Presentation:
Corporate Taxation
Chapter Fifteen: S Corporations
Professors Wells
April 20, 2015
“Tax Option” Corporations/Subchapter S.

Fundamental inquiry: Should the corporation (as an entity) be subject to any federal income tax?

Alternatively, should the corporate/shareholder tax regime be fully integrated?

Note other options: the “check-the-box” regs. And transparent entities (e.g., LLCs, limited partnerships, general partnerships, and the disregarded entity or “tax nothing”).
Comparisons – S Corp. vs. C Corp. vs. Partnership

1) Shareholders of an S corporation must report a prorata share of each corporate item (as determined at the corporate level); Partnerships – special allocations of income and deductions are permitted.

2) Partnership vs. S Corporation – debt. Debts incurred by the S corporation have no effect on the tax basis for shareholder’s stock.

3) Note: Continuing impact of Subchapter C to S corporations after S election (made when a C corp).
§1361(b) – must be a domestic corporation (but not be an “ineligible corporation”).

1) 100 total shareholder maximum limit. H&W count as one shareholder. Note: Members of a family are treated as one shareholder (6 generations to determine the “family” relationship), as of 2005.

2) Only shareholders who are individuals, estates, certain types of trusts, and exempt organizations.

3) No nonresident alien shareholders permitted as shareholders.

4) Not more than one class of stock (but outstanding voting stock and nonvoting stock of the same class are acceptable). No limitation is applicable based on the size/net worth of the corporation. Some S corporations have a significant net worth.
1) Banks & insurance companies – not eligible to be S corporations, except when? See §1361(b)(2)(A).

2) Are S corporation subsidiaries permitted?
   a) C corporation status for a sub? Yes.
   b) S corporation status? QSSS election & the subsidiary is then disregarded as a taxable entity. §1361(b)(3). When the QSSS election is terminated – deemed incorporation (i.e., §351) treatment.
1) Voting trust – each beneficial owner is treated as a separate shareholder.

2) Grantor trust – e.g., a revocable “living trust”.

3) Former grantor trust continuing for 2 years after grantor’s death as a testamentary trust.

4) Testamentary trust receiving S corporation stock under the terms of last will (for 2 years after death).

5) Qualified Sub S Trust (QSST). QTIP Trust?

6) Electing Small Business Trust (ESBT). E.g., a “spray & sprinkle” trust.
Objective of the one class requirement: to prevent “special allocations” enabling income shifting among the owners.

Shares are to provide identical rights as to (1) profits distributions and (2) liquidation proceeds).

Ordinarily, no second class of stock arises from: (1) contractual arrangements, or (2) redemption or stock purchase (i.e., buy-sell) agreements.

The Code provides a straight debt “safe harbor” (to avoid a second class of stock).
Requirements for the debt “safe harbor”:

1) Interest rate and payment dates are not contingent on the corporate profits or the borrower’s discretion.

2) Non-convertibility of debt into stock.

3) The creditor is an individual (not NRA), estate, trust or a bank lender.

Subordination of the debt is not disqualifying here.
Problem (a)
Z Corporation – 120 Shares

Issue: S corporation 100 shareholder limit.

Z has (i) 99 individual shareholders, and (ii) two shareholders, A & B (siblings, not spouses) holding 21 shares JTWROS. Does a violation of the 100 shareholder limit occur? §1361(b)(1)(A).

Are A & B to be treated as a single shareholder? Yes (since family members). Corp has only 100 shareholders. §1361(c)(1)(B).
Z has 99 shareholders and two additional married shareholders holding both (1) community and (2) separate property.

§1361(c)(1) treats husband and wife as one shareholder and the corporation will have only 100 shareholders.

The format of the husband/wife ownership is not relevant (e.g., JTWROS is not essential).

Both A & B must file S corp. shareholder consents.
Problem (c) Transfer from Probate Estate

A dies and bequeaths (community & separate) interests in Z stock to friend, F.

The §1361(c)(1) rule concerning shareholder count applies to spouses and their estates. Estates are permissible shareholders.

Upon distribution to F the election will terminate (under §1362(d)(2)(A)), since Z will then have 101 shareholders (with B & F not treated as “family”).

Termination upon the share distribution date.
Remaining 21 shares are held by a voting trust which has three beneficial owners.


Each beneficiary of the trust is treated as a shareholder; therefore, Z will have 102 shareholders and Z will not qualify as an S corp.
The remaining 21 shares are owned by a revocable living trust created by an individual (with income taxable to grantor).

A trust treated as owned by an individual is a permissible shareholder under §§1361(b)(1)(B) & 1361(c)(2)(A)(i).

Z will qualify since only 100 shareholders (the deemed owner/trust grantor is treated as a shareholder).
The remaining 21 shares in Z Corp. are owned by a QTIP trust. What is a “QTIP trust”?

Is this trust a “qualified subchapter S trust” (QSST) under §1361(d)? See §1361(d)(3).

The trust will be treated as a trust described in §1361(c)(2)(A)(i) if the beneficiary makes an election under §1361(d)(2).

The beneficiary treated (for income tax) as owner of trust assets (under §678).
Z has a partnership with two other S corporations, each of which have 100 individual shareholders, for the purposes of jointly operating a business.

Rev. Rul. 94-43: The three S corporations (each having the maximum shareholders) do not lose separate S status when organizing a partnership for joint operation of a business even when avoiding the shareholder limits.
Z Corporation has outstanding two classes of common stock, differing only as to voting rights.

Does Z violate the one-class-of stock limitation in §1361(b)(1)(D)? Under §1361(c)(4) the difference in voting rights between the two classes is not deemed to create two classes of stock for S corp. rules.

Authorized but unissued preferred stock is not relevant (until issued). See Reg. §1.1361-1(l)(1).
A shareholder agreement mandates larger payments to those shareholders with greater state income tax burdens.

