**8818. What special considerations apply when an S corporation uses a buy-sell agreement?**

Owners of S corporations, like C corporations, can execute buy-sell agreements to provide for the transition of a business owner’s interests based upon one or more triggering events. The S corporation also may choose to structure the agreement as either a cross-purchase or redemption agreement. In addition to the factors that are important to any business, S corporations must consider the following factors: (1) preservation of the S corporation status; (2) requiring distributions to ensure shareholders have adequate funds to pay for the S corporation’s income taxes at the shareholder level; and (3) protecting its fiscal year.

When an S corporation[[1]](#footnote-1) fails to qualify it automatically becomes a C corporation.[[2]](#footnote-2) Because S corporation qualification is tied to the number and types of shareholders, the use of a properly structured buy-sell agreement may be critical to protecting the business’ qualification as an S corporation.[[3]](#footnote-3) Provisions prohibiting certain transfers and acts should be included in the buy-sell agreement, including the following:[[4]](#footnote-4)

(1) Prohibitions on the transfer of stock to a prohibited S corporation shareholder, such as a corporation, foreign individual or ineligible trust; and

(2) Prohibitions on the transfer of stock to an additional new shareholder if the transfer would bring the total number of shareholders above the permitted number (currently 100).

Further, an S corporation buy-sell agreement may contain different triggering events than those commonly used for a C corporation or partnership. An S corporation must make a variety of elections that can impact all of its shareholders. The fact that an S corporation is limited to issuing one class of stock (see Q 8795) often means that distribution requirements must be uniform for all shareholders so that variances are not found to create a second class of stock and disqualify the S corporation from its status.[[5]](#footnote-5) A buy-sell agreement could be structured so that remaining business owners have the right to purchase the interests of a shareholder who disagrees with the rights created with respect to the S corporation’s single class of stock.

Because S corporations are taxed at the individual shareholder level, rather than at the entity level, regardless of whether the S corporation actually distributes dividends, a buy-sell agreement can be used to ensure the shareholders’ ability to pay their income tax liabilities.[[6]](#footnote-6) A provision that triggers a buyout upon failure of the S corporation to meet its dividend obligations could be used to protect the interests of less wealthy shareholders.

Buy-sell agreements may also be useful in protecting the fiscal year of the S corporation. Generally, an S corporation is required to observe a calendar year as its tax year unless it can establish a valid reason for adopting a fiscal year.[[7]](#footnote-7) If more than 50 percent of the S corporation’s shares are transferred, it must change to a calendar year or reestablish its entitlement to a fiscal year.[[8]](#footnote-8) To prevent this occurrence, an S corporation’s buy-sell agreement should contain provisions that would prevent shareholders from transferring enough shares to disqualify the S corporation from its current use of a fiscal year, if desired.

**Planning Point:** Often times a buy sell agreement will permit transfers of the ownership interest among a group of “permitted transferees”. This provision is included where the parties do not mind having the ownership pass to family members or trusts for their benefit. However, where the entity is an S corporation, it is important to make sure that any transfer is not to an entity which will terminate the S corporation election. This would usually occur if the transfer is to a trust which does not qualify to own stock in an S corporation. 3

1. . IRC Sec. 1361(b). [↑](#footnote-ref-1)
2. . IRC Sec. 1362(d). [↑](#footnote-ref-2)
3. . *Hunt v. Data Mgmt. Resources, Inc.,* 985 P2d 730 (1999). [↑](#footnote-ref-3)
4. . See *Minton v. Comm.,* TC Memo 2007-372 (example of binding shareholder agreement). [↑](#footnote-ref-4)
5. . Treas. Reg. §1.1361-1(l)(2)(iv), (Ex. 6). [↑](#footnote-ref-5)
6. . IRC Secs. 7519, 444. [↑](#footnote-ref-6)
7. . IRC Sec. 1378. See also Rev. Proc. 87-57, 1987-2 CB 687, Rev. Proc. 87-32, 1987-2 CB 396, regarding what constitutes a sufficient business purpose for adopting a fiscal year that does not end on December 31. [↑](#footnote-ref-7)
8. . Tax Reform Act of 1986, Pub. L. No. 99-514, Sec. 806(e).

   3 See T. Reg. Sec. 1.1361-1(b) [↑](#footnote-ref-8)