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Case Study on the Tax Ramifications of S Corporation Shareholder Termination or Change of Ownership Interest

(Full Paper Submission)

Elizabeth Conner
University of Colorado - Denver
elizabeth.conner@ucdenver.edu

Doug Laufer
Metropolitan State University of Denver
lauferd@msudenver.edu

ABSTRACT

The purpose of this paper and the conference presentation is to discuss the wide variation in income tax effects that can occur when a shareholder of an S corporation either terminates or changes his or her ownership interest in the corporation. A case study used in an income tax course to focus on this matter will be presented. The case is intended to enhance student’s thinking skills and technical competencies.

KEYWORDS: Case study, accounting education, income tax, S Corporation

INTRODUCTION

An S corporation is a hybrid type entity because it is has characteristics of both a regular C corporation and a partnership. Many small businesses today are structured as S corporations because an S corporation affords the same legal protection as a regular C corporation and is considered a pass- through entity similar to a partnership where the profits/losses are passed directly to the shareholders. This allows an S corporation to avoid double taxation on the corporate income.

As a pass-through entity, an S corporation must allocate its profit/loss for the year pro rata (also known as daily proration) to its shareholders based on the number of outstanding shares each shareholder owns during the tax year.

If a shareholder sells his or her shares during the year, the shareholder will use the same daily proration allocation to report his or her share of the S corporation profit/loss for the days the shareholder owned the stock, (including the day of sale). In addition, the shareholder will report a capital gain or loss from the sale of the shares in the S corporation.

The IRS allows another method of allocating profit/loss of an S corporation when a shareholder sells his or her shares in the corporation during the year. This is known as the “closing of the books method.” This method treats the taxable year of the S corporation as if it consists of separate taxable years. The closing of the books method is only permitted when elected by all affected shareholders (those with changing ownership during the year).

For a shareholder who terminates his or her ownership interest in the S corporation during the year, the S corporation makes the election by attaching a statement to the tax return stating that
it is electing for the taxable year under Treas. Reg. § 1.1377-1 to treat the taxable year of the S corporation as two taxable years for the shareholder who terminates his or her entire interest in the company during the year.

For a shareholder that is selling a partial interest, the disposition must be deemed a qualifying disposition where the shareholder sells 20% or more of his or her ownership interest within a thirty-day period. Upon agreement by all affected shareholders, the S corporation can make an election by attaching a statement to the tax return stating that it is electing for the taxable year under Treas. Reg. § 1.1368-1(g)(2)(i) to treat the taxable years as if it consists of separate taxable years.

The S corporation and its shareholders should be aware that the daily proration method used in allocating the profits/losses of the S corporation each year to its shareholders is not necessarily the only method allowed in a year that a shareholder sells his or her interest. The alternative method “closing of the books” may give a much better income tax result to the affected shareholders over the daily proration method. Tax planning is essential in this area because the differences in income taxes levied on the affected shareholders can be vastly different.

PURPOSE

The purpose of this paper and the conference presentation will be to share a case study used in an income tax course. The case facts, assignment requirements, solutions and discussion are presented below. The case provided a platform for the discussion of the wide variation in income tax effects that can occur when a shareholder of a Sub-S corporation either terminates or changes in his or her ownership interest in the corporation.

Case Objectives

This case study is appropriate for an Income Tax I or Tax II course. The objectives of this case are threefold. First, this case requires the students to analyze a fact pact relating to the operations of an S Corporation. Based on the above facts the students will be required to determine the tax impact on the organizations shareholders. In completing the first requirement the students will research relevant U.S. tax rules and regulations. Lastly, this case will aid in the development of the students’ analytical and critical thinking skills as they endeavor to prepare case solutions and compare the outcomes under income tax law alternatives.

Pedagogical Objectives

Taxation and accounting curricula has changed significantly over the last two decades. Rote technical memorization has been replaced by an expanded focus on broader business, communication, and analytical skills (Myers, 2005). Accounting educators are continually attempting to develop new and more effective ways to deliver subject matter. The challenge is to provide students with materials that have real world relevance and engage students actively in the learning process. The result is an expanded array of teaching pedagogies that support an active learning approach and help students develop skills set forth in the AICPA Core Competency Framework (Framework). The Framework details the skills needed for entry into the profession of accounting. Competencies are categorized as functional (technical competencies most closely aligned with the value contributed by accounting professionals), personal (individual attributes and values) and broad business perspective competencies (relating to understanding of internal and external business contexts) (AICPA, 2004).
The case method is a pedagogy that provides a process by which students are actively involved in the learning process; utilization of the case method also addresses the core competencies detailed in the Framework. There has been a good deal of research that supports the use of the case method in accounting instruction (Stout, 1996). The case method differs significantly from the traditional lecture-based content teaching approach; the emphasis shifts to the student with a focus on discussions (i.e. communication) and induction (i.e. critical thinking) (Webb, 2005). To be effective case studies must have real world relevance, provide a valuable experience, and be an integral part of the course (Gelinas, 2001).

