S Corporation Distributions and Liquidations

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S Corporation Distributions and Liquidations

-by Neil E. Harl

The handling of distributions and liquidations in S corporations can be confusing at best and our article in the May 30, 2008 Agricultural Law Digest in retrospect did little to clarify the situation. The important point is that S corporation distributions are handled differently than S corporation liquidations.

S corporation distributions

For an S corporation with earnings and profits, distributions are governed by I.R.C. § 1368 and are treated as follows –

• Distributions are considered a non-taxable return of previously taxed income to the extent of the “accumulated adjustments account.” That is the gross income after 1982 less deductible expenses with minor adjustments.

• Distributions above the AAA account are treated as dividends to the extent of the S corporation’s accumulated earnings and profits.

• Any distribution beyond amounts from the AAA account and dividends are treated as a return of the income tax basis on the stock until the income tax basis is exhausted.

• Any distributions beyond that point are treated as capital gain. The gain is considered as gain from the sale or exchange of the S corporation stock.

With this layering of distribution amounts, an S corporation with accumulated earnings and profits (from years the corporation was a C corporation) making distributions after the death of a shareholder would report the dividend income before reaching the layer for distribution as return of income tax basis on the stock which is not taxable.

S corporation liquidation

Subchapter S of the Internal Revenue Code specifies that “except as otherwise provided in this title, and except to the extent inconsistent with this subchapter, subchapter C shall apply to an S corporation and its shareholders.” I.R.C. § 331(a), which is within “this title,” states that “amounts received by a shareholder in a distribution in complete

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liquidation of a corporation shall be treated as in full payment in exchange for the stock.” [Emphasis added.] Note that the language does not refer to S corporation shareholders or C corporation shareholders, but to “a shareholder.”11 Moreover, I.R.C. § 331(b) specifically indicates that, except for certain liquidating distributions of personal holding companies, I.R.C. § 301 does not apply to liquidating distributions.12 Section 301(c) is referred to in I.R.C. § 1368(a) as the subsection that would apply to S corporation distributions were it not for I.R.C. § 1368(a).

However, with I.R.C. § 331 trumping the S corporation distribution rules13 as well as the C corporation distribution rules,14 the provisions in Section 331(a) govern S corporation liquidations. That means that S corporation distributions in complete liquidation are treated as in full payment in exchange for the stock which in turn means that the difference between the income tax basis in the stock and the fair market value of the liquidation is taxed as capital gain. Thus, the taxation of accumulated earnings and profits is governed by neither the layering rules of I.R.C. § 1368 nor the specific provisions of I.R.C. § 30117 which provide that the portion of a distribution which is a dividend is to be included in gross income.

Keep in mind that a liquidation followed by a transfer to another corporation of all or part of the assets of the liquidating corporation may be treated as a dividend distribution or as a transaction in which no loss is recognized and gain is recognized only to the extent of “other property.”18

In conclusion

Particularly where the outstanding S corporation stock has a relatively high income tax basis (such as from recent shareholder deaths), and the S corporation has sizeable earnings and profits from years it was a C corporation, the choice between a complete liquidation19 and a series of distributions short of a complete liquidation20 can be an important one.

All of this does not take into account the possibility of built-in gains tax21 which applies to sales or exchanges of appreciated assets which are disposed of within 10-years after the corporation became an S corporation.22

ENDNOTES


2 I.R.C. §§ 1368, 301, 331(a). I am indebted to Steven J. Roy, Nyemaster Law Firm, 700 Walnut Street, Suite 1600, Des Moines, Iowa 50309, for calling the matter to my attention.

3 I.R.C. § 1368(e)(1).

4 I.R.C. § 1368(e)(1)(A).

5 I.R.C. § 1368(c)(2).

6 I.R.C. § 1368(b).

7 I.R.C. § 1368(c).

8 Rev. Rul. 95-5, 1995-1 C.B. 100. See Ltr. Rul. 9501001, November 19, 1993 (S corporation with no accumulated earnings and profits).

9 I.R.C. §§ 1361-1379.

10 I.R.C. § 1371(a).

11 I.R.C. § 331(a).

12 I.R.C. § 331(b).

13 I.R.C. § 1368(a).

14 I.R.C. § 301(c).

15 I.R.C. § 331(a).

16 I.R.C. § 1368(c)(2).

17 See I.R.C. § 301(c)(1).

18 Treas. Reg. § 1.1331-1(c).

19 I.R.C. § 331(a).

20 I.R.C. § 1368.

21 I.R.C. § 1374(a).

22 I.R.C. § 1374(d)(3).

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr

BANKRUPTCY

GENERAL

EXEMPTION

2008 STIMULUS PAYMENT. The debtor filed for Chapter 7 on April 21, 2008, after enactment of the Economic Stimulus Act of 2008. The debtor received a payment under the act in May 2008 and amended the bankruptcy schedules to include the payment and to exempt, under Idaho Code § 11-603(4), the payment as a public assistance payment. The court held that the payment was not exempt as public assistance because the payment did not have a public assistance purpose but was intended as an economic stimulus. The court also held that the entire payment was subject to bankruptcy estate administration because the payment was not an advance payment of a 2008 tax refund. In re Wooldridge, 2008-2 U.S. Tax Cas. (CCH) ¶ 50,670 (Bankr. Idaho 2008).