S Corp Redemptions: Characterization, Tax Consequences Post-Tax Reform, Application of Sections 302 and 301
Sale or Exchange vs. Distribution, Evaluating Conversion to a C Corp, Available Tax Planning Techniques

WEDNESDAY, DECEMBER 19, 2018
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S CORPORATION REDEMPTIONS: CHARACTERIZATION, TAX CONSEQUENCES POST TAX REFORM
APPLICATION OF SECTIONS 302 AND 301

GENERAL TAX REDEMPTION PRINCIPLES

DECEMBER 19, 2018

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I. S Corporation Redemptions and the impact of Tax Reform

II. Stock Redemptions Under Section 302: Application, Tax Consequences, Exceptions

III. Section 301 and Tax Consequences of Failing to Qualify Under Section 302

IV. Best Practices and Tax Planning Techniques in Structuring a Redemption

V. Converting to a C Corporation: Key Considerations and Potential Tax Traps
OVERVIEW OF TAX STOCK REDEMPTION RULES

- **Section 317 (b)** – Definition of a Redemption for Tax Purposes – stock acquired by the corporate issuer from a shareholder in exchange for property (including cash), whether or not the stock so acquired is cancelled, retired, or held as treasury stock

- **Section 302** – Distributions in Redemption of Stock – sale or exchange treatment vs. distribution treatment

- **Section 301** – Distributions of property, including cash, existence of earnings and profits for tax purposes

- **Section 316** – Definition of a dividend for tax purposes
OVERVIEW OF TAX STOCK REDEMPTION RULES (CONT)

- **Section 311** – Impact on the Corporation on a redemption
- **Section 312** – Impact of a redemption on a Corporation’s earnings and profits
- **Section 318** – Application of stock ownership attribution rules on redemptions – constructive ownership of stock
WHAT ARE THE STAKES?
APPLICATION OF THE CONSTRUCTIVE OWNERSHIP RULES UNDER SECTION 318

Between members of a family (spouse, children, grandchildren and parents)

Attribution from partnerships, estates, trusts, and corporations

Attribution to partnerships, estates, trusts, and corporations

Treatment of Options

General Operating Rules (double attribution required in certain circumstances)
SECTION 302(B)(1) REDEMPTIONS

- Meaningful reduction in interest
- Focus on reductions in:
  - Right to vote and thereby exercise control
  - Right to participate in current and accumulated earnings
  - Right to share in net assets on liquidation
- Issues involving different classes of stock
- Public vs. private corporation redemptions
SECTION 302(B)(2) REDEMPTIONS

- Substantially disproportionate redemptions – a mechanical test

- Shareholder’s percentage ownership of outstanding voting stock (as well as percentage of common stock – both voting and non-voting) is reduced immediately after the redemption to less than 80% of his/her percentage ownership immediately before the redemption, AND the shareholder owns after the redemption less than 50% of the total combined voting power of all classes of stock entitled to vote

- Must take into account related in time redemptions in applying 80% and 50% tests
SECTION 302(B)(3) REDEMPTIONS

- Redemptions resulting in a complete termination of interest
- Section 302(c)(2) – Possible to waive family attribution rule (but not other attribution rules)
- “No continued interest in the Corporation” requirement under family waiver rules
SECTION 304 RULES

- Redemptions through use of related corporations
- Sales to brother-sister corporations and parent-subsidiary corporations
- Tested under modified Section 302 Redemption rules
S Corporation Redemptions: Characterization, Tax Consequences

December 19, 2018
David M. Czarnecki
Member, Morse Barnes-Brown Pendleton
• Generally, no E&P for S-Corporations
  – Section 1371(c)
• S-Corporation may have accumulated E&P from either:
  – Former C-Corporation status; or
  – Reorganizations involving another corporation with E&P
Distributions – No E&P

- Distributions for S-Corp with no E&P:
  - Non-taxable to extent of stock basis
    - Section 1368(b)(1)
  - To extent exceeds basis, taxable as gain from sale or exchange of property (generally capital gain)
    - Section 1368(b)(2)
• The AAA Account – Section 1368(e)
  – Measures S-Corporation’s ability to make distributions on a tax free basis.
    • Generally consists of net income/loss from all S-Corp years less any distributions sourced from AAA.
  – Practically speaking, matters only in certain circumstances, including:
    • If S-Corp has E&P
    • If S-Corp converts into C-Corp
Distributions from Corp. with E&P

• Distributions from AAA follow “basic” rule:
  – Tax free to extent of basis; and
  – Thereafter, gain from sale or exchange.
    • Section 1368(c)(1)

• Distributions in excess of AAA:
  – Taxable as dividend to extent of E&P (Section 1368(c)(2))
  – Thereafter, gain from sale or exchange. (Section 1368(c)(3))

• Can elect to distribute E&P prior to distributions of AAA (Section 1368(e)(3))
  – Requires consent of each shareholder to whom a distribution is made during the taxable year.
• Reg. 1.1368-3, Example 4:
  – Accumulated E&P: $1,000
  – Accumulated AAA: $2,000 as of January 1, 2001
  – Sole stockholder:
    • 100 shares, basis of $20/share as of Jan 1, 2001 ($2,000 aggregate basis)
  – April 1: $1,500 distribution to sole shareholder
  – Jan – April 1 Net Earnings: $500
Example (continued)

• Step 1: Allocate earnings for year to date of distribution:
  – AAA and basis in stock are each increased by $500 to $2,500

• Step 2: Adjust for distribution
  – AAA and basis in stock are each decreased by $1500
• Distributions can be made on a tax free basis during the post-termination transition period (Section 1371(e))
  – Cash only
  – Within specified window
  – Only to extent of AAA balance
Redemptions

• Shareholder
  – Capital gain/loss for proceeds less basis
    • Loss subject to certain limitations (267(a))

• Corporation
  – No gain/loss on redemption
    • (but may have gain/loss from distribution of property)
  – Adjust AAA account ratably (Section 1368(e)(1)(B))
  – Also adjust E&P ratably (Section 312(n)(7))
Comparison – Use of Basis

• Redemptions:
  – Gain/loss determined by basis of shares redeemed

• Distributions:
  – Stockholder can use basis in all shares, to the extent of AAA
Comparison – Effect on AAA/E&P

• Redemption
  – Pro-rata reduction of AAA and E&P
• Distribution
  – Redemption reduces AAA to extent of distribution
  – Can elect to allocate to E&P first
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With over 15 years of extensive transactional experience, Dave is exceptionally proficient in guiding clients through a wide range of transactions, including mergers and acquisitions, private equity transactions, venture capital financings, joint ventures, and entity formations.

Dave's experience also includes a strong background in taxation and finance, which allows him to bring an uncommon perspective to structuring transactions from both a tax and an economic perspective.

From start-up venture through ultimate exit, Dave's practice includes a special emphasis on advising companies on a wide range of legal matters, including formation, taxation, capitalization, equity incentive plans, employee compensation, corporate governance, and securities issuances.