This case is designed to accomplish a number of the above pedagogical objectives by actively involving students in the learning process, employing the use of an activity based on real world relevance, and enhancing the development of the critical thinking ability of students and other competencies outlined in the Framework.

Teaching Method

The case material can be used to motivate class discussion of importance of proper tax planning and that knowledge of tax law is critical to representing tax clients in a competent, professional manner. As the instructor covers a particular topic, the related case study topic can be assigned to the student. Students will be expected to complete specific readings in the text as well as researching primary and secondary tax authority in order to be able to complete the related case assignment. The student will be expected to use Excel application in completing the number crunching part of the assignment. A portion of a class meeting should be devoted to discussion of the case assignment. This activity can be structured as a group activity or as general class discussion.

CASE STUDY FACTS AND DISCUSSION

S Corporation – Termination of a Shareholder’s interest: Daily Proration Example

The following example illustrates daily proration and the termination of a shareholder’s interest during the tax year. Daily proration is required when no special election is made to use closing of the books.

Facts:

Mary Simpson and Jack Depew (unrelated taxpayers) are the sole shareholders of an antique furniture company called Antique Haven, Inc. Mary and Jack incorporated their business several years ago and filed the necessary election to be treated for tax purposes as a Subchapter S corporation with a calendar year end. The Company issued an equal number of common shares (300 shares) to Mary and (300 shares) to Jack in exchange for $6,000.

At the beginning of 2015, Mary and Jack each had a basis in the stock of Antique Haven, Inc. of $200,000. The Company has been experiencing some tough times with the downturn in the economy and various other factors pertaining to the business environment where Antique Haven is located. The Company has not paid any distributions to Mary and Jack for the past couple of years due to cash flow problems.
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S-Corporation Tax Ramifications

For the first several months of 2015, the Company reported nothing but operating losses. Mary decided that she had enough and wanted out of Antique Haven.

On May 31, 2015, Mary sold all of her 300 shares to Sally Benson for $100,000. The Company reported a loss (non-separately computed) of $319,969 from January 1 - May 31, 2015.

In the summer of 2015, Antique Haven decided to engage in an active advertising campaign to try and improve its operating performance. The advertising proved successful and with the bustling holiday shopping season, the Company was happy to report an overall profit (non-separately computed) of $470,120 for the year 2015.

**Required:**
**Part One:** As a pass-through entity the S corporation reports its profit/loss to the shareholders using a pro rata (daily proration) method of allocation. What is pro rata or daily proration allocation?

**Part Two:** Based on the above facts what is the tax impact for 2015 on Mary, Jack and Sally?

**Part One Solution/Discussion:**
According to Treas. Reg. § 1.1377-1(a)(1), a shareholder’s pro rata share of any S corporation item of income or expense for any taxable year is the sum of the amounts determined with respect to the shareholder by assigning an equal portion of the item to each day in an S corporation’s taxable year, and then dividing that portion pro rata among the shares outstanding on that day.

In essence, the income and expenses are allocated based on the number of outstanding shares that each shareholder owns on each day of the tax year (IRC §1366(a) and §1377(a)).

If a shareholder terminates his or her interest during the year, Treas. Reg. § 1.1377-1(a)(2) specifies that the terminating shareholder will be considered a shareholder on the day of disposition.

**Part Two Solution/Discussion:**
Mary will have ordinary income from the S corporation, Antique Haven, Inc. of $97,244, all of which stems from the later part of the year when she was not even a shareholder. She will also have a long-term capital loss from the sale of her stock to Sally Benson of $197,244. If she has no other capital gains to offset this long-term capital loss she will only be able to deduct $3,000 per year against her ordinary income.

Jack is not affected since his ownership did not change. Sally Benson, being the new shareholder, will have ordinary income of $137,816 from Antique Haven, Inc. for the remaining 214 days of the 365-day year that she became a 50% owner from her purchase of Mary’s stock.
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S-Corporation Tax Ramifications

S Corporation – Termination of a Shareholder’s interest: Alternative Allocation Method - Closing of the Books

As shown in the above example, Mary is being “penalized” using daily proration because Antique Haven’s profit of $470,120 for the entire year is allocated to her pro rata based on her ownership of 300 shares (50% interest) for 151 of 365 days. This caused her basis in the stock to go up by almost $100,000 and as a result the loss on the sale of her stock was larger. Also, since no distributions were paid by Antique Haven to the shareholders Mary was not able to reduce her basis by receiving any cash flow from the Company.

