

**S CORPORATION STOCK REDEMPTION BUY-SELL
(INCLUDING DISABILITY)
(INCORPORATING THE SHORT TAX YEAR TECHNIQUE)**

TECHNICAL PREFACE

Life Insurance proceeds received by a C Corporation to fund a Stock Redemption do not increase the surviving shareholder's basis in the Corporation. However, life insurance proceeds received by an S Corporation to fund a Stock Redemption on the shares of a deceased shareholder do increase the basis of the survivors; stock owned by the deceased Stockholder's estate receives a step-up in basis equal to the stock's date-of-death value. How the survivors can receive a full step-up in basis in conjunction with an S corporation stock redemption is explained below.

SHORT TAX YEAR ELECTION:

First, the S Corporation should be a "cash basis" taxpayer. The "key" is then to provide for the following Redemption buy-sell sequence after death of a shareholder:

1. Corporation redeems deceased stock from the estate using an interest-bearing note.
2. Stockholders (including the consenting Personal Representative of the deceased Stockholder) file, on behalf of Corporation, an election, under IRC Sec. 1377 (a)(2), to terminate the Corporate tax year.
3. Corporation then files death claim, receives proceeds and pays deceased's estate full amount of note and interest.

The essential element in this sequence is that when the Corporation receives the death proceeds, the deceased's interest no longer exists, as it has been redeemed and retired. This leaves a full step-up to the Surviving Stockholders - exactly the goal we are seeking.

The Stock Redemption Agreement should require each Stockholder to modify existing wills (or to create new wills if none exist), mandating that the personal representative consents to continuing S Corporation elections and to otherwise comply with the procedures set forth above.

Note: A stock redemption plan for an S corporation that uses accrual accounting would use the same stock redemption agreement appropriate for a C corporation, e.g., one of the following that client's counsel believes to be appropriate: Corporation Stock Redemption Buy-Sell, Corporation Optional Stock Redemption Buy-Sell, or Corporation Optional Stock Redemption Buy-Sell with Trustee, all located in the Business Buy-Sell Plans section of InsMark's Documents On A Disk™ System (Versions 20.0 and higher).

The short tax-year technique that allows the surviving shareholders to receive a full step-up in basis applies only to S corporations using the cash method of accounting. However, even though the short tax year election is not useful to accrual method S corporations, unlike a C

corporation, there is still a partial step-up in basis for the surviving S corporation shareholders when the insurance proceeds accrue to the benefit of the S corporation at the insured's death. This is based upon the surviving shareholders' percentage ownership in the business.

INSURANCE AND PURCHASE PRICE:

This Agreement contemplates the Corporation's purchase of increasing death benefit key employee life insurance on the lives of all Stockholders, thereby avoiding multiple policies, fees, loads, minimum premium requirements, etc. The Agreement provides that corporate values are determined by adding the "Adjusted Book Value", "Goodwill", "Earning Capacity". (i.e., similar to the ARM-34 Formula, *infra*). Thus, corporate assets will be adjusted to reflect assets carried below market value and assets that have been depreciated below current market value. (Note: Under this approach, only policy cash values will be included in the purchase price valuation. This tends to equalize the disproportionate premiums represented by older, larger stockholders and eliminates the pure death proceeds from inflating the purchase price and Estate Tax values. Any formula used that does not take into consideration Adjusted Book Value before death should specifically eliminate death proceeds from the purchase price valuation.) The Purchase Price should be redetermined under the same procedure every one to two years. If the Stockholder dies or retires beyond the valuation period, the Corporation's Independent Appraiser is directed to reevaluate the Corporation using the procedure above.

The disability purchase price is to be determined by the Corporation's Independent Appraiser using the same valuation method as above, but at the expiration of the disability waiting period elected. To add certainty to the arrangement, the buy and sell obligations are mandatory, not optional. A "proportional" purchase automatically results in a stock redemption Agreement.

LIFETIME INSTALLMENT SALE TAX TREATMENT:

The Agreement should direct that life insurance cash values be used to fund the lifetime installment sale obligations. Generally, policy cash values can be tailored to fully fund an installment sale at retirement. On the other hand, the policy "disability waiver of premium" rider releases premium dollars upon disability as well as creating future cash value increases. These disability cash sources are a big assist in the disability buy-out particularly if complemented with individual disability income protection. Under either buy-sell obligation, the Corporation has the privilege of exercising policy loan or withdrawal rights to reach the cash values. An added benefit is that, in most instances, the remaining death benefits are sufficient to prepay any remaining installment balance if the Stockholder dies within the installment purchase period.

Installment Sale Tax Treatment (with the benefit of the mid-term capital gain rate) should continue to be available to the Stockholder where he receives at least one payment after the close of his taxable year. (IRC Sec. 453.)

KEY EMPLOYEE INSURANCE AND THE ACCUMULATED EARNINGS QUESTION:

S Corporations are exempt from the Accumulated Earnings Penalty Tax.

