

**CHAPTER 21**  
**S CORPORATIONS**  
**SOLUTIONS TO PROBLEM MATERIALS**

<u>Question/ Problem</u>	<u>Topic</u>	<u>Status: Present Edition</u>	<u>Q/P in Prior Edition</u>
1	Restrictions on S corporations	New	
2	Use of a qualified Subchapter S subsidiary	Unchanged	2
3	S corporations and like-kind exchanges	Unchanged	3
4	Nonresident alien	Unchanged	4
5	Reelection after termination	Unchanged	5
6	Passive investment income	New	
7	Schedule M	Unchanged	7
8	AAA bypass election	Unchanged	8
9	AAA versus stock basis	Unchanged	9
10	Stock basis	Unchanged	11
11	Built-in gains tax	New	
12	C corporation NOL and S election	Unchanged	12
13	Subchapter S taxable income	Unchanged	13
14	Nonseparately computed income	Unchanged	14
15	Nonseparately computed income	Unchanged	15
16	Income allocation	Unchanged	16
17	Distributions	New	
18	Distributions	Unchanged	18
19	Distributions	Unchanged	19
20	Shareholder basis and liquidation	Unchanged	20
21	Shareholder basis: Losses and distributions	Unchanged	21
22	AAA: losses and distributions	Unchanged	22
23	Stock basis/AAA	Unchanged	23
24	Distribution	Unchanged	24
25	AEP bypass election	Unchanged	25
26	Alternative minimum tax	New	
27	Loss allocation	New	

<u>Question/ Problem</u>	<u>Topic</u>	<u>Status: Present Edition</u>	<u>Q/P in Prior Edition</u>
28	Loss allocation	New	
29	AAA/stock basis/AEP	Unchanged	29
30	Built-in gains tax	Unchanged	30
31	Built-in gains tax	Unchanged	31
32	Passive investment income tax	Unchanged	32
33	Stock basis	Unchanged	33
34	Built-in gains tax	Unchanged	34
35	Family S corporation and reallocation of operating income	Unchanged	35
36	Liquidation of S corporation	Unchanged	36
37	Per-books election	Unchanged	37

## CHECK FIGURES

- |       |   |       |   |
|-------|---|-------|---|
| 13.a. | \$75,000.   | 24.   | Each shareholder has \$200,000 dividend income, \$250,000 ending basis. |
| 13.b. | \$25,000.   | 25.   | Each shareholder has \$300,000 dividend income, \$350,000 ending basis. |
| 14.   | \$68,000.   | 27.   | \$12,000.   |
| 15.a. | Sammy's share, \$26,000.  | 28.   | \$19,200 operating loss; \$4,800 capital loss.                          |
| 15.b. | \$6,000.  | 29.   | AAA, (\$7,000); stock basis, \$1,000; AEP, \$1,000.                     |
| 16.a. | Thomas \$123,287.85; Estate \$376,712.87; Ralph \$500,000.                  | 30.a. | \$19,600 liability.   |
| 16.b. | Ralph \$500,000; Thomas \$200,000; Estate \$300,000.                        | 30.b. | \$29,750.   |
| 17.   | \$11,000 ordinary income; \$15,000 return of capital; \$1,000 capital gain. | 30.c. | \$17,500.   |
| 18.   | Tobias \$90,000 ordinary income (salary); Goblins \$90,000 deduction.       | 31.   | \$19,950 tax liability.   |
| 19.   | Tobias \$90,000 ordinary income (dividend); Goblins no deduction.           | 32.   | \$10,500.   |
| 20.a. | \$20,000.   | 33.   | Andre \$12,500; Crum \$16,500; Barbara \$22,500.                        |
| 20.b. | Adam \$150,000; Bonnie \$70,000.  | 34.   | Corporate tax, \$21,070; Farris' gain, \$35,718.                        |
| 20.c. | Adam (\$40,000); Bonnie \$40,000.   | 37.   | \$70,000.   |
| 21.   | Bip's ending stock basis \$0.   |       |   |
| 22.   | Ending AAA (\$30,000); ending AEP \$55,000.                                 |       |   |
| 23.a. | \$41,000.   |       |   |
| 23.b. | \$66,000.   |       |   |

