
S CORPORATION
§311(b)
§1239

REAL ESTATE IN S CORPORATIONS: HOW MODERN MACGYVERS CAN SAVE CLIENTS FROM A TICKING TAX TIME-BOMB

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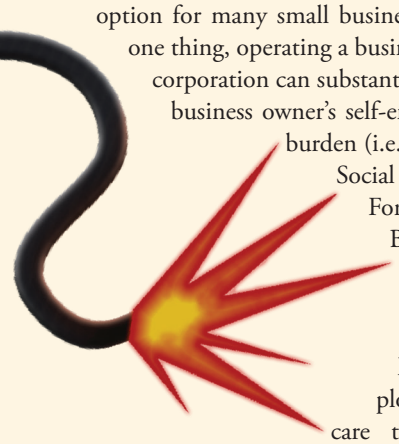
If you grew up in the 80s or 90s, you may remember a TV show where the protagonist, MacGyver, constantly found himself in life-threatening situations that required last-minute improvisation using limited resources at hand. The show was so popular that "MacGyver" became a verb for the very concept of resourcefully improvising one's way out of a difficult situation. In the stereotypical episode, MacGyver diffuses a bomb just before time runs out using only a paperclip. This article will explain why real estate (or other appreciated assets) held in an S corporation is a ticking tax time-bomb and will address how advisors can potentially "MacGyver" the Internal Revenue Code to save clients from a detonation of unfavorable tax consequences.



Let's start by acknowledging that S corporations have their place and are a great option for many small business owners. For one thing, operating a business out of an S corporation can substantially reduce the business owner's self-employment tax burden (i.e., Medicare and Social Security taxes). For example, Joe Biden famously avoided hundreds of thousands of dollars in self-employment Medicare taxes over his public speaking career by operating that business out of an S corporation. Unfortunately, in many cases, clients mistakenly assume, or are improperly advised, that S corporations are also an appropriate tax entity for holding real estate and other appreciating assets.

The main issue with holding real estate in an S corporation is that a tax recognition event is triggered under IRC Section 311(b) (or 336(a) if the S corporation is being liquidated) any time an S corporation distributes appreciated property to a shareholder. Additionally, IRC Section 1239 requires that the 311(b) gain be recharacterized as ordinary income for distribution of depreciable property (e.g., real estate) to certain related parties, including a greater-than-50% shareholder.

For example, suppose Angus and Jack decide to invest in real estate together. They fund a limited liability company (LLC) and make an election for the LLC to be taxed as an S corporation (i.e., the entity is an LLC for state law purposes but an S corporation for income tax purposes). Assume they hire a property manager for the properties acquired through the S corporation and are not actively involved in the real estate business. Five years later, when the S corporation holds a portfolio of appreciated real estate, they decide they want to split up the business. As opposed to an entity taxed as a partnership, where the partners would have some options to divide the property on a tax-deferred basis, this LLC taxed as an S corporation has no such options. Because Angus and Jack are not actively involved in the business, a tax-free division of the S corporation into two S corporations is not possible under IRC Section 355. Further, the S corporation cannot distribute the property to Jack and Angus (non-pro-rata or otherwise) without triggering a tax on any inherent gain in the property (i.e., fair market value less income tax basis) under IRC Section 311(b). For example, if the S corporation distributes property to shareholders with a fair market value of $2M and an income tax basis of $1M at the time of distribution, the S corporation will realize a gain of $1M.

What if Angus and Jack hold the S corporation shares and underlying property until they die? Can they use the step-up in basis under IRC Section 1014 to eradicate the 311(b) gain?

Under IRC Section 1014, most property an individual holds directly in his or her estate at death (e.g., partnership interests, S corporation shares, real estate, etc.) receives a step-up in income tax basis to fair market value. However, when the individual owns assets through a legal entity (e.g., the S corporation) that is not disregarded for income tax purposes, only the decedent's ownership interest in the entity receives the step-up in basis, while the underlying assets retain their historical income tax basis.

For example, suppose Angus passes away

when the fair market value of the real estate is $2M and its income tax basis is $1M. Angus's estate will receive a step-up in basis with respect to its S corporation shares under IRC Section 1014. In other words, if Angus has a 50% interest in the S corporation, his estate's basis in his shares will be stepped up to their fair market value of $1M ($2M overall fair market value of the S corporation multiplied by his 50% ownership). However, the underlying real estate will retain its $1M income tax basis.

This is problematic because Angus's estate will miss out on (1) being able to take enhanced depreciation deductions from the stepped-up basis and (2) using the stepped-up basis to offset gain on a future sale of the real property. Contrast this to entities taxed as partnerships, where the partners can elect under IRC Section 754 to allow a step-up in basis to the deceased partner's share of the underlying partnership property to match the basis step-up to the partnership interest. If the LLC were taxed as a partnership, Angus's estate could potentially step-up its basis in its share of the underlying real estate to $1M to match its outside basis in its partnership interest, allowing his estate to take larger depreciation deductions going forward based on the new Section 754 basis.

