

Larry's Tax Law

A Journey Through Subchapter S / A Review of The Not So Obvious & The Many Traps That Exist For The Unwary: Part XVI – Changes in Ownership During the Taxable Year

By Larry Brant on 4.3.25 | Posted in Internal Revenue Code, Tax Laws, Tax Planning

Now that the scurrying around and worrying relative to developments impacting the Corporate Transparency Act (“CTA”) that were coming at us with laser speed are on a slow simmer, I can turn my attention back to my multi-part series on Subchapter S. Don’t worry, I am not abandoning my coverage of the CTA. I intend to report any future developments, earth-shattering or otherwise.

INTRODUCTION

At the most fundamental level, corporations with an election in effect under Code Section 1362 are flowthrough entities. Items of income, loss, deduction and credit pass through to the shareholders under Code Section 1366 on a pro-rata basis. Likewise, all operating and liquidating distributions must be made to the shareholders in strict proportion to share ownership. Unlike Subchapter K, which allows in certain circumstances special allocations of the pass-through items and disproportionate distributions, Subchapter S is not so forgiving.

These concepts seem mundane. Unfortunately, in practice, they can sometimes create havoc for the unwary.

In this Part XVI of my multi-part series on some of the not-so-obvious aspects of Subchapter S, I explore how the flowthrough of items of income, loss, deduction and credit are impacted when there are changes in the ownership of an S corporation during the taxable year.

GENERAL RULE

Absent any changes in ownership of an S corporation during the taxable year, the rule is simple – all items of income, loss, deduction and credit are allocated and passed through to the shareholders on a pro-rata basis.

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When there has been a change in ownership of an S corporation during the taxable year, however, different rules come into play. These changes in ownership can come about in different ways:

1. The corporation redeems shares;
2. The corporation issues new shares;
3. An existing shareholder transfers shares to another existing shareholder; or
4. A shareholder transfers shares to a non-shareholder.

In accordance with Code Section 1377(a)(1), as a general rule, in each of these circumstances, each shareholder's pro-rata share of items of income, loss, deduction and credit for the taxable year is determined by a three-step process:

Step 1. Compute the items of income, loss, deduction and credit for the entire taxable year;

Step 2. Divide the amounts arrived at in Step 1 by the number of days in the taxable year (365 days in the year, except in a leap year); and

Step 3. Assign the amounts arrived at in Step 2 to each share (or fractional share) multiplied by the number of days each share (or fractional share) was owned during the taxable year.

EXAMPLE 1: X Corporation is solely owned by Shareholder A who holds 100 shares. On February 1, 2024, Corporation X issues 100 new shares to Shareholder B. For taxable year 2024, Corporation X had \$2 million of gross income and \$1 million of expenses (or \$1 million of taxable income). On IRS Schedule K-1 for the 2024 taxable year, Shareholder A will be allocated \$542,466.54 of taxable income and Shareholder B would be allocated \$457,534.91 of taxable income, computed as follows:

Step 1. X Corporation has taxable income of \$1 million for the taxable year.

Step 2. \$1 million divided by 365 days = \$2,739.73 per day

Step 3. Shareholder A: 100% of the shares for 31 days ($31 \times \$2,739.73 = \$84,931.63$) and owns 50% of the shares for 334 days ($334 \times \$2,739.73 \times 50\% = \$457,534.91$) or a total of \$542,466.54 of taxable income ($\$84,931.63 + \$457,534.91$). Shareholder B: 50% of the shares for 334 days = \$457,534.91 of taxable income ($334 \times \$2,739.73 \times 50\%$).

EXAMPLE 2: Same facts as Example 1, but Shareholder B only obtained 50 shares, which he purchased from Shareholder A. Same results.

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EXAMPLE 3: Same facts as Example 1, but rather than acquiring new shares from Corporation X, Shareholder B purchased 100% of Shareholder A's shares. On IRS Schedule K-1 for the 2024 taxable year, Shareholder A will be allocated \$84,931.63 of taxable income ($31 \times \$2,739.73 = \$84,931.63$) and Shareholder B will be allocated \$915,069.82 of taxable income ($334 \times \$2,739.73 = \$915,069.82$).

EXAMPLE 4: X Corporation is owned by Shareholder A who holds 100 shares and Shareholder B who owns 200 shares. On February 1, 2024, Corporation X redeems all 100 shares owned by Shareholder A, terminating his interest in X Corporation. Under the general rule, for taxable year 2024, Corporation X had \$2 million of gross income and \$1 million of expenses (or \$1 million of taxable income). On IRS Schedule K-1 for the 2024 taxable year, Shareholder A will be allocated \$28,310.54 of taxable income and Shareholder B would be allocated \$971,690.90 of taxable income, computed as follows:

Step 1. X Corporation has taxable income of \$1 million for the taxable year.

