S Corporation Buy-Sell: Life Has Never Been So Good

Terri L. Getman, CLU

Terri L. Getman, J.D., CLU, is vice president of advanced marketing for the Prudential Insurance Company of America. Getman has developed an ability to tie life insurance sales application to advanced marketing concepts, making her a popular speaker. In her 23 years in the financial services industry, she has logged more than 1,000 presentations at the National Association of Insurance and Financial Advisors and its local chapters, Society of Financial Service Professionals and Estate Counsel meetings. Additionally, Getman has authored articles in publications such as *Life Insurance Selling*, *National Underwriter* and *Broker World*.

Prudential Financial
13001 Bass Lake Road, Suite 4C
Plymouth, MN 55442
Phone: 763.519.2446
E-mail: terri.getman@prudential.com

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Are the "golden rules" of buy sell planning preventing you from capitalizing on the benefits that only life insurance can provide to your closely held business clients?

When it comes to buy sell planning for closely held businesses, the structure I generally hear suggested by the financial professional is the cross purchase buy sell arrangement. Why is this the case? All too often the response I hear, is what I call, the "golden rules" of buy sell planning. What are these rules?

First, the life insurance proceeds received by the surviving owners in a cross purchase arrangement are received income tax-free; whereas, the proceeds received by a corporation under a stock redemption can be subject to alternative minimum tax (AMT). Second, the surviving owners in a cross purchase buy sell arrangement receive a step-up in basis for the interest they purchase. In contrast, the surviving owners in a redemption arrangement do not receive an increase in basis. And finally, while most practitioners rarely understand the negative tax consequences caused by the family attribution rules in a redemption arrangement, what is understood is that that a cross purchase arrangement avoids the problem.

The "Golden Rules" Don't Apply To Pass-Through Business Entities

The problem with these golden rules is they stem from buy sell planning for a C corporation, and do not apply to buy sell arrangements in a pass-through business entity. In fact, there are key differences that may warrant the use of the stock redemption form of buy sell arrangement in a pass-through entity. One of the differences is the tax rules for pass-though entities offer certain advantages for using life insurance that are not available to C corporations. Consequently, there are more reasons to use life insurance in a buy sell arrangements in a pass-through entity.

My objective in this presentation is to arm you with an understanding of the unique benefits life insurance provides to business owners of a pass-through business entity, with a particular focus on S corporations. With this information you will then be able to demonstrate the value of using permanent life insurance as a buy sell funding vehicle.

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Case Study. To help illustrate the effect life insurance can have I will be using an example of a case I worked on a few years ago. The case involved an S corporation, so the information will be specific to S corporate shareholders, but many of the life insurance concepts are transferable to other forms of pass-though business entities.

The case involved two brothers, Bob and Jim, who established a business that flourished, and at some point they incorporated it as a regular C corporation. As the business grew Bob's adult children joined the business. Then in 1986, when individual tax rates were lower than corporate tax rates, the brothers opted to make an S election. At the time of the S election, the business had over $1,500,000 of retained earnings and profits.

As the business grew, Bob began to distribute stock to his children. Over a period of years he was successful in transferring his non-voting S stock to his children.

Unfortunately, one of the children predeceased Bob. Since the family wanted to retain the business within the family they had the unpleasant experience of purchasing the stock from the spouse of the deceased child. After the purchase the ownership of the business was as follows:

Owner	Ownership	Value	Basis
Bob	17	1,500,000	618,8000
Child #1	11	1,000,000	400,400
Child #2	11	1,000.000	400,400
Child #3	11	1,000,000	400,400
Jim	50	4,500,000	1,820,000

The experience of having to purchase the deceased child's interest led the family to seek our help in establishing a buy sell arrangement. What follows is the process used to help capture the sale.

The first step in designing a buy sell arrangement is to understand the client's objectives. In this case both brothers plan to "die with their boots on." Bob wanted to provide for his spouse and pass his interest equally to his children. Jim wanted his family out of the business. Finally, everyone wanted to make sure that the business stayed in the family at the death of the children.

