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S Corporation Allocations Upon Transfer of Stock

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When a shareholder of a corporation that has elected under Internal Revenue Code ("Code") Section 1362 to be an S corporation is planning to sell the shareholder's stock, the seller and the purchaser (or purchasers) should consider how items of income, gain, loss, deduction and credit of the corporation for the year of the sale will be allocated as between the selling shareholder and the purchasers (collectively the "affected shareholders"), taking into account that all such items flow through to S corporation shareholders under the relevant Code provisions. If the selling shareholder's stock is being redeemed by the corporation, all of the remaining shareholders will be affected by this allocation.

The focus of the brief summary of allocation possibilities below is on the choices available where the selling shareholder (sometimes referred to as the "terminating shareholder") is transferring all of the shareholder's stock, in a transaction that is not expected to result in the termination of the status of the corporation as an S corporation.

Absent any contrary election, Section 1377 and regulations thereunder mandate allocation among the affected shareholders on the basis of chronological proration: an equal portion of each tax item is assigned to each day of the taxable year of the corporation, and that item is then divided pro rata among all the shares outstanding on that day. Thus, for example, if a 50% shareholder sells all of the shareholder's stock on the 91st day of the corporation's calendar taxable year of 365 days, under the default rule the selling shareholder will be allocated 50% of 91/365ths (altogether, approximately one-eighth) of each of the corporation's tax items for the year in which the sale occurs.

The proration approach is generally simple to apply, and may result in an appropriate allocation in many situations, including those where a corporation's income is relatively stable throughout the pre- and post-closing periods of the sale year.

In many circumstances, however, one or more of the parties to the stock sale may benefit from an election by the corporation under Code Section 1377(a)(2) ("terminating election"). Under such an election, the taxable year of the corporation is effectively divided into two periods for purposes of determining the allocation of tax items for the year of the stock sale to the selling shareholder and the shareholder or shareholders purchasing such stock, with the first period ending on the date of the stock sale. If the election is made, the S corporation must allocate its tax items between the two periods based on its regular method of accounting.

A terminating election may be particularly appropriate where the terminating shareholder participates in earnings of the corporation as an economic matter (for example, by periodic distributions or through an adjustment to the selling price of the shares) to the date of the stock sale, but not thereafter. The terminating shareholder may have in mind the possibility of an extraordinary gain or improvement in income from operations of the corporation, in the year of the stock sale but after the date of such sale, that may affect the shareholder's tax liability without resulting in an increase in the distributions to the terminating shareholder or the consideration paid for the terminating shareholder's shares.

The terminating election may only be made only by agreement of the S corporation and all of the affected shareholders. To make the election, the electing corporation must attach a statement to its timely filed original or amended tax return (Form 1120S) for the taxable year that includes the termination of the entire interest of a shareholder, and the statement must include the information required by the relevant regulation under Code Section 1377 (Treasury Reg. § 1.1377-1(b)(5)(i)).

The potential consequences where a stock sale agreement does not expressly address whether or not a terminating election will be made are illustrated in *Manfre v. May*, No. 1:18-cv-2184 (N.D. Ill. March 12, 2019), a recent district court decision that is discussed below.

Facts in *Manfre v. May*

R&M Freight, Inc. ("R&M"), an S corporation incorporated in Illinois with its principal place of business in that state, was engaged in air and ocean freight forwarding and had four equal

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shareholders: David May, Jerome May, William May (collectively the "Mays"), and Thomas Manfre ("Manfre"). In 2008, Manfre filed a "shareholder dispute lawsuit" against the Mays. To resolve the litigation, Manfre and the Mays entered into a contract (the "Agreement") that provided for the sale of the R&M stock owned by Manfre to the Mays. The Agreement had a stated effective date of March 31, 2009, but also stated that the closing "shall occur on or before June 6, 2009."

It appears that the Agreement did not expressly provide that the corporation and the shareholders would make a terminating election under Section 1377, or otherwise address the allocation of the income of R&M for the year of the sale. The Agreement did include a "further assurances" provision stating that "[e]ach of the Parties shall execute and deliver all such other instruments and take all such other actions as each other may reasonably request from time to time to effectuate the purposes of this Agreement."

Soon after the closing, Manfre requested that the Mays sign a "Section 1377 Election" form, but they refused. In December 2009 Manfre wrote to the Mays, asserting that the further assurances provision required them to agree to make the terminating election upon his request, and further requested that the Schedule K-1 to be issued to him by R&M for 2009, to report his share of the corporation's tax items for that year, reflect March 31, 2009, as the final date of his stock ownership.

