Thought Leadership Discussion

Consideration of Negative Influences on S Corporation Values in Transfer Tax Business Valuations

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The valuation of an S corporation ownership interest is a typical assignment in the transfer tax context. In such equity interest analyses, valuation analysts ("analysts") typically recognize the economic benefits of the S corporation's tax pass-through entity ("TPE") status—compared to that of a C corporation's income tax status. Analysts have developed a variety of procedures to quantify the value impact (typically the value increment) associated with the S corporation's TPE status. Many of these procedures involve the following three-step process: (1) value the subject entity as if it were a C corporation, (2) separately measure some (or all) of the income tax benefits related to the subject entity's S corporation tax status, and (3) sum the two value components in order to conclude the total value of the subject S corporation ownership interest. However, analysts sometimes neglect to account for the fact that there are negative influences—as well as positive influences—associated with an entity's S corporation income tax status. Such negative influences include restrictions on the number of and type of company shareholders, limitations on the current shareholders' ownership exit opportunities, inadvertent disqualification events related to the S corporation status, special tax situations upon the death of the S corporation shareholders, state income tax requirements for S corporations, and other issues that may negatively impact the value of an S corporation ownership interest. In business and security valuations developed for transfer tax (and other) purposes, analysts should be aware of—and should intentionally consider—the "cons" as well as the "pros" associated with the subject entity's S corporation income tax status.

Introduction

Valuation analysts ("analysts") are routinely asked to develop a valuation of an ownership interest in an S corporation for gift tax, estate tax, generation-skipping transfer tax, and other transfer tax purposes. In addition, analysts may also be asked to value the stock of an S corporation for income tax, financial accounting, personal financial planning, transaction pricing and structuring, financing collateral, family law and other litigation matters, and many other purposes.

For many other client purposes, analysts may also be asked to value an ownership interest in a limited liability company, partnership, or some other form of tax pass-through entity ("TPE").

In these valuation assignments, it is important for analysts (and other professional advisers) to understand that there are material taxation (and, therefore, economic) differences between:

1. an S corporation and
2. an otherwise identical C corporation.

It is also important for analysts (and other professional advisers) to understand that there are material taxation (and, therefore, economic) differences between (1) an S corporation and (2) other types of TPE.

For an industrial or commercial business entity, and for a professional practice or professional services firm, there are obvious federal income taxation benefits associated with electing S corporation status. These benefits typically result in a value increment or increase for the S corporation—compared to the value of an otherwise identical C corporation.

This discussion begins with a summary of these well-known economic benefits of S corporation income tax status.

Over the years, analysts have developed various methods and procedures for quantifying the value increment associated with a subject company's S corporation tax status.

Generally, most of these valuation methods and procedures apply a three-step process. That three-step process is summarized as follows:

1. Apply generally accepted approaches and methods to value the subject entity as if it were a regular C corporation
2. Identify and quantify the income tax (and other) economic benefits associated with the subject entity's TPE status
3. Sum value component one (as if the subject entity were a C corporation value) and value component two (sometimes called the S corporation value premium) in order to conclude the total value of the subject entity

There are also somewhat less obvious negative aspects related to an industrial or commercial business entity electing S corporation status. These negative aspects include restrictions on the number and the type of S corporation shareholders.

Such restrictions may negatively affect the liquidity of individual S corporation ownership interests. And, such restrictions may negatively affect the ownership transition and exit planning strategies available to a family-owned S corporation.

There are special tax considerations related to the transfer of S corporation stock at the time of the owner's death. And, owners of S corporation stock have to be intentional with regard to the risks (and the tax costs) associated with an inadvertent termination of the subject entity's S corporation status.

S corporation owners—and analysts—should also be aware that many states tax S corporations for state corporation income tax purposes. Many states tax S corporations as if they were C corporations. And, many other states apply a special corporate income tax rate to S corporations.

The point of this discussion is that there are both positive and negative influences on the value of an S corporation business entity.

This discussion will not recommend analyst procedures related to the measurement of the S corporation status value premium. Likewise, this discussion will not recommend analyst procedures related to the measurement of the discount for lack of marketability ("DLOM") or any other value decrements related to an entity's S corporation tax status.

Such recommendations are beyond the scope of this discussion. And, these procedural topics have been thoroughly addressed in the valuation professional literature.

Analysts are quick to identify and quantify the implicit and explicit S status economic benefits in the S corporation business valuation.

The objective of this discussion is to summarize the offsetting economic risks associated with an S corporation ownership interest. Analysts should be equally conscious of the risks—as well as the benefits—of S corporation status in the valuation of a private company or professional practice.

This discussion summarizes many of these risk factors that analysts, stockholders, estate planners, and tax counsel should consider in the valuation of an S corporation ownership interest for transfer tax purposes.

Summary of S Corporation Benefits

The economic benefits of electing S corporation federal income tax status are generally well known. An S corporation is sometimes referred to as a hybrid-type of business organization, between a C corporation and a partnership.

S corporation tax status avoids the double taxation disadvantage associated with the typical privately owned C corporation. In an S corporation, all entity-level income, losses, deductions, and certain credits pass through to the company or practice shareholders. That is why an S corporation is frequently referred to as a TPE.

