Form 1120S Schedule K-1 Analysis – Basis Calculations & Distributions for S Corporations – Case Suggested 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 – 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. Certain 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 2 – 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 3 – Shareholder Stock Basis

Year 1

1. Jen's ending stock basis would be zero with $6,000 of losses/deductions suspended in excess of basis calculated as follows:

	Jen's Stock Basis	Where to report on personal income tax return?
Cash contribution	$10,000	
Property contribution	$14,000	
Interest income	$1,000	Schedule B
Dividend income	$2,000	Schedule B - 15% maximum LTCG rate if qualified
Tax exempt interest income	$3,000	Form 1040, line 8b
	$30,000	
Distributions	($ 0)	Tax-free up to stock basis
	$30,000	
Non-deductible expenses	($6,000)	Non-deductible & not reported on return
	$24,000	
Trade or business loss	($16,000)	Form 8582 as passive loss
Short-term capital loss	($8,000)	Schedule D
Ending basis	$ 0	

NOTE – The trade or business loss ($20,000) and short-term capital loss ($10,000) exceeded Jen's $24,000 stock basis. The losses and deductions allowable in excess of the stock basis are pro-rated. Thus the trade or business loss is 66.67% (i.e., $20,000/$30,000) and the short-term capital loss is 33.33% (i.e., $10,000/$20,000) of the losses allowable up to the $24,000 stock basis. Jen would have a ($4,000) trade or business loss and ($2,000) short-term capital loss carry-forward in excess of her stock basis.

2. Yes! Jen could have done the following to increase her deductions:
   a. Made a loan to the S corporation (by December 31, Year 1) to increase debt basis;
   b. Contributed capital (by December 31, Year 1) to increase stock basis; or
   c. Made an irrevocable §1.1367-1(g) election on the Form 1040 to reduce basis for deductible losses and expenses prior to non-deductible.

Year 2

3. Jen's ending stock basis would be zero with $8,000 of losses/deductions suspended in excess of basis calculated as follows:

	Jen's Stock Basis	Where to report on personal income tax return?
Beginning basis	$ 0	
Trade or business income	$50,000	Form 8582 as passive income
Interest income	$500	Schedule B
Tax exempt interest income	$1,500	Form 1040, line 8b
	$52,000	
Distributions	($40,000)	Tax-free up to stock basis
	$12,000	
Trade or business loss suspended from prior year	($4,000)	Form 8582 as passive loss
Short-term capital loss suspended from prior year	($2,000)	Schedule D
§179 deduction	($6,000)	Form 8582 as passive loss
	$ 0	
Non-deductible expenses	($ 0)	$8,000 suspended in excess of basis*
Ending basis	$ 0	

***NOTE** – The $8,000 of non-deductible expenses in excess of stock basis is suspended and carried forward to reduce basis in later years.

Case 4 - S Shareholder Stock & Debt Basis

Required – Year 1

1. Frannie's ending stock and debt basis would be zero with $15,000 of losses/deductions suspended in excess of basis calculated as follows:

	Stock Basis	Debt Basis	Carry-Forward
Beginning basis	$1,000	$9,000	
Interest income	$1,000		
Dividend income	$500		
Tax exempt interest income	$1,500		
	$4,000	$9,000	
Non-deductible expenses	($4,000)	($4,000)	
	$ -	$5,000	
Trade or business loss	$ -	$(5,000)	$(15,000)
Ending basis – Year 1	$ -	$ -	$(15,000)

Required – Year 2

2. Frannie's ending stock and debt basis would be zero with $10,000 of losses/deductions suspended in excess of basis calculated as follows:

	Stock Basis	Debt Basis	Carry-Forward
Beginning basis	$ -	$ -	
Trade or business income	$23,000	$ -	
	$23,000	$ -	
Distribution	($10,000)		
	$13,000		
Non-deductible expenses	($3,000)	$ -	
	$10,000	$ -	
Trade or business loss carry-forward*	($7,500)	$ -	($7,500)
Short-term capital loss*	($2,500)	$ -	($2,500)
Ending basis	$ -	$ -	

***NOTE** – The losses and deductions allowable in excess of the stock basis are pro-rated. Thus, the trade or business loss suspended from the prior year is 75% (i.e., $15,000/$20,000) and the short-term capital loss is 25% (i.e., $5,000/$20,000) of the losses and deductions allowable up to the $10,000 stock basis.