Step 2. \$1 million divided by 365 days = \$2,739.73 per day

Step 3. Shareholder A: $1/3^{\text{rd}}$ of the shares for 31 days ($31 \times \$2,739.73 = \$84,931.63$) $\times 1/3^{\text{rd}} = \$28,310.54$ taxable income. Shareholder B: $2/3^{\text{rds}}$ of the shares for 31 days ($31 \times \$2,739.73 = \$84,931.63 \times 2/3^{\text{rds}} = \$56,621.08$) plus 100% of the shares for 334 days ($334 \times \$2,739.73 = \$915,069.82$) for total taxable income of \$971,690.90 ($\$56,621.08 + \$915,069.82$).^[1]

ALTERNATIVE RULES

The above rule is the default rule. There are, however, two alternative rules that could come into play when shares change hands during the taxable year. These alternatives come from two sources, namely Code Section 1377(a)(2) and Treasury Regulation Section 1.1368-1(g). Both of these alternatives are elective.

Again, under Code Section 1366, items of income, loss, deduction and credit are allocated to the shareholders on a pro-rata basis. If there is a change in the share ownership during the taxable year, absent an election under Code Section 1377(a)(2) or Treasury Regulation Section 1.1368-1(g), these items for the taxable year are allocated to the shareholders as illustrated above under the general rule prescribed by Code Section 1377(a)(1).

Code Section 1377(a)(2) Election

An election under Code Section 1377(a)(2) only applies to the situation where a shareholder's complete interest in the S corporation is terminated during the taxable year (i.e., 100% of his shares are transferred).

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Practice Alert: Code Section 1377(a)(2) does not apply when shares are issued by the corporation to a new shareholder or to an existing shareholder (increasing his or her share percentage), or when a shareholder transfers less than all of the shareholder's shares during the taxable year. The election is only available when a shareholder's entire interest in the S corporation is transferred during the taxable year.

Under Code Section 1377(a)(2), an election may be made to require that the corporation closes its book on the date of a termination of a shareholder's interest in the S corporation, thereby creating two short taxable years, in which case the corporation allocates the items of income, loss, deduction and credit on a pro-rata basis to the shareholders owning shares during each short taxable year.

EXAMPLE 5: Same facts as Example 4, except Corporation X had a taxable loss of \$200,000 for January 1, 2024, through January 31, 2024, and taxable income of \$1,200,000 for February 1, 2024, through December 31, 2024, and an election was made under Code Section 1377(a)(2) to close the books of Corporation X. On IRS Schedule K-1 for the 2024 taxable year, Shareholder A would be allocated a loss of \$66,666.67 ($\$200,000 \text{ loss} \times 1/3^{\text{rd}} = -\$66,666.67$), and Shareholder B would be allocated \$1,066,666.67 of taxable income ($\$200,000 \text{ loss} \times 2/3^{\text{rds}}$ or $-\$133,333.33 + 100\% \text{ of } \$1,200,000 = \$1,066,666.67$).

EXAMPLE 6: Same facts as Example 5 but rather than have his or her shares redeemed by Corporation X, Shareholder A sold the shares to Shareholder C. If an election was made under Code Section 1377(a)(2), on IRS Schedule K-1 for the 2024 taxable year, Shareholder A would be allocated a loss of \$66,666.67 ($\$200,000 \text{ loss} \times 1/3^{\text{rd}} = -\$66,666.67$), Shareholder B would be allocated \$666,666.67 of taxable income ($\$200,000 \text{ loss} \times 2/3^{\text{rds}}$ or $-\$133,333.33 + 2/3^{\text{rds}}$ of $\$1,200,000 = \$666,666.67$), and Shareholder C would be allocated \$400,000 of taxable income ($1/3^{\text{rd}}$ of $\$1,200,000 = \$400,000$).

The above examples illustrate the difference in the tax impact on the shareholders when an election is made under Code Section 1377(a)(2) and when no election is made. In a business where the income and expenses are not evenly generated or incurred during the taxable year, closing the books can create greatly different results. The tension between the affected shareholders may be dramatic. Without an election, as illustrated above, the tax impact on the affected shareholders can greatly differ.