The next step in the design of the buy sell necessarily involves an understanding of the tax rules as they apply to S corporations. This part of the discussion will seem a little esoteric; however, once we get to the buy sell discussion, the importance of understanding this background will become clear. Next we are going to discuss the tax effect life insurance has in an S corporation. Finally, we are going bring the information together to illustrate the value life insurance plays in a funded buy sell plan in an S corporation, with particular focus on the redemption form of arrangement.

Taxation of S Corporation Shareholders

There are four key tax concepts that one must understand to appreciate S corporation buy sell agreements funded with life insurance. These concepts are: (1) the pass-through of income and losses, (2) earnings and profits (E & P) verses the accumulated adjustment account (AAA), (3) shareholder's adjusted basis, and (4) S distributions.

Pass-Through of Income and Losses. Like other pass-though business tax entities, S corporate taxation is built on the principle that the shareholder, rather than the S corporation, is taxed on the earnings of the business after corporate level deductions are taken into account. Shareholders in an S corporation have two potential sources of taxation. First, they are taxed on the current net earnings of the business; and second, on actual distributions of property or cash; called S distributions. So how are the current earnings taxed to the shareholders?

Generally, the tax character of the item received by the S corporation passes through to the shareholders. For example, tax-exempt income earned by the business in the form of life insurance death proceeds passes through income tax-free to the shareholders. And consistent with the pass-through system of taxation, the earnings are taxed

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to the shareholders whether or not the item is actually distributed. There are two methods of allocating the earnings to the shareholders.

Generally, current earnings are taxed to the shareholders in proportion to their ownership interest based on a per-share-per-day basis. This is called the "per diem" approach. Under this approach, all the earnings for the entire tax year are deemed earned equally each day. For example, if an S corporation had annual net earnings of $365,000, under the per diem approach the business is deemed to have earnings of $1,000 per day. So a 50% owner would have $182,500 of reportable earnings. And if the shareholder terminated his interest mid-year, the shareholder would report $91,250 of earnings. Of course, in reality business earnings fluctuate. Consequently, with this approach a shareholder may have to report earning actually earned during periods he or she is not a shareholder – such as in year of a shareholder's death or termination of their ownership.

As an alternative to the per diem approach, the short year election can be used, but only in a year where a shareholder has completely terminated his or her interest in the S corporation, and only if all the affected shareholders consent. Under this approach, two tax years are created within a calendar year, with allocations based on the earnings within each period. When this election is made, the books of the business are closed, and the earnings of the business are allocated to the shareholders of record on the date of the closing. With this approach the terminated shareholder will not report items of income, deductions and credits earned after the date of termination. This is an important election for buy sell planning.

Earnings & Profits Verses Accumulated Adjustment Account. In addition to being taxed on the earnings of the S corporation, an S shareholder can be taxed on S distributions. S distributions are actual distributions or withdrawals of cash or property – including redemptions of stock pursuant to a buy sell arrangement.

The tax treatment of an S corporate distribution depends on two factors: (1) the adjusted basis of the shareholder's stock and (2) the source of the distribution - that is, whether the distribution is from accumulated earnings and profits (E & P) or from the accumulated adjustment account (AAA). So what are E & P and AAA. Furthermore, why should we care.

In a C corporation, earnings retained by the business are taxed at the corporate level and not taxed to the shareholder. When this happens an accumulated earnings and profit account (E & P) is created. When these earnings are distributed to a shareholder they are taxed as dividends.

In contrast, current earnings in an S corporation are taxed to the shareholders, even when they are retained by the business. When this happens an account called the AAA is created. Since S shareholders have already been taxed on AAA earnings, distributions from AAA are not taxable. The AAA account of an S corporation is adjusted to reflect the activity of the business. Specifically, the amount of AAA increases when the corporation earns taxable income, and it decreases when the corporation makes actual distributions (other then for tax exempt expenses) to its shareholders.

A business that has always been taxed as an S corporation, will generally not have E & P. However, since it's possible for an S corporation to acquire a C corporation, or a C corporation to elect S tax status, it's possible for an S corporation to have both types of earnings. In enacting Subchapter S to the Internal Revenue Code, Congress did not intend to have an S corporation with prior retained C earnings avoid taxation on distributions of E & P. As a result, S corporations with earnings from the time it was a C corporation must maintain an E & P account in addition to tracking AAA.

