Selling an S corp? Earn best tax result by cutting all ties

Sooner or later, you may decide to sell off your S corporation and retire. If you run a family shop, you may plan to sell your stock to younger family members who are already working in the business.

Strategy: To make sure all your gain from the sale is taxed at low capital-gains rates, handle the sale the right way: Sell the company lock, stock and barrel.

If you retain any financial interest in your S corporation, you may not qualify for capital-gain treatment due to the "related-party" rules. That's because the sale isn't a complete stock redemption. (This consideration applies only if your S cor-poration was formerly a C corporation and had accumulated earnings and profits at the time it switched to S-corp status.)

What if the younger generation can't come up with the cash to cement the deal? No problem. You can finance the acquisition yourself. Can that be done? Yes, the taxpayer in a new court ruling managed to have his cake and eat it, too.

Sever ties with the company. Tax law allows you to pocket favorably taxed capital gain from the sale of your company as long as you *completely terminate* your interest in the company. If the termination isn't complete, those distributions may be taxed as dividends, according to the related-party rules. That includes indirect ownership.

Treatment as dividends would be disadvantageous if you have a significant amount of tax basis in the shares that the company is redeeming, because you get no offset for that basis. When the redemption payment is treated as a dividend, the entire amount is taxable at a maximum federal rate of 15 percent.

But you can take advantage of a key loophole in this rule.

The related party rules don't apply if you have no personal financial interest in the company after the sale other than being a creditor (and you don't acquire any financial interest for 10 years).

Facts of the new case: The sole shareholder of an S corporation cashed in 90 percent of his shares and sold the remaining 10 percent to three key employees. One of the employees was his son.

The purchases were secured by promissory notes payable in quarterly installments at an 8 percent rate.

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The owner financed the deal himself. Then, he reported the sale as capital gains received on the installment basis.

Although his son came to own 65 percent of the shares as a result, the original owner claimed the related-party rules
didn't prevent a complete redemption. *Reason:* He had divested himself completely of the stock, other than being a creditor.

The IRS argued that those credit obligations effectively gave the taxpayer a financial stake in the company.

Thumb's up: The Tax Court sided with the taxpayer, saying his creditor relationship didn't cause him to be viewed as having an ownership interest in the company.

S corps: Beware limits on benefits write-offs

In the court case discussed at right, the original owner's wife continued to work as an employee even after her husband sold the S corporation to their son. This wasn't detrimental to the tax treatment of the sale because the wife had no financial interest in the business.

But a different tax trap tripped up the wife. Because their son now owned 65 percent of the shares in the company after the sale, she was treated as a "2 percent shareholder" under the related-party rules.

If you own 2 percent or more of an S corporation, you're taxed on the value of certain fringe benefits received. And since the wife received health insurance as an employee, she was hit with a tax bill on the coverage.

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