# BASIS PLANNING FOLLOWING THE DEATH OF AN S CORPORATION SHAREHOLDER

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**Decedent's estates frequently** include interests in closely held businesses taxed as partnerships or S corporations. As a general matter, any assets included in a decedent's estate for federal estate tax purposes will be subject to a basis adjustment under §1014. The §1014 basis adjustment applies to the partnership interests and S corporation stock owned by a decedent (the basis in the partnership interests and/or S corporation stock is commonly referred to as the "outside basis"), but not to the assets owned by the partnership or S corporation (the entity's basis in its assets is commonly referred to as the "inside basis").

Subchapter K of the Code provides entities taxed as partnerships with a statutory mechanism under §754 and §743 to adjust the inside basis in partnership assets in connection with a partner's death. More specifically, a §754 election allows a partnership to adjust the inside basis of partnership assets to the extent an estate's outside basis (which is adjusted to equal fair market value under §1014) exceeds the estate's proportionate share of the partnership's inside basis.[1] In short, the goal of §754 is to achieve uniformity between the estate's outside basis and the estate's share of the inside basis following the death of a partner.[2]

Unfortunately, for S corporations and their shareholders, Subchapter S does not contain a provision similar to §754 with respect to assets held by an S corporation. In certain situations, however, there may be an opportunity to obtain a tax-free basis adjustment for the assets held by an S corporation by going through the mechanics of a liquidation.

## Mechanics of S Corp Liquidations With Appreciated Assets

As a preliminary matter, there are two fundamental concepts underlying the planning strategy discussed herein: the first is the effect of §1014 on the outside basis of S corporation stock following the death of a shareholder; the second is the income tax consequence of distributing appreciated property from an S corporation to its shareholders.

## §1014 Basis Adjustment for S Corp Stock

As noted above, generally under §1014, the tax basis of a decedent's property is adjusted to be equal to the fair market value of such property at the time of the decedent's death. For S corporation stock specifically, the outside basis in the stock that was owned by a deceased shareholder will be adjusted to be equal to its fair market value at the time of the shareholder's death.[3] However, §1014 will have no effect on the inside basis of the S corporation's assets.

## Distribution of Appreciated S Corp Assets

For S corporations not subject to the built-in gains tax under §1374,[4] a non-liquidating distribution of appreciated assets triggers gain in the same manner as if the assets had been sold. Any such gain would be passed through to the shareholders under the normal Subchapter S rules,[5] which causes each shareholder's outside basis in his/her stock to increase to the extent of his/her proportionate share of such gain.[6]

Similarly, when an S corporation liquidates, the S corporation generally recognizes gain or loss on the distribution of its assets, equal to the difference between the fair market value of each asset and the corresponding tax basis of such asset, and such gain is passed through to the shareholders under the normal Subchapter S rules.[7] In a liquidation transaction, the shareholders surrender their stock in exchange for the assets of the S corporation; each shareholder will recognize gain (or loss) to the extent the fair market value of the assets received from the S corporation is greater than (or less than) the shareholder's outside basis in his/her S corporation stock. Thus, a liquidation of an S corporation has two effects on the shareholders' individual tax returns: (1) a gain (or loss) passes through to the shareholders in connection with the distribution of the S corporation's assets, thereby increasing (or decreasing) each shareholder's outside basis in his/her S corporation stock; and (2) a separate gain (or loss) is recognized by each shareholder on the sale of S corporation stock to the extent the assets received in exchange for the stock have a value greater (or less) than the shareholder's outside basis in the stock.

By way of example, assume an S corporation entirely owned by a decedent's estate owns assets (all of which are capital assets) with a fair market value of $2,500,000 and an inside basis of $2,000,000. When such assets are distributed to the shareholder's estate, $500,000 of long-term capital gain must be recognized by the estate. Thus, following such distribution, the estate's outside basis in the S corporation will increase by $500,000 from $2,500,000 (which corresponds to the fair market value of the S corporation's assets) to $3,000,000. In liquidation of the S corporation, the estate surrenders its stock having an outside basis of $3,000,000 in exchange for assets having a value of $2,500,000, thus triggering a capital loss of $500,000. Thus, the $500,000 gain and the $500,000 loss realized in connection with the liquidation will offset, leaving the estate with an adjusted basis in the S corporation's assets without triggering additional income tax. This example can be further illustrated as follows:

### Example

| | |
|---|---|
| FMV Assets Distributed in Liquidation | $2.5M |
| Inside Basis of Assets | $2.0M |
| Shareholder Gain on K-1 | $500K |
| Estate's Outside Basis | $2.5M |
| Shareholder Gain on K-1 | $500K |
| Estate's Outside Basis After Distribution | $3.0M |
| FMV Assets Distributed in Liquidation | $2.5M |
| Estate's Outside Basis After Distribution | ($3.0M) |
| Loss on Liquidation | ($500K) |
| Long-term Capital Gain on K-1 | $500K |
| Long-term Capital Loss on Liquidation | ($500K) |
| Net long-term capital gain (loss) | $ 0 |

### Other Considerations and Challenges

Depending on the nature of the S corporation assets distributed in liquidation, the income may be characterized as capital or ordinary. To the extent such income is characterized as ordinary, such income would not be offset by the capital loss recognized on liquidation. Instances where the income recognized in connection with the distribution of assets from an S corporation may be characterized as ordinary include those where: an asset is simply not a capital asset, such as inventory or accounts receivable; a taxpayer previously sold depreciable property and took an ordinary loss under §1231; §1239 is applicable to a distribution of depreciable property; and depreciation deductions taken on personal property must be recaptured under §1245. The tax cost resulting from the mismatch occurring as a result of these rules (i.e., the recognition of ordinary income on distribution and a capital loss on liquidation) may be partially offset by virtue of §199A, which does apply to ordinary income items but not capital gain.

In addition to the above, state and local income tax consequences should be considered, particularly when the S corporation has taxable income in multiple jurisdictions. In those instances, the gain resulting from the distribution of certain assets may be subject to tax in multiple jurisdictions, whereas the loss resulting from the disposition of a shareholder's stock would likely be recognized only in the domicile of the shareholder (as the disposition of stock would be taxed as a disposition of intangible personal property).

Finally, in those instances when a deceased shareholder's estate is not the sole shareholder, the estate should consider the tax consequences of a liquidation to the other shareholders and the fiduciary duties owed to the other shareholders, not all of whom may have outside bases exceeding their proportionate share of the S corporation's inside basis.

### Conclusion

While S corporations do not have a statutory mechanism similar to §754, it is possible to replicate the same effect by liquidating an S corporation when a shareholder's outside basis exceeds the shareholder's proportionate share of the S corporation's inside basis. While there are several considerations and challenges presented by this strategy, there are many instances where it could be very beneficial, including most notably following the death of a sole shareholder. ◀

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[1] *Note that a § 754 election can have the opposite effect as well, causing a downward adjustment in basis.*

[2] *Note that a § 754 election can also be made when there has been a transfer of a partnership interest by sale or exchange.*

[3] *IRC §§ 331, 1001(a).*

[4] *The built-in gains (BIG) tax is applicable to an S corporation that was previously taxed as a C corporation.*

[5] *IRC § 1366(a).*

[6] *IRC §§ 1367(a)(1), (b)(2)(B).*

[7] *IRC §§ 1371(a)(1), 336.*