The Schedule K-1 for 2009 as ultimately issued to Manfre in August 2010 did not reflect a terminating election, and apportioned income of the corporation for 2009 to Manfre on the basis of proration to June 6, 2009. Upon receipt of the Schedule K-1, Manfre wrote to one of the Mays to assert that the Schedule K-1 he received was in breach of the Agreement, in that it failed to reflect the terminating election under Section 1377 that Manfre had requested under the further assurances provision, and to request that the Schedule K-1 be corrected to reflect the date of termination of his stock ownership as March 31, 2009. The Mays declined to correct the Schedule K-1.

In 2018, Manfre filed a complaint in a Federal district court in Illinois asserting that R&M and the purchasing shareholders (or their successors in interest) had breached the Agreement and that this breach resulted in adverse Federal and state tax consequences to Manfre in excess of $75,000. The defendants filed a motion to dismiss asserting (i) lack of subject matter jurisdiction, by reason of a failure to establish that the damages could exceed $75,000 (as necessary for the Federal court to have jurisdiction of the matter based on the parties' diversity of citizenship), and (ii) that the complaint was insufficient to plead a breach of contract under Illinois law.

Discussion

The court concluded that the amount in controversy exceeded $75,000. Manfre submitted income statements of R&M for the three-month period ended March 31, 2009, which indicated a loss of $125,003 for that period, of which his share would have been $31,250 if the requested terminating election had been made and if the allocation of tax items had been made in a manner conforming with that election and on the basis of the stated effective date for the Agreement of March 31.

The Schedule K-1 that was in fact issued to Manfre allocated 2009 tax items of R&M to Manfre on a proration basis through June 6, 2009, resulting in an allocation of income to him in the amount of $143,300. The court concluded that the aggregate difference in Federal and state tax obligations of Manfre resulting from the difference between the loss on the Schedule K-1 that, in Manfre's view, should have been issued to him, and the income shown on the Schedule K-1 actually issued to him, exceeded $75,000, and therefore that there was no legal certainty that his damages were less than the statutory threshold for jurisdiction.

The discussion in the opinion as to the amount at issue does not refer to the nuance that the allocation of income to Manfre per the Schedule K-1 issued to him thereby increased his stock basis under Code Section 1367 to be taken into account in determining his gain or loss by reason of the sale, which increase might (or might not) have resulted in a tax benefit substantially offsetting the tax detriment otherwise resulting from the allocation of income on the Schedule K-1.

The court also found that the further assurances provision in the Agreement could be construed to require the Mays to accommodate the request for a terminating election under Section 1377, because "it would appear reasonable for a business owner terminating his interest in a company to stop paying taxes on income earned by the company after the termination date." Accordingly, the motion to dismiss for failure to state a claim on which relief could be granted was denied.

Observations

The court did not conclude that the further assurances provision implicitly required that a Section 1377 terminating election be made at Manfre's request, but rather that his argument to that effect was sufficient for the matter to survive the defendants' motion to dismiss. Thus, Manfre may well not prevail on this issue in further proceedings.

Although no details are provided in the *Manfre* opinion as to the circumstances that led Manfre to sue the Mays, it is certainly conceivable, based on the limited facts set forth, that the Mays would have agreed to make a Section 1377 terminating election if the intended manner of allocation of income for the year of sale had been discussed in the negotiation of the settlement of that lawsuit.

Alternatively, if the parties had been aware during negotiations that the default allocation approach of proration would eliminate any allocation of ordinary loss to Manfre and result in an allocation of ordinary income to Manfre for the sale year, which allocation would then—through the resulting basis adjustment to Manfre's shares—reduce his capital gain from the sale of shares, Manfre might have been prepared to accept this result if the consideration to be

paid for his shares had been increased sufficiently to compensate him for the negative tax rate arbitrage of (i) an increase in his ordinary income for the year (with the continuing shareholders benefiting through the reduction in ordinary income allocable to them for the same period) offset by (ii) a reduction of his capital gain.

The discussion in the opinion also suggests that the actual closing of the sale of stock probably occurred well after the Agreement's stated effective date, raising the further question of whether tax items should have been allocated on the corporation's Schedules K-1 for 2009 based on the actual date of closing or based on the stated effective date of the Agreement. Setting aside the question of whether the tax law effectively mandates that allocation be made based on the actual date of the sale of stock, the post-closing dispute described in the opinion might have been avoided if the parties to the settlement discussions had discussed the date that would be controlling for allocation purposes and addressed this point in the contract for the sale of stock that was a part of the settlement.

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