## DISCUSSION QUESTIONS

1. Although the Federal tax treatment of partnerships and S corporations is similar, there are some differences. For example, liabilities affect owners' basis differently, and S corporations may incur a tax liability at the corporate level. Further, many C corporation provisions apply to S corporations (e.g., liquidation). Where the S corporation provisions are silent, the C corporation rules apply. p. 21-2
2. An S corporation may own up to 100% of a C corporation as well as certain wholly-owned S corporations. An S corporation is *not* allowed the dividends received deduction, and it cannot join in filing a consolidated tax return. pp. 21-5 and 21-6
3. Willis, Hoffman, Maloney, and Raabe, CPAs  
5191 Natorp Boulevard  
Mason, OH 45040

May 20, 2003

Bob Roman  
8411 Huron Boulevard  
West Chester, PA 19382

Dear Mr. Roman:

A qualified Subchapter S subsidiary (QSSS) should be helpful in your situation. The advent of QSSSs has enhanced your ability to insulate different projects from the liabilities of other projects and, at the same time, reducing the tax costs previously associated with such liability insulation.

Create a QSSS and make the § 1031 exchange, and the parent S corporation does not have the potential liability exposure. Thus, by using a QSSS your parent corporation avoids any potential environmental liabilities.

QSSSs are treated as disregarded entities. They have a separate legal existence for liability purposes, but exist only as a division of the parent S corporation for tax purposes.

Sincerely,

Gene Crumbley, CPA  
Partner

p. 21-6

4. The two shareholders will have difficulty making the S election effective for 2003.
  - For the election to be effective as of January 1, 2003, the previous shareholder also must consent to the election. Under § 1362(b)(2)(B)(ii), where any shareholder who owns stock at the beginning of the tax year for which the election is effective, but not on the date of the election, does *not* consent to the election, the election is effective as of the *next* taxable year.

- Effective if the previous shareholder does consent, this previous shareholder is *not* a qualified shareholder (i.e., a nonresident alien). Thus, the S election is effective for 2004 (but not for 2003).

p. 21-10

## 5. TAX FILE MEMORANDUM

Date: September 8, 2003

From: Doreen Lane

Re: Involuntary termination of two-person S corporation—Elvis Samford shareholder.

I told Mr. Samford over the phone that, after an election has been terminated, five years must pass before a new election can be made. Theoretically, Mr. Samford must wait until the year 2007 before a new election is available. He does *not* qualify for the special waiver of the 5-year waiting period created by the Small Business Jobs Protection Act of 1996 (only for years before 1997). Section 1362(f) does allow the IRS to make exceptions to this rule and permit an earlier election in two situations.

- There is a more-than-50% change in ownership after the first year for which the termination is applicable.
- The event causing the termination was not reasonably within the control of the S corporation or its majority shareholders.

Thus, Mr. Samford might have a chance of an early election. Reg. § 1.1372-5(a) and Rev. Rul. 78-274, 1978-2 C.B. 220.

pp. 21-11 and 21-12

6. If an S corporation has C corporation E & P *and* passive income in excess of 25% of its gross receipts for three consecutive taxable years, the S election is terminated as of the beginning of the fourth year. § 1362(d)(3)(A)(ii) and p. 21-12
- 7.
- |    |       |    |       |    |       |    |       |
|----|-------|----|-------|----|-------|----|-------|
| a. | + OAA | d. | - PTI | g. | - AAA | j. | - AAA |
| b. | - AAA | e. | + OAA | h. | - AAA |    |       |
| c. | + AAA | f. | - OAA | i. | - AAA |    |       |

Example 25

8. Collett should consider the following factors.
- A bypass election is available to the S corporation. With the consent of all of its shareholders, an S corporation may elect to have a distribution treated as made from AEP rather than from AAA. The distribution will be taxable to the shareholder, but any AEP is eliminated. pp. 21-19 and 21-36

- Absent the bypass election, no adjustments are made to AEP during S years except for distributions taxed as dividends and adjustments from redemptions, liquidations, and reorganizations. pp. 21-16 and 21-17
- Even without AEP, the S corporation should maintain an AAA. This figure is needed during the post-termination transition period of approximately one year. A cash distribution can reduce AAA during this postelection termination period. pp. 21-20 and 21-21
- The AAA bypass election may be used in the final year of an S election to avoid the accumulated earnings tax or personal holding company tax. Example 51

9. TAX MEMORANDUM

Date: November 1, 2003

To: Caleb Hudson

Re: Differences between AAA and stock basis of an S corporation.

