opinion requires the lawyer to take some action but it does not require the lawyer to notify the clerk of court if the lawyer learns that the personal representative has breached her fiduciary duty to the estate.

For my own practice, the two takeaways from Opinion #2 of FEO 2 are (1) don't keep the checkbook for the PR, and (2) don't write out checks for the PR to sign. Those are unfortunate results of FEO 2 since in many cases the lawyer's keeping the checkbook probably helped achieve the goals that FEO 2 is ostensibly trying to promote, but now some lawyers will be less willing to take on that obligation – and clients may not be willing to pay for the lawyer's review time. A third takeaway, not discussed above but easy to implement, is to make sure that the lawyer's standard correspondence to PRs at the beginning of the administration process should “advise the personal representative of her fiduciary responsibilities relative to the safekeeping of the funds of the estate.”

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Timing Is Everything

By Linda F. Johnson

World-renowned golf pro Arnold Palmer said, “Timing is everything in life and golf” (www.asquotes.com). While this author cannot speak to whether timing is truly everything, timing is certainly everything in dealing with the basis opportunities that arise from the death of an S corporation shareholder who owns 100 percent of the shares at the shareholder’s death.

Background – Share Basis (Outside Basis) vs. Asset Basis (Inside Basis)

The income, losses, deductions, and credits from an investment in an S corporation are taxed directly to the shareholders. I.R.C. § 1366(a)(1); I.R.C. § 1377(a)(1). A shareholder’s basis in S corporation stock is calculated through a system of adjustments to the shareholder’s initial capital contribution or the cost of the shares purchased. This basis system is similar to the rules that apply to partnerships and LLCs. I.R.C. § 731-737, 751(b) and 755.

The basis is increased by the taxable income that is allocated annually to the shareholder. I.R.C. § 1367(a)(1). In computing basis in shares of stock, the shareholder starts with his initial capital contribution to the S corporation or the initial cost of the shares he purchased (the same as a C corporation). That amount is then increased or decreased based on the flow-through income amounts from the S corporation. Income and capital gains will increase share basis, while operating losses, capital losses, and distributions will decrease share basis. https://www.irs.gov/businesses/small-businesses-self-employed/s-corporation-stock-and-debt-basis. These adjustments to share basis are made without regard to the value of the corporation’s assets.

Simply summarized, the tax effect of a distribution by the S corporation to its shareholder depends on the shareholder’s basis in the S corporation’s shares. If the distribution allocated to the shareholder exceeds his basis, then the difference is taxed to the shareholder as capital gain (distribution – basis = capital gain). I.R.C. § 1368(b)(2). If there is a liquidating distribution of an S corporation and assets are distributed in kind, then the distribution is treated as a sale of assets to the shareholder at fair market value (FMV). I.R.C. § 336. The S corporation calculates its gain or loss as if the assets were sold to a third party. The S corporation then reports the amount of gain or loss that passes through to the shareholder. I.R.C. § 1366(a).

For example, assume a shareholder made a capital contribution to X Corporation of $50,000, which X Corporation invested. At the time of liquidation, the fair market value of X Corporation’s asset was $150,000. If, on liquidation, the asset is distributed to the shareholder in kind, X Corporation is deemed to have sold the asset at its fair market value, and X Corporation has a $100,000 capital gain, which flows through to the shareholder.

Opportunities at the Death of a Shareholder

What happens upon the death of an S corporation shareholder? The shares owned by the decedent shareholder receive a step-up in basis, that is, a revaluation to fair market value as of date of death. I.R.C. § 1014. Fair market value is defined as: “… the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts. The fair market value of a particular item of property includible in the decedent’s gross estate is not to be determined by a forced sale price. Nor is the fair market value of an item of property to be determined by the sale price of the item in a market other than that in which such item is most commonly sold to the public, taking into account the location of the item wherever appropriate.” Treas. Reg. § 20.2031-1.

The S corporation’s assets, however, do not receive a basis step-up at the shareholder’s death. This can result in the inside basis of the assets differing from the outside basis of the shares. There can be a significant difference between the fair market value of the assets inside the corporation and their tax basis. How can the heirs, who inherit the shares, receive a benefit from the increase in the value of the shares? What happens if the S corporation’s assets are sold? What happens if the corporation’s assets are distributed to the new shareholder?

The heir shareholders, if willing to liquidate the S corporation, can use S corporation stock basis rules, and recognize a loss to offset...
the gain that results on the distribution of the corporation's assets. The Service has recognized the validity of using a loss to offset the gain in this instance, as set out in PLR 9218019. An example of how the offset works is:

X owns all the shares of Acme Corporation, an S corporation. X invested $25,000 in Acme Corporation. Acme Corporation purchases land (a capital asset, not ordinary asset) for $25,000. X dies in December 2017. The fair market value of the shares is determined to be $1,000,000. Acme Corporation recognizes a capital gain of $975,000. The capital gain passes through to X's heir and will be reported on the heir’s 2018 individual tax return.

Stepped-up basis of shares (at date of death) $1,000,000
Add gain from sale of land $ 975,000
New shareholder basis $1,975,000

The heir shareholder adopts a plan of liquidation for the Acme Corporation in 2018, and surrenders his shares in liquidation in 2018.

Shareholder receives a distribution of $ 1,000,000
Less basis of shares redeemed $(1,975,000)
Capital loss upon liquidation $ 975,000

The capital loss created at liquidation of $975,000 can be offset against the $975,000 of the capital gain from the sale of the land that passed through to the shareholder. (This assumes there is no depreciation recapture, which would generate ordinary income.) These events must occur in the same tax year for the shareholder to receive the benefit of the stepped-up basis in the stock and to reduce the net taxable gain to zero on the 2018 individual tax return. (Note: Under I.R.C. Section 311, a corporation recognizes gain when appreciated property is used to redeem shares. Just as for a sale, the gain from the liquidation in kind could be handled as outlined above.)

**Timing is Critical – Don't Blow It!**

Timing is everything, in tax planning and golf. To illustrate the importance of timing, if the corporation does not liquidate in the same year as the asset sale, but instead liquidates in 2019, then the shareholder must recognize a $975,000 capital gain in 2018 and a $975,000 capital loss in 2019. If the shareholder has no other capital gains in 2019, the capital loss will be limited to $3,000 and the balance of the loss can only be carried forward to succeeding years and not carried back to preceding years. I.R.C §1211(b) and §1212(b).

The analysis will differ if the decedent is a member of a limited liability company. An LLC is taxed as a partnership by default, unless the LLC elects to be taxed as a C corporation or S corporation. At the death of a member, the member's estate is required to report all assets owned by the decedent at their fair market value for estate tax purposes. The step-up in basis of the LLC interest of a member only applies to the “outside” basis, the tax basis in the hands of the successor owner. The inside basis, the basis of the assets held by the LLC, will remain the same and create a discrepancy. To eliminate the difference in basis, the LLC inside basis in the assets should have a corresponding step up. I.R.C. Section 743(b) allows an adjustment to the inside basis of the LLC assets upon a transfer of the LLC interest caused by the member's death. The LLC must make an I.R.C. Section 754 election. The election must occur within the tax year that includes the deceased member’s date of death. The LLC (taxed as a partnership) has a tax benefit that is not available to other forms of business entities, such as S corporations or other closely held corporations. In making the election to adjust the inside basis of the assets in an LLC, the timing of sale and liquidation is less important, and the timing of the Section 754 election is critical.

Timing really is everything in dealing with the inside basis-outside basis discrepancy for S corporations and certain LLCs. We can't all be great at golf like Mr. Palmer, but we can keep in mind his wise words about timing.

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