Staff Tax Training – S Corporations (Form 1120S) Case Solutions

DISCLAIMER – All problems, exercises, activities, etc., have at least one suggested solution, even if there may be more than one way to solve the problem. There are no official answers, nor is there only one right way to solve the problem or to arrive at the solution.

Case 1 – Second Class of Stock

1. Non-voting stock will not result in a second class of stock. In general, a corporation will not have a second class of stock issue as long as all outstanding shares of stock confer identical rights to distribution and liquidations proceeds.

2. A difference in timing between the constructive distributions and the actual distributions to the other shareholders does not cause the corporation to be treated as having more than one class of stock. Although a corporation is not treated as having more than one class of stock so long as the governing provisions provide for identical distribution and liquidation rights, any distributions (including actual, constructive, or deemed distributions) that differ in timing or amount are to be given appropriate tax effect in accordance with the facts and circumstances.

3. Under §7872, the IRS could reclassify these below-market interest rate loan amounts as distributions to Larry and Curly. Since the loan agreement is not a governing provision, ASU will not be treated as having more than one class of stock.

4. Any instrument, obligation, or arrangement issued by a corporation (other than outstanding shares of stock), regardless of whether designated as debt, is treated as a second class of stock of the corporation if:
    a. the instrument, obligation, or arrangement constituters equity or otherwise results in the holder being treated as the owner of stock under general principles of Federal tax law; AND
    b. a principal purpose of issuing or entering into the instrument, obligation, or arrangement is to circumvent the rights to distribution or liquidation proceeds conferred by the outstanding shares of stock or to circumvent the limitation on eligible shareholders.

    There are three safe harbors where the due from shareholder will not be treated as a second class of stock. The safe harbors are for:
    a. short-term unwritten advances of $10,000 or less,
    b. proportionately held obligations and
    c. the straight debt safe harbor.

Case 2 – S Termination Year

1. The effective date of the S termination is October 1, 2X06.

2. The S corporation short-year is from January 1 to September 30 and the C Corporation short-year is from October 1 to December 31.

3. Both returns are due by March 15, 2X07.

4. All items are required to be allocated on a daily pro rata basis unless the corporation elects to allocate the items on the basis of its normal accounting method.

5. Yes. The pro rata allocation rules do not apply if at any time during the S termination year, as a result of sales or exchanges of stock in the corporation during that year, there is a change in ownership of 50% or more of the issued and outstanding shares of stock of the corporation. Thus, Bucky is required to allocate the items on the basis of its normal accounting method.

6. The IRS provides relief for inadvertent invalid elections or termination in the form of a private letter ruling. See Reg. §1.1362-4.

Case 3 – Allocation of income & expenses

1. If an individual, who is a member of the family of one or more shareholders of an S corporation, renders services for, or furnishes capital to, the corporation without receiving reasonable compensation, the IRS will prescribe adjustments to those items taken into account by the individual and the shareholders as may be necessary to reflect the value of the services rendered or capital furnished. See Reg. §1.1366-3(a). In this case, the IRS would try to reclassify $30,000 of ASU's net income as wages paid to Sparky.

2. Fringe benefits paid to more than 2% shareholders or certain family members must be treated as wages paid. Health insurance is one of the benefits that is required to be treated as wages.

3. The S corporation is required to allocate items to Moe using the daily pro rata allocation method. Because Moe is treated as a shareholder on the date of distribution he is deemed to own 100 shares from January 1 to March 31 and 50 shares from April 1 to December 31. His daily pro-rata ownership percentage would be 6.24% (i.e., (100/1,000 shares x 90/365 days) 2.47% plus (50/1,000 shares x 275/365 days) 3.77%).

4. If the affected shareholder's (i.e., Sparky and whomever his sold his stock to) elect, the corporation can allocate items to the shareholders as if the taxable year consisted of two separate taxable years (i.e., using actual books from January 1 to March 31 and April 1 to December 31).

Case 4 – Reasonable compensation & other deductions

1. Yes! The IRS would and could try to classify all or a part of the distributions as wages. A service S-corporation is more likely to get audited than a non-service entity.

2. Possibly. An S corporation is not subject to the accumulated earnings tax so retaining profits is not an issue. There is no question on whether the IRS can reclassify distributions as wages. But what if no wages are paid? The issue is whether or not the IRS has the authority to require an S corporation to pay out reasonable wages. §1.1366-3(a) applies to closely held businesses not paying reasonable wages and trying to shift income to lower brackets. This regulation does not appear to apply in this situation.

