

Checkpoint Contents

Estate Planning Library

WG&L Estate Planning Treatises

Structuring Buy-Sell Agreements: Analysis With Forms - Zaritsky, Aghdami & Mancini

Chapter 4: S Corporation Buy-Sell Agreements

¶4.04. Taxation of Sales and Redemptions of S Corporation Stock—Redemption vs. Cross-Purchase Buy-Sell Agreements

¶ 4.04[1][a][iii] Medicare tax on net investment income .

The Health Care and Education Reconciliation Act of 2010 enacted Section 1411, which establishes a 3.8 percent tax on net investment income (NII) realized by certain individuals, estates, and trusts for taxable years beginning after December 31, 2012.^{71.7} On November 30, 2012, the Treasury Department released proposed regulations regarding NII realized by certain individuals, estates, and trusts for taxable years beginning after December 31, 2012.^{71.8} Although the regulations are in proposed form, they may be relied on until final regulations are effective.

The new tax applies to individuals, estates, and trusts with unearned NII in excess of certain amounts. For individuals, the tax is equal to 3.8 percent of the lesser of (1) the individual's NII for the taxable year or (2) the excess of the individual's modified adjusted gross income (AGI) for the taxable year over the threshold amount. The threshold amounts for individuals are generally \$250,000 for joint filers and \$200,000 for single filers. For estates and trusts, the tax is equal to 3.8 percent of the lesser of (1) the estate's or trust's undistributed NII or (2) the excess of the estate's or trust's AGI over the dollar amount at which the highest tax bracket begins for such taxable year (e.g., \$11,950 for 2013). The tax does not apply to nonresident aliens or certain types of trusts, including trusts where all unexpired interests are devoted to charitable purposes, trusts exempt from tax under Section 501, or charitable remainder trusts exempt from tax under Section 664.

Net investment income is investment income less deductions properly allocable to such income.

“Investment income” is defined to include

1. Gross income from interest, dividends, annuities, royalties, and rents, unless derived in the ordinary course of a trade or business to which the 3.8 percent surtax does not apply (Category 1 Income);

2. Other gross income derived from a trade or business to which the Medicare contribution tax does apply (Category 2 Income); and

3. Net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in a trade or business to which the Medicare contribution tax does not apply (Category 3 Income).^{71.9}

Investment income does not include amounts subject to self-employment tax,^{71.10} distributions from tax-favored retirement plans (e.g., qualified employer plans and IRAs),^{71.11} or tax-exempt income (e.g. earned on state or local obligations).

The 3.8 percent surtax applies to a trade or business only if it is a Section 469 passive activity of the taxpayer or a trade or business of trading in Section 475(e)(2) financial instruments or commodities.^{71.12} The surtax does not apply to trades or businesses conducted by a sole proprietor, partnership, or S corporation (but income, gain, or loss on working capital is not treated as derived from a trade or business and thus is subject to the tax).^{71.13}

Generally, an interest in a partnership or S corporation (a passthrough interest) is not considered property held in a trade or business (although the underlying business itself may be). Therefore, gain or loss from the sale of a passthrough interest would be included in NII under Category 3. There is an exception that provides that gain or loss from a disposition of an interest in a partnership or S corporation is taken into account by the partner or shareholder as NII only to the extent of the net gain or loss that the transferor would take into account if the entity had sold all its property for fair market value immediately before the disposition.^{71.14} Section 1411(c)(4) is applied on a property-by-property basis, and a determination must be made on how the property was held in order to determine whether the gain or loss to the transferor from the hypothetical disposition of such property would have been gain or loss subject to Section 1411(c)(1)(A)(iii). Under the proposed regulations, a transferor computes the gain or loss from the sale of the

underlying properties of the partnership or S corporation using a deemed asset sale method (Deemed Sale), and then determines if, based on the Deemed Sale, there is an adjustment (either positive or negative) to the transferor's gain or loss on the disposition of the partnership or S corporation interest for purposes of Section 1411(c)(1)(A)(iii). A positive adjustment reduces a loss on the disposition of the interest, and a negative adjustment reduces the gain on the disposition of the interest.