- Stock basis typically opens at a positive amount, and AAA starts out with a zero balance.
- AAA is a corporate account, and stock basis is calculated at the shareholder level.
- AAA can have a negative balance, but stock basis cannot go below zero.
- AAA is not adjusted for tax-exempt income or related expenses or for Federal taxes attributable to a C corporation tax year. Stock basis is adjusted for these items.

pp. 21-17, 21-18, 21-22, 21-23, and Exhibit 21-1

10.    a.    -            d.    +            g.    -            j.    +            m.    +  
        b.    +            e.    -            h.    -            k.    +            n.    -  
        c.    -            f.    +            i.    -            l.    -            o.    -

pp. 21-22 and 21-23

11.    On the conversion date, the S corporation must include the stock value of the subsidiary in the net unrealized built-in gain, subject to a future built-in gains tax. Later, when the subsidiary is liquidated, a second net unrealized built-in gain is recognized. Thus, the S corporation may pay a built-in gains tax twice on the same appreciation. pp. 21-28 and 21-29
12.    Texas, Inc. should remain a C corporation for 2003 and possibly for the next few years. The \$110,000 NOL carryover could not be used if the S election were made (except for purposes of the built-in gains tax). The projected income for 2003-2006 indicates that Texas can take advantage of this NOL if it remains a C corporation.

pp. 21-27 and 21-33

**PROBLEMS**

13. a. Book income \$90,000  
 Add: Long-term capital loss 6,000  
 \$96,000
- Deduct:
- |                             |              |                 |
|-----------------------------|--------------|-----------------|
| Dividends received          | \$9,000      |                 |
| Tax-exempt interest         | 2,000        |                 |
| § 1231 gain                 | 6,000        |                 |
| Recovery of bad debts       | <u>4,000</u> | (21,000)        |
| Subchapter S taxable income |              | <u>\$75,000</u> |
- b. \$25,000 ( $\$75,000 \div 3$ )

Example 16

14. Sales \$130,000  
 § 1250 gain 12,000  
 \$142,000
- |                               |               |                  |
|-------------------------------|---------------|------------------|
| Cost of goods sold            | \$42,000      |                  |
| Administrative expenses       | 15,000        |                  |
| Depreciation expense          | <u>17,000</u> | (74,000)         |
| Nonseparately computed income |               | <u>\$ 68,000</u> |

Example 16

15. a. Sales \$100,000  
 § 1250 gain 20,000  
 \$120,000
- Less:
- |                               |               |                  |
|-------------------------------|---------------|------------------|
| Cost of goods sold            | \$40,000      |                  |
| Administrative expenses       | 5,000         |                  |
| Depreciation                  | <u>10,000</u> | 55,000           |
| Nonseparately computed income |               | \$ 65,000        |
|                               |               | <u>X 40%</u>     |
| Sammy's share                 |               | <u>\$ 26,000</u> |
- b.  $\$15,000 \times .40 = \$6,000$  LTCG to Sammy

Example 16

16. a. Absent a per-books election, the income is allocated by assigning an equal portion of the annual income of \$1 million to each day (or \$2,739.73 per day) and allocating the daily portion among the two shareholders. Thomas is allocated 50% of the daily income for 90 days from January 1 through March 31, or \$123,287.85 ( $\$2,739.73 \div 2 \times 90$ ). Thomas's estate would be allocated 50% of the income for the 275 days from April 1 through December 31, or \$376,712.87 ( $\$2,739.73 \div 2 \times 275$ ). Ralph would be allocated \$500,000 for the full year.

- b. If the per-books election is made, the income of \$400,000 from January 1 through March 31 is divided equally between Ralph and Thomas, so that each would be allocated \$200,000. The income of \$600,000 from April 1 through December 31 is divided equally between Ralph and Thomas's estate, or \$300,000 to each.

