THE TAX ADVISER

Distributing Property to S Corporation Shareholders

CASE STUDY
Published April 01, 2011

Editor: Albert B. Ellentuck, Esq.

An S corporation can distribute property (as well as cash) to its shareholders. If property is distributed, the amount of the distribution is considered to be the property's fair market value (FMV) (Sec. 301(b)). The tax attributes of the distribution are generally determined as if the distribution had been made in cash.

When appreciated property (property that has an FMV in excess of its adjusted basis) is distributed, gain is recognized in the same manner as if the S corporation had sold the property to the shareholders at its FMV (Sec. 311(b) via Sec. 1371(a)). The gain passes through to the shareholders and increases their basis in their stock. No loss is allowed, however, if the distributed property has an FMV that is less than the corporation's tax basis in such property. (Under Sec. 336, a loss can be recognized if the distribution is in liquidation of the corporation.) The shareholder's basis in the distributed property is its FMV (Sec. 301(d)).

> ***Example 1:*** *A* and *B* each own 50% of *A&B* Inc.'s stock. Each shareholder wants to receive a distribution of $20,000, but the corporation does not have the cash available to make the distributions. *A* suggests that *A&B* distribute $20,000 cash to him and a fully depreciated piece of equipment worth $20,000 to *B*. (The equipment originally cost $50,000.) *A&B* has been an S corporation, and *A* and *B* have been shareholders, for 12 years. *A&B* has not previously merged with another corporation.

If the equipment is distributed to *B*, a gain of $20,000 (FMV of $20,000 less basis of zero) will be recognized at the corporate level. All of the gain will be subject to tax as ordinary income due to depreciation recapture (Sec. 1245). It will be passed through so that *A* and *B* each will report $10,000 of income from the deemed sale. *B* will be considered to have received a $20,000 distribution, and the tax attributes of the distribution will be determined as if the distribution had been made in cash. *B*'s basis in the equipment will be its $20,000 FMV, so if she sold it for $20,000, she would recognize no gain or loss from the sale (Sec. 301(d)).

If the shareholders do not want to report gain from the distribution, they could distribute equipment to *B* that had a basis higher than its FMV so that corporate-level gain could be reduced or eliminated. As a general rule, however, assets that have basis in excess of FMV should not be distributed to a shareholder because the potential loss cannot be used by either the corporation or the distributee shareholder.

To summarize, distribution of the equipment to *B* would cause *A&B* to recognize ordinary income of $20,000. Distribution of an appreciated asset to a shareholder is treated at the corporate level as if it had been sold to her at its FMV. This can cause other shareholders to report gain from the transaction.

Evidently, *B*'s holding period begins when she actually or constructively receives the property because the distribution is treated as if the property were sold to the shareholder at its FMV on that date. Furthermore, since *B*'s basis in the property is its FMV (rather than a carryover of the corporation's basis), the corporation's holding period would apparently not tack onto *B*'s holding period.

Observation: Distributions of appreciated property can cause tax at the corporate level if the corporation is subject to the built-in gains tax.

Determining FMV of Distributed Property

The Tax Court has ruled (and the Ninth Circuit agrees) that the FMV of the distributed property is determined as if it were sold in its entirety, even though the distributee shareholders may ultimately receive property of lesser value. In *Pope & Talbot, Inc.*, 104 T.C. 574 (1995), aff'd, 162 F.3d 1236 (9th Cir. 1999), the corporation transferred land and other property with an FMV of $115 million to a partnership. Immediately after the transfer, the shareholders received interests in the limited partnership valued at a total of $40 million. The corporation calculated its gain on the distribution as if it had sold the property for $40 million. The Tax Court ruled that the value of the property was $115 million, the amount the corporation would have received had it sold the property in its entirety to the shareholders at its FMV. Even though the corporation in this case was a C corporation, the same premise should apply to an S corporation.

Distributing Property When Basis Exceeds FMV

No loss is recognized at the corporate level when an S corporation distributes property with an FMV that is less than its basis. (Conversely, a loss can be recognized if the distribution is in liquidation of the corporation.)

Generally, stock basis and accumulated adjustments accounts (AAAs) are reduced by corporate expenses and losses that are neither deductible nor capitalizable (Sec. 1367(a)(2)(D); Regs. Sec. 1.1367-1(c)(2)). Although there is no authority exactly on point, it appears that stock basis and AAA are reduced by the unrecognized loss when an S corporation distributes property having an adjusted basis that exceeds its FMV.

Because the loss on property distributed when its basis exceeds its FMV is unrecognized, and because stock basis and AAA may be reduced by the unrecognized loss, distributions of such property should be avoided.

> ***Example 2:*** The facts are the same as in Example 1, except the equipment distributed to *B* has a basis of $25,000 and an FMV of $20,000. Although the property's FMV is less than its basis, no loss is recognized at the corporate level. The transaction is considered to be a distribution in the amount of the equipment's FMV—$20,000. Distributing property that has not appreciated solves the problem of corporate-level gain on distribution, but it creates another problem: disallowance of the $5,000 loss. *B*'s basis in the equipment is $20,000, its FMV (Sec. 301(d)).

Because Sec. 1367(a)(2)(D) requires that stock basis and AAA be reduced by corporate expenses and losses that are neither deductible nor capitalizable, the corporation's AAA is evidently reduced by the $5,000 unrecognized loss. In addition, each 50% shareholder evidently reduces stock basis by $2,500. As a result of the $20,000 equipment distribution, *B*'s stock basis is, in total, reduced by $22,500.

Assuming Liabilities by Shareholder Reduces Property Distribution

The amount of a property distribution is reduced by the amount of any liabilities assumed by the shareholder (Regs. Sec. 1.301-1(g)). A recourse liability is treated as being assumed by the transferee shareholder if that shareholder has agreed to, and is expected to, satisfy the liability. A nonrecourse liability generally is treated as having been assumed by the transferee shareholder if the distributed asset is subject to that liability (Sec. 357(d)).

Recognizing Ordinary Income on Distribution of Depreciable Property

If property sold or exchanged between related parties is depreciable by the buyer, any gain recognized on the sale or exchange is treated as ordinary income (Sec. 1239). This rule applies even if (1) the property was not depreciable by the seller, (2) the buyer does not actually depreciate it, or (3) the parties have no tax avoidance motives.

For these purposes, the term “related person” includes an S corporation and a shareholder who owns (directly or indirectly) more than 50% of its stock, as well as an S corporation and another corporation (C or S corporation) if the same persons own more than 50% of the stock of each corporation (Sec. 1239(b)).

The ordinary income rule of Sec. 1239 applies to distributions of property because gain on such distributions is treated as if the property were sold to the shareholder at its FMV (Sec. 311(b) via Sec. 1371(a)).

If an S corporation’s sale or exchange (or distribution) of property to a related party includes depreciable and nondepreciable property, any gain is allocated among the properties, and only the gain allocable to the depreciable property is subject to the ordinary income rule. Thus, the S corporation and the distributee shareholder could, to the extent reasonable, allocate more of the sales price to the nondepreciable property. However, this would reduce the shareholder’s future depreciation deductions because he or she would have to forgo depreciation on the nondepreciable portion.

This case study has been adapted from *PPC’s Tax Planning Guide—S Corporations*, 24th Edition, by Andrew R. Biebl, Gregory B. McKeen, George M. Carefoot, James A. Keller, and Brooke Paschall, published by Practitioners Publishing Company, Ft. Worth, TX, 2010 ((800) 323-8724; ppc.thomson.com).

EditorNotes

Albert Ellentuck is of counsel with King & Nordlinger, L.L.P., in Arlington, VA.