S Corporation Dissolution – Part 1

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Overview

The S corporation as an entity choice for the operating part of a farming or ranching business has waned over the years in favor of the general partnership (for larger operations) or the limited liability company (LLC). While it can provide self-employment tax savings, those savings may also be achieved by using a different entity form. Also, an S corporation requires a lot of administrative "maintenance" that some might find too cumbersome. But, an S corporation does avoid the corporate level tax as a "flow-through" entity and is generally easy to switch to a different entity form (depending on the facts).

While an S corporation might be an acceptable entity choice for professional service businesses such as law firms and accounting firms, it tends not to work as well as the operating entity for a farm or ranch. The S corporation can also present some tricky issues upon liquidation.

Part one of a two-part series – tax (and income tax basis) issues upon liquidation of an S corporation. It's the topic of today's post.

For farm businesses large enough to qualify for more than one government farm program payment limit, a partnership will allow qualification. An S corporation will be limited to a single payment limit. Another drawback of the S corporation is the adverse impact upon death of a shareholder. That adverse impact is shown in the fact that the heirs of the deceased shareholder do not get the benefit of a step-up in basis in the underlying corporate assets to fair market value as of the date of the shareholder's death. Unlike a partnership where the heirs receive a full income tax basis increase for all of the underlying partnership assets, an heir of an S corporation shareholder only receives a basis increase in the corporate stock equal to the fair market value of the S corporation at death.

Shareholder Death and Corporate Liquidation

Upon the death of an S corporation shareholder, the decedent's stock ownership interest receives a step-up in basis to fair market value. This basis adjustment coupled with the basis increase that results from gain recognition inside the corporation upon liquidation of corporate assets (e.g. sale/distribution of assets, real estate, etc.) and the pass-through of the taxation of this gain to the shareholder (on Schedule K-1), results in only one level of taxation being incurred on liquidation, and that is at the shareholder level.

Since stock basis has been increased by death and pass-through of income, no gain recognition results when cash or property is distributed to the decedent's estate/heirs (in exchange for stock) to complete the liquidation, since the pass-through gain (Schedule K-1) to the estate/heirs will be offset by a matching loss from liquidation of the stock.

Property Distributions

Distributions of property (other than cash) are treated as though the corporation sold the property to the shareholder for its fair market value, pursuant to I.R.C. §311(b). The corporation recognizes gain to the extent the property's fair market value exceeds its adjusted basis. When appreciated property is distributed to an "S" corporate shareholder in exchange for stock, the gain recognized at the corporate level passes through to all shareholders (via Schedule K-1) based on their percentage ownership in the corporation.

If the "S" corporation only had one shareholder whose interest is liquidated at death, gain recognition does not cause taxation problems due to a matching loss offset resulting from the stock basis adjustments discussed above. In other words, when the S corporation recognizes table gain, that gain increases the estate's basis in the stock in an amount equal to the taxable gain that the S corporation recognizes. This taxable gain is reported to the estate on the corporation's final Schedule K-1 (Form 1120S). The estate's tax basis in its S corporation stock is increased to the fair market value of the S corporation's stock upon the shareholder's death and is further increased as a result of the deemed sale of the S corporation stock upon liquidation. Simultaneously, the estate recognizes a taxable loss equal to the 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 heir's Schedule D (Form 1040 or Form 1041). Typically, the S corporation gain on the Schedule K-1 (Form 1120S) reported on Schedule E (Form 1040 or Form 1041) and the loss on the Schedule D will net out with no tax due by the estate or the heirs for the S corporation gain on liquidation.

Caution. In some instances, a farming S corporation may have one spouse as a shareholder and own ordinary income assets such as grain and equipment. Upon the shareholder's death with the corporate stock passing to the surviving spouse, the sale of those assets by the surviving spouse will trigger ordinary income to the surviving spouse that will be taxed at the highest rate. If the surviving spouse then liquidates the S corporation, a capital loss will be triggered in a like amount that will be reported at $3,000 per year (or offset against other capital gains).

Note. The business will now have a new step-up in basis in all of its asset which the heirs can contribute tax-free to a new partnership.

However, if the "S" corporation has more than one shareholder, a distribution of property to a single shareholder (deceased or otherwise) in liquidation of their stock interest will result in a taxation event for all corporate shareholders.

Example: Assume that Farm Corp. has four equal shareholders. Mary, a shareholder who owns 25 percent of the S corporation's stock dies. The corporation distributes farm real estate to Mary's estate in liquidation of her stock interest. Mary's estate would report 25 percent of any gain at distribution and would be able to offset this taxable gain through a matching capital loss created by the liquidation of her stock in Farm Corp. Unfortunately, the other shareholders would be responsible for paying tax on the remaining 75 percent of any gain.

Note: An alternative to avoid this taxation problem when there are multiple shareholders in an S corporation is to simply have the remaining shareholders purchase the stock of the deceased shareholder. Implementing a corporate buy-sell agreement among the shareholders might be advantageous to accomplish the desired result.

A shareholder's income tax basis in distributed property distributed by the corporation is the property's fair market value at the date of distribution. But the distributee shareholder's holding period begins when the shareholder actually or constructively receives the property, because the distribution is treated as if the property were sold to the shareholder at its fair market value on that date. Since the shareholder's basis in the property is its fair market value (rather than a carryover of the corporation's basis), the corporation's

holding period does not tack on to the shareholder's holding period. Thus, the redeeming shareholder would need to hold distributed property for one year after distribution prior to sale to achieve capital gain income tax treatment on a subsequent sale.

Conclusion

In Part Two, I will take a look at some alternatives for avoiding the negative tax consequences associated with liquidating an S corporation.

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