3. There is no safe harbor method to determine reasonable wages. One might compare their wages to others doing similar jobs in the same geographical location. Most IRS audits "used" to happen to those paying wages lower than the social security wage base. That is NOT the case anymore. The IRS is attacking service S-corporations, regardless of the wages paid.

4. As an employee, the home office deduction will be deducted and limited to 2% of the Vegas's AGI. An alternative would be to have the S corporation pay rent to Vegas for the business use of his home. Even though §280A(c)(6) prohibits any deductions Vegas could take attributable to the rental of his residence, it would be a way to get money out of the S corporation not subject to self-employment tax. Also, S-corporation would be to set up an accountable reimbursement plan and have the S corporation reimburse Vegas for the business use of his home (i.e., for utilities, repairs, maintenance etc.).

5. IRS Notice 88-37 states that the interest expense from debt financed distributions should be separately stated to the shareholders as other deduction on Schedule K-1, line 12. Under the tracing of the loan proceed rules the shareholder will determine the character of the interest expense depending on what they used the distribution proceeds for. Thus, for example the interests expense would be characterized as investment interest expense if the proceeds were invested in the stock market or personal interest if they were used to put in a swimming pool in the shareholder's back yard.

Case 5 – Issues of converting from a C to S corporation

1.
    a. Net operating loss carryforward NOL's have a 2 year carryback period and 20 year carryforward period that can be used to offset any built-in gain recognized by the S corporation. The NOL would get reported on Schedule D, Line 17.
    b. Capital losses have a 3 year carryback period and 5 year carryforward period. These losses can be used to offset any built-in gain recognized by the S corporation due to the sale of capital assets. Note: in this case the carryforward expires in 2X08. The capital loss would get reported on Schedule D, Line 17.
    c. General business credits have a 1 year carryback period and 20 year carryforward period. These credits can be used to offset any built-in gain tax due during the recognition period. The credit would be reported on Schedule D, Line 20.
    d. The PAL will carryforward until there is passive income to offset it or a complete disposition of the passive activity. Thus, the PAL can be deducted if the rental building is sold.

2. **Advantages of remaining a C corporation:**
    - Easier to utilize the carryfoward losses and credits
    - Dividend distributions are only taxed at a maximum 20% rate to individual shareholders
    - Deductibility of fringe benefits.
    - No BIG tax problems

   Disadvantages of remaining a C corporation:
    - May lose carryforward losses and credits
    - Double taxation on dividends and liquidations
    - Could have accumulated earnings tax problem

3.
   a. **Accounts Receivable -** For cash basis taxpayers, accounts receivable is a potential problem. The BIG on Not2Smart's A/R is $500,000. The collection, most likely in the first S year, will trigger the BIG tax. Not2Smart could have tried to collect as much of the A/R in their last C year to avoid the BIG tax.

   b. **Inventory -** The IRS could challenge the FMV of the inventory using the hypothetical buyer theory. The IRS might take the position that the FMV is somewhere between cost and retail value.

   c. **Marketable securities -** The BIG is $100,000. Not2Smart could have sold the assets in its last C year and offset the $80,000 capital loss carryforward. The corporation will still be able to utilize the loss carryforward through 2X08.

   d. **Rental building -** The BIG is $400,000. If audited, the IRS might challenge the real estate valuations. If sold any §1231 gain could be used to offset the $80,000 capital loss carryforward and would trigger the deduction of the $65,000 passive activity loss carryforward.

   e. **Equipment -** The $60,000 BIG on the 7 year property is most likely from the increased §179 expense deduction. Thus, the sale of any of this will trigger the BIG. The BIL from the 5-year property cannot be used to offset the BIG unless it is sold in the same year.

   f. **Goodwill -** If Not2Smart sells all of the assets of the business during the recognition period it could cause a potential problem because they never valued goodwill. Remember, all gains on the sale of assets are BIGs unless the taxpayer can prove otherwise. Thus, any gain allocated to goodwill could be challenged.

   g. **Liabilities -** The $230,000 of A/P is treated as a BIL and can be used to offset any BIG (i.e., the A/R). Not2Smart could have tried to increase their liabilities in the last C corporation year to offset the BIG. For BIG purposes they could have accrued reasonable wages and bonuses to the shareholders and treated the amount as a BIL. However, any BIL paid to a related party has to be paid within the first 2½ months of the S corporation's first year.

