

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

HIGHLIGHTS OF THE PLAN

S Corporations receive 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, an S Corporation Stock Redemption plan funded with life insurance can be particularly efficient. However, for S corporations that use the accrual accounting method, no step-up in basis is available to the surviving shareholders for the shares redeemed from the deceased shareholder's estate. The plan works as follows:

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.

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.

THE AGREEMENT

The Stockholders enter into a binding buy-sell agreement with the S Corporation that:

1. Requires the S Corporation to purchase a Stockholder's interest at an agreed price upon each Stockholder's:
 - a. Premature death;
 - b. Total disability (usually following a 1-2 year waiting period);
 - c. Retirement.
2. Requires the S Corporation to purchase life insurance on the lives of the Stockholders in order to fund the contractual purchase obligations and use corporate assets or income to pay the premiums required.
3. Assumes the use of increasing death benefit life insurance policies containing projected cash values at each Stockholder's estimated retirement age that are sufficient to fund a retirement installment sale.
4. Offers an option to purchase individual disability policies to complement or fully fund a disability installment sale.

ADVANTAGES TO THE S CORPORATION AND SHAREHOLDERS

1. The presence of a well-funded plan creates certainty rather than doubt in the purchase arrangement.
2. The plan provides the S Corporation with money for death or retirement funding, and it guarantees at least partial funding in the event of a Stockholder's disability. (Separate disability policies can be used for full funding.)
3. With three or more Stockholders, a stock redemption buy-sell plan avoids the use of multiple policies required by a cross purchase plan. (In a cross purchase arrangement, where "N" is the number of Stockholders, the formula $(N) \times (N-1)$ equals the policies needed. For example, with five Stockholders, $(5) \times (5-1) = 20$. Thus, twenty policies are needed to fund a plan covering only five Stockholders.)
4. The plan assures that all funding is significantly discounted through the use of life insurance. If the S Corporation is a cash basis taxpayer and the shareholders elect the short tax year method, the remaining shareholders can receive a full step-up in basis for shares redeemed by the Corporation.

5. The plan generates a sense of stability to customers, suppliers, bankers, and employees of the S Corporation.
6. The plan enhances the financial strength of the S Corporation through the increasing cash values of the life insurance.

ADVANTAGES TO THE ESTATE AND HEIRS OF THE STOCKHOLDERS

1. The presence of a well-funded plan creates certainty rather than doubt for the heirs of a deceased Stockholder.
2. The plan avoids requiring a Stockholder's family to rely upon uncertain fortunes of the business at the Stockholder's death.
3. At a Stockholder's death, the plan establishes, in most instances, a fixed price for the business interest for federal estate tax purposes, thereby avoiding costly legal battles with the IRS.
4. At a Stockholder's death, the plan assures that the Stockholder's estate and heirs will receive tax-free cash equal to the "going concern" value of the business, thereby avoiding possible losses due to forced liquidation.
5. The plan assures that the Executor of the deceased Stockholder will receive the cash necessary to fund estate liquidity costs associated with the Stockholder's interest in the S Corporation.
6. During a lifetime installment sale, the plan provides for life insurance death benefits sufficient for the immediate prepayment of remaining installment balances by the surviving Stockholders.

ADVANTAGE TO ALL S CORPORATION STOCK REDEMPTION PARTICIPANTS

A well-funded plan creates a corporate climate likely to result in a more productive environment for all Stockholders.

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 percentage 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 can be 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.

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.