Once S status is elected, the E & P account will not increase; instead all future retained taxable earnings will increase the AAA of the S corporation. On the other hand, distributions from an S corporation that was once a C corporation may reduce both AAA and E & P. And of course, to the extent the S distribution is from E & P it will normally be subject the S shareholder to taxation. And this bring us to the point of why we care about whether an S corporation has E & P.

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For buy sell planning it's critical that you know whether the S corporation has any E & P, and the amount, because a redemption of stock may be taxed as an S distribution – and a distribution of E & P is normally taxable.

How do you know if the S corporation has E & P? As part of the fact-finding process you only need to ask the business owner if the business ever filed a business tax return. If the answer is yes, then ask for the name of their tax preparer – he or she will be able to provide the specific E & P amount.

Shareholder's Adjusted Basis. The second component for determining the tax treatment of an S distribution is the shareholder's adjusted basis. Basis is the benchmark for determining how much can be distributed, or withdrawn, from an S corporation without a shareholder incurring capital gains tax. In a C corporation a shareholder's basis is generally determined by his or her capital contributions. Earnings and expenses of a C corporation do not impact shareholder basis.

In contrast, an S shareholder's basis is constantly adjusted to reflect the income and expenses of the business. A shareholder's basis will increase whether the earnings are derived from taxable or tax-exempt income. Thus for example, life insurance death proceeds received by an S corporation will increase a shareholder's basis. A shareholder's basis will decrease when any of the following take place: (1) when income (taxable or tax-exempt) is distributed to the shareholders; (2) when the corporation suffers a loss; (3) when the corporation incurs "nondeductible expenses to extent not charged to the capital account;" and (4) when a distribution represents a return of capital.

Basis plays an important role for the owners of both S and C where stock will be sold. In fact, the ability to manipulate basis through the activity of the business may be one of the primary reasons S shareholders maintain their S tax status.

With the background on basis and AAA/ E & P we can now describe the tax treatment of an S distribution. Again it's important to understand how an S distribution is taxed because the tax treatment of a stock redemption buy sell arrangement may be governed by the S distribution rules.

S Distribution Taxation. The tax treatment resulting from an S distribution of cash or property by an S corporation varies according to whether the corporation has E & P.

The rules governing the taxation of a distribution by an S corporation that does not have E & P is very simple. Distribution will be tax-free to the extent of the shareholder's adjusted basis with excess taxed as a capital gain.

On the other hand, if an S corporation has E & P, then a distribution is taxed as follows:

(1) AAA is reduced and basis of the shareholder is reduced and distributed to the shareholders tax-free.
(2) Once AAA is reduced to zero, excess distribution is taxable as a dividend to the extent of E & P. (Basis is not reduced by this part of the distribution.)
(3) After all E & P is distributed the balance of the shareholder's basis is distributed tax-free.
(4) Finally, any additional distribution is a capital gain.

The discussion above indicates the importance that basis and E & P play in determining the taxation of an S distribution. Since business owners often look to the business as their primary source of retirement income – either by taking distributions or selling – S shareholders recognize the importance of maintaining a high basis. With the background of the tax rules that we have covered thus far you can see that life insurance can have an impact on shareholder basis. So let's turn our attention to the specific impact the tax rules have on life insurance owned by an S corporation.

Special Considerations of Life Insurance Owned By An S Corporation

The tax rules governing S corporations provide unique benefits to S corporate owned life insurance arrangements not available to C corporations. To understand these unique benefits I will first cover the impact of an S corporation owning term insurance and then contrast it with a permanent policy.

Term Insurance. Like the C corporation, the S corporation is not allowed an income tax deduction for premiums

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paid on corporate owned policies where the corporation is the beneficiary. In a C corporation, this would make the earnings used by the business to pay premiums subject to corporate level taxes.

In contrast, in an S corporation, the income used to pay the nondeductible premium expense is passed through and taxed to the shareholders in proportion to their stock ownership. Consequently, one of the principal effects of S corporate owned insurance is that S shareholders are taxed on the earnings used to pay the premium expense, with the largest shareholder bearing the greatest tax burden as demonstrated by the following example.