A special irrevocable election can be made under IRC §1377(a)(2)(b) and Treas. Reg. §1.1377-1(b)(1). If a shareholder’s entire interest in an S corporation is terminated during the S corporation’s taxable year and the corporation and all affected shareholders (those with changing ownership during the year) agree, the S corporation may elect to treat the S corporation’s taxable year as consisting of “two separate taxable years,” the first of which ends at the close of the day on which the shareholder’s entire interest in the S corporation is terminated. This election is not allowed if the S election is terminated upon the cessation of the shareholder’s interest.

The S corporation makes the election by attaching a statement to a timely filed tax return (including extensions) stating that it is electing under Treas. Reg. §1.1377-1 to treat the taxable year of the S corporation as two taxable years for the shareholder who terminates his or her entire interest in the company during the year.

Case Study - Closing of the Books Method

**Required:** Using the same facts as provided for the case above what is the tax impact for 2015 on Mary, Jack and Sally if the closing of the books method is elected?

**Closing of the Books Method Solution/Discussion:**

Mary will have an ordinary loss from the S corporation, Antique Haven, Inc. of $159,985, all of which stems from the first part of the year (151 days) when she was a shareholder. She will also have a long-term capital gain from the sale of her stock to Sally Benson of $59,984. This
Outcome to Mary from a tax standpoint is much better than daily proration because she can deduct the entire ordinary loss against her other ordinary income and her long-term capital gain is taxed at a more favorable rate than ordinary income.

Jack is not affected since his ownership did not change. Sally Benson, being the new shareholder, will have a much larger ordinary income of $395,044 from Antique Haven, Inc. for the remaining 214 days of the year that she became a 50% owner from her purchase of Mary’s stock. This will give her a healthy basis at year-end to absorb potential future losses from Antique Haven and distributions paid by the Company.

NOTE: Since Mary and Sally are the affected shareholders, both must agree to use closing of the books method. This election is irrevocable. Antique Haven’s tax year will be separated into two taxable years, the first being January 1-May 31 (151 days) when Mary sells her entire interest in the Company and the second being June 1-December 31 (214 days), the period when Sally Benson became a 50% shareholder. NOTE: This does not mean the Company files two tax returns for the year. It still files one tax return but the income reported to the shareholders is based on two split accounting periods.

<table>
<thead>
<tr>
<th>Beginning stock basis</th>
<th>Mary</th>
<th>Jack</th>
<th>Sally</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>$200,000</td>
<td></td>
<td></td>
<td></td>
<td>$400,000</td>
</tr>
</tbody>
</table>

**Closing of the books method upon making the election:**

**Mary**
- ($319,969) loss/ 151 days: $(2,119.00) per day
- Jan 1-May 31 = 151 days: $(159,985)

**Jack**
- Calendar year 2015: $470,120 x 50% = 235,060

**Sally**
- $470,120 + $319,969 = $790,089 = 214 days: $3,692 per day
- June 1 - Dec. 31 = 214 days: 395,044

**Ordinary Income (loss) reported on K-1**
- Mary sells her entire interest to Sally: $(100,000)

**Subtotal: Stock basis**
- 40,016
- 435,060
- 395,044
- 870,120

**Long-term capital gain (loss)**
- 59,984
- N/A
- 100,000
- 0
- 59,984

**S Corporation – Change in a Shareholder’s Interest through Sale of Stock Other Than Termination of an interest**

Similar rules apply to an S corporation’s shareholders when a shareholder sells a portion of his or her shares in an S corporation, that is, a pro rata allocation (daily proration) is required. However, if the selling shareholder meets the qualifying disposition rules set forth in Treas. Reg. § 1.1368-1(g)(2)(i) (shown below) and all affected shareholders consent, the S corporation can elect under Treas. Reg. § 1.1368-1(g)(2)(iii) to use an alternative allocation method called closing of the books. The case study can be expanded to include a comparison of outcomes under the pro rata allocation and closing of the books methods for this scenario. Pertinent facts, calculations and outcomes are included below to assist any instructor that desires to include this situation in the case study.
Qualifying Disposition:
A disposition by a shareholder of 20 percent or more of the outstanding stock of the corporation in one or more transactions during any thirty-day period during the corporation’s taxable year;
A redemption treated as an exchange under IRC § 302(a) or IRC § 303(a) of 20 percent or more of the outstanding stock of the corporation from a shareholder in one or more transactions during any thirty-day period during the corporation’s taxable year; or
An issuance of an amount of stock equal to or greater than 25 percent of the previously outstanding stock to one or more new shareholders during any thirty-day period during the corporation’s taxable year.

Example:
To illustrate a change in a shareholder’s interest during the year, assume the same facts as the original example set forth in this case except that Mary sells 180 of her 300 shares to Sally on May 31. Mary downsizes from owning 50% to owning 20% of Antique Haven, Inc. and Sally will become a 30% owner of Antique Haven, Inc. Jack will remain a 50% owner.