Example 20

17. \$11,000 ordinary income; \$15,000 return of capital; and \$1,000 capital gain. Joy's stock basis is increased by the \$11,000 ordinary income allocable to her, giving Joy a basis of \$15,000 before the distribution. The first \$15,000 of the distribution is a return of capital, reducing the stock basis to zero. The remaining \$1,000 constitutes capital gain (the excess over stock basis). Example 22
18. Tobias recognizes \$90,000 of ordinary income. The corporation has a \$90,000 deduction which passes through to Tobias. His stock basis is reduced to zero, and he has a \$10,000 loss carryover. Figure 21-1 and Concept Summary 21-1
19. Tobias recognizes \$90,000 of dividend income, with no deduction pass through, and has an \$80,000 remaining stock basis. AEP is reduced to zero. Concept Summary 21-1
20. a. Bonnie's initial basis in her stock is \$20,000, pursuant to §§ 1371 and 358.
- b. Adam's and Bonnie's bases in their stock after the sale of the property contributed by Bonnie is determined as follows.

	<u>Adam</u>	<u>Bonnie</u>
Initial basis (§ 358)	\$100,000	\$20,000
Gain on sale (§§ 1363 and 1366)	<u>50,000</u>	<u>50,000</u>
Adjusted basis	<u>\$150,000</u>	<u>\$70,000</u>

- c. If the sale described in b. took place, Adam's and Bonnie's gain (loss) recognized upon the liquidation of the company is determined as follows.

	<u>Adam</u>	<u>Bonnie</u>
FMV of property distributed (§ 331)	\$110,000	\$110,000
Less: Adjusted basis	<u>(150,000)</u>	<u>(70,000)</u>
Gain/(loss) recognized	<u>(\$ 40,000)</u>	<u>\$ 40,000</u>

pp. 21-22 and 21-40

21. TAX FILE MEMORANDUM

Date: October 21, 2003

RE: S losses and distributions

S corporation tax law now provides that distributions are treated as reductions of stock basis before considering any losses. Thus, Bip Wallace should treat the loss and distribution as follows.



Bip's beginning stock basis	\$100,000
Less: Current year distributions	<u>(70,000)</u>
Basis before loss	\$ 30,000
Less: Partial loss	<u>(30,000)</u>
Ending stock basis	<u>\$ -0-</u>
 Suspended loss	 <u>\$ 25,000</u>

p. 21-23 and Example 35

22. There will be a \$30,000 negative balance in AAA, and AEP remains at \$55,000.

	<u>AAA</u>	<u>AEP</u>
Beginning balance, 1-1-01	\$100,000	\$55,000
Less: Distributions	(70,000)	-0-
Less: Loss	<u>(60,000)</u>	<u>-0-</u>
Ending Balance	<u>(\$ 30,000)</u>	<u>\$55,000</u>

In this case, AAA is adjusted first for the distributions and then for the loss. However, the negative balance must be restored to a positive balance before the shareholders may receive any distributions that will not be taxed as dividend income.

Exhibit 21-1

23.	a.	Beginning stock basis		\$22,000
		Add:		
		Taxable income	\$16,000	
		Dividend income	6,000	
		Tax-exempt interest	9,000	
		STCG	3,000	
		Section 1231 gain	<u>3,500</u>	<u>37,500</u>
				\$59,500
		Less:		
		Charitable contributions	\$ 2,500	
		Political contributions	4,000	
		STCL	6,000	
		Dividends to Malcom	<u>6,000</u>	<u>(18,500)</u>
		Ending stock basis		<u>\$41,000</u>
		 p. 21-23		
	b.	Beginning AAA		\$40,000
		Add:		
		Taxable income	\$32,000	
		Dividends received	12,000	
		STCG	6,000	
		Section 1231 gain	<u>7,000</u>	<u>57,000</u>
				\$97,000

Less:			
Charitable contributions		\$ 5,000	
Political contributions		8,000	
STCL		12,000	
Dividends to Malcolm		<u>6,000</u>	<u>(31,000)</u>
Ending AAA			<u>\$66,000</u>

## Exhibit 21-1

24. On the distribution of the securities, there is a recognized gain of \$200,000 to Money, Inc. (\$1 million – \$800,000), which increases AAA by \$200,000. This \$200,000 of gain flows through to the two shareholders (\$100,000 each), and each shareholder increases his or her stock basis by \$100,000.