Under §1.1367-2(c)(1), if there has been a reduction in the basis of an indebtedness of the S corporation to a shareholder, any net increase in any subsequent taxable year of the corporation is applied to restore that reduction before any net increase is applied to restore the basis of a shareholder's stock in an S corporation. Since there is not a net increase, none of the $23,000 of trade or business income will increase the debt basis.

Loan Repayment - Frannie must recognize $6,000 of income on the repayment of the loan. If a note secures the debt, the gain is treated as a capital gain. Otherwise the gain is treated as ordinary income. The face amount of the loan owed to Frannie will be $3,000.

3. Frannie's ending stock is zero and debt basis is $1,000 calculated as follows:

	Stock Basis	Debt Basis	Carry-Forward
Beginning basis	$ -	$ -	
Trade or business income	$33,000	$3,000	
	$33,000	$3,000	
Distribution	($10,000)	$ N/A	
	$23,000	$3,000	
Non-deductible expenses	($3,000)	$ -	
	$20,000	$3,000	
Trade or business loss carry-forward*	($15,000)	$ -	
Short-term capital loss*	($5,000)	$ -	
	$ -	$3,000	
Loan Repayment	N/A	($2,000)*	
Ending basis	$ -	$1,000	

Under §1.1367-2(c)(1), if there has been a reduction in the basis of an indebtedness of the S corporation to a shareholder, any net increase (i.e., $3,000 in this case) in any subsequent taxable year of the corporation is applied to restore that reduction before any net increase is applied to restore the basis of a shareholder's stock in an S corporation. Thus, the $3,000 of trade or business income will increase the debt basis and $33,000 will increase the stock basis.

Under Rev. Proc. 64-162: When a corporation repays debt owed to the shareholder before the debt basis is restored, the shareholder must recognize income. If the debt basis has been reduced but not below zero, then only a portion of the repayment is recognized as income.

NOTE – The taxpayer must pro-rate a portion of the loan repayment as return of debt principal and a portion as income.

***Loan Repayment -** Frannie must pro-rate a portion of the loan repayment as return of debt principal and a portion as income. Thus, she must recognize $4,000 of income on the repayment of the loan and reduce her debt basis by $2,000. If a note secures the debt, the gain is treated as a capital gain. Otherwise the gain is treated as ordinary income. The face amount of the loan owed to Frannie will be $3,000.

Case 5 – Debt Basis Loan Repayments

1. Nola will have a ending stock basis of zero and debt basis of $1,200 calculated as follows:

	Stock Basis	Debt Basis
Beginning basis	$ -	$4,000
Trade or business income	$10,000	$ -
	$10,000	$4,000
Distribution	($9,000)	$ N/A
	$1,000	$4,000
Loan Repayment	N/A	($800)*
	$1,000	$3,200
Non-deductible expenses	($1,000)	($2,000)
Ending basis	$ -	$1,200

***Loan Repayment -** Any indebtedness that has been satisfied by the corporation or disposed of or forgiven by the shareholder, during the taxable year, is not held by the shareholder at the close of that year and is not subject to basis reduction. Thus, the loan repayment is taken into consideration prior to any losses/deductions in excess of stock basis. Nola must pro-rate a portion of the loan repayment as return of debt principal and a portion as income (i.e., 4/5 is return of basis and 1/5 is income). Thus, she must recognize $200 of income on the repayment of the loan and reduce her debt basis by $800. If a note secures the debt, the gain is treated as a capital gain. Otherwise the gain is treated as ordinary income. The face amount of the loan owed to Nola will be $4,000.

2. Nola will have a ending stock basis of zero and debt basis of $200 calculated as follows:

	Stock Basis	Debt Basis
Beginning basis	$ -	$4,000
Trade or business income	$10,000	$ N/A
	$10,000	$4,000
Distribution	($10,000)	$ N/A
	$ -	$4,000
Loan Repayment	N/A	($800)*
	$1,000	$3,200
Non-deductible expenses	$ -	($3,000)
Ending basis	$ -	$ 200

NOTE – Nola will recognize a $2,000 capital gain on the distribution in excess of her stock basis.