Because the proposed regulations apply a Deemed Sale by the passthrough entity of all its assets for cash equal to the FMV of the entity's properties, any gain or loss on the interest sale that is not reflected in the underlying properties of the passthrough entity (as the result of an inside-outside basis disparity) would not create an adjustment.⁷¹⁻¹⁵ The proposed regulations provide that the Deemed Sale applies rules similar to Regulations Section 1.743-1(d)(2). The Deemed Sale is applied as follows:

1. Make a hypothetical disposition of all the entity's properties (including goodwill) in a fully taxable transaction for cash equal to the FMV of the entity's properties immediately before the disposition of the interest;
2. Compute the gain or loss on each of the entity's properties (including goodwill). The calculation is determined by comparing the FMV of each property with its adjusted basis. Gain or loss from each property must be computed separately.
3. Allocate the gain or loss from each property determined in the second step to the transferor. For an S corporation, the amount of gain or loss allocated to the transferor is determined under Section 1366(a), and the allocation should not take into account any reduction in the transferor's distributive share in Section 1366(f)(2) resulting from the hypothetical imposition of tax under Section 1374 as a result of the Deemed Sale.

4. Determine whether the amount of gain or loss allocated to the transferor for each property under the Deemed Sale would have been taken into account in determining the transferor's net gain under Section 1411(c)(1)(A)(iii) if it were an actual disposition.^{71.16}

Any transferor making an adjustment must attach the statement described in Proposed Regulations Section 1.1411-7(d) to the transferor's return for the year of disposition.

For example, if in the Deemed Sale the transferor would have been allocated a net gain from property held in a trade or business not described in Section 1411(c)(2) (thus, a negative adjustment), and the transferor had a gain on the disposition of the interest, then the gain on the disposition of the interest will be reduced for purposes of determining NII. But, in a situation in which a transferor has a gain (determined without regard to Section 1411(c)(4)) from the disposition of the partnership or S corporation interest, a negative adjustment cannot result in the transferor having a loss on the disposition of the partnership or S corporation interest for purposes of Section 1411(c)(1)(A)(iii), and a positive adjustment is not taken into account. If a transferor has a \$100,000 gain on the disposition of S corporation stock, the Section 1411(c)(4) adjustment cannot result in a gain for Section 1411 purposes greater than \$100,000, and cannot result in a loss for Section 1411 purposes.^{71.17}

Similarly, in a situation where a transferor has a loss from the disposition of the partnership or S corporation interest, a positive adjustment cannot result in the transferor having a gain on the disposition of the partnership or S corporation interest for purposes of Section 1411(c)(1)(A)(iii), and a negative adjustment is not taken into account. For example, if a transferor has a \$50,000 loss on the disposition of S corporation stock, the Section 1411(c)(4) adjustment cannot result in a loss for Section 1411 purposes greater than \$50,000, and cannot result in a gain for Section 1411 purposes.

The proposed regulations provide rules to determine the treatment of gain or loss from goodwill for purposes of Section 1411(c)(4). If the entity is engaged in one trade or business, the entire gain or loss on the goodwill will be treated as gain or loss from the disposition of property held for use in that trade or business, and no portion of the gain or loss will be treated as attributable property not held for use in the trade or business. If the entity is engaged in more than one trade or business, the gain or loss on the goodwill is allocated between the trades or businesses based on the relative FMV of the property (excluding cash) held for use in each trade or business.^{71.18}

If the taxpayer sells the passthrough interest in an installment sale, the adjustment to net gain is calculated in the year of the disposition, but the gain and any adjustment are deferred. If an installment sale attributable to a disposition of an interest in a partnership or S corp occurred before the effective date of Section 1411, taxpayers may elect into the proposed reliance regs.

If a qualified subchapter S trust sells S corp stock, any gain or loss recognized on the sale will be that of the trust, not of the income beneficiary.^{71.19} In addition, exception does not apply to disposition of stock in an S corporation if an election under Section 338(h)(10) is made.

^{71.7} Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, 111th Cong., 2d Sess., 124 Stat. 1029.

^{71.8} 77 Fed. Reg. Vol. 72,611.

^{71.9} IRC § 1411(c).

^{71.10} IRC § 1411(c)(6).

^{71.11} IRC § 1411(c)(5).

^{71.12} IRC § 1411(c)(2).

^{71.13} IRC § 1411(c)(3).

^{71.14} IRC § 1411(c)(4).

^{71.15} Prop. Reg. § 1.1411-7(e), Ex. 2.

^{71.16} Prop. Reg. § 1.1411-7(c).

^{71.17} Prop. Reg. § 1.1411-7(e), Ex 3.

^{71.18} Prop. Reg. §§ 1.1411-7(c)(5)(ii)(B); 1.1411-7(e), Ex. 8.

^{71.19} Prop. Reg. §§ 1.1411-7(b)(1), 1.1411-7(b)(2).

© 2013 Thomson Reuters/RIA. All rights reserved.