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# **S Corp Redemptions: Characterization, Tax Consequences, Application of Sections 302 and 301**

Sale or Exchange vs. Distribution, Evaluating Conversion to a C Corp, Available Tax Planning Techniques

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THURSDAY, MAY 14, 2020

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

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Today's faculty features:

John P. Barrie, Partner, Bryan Cave Leighton Paisner, New York

David M. Czarnecki, Member, Morse Barnes-Brown & Pendleton, Boston

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# S Corporation Redemptions: Characterization, Tax Consequences

May 14, 2020  
David M. Czarnecki  
Member, Morse



## Redemptions - Characterization

- Redemptions
  - May be respected as a redemption (i.e., a sale of stock) and taxable under Section 302; or
  - May be treated as a distribution with respect to stock under Section 301
    - If treated as a distribution, may be treated either as a dividend distribution or a non-dividend distribution



## Distributions - Generally

- Distributions: Dividend vs. Non-Dividend Distributions.
  - Generally, distributions will be treated as dividends if paid out of the Earnings & Profits of the Corporation - Section 316(a)
  - Dividends are taxable to shareholders at the applicable dividend rate - Section 301(c)(1)
  - Non-dividend distributions are treated as first, a return of capital (i.e., as an offset of any basis of the shareholder), and thereafter as gain from the sale of stock – Section 301(c)(2) and (3)



## Earnings & Profits - Generally

- Earnings & Profits
  - Generally, measures the ability of a corporation to pay dividends to its shareholders, without distributing any capital contributed by shareholders or creditors
    - Increased by net earnings of a corporation
    - Decreased by net losses and dividends



## Earnings & Profits – S Corporations

- Generally, no Earnings & Profits 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 – S-Corporations with 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)



## AAA Account

- 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.



## Distributions – Example

- 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





## Termination of S-Election

- 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 (i.e., if redeem 25% of outstanding stock, reduce AAA and E&P by 25%)
- Distribution
  - Redemption reduces AAA to extent of distribution
  - Can elect to allocate to E&P first



## Timing of Adjustments

- Generally, calculations of adjustments arising from distributions and redemptions are calculated at the end of the taxable year (1.1368-1)
  - Any net increase to the basis of stock is calculated prior to the adjustments arising from the distribution or redemption



## Timing – Election for Qualifying Disposition

- Election under 1.1368-1(g)(2) for “qualifying disposition”
  - Includes a redemption treated as an exchange under Section 302(a) or Section 303(a) of 20% or more of the outstanding stock over any 30 day period during the taxable year
  - Election allows corporation to treat the pre-disposition and post-disposition periods of the year as two separate taxable years
  - May allow for significant planning opportunities.



## Bio



### David M. Czarnecki

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As a corporate attorney and chair of the firm's tax practice, 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 and creating equity structures from both a tax and an economic perspective.

From start-up venture through ultimate exit, Dave's practice includes an 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.



**S CORPORATION REDEMPTIONS:  
CHARACTERIZATION , TAX CONSEQUENCES  
POST TAX REFORM  
APPLICATION OF SECTIONS 302 AND 301**

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**GENERAL TAX REDEMPTION PRINCIPLES**

**MAY 14, 2020**

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# PROGRAM OUTLINE – TOPICS TO BE COVERED

- I. **S Corporation Redemptions and the impact of Tax Cuts and Jobs Act of 2017 and CARES Act of 2020**
- 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?

# SECTION 302 STOCK REDEMPTION RULES

# 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-subsidary corporations**
- **Tested under modified Section 302 Redemption rules**