Unfortunately, there is no parallel provision to IRC Section 754 for S corporations. The estate is stuck holding the real estate through the S corporation at its historical basis. And even if the property is held indefinitely by Angus's heirs, each successive generation will face the same problem.

So how can advisers help clients and their heirs diffuse this ticking tax time-bomb?

If an S corporation holds appreciating property that has minimal built-in gain (either because it has experienced minimal to no economic appreciation or has not yet been substantially depreciated for income tax purposes), the S corporation should distribute the property to the shareholders immediately, and the shareholders should place the property in a new LLC (taxed as a partnership or disregarded for income tax purposes if the LLC has only one member) or limited partnership. Because there is minimal to no built-in gain, there would be minimal to no gain under IRC Section 311(b).

On the other hand, if the S corporation property has appreciated beyond the point of no return, advisers should take certain steps to enable a "MacGyvering" of the IRC Section 1014 basis step-up at the client's death that allows the client's estate to liquidate the S corporation tax-free, using the stepped-up basis in the S corporation shares as an offsetting loss against the flow-through capital gain from the real estate. This is easier said than done but will include some combination of current estate and business succession planning as well as careful steps during the administration of the client's estate and revocable living trust. This will also require that the client hold the property, or replacement property acquired on a tax-deferred basis in one or more like-kind exchanges under IRC Section 1031, until the client's death.

For example, assume Angus is the sole owner of an S corporation that owns real estate. At Angus's death, the real estate is worth $2M and has an income tax basis of $1M. Angus's estate will receive a step-up in basis for the shares to $2M, but the real estate will retain its $1M income tax basis. In theory, Angus's estate can liquidate and dissolve the S corporation in the same tax year as the distribution, recognize $1M of gain on the sale of the real estate, and write off its remaining $1M of basis in the shares to net out the gain from the sale. The estate can purchase replacement real estate that will begin generating enhanced purchase-price depreciation deductions in the hands of the estate (which will likely elect to own the property through a new LLC taxed as a partnership).

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Alternatively, if Angus's estate wants to keep the original property owned by the S corporation, it could work around IRC Section 1239 by placing the real estate in an LLC that is taxed as a partnership. Section 1239 recharacterizes capital gain as ordinary gain when real estate is transferred from a corporation to a 50%-or-more shareholder; however, the LLC membership interests are not depreciable property and will not trigger Section 1239 on the distribution of the membership interests from the S corporation. The gain will remain a capital gain, against which the estate can write off the capital loss from the liquidation of the S corporation shares. The estate will need to make a 754 election in order to transfer the new purchase price basis in the membership interests to the underlying real estate. The estate will also need to be mindful of the step transaction doctrine and should separate the formation of the LLC and the liquidation of the S corporation by as much time as possible—ideally, Angus should plan ahead and have the LLC formed during his lifetime.

There is also a potential obstacle under IRC Section 267(b), which disallows losses on the liquidation of shares by an individual or trust owning more than 50% of the shares of the S corporation. Therefore, if Angus's shares are owned by a trust or one or more individual beneficiaries, the loss offset may be disallowed. Even if the trust or individual(s) owned 50% or less of the S corporation shares, there may be ownership attribution through certain related party rules under IRC Section 267(c). For example, if Angus's estate were distributed 50/50 to two children, they would each be deemed to own 100% of the LLC under IRC Section 267(c) by virtue of family attribution rules.

The Macgyver "paperclip" is found in *Hanna's Estate v. Comm'r*, 320 F.2d 54 (6th Cir. 1963). In that case, the court held that the limitation on losses between individuals and corporations under IRC Section 267(b)(2) is strictly construed to apply only to "individuals" and not an "estate." Effectively, this provides a loophole to the loss disallowance rule for the liquidation of an S corporation by an estate that owns more than 50% of the S corporation.

Therefore, in order to write off the excess basis against the capital gain from the liquidation, the shares must be held in the decedent's estate. This is potentially problematic as most modern estate plans have clients place their

assets in a revocable living trust that bypasses their estate at death. One option is for the estate planning attorney to leave shares of the real-estate-holding S corporation out of the client's revocable living trust so that the shares are held in the estate at death. However, this is not ideal for the client's heirs, who will now need to have the shares administered through probate. Alternatively, if the shares are held in a revocable living trust, IRC Section 645 allows the trustee and the executor under the client's last will and testament to make an election for the administrative trust created at the client's death to be treated as part of the client's estate for income tax purposes. Therefore, a trust that has made this election should be treated as part of the decedent's estate for purposes of Section 267(b). A 645 election expires two years from the decedent's death or, if the estate files an estate tax return, six months from the final determination of estate tax liability.

Does this solve the issue for Angus and Jack in the original example?