Example: Assume the business decided to purchase $1,000,000 of term insurance on a non-shareholder key employee with premiums which over 30 years total $52,800.

Owner	Ownership	Premium Expense Reportable As Income
Bob	17	8,976
Child #1	11	5,808
Child #2	11	5,808
Child #3	11	5,808
Jim	50	26,400

In addition to the tax burden, the basis rule provides that a shareholder's basis is reduced by any "nondeductible expense to extent not charged to the capital account." Since the payment of corporate owned life insurance is a nondeductible expense, term insurance premium payment will reduce the basis of the S shareholder on a dollar for dollar basis, with the largest shareholders having the greatest decrease. The AAA is not reduced because it is not decreased by expenses related to tax-exempt income. The following illustrates the impact premium payment has on shareholder basis.

Owner	Percentage Ownership	Premium Expense Reportable As Income	Basis Decrease Premium
Bob	17	8,976	(8,976)
Child #1	11	5,808	(5,808)
Child #2	11	5,808	(5,808)
Child #3	11	5,808	(5,808)
Jim	50	26,400	(26,400)

At the death of the insured, the proceeds on a term policy paid to the S corporation are not subject to income taxation either to the S corporation or the shareholder. Consequently, unlike the C corporation, the S corporation is not subject to AMT. In addition, the death proceeds from a term policy received by the S corporation increases the basis of the S shareholder's stock on a dollar-for-dollar basis, in proportion to the shareholder's interest, as illustrated below.

Owner	Percentage Ownership	Premium Expense Reportable As Income	Basis Decrease Premium	Basis Increase Death Proceeds
Bob	17	8,976	(8,976)	170,000
Child #1	11	5,808	(5,808)	110,000
Child #2	11	5,808	(5,808)	110,000
Child #3	11	5,808	(5,808)	110,000
Jim	50	26,400	(26,400)	500,000

This interaction between shareholder basis and life insurance death proceeds is one of the strongest selling points for insurance in an S corporation. The financial

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services professional who understands the important role basis plays in an S corporation can use this information to his/her advantage when explaining the benefits of life insurance. In addition to the normal discussions of how life insurance can provide income tax-free cash to help cover losses, what shareholder would not be delighted to hear that they receive a basis increase as part of the transaction? Now let's turn our attention to a permanent policy.

Permanent Insurance. The tax impact to the shareholders of an S corporation purchasing a permanent policy is identical to the purchase of a term policy. That is, the nondeductible premium payment expense is passed through to the shareholders in proportion to their stock ownership.

However, unlike the term insurance situation, the premium expense does not necessarily reduce the basis of the shareholder by the full premium payment. When a permanent policy is purchased the exact effect of the premium payments on stock basis is not clear. The issue stems from the description that basis is reduced by "nondeductible expenses to extent *not charged to the capital account*." Conceptually, the portion of the premium corresponding to the cash value increase is "properly charged to the capital account" and should not reduce basis. Only the remainder of the premium expense would then represent the "nondeductible expense;" reducing shareholder basis.

Under this rule, over a period of years the impact on shareholder basis may be less with a permanent policy than a term policy. Specifically, the payment of premium on a term policy will initially have less of an impact on shareholder basis than that of a permanent insurance. However, as the cash value in the permanent policy grows its impact on shareholders' basis will gradually decline, while the cumulative cost of term insurance will gradually have a greater drag on shareholder basis. Eventually, you may reach a crossover point where the impact on shareholder basis can be less with a permanent policy than a term policy. Again lets look at an example.

The following assumes the business purchases a $1,000,000 permanent policy with high cash value structured as a "limited pay" (based on current illustrated rates and expenses the policy will continue without the need for additional out of pocket premium payments). The total premium payment for the permanent policy over 30 years is $87,050, but note the impact on the shareholders' basis is less.

Owner	Percentage Ownership	Premium Expense Reportable As Income	Basis Decrease Premium
Bob	17	15,070	(439)
Child #1	11	9,576	(284)
Child #2	11	9,576	(284)
Child #3	11	9,576	(284)
Jim	50	43,525	(1,291)

To summarize, the payment of premium reduces shareholder basis, but the reduction in basis can be less over a period of years for a permanent policy than a term policy.