NOTE: Because Mary sells 30% of her stock to Sally this meets the qualifying disposition requirements shown above.
Assume no special election is made under Treas. Reg. § 1.1368-1(g)(2)(iii) to use closing of the books method. Antique Haven will be required to use daily proration to allocate its profit for the year.

Outcome:
Mary will have ordinary income from the S corporation, Antique Haven, Inc. of $152,370, comprised of two split taxable years. She will also have a long-term capital loss from the sale of her stock to Sally Benson of $45,711. If she has no other capital gains to offset this long-term capital loss she will only be able to deduct $3,000 per year against her ordinary income. As was discussed when Mary terminated her interest in Antique Haven, Mary is being “penalized” using daily proration because Antique Haven’s profit of $470,120 for the entire year is allocated to her pro rata based on her ownership of 300 shares (50% interest) for 151 of 365 days and her
ownership of 120 shares (20% interest) for 214 of 365 days. Mary's basis will increase by the ordinary income and as a result the loss on the sale of her stock will be larger. Also, since no distributions were paid by Antique Haven to the shareholders Mary was not able to reduce her basis by receiving any cash flow from the Company.

Jack is not affected since his ownership did not change. Sally Benson, being the new shareholder, will have ordinary income of $82,690 from Antique Haven, Inc. for the remaining 214 days of the 365-day year that she became a 30% owner from her purchase of a portion of Mary's stock.

2. Assume Mary and Sally agree to make the special election under Treas. Reg. § 1.1368-1(g)(2)(iii) to use closing of the books method. Antique Haven will make the election by attaching a statement to its timely filed tax return (including extensions).

<table>
<thead>
<tr>
<th>NOTE: Mary sold of 30% of her stock to Sally</th>
<th>Mary</th>
<th>Jack</th>
<th>Sally</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beginning stock basis</td>
<td>$200,000</td>
<td>$200,000</td>
<td>$50</td>
<td>$400,000</td>
</tr>
<tr>
<td><strong>Closing of the books method upon making the election:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Mary</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>$(3319.969) loss/ 151 days</td>
<td>$(2119.00) per day</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Jan 1 - May 31 = 151 days</td>
<td>x 151 days x 50%</td>
<td>(159,985)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>$790,089 /214 days=</td>
<td>$3,692 per day</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>June 1 - Dec. 31 =</td>
<td>x 214 days x 20%</td>
<td>158,018</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Jack</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Calendar year 2015</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>$470,120 x 50%</td>
<td>235,060</td>
<td></td>
<td>235,060</td>
<td></td>
</tr>
<tr>
<td><strong>Sally</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>$(470,120+3319.969)-$(790,089)</td>
<td>$3,692 per day</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>June 1 - Dec. 31 = 214 days</td>
<td>x 214 days x 30%</td>
<td>237,026</td>
<td></td>
<td>237,026</td>
</tr>
<tr>
<td><strong>Ordinary income (loss) reported on K-1</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Subtotal: Stock basis</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>$198,033</td>
<td>435,060</td>
<td>237,026</td>
<td>870,120</td>
<td></td>
</tr>
<tr>
<td>Mary's stock basis sold: 30% x $198,033=</td>
<td>59,410</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mary sells 30% interest to Sally</td>
<td>(60,000)</td>
<td>N/A</td>
<td>60,000</td>
<td>0</td>
</tr>
<tr>
<td><strong>Long-term capital gain</strong></td>
<td>590</td>
<td></td>
<td></td>
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</tr>
</tbody>
</table>

**Outcome:**

Mary will have an ordinary loss from the S corporation, Antique Haven, Inc. of $1,967. She will also have a small long-term capital gain from the sale of her stock to Sally Benson of $590. This outcome to Mary from a tax standpoint is much better than daily proration because she can deduct the ordinary loss against her other ordinary income and her long-term capital gain is taxed at a more favorable rate than ordinary income.

Jack is not affected since his ownership did not change. Sally Benson, being the new shareholder, will have ordinary a much larger ordinary income of $237,026 from Antique Haven, Inc. for the remaining 214 days of the year that she became a 30% owner.

**CONCLUSION**

There is a need to provide students with challenging assignments that escape the one right answer syndrome and require critical thinking. The use of real-world based cases is an excellent vehicle in support of that goal. In this case study proper tax planning and knowledge of tax rules are critically important to assist and advise shareholders of Sub-S corporations who are
contemplating a change in their ownership. Hopefully the material provided in this paper will help meet this need.

REFERENCES


Internal Revenue Code § 302

Internal Revenue Code § 303

Internal Revenue Code § 1366

Internal Revenue Code § 1377

IRC Treasury Regulations § 1.1368-1

IRC Treasury Regulations § 1.1377-1

