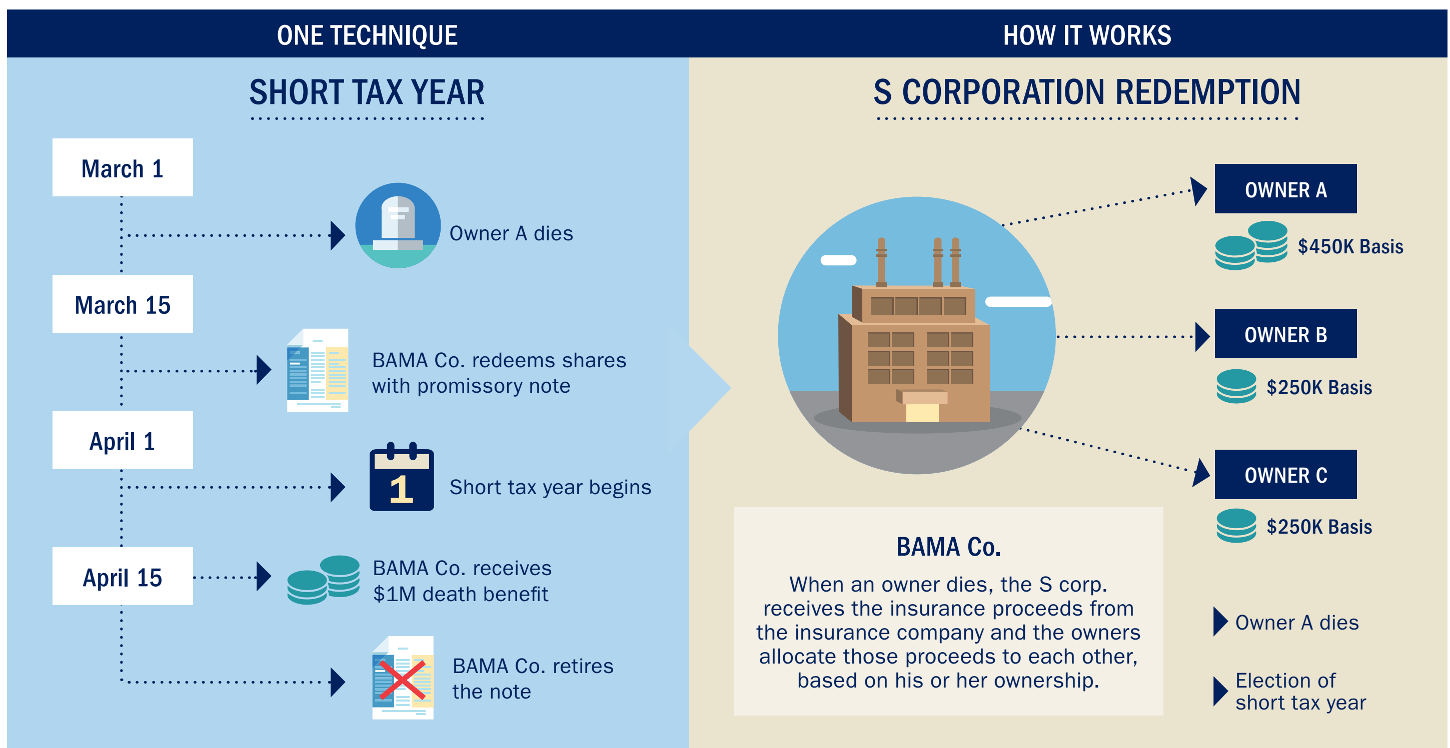
advantages of S Corp. stock redemption

in business continuation planning[1]

Many closely held companies conduct business as S Corporations because of the numerous tax advantages this structure affords. Less well known, however, is the S Corp. advantage in business continuation planning: the ability to use the corporate redemption to get for surviving shareholders a full increase in basis. This article attempts to explain this concept with a hypothetical case study illustration.