What does this mean to the financial services professional? If it's determined that there is a need for corporate owned life insurance, such as in the case of key person, debt liquidation or stock redemption arrangements, then the type of coverage should be considered. Within this context, in addition to discussing items such as the cash flow of the business and the duration of coverage, impact on shareholder basis should be mentioned. Understanding an S shareholder's desire to maintain a high basis, can gain you credibility with your prospect and help you to align the "right" type of policy. Of course, if the need for coverage is long term, keeping basis at a high level provides an additional reason for using permanent insurance!

Even where it's determined that term insurance is the "right" policy for the prospect, the basis discussion can provide you a segue to a discussion on buy sell planning. Now that you have a background of the S tax rules and their impact on life insurance, we are ready to focus on how these rules impact the design of a funded buy sell

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arrangement in an S corporation. To aid in our understanding we return to the case study.

Buy Sell Planning For The S Corporation

One of the major decisions of any buy sell agreement is to decide who will purchase the stock: the business under a redemption arrangement; or the owners under a cross purchase arrangement. Which approach might we suggest, and why?

Since the stock redemption arrangement, funded with life insurance, in an S corporation offers a number of advantages not available to a C corporation let's first examine how it works.

Stock Redemption Arrangement. The structure of a stock redemption arrangement in an S corporation is the same as in a C corporation. It involves the corporation's purchase of its own shares from a shareholder. This is where the similarities end.

Let's assume that the business in our case study purchases a $4,500,000 policy on Jim to fund the purchase of his stock. Let's further assume that the premiums of $135,000 are paid from the taxable earnings of the business and the policy does not have cash value at the end of the first year.

Recall from the earlier discussion on premium payment; the income earned to pay the nondeductible premium on an S corporate owned policy is taxed to the shareholders based on their proportionate interest in the business. Jim would have the greatest tax burden of $67,500, Bob $22,950 and each child $14,850.

Next note that the taxable and tax-exempt income earned by the business increases the shareholders' basis, and the $135,000 of premium expense decreases the shareholders' basis. Both the basis increase for earnings and the decrease for the premium expense are in proportion to the ownership interest; with the basis impact of the

Impact of $135,000 Premium Payment on S Corporation Owned Policy of $4,500,000 on Jim

BASIS				AAA
Year 1	Jim (50%)	Bob (17%)	Each Child (11%)	
Beginning Basis	$1,820,000	$ 618,800	$ 400,400	$3,220,000
Taxable Earnings of S Corporation	$ 67,500	$ 22,950	$ 14,850	$ 135,000
Basis Increase for Corp. Earnings (Tax-Exempt & Taxable)	$ 67,500	$ 22,950	$ 14,850	----
Decrease Basis for Premium Expense	($ 67,500)	($ 22,950)	($ 14,850)	
Ending Basis	$1,820,000	$ 618,800	$ 400,400	$3,355,000

Impact of $4,500,000 Death Proceeds on Jim Allocated Pro Rata – Per Diem Approach

	BASIS		AAA
Year 1	Jim	Survivors	
Beginning Basis	$ 1,820,000	$1,820,000	$3,220,000
Taxable Income of Death Proceeds	0	0	N/A
Basis Increase for Death Proceeds	$ 1,125,000	$3,375,000	N/A
Ending Basis	$ 2,945,000	$5,195,000	$3,220,000
Step Up Stock Basis for Death	$ 4,500,000		

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premium expense dependent on whether the policy is term or permanent. In the case study, since the policy did not have cash value in the first year, the full premium reduced the basis of each shareholder in proportion to their ownership, with Jim's basis decreasing by $67,500, Bob's $22,950 and each child $14,850.

Finally, taxable income earned by the business increases the S corporations AAA, while the premium payment does not impact AAA.

Continuing the case study, let's assume that Jim dies on July 1. At Jim's death the insurance proceeds are received by the S corporation income tax-free. Unlike a C corporation, the proceeds received by an S corporation are not subject to AMT. Note this is in conflict with the first "golden rule" that, "proceeds received by corporation are subject to AMT." Thus, the first reason for not using a stock redemption arrangement, does not apply to S corporations – or for that matter other pass-through business entities. And, this is not the only difference.