Z will be treated as having more than one class of stock because of the rights of all shareholders are not identical.

Cf., Reg. §1.1361-1(l)(2)(ii) recognizing that some states may require direct payments to the state taxing authority.
Individuals own shares of stock and 15 year bonds.

25:1 debt/equity ratio.

Substantial possibility exists that the Z bonds will be classified as equity under general debt/equity tax principles. Bonds (i) are held proportionately and (ii) are subordinated to the rights of general creditors.

If “straight debt” exists then not considered as a second class of stock under §1361(c)(5)(A) & (B).
Election. §1362. (1) S Corporation election is available if (2) all the shareholders consent.

Election is effective as of beginning of the tax year if made by 15th day/3rd month of the current year.

All shareholders during the pre-election period (during the tax year) must consent and be eligible. Otherwise, the election is effective as of beginning of the following taxable year.
Revocation: Revocation occurs if more than $\frac{1}{2}$ of shares consent to the revocation.

Revocation may specify a prospective effective date. Code §1362(d)(1)(D).

Termination: If:
1) Exceeding the 100 shareholder limitation;
2) Issuance of a second class of stock; or,
3) Transfer of stock to an ineligible shareholder.
S Corporation election terminates where for three consecutive years:

1) “Passive investment income” exceeds 25 percent of S Corporation’s gross receipts, and

2) Corp has Subchapter C E&P.

Ordinarily applies where (1) Corp was a C Corp, but (2) can be where an acquisition of a C Corp (with E&P) has occurred. Special bank treatment – interest is not passive income.
No new S Corp election after termination – subject to a 5 year waiting period. § 1362(g).

However, Code § 1362(f) provides relief when an “inadvertent termination” occurs.

Corporation has a burden to so demonstrate & agree with the IRS concerning any remedial measures to be implemented.
S Corporation must use a “permitted year”: 

1) A calendar year; or 

2) An accounting period for which a “business purpose” (cannot be based on tax deferral) is established, e.g., “natural business year.”

Code §1378. Why this requirement? 

Option to have a fiscal year if paying a deferral charge. Code §§444 and 7519.
1) Who must consent to the S Corporation election? §1362(a)(2) requires all shareholders to consent to the election. This includes shareholders with nonvoting stock.

2) B sold stock to brother (G) prior to the election: Both B & G are required to consent for the election to be effective for the first year.

3) Is a partnership a prior permitted shareholder? No. Therefore, no qualification for 1st year.
When to make the Sub S election?

§1362(b)(1)(B) requires an election on or before the 15th day of the third month of the taxable year (for retroactive effect to the beginning of the year).

When does the taxable year begin? Reg. §1.1362-6(a)(2)(ii)(C) specifies the year begins when the corporation begins to do business or acquires assets). Oct. 3 in this problem. Therefore, plus two months and 15 days from Oct. 3.
What taxable year is available?

Under §1378(a) Snowshoe must have a “permitted year” as its taxable year.

Under §1378(b) a “permitted year” is (1) a calendar year or (2) any other accounting period for which the corporation establishes a business purpose to the satisfaction of the IRS.

Deferral of income is not a “business purpose”.
Is revocation of the S election permitted without the consent of B, C or D?

A needs the consent of **one other** shareholder.


Revocation is only made with the consent of shareholders, who at the time of revocation, hold **more than one-half** of the issued and outstanding stock, including any nonvoting stock.
Sale to nonresident alien.

This sale will terminate the S election (under §1362(d)(2)) since Snowshoe will have a nonresident alien as a shareholder and cease to be a small business corporation.

This termination is effective on the date of cessation of the S Corporation status.

This termination will divide the corporation’s tax year into (1) an S short year and (2) a C short year.
Mistaken stock sale to the NRA.

Possible applicability of the special Code §1362(f) rule for inadvertent elections or terminations. See Reg. §1.1362-4(b) for determining that the termination was inadvertent.

Planning: Have a shareholder’s agreement!
Does it matter for purposes of retaining its S status if Snowshoe’s business is diversified and receive income from real estate, dividends, and interest?

Answer: No, it does not matter. §1362(d)(3) terminates the S election only if:

1) Corporation has Subchapter C earnings and profits at the end of three consecutive years; and,

2) More than 25 percent of the gross receipts is passive investment income.
1) S Corporation is exempt from tax. §1363(a).

2) Determination made at corporate level of:
   (i) gross income;
   (ii) deductions;
   (iii) other items.

No dividends received deduction to the S Corp.

Tax elections are made at the corporate level

Treated as an entity for tax filing purposes.
A prorata share of Corp’s income is deemed distributed to the shareholders - §1366(a) & (c).

Tax characterization is retained on a flow-through basis to the shareholders.

This necessitates:

1) Separately stated items - §1366(a)(1)(A), and,
2) Non-separately stated items - §1366(a)(1)(B).

Allocation on a prorata per share daily basis.
§1367 requires (i) an increase of shareholder’s tax basis for income items, and (ii) a reduction of tax basis by (a) losses, deductions and non-deductible expenses not constituting capital expenses, and (b) tax-free distributions.

The ordering of these tax basis adjustments:
1) Increased by current income;
2) Decreased by any distributions;
3) Decreased by any losses.
Code §1366(d) limits losses allocated to a shareholder to that shareholder’s:

1) Adjusted basis in the stock; plus
2) Adjusted basis in any indebtedness of the corporation to the shareholder.

Possible loss carry forward to be treated as a loss in a subsequent year. Code §1366(d)(2).

Possible restrictions: Code §§465 and 469.
Issue: Does the shareholder’s guarantee of a bank loan constitute either (i) an equity investment by the shareholder, or (ii) an indirect shareholder loan to the corporation?