Case 6 – Schedule M-2 Ordering Rules & Basis Calculation

1. Schedule M-2 calculation:

	AAA	OAA
	$50,000	$15,000
Net business income	$80,000	
Interest income	$5,000	
Dividend income	$4,000	
Net §1231 gain	$12,000	
Tax exempt interest income	$0	$15,000
	$151,000	$30,000
Rental real estate loss	($10,000)	
Short-term capital loss	($20,000)	
§179 expense	($50,000)	
Charitable contributions	($11,000)	
Deductions related to portfolio income	($1,000)	
Non-deductible expenses	($15,000)	($3,000)
	$44,000	$27,000
Distributions	($44,000)	($6,000)
	$0	$21,000

2. Stock basis calculation:

	Stock
Beginning basis	$75,000
Increase for all income:	
Net business income	$80,000
Interest income	$5,000
Dividend income	$4,000
Net §1231 gain	$12,000
Tax exempt interest income	$15,000
	$191,000
Distributions	($50,000)
	$141,000
Non-deductible expenses	($18,000)
	$123,000
Rental real estate loss	($10,000)
Short-term capital loss	($20,000)
§179 expense	($50,000)
Charitable contributions	($11,000)
Deductions related to portfolio income	($1,000)
Ending basis	$31,000

Case 7 - Stock Redemptions

1. AAA is reduced for ordinary distributions prior to any redemption distributions. Since the redemption of Ron's stock is treated as a sale or exchange, the AAA, OAA & E&P will be decreased by the redemption distribution in proportion to the number of shares redeemed as follows:

	AAA	OAA	PTI	E&P
Beg. Balance	$500,000	$50,000	N/A	$300,000
Ordinary Distr.	(100,000)	0	N/A	0
	400,000	50,000	N/A	300,000
Redemption	(200,000)	(25,000)	N/A	(150,000)
12-31-2X06	$200,000	$25,000	N/A	$150,000

The $50,000 ordinary distribution will not be taxed to Ron and will reduce his stock basis down to $100,000 (i.e., $150,000 - $50,000). Since the redemption is treated as a sale or exchange of Ron's stock, he will report a long-term capital gain of $300,000 (i.e., $400,000 - $100,000 stock basis) on his schedule D.

2. AAA is reduced for ordinary distributions prior to any redemption distributions. Since Ron and Nancy are related, the redemption of Ron's stock is treated as a distribution. Thus, the AAA will be decreased by the full dollar amount of the redemption distribution as follows:

	AAA	OAA	PTI	E&P
Beg. Balance	$500,000	$50,000	N/A	$300,000
Ordinary Distr.	(100,000)	0	N/A	0
	400,000	50,000	N/A	300,000
Redemption	(400,000)	0	N/A	0
12-31-06	$0	$50,000	N/A	$300,000

The $50,000 ordinary distribution will not be taxed to Ron and will reduce his stock basis down to $100,000 (i.e., $150,000 - $50,000). Since the redemption is treated as a distribution to Ron and the entire $400,000 was paid out of the S corporations AAA it will flow through to him on his schedule K-1. Thus, the $100,000 of the redemption distribution will not be taxed reduction Ron's stock basis down to zero and the excess $300,000 will be reported as a long-term capital gain on his schedule D. Note: If the redemption distribution was more than $400,000, then any amount that was paid out of the S corporations prior E&P would be taxed as a dividend and not a capital gain.

Case 8 – Corporate Liquidation

Required #1 – C- Corporation Gain & Tax

There would be a $700,000 gain recognized at the C corporation level calculated as follows:

Deemed Sales Price (FMV assets)	$1,150,000
Less: adjusted basis of assets	(450,000)
Gain on deemed sale of assets	$700,000
Tax rate	x 34%
Tax on deemed sale	$238,000

After the corporation pays the tax of $238,000 they only have $2,000 of cash. Thus, the FMV of the assets that gets distributed to Bucky to buy back his stock is only $912,000. This amount will get reported to Bucky on a Form 1099-DIV ($2,000 of cash and $910,000 of property).

NOTE – The corporation is required to file a Form 966 within 30 days of plan of liquidation and attach it to their final tax return too.