For federal tax purposes, all of the entity's income is taxed once, at the shareholder level. (Again, some states may tax S corporation income at the entity level.)

Not having to pay federal income taxes at the entity level is the principal benefit of the S corporation election. This particular economic benefit may be most valuable in the early years of an entity's business life.

This benefit may be particularly important because the start-up or early-stage entity may have limited liquidity. The cash that would otherwise go to C corporation income tax payments could be used to find growth-related operating expenses, working capital investments, or capital expenditures.

It is noteworthy that S corporations are exempt from federal income taxes on most—but not all—income. For example, certain capital gains and passive income are subject to federal taxation at the S corporation level.

In addition, the S corporation tax status may reduce the total income tax liability of the privately company or professional practice stockholders.

By characterizing the cash distributions from the company as either salary payments or dividends/distributions, the shareholder/employees may be able to reduce their self-employment taxes. The S corporation is allowed to deduct business expenses and reasonable salaries paid to employees (including shareholder/employees).

S corporation shareholders can be company/practice employees. Such employee/shareholders can earn salaries that are deductible by the company practice.

In addition, such employee/shareholders can also receive distributions of the company profits on a tax-free basis—as long as the distributions do not exceed the shareholder's stock basis.

If the distributions do exceed the shareholder's stock basis, then the excess may be taxed as capital gains (i.e., at a lower tax rate than would apply to ordinary income).

Outside of the taxation area, incorporation may provide credibility to a start-up, early-stage, or other privately owned company or professional practice—compared to either sole proprietorship or partnership status. That is, potential customers, suppliers, landlords, employees, bankers, and others may find a corporation entity to be more credible—compared to a similar sized partnership or proprietorship.

Like any other corporation, an S corporation provides certain legal liability protections to the company or practice owners—compared to the proprietorship or partnership form of business organization. For example, S corporation status (and limited liability company—or LLC—status) provide the assets of the business owners with certain protection from business creditors.

In addition, the S corporation (and the LLC) business owners generally cannot be held personally responsible in lawsuits filed against the company or practice.

Risks Associated with the S Corporation Income Tax Status

S corporation status is created under Subchapter S of the Internal Revenue Code. An S corporation is defined in Internal Revenue Code Section 1361.

To achieve S corporation income tax status, the entity has to file Form 2553, Election by a Small Business Corporation. The Form 2553 has to be signed by all of the company shareholders.

The Form 2553 should be filed with the Internal Revenue Service (the "Service"):

1. within 75 days of the company's initial incorporation or
2. within 75 days after the beginning of each tax year.

The Service may accept the filing of an S election after the 75-day period has passed, but the Service is not required to do so.

Valuation analysts, private company owners, estate planners, and tax counsel are generally familiar with the economic benefits associated with S corporation tax status. The most significant of these economic benefits were summarized above. In particular, the taxation-related benefits of S corporation status are well known.

Analysts have developed numerous methods and procedures to incorporate the value increment—or value premium—associated with this tax status election into the valuation of S corporation ownership interests. These methods and procedures are generally described in the professional valuation literature and will not be repeated here.

As with most federal taxation elections, there are risks as well as benefits associated with the S corporation income tax status. Both private company and professional practice owners should consider these risks when making investment, transaction, financing, taxation, and even litigation decisions.

Estate planners should consider these risks when making and implementing estate planning recommendations to owners of private businesses and professional practices.

Tax counsel should consider these risks with regard to all planning, compliance, and controversy decisions related to the client's private company or professional practice.

And, valuation analysts should consider these risks in the valuation of the S corporation business entity and S corporation securities.

Analysts may consider that such risks may have a decremental impact or negative influence on the subject entity's value. Analysts may consider if that impact or influence may partially offset or mitigate the incremental value—or the value premium—associated with the subject entity's S corporation status.

These analyst considerations are the primary focus of this discussion.

Some of the risks associated with an S corporation ownership interest are summarized below. Analysts should be aware of these risks—and their associated value influences—when developing and reporting the S corporation valuation analysis.

A description of how (procedurally) the analyst incorporates these risk considerations is beyond the scope of this discussion.

Some analysts have considered incorporating these risk factors into one or more of the following business and security valuation variables:

1. The development and final selection of the present value discount rate or the direct capitalization rate in the application of the business valuation income approach
2. The assessment, adjustment, and final selection of valuation pricing multiples (whether capital-market-derived or transaction-derived) in the application of the business valuation market approach
3. The identification and measurement of goodwill (or of the recognition of some type of deferred tax liability) in the application of the business valuation asset-based approach
4. The recognition in the valuation synthesis and conclusion process of (a) some increment in the assessment and measurement of an entity level value adjustment for illiquidity or (b) a security level value adjustment for lack of marketability
5. Other adjustments to (a) the valuation variables applied or (b) the value indications concluded

The only best practice recommended by this discussion is that the analyst (and the business owner, the estate planner, the tax counsel, and any other professional adviser) should consider both the following risks (economic disadvantages) as well as the above-described benefits (economic advantages) in any analysis of the S corporation.