Holding: Not the equivalent of a loan by the shareholder, and, therefore, no increase in the S Corp. tax basis to the shareholder from the guaranteed bank loan.

Advice: (1) shareholder borrows from a bank, and (2) then shareholder loans the borrowed funds to the corporation.
Transferor in §351 transaction transfers assets into corporation having an aggregate built-in loss. Loss shifting available?

§362(e)(2) requires a corporation to reduce its tax basis in the property to FMV.

Alternatively, shareholder of the corporation can elect to reduce shareholder’s basis for the stock.

See p.710 examples re various tax effects.

Advice: Do not contribute loss property to corp.!
§1(h) provides for several capital gains rates: e.g., (1) 20% (normal maximum CG rate) & (2) 28% (collectibles gain).

Regulations provide for partial capital gains “look-through” rule for sales and exchanges of a share interest in an S Corporation.

However: Not applicable to ordinary income property, e.g., inventory or §1250 depreciation recapture (cf., Sub K).
### Separately Stated Items:

<table>
<thead>
<tr>
<th>Item</th>
<th>A</th>
<th>B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax Exempt Income</td>
<td>667</td>
<td>333</td>
</tr>
<tr>
<td>Interest Expense</td>
<td>(4,000)</td>
<td>(2,000)</td>
</tr>
<tr>
<td>§1231 Gain</td>
<td>8,000</td>
<td>4,000</td>
</tr>
<tr>
<td>STCG (AT&amp;T)</td>
<td>5,000</td>
<td>2,500</td>
</tr>
<tr>
<td>Net LTCG (15 – 9 = 6)</td>
<td>4,000</td>
<td>2,000</td>
</tr>
<tr>
<td>Recovery of Bad Debt</td>
<td>3,000</td>
<td>1,500</td>
</tr>
<tr>
<td><strong>Total Income</strong></td>
<td>20,667</td>
<td>10,333</td>
</tr>
</tbody>
</table>

### Non-Separately Computed Income or Loss:

<table>
<thead>
<tr>
<th>Item</th>
<th>A</th>
<th>B</th>
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</thead>
<tbody>
<tr>
<td>Business Income</td>
<td>92,000</td>
<td></td>
</tr>
<tr>
<td>Plus §1245 Gain</td>
<td>7,000</td>
<td>99,000</td>
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<tr>
<td>Salary Expense</td>
<td>(44,000)</td>
<td></td>
</tr>
<tr>
<td>Depreciation</td>
<td>(8,000)</td>
<td></td>
</tr>
<tr>
<td>Property Taxes</td>
<td>(7,000)</td>
<td></td>
</tr>
<tr>
<td>Supplies</td>
<td>(4,000)</td>
<td>(63,000)</td>
</tr>
<tr>
<td><strong>Net:</strong></td>
<td>36,000</td>
<td>(allocated 24,000 to A &amp; 12,000 to B)</td>
</tr>
</tbody>
</table>
A’s basis in stock (as adjusted):

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Initial Basis</strong></td>
<td>$12,000</td>
</tr>
<tr>
<td>1) §1367(a)(1)(A) increase:</td>
<td>20,667</td>
</tr>
<tr>
<td>2) §1367(a)(1)(B) increase:</td>
<td>24,000</td>
</tr>
<tr>
<td></td>
<td>(99k less 63x = 36x times 2/3rds)</td>
</tr>
<tr>
<td>3) §1367(a)(2)(D) decrease (bribe):</td>
<td>(4,000)</td>
</tr>
<tr>
<td>4) §1367(a)(2)(B) decrease (interest):</td>
<td>(4,000)</td>
</tr>
</tbody>
</table>

A’s Basis After Adjustments $48,667

(Note: Adjustments for §103 interest and bribe.)
Problem 1(c)  
Accounting Method

Whose accounting method will control timing of income and deductions?

Answer:  S Corporation will select its own accounting method, subject to the restrictions in the Code. See §1363(c)(1). The corporation’s accounting method controls the timing of its recognition of its income and deductions.
Who makes the §1033 involuntary conversion gain nonrecognition election – the corporation or the shareholder?

Code §1363(c)(1) specifies that any election affecting the computation of items derived from an S Corporation shall be made by the corporation.

See the exceptions in Code §1363(c)(2).
Property is described in Code §1221(1). (Now Code §1221(a)(1).)

What is the relevance in the S Corp. context?

§1366(b) – entity level characterization.

However, a possible “dealer” problem can exist at the shareholder level when property is held by the shareholder for sale in the ordinary course of business.
Problem of allocation and adjustment rules – 1/3rd shareholder sells ½ of her stock at mid-year:

**Basis for Shares to be Sold**  $ 5,000  (1/2 of 10K stock basis)
**Plus: Business Income Share**  10,000  (1/3*1/2) * (1/2* $120K)
**Less: Allocable §1231 loss**  (5,000)  (1/3*1/2) * (1/2 *60K)
**Basis for Shares Sold:**  (10,000)

Sale for 25,000 less 10,000 basis = 15,000 gain
G’s tax basis in the mid-year purchased stock as of the end of the year:

§1012 Cost Basis $25,000
Plus: §1367(a)(1)(B) 10,000 income
Less: §1367(a)(2)(B) (5,000) loss
Equals: 30,000

(Allocations based on 1/12 of total amounts)
D sold all D’s stock to G for $50,000.

§1377(a)(2) allows D and G to treat the year as consisting of two taxable years – the first of which ends on the date of D’s sale. Closing of the books would occur for purposes of making allocations to D and G (including an allocation of the entire §1231 loss attributable to D’s shares to D).