The \$100,000 operating income increases the corporate AAA by \$100,000. The operating income flows through to the two shareholders (\$50,000 each) and increases each shareholder's stock basis by \$50,000. Thus, before the distribution of securities, AAA is \$600,000 (\$300,000 + \$100,000 + \$200,000). The \$1 million distribution is treated as coming first from AAA, to the extent of \$600,000, and then from AEP, to the extent of \$400,000. AAA is reduced to zero (\$600,000 – \$600,000), and AEP is reduced to \$200,000 (\$600,000 – \$400,000).

Before the distribution, each shareholder's basis is \$550,000 (\$400,000 + \$100,000 + \$50,000). Basis then is reduced by the nontaxable portion of the distribution (i.e., \$300,000 from AAA) to \$250,000 each. Each shareholder has \$200,000 of dividend income resulting from the distribution.

## Concept Summaries 21-1, 21-2, and § 1367(a)(2)(A)

25. Most of the results are the same as in 25, except that AEP is reduced to zero. Each shareholder receives a \$300,000 taxable distribution and a \$200,000 tax-free distribution from AAA. The AAA is \$200,000 at the end of the year (\$600,000 – \$400,000), and each shareholder's basis is \$350,000 (\$550,000 – \$200,000). Concept Summaries 21-1 and 21-2
26. Section 56(b)(1)(A)(i) denies a deduction for the \$300,000 of investment expenses for purposes of the alternative minimum tax, even though net taxable income is zero (\$300,000 – \$300,000). Thus, \$300,000 of investment income flows through to the shareholder. If an S corporation makes cash distributions to the shareholder in order to pay any AMT, these distributions will in turn create additional alternative minimum tax liability. Concept Summary 21-12 and p. 21-14
27. \$12,000 (\$60,000 X .50 X 146/365). p. 21-15

## 28. TAX FILE MEMORANDUM

Date: December 3, 2003

RE: Flow through of Losses

If a shareholder's basis is insufficient to allow the full use of the flow-through losses and there is more than one type of loss, the amount of each deductible flow-through loss is determined on a pro rata basis.

Ms. Muhammad's share of the operating loss is \$24,000 (\$80,000 X 30%) and of the capital loss is \$6,000 (\$20,000 X 30%). Since her basis in the stock is \$24,000, only \$24,000 is deductible. Thus, \$19,200 of the operating loss [(\$24,000/\$30,000) X \$24,000] and \$4,800 of the capital loss [(\$6,000/\$30,000) X \$24,000] can be deducted currently by Ms. Muhammad. The unused losses (\$4,800 operating loss; \$1,200 capital loss) are carried forward to future years. pp. 21-25, 21-26, and Figure 21-1

29.	<u>AAA</u>	<u>Stock Basis</u>	<u>AEP</u>
Beginning balance	\$2,000	\$10,000	\$5,000
Distribution (\$6,000)	(2,000)	(2,000)	(4,000)
Balance	\$ -0-	\$ 8,000	\$1,000
LTCG	<u>2,000</u>	<u>2,000</u>	<u>-0-</u>
Balance	\$2,000	\$10,000	\$1,000
Loss (\$9,000)	(9,000)	(9,000)	No effect
Ending balances	<u>(\$7,000)</u>	<u>\$ 1,000</u>	<u>\$1,000</u>

30.	a.	Inventory:	
		FMV (\$90,000 X .80)	\$72,000
		Adjusted basis (\$70,000 X .80)	(56,000)
		Built-in gain realized	\$16,000
		Collection of receivables	<u>40,000</u>
		Taxable income	\$56,000
		Tax rate	<u>X 35%</u>
		Liability	<u>\$19,600</u>
	b.	\$195,000 – \$110,000 = \$85,000 X .35 = \$29,750.	
	c.	\$270,000 – \$220,000 = \$50,000 X .35 = \$17,500.	

