Overview | Short-year election

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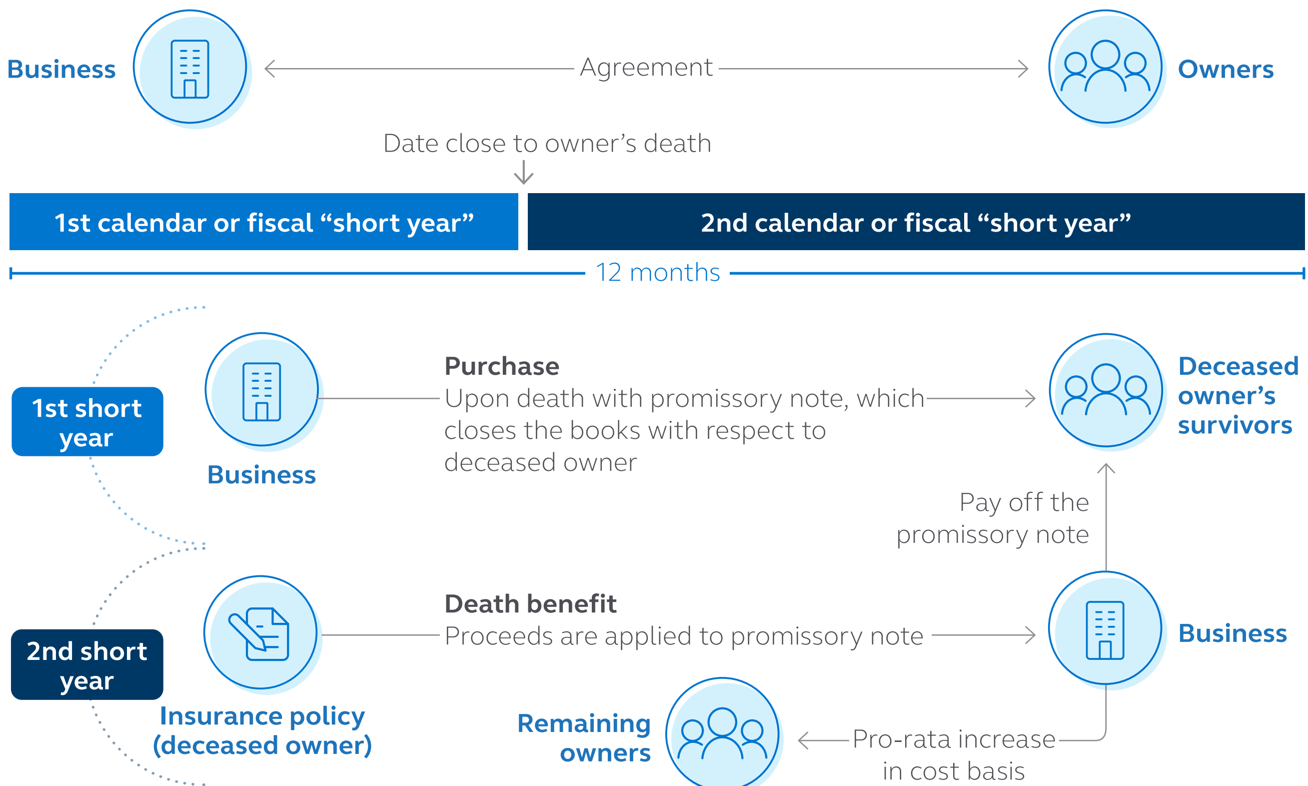
Prepare today for the unknown future of your business.

Do you and your co-owners have a strategy in place to transfer your business to the right people, at the right time, for the right amount of money? A short-year election is a special provision in the Internal Revenue Code (IRC) that may help protect the future of select S corporations. This provision is available only for companies using cash-basis accounting. It involves making a short tax year election under IRC Section 1377(a)(2) following the death of a business owner, to enable the surviving owners to receive a higher basis increase following an entity purchase buyout.

Here's how it works

Once an entity purchase buy-sell agreement is in place, the business purchases a life insurance policy on each owner. Upon the death of one owner, the remaining owners elect to split the current fiscal year into two short years. The first short year generally ends on a date closely following the owner's death, when the stock is redeemed from the estate. The second short year opens the next day and ends at regular year end.



Short tax year election example**:**

Alex, Brody, and Chris equally own an S corporation valued at $3 million. The company has an entity purchase arrangement, funded with $1 million of life insurance on each owner. If Alex passes away, the $1 million of life insurance flowing into the company will increase each owner's basis by $333,000. However, Alex's family will receive a stepped up basis upon the purchase of Alex's shares, so Alex's basis increase is "wasted." Without a short tax year election, Brody and Chris's basis in the company would be increased by just $333,000, but with the election, each one's basis increases by $500,000. This reduces their capital gain, in the event of a future sale.

For illustrative purposes only.

What you need to know

There are advantages to this sort of an agreement, just as there are some other things to consider.

Fewer policies are needed. The business owns and pays premium on one policy per owner.

Business faces tax implications prior to death. Premiums aren't deductible and reduce cost basis in the business, pro rata (to the extent a cash value increase doesn't offset cost basis reduction from the premium payment).

Business receives a tax-free death benefit. Business receives death proceeds from the life insurance policy on the deceased owner (assuming compliance with IRC Section 101(j)).

Remaining owners receive tax benefits upon a future sale. They receive an increase in cost basis in the business, pro rata.

Deceased owner's survivors benefit. Unnecessary cost basis increase for the deceased owner is avoided and no capital gains tax will be due, since the sale price will likely be adjusted cost basis.

Possible impact on value of business in an entity purchase arrangement. The U.S. Supreme Court in *Connelly v. US* (2024) held that if the buy-sell agreement does not successfully lock in a value for estate tax purposes, life insurance paid to a company generally increases the value of the company for estate tax purposes, with no offset for the redemption obligation. It appears that a 1377 election would not alter the effect of *Connelly* on the value of the business for estate tax purposes. If any owner anticipates being subject to the federal estate tax, the owners might wish to reconsider the buy-sell design. Alternatively, additional life insurance (likely owned in an irrevocable trust) may be needed to provide liquidity to pay any estate tax that may be due.

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