D’s Basis for Shares Sold: $10,000

Plus: Business Income Share 20,000 \( (1/3^{rd} \times (1/2 \times $120,000)) \)

Less: Allocable §1231 Loss (20,000) \( (1/3^{rd} \text{ of } 60,000) \)

Basis for Shares Sold: 10,000

Sale for 50,000 less 10,000 Basis = 40,000 gain \( (Cf., \text{ no election: } 10 \text{ loss, } 20x \text{ basis } \& \text{ 30x gain}) \)
Loss limitation rules - §1366(d). Total $8,000 loss incurred by corporation. Dick and Harry each own ½ of the S Corporation and each has $2,000 stock basis. Dick also loaned $4,000 to Ace. Dick’s basis is $6,000 for the stock and note.

**Dick**

Can take a $4,000 loss (½ of $8,000).

Stock basis reduced to -0-

Note Basis reduced to $2,000. §1367(b)(2)(A)

**Harry**

Harry can take only a $2,000 loss.*

Basis in Harry’s stock is reduced to -0-.

*To Harry the additional $2,000 loss is **suspended** and can be used only when Harry subsequently has tax basis in his shares (or loans his funds to the corporation and has a tax basis in the loan).

Note: Bank borrowing does not provide additional tax basis (e.g., Harris case).
Ace has $6,000 of net income from operations in next year: $3,000 is allocated to Dick and $3,000 is allocated to Harry.

Dick’s basis in the note will be restored by $2,000 and stock basis increased by $1,000.


Harry’s stock basis is also (1) increased by $3,000 under §1367(a)(1)(B) and then (2) the $2,000 loss is used and his stock basis is then reduced to $1,000.
Allocation of different types of losses.

Dick not affected, since he is allocated $1,000 of operating loss and $3,000 of long term capital loss which reduces the basis of his stock to zero and his note to $2,000.

Harry is allocated $1,000 of operating loss and $3,000 of long term capital loss.

Harry’s loss is limited to $2,000 under §1366(d)(1). His loss is proportionately allocated.
Ace’s S Corporation status was terminated at the end of the year. Harry has $2,000 of suspended loss.

§1366(d)(3) allows Harry to deduct the suspended loss if he has stock basis on the last day of any post-termination period.

Harry will have at least one year to increase his tax basis in the stock.
Allied (S Corp) sells depressed real estate to Portland (S Corp) for $20,000 less than Allied’s tax basis for the real estate.

Tax issue concerns the applicability of the Code §267 loss disallowance rules to related S Corps.

Code §267(b)(11) specifies that the loss is disallowed since Betty & Chuck together own over 50% of the value of each S Corporation.
Allied (an S Corp) sells real estate at a loss to Portland, a C Corporation.

The same persons own more than 50% of each corporation.

This ownership relationship causes the Code §267 limitation to apply – see Code §267(b)(12).

Allied is not allowed to deduct the loss.
Allied has an accrual method taxpayer owes a salary of $1,500 to Betty (on the cash method).

Allied pays the salary on the next January 15.

A gap exists between accounting periods.

See Code §267(e)(1)(B)(ii) concerning the relationship test when a pass-through entity.

Code §267(a)(2) – Allied is not allowed the deduction until the following year since the salary is not includible in Betty’s income until paid.
Assume: The S Corporation without accumulated earnings and profits (E&P) makes distributions to shareholders. See Code §1368(b)(1) & (2).

The distributions are:

1) First, sourced from the shareholder’s tax basis for the stock. See §1367 re tax basis adjustments.

2) Then, excess over the tax basis recover is treated as capital gain.
The S Corporation with earnings and profits makes distributions. See Code §1368(c).

The allocation of distributions is (in this order):

a) From the accumulated adjustments account (AAA) (undistributed S Corporation income);
b) Dividend income to the extent of E&P;
c) Tax basis recovery for the stock; and
d) Capital gain (as if from the sale of property).
The S Corporation can distribute appreciated property to its shareholders.

Gain recognition occurs at the corporate (distributor) level upon the distribution. §311(b).

This gain passed through to S Corp. shareholder.

The shareholder will take a fair market value tax basis for the property received from the corp.

This concept applies to all S Corp. distributions.
Problem 1(a)
§1368 Distribution Effects

FACTS: Ajax will earn $9,000 of net income from operations and have a $3,000 long-term capital gain on the sale of 100 shares of Exxon stock. On October 15, Ajax distributes $5,000 to Dewey and $10,000 to Milt.

Answer: Ajax has always been an S corporation so it does not have E&P and consequently §1368(b) applies to the distributions.

<table>
<thead>
<tr>
<th>Dewey 1/3&lt;sup&gt;rd&lt;/sup&gt;</th>
<th>Milt 2/3&lt;sup&gt;rd&lt;/sup&gt;</th>
</tr>
</thead>
<tbody>
<tr>
<td>Basis: 3,000</td>
<td>Basis: 5,000</td>
</tr>
<tr>
<td>Plus: +3,000 (1/3&lt;sup&gt;rd&lt;/sup&gt; of 9,000 nonseparate) (§1367(a)(1)(B))</td>
<td>Plus: +6,000 (2/3&lt;sup&gt;rd&lt;/sup&gt; of 9,000 nonseparate) (§1367(a)(1)(B))</td>
</tr>
<tr>
<td>Plus: +1,000 (1/3&lt;sup&gt;rd&lt;/sup&gt; of 3,000) separate §1367(a)(1)(A)</td>
<td>Plus: +2,000 (2/3&lt;sup&gt;rd&lt;/sup&gt; of 3,000 separate §1367(a)(1)(A))</td>
</tr>
<tr>
<td>Equals: 7,000 Basis (§1367(a)(1)(A) &amp; (B))</td>
<td>Equals: 13,000 Basis (§1367(a)(1)(A) &amp; (B))</td>
</tr>
<tr>
<td>Less: -5,000 Tax-free Distribution (§1368(b)(1)/§1367(a)(2)(A))</td>
<td>Less: -10,000 Tax-free Distribution (§1368(b)(1)/§1367(a)(2)(A))</td>
</tr>
<tr>
<td>Equals: 2,000 Remaining Basis</td>
<td>Equals: 3,000 Remaining Basis</td>
</tr>
</tbody>
</table>
FACTS: Same facts except now Ajax distributes $8,000 to Dewey and $16,000 to Milt.