Required #1 – Shareholder Gain & Tax

Bucky will report the $912,000 liquidating distribution on Schedule D as a sale of his stock back to the corporation. Thus, Bucky will have a $862,000 long-term capital gain (i.e., $912,000 less $50,000 stock basis). Bucky will pay $172,400 in tax (i.e., $862,000 x 20%).

NOTE – The overall tax paid the C corporation ($238,000) and the shareholder ($172,400) was $410,400 on a total gain of $700,000 (i.e., 58.63% effective rate). This does not factor in the potential 3.8% net investment income tax (i.e., unearned income Medicare contribution tax).

Required #2 – S Corporation Gain

There would be a $700,000 gain recognized at the S corporation level calculated as follows:

Deemed Sales Price (FMV assets)	$1,150,000
Less: adjusted basis of assets	(450,000)
Gain on deemed sale of assets	$700,000

The entire gain will flow through to Bucky on his Schedule K-1 and he will pay the tax on the gain (not the S corporation).

NOTE – The gain that flows through to Bucky will increase his stock basis.

The FMV of the assets that gets distributed to Bucky to buy back his stock is $1,150,000. This amount will get reported to Bucky on a Form 1099-DIV ($240,000 of cash and $910,000 of property).

NOTE – The corporation is required to file a Form 966 within 30 days of plan of liquidation and attach it to their final tax return too.

Required #2 – Shareholder Gain & Tax
The gain that flows through to Bucky will be taxed at the individual income tax rates as follows:

	Gain	Rate	Tax
Accounts receivable	$40,000	39.6%	$15,840
Inventory	30,000	39.6%	11,880
Marketable securities	60,000	20%	12,000
Equipment - §1245	20,000	39.6%	7,920
Equipment - §1231	0	20%	0
Land	50,000	20%	10,000
Building - §1250	0	39.6%	0
Building - §1231	200,000	25%	50,000
Building - §1231	300,000	20%	60,000
Totals	$700,000		$167,640

Bucky will report the $1,150,000 liquidating distribution on Schedule D as a sale of his stock back to the corporation. Thus, Bucky will have a $400,000 long-term capital gain (i.e., $1,150,000 less $50,000 stock basis). Bucky will pay $80,000 in tax (i.e., $400,000 x 20%).

NOTE – The overall tax paid by the shareholder was $247,640 ($167,640 + $80,000) on a total gain of $700,000 (i.e., 35.37% effective rate). This does not factor in the potential 3.8% net investment income tax (i.e., unearned income Medicare contribution tax).

Case 9 – Shareholder Stock Basis

	Stock Basis	Where to report on personal income tax return?
Initial basis	$24,000	
Net business income	$10,000	Schedule E if materially participates
Interest income	$1,000	Schedule B
Dividend income	$2,000	Schedule B - 20% maximum LTCG rate if qualified
Tax exempt interest income	$3,000	Form 1040, page 1, line 8b
	$40,000	
Distribution	$(20,000)	Tax-free
	$20,000	
Non-deductible expenses	$(8,000)	Non-deductible & not reported on return
	$12,000	
Rental real estate loss	$(9,000)	Form 8582 as passive loss
Long-term capital loss	$(3,000)	Schedule D
Ending basis	$0	

NOTE – Ben would have a $6,000 rental loss and $2,000 long-term capital loss in excess of basis that will carryforward to next year.

Case 10 – S Shareholder Stock & Debt Basis

1. Since there is not a net basis increase, Freddie's debt basis will not be adjusted for any Schedule K-1 income or expense items. Freddie will have an ending stock and debt basis of zero as follows:

	Stock Basis	Debt Basis
Beginning balance	$ 0	$0
Trade or business income	23,000	0
	23,000	0
Non-deductible expenses	(3,000)	0
	20,000	0
TorB loss carryforward ($20,000 x ($15,000/$25,000))	(12,000)	0
S-T capital loss ($20,000 x ($10,000 x $25,000))	(8,000)	0
	$ 0	$0

NOTE – Freddie will have a $3,000 trade or business loss and $2,000 short-term capital loss that will carryforward to next year.

2. Freddie must recognize $7,000 income on the repayment of the loan. If a note evidences the loan, the gain is treated as a capital gain. If there isn't a note, the gain is treated as ordinary income. The face amount of the loan owed to Freddie will be $2,000.