Concept Summary 21-3, § 1374(d)(2), and Reg. § 1.1374-3

31.	Taxable income (less than net built-in gain)	\$65,000
	Less: NOL	<u>(8,000)</u>
	Tax base	\$57,000
	Rate	<u>X 35%</u>
	Tax liability	<u>\$19,950</u>

Concept Summary 21-3

32. The S corporation incurred net passive investment income of \$60,000 [\$100,000 (passive investment income) – \$40,000 (expenses incurred in connection with earning the passive investment income)]. Since 25% of \$190,000 (gross receipts) = \$47,500, passive investment income (PII) beyond the amount allowed is \$52,500 (\$100,000 – \$47,500).

$$\frac{\$52,500 \text{ (PII in excess of 25\% gross receipts)}}{\$100,000 \text{ (PII for the year)}} \times \$60,000 \text{ (net PII)} = \$31,500 \text{ ENPI}$$

Thus, the § 1375 penalty tax is \$10,500 (35% X \$30,000), because taxable income is less than ENPI.

Example 47

33.	<u>Andre</u>	<u>Crum</u>	<u>Barbara</u>
Beginning Bases	\$18,000	\$22,000	\$28,000
Distribution	12,500	12,500	12,500
STCG	(5,000)	(5,000)	(5,000)
Nondeductible fees and penalties	(1,000)	(1,000)	(1,000)
Net tax operating loss	(10,000)	(10,000)	(10,000)
LTCL	(2,000)	(2,000)	(2,000)
Ending stock bases	<u>\$12,500</u>	<u>\$16,500</u>	<u>\$22,500</u>

p. 21-22 and Example 30

34. Yates Corporation recognizes an \$80,600 gain (\$130,800 – \$50,200), of which \$60,200 (\$110,400 – \$50,200) is subject to the corporate built-in gains tax. The other \$20,400 (\$130,800 – \$110,400) of the gain is subject to the S corporation pass-through rules and is not taxed at the corporate level.

Thus, the corporate tax is \$21,070 (0.35 X \$60,200). Mark Farris basically uses 60% of this tax (\$21,070 X .60 = \$12,642) to reduce his flow-through gain of \$48,360 (\$80,600 X .60 = \$48,360), resulting in a net taxable gain of \$35,718 (\$48,360 – \$12,642).

Example 41

35. This family may be trying to avoid salaries to obtain employment tax savings. Likewise, the absence of salaries to the parents shifts income to the daughter, who may be in a lower tax bracket. Under § 1366(e) and Reg. § 1.1373-1(a)(2), the IRS agent could require that reasonable compensation be paid to all three owners. Additional payroll taxes also may be assessed. In this case, however, the allocation of compensation to the daughter results in an increase in her earned income and a decrease in her unearned income (i.e., her pro rata share of S corporation ordinary income). This, in turn, results in a reduction in the kiddie tax, which applies only to unearned income, and consequently may reduce the overall income taxes paid by the family members. However, the agent also would impose payroll taxes upon the salary amounts.

	<u>No Salaries</u>	<u>With Salaries*</u>
Bonnie	\$60,000	\$35,000
Clyde	60,000	35,000
Daughter	60,000	35,000

\*\$180,000 – \$30,000 – \$35,000 – \$10,000 = \$105,000 X 1/3 = \$35,000

Example 48

36. TAX FILE MEMORANDUM

Date: June 18, 2003

From: Judy Hernandez

Re: Friedman, Inc., liquidation

I told Arnold Schwartz, CFO, over the phone that S corporations are subject to many of the same liquidation rules applicable to regular corporations. For example, the distribution of the appreciated land and inventory is treated as if the property were sold to the shareholders in a taxable transaction.

The S corporation incurs no corporate tax (except for any § 1374 tax), but the gains flow through to the shareholders. Any corporate gain increases the shareholders' stock bases by like amounts and reduce any gains realized by the shareholders when they receive the liquidation proceeds. Typically, double tax is avoided, but special tax attributes disappear (i.e., AAA).

With respect to the depreciated marketable securities, the S corporation can recognize the loss.

p. 21-40

37. If the corporation makes the short-year election, Will receives only \$70,000 of the loss. Without the election, Will would receive \$100,000 of the loss. Thus, it is unlikely that Will would consent to the election. Example 19

NOTES