**Dewey 1/3rd**

<table>
<thead>
<tr>
<th>Basis</th>
<th>3,000</th>
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<tbody>
<tr>
<td>Plus</td>
<td>+3,000</td>
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<tr>
<td></td>
<td>(1/3rd of 9,000 nonseparate)</td>
</tr>
<tr>
<td></td>
<td>(§1367(a)(1)(B))</td>
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<tr>
<td>Plus</td>
<td>+1,000</td>
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<tr>
<td></td>
<td>(1/3rd of 3,000 separate income)</td>
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<td>§1367(a)(1)(A)</td>
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<td>Equals:</td>
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<tr>
<td>Basis</td>
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<td>Tax-free Distribution</td>
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<td>(§1367(a)(1)(A) &amp; (B))</td>
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<tr>
<td>Basis</td>
<td>-0-</td>
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<td></td>
<td>Gain §1368(b)(2)</td>
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**Milt 2/3rd**

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<td>(2/3rd of 9,000 nonseparate)</td>
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<td>(§1367(a)(1)(B))</td>
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<tr>
<td>Plus</td>
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<td>(2/3rd of 3,000 separate income)</td>
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<td>Basis</td>
<td>-0-</td>
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<td>Gain §1368(b)(2)</td>
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</tbody>
</table>
Problem 1(c)  
Stock Redemption

FACTS: Same facts as (a) except that Ajax makes no distributions but redeems Dewey on the last day of the year for $20,000.

Dewey 1/3

Basis: 3,000
Plus: +3,000 (1/3rd of 9,000 nonseparate) (§1367(a)(1)(B))
Plus +1,000 (1/3rd of 3,000 separate income §1367(a)(1)(A)
Equals: 7,000 Ending Basis (§1367(a)(1)(A) & (B))

Gain $13,000 ($20,000 - $7,000 ending basis)

The redemption is treated as a complete termination under §302(b)(3)
**Problem 1(d)**  
Pro Rata Stock Redemption

**FACTS:** Same facts as (a) except that Ajax makes no distributions but redeems 1/4\(^{th}\) of Dewey’s stock for $5,000 and 1/4\(^{th}\) of Milt’s stock for $10,000 on October 15.

**Answer:** Redemption is classified as a §301 distribution – see §302(d). Therefore, characterized under §1368(b). Dewey’s basis is 7,000; Milt’s basis is 13,000. Results will be as in (a) above.

### Dewey

<table>
<thead>
<tr>
<th>Basis</th>
<th>Plus</th>
<th>Equals</th>
<th>Less</th>
<th>Equals</th>
</tr>
</thead>
<tbody>
<tr>
<td>3,000</td>
<td>+3,000</td>
<td>7,000</td>
<td>-5,000</td>
<td>2,000</td>
</tr>
</tbody>
</table>

### Milt

<table>
<thead>
<tr>
<th>Basis</th>
<th>Plus</th>
<th>Equals</th>
<th>Less</th>
<th>Equals</th>
</tr>
</thead>
<tbody>
<tr>
<td>5,000</td>
<td>+6,000</td>
<td>13,000</td>
<td>-10,000</td>
<td>3,000</td>
</tr>
</tbody>
</table>
### Problem 1(e)  
**Gain or Loss Property**

**FACTS**: Same facts as (a) except that Ajax distributes property (FMV=$8,000 B=$9,000) to Dewey and property (FMV=$16,000 B=$13,000) to Milt.

**RESULT**: Depreciated property to Dewey provides no tax loss per §311(a)(2). Distribution to Milt creates an additional §311(b) gain of $3,000 to Ajax that gets allocated $1000 to Dewey and $2000 to Milt.

<table>
<thead>
<tr>
<th>Dewey 1/3&lt;sup&gt;rd&lt;/sup&gt;</th>
<th>Milt 2/3&lt;sup&gt;rd&lt;/sup&gt;</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Basis</strong>: 3,000</td>
<td><strong>Basis</strong>: 5,000</td>
</tr>
<tr>
<td><strong>Plus</strong>: +3,000</td>
<td><strong>Plus</strong>: +6,000</td>
</tr>
<tr>
<td>(1/3&lt;sup&gt;rd&lt;/sup&gt; of 9,000 nonseparate) (§1367(a)(1)(B))</td>
<td>(2/3&lt;sup&gt;rd&lt;/sup&gt; of 9,000 nonseparate) (§1367(a)(1)(B))</td>
</tr>
<tr>
<td><strong>Plus</strong>: +2,000</td>
<td><strong>Plus</strong>: +4,000</td>
</tr>
<tr>
<td>(1/3&lt;sup&gt;rd&lt;/sup&gt; of 6,000 3,000) separate income §1367(a)(1)(A)</td>
<td>(2/3&lt;sup&gt;rd&lt;/sup&gt; of 6,000 3,000) separate income §1367(a)(1)(A)</td>
</tr>
<tr>
<td><strong>Equals</strong>: 8,000</td>
<td><strong>Equals</strong>: 15,000</td>
</tr>
<tr>
<td>Basis (§1367(a)(1)(A) &amp; (B))</td>
<td>Basis (§1367(a)(1)(A) &amp; (B))</td>
</tr>
<tr>
<td><strong>Less</strong>: -8,000</td>
<td><strong>Less</strong>: -16,000</td>
</tr>
<tr>
<td>Tax-free Distribution (§1368(b)(1)/§1367(a)(2)(A))</td>
<td>Tax-free Distribution (§1368(b)(1)/§1367(a)(2)(A))</td>
</tr>
<tr>
<td><strong>Equals</strong>: -0-</td>
<td><strong>Equals</strong>: 1,000</td>
</tr>
<tr>
<td>Remaining Basis</td>
<td>Gain §1368(b)(2)</td>
</tr>
<tr>
<td><strong>Basis</strong>: -0-</td>
<td><strong>Basis</strong>: -0-</td>
</tr>
<tr>
<td>§1367(a)(2)(A)</td>
<td>§1367(a)(2)(A)</td>
</tr>
</tbody>
</table>
**Problem 1(f)**  
**Corp’s Notes Distributed**