CORPORATE REDEMPTIONS AND SECTION 302, “INCOMPLETE REDEMPTIONS”; AND SECTION 318, “FAMILY ATTRIBUTION RULES”:

S Corporations are equally subject to the above two code sections, which are of particular concern in Family-Owned Corporations. On the other hand, if the redemption can be made to qualify, all of the codified exemptions are equally available.

SUICIDE CLAUSE:

A suicide clause should be included as one of the Agreement's final paragraphs. The Corporation might face a suit by a deceased Stockholder's heirs for specific performance of the Buy-Sell, despite the Insured Stockholder's self-inflicted death. In short, liability could attach when the “contestability clause” of the policy precludes the insurer from paying the full death proceeds.

To protect the Corporation, the clause provides that the Agreement is terminated and rescinded with respect to that Stockholder, if his/her death by suicide occurs within two years of the Agreement's execution.

Caution: In FSP FAS 150-3 issued on November 7, 2003, the Financial Accounting Standards Board extended indefinitely the effective date of FAS 150 for non-public businesses that are not required to be registered with the Securities and Exchange Commission (SEC). In FAS 150, the Financial Accounting Standards Board (FASB) would have required public and private businesses that use GAAP accounting to account for shares of stock or ownership interests subject to a mandatory redemption agreement by reducing the value of owner's equity on the balance sheet and listing the shares of stock or ownership interests as a liability by calling them “shares subject mandatory redemption.” This would have had the effect of reducing or eliminating the owner's equity account on the balance sheet and increasing the debt/obligations portion. This accounting requirement, which would have applied to privately owned companies for tax years beginning after December 15, 2003 and publicly traded companies for tax years beginning after June 5, 2003, would have had a negative effect on the use of mandatory stock or entity redemptions. Keep in mind that FAS 150 applies to public businesses and registered non-public businesses and is still under study by the FASB. It may yet resurface to affect all privately owned businesses. To avoid possible negative effects from FAS 150 on the business balance sheet, if it becomes the accepted guideline for unregistered non-public businesses, companies with mandatory stock or entity redemption buy-sell agreements in place may want to consider switching to a “wait-and-see” buy-sell or a cross-purchase arrangement, and those establishing a new buy-sell agreement may want to choose “wait-and-see” or cross-purchase over stock or entity redemption.

S CORPORATION STOCK REDEMPTIONS:

A stock redemption plan for an S corporation that uses accrual accounting would use the same stock redemption agreement appropriate for a C corporation. For S corporation stock redemption agreements, see the various Stock Redemption Buy-Sell specimen document sets (not designated for S corporations) located in the Business Buy-Sell Plans section of InsMark's Documents On A Disk™ System (Versions 20.0 and higher).

An S Corporation that uses cash basis accounting receives unique taxation of life insurance death proceeds in that the pure death protection of the policy proceeds received by the S Corporation automatically increases the basis of each surviving Stockholder proportionate to his/her ownership interest in the corporation; stock owned by the deceased Stockholder's estate receives a step-up in basis equal to the stock's date-of-death value. Thus, a Stock Redemption plan for a cash basis S Corporation funded with life insurance is particularly efficient. See the S Corporation Stock Redemption Buy-Sell specimen document set located in the Business Buy-Sell Plans section of InsMark's Documents On A Disk™ System (Versions 20.0 and higher).

Even though the short tax year election is not useful to an S corporation that uses accrual accounting, unlike a C corporation, there is still a partial step-up in basis for the surviving S corporation shareholders when the insurance proceeds accrue to the benefit of the S corporation at the insured's death. This is based upon the surviving shareholders' percentage ownership in the business. However, under the Cross-Purchase or Optional Buy-Sell Agreements, a full step-up in basis equal to the life insurance proceeds paid is available, thereby mitigating ordinary income tax upon any subsequent lifetime sale by the survivors. This is true under the "Optional" even where the Redemption Option is elected because the survivors, by contributing the life insurance proceeds as "capital contributions" to the Corporation, trigger the same "step-up" in basis as under the Cross-Purchase.

COMPANY-OWNED LIFE INSURANCE (SECTION 863 OF THE PENSION PROTECTION ACT OF 2006):

Section 863 of the Pension Protection Act of 2006 provides rules relating to the income taxation of company-owned life insurance (COLI). For some time prior to the passage of the bill, Congress was concerned about the practice of certain large corporations purchasing life insurance as an investment on the lives of its employees, including many rank and file employees who were not officers, directors, or highly compensated. This investment oriented life insurance was known as corporate owned life insurance or COLI. Where state law permitted, this type of coverage was often obtained without the knowledge or consent of the insured employees and was not limited to highly compensated employees.

In an effort to remedy the perceived abuses of this type of investment oriented coverage on rank and file employees, Congress worked together with the life insurance industry to pass Section 863 of the Pension Protection Act of 2006. This portion of the Act is sometimes called the "COLI Best Practices Act", although its reach extends to all company-owned life insurance, not just corporate owned life insurance.