Restrictions on the Number and Type of S Corporation Shareholders

Internal Revenue Code Section 1361 provides the limitations and restrictions with regard to S corporation shareholders. A company or practice elects to become an S corporation under the provisions of Section 1362.

The most common of the Section 1361 limitations and restrictions are listed below:

1. The company or practice has to be a domestic corporation or other entity.
2. The company or practice may have no more than 100 shareholders at any one time. (An individual and his or her spouse are considered to be one shareholder.)
3. Each of the S corporation shareholders has to be an individual, estate, trust, tax-exempt organization, or another S corporation (a C corporation or a partnership cannot be an S corporation shareholder).
4. The company or practice may not have a nonresident alien as a shareholder.
5. The corporation may only have one class of stock. All of the company or practice stock should have the same rights with regard to profit distributions and liquidation distributions.
6. The company or practice may not be an ineligible corporation, including a financial institution, an insurance company, or a domestic instruction sales corporation ("DISC").
7. The company or practice has to have to adopt either a December 31 tax year-end (the most common) or a natural business year-end, an ownership tax year, or a 52- or 53-week tax year.
8. The company or practice has the consent of each of the shareholders. (If two spouses have a community interest in the S corporation stock, then both spouses need to consent.)

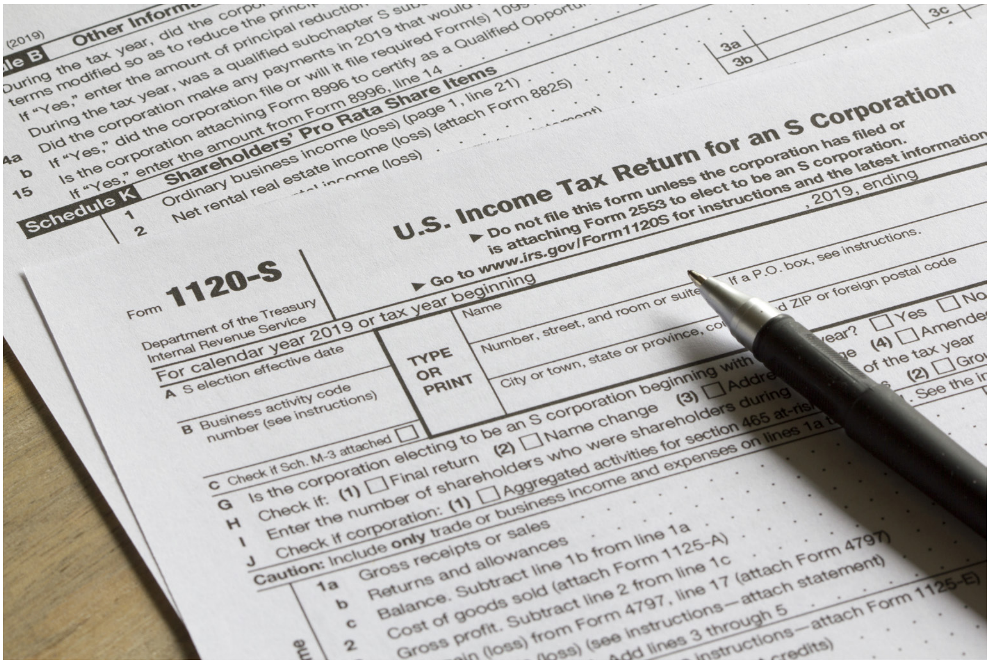
First, to be an S corporation, the business has to be a corporation or entity based in the United States.

Second, the company or practice may have no more than 100 shareholders at any one time. Shareholders may buy and sell the S corporation stock during the year. So, in total, the company may have more than 100 recorded shareholders throughout the year. But, the company may not have more than 100 shareholders at any one point in time.

Members of a family may be treated as one shareholder. A husband and wife (the terms used in Section 1361(c)(1)(A)(i)) and their estates are treated as one shareholder. Also, all members of a family (and their estates) are treated as one shareholder.

Section 1361(c)(1)(B)(i) states: "The term 'members of a family' mans a common ancestor, any lineal descendant of such common ancestor, and any spouse or former spouse of such common ancestor or any such lineal descendant."

Third, the Internal Revenue Code prohibits most types of entity from being shareholders of an S corporation. Even individuals have to meet the qualifications to be shareholders of an S corporation.



To be an S corporation shareholder, an individual has to meet one of the following two qualifications:

1. Be a U.S. citizen
2. Be a permanent resident of the United States.

So, individuals who are not U.S. citizens or U.S. residents cannot be shareholders in an S corporation.

Fourth, the following types of taxpayers are not allowed to own stock in an S corporation:

1. A C corporation
2. A partnership
3. A nonresident alien
4. A foreign trust
5. A multiple-member limited liability company
6. A limited liability partnership
7. An individual retirement account (“IRA”)

Fifth, Section 1361(b)(1)(D) clearly indicates that an S corporation may not have more than one class of stock.

However, Section 1361(c)(4) provides for differences in common stock voting rights as follows: “For purposes of subsection (b)(1)(D), a corporation shall not be treated as having more than one class of stock solely because there are differences in voting rights among the shares of common stock.”