Recall from our discussion of life insurance, that proceeds received by an S corporation increase the basis of the shareholders. Therefore, in our case study when the business receives the proceeds, the shareholders receive an increase in the basis of their stock. This is in conflict with the second "golden rule" that surviving owners in the stock redemption form of buy sell do not receive an increase in the basis of their stock. In fact, in an S corporation, as in other pass-though business entities, when life insurance is used to fund a stock redemption arrangement, the surviving owners receive an increase in the basis of their stock. It's the life insurance funding that provides the basis increase – providing you a reason to suggest that the stock redemption arrangement be funded with life insurance!

How much basis increase will the surviving shareholders receive? The amount of basis increase a shareholder will receive depends on how the life insurance proceeds are allocated. You may recall from the discussion on taxation of S corporate earnings, the allocation of earnings in an S corporation depends on whether the business is using the general per diem approach, or whether the shareholders have agreed to a short year election.

Under the per diem approach the life insurance death proceeds are allocated based on a pro rata ownership of the business. In the case study, since the surviving shareholders own 50% of the business for half the year and 100% after Jim's death for half the year, 75% of the death proceeds are allocated to them. This increases their basis to $5,195,000. The remaining death benefit is allocated to Jim, increasing his basis by $1,125,000 to $2,945,000.

However, since Jim is dead (and assuming he does not die in 2010 when the current estate tax law is replaced by a modified carryover basis tax regime) his stock basis is "step-up" to the fair market value at date of death or $4,500,000. In effect, part of the basis increase attributed to the life insurance death proceeds is wasted on Jim.

You might be wondering, is there is a way to allocate the full death benefit to the surviving owners since the deceased owner is already receiving a step-up in basis? Fortunately, the answer is yes, when the S corporation is a cash basis taxpayer and where the shareholders have made the short year election. Recall I earlier indicated that the short year election is an important election for buy sell planning – now we are going to see why it's important.

Using the short year election in combination with the purchase of life insurance the surviving owners of a cash basis S corporation can receive a full increase in basis – the same as a cross purchase arrangement. Following is how the short year election works in a stock redemption arrangement funded with life insurance.

First, in the year of Jim's death his stock is redeemed in exchange for a promissory note pursuant to the terms of the stock redemption agreement. The redemption also terminates the tax year pursuant to the short year election. Jim no longer has an interest in the S corporation.

In second short tax year the business files the death claim. The proceeds are allocated to the shareholders of record, which only include the surviving owners. The full $4,500,000 of death proceeds inure to the benefit of the surviving shareholders, increasing their basis by the full amount – the same as a cross purchase arrangement. Note, it's the life insurance proceeds that provides the increase in basis.

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Impact of $4,500,000 Death Proceeds on Jim Allocated Based on Short Year Election

	BASIS		AAA
Year 1	**Jim**	**Survivors**	
Beginning Basis	$ 1,820,000	$1,820,000	$3,220,000
Taxable Income of Death Proceeds	0	0	N/A
Basis Increase for Death Proceeds	$ 0	$4,500,000	N/A
Ending Basis	$ 1,820,000	$6,320,000	$3,220,000
Step Up Stock Basis for Death	$ 4,500,000		

The business now has cash, which it can distribute in payment of the promissory note. The payment of the debt has no effect on the basis of the surviving shareholders. The corporation has simply exchanged an asset for the removal of a liability. Likewise, Jim's basis remains stepped-up to its fair market value at date of death.

In summary, unlike a C corporation, the surviving owners of an S corporation can receive an increase in basis in a stock redemption arrangement, but only when the arrangement is funded with life insurance. Furthermore, in a cash basis business by combining the short year election with life insurance as the funding vehicle it's possible to increase the basis of the surviving owners by the full amount of the death proceeds. Bottom line, the combination of life insurance funding and short year election can eliminate the difference between a stock redemption and cross purchase arrangement; and eliminates the second "golden rule!"

Now that we have a clearer understanding of what happens to the surviving S shareholders, let's turn our attention to what happens to the estate of the deceased S shareholder.