Section 863 of the Pension Protection Act adds a new subsection (j) to Internal Revenue Code (IRC) Section 101 and new IRC Section 6039I.

Effective June 15, 2009, the IRS issued Notice 2009-48; 2009-24 I.R.B. 1085 (6-15-2009). This Notice is discussed in detail below and applies to policies issued on or after that date.

Application of Section 101(j) to Common Employee Insurance Arrangements —The notice

and consent requirements of IRC Sec. 101(j) and reporting requirements of IRC Sec. 6039I may apply to certain common employee insurance arrangements, which include certain types of split dollar life insurance, buy-sell arrangements, VEBAs, qualified plans, rabbi trusts, and secular trusts.

- *Split Dollar Life Insurance Arrangements:* If proper notice and consent is given, death benefits payable to the Company and family members of the insured under a split dollar arrangement are exempt from the COLI income inclusion rules of Section 101(j)(1). However, if the notice and consent requirements are not met, any death benefit payable to the Company (or a party related to the company, such as a greater-than-50% shareholder of the Company) in excess of its premiums paid, would result in making that excess amount taxable. This means that most employer-employee economic benefit split dollar arrangements would need to meet the notice and consent requirements. If the employer's interest in the death benefit never exceeds its premiums paid, no part of the death benefit the Company receives will be taxable. In any event, the reporting requirements of IRC Section 6039I must be met.
- *Buy-Sell Arrangements:* Provided that proper notice and consent is given, death benefits payable to the Company (or a party related to the Company, such as a controlling shareholder) for the purpose of purchasing stock or other business interests in the policyholder (company) from any family member of the insured, trust for a family member of the insured, or the insured's estate are not taxable to the Company. Thus, insurance death benefits used to purchase business interests in entity redemption arrangements and cross-purchase arrangements in which stock or other business interests are purchased by a controlling shareholder must meet the notice and consent and reporting requirements of IRC Sections 101(j) and 6039I.
- *Voluntary Employee Beneficiary Arrangements (VEBAs):* According to Q&A 1 of Notice 2009-48, Section 101(j) does not apply to a life insurance policy owned by a VEBA. If 101(j) does not apply, the reporting requirements of 6039I would not apply either.
- *Qualified Plans:* The application of Sections 101(j) and 6039I would be similar to the treatment for VEBAs.
- *Rabbi Trust:* Because a rabbi trust is a grantor trust established by an employer (Company) to meet its obligations under a nonqualified deferred compensation plan, the rabbi trust would be treated the same as the employer (Company) for purposes of Sections 101(j) and 6039I. Thus, all the rules discussed above relating to the Company would apply to insurance death benefits owned and received by a rabbi trust.
- *Secular Trust:* Because a secular trust is funded by an employee with after-tax dollars, Section 101(j) would generally not apply. However, where the grantor of the secular trust is a party related to the Company, such as a controlling shareholder, the notice and consent and reporting requirements of Section 101(j) and 6039I may apply.

The “COLI Best Practices” legislation of IRC Section 101(j) appears to be broad in scope. This means that it could conceivably apply to any situation in which an employer, or person with a certain business relationships with the employer, owns insurance on the life of an employee. This would generally include key person insurance owned by a business such as a “C” or “S” corporation, limited liability company, general or limited partnership, business trust, or the owner of a sole proprietorship. This would also include life insurance used to fund a deferred

compensation plan as well as InsMark's Executive Trifecta® plan.

As discussed above, split dollar life insurance arrangements in which a business is the “owner” of the contract for split dollar purposes is also subject to the legislation. Some authorities include any kind of employer-sponsored split dollar life insurance and life insurance owned by co-shareholders and partners for buy-sell purposes within the scope of IRC Section 101(j), although this application of the law is not entirely clear. As a practical matter, though, only a split dollar plan in which the employer's interest was in excess of its cumulative premiums would be subject to this legislation.

Most certainly, any kind of personally owned life insurance or life insurance owned by a trust or family member that is not connected to a business is beyond the scope of this legislation. Neither would life insurance owned by a charitable organization on the life of a non employee donor or life insurance purchased by a creditor to secure a bona fide loan be subject to IRC Section 101(j).

IMPORTANT NOTE:

A complete summary of the Section 409A and Company-Owned Life Insurance (COLI) rules is contained in the Special Files Section of Documents On A Disk in a file called “Company-Owned Life Insurance Summary”. In the current document set and in the Special Files Section, you will find a specimen “Company-Owned Life Insurance - Notice and Consent” (**as required by IRC Sec. 101(j)**) and IRS Form 8925 – Report of Employer-Owned Contracts in the file entitled “Company-Owned Life Insurance - Annual Reporting Form 8925” (**as required by IRC Sec. 6039I**).

Important Note: This material is for educational purposes only. In all cases, the approval of a client's legal and tax advisers must be secured regarding the implementation or modification of any planning technique as well as the applicability and consequences of new cases, rulings, or legislation upon existing or impending plans.