Sixth, an “ineligible corporation” cannot be an S corporation shareholder. The term “ineligible corporation” is defined in Section 1361(b)(2) as follows:

> For purposes of paragraph (1), the term “ineligible corporation” means any corporation which is—
>
> (A) a financial institution which uses the reserve method of accounting for bad debts described in Section 585,
>
> (B) an insurance company subject to tax under subchapter 2, or
>
> (C) a DISC or former DISC.

Seventh, there are several requirements related to the selection of the S corporation’s tax year.

To be an S corporation, the business has to change to or adopt one of the following tax years:

1. The calendar year ending December 31
2. A period of 12 consecutive months that ends during a low period of business activities
3. An ownership tax year
4. A tax year selected pursuant to Section 444
5. A 52- or 53-week tax year, as long as the company’s fiscal year is maintained on the same basis
6. Any other tax year for which the company demonstrates a valid business purpose

Eighth, Section 1362 describes the shareholder election requirements related to an S corporation.

Section 1362(a)(2) states that all shareholders have to consent to the S election, as follows: “An election under this subsection shall be valid only if all persons who are shareholders in such corporation on the day in which such election is made consent to such election.”

Given the above-listed restrictions, then, who can be an S corporation shareholder? With respect to individual shareholders, we know that any U.S. citizen or U.S. permanent resident can be an S corporation shareholder. However, many types of entities are prohibited from being the owner of an S corporation.

The types of entities that are permitted to be S corporation shareholders fall into three general categories:

1. Single-member businesses
2. Estates of recently deceased S corporation shareholders
3. Bankruptcy estates of S corporation shareholders who have recently filed for bankruptcy

In many of the above-noted instances, the entity is allowed to hold the S corporation stock on a temporary basis only. That is, the Internal Revenue Code allows such temporary ownership in order to prevent the collapse of the S corporation due to the bankruptcy or the death of the S corporation shareholder.

In addition to the above types of entities, the following list includes some of the entities that can be an S corporation shareholder:

1. Single-member S corporations, the owners of which are U.S. citizens or U.S. permanent resident
2. Certain S corporations called Qualified Subchapter S Corporations
3. Grantor trusts (also known as living trusts)
4. Some testamentary trusts
5. Some tax-exempt organizations (including not-for-profit entities)
6. Some voting trusts
7. Some irrevocable trusts

Accordingly, there are a number of types of individuals and types of entities that may own S corporation stock. This discussion is not intended to imply that there is no liquidity related to the S corporation or the S corporation shares.

That said, when measuring the impact of liquidity (or the lack thereof) on the value of the S corporation business entity or the S corporation shares, the analyst should consider that the following types of individuals and entities may not own S corporation stock: all foreign individuals (who are not permanent U.S. residents), all partnerships, all C corporations, all multi-member limited liability companies, all limited liability partnerships, all business trusts, all foreign trusts, and all IRAs.

Considerations with regard to S Corporation Liquidity

Ignoring the investment risks associated with S corporation disqualification (discussed below) and other risk factors, the analyst should appreciate that S corporation stock is generally less liquid than identical C corporation stock.

Let's assume that the subject S corporation has the same owner legal protections and the same other legal benefits as the hypothetical comparable C corporation.

Let's assume that the subject S corporation has the same entity size, expected growth rate, profit margin, return on investment, and other financial and operational attributes as the comparable C corporation.

The fact is, there are simply fewer market participants available that would qualify to be a willing buyer to transact with the S corporation current owner/willing seller.

There is a smaller pool of willing buyers who could own (and, therefore, who could buy) the S corporation stock—compared to the otherwise identical C corporation stock. The analyst should consider this more limited population of potential market participants somewhere and somehow in the valuation analysis.

The analyst may incorporate these considerations in the individual valuation analyses. That is, the analyst may account for these considerations within the valuation approaches and methods developed within the analysis.

Or, the analyst may incorporate these considerations as a component of a discount for lack of marketability ("DLOM") or other type of valuation adjustment when reconciling various value indications into a final value conclusion.

These considerations should be accounted for in valuations developed for transfer tax purposes—as well as for other purposes. In addition, these considerations have practical implications for S corporation transaction pricing and structuring purposes.

That is, the limitations and restrictions regarding the number and type of S corporation shareholders may directly affect the exit strategies available to the S corporation owners seeking an ownership transition.

Impact of Limitations on S Corporation Exit Strategies

Most owners of either private companies or professional practices have to someday plan for an ownership transition. This statement applies to most family-owned businesses. And, this statement generally applies to most private companies or professional practices, whether or not they are closely held by family members.

The current company or practice manager/owners eventually want to retire. And, eventually, all manager/owners face the inevitable end of life.

Many owners of successful private companies or professional practices consider an initial public offering of the company stock as a potential exit strategy.

Other owners may consider the sale of the company or the practice to a strategic competitor, a sale to a private equity sponsor, a sale through a roll-up transaction involving several companies, a sale to the company's nonowner management team, or a sale to the general employees through an employee stock ownership plan ("ESOP") or other structure.

"Typically, an ESOP can own an S corporation. However, many ESOP acquisitions involve multiple classes of equity."