Returning to the original example, Angus's estate could have the S corporation distribute a 50% co-tenancy interest in the property to the estate in liquidation of the estate's shares, which will trigger a $500k gain to the S corporation under Section 311(b) (e.g., $1M fair market value of 50% co-tenancy interest less $500k pro rata basis of 50% co-tenancy interest). Because Angus's estate is completely liquidating its shares, it can potentially use the extra stepped-up basis in its shares as a loss write-off against its $250k share of the flow-through gain. However, Jack probably will not agree to this since he will get hit with the other $250k of flow-through gain with no corresponding write-off (i.e., the 311(b) gain is allocated pro rata to the shareholders even though it is being triggered by a distribution to a single shareholder).

A cleaner solution would be to have Jack purchase Angus's shares (perhaps pursuant to a buy-sell agreement) for their $1M fair market value upon Angus's death. Angus's estate would be able to use the stepped-up basis in its shares to avoid any capital gain on the sale of the shares. Later, when Jack passes away, his estate, as sole 100% shareholder, will receive a stepped-up basis in all of the shares and can liquidate the S corporation. For example, assume that the real estate is now worth $2.5M and has a basis of $700k. Jack's estate will get hit with $1.8M of taxable flow-through income on liquidation; however, it will be able to use its extra basis in the shares from the basis step-up as a capital loss to net out the gain. Jack's heirs can reinvest the proceeds as they wish, including in a new piece of real estate that generates larger annual depreciation deductions based on its purchase price.

There is an additional wrinkle when a married couple owns real estate in an S corporation. For example, suppose that Angus and Riley, a married couple, own shares in an S corporation as community property, and that the S corporation owns appreciated real estate. Upon Angus's death, all of Angus's separate property along with the entire community estate will receive a step-up in basis to fair market value under IRC Section 1014. Because the S corporation shares are community property, all of the shares will receive a step-up in basis; however, a pro-rata division of these shares between Angus and Riley will be problematic. For example, if Riley (or her survivor's trust) receives a pro rata 50% allocation of the shares as her share of community property, she will likely not be able to liquidate the S corporation and avoid the application of IRC Section 267. While she would not own more than 50% of the S corporation shares directly, she will be attributed ownership from the estate under Section 267(c) unless neither she nor any of her family members (as defined in IRC Section 267(c)(4)) is a beneficiary of Angus's estate.

Instead, the personal representative of Angus's estate should make a non-pro-rata allocation of all of the S corporation shares to Angus's estate, with an offsetting allocation of other community property to Riley. If this is not possible based on the value of the assets in the estate, then Angus's estate should issue a promissory note to Riley to compensate for the non-pro-rata allocation of the S corporation shares to Angus's estate. If the shares are held in a classic revocable living trust structure, then in addition to allocating the shares entirely to Angus's administrative trust, Riley will need to ensure that Angus's estate and the trustee of his administrative trust make an election for the administrative trust created at Angus's death to be treated as Angus's estate for income tax purposes under IRC Section 645.

Assuming Angus and Riley properly thread the needle and the S corporation shares are owned 100% either directly by Angus's estate, or by an administrative trust that is treated as part of Angus's estate by virtue of an election under IRC Section 645 at the time of liquidation, Angus's estate or administrative trust can liquidate and dissolve the S corporation in the same tax year as the distribution and write off the extra basis in the shares created under IRC Section 1014 as a loss that negates the capital gain on the liquidation of the real estate.

Although beyond the scope of this article, IRC Sections 1245 and 1250 may apply in some scenarios to require recapture of depreciation deductions at ordinary income tax rates. The capital loss from liquidating the S corporation shares cannot be used to offset this ordinary income and will need to be carried forward to future years. For this reason, depreciation recapture should be considered before liquidating the S corporation.

As the foregoing examples illustrate, S corporations are not an appropriate tax entity for holding real estate and other appreciating assets due to a stealth tax under IRC Section 311(b) on distributions of appreciated property to shareholders and the lack of a parallel provision to IRC Section 754 (which allows partnerships to transfer a partner's stepped-up partnership interest basis to the partner's share of partnership assets). Nevertheless, advisers can potentially "MacGyver" IRC Section 1014 at the client's death by using the estate's stepped-up basis in the S corporation shares to allow the client's estate to liquidate the shares tax-free. While liquidating an S corporation with multiple shareholders may be problematic due to the pro rata allocation of the capital gain from the real estate to shareholders who have not yet received a basis step-up, shareholders with a long-term business succession plan may be able to navigate this situation with buy-sell provisions that result in the last survivor owning 100% of the S corporation shares. In the case of a 100% shareholder of an S corporation owning appreciated real estate, all of the shares must be held by the client's estate (or a trust treated as part of the client's estate under IRC Section 645) upon liquidation and the S corporation must be wound up and dissolved in the year of distribution in order for the offsetting loss to be applied against the flow-through capital gain.

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