
Inheriting or purchasing S corporation stock

TAX: Anticipation of the issue can save taxpayers from phantom gain.

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Guest Contributor

Did your client die with S corporation stock that has appreciated in value or purchase S corporation stock for more than the S corporation's basis in the assets? If so, it's never too early to talk about one major issue: phantom gain.

Background

Joe and Mary Smith bought an apartment house 25 years ago in an S corporation. The basis of the apartment in the S corporation is \$2 million, but it is worth \$5 million. On Joe's death, the S corporation stock is valued at \$5 million. If Mary inherits Joe's half-interest, her basis in the corporation's stock would be \$5 million — the fair market value of the S corporation, assuming it is community property. The problem is that the S corporation continues to own an apartment with a \$2 million basis. Only the basis of the stock is increased to fair market value.

If the apartment is sold, the S corporation and its shareholder will report the gain of \$3 million (\$5 million less the corporation's basis of \$2 million). If the Smiths had owned the property in their own names, Mary would have received a stepped-up basis and no gain would be reported (\$5 million sale less \$5 million fair market value basis). Similarly, if the apartment were in a partnership or LLC, Mary could have received a stepped-up basis in the apartment (even if the Smiths didn't own 100% of the partnership) if the partnership made an IRC §754 election. That election allows the partners to adjust their inside basis in the apartment in the hands of the partnership to account for the difference between the inside basis of \$2 million and the outside basis \$5 million. When the property is sold, no gain or loss would be reported by the partner.

Unfortunately, the stepped-up basis that applies to direct ownership or ownership through a partnership is not available if the property is owned through an S corporation. In that case, the basis increase only applies to the stock, just as if the stock were publicly traded. Even though it might not make sense, §754 only applies to partnerships; it doesn't apply to S corporations.

If the S corporation sells the apartment soon after Joe's death, the results can be disastrous unless a solution can be found. Suppose the building is sold three months after Joe's death for \$5 million. The S corporation and Mary report the \$3 million gain. The effect is to raise her basis in the stock from \$5 million (date of death value) to \$8 million (increased by \$3 million for the passthrough of the gain). Several years later, when the corporation is liquidated and Mary receives a liquidating distribution of \$5 million, she will be entitled to a \$3 million

long-term capital loss, which she can claim at a rate of \$3,000 per year for the following 1,000 years or when she dies, whichever comes first. Of course, she could also use it if she has any capital gains. Unless something is done, Mary will effectively report \$3 million of phantom income because the apartment was owned in an S corporation rather than outright or in a partnership.

Liquidating the business

Sometimes there is a solution that can be used when, due to the sale of the assets, the corporation no longer has a reason to continue as a trade or business. In that case, liquidating the business in the same year as the sale of assets results in a capital loss that can offset most or all of the phantom capital gain. This only works if the liquidation is in the same tax year as the sale and if the character of the loss is the same as the character of the gain on the sale. If, in the above example, the sale and liquidation occur in the same year, then the K-1 will report the \$3 million §1231 gain, and the shareholder will also report a \$3 million long-term capital loss. The result is that the gain and the loss offset.

This may not be as easy to accomplish as it seems. The reason is that estate administration takes time. A newly appointed executor, administrator, or trustee may not realize this issue exists and may not consult with their tax advisor when they get an offer of \$5 million for the building.

Even if the owner is aware of the problem, there may be reasons why the corporation cannot be liquidated in the year of sale. This is the case when the building is only a small part of the overall business or if there are multiple shareholders who may not want to liquidate the corporation.

In addition, some of the gain may be ordinary gain. For example, this would be the case if the corporation had made a §179 election in the prior year to expense \$250,000 of §1245 property. The sale would result in \$250,000 of ordinary income and \$2.75 million of capital gain. In this situation, at least by liquidating in the same year, the net taxable income and comparable capital loss would only be \$250,000.

When there are other operations in the corporation, the liquidation of an S corporation results in a deemed sale of all the assets at fair market value. This has the effect of accelerating any unrealized gain. This is probably not a major tax problem if the gain is capital gain and if there is a sole shareholder who would have a comparable capital loss due to the liquidation. The same cannot be said if other shareholders (even other family members) own a substantial portion of the stock, as they would not have a comparable capital loss. They will have phantom gain.

In an ideal world, someone who inherits S corporation stock can avoid the phantom gain problem by selling the stock to a buyer who pays the full fair market value, thus transferring the problem to the buyer. The next best option is that they sell the corporate assets and liquidate the corporation within the same tax year. Either way, it is important that they are informed of the problem in advance of a sale. Who wants to tell their client one year that they have a \$3 million gain and the next year they have a \$2,997,000 capital loss carryover because they didn't liquidate the company a few months earlier? Not me.

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