Even those business owners who are planning to "keep the company in the family" are de facto considering an ownership transition transaction. Such an ownership transfer to the next generation could be accomplished by sale, gift, or bequest.

Implicitly or explicitly, analysts incorporate exit strategies (whether well-developed or amorphous) into their business valuation analyses. All generally accepted business valuation approaches and methods incorporate some type of residual value, reversionary value, or terminal value.

Such value components may be implicit in the analysis. But even the assumption that the subject company or practice will generate income forever implicitly assumes that, at some point, there will be a new owner to enjoy the benefit of that expected future income.

However, if the subject company or practice wants to retain its S corporation status, several typical ownership transition or exit strategies may not be available to it. For example, the S corporation cannot be a publicly traded company. Some private equity or other types of investors may not be interested in buying the S corporation (unless it converts to a C corporation first).

The same reluctance to purchase may be the case with a large C corporation strategic acquirer (whether it is public or private). The C corporation buyer cannot be an S corporation shareholder.

Other exit options may be available, but these options may be limited with respect to their implementation or structure.

Typically, an ESOP can own an S corporation. However, many ESOP acquisitions involve multiple classes of equity.

The company or practice employees may buy one class of stock through the ESOP trust. The company management may buy a different class of stock. Certain founding family members may retain a different class of stock—at least for a period of time.

However, such a more complex (but typical for an ESOP acquisition) capital structure would violate the one class of common stock restriction for the subject S corporation.

Again, one way or the other, the analyst may have to accommodate these exit strategy restrictions in the S corporation business valuation. And, the current business owners, the estate planners, and the tax counsel should consider these restrictions in their estate planning and/or wealth transfer deliberations.

The Inadvertent Disqualification of S Corporation Status

Most of the S corporation disqualification events relate to the limitations and restrictions summarized above. If the subject S corporation fails to maintain its status as a "small business corporation" under Section 1361(b), the S election automatically terminates on the date that the disqualifying event occurs.

Section 1361(b)(1) and Section 1362(d)(2) can be considered together to develop a list of disqualifying events that could unexpectedly terminate the company's S corporation status.

As explained further below, this risk of a disqualifying event can affect both the company itself and the company shareholders.

The most common of the S corporation disqualifying events include the following:

1. The company or practice has more than 100 shareholders at any time during the year. This event could happen to a company with a fairly large number of shareholders, particularly when shareholders are "coming and going" at various times during the year.

2. The company or practice has an ineligible shareholder. This event could happen when one of the current qualifying shareholders transfers the stock to a C corporation, partnership, ineligible trust, or nonresident alien.

   This event could happen, for instance, when a current qualifying shareholder experiences a divorce. The S corporation shares are allocated between the former spouses. A former spouse moves to Canada (or any other country) and remarries. Now, there may be a nonresident alien shareholder that the S corporation is totally unaware of.

3. The company or practice has more than one class of stock. Initially, this disqualification is easy to prevent. However, after many years of business operations, it is possible to forget this (and other) requirements.

   The disqualification event may be inadvertently triggered when one group of employee/shareholders—or one group of family/shareholders—receive some special profit sharing or similar consideration.

4. The company or practice becomes an “ineligible corporation.” For example, the subject company becomes a financial institution, an insurance company, or a DISC. This type of disqualifying conversion (or acquisition) should be relatively easy to spot—and to prevent.
5. The company or practice changes it place of incorporation to a foreign country (and no longer qualifies as a domestic corporation). Such a change of incorporation should be easy to spot—unless this S corporation requirement is simply overlooked.

Section 1362 provides all of the specific events that can cause a corporation to fail to qualify as a small business corporation. Filing the corporation’s tax return based on an improper tax year is not a Section 1362 disqualifying event, and such a filing may be forgiven by the Service (if corrected).

The S corporation should be careful not to trigger a disqualification if it dissolves and reincorporates, for whatever reason. However, the Service has issued private letter rulings allowing a corporation to keep its S corporation status when it was administratively dissolved by its state of incorporation. In these instances, the subject companies failed to file annual reports and pay annual license fees to the respective states.

In another private letter ruling, a state administratively dissolved an S corporation. The state later reinstated the corporation, and the company obtained a new employer identification number (“EIN”).

The Service ruled that the administrative dissolution did not disqualify the S corporation status. However, because of the new EIN, the Service did make the corporation file a new Form 2553 Election by a Small Business Corporation.

The above-listed S corporation disqualifying events, while typical, are pretty easy to identify—and to prevent.

Some other S corporation disqualifying events are more rare, but they are also easy to miss. Some examples include the following events:

1. Say the successor beneficiary of a qualified subchapter S trust (“QSST”) refuses to consent to the original QSST election. Such a refusal would mean that the QSST is no longer a qualifying S corporation shareholder—and the S election is disqualified.
2. Say the subject S corporation stock is pledged as collateral for a shareholder’s personal loan. The shareholder defaults on the loan. The S corporation stock collateral is foreclosed by the financial institution creditor. That financial institution is an ineligible shareholder—and the S election is disqualified.
3. Say the subject S corporation has accumulated earnings and profits (“AE&P”) and receives more than 25 percent of its gross receipts from passive income for three years in a row. That passive income will disqualify the S election.
4. Say an S corporation shareholder dies, and the shareholder’s estate holds on to the shares for more than two years. The estate’s prolonged stock ownership will disqualify the S election.