**FACTS:** Same facts as (a) except that Ajax distributes its own notes to Dewey (FMV=$8,000) and to Milt (FMV=$16,000).

**RESULT:** Distribution creates no corporate gain per §311(b)(1)(A). Dewey & Milt take a FMV basis in the note per §301(d) and gain same as 1(d).

---

**Dewey 1/3<sup>rd</sup>**

- **Basis:** 3,000
- **Plus:** +3,000 (1/3<sup>rd</sup> of 9,000 nonseparate)  
  (§1367(a)(1)(B))
- **Plus:** +1,000 (1/3<sup>rd</sup> of 3,000) separate income  
  §1367(a)(1)(A)
- **Equals:** 7,000  
  Basis (§1367(a)(1)(A) & (B))
- **Less:** -8,000 Distribution of Note  
  (§1368(b)(1)/§1367(a)(2)(A))
- **Equals:** 1,000  
  Gain §1368(b)(2)
- **Basis:** -0-  
  §1367(a)(2)(A)

**Milt 2/3<sup>rd</sup>**

- **Basis:** 5,000
- **Plus:** +6,000 (2/3<sup>rd</sup> of 9,000 nonseparate)  
  (§1367(a)(1)(B))
- **Plus:** +2,000 (2/3<sup>rd</sup> of 3,000 separate income  
  §1367(a)(1)(A)
- **Equals:** 13,000  
  Basis (§1367(a)(1)(A) & (B))
- **Less:** -16,000 Distribution of Note  
  (§1368(b)(1)/§1367(a)(2)(A))
- **Equals:** 3,000  
  Gain §1368(b)(2)
- **Basis:** -0-  
  §1367(a)(2)(A)
Problem 2(a) E&P  
§1368(c) Distribution Rules

**FACTS:**  P has Acc. E&P of $6,000, operating income in current year of $6,000 and long-term capital gain of $4,000. On 11/1, P distributes $5,000 to Nancy and $5,000 Opal. AAA= $10,000 and thus distribution of $10,000 did not exceed AAA account.

### Nancy 1/2

<table>
<thead>
<tr>
<th>Basis: 1,000</th>
<th>Plus: +3,000 (1/2 of 6,000 nonseparate income §1367(a)(1)(B))</th>
<th>Plus: +2,000 (1/2 of 4,000) separate income §1367(a)(1)(A)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Equals: 6,000 Basis (§1367(a)(1)(A) &amp; (B))</td>
<td>Equals: 10,000 Basis (§1367(a)(1)(A) &amp; (B))</td>
</tr>
<tr>
<td>Less: -5,000 Distribution</td>
<td></td>
<td>Less: -5,000 Distribution</td>
</tr>
<tr>
<td>Equals: 1,000 Ending Basis</td>
<td></td>
<td>Equals: 5,000 Ending Basis</td>
</tr>
</tbody>
</table>

### Opal 1/2

<table>
<thead>
<tr>
<th>Basis: 5,000</th>
<th>Plus: +3,000 (1/2 of 6,000 nonseparate income §1367(a)(1)(B))</th>
<th>Plus: +2,000 (1/2 of 4,000) separate income §1367(a)(1)(A)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Equals: 10,000 Basis (§1367(a)(1)(A) &amp; (B))</td>
<td></td>
</tr>
<tr>
<td>Less: -5,000 Distribution</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equals: 5,000 Ending Basis</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Problem 2(b)  
§1368(c) Distribution Rules

FACTS: Same as (a) except P distributes $10,000 to Nancy and $10,000 to Opal.

RESULT: Nancy’s basis is reduced to zero and Opal’s is reduced to $3,000 under §1367(a)(2)(A). P’S AAA account is reduced to zero. Characterization of the distribution is as follows:

<table>
<thead>
<tr>
<th>Nancy ½</th>
<th>Opal½</th>
</tr>
</thead>
<tbody>
<tr>
<td>$10,000 Distribution</td>
<td>$10,000</td>
</tr>
<tr>
<td>$5,000</td>
<td>§1361(c)(1), (b)(1) Nontaxable $5,000</td>
</tr>
<tr>
<td>$3,000</td>
<td>§1368(c)(2) –no stock basis decrease $3,000</td>
</tr>
<tr>
<td>$1,000</td>
<td>§1368(c)(3), (b)(1) basis decrease $2,000</td>
</tr>
<tr>
<td>$1,000</td>
<td>§1368(c)(3), (b)(2) gain in excess of basis $1,000</td>
</tr>
</tbody>
</table>

C Earnings=$6,000
Op Income=$6,000
LTCG=$4,000

AAA
FACTS: Same as (a) except P also received $4,000 of tax exempt interest during the year and distributed $2,000 to Nancy and $2,000 to Opal. (total of $14,000).

RESULT: Nancy and Opal will increase their basis by an extra $2,000 each, so it will now be $8,000 for Nancy and $12,000 for Opal. But importantly, P’s AAA is still $10,000 because no AAA adjustment is made for tax-exempt interest. See §1368(e)(1)(A).