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An election under Code Section 1377(a)(2) is made by attaching a statement to the S corporation's IRS Form 1120S for the taxable year in which a shareholder's interest was terminated stating that the shareholders elect to close the books under Code Section 1377(a)(2). Prior to the Small Business Job Protection Act of 1996, PL 104-188, 1996, if any S corporation shareholder terminated his or her interest during a taxable year, the corporation (with the consent of all shareholders) was allowed to elect to allocate items of income, deduction, credit or loss by closing its books on the date of termination rather than applying the normal per-share/per-day allocation rules. Congress believed that the election should not require the consent of any shareholder whose tax liability is unaffected by the election. Consequently, in accordance with § 1306 of the 1996 Act, for taxable years beginning in 1997 and later, only the terminating shareholder and the shareholder(s) to whom the shares are transferred must consent to the election to close the books. However, if the shares are transferred to a corporation (including a redemption by the S corporation), however, all persons who were shareholders of the S corporation during the taxable year must consent to the election.

Practice Alert: To avoid unneeded tension among shareholders, any agreement to transfer shares where the transfer will cause a termination of interest should clearly provide whether the affected parties (transferor and transferee) agree to join in an election to close the books under Code Section 1377(a)(2). Failure to include such a provision may lead to conflict after the transaction is completed.

Practice Alert: Because a transaction where the acquirer of shares is a corporation, as is the case in a redemption, requires that all shareholders of the S corporation agree to make an election under Code Section 1377(a)(2), it may be wise to consider including a provision in an agreement among the corporation and all shareholders (i.e., the shareholder agreement) that provides whether an election under Code Section 1377(a)(2) will be made in the case of a transfer to a corporation such as a redemption.

Election Under Treasury Regulation Section 1.1368-1(g)

Treasury Regulation Section 1.1368-1(g) provides another election out of the general rule relating to how to allocate items of income, loss, deduction and credit among the shareholders in cases where there is a change in ownership during the taxable year. This election is not as well-known as the Code Section 1377(a)(2) election.

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An election under Treasury Regulation Section 1.1368-1(g) only applies in three circumstances:

- When a shareholder disposes of 20% or more of the S corporation's outstanding shares in one or more transactions in any 30-day period during the taxable year.
- When a shareholder has 20% or more of the S corporation's outstanding shares redeemed in one or more transactions treated as an exchange under Code Sections 302(a) or 303(a) in any 30-day period during the taxable year.
- When there is an issuance of shares by the S corporation during any 30-day period during the corporation's tax year equal to 25% of the previously outstanding shares.

Like an election under Code Section 1377(a)(2) election, an election under the Treasury Regulation allows the closing of the S corporation's books and an allocation of items of income, loss, deduction and credit among the shareholders on a pro-rata basis during each of the two short taxable years. There are significant differences between the two elections, including:

- If there is a termination of interest, an election under the Treasury Regulation is unavailable. In other words, an election, if any, can only be made under Code Section 1377(a)(2). Code Section 1377(a)(2) trumps Treasury Regulation 1.1368-1(g).
- The election under the Treasury Regulation is made in the same manner as an election under Code Section 1377(a)(2). See Reg. Section 1368-1(g)(2)(iv).
- The election must be signed by all persons who were shareholders during the taxable year (both short years). See Reg. Section 1368-1(g)(2)(iii). See also, PLR 202345005. It appears the required consent under the Treasury Regulations election may differ from the consent required by Code Section 1377(a)(2) (only affected shareholders must consent).
- The election under the Treasury Regulation is allowed only in the three situations outlined above.

Because an election out of the general rule made pursuant to Treasury Regulation Section 1.1368-1(g) requires the consent of all persons who were shareholders during the taxable year (i.e., both short taxable years), the same dilemma relative to consents that is present in the case of an election under Code Section 1377(a)(2) exists. Tax advisers should discuss the matter with their clients before a qualifying event occurs and consider obtaining agreement to the approach that will be pursued if a qualifying event ever occurs in a document such as a shareholder agreement (to which existing and new shareholders will be bound by). Getting consensus from the shareholders down the road when a qualifying disposition occurs may not be easy to obtain.

CONCLUSION

As discussed above, the general rule in the S corporation setting is that all items of income, loss, deduction and credit are allocated among shareholders on a pro-rata basis on a taxable year basis. There is no closing of the books. However, under Code Section 1377(a)(2) and Treasury Regulation 1.1368-1(g), in certain circumstances, an S corporation and its shareholders may elect out of the general rule, closing the books of the corporation and allocating these items to the shareholders on a pro-rata basis over two short tax years. Depending upon the activity of the S corporation, the tax outcome under an election out of the general rule may vary among shareholders. Consequently, tax advisers need to discuss the options with the corporation and its shareholders. Obtaining agreement among the shareholders as to which approach will be taken before a qualifying event occurs is likely warranted.

Stay tuned for more installments in my multi-part series on some of the not-so-obvious aspects of Subchapter S!

[1] These computations were rounded off by my handy dandy calculator.

Tags: A Journey Through Subchapter S, S corporation, shareholders