Analysts (and other professionals) should be aware that the U.S. Tax Court has ruled that Section 1362(d) does not provide an exhaustive list of all of the S corporation disqualifying events.

For example, the *Farmers Gin* decision[1] relates to an S corporation that inadvertently terminated its S election. In the *Farmers Gin* decision, the company did not adopt a permitted tax year after business conditions changed so that its previously permitted tax year was no longer allowable.

The point is, as mentioned above, the use of an unpermitted tax year is not a disqualifying event that is specified in Section 1362.

Events, obvious or otherwise, that can cause an inadvertent disqualification of a company’s S election represents a risk associated with S corporation ownership. In fact, such an inadvertent S status disqualification represents a risk both to the S corporation and to the company’s shareholders.

As with any other business risk, the analyst should consider this risk of inadvertent S election disqualification in the S corporation business valuation.

If the company or practice deliberately or unintentionally experiences an S election disqualifying event, the Service can withdraw the company’s S corporation status. In some cases, the Service may require the company or professional practice to pay back taxes, at the C corporation income tax rate, for the three years prior to the S status revocation.

In addition, such a company or practice would have to wait another five years to reapply for S corporation income tax status.

Considerations when the S Corporation Shareholder Dies

The death of an S corporation shareholder can create tax complications for the TPE. One of the complications—and one of the risks of S corporation stock ownership—is an inadvertent termination of the company’s S corporation status.

There may also be tax complications related to the decedent shareholder's estate. Many of the more typical complications are summarized below.

Analysts—and S corporation shareholders—should consider the impact of these potential tax complications on the value of the subject S corporation ownership interest.

Reporting S Corporation Income and Loss in the Year of Death

In an S corporation, a shareholder's pro rata share of the company's income and loss is typically determined by allocating equal portions to each day of the year. Then, the company allocates income and loss to each shareholder based on the number of shares outstanding on each day.

This income and loss allocation procedure is described in Section 1377(a)(1).

In the year when the shareholder's S corporation ownership interest terminates, such as upon the shareholder's death, the S corporation can elect (under Section 1377(a)(2) and Regulations Section 1.1377-1(b)) to implement an interim closing of the company's books.

That is, the TPE company or practice can elect to treat the S corporation's tax year as two separate tax years for income allocation purposes. All affected company or practice shareholders and the S corporation itself have to consent to this election.

Such a separate tax year election may or may not benefit the S corporation shareholders. Due to accounting and tax return preparation fees, the interim closing of the company books may be costly to complete. But making the election may be beneficial, particularly in situations where extraordinary items occur either before or after the shareholder's death.

For example, let's assume the subject S corporation generates a large gain predeath. In that case, the ultimate beneficiaries of the shares may prefer that the decedent pay his or her full share of tax on that item in contrast to burdening the beneficiaries with a portion of the gain (and the related tax).

If the decedent's estate is subject to estate tax, then the payment of tax on the S corporation gain reported on the decedent's final income tax return will reduce the estate tax liability.

When such a situation occurs, the decedent's beneficiaries—and the company itself—will have to carefully analyze the pros and cons of this tax election.

The Inadvertent Termination of the S Election

The failure of the corporation and the successor shareholders to consider all of the implications to the corporation's S tax status after a shareholder's death is a typical cause of the inadvertent termination.

In many cases, the successor shareholder, whether that shareholder be the estate, a testamentary trust, or a beneficiary, may not recognize that it needs to take certain steps to remain a qualified shareholder.

These steps are generally described in Section 1361(b)(1)(B) and Section 1361(c)(2)(A) and in Regulations Section 1361-1(h)(1).

By the time the S corporation or the new company shareholder recognizes, for example, that a qualified Subchapter S trust or electing small business trust election has been overlooked, there may be an S termination event triggered.

In many cases, the S corporation itself may not be aware of what its shareholders are doing at the time of the shareholder death. The S corporation generally has no visibility into the estate plans of its various shareholders.

That is, the company or practice itself is generally unaware of who will get shares upon the shareholders' death, and whether those parties are timely making the needed elections.

In many cases, the S corporation may be unaware that one of its shareholders has died. This means that the company's S election can terminate before the TPE is even aware of the event that triggered the S termination.

Such termination events are generally described in Section 1362(d)(2) and Regulations Section 1.1362-4(b).

Let's consider an illustrative scenario. Let's assume a particular decedent owned the S corporation shares in a revocable trust during his or her life. Upon death, the revocable trust becomes an irrevocable trust, with its own income tax filing requirement.

During the first tax year, let's assume that the executor/trustee makes a timely Section 645 election to treat the trust as part of the estate. This election allows the executor/trustee to file one income tax return. That tax return reports the combined activity of the estate and of the qualified revocable trust.

This trust may or may not need to make an S election.

The need to make an election depends on what happens with those S corporation shares—and when it happens. If the S corporation shares are immediately transferred to another trust, then an election may be due within 2-1/2 months of that transfer.[2]

Alternatively, if the S corporation shares are retained for the maximum duration of the Section 645 period, then an S election may not be due for more than four years. This provision is described in Regulations Section 1.1361-1(h)(1)(iv).