1. Nancy receives $2,000 in excess of the AAA account and is taxed on this as a dividend per §1368(c)(2). Nancy’s ending basis will be $3,000 ($2,000 higher than in problem 2(a)).

2. Opal receives $2,000 in excess of the AAA account and is taxed on this as a dividend per §1368(c)(2). Opal’s ending basis will be $3,000 ($2,000 higher than in problem 2(a)).
FACTS: Same as (a) except P makes no distributions and Nancy sells to Rose for $6,000. P distributes $6,000 to each shareholder next year.

RESULT: Rose has $5,000 of the distribution (½ of 10,000 AAA) is characterized as basis recovery since not exceeding the AAA. See §1368(c)(1). Dividend (from E&P) in the amount of $1,000. Stock basis is reduced to $1,000 (6,000 less 5,000 AAA distribution).
FACTS: Nancy and Opal revoke P’s S election effective January 1 of next year. P has $5,000 of earnings next year. What is the result if Nancy and Opal receive a $7,000 distribution next year?

Answer: Cash distribution during the post-termination transition period is covered by §1377(b). The first $5,000 represents basis recovery (§1371(e)(1), takes precedence) and the next $2,000 is a dividend under §301(c)(1).
1) Tax on built-in-gains - §1374
   - No avoidance of accrued double tax burden.
   - Net built-in gains taxed for ten years.

2) Tax on passive investment income.
   - Possible loss of S Corporation status, and
   - §1375 tax (35% of excess net passive income).

When passive income is exceeding 25% of gross receipts for 3 years.
Problem 1(a)

FACTS: B was formed as a C corporation in 2000 and elected S status in 2004 when it had the following at the time of the S election:

<table>
<thead>
<tr>
<th>Asset</th>
<th>Adj. Basis</th>
<th>FMV</th>
<th>Recognized BIG</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>$30,000</td>
<td>$20,000</td>
<td>-$10,000</td>
</tr>
<tr>
<td>Building</td>
<td>$10,000</td>
<td>$35,000</td>
<td>$25,000</td>
</tr>
<tr>
<td>Machinery</td>
<td>$15,000</td>
<td>$30,000</td>
<td>$15,000</td>
</tr>
</tbody>
</table>

B sells the building for a $40,000 gain in 2005 and has S corp income of $75,000.

RESULT: B has a RBIG for $25,000 of the $40,000 of gain. B will pay corporate-level tax of $8,750 (35% * $25,000) per §1374. Shareholders will again include the gain (less the tax) as income ($25,000 - 8,750 = $16,250).
FACTS: B was formed as a C corporation in 2000 and elected S status in 2004 when it had the following at the time of the S election:

<table>
<thead>
<tr>
<th>Asset</th>
<th>Adj. Basis</th>
<th>FMV</th>
<th>Recognized BIG</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
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<tr>
<td>Building</td>
<td>$10,000</td>
<td>$35,000</td>
<td>$25,000</td>
</tr>
<tr>
<td>Machinery</td>
<td>$15,000</td>
<td>$30,000</td>
<td>$15,000</td>
</tr>
</tbody>
</table>

B sells the building for a $40,000 gain in 2005 and has S Corp income of $20,000.

RESULT: B has a RBIG for $25,000 but it is limited to $20,000 per §1374(d)(2). B will pay corporate-level tax of $7,000 (35% * $20,000) per §1374. Shareholders will again include the gain (less the tax) as income.
Problem 1(c)

FACTS: Same as (a) except that after selling the Building for $50,000 in 2005 it sells the Machinery for $40,000 in 2006.

<table>
<thead>
<tr>
<th>Asset</th>
<th>Adj. Basis</th>
<th>FMV</th>
<th>Recognized BIG</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>$30,000</td>
<td>$20,000</td>
<td>-$10,000</td>
</tr>
<tr>
<td>Building</td>
<td>$10,000</td>
<td>$35,000</td>
<td>$25,000</td>
</tr>
<tr>
<td>Machinery</td>
<td>$15,000</td>
<td>$30,000</td>
<td>$15,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>$30,000</td>
</tr>
</tbody>
</table>

RESULT: Disregarding further cost recover, B has a $25,000 gain with respect to an asset that had a RBIG of $15,000. However, the total NUBIG is $30,000 and an RBIG of $25,000 was recognized in 2005. So, the S Corp has only $5,000 of NUBIG remaining in 2006 and this limits the amount of RBIG that is recognized to $5,000 (tax of $1,750). See §1374(c)(2).
FACTS: B trades the building for an apartment building in a §1031 exchange and then sells the apartment building for $50,000 in 2005 when it would have substantial S corp taxable income.

<table>
<thead>
<tr>
<th>Asset</th>
<th>Adj. Basis</th>
<th>FMV</th>
<th>Recognized BIG</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>$30,000</td>
<td>$20,000</td>
<td>-$10,000</td>
</tr>
<tr>
<td>Building</td>
<td>$10,000</td>
<td>$35,000</td>
<td>$25,000</td>
</tr>
<tr>
<td>Machinery</td>
<td>$15,000</td>
<td>$30,000</td>
<td>$15,000</td>
</tr>
</tbody>
</table>

RESULT: Same answer as (a). The basis of the apartment building is determined by reference to the adjusted basis of the building so it is treated as held by B as of the beginning of the first S year. §1374(d)(3)(B) and (6).

