Guardian

Stock redemption plans for S corporations — friend or foe?

Numerous closely held businesses operate as S corporations because of the many tax advantages this type of entity provides its owners/shareholders. Most notable is the pass-through of all items of income, credits, and deductions to the individual shareholders. However, in the context of business succession planning, many business owners (and their advisors) are unaware of the advantages a stock redemption plan can provide, such as the ability for surviving shareholders to receive a full increase in cost basis.

Let's briefly review the two major types of buy-sell arrangements: the entity plan and the cross purchase plan. The entity buy-sell plan is a contract between the business and the business owners. The agreement obligates the business entity to purchase from the estate of a deceased owner, or from a disabled or departing owner, her or his interest at an agreed-upon price. Entity buy-sell agreements between corporations and their shareholders are called **stock redemption plans**. Buy-sell agreements between partnerships and their partners — or LLCs and their members — are usually called **entity buy-sell plans**.

The cross purchase buy-sell plan is a contract between the owners of a business. The business itself, unlike in the entity plan, is not a party to the agreement. The agreement obligates the remaining owners to purchase from the deceased, disabled, or departing owner her or his business interest at an agreed-upon price. Cross purchase agreements can be entered into between the shareholders of a corporation, partners in a partnership, or members in an LLC. They can also be entered into between owners and third parties.

Each type of arrangement has its own advantages and disadvantages. For example, a cross purchase agreement with several co-owners may require numerous life and disability buy-out insurance policies to fund the agreement. However, a significant advantage of cross purchase agreements is that when a remaining owner purchases a deceased or departing owner's interest, the remaining owner's basis is increased by the price she or he paid for the business interest. Increased basis is preferable because the remaining shareholders may wish to sell their shares or the business during their lifetime. The increased basis may therefore help to reduce capital gains taxes.

A stock redemption plan may present a problem known as "transfer-for-value" if a redemption plan is changed to a cross purchase plan, requiring the corporation to transfer the policies it owns to the co-shareholders of each insured. Violation of the transfer-for-value rules may result in income taxation of the life insurance death proceeds.

Additionally, in a stock redemption arrangement for a C corporation, any life insurance proceeds received to fund the redemption are used by the corporation to pay for the shares, not by the other individuals. As such, they do not increase the surviving shareholders' basis in the business. However, for an S corporation in a "death time" stock redemption funded by life insurance, this is not completely true. In fact, unlike shareholders in a C corporation, the surviving shareholders in an S corporation can receive an increase in basis for the price of the stock purchased during redemption. How can that be?

Let's use an example. Rob and Melissa operate their business as an S corporation. To ensure business continuity at the first shareholder's death, the S corporation enters into a stock redemption agreement with the shareholders and purchases an insurance policy on each shareholder, naming itself as owner and beneficiary of each policy. At the first shareholder's death, the S corporation receives the death proceeds.

As a "pass-through" entity, the tax-free effect of the insurance proceeds is allocated to each shareholder in accordance with their ownership interest in the business. This allocation increases the basis of the S corporation's shareholders. So, in our example, if Rob and Melissa are equal shareholders, the allocation would increase the basis on each of their interests, including the deceased shareholder, by one-half.

Now, you may be thinking that the allocation of insurance proceeds to the deceased shareholder to receive an increase in basis does not make sense. And you would be right. Under IRC Section 1014, the stock (and most other assets) owned by a decedent receive a "step-up" in basis to their fair market value at the date of death. So, as a result of this step-up in basis, the allocation of the death proceeds by the S corporation to the decedent is "wasted," since basis cannot be increased beyond its fair market value.

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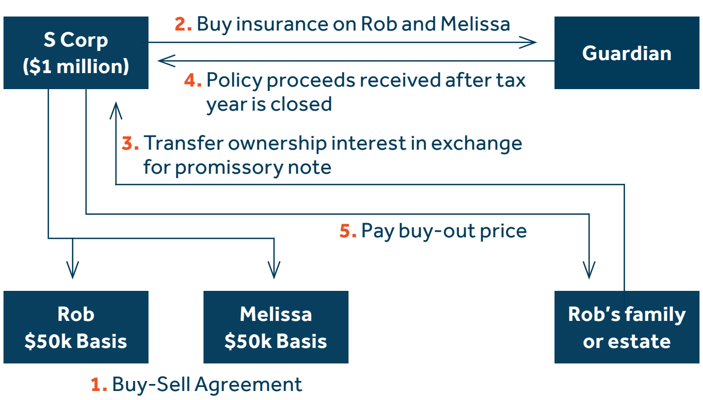
S corporation stock redemption and short tax year election

So, is there a way to allocate that portion of the death proceeds to the surviving shareholders to increase their basis in the business, rather than wasting it on the deceased shareholder? Yes, and it's called "terminating the tax year" or a "electing a short tax year." The one requirement is that the S corporation must be a cash basis taxpayer. This technique does not work under the accrual method of accounting but most S corporations are on a cash basis accounting method.

1. Rob, Melissa and the corporation enter into a stock redemption agreement.

2. The corporation is worth $1 million, even though Rob and Melissa started the company with $50,000 each. The corporation buys a policy on both Rob and Melissa for $500,000 since they are equal owners.



3. Assuming Rob dies first, the corporation redeems his shares from the executor of his estate and issues a short-term interest-bearing note for the purchase price. Now Melissa is the only remaining shareholder.

4. Melissa's corporate accountant files, on behalf of the S corporation, an election to terminate the corporation's tax year. This is permitted under IRC Section 1377(a)(2). In the "new" year, the corporation claims and receives the insurance proceeds, which are then allocated to the remaining shareholder, which, in our example, is Melissa. Remember that when the corporation receives the death proceeds, Rob's interest no longer exists, as it has been redeemed and retired. This leaves a full step-up to the surviving shareholder.

5. The S corporation then uses the proceeds to pay the full amount of the note and interest to Rob's estate. Melissa's basis has increased to $550,000 (original $50,000 plus $500,000 insurance proceeds).

Note: It is advisable that the stock redemption agreement require each shareholder to modify their existing wills, mandating that the personal representative of their respective estates consent to continuing the S corporation election, prior to the actual redemption, and to comply with the procedures as outlined.

So, where you have a situation involving an S corporation, while a cross purchase may still be preferable, depending upon the number of shareholders and other factors, a stock redemption plan should not be immediately dismissed. The number of insurance policies required to fund the agreement are minimized, yet the surviving shareholders can receive an increase in cost basis.

The main thing to remember with this strategy is that when the S corporation receives the death benefit, the deceased's shares no longer exist, since they have been redeemed and retired. This technique only applies to a death-time redemption, funded with life insurance, or a disability buy-out redemption funded with disability insurance, owned by the corporation.

Please consult with your Guardian financial professional if you have any questions concerning this document.

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