The takeaway is that any time an S corporation shareholder dies, the parties should pay immediate attention to the decedent's plan with respect to:

1. the transfer of the TPE shares and
2. any potential need for, and timing of, required elections.

It is noteworthy that Revenue Procedure 2013-30 may provide automatic relief for taxpayers to make a late S election in these types of scenarios. But the window for relief under this revenue procedure closes three years and 75 days after the election's intended effective date.

The latest intended effective date for an irrevocable grantor trust is two years after the death of a grantor. That window may possibly provide additional time to make the S election.

However, the risk is that these types of required S election oversights may not be discovered until many years later. Such a late stage discovery can trigger the need to seek uncertain relief via a private letter ruling.

S Corporation Gain on the Sale of Assets and Step-Up in the Basis of Shareholder's Shares

A partnership TPE can take advantage of a Section 754 election to help a successor partner equalize his or her inside and outside basis. However, an S corporation has no similar option.

When an S corporation shareholder dies, the decedent's TPE shares basis is stepped up to fair market value.[3] However, there is no adjustment to the inside basis of the S corporation's assets.

As a consequence, the benefit of the step-up may be deferred until the successor S corporation shareholder disposes of his or her stock. This deferral can create a potential trap for the successor shareholders.

Let's consider what would happen if, at a later date, there is a sale of substantially all of the S corporation's assets. Let's assume that the S corporation shareholder does not liquidate his or her interest in that same year.

In our illustrative example, let's assume that an S corporation has an inside net basis of $10 million. That S corporation is owned by shareholders with an outside basis of $50 million (perhaps due to a step-up in basis upon a previous shareholder's death).

If the S corporation sells all of its assets, then $40 million of gain will be triggered. This gain will pass through to the shareholders and increase the S corporation stock basis.

If the shareholders fail to liquidate their ownership interests in that same tax year, the step-up basis will not shield the $40 million of gain. Instead, the loss that will likely occur upon liquidation would be deferred. And, the loss may be deferred to a year when the shareholders have no offsetting gains.

This deferral will trap the loss and defer the related tax benefit until the shareholders can trigger other gains (assuming that is even possible).

A successor S corporation shareholder should be aware of this type of trap. The shareholder should plan to time the recognition of any losses so they occur in the same tax year in which the gain from the S corporation asset sale is reported.

Buy-Sell Agreements and Shareholder Life Insurance

A buy-sell agreement is typically an agreement between:

1. the S corporation shareholders or
2. the S corporation shareholders and the corporation itself.

The agreement specifies the terms of the events, such as the death of the shareholder that will trigger the required transfer of the corporation share.

A buy-sell agreement is important in the case of any privately owned company or professional practice. Such an agreement is particularly important in the case of an S corporation because it can help provide assurance as to how shares will transfer from a deceased shareholder.

Such a buy-sell agreement can help prevent transfers that may otherwise trigger an inadvertent termination of the corporation's S tax status.

Life insurance on the shareholder is the typical means to provide the necessary liquidity to fund these buy/sell transactions. Such life insurance policies are typically owned either:

1. by the S corporation itself or
2. by its shareholders.

The appropriate ownership of the life insurance policies often depends on the structure of the buy-sell agreement.

Buy-sell agreements are typically structured in one of two ways:

1. As a redemption agreement
2. As a cross-purchase agreement

With a redemption agreement, the S corporation has the right (or the obligation) to purchase TPE shares of the deceased shareholder. A cross-purchase agreement gives the other company shareholders the option (or the obligation) to purchase the TPE shares of the deceased shareholder.

The ultimate ownership consequences of a cross-purchase agreement versus a redemption agreement may not differ significantly. But the agreement parties can encounter difficulties if the ownership of the life insurance policies is not in line with the provisions of the buy-sell agreement.

When the buy-sell agreement calls for the S corporation to redeem the deceased shareholder's shares, then the company should typically own and be the beneficiary of the life insurance policy.

Alternatively, if the buy-sell agreement is structured as a cross-purchase, then the shareholders typically should own and be the beneficiaries of the life insurance policies.

Taxpayers who fail to coordinate the ownership of the insurance policies with the terms of the buy-sell agreement can create unnecessary tax problems both for themselves and for the corporation.

Suspended Passive Losses upon Death

Upon the shareholder's death, special rules will apply to suspended passive losses arising from the TPE interest owned at death. The unused losses are allowed as a deduction on the decedent's final personal income tax return.

These unused losses are only allowed to the extent these losses are in excess of the difference between:

1. the basis of the ownership interest in the transferee's hands in excess of
2. the adjusted basis of the ownership interest immediately before the death of the taxpayer.

These rules are also provided in Section 469(g)(2)(A).

This "difference" in basis is typically referred to as the step-up or step-down upon death of the basis of an asset to its fair market value. The rules are provided in Section 1014.

This provision means that effectively to the extent of the basis step-up, suspended passive losses will be permanently disallowed. Those unused passive losses do not carry forward to the decedent's estate, trust, or its beneficiaries.