Best Practices of a Buy-Sell Agreement

First, let's look at a key component in business continuation planning: the buy-sell agreement. There are two major types of buy-sell agreements: the entity redemption plan and the cross-purchase plan. With a redemption plan, the business enters into a contract with the owners to purchase each owner's interest at a specified time. In the cross-purchase arrangement, the owners establish an agreement among themselves to buy and sell the stock. The business entity is not a party to the arrangement.



1 Originally published in *National Underwriter,* February 18, 2008 by Clay Bristow, Senior Case Design Specialist, JD, LLM, Advanced Markets.

Each type of buy-sell agreement holds advantages and disadvantages, depending on the goals and objectives of the business owners. Typically, however, most owners look for a buy-sell agreement that:

- Is easy to understand and administer.
- Affords the surviving owners a greater percentage ownership in the business.
- Increases the basis in the business for the surviving owners.
- Does not encounter a problem with the transfer for value rule, which converts life insurance proceeds into taxable income.

In addition, if the buy-sell agreement is funded with life insurance, it is typically desirable to acquire one policy per owner.

Pros and Cons

A cross-purchase agreement with three owners or more will typically be subject to the transfer for value rule. An entity purchase may present a problem in that the arrangement may not increase the basis of the surviving business owners.

A "C Corporation," as a stand-alone entity, is independent of its shareholders. It is a separate taxpayer, as are its shareholders.

Therefore, life insurance proceeds that a C Corp. receives to fund an entity redemption stay with the corporation and do not increase the surviving shareholders' basis in the business.

The treatment of life insurance proceeds by an S Corporation is handled differently. Because the S Corp. is not considered a separate taxable entity apart from its shareholders, income and deductions "pass through" to the shareholders. Life insurance proceeds received by an S Corp. increase the basis of all shareholders.

In the stock redemption agreement, the S Corp. purchases an insurance policy on each shareholder and is the owner and beneficiary of each insurance contract. When an owner dies, the S Corp. receives the insurance proceeds from the insurance company and allocates those proceeds to each owner, based on his or her ownership in the S Corp. For example, if there were three equal owners of the business, the allocation would increase the basis of each shareholder, including the deceased, by one-third.

The Internal Revenue Code, per Sec 1014, increases or "steps up" the basis of a decedent in stock owned by the decedent at his or her death to the stock's fair market value. As a result of the step-up in basis afforded by Sec 1014, any allocation of insurance proceeds to the decedent will be wasted, since basis cannot be increased beyond its fair market value.

the S Corp.'s advantage?

The ability to use the corporate redemption to get for surviving shareholders a full increase in basis.

There is a way, however, to allocate the portion of basis to a surviving shareholder, instead of wasting it on the deceased shareholder. A possible solution is to use the S Corporation stock redemption buy-sell agreement with the short tax year technique. The one requirement for this technique is that the S Corporation must be a cash-basis taxpayer for accounting purposes.

If this is the case, the following actions can be taken upon the death of a shareholder. This illustration assumes three equal owners of the business.

1. The corporation buys (redeems) the shares from the executor of the deceased shareholder. The corporation issues a short-term interest-bearing note to the executor in exchange for the deceased shareholder's stock. At this point, there are only two remaining shareholders, plus one creditor.
2. The stockholders plus the executor of the deceased shareholder file, on behalf of the corporation, an election to terminate the tax year of the S Corp. This is permitted under Sec. 1377 (a)(2) of the Code.

3. The S Corp. files a death claim with the insurance company.

4. The insurance proceeds are received by the S Corporation. The value is allocated to the shareholders. In this case, there is a 50/50 split, since there are two equal shareholders.

5. The proceeds are paid to the deceased shareholder's executor along with any short-term interest due to eliminate the debt.

Summing up

The key point to keep in mind with this technique is that when the S Corp. receives the death benefit from the insurance company, the deceased shareholder is no longer an owner of the business. The shares have been purchased, and the only interest that remains in the business is that of a creditor. This permits a complete step-up of basis to the surviving shareholders, which is often a major goal of shareholders in determining what kind of buy-sell agreement to select.

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