From the standpoint of the estate of the deceased shareholder, I often hear financial service professionals describe the tax consequences as follows: as long as the estate of the deceased shareholder sells the stock for the date of death value, the estate of the deceased shareholder will not incur any tax. This rule describes the results of a "sale" under a cross purchase arrangement, but it's not the tax rule for a stock redemption arrangement.

The income tax consequences of a stock redemption arrangement in an S corporation are similar to the C corporation. Like the C corporation, a redemption of a deceased S shareholder's stock is taxed as a "distribution," except where it meets the requirements of a "sale." To receive "sale" treatment, the redemption must generally qualify as either a complete or substantially disproportionate termination of the shareholder's interest. The problems is that in a closely held business, such as the one in the case study, the attribution rules of IRC § 318 must be considered.

The attribution rules are complex. Beyond knowing that they can be avoided by using the cross purchase arrangement, they are often not understood In general, the attribution rules apply to both C and S corporations where certain family members (spouse, children, grandchildren and parents) and certain entities own stock in the business. The attribution rules cause stock owned by these other individuals/entities to be deemed owned by the redeeming shareholder. Consequently, when the attribution rules apply, both the redeeming shareholder, and the deemed interest owned by the other shareholders, must be terminated to qualify the redemption as a complete or substantial disproportionate termination. If all the interests are not terminate, the redemption by the deceased shareholder will not qualify as a "sale" rather it will be taxed as a "distribution."

An example might help our understanding of the attribution rules. Clearly, in our case study, under the attribution rules Bob's interest will be attributed to the

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children and the children to Bob; however, no interest will be attributed to Jim since the attribution rules do not apply between brothers and sisters. Thus, it will be possible to totally redeem the interests of Jim, but not those of the children or Bob. This means that a redemption of Jim's stock will be taxed as a "sale;" while the redemption of Bob's or his children's stock, will be taxed as a "distribution."

What this means for Jim is that since his transaction qualifies as a "sale," when the S corporation redeems his stock, as long as his estate receives cash equal to his date of death (step-up) value, he will not incur any tax. On the other hand, if Bob or any of the children should die, and the business redeems their stock, the redemption will not qualify as a total or substantially disproportion termination; therefore, it will be taxed as a "distribution."

If our case study involved a C corporation, a redemption of Bob's or the children's stock would be subject to ordinary income to the extent of E & P. Obviously, this is a tax result you want to avoid, which is why the third "golden rule" provides that were the attribution rules apply, structure the arrangement as a cross purchase to avoid the adverse dividend taxation results.

You might be wondering whether the same tax consequences occur in an S corporation. The answer *- it depends*. Recall we previously indicated that the taxation of an S distribution depends on whether there is E & P. And that it's important to know whether an S corporation has E & P, because it's one of the factors in our decision of how to structure the buy sell arrangement. Now we are going to see the impact of E & P on a stock redemption plan.

Before going to our case study, where the business had a significant amount of E & P, let's look at the situation where the S corporation does not have E & P such as where the business has always been an S corporation.

You can see from the chart, that when an S corporation does not have E & P, as long as the estate receives cash equal to its date of death (step-up) value, the estate of the deceased shareholder will not incur any tax. Notice this is the same tax result when the redemption qualifies as a "sale." What this means is the tax consequences of an S corporation without E & P is the same whether the redemption is taxed as a "sale" or a "distribution." Consequently, where the S corporation does not have any E & P, such as where the business has always been taxed as an S corporation, the third "golden rule" of family attribution is not a problem!

Where Redemption is Taxed As An S Distribution
No E & P
Tax-free to extent of basis
Capital gain to extent distribution exceeds basis
E & P
Tax–free to extent AAA, reducing AAA & basis of the shareholder
Taxable as a dividend to the extent of E & P (basis is not reduced by this part of the distribution)
Tax-free to extent remaining shareholder basis
Capital gain to extent distribution exceeds basis

In contrast, where the S corporation has E & P, the chart indicates that a distribution in excess of AAA is taxable to the extent of E & P. Thus, an S shareholder who has his stock redeemed by an S corporation with E & P faces the same dividend tax treatment as a shareholder in a C corporation. What this means for the case study is, if either Bob or his children's interest is redeemed they will have dividend tax risk.