The rules are provided in Section 469(g)(2)(A). Losses in excess of the basis step-up are allowed on the decedent's final tax return. If there is no basis step-up (for example, because the value of the ownership interest has decreased), then the suspended losses are fully deductible on the decedent's final income tax return.

Suspended Losses Due to Lack of Regular Tax Basis upon Death

Suspended losses due to a lack of regular tax basis will disappear upon the transfer at death from the decedent to his or her estate, trust, and beneficiaries.

Suspended Losses Due to Lack of At-Risk Basis upon Death

Unused at-risk losses will also not carry forward to the decedent's estate, trust, and beneficiaries. Instead, these amounts are added to the tax basis of the ownership interest in the hands of the recipient.

However, because this addition occurs prior to the basis adjustment under Section 1014, there is no net change in the tax basis.

Estate Planning Procedures

There are various planning procedures that can be implemented for older S corporation shareholders. For example, the older S corporation shareholder should consider selling the ownership interest with the suspended losses.

Such a sale would be beneficial if the benefit of triggering the carryovers exceeds any gain on the ownership interest.

State Taxation of the S Corporation

Analysts—and S corporation shareholders—should be aware that many states apply some form of TPE income tax on S corporations. Such a state income tax should not be ignored in the valuation of the S corporation or of the S corporation ownership interest.

Currently, over half of the 50 states impose some form of income tax on a TPE.

Some states impose the regular C corporation income tax rate on the TPE. Effectively, these states ignore the company's S corporation status for state income tax purposes.

Many states impose a reduced corporation income tax rate (for example, a flat 1 percent state income tax rate) on the TPE. While such a reduced income tax rate is advantageous in comparison to the C corporation tax rate, any valuation analysis should recognize that the TPE is still subject to some income tax liability.

In addition, the valuation may consider the possibility that states in which the subject S corporation operates may:

1. impose a de novo income tax on the TPE or
2. increase a currently reduced TPE income tax rate to a higher income tax rate.

In other words, the valuation should recognize the risk that the S corporation may be subject to a greater state income tax liability in the future.

It is also noteworthy that many states require the company to elect TPE status in that state. In other words, state TPE status may not be automatically achieved when the company files a federal S corporation election.

Such states have their own election, periodic filing, and shareholder qualification requirements. Therefore, in some states, there is the risk that the S corporation could inadvertently terminate its state S tax status—even if it does not terminate its federal S tax status.

The takeaway is that analysts—and shareholders and other professionals—should not ignore state income tax considerations in any analysis of an S corporation or other form of TPE.

Summary and Conclusion

Valuation analysts are regularly retained to value S corporations and S corporation ownership interests for gift tax, estate tax, and other transfer tax purposes. In addition, analysts may also be asked to value S corporation ownership interests for income tax, financial accounting, personal financial planning, litigation, and many other purposes.

The TPE economic benefits of S corporation status are generally well known to analysts—and to S corporation shareholders, estate planners, tax counsel, and other professionals.

Over the years, analysts have developed generally accepted methods and procedures for incorporating the value increment (often called a value premium) associated with these TPE benefits into the valuation analysis.

There are risks as well as benefits associated with the S corporation tax status. This discussion summarized many of the typical risks associated with S corporation tax status.

Many of these risks relate to an inadvertent disqualification and termination of the S status. These risks typically affect both (1) the S corporation itself and (2) the company or practice shareholders.

Some of these risks are specific to the transfer of S corporation ownership interests at the time of the shareholder's death. Even these shareholder-death-related risks can affect the S corporation as well as the deceased shareholder's estate.

There are statutory restrictions and limitations on the type of—and the number of—S corporation shareholders. These restrictions may affect the discount for lack of marketability—or other valuation adjustment—related to the S corporation stock. Such restrictions may also affect the owners' retirement exit planning, and ownership transaction strategies.

"[T]he valuation should recognize the risk that the S corporation may be subject to a greater state income tax liability in the future."

These restrictions may have an impact on the company or practice liquidity—or other value adjustment—related to the S corporation business enterprise.

And, analysts should recognize that S corporations are subject to a state-level TPE income tax in many states. Some states apply the regular corporation tax rate to the TPE. Some states apply a reduced income tax rate to the TPE.

Nonetheless, analysts—and other interested parties—should not ignore state income tax considerations in the valuation of an S corporation.

The takeaway of this discussion is that analysts—and shareholders, estate planners, tax counsel, and other professionals—should be aware of the risks and restrictions associated with an S corporation ownership interest.

Analysts should incorporate these negative considerations (either quantitatively or qualitatively) in the S corporation valuation developed for transfer tax planning, compliance, or controversy purposes.

And, analysts—and other interested parties—should also incorporate these risk and restriction considerations in the S corporation valuation developed for transaction pricing, financing collateral analysis, personal financial planning, financial accounting, litigation, or any other purpose.

Notes:

1. Farmers Gin, Inc. v. Commissioner, T.C. Memo 1995-25.
2. See Sections 1361(c)(3) and Regulation Sections 1361-1(j)(6) and 1.1361-1(m)(2).
3. See Internal Revenue Code Section 1014(a)(1).

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