<table>
<thead>
<tr>
<th>Asset</th>
<th>Adj. Basis</th>
<th>FMV</th>
<th>Recognized BIG</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>$30,000</td>
<td>$20,000</td>
<td>-$10,000</td>
</tr>
<tr>
<td>Building</td>
<td>$10,000</td>
<td>$35,000</td>
<td>$25,000</td>
</tr>
<tr>
<td>Machinery</td>
<td>$15,000</td>
<td>$30,000</td>
<td>$15,000</td>
</tr>
</tbody>
</table>

RESULT: The sale will not be subject to §1374 because it occurs outside of the 10-year period beginning on the first day for which the corporation elected S status. §1374(d)(7). Thus, shareholders avoid a corporate level tax.
FACTS: S Corporation elected S corporation status beginning in 2010 and will have Subchapter C earnings and profits at the close of the current taxable year. This year, S expects that its business operations and investments will produce the following tax results:

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross income</td>
<td>$75,000</td>
</tr>
<tr>
<td>Business Deductions</td>
<td>$60,000</td>
</tr>
<tr>
<td>Tax-Exempt Interest</td>
<td>$23,000*</td>
</tr>
<tr>
<td>Dividends</td>
<td>$12,000*</td>
</tr>
<tr>
<td>LTCG</td>
<td>$35,000</td>
</tr>
</tbody>
</table>

RESULTS: Gross Receipts total $145,000 (summation of “blue items”). See §1362(d)(3)(B)(i); Reg. §1.1362-2(c)(4)(i). S Corp’s passive income (see * items) of $35,000 is not more than 25% of gross receipts (35=140*25%), so the corporation is not subject to the §1375 tax.
FACTS: Same as 2(a) except that S Corporation receives an additional $5,000 of tax-exempt interest.

Gross income $75,000
Business Deductions $60,000
Tax-Exempt Interest $28,000*
Dividends $12,000*
LTCG $35,000

RESULTS: Gross receipts now total $150,000 (summation of “blue items”). See §1362(d)(3)(B)(i); Reg. §1.1362-2(c)(4)(i). S Corp’s passive income of $40,000 is more than 25% of gross receipts (37.5=150*25%), so the corporation is subject to the §1375 tax on its excess passive income of $2,500 (for $875 of tax at 35%).
FACTS: Bay was formed in 2009 as a C corporation. 1/3\textsuperscript{rd} of Bay’s gross receipts are derived from marine service and repair work. 1/3\textsuperscript{rd} of Bay’s total receipts come from the rental of berths to boat owners. Bay has substantial C corp earnings. What would be the impact if Bay elects S status?

RESULT: It is likely then that one-third of Bay's gross receipts will constitute passive investment income (the berthing fees). To avoid any problem with §§ 1362(d)(3) and 1375, Bay would need to make distributions large enough to eliminate its earnings and profits account. If Bay were a newly formed corporation, it would not have Subchapter C earnings and profits and would not be concerned with §§ 1362(d)(3) and 1375.
Provisions of Subchapter C are also applicable (unless inconsistent) to S Corp. - §1371(a):

- **Formation** - §351 applicable (e.g., 80% control)
- **No DRD** (p.701)
- **Distributions and (complete) liquidations**
- **Taxable disposition** – stock or asset purchase
  - pass-through of gain/loss on an asset sale
  - gain on stock sale (historic inside asset basis). §338(h)(10) is available in the S Corp context
- **Tax-free reorganizations** – may lose S Corp. status if acquired by C corporation
FACTS: Hi–Flying Co. has been a C corporation many years and developed a new innovative technology. Can Hi–Flying’s shareholders improve their tax situation in a future takeover by making an S election? In general, if Hi–Flying makes an S election, would you advise a potential corporate purchaser desiring a cost basis in Hi–Flying’s assets to structure its acquisition as a purchase of stock or assets?

Results:

1. If C corporation, then double tax outright.
If S corporation, then double tax to the extent of NUBIG per §1374 for 10-year period. Thus, post-S election gain is not taxed. If outside the 10-year period, then avoid double tax entirely. But see Martin Ice Cream v. Commissioner. My views on personal goodwill planning: Wells & Bergez, Disposable Personal Goodwill, Frosty the Snowman, and Martin Ice Cream All Melt Away in the Bright Sunlight of Analysis, 91 NEB. L. REV. 170 (2012)
FACTS: T is a C corporation which has substantially appreciated assets and is a takeover candidate being pursued by several suitors. P has a Subchapter S election in effect and is considering making a bid for T. P will offer to purchase T’s stock for cash or a combination of cash and P notes.

RESULT: P can acquire T without loss of S status. P can liquidate T under §332 tax-free per §1371(a)(2). P can then hold the T assets subject to §1374 treatment.
FACTS: Same as 2(a) except P will acquire T in a C reorganization.

RESULTS: Care would have to be taken to not end up with more than 100 P shareholders, an impermissible P shareholder or more than one class of P equity outstanding. P will inherit Target's tax attributes, including its E & P. This will require P to monitor its passive investment income to avoid termination of its election under § 1362(d)(3) or exposure to the § 1375 tax. Since P will take a transferred basis in Target's assets it also will have exposure to the § 1374 tax on those assets for 10 years following the acquisition. §1374(d)(8).
Dividend or compensation (latter situation: subject to payroll taxes)?

Avoid Federal payroll taxes by only paying S Corp. dividends (and not deductible compensation)?

See Radtke case (*next slide*); how moderate this result through tax planning?

See, also §1372: Possible limit on fringe benefit special treatment to a more than 2% shareholder.
FACTS: Legal services corporation & one employee (the attorney). Zero salary and all earnings received as “dividends”. No federal employment taxes paid. Do the dividends constitute wages?

Held: The dividends are to be re-categorized as wages (and, therefore, are subject to FICA and FUTA).
Comparing Subchapters K & S

Note the multiplicity of similar types of entities, but differences (partnership vs. S Corp):

- income (special partnership allocation)
- effect of debt on tax basis
- sale of interest (stock vs. partnership interest)