It's important to note, that it is only where the S corporation has E & P, and the attribution rules apply, that the third "golden rule" applies in an S corporation. In all other situations, the stock redemption form of buy sell does not have the dividend tax risk.

For purposes of the case study, the buy sell can be structured as a stock redemption arrangement for Jim, but for the children we will need to use the cross purchase arrangement. You might be wondering – is there a benefit to structuring Jim's as a stock redemption? The answer is yes.

S Corporation Buy-Sell: Life Has Never Been So Good *(continued)*

When Jim's stock is redeemed in an income tax-free exchange the AAA and E & P is reduced by the same percentage of shares redeemed. What this means is $750,000 of taxable E & P is reduced from the S corporation on an income tax-free basis. The reduction in E & P means there is less potential for taxable dividends if distributions are made to the surviving shareholders. In contrast, E & P is not reduced when a buy sell is structured as a cross purchase arrangement. Thus, there is an affirmative reason for structuring Jim's buy sell as a redemption arrangement.

Once you begin to introduce the stock redemption arrangement as a viable option, you may find that business owners often prefer it's use because it provides simplicity; it only requires one policy per shareholder; it gives the owners a sense security that the agreement will be completed because the funds will reside with the business instead of scattered among the shareholders; and last but not least, owners love the fact that the business pays the premiums. Consequently, you may experience less resistance to establishing a buy sell.

In summary, stock redemption arrangements in S corporations are not subject to AMT, where life insurance is used to fund the arrangement the surviving shareholders will receive some increase in basis, and, as long as the S corporation does not have any E & P the attribution rules are not a problem. Bottom line, the "golden rules," generally don't apply to S corporation redemptions. ***In fact, the stock redemption arrangement may be the preferred structure in an S corporation that doesn't have E & P.***

However, where the S corporation has E & P and other family members are shareholders, the cross purchase arrangement may be the favored structured. Since a cross purchase arrangement operates basically the same in an S corporation as it does in a C corporation we will close with a very quick review of this structure.

Cross Purchase Arrangement. A cross purchase arrangement involves an agreement between the shareholders. One of the benefits of the cross purchase form is through the agreement it's possible to restructure the percentage of ownership among the surviving shareholders. This has an appealing aspect for our case because we can structure this part of the buy sell to limit the purchase of the children's stock to the children.

Where insurance is used to fund a cross purchase arrangement, the premiums are paid by the shareholders with after-tax non-deductible dollars. Since the S corporation is not involved, basis and AAA are not affected. The death proceeds are received by the shareholders generally income tax-free. Again, since the S corporation is not involved basis and AAA are not affected.

From the purchasing surviving shareholders' perspective, the transaction is taxed as a "sale." Consequently, the purchase price paid for the deceased shareholder's stock becomes their basis, effectively increasing the stock basis of the survivors. Unlike the stock redemption arrangement, in the cross purchase structure the surviving shareholders retain the AAA and E & P account. This may be positive or negative depending on the amount reflected in each account.

Finally, from the viewpoint of the deceased shareholder, his/her basis is stepped up to the fair market value at date of death. And, as long as the stock is sold for this fair market value, the estate of the deceased shareholder will not recognize gain.

In summary, the buy sell structure that we presented was a combination stock redemption for Jim and a cross purchase for the children. Since Bob simply wanted to provide for his spouse and to pass his business interest equally to the children we suggested that Bob's estate planning documents could be drafted to provide for this distribution. We captured the sale because of the credibility we built on our knowledge of the life insurance portion of the transaction.

Clearly, the tax aspects of the S corporation impact stock redemption arrangements in several respects that are significantly different from the "golden rules." We have seen that the tax rules in an S corporation actually provide certain advantages for using life insurance –

permanent life insurance. My objective for this program has been to leave you in a position to demonstrate the value of using permanent life insurance as a buy sell funding vehicle in an S corporation.

Don't let the "golden rules" of buy sell planning prevent you from capitalizing on the benefits that only life insurance can provide to your closely held business clients.