***Loan Repayment -** Any indebtedness that has been satisfied by the corporation or disposed of or forgiven by the shareholder, during the taxable year, is not held by the shareholder at the close of that year and is not subject to basis reduction. Thus, the loan repayment is taken into consideration prior to any losses/deductions in excess of stock basis. Nola must pro-rate a portion of the loan repayment as return of debt principal and a portion as income (i.e., 4/5 is return of basis and 1/5 is income). Thus, she must recognize $200 of income on the repayment of the loan and reduce her debt basis by $800. If a note secures the debt, the gain is treated as a capital gain. Otherwise the gain is treated as ordinary income. The face amount of the loan owed to Nola will be $4,000.

Case 6 – Multiple Shareholder Loans to the S Corporation

	Stock	Debt #1	Debt #2
Initial basis – Year 1	$10,000	$5,000	
Trade or business loss – Year 1	($10,000)	($3,000)	
Ending basis – Year 1	$ 0	$2,000	
Loan – Year 2			$6,000
Trade or business loss – Year 2	$ 0	($1,000)	($3,000)
Ending basis – Year 2	$ 0	$1,000	$3,000
Trade or business income – Year 3		$3,000	
Loan #1 repayment – Year 3		($5,000)	
LTCG on loan repayment	$ 0	$1,000	$ 0
Ending basis – Year 3	$ 0	$ 0	$3,000

Year 1

The $13,000 loss will bring the stock basis to zero and debt #1 basis to $2,000. Assuming Sue materially participated in the business, she will deduct the $13,000 on schedule E as a non-passive loss.

Year 2

Under §1.1367-2(b)(3), if a shareholder holds more than one indebtedness at the close of the corporation's taxable year or, if applicable, immediately prior to the termination of the shareholder's interest in the corporation, the reduction in basis is applied to each indebtedness in the same proportion that the basis of each indebtedness bears to the aggregate bases of the indebtedness to the shareholder. Thus, $1,000 (i.e., $4,000 loss x $2,000 Debt #1 basis/$8,000 total debt basis) of the trade or business loss will be allocated to Debt #1 and $3,000 (i.e., $4,000 loss x $6,000 Debt #2 basis/$8,000 total debt basis) to Debt #2.

Year 3

Under §1.1367-2(c)(2), if a shareholder holds more than one indebtedness as of the beginning of a corporation's taxable year, any net increase is applied first, to restore the reduction of basis in any indebtedness repaid (in whole or in part) in that taxable year to the extent necessary to offset any gain that would otherwise be realized on the repayment. Thus, the entire $3,000 of trade or business income is allocated to increase Debt #1 basis to increase it to $4,000 before the loan repayment of $5,000. The $1,000 of gain on the loan repayment in excess of basis is treated as a long-term capital gain because the loan was secured by a note and held greater than one year.

Case 7 – Open Account Debt (Multiple Loans)

Required – Year 1

Jack would be able to deduct the entire $51,000 up to his stock basis first and then his debt basis as follows:

	Stock Basis	Debt Basis
Capital contribution	$1,000	
Loan to S corporation – 12-31-Year 1	$ -	$50,000
	$1,000	$50,000
Trade or business loss	($1,000)	($50,000)
Ending basis – Year 1	$ -	$ -

Required – Year 2

Final Reg. §1.1367-2(a)(2) states: The term open account debt means shareholder advances not evidenced by separate written instruments and repayments on the advances, the aggregate outstanding principal of which does not exceed $25,000 of indebtedness of the S corporation to the shareholder at the close of the S corporation's taxable year. Advances and repayments on open account debt are treated as a single indebtedness. If the shareholder advances not evidenced by a separate written instrument, net of repayments, exceeds an aggregate outstanding principal amount of $25,000 at the close of the S corporation's taxable year, for any subsequent taxable year the aggregate principal amount of that indebtedness is treated in the same manner as indebtedness evidenced by a separate written instrument for purposes of this section. For any subsequent taxable year, that indebtedness is not open account debt and is subject to all basis adjustment rules applicable to basis of indebtedness of an S corporation to a shareholder in this section.

Thus based upon the final regulations, the loan made in Year 1 has to be treated as a separate loan from the loan in Year 2. Thus, the loan repayment of $50,000 will result in ordinary income for Jack. The ending stock and debt basis are calculated as follows:

	Stock Basis	Debt #1 Basis	Debt #2 Basis
Beginning basis	$ -	$ -	
Loan to S corporation – 12-31-Year 2	$ -	$ -	$80,000
	$ 0	$ 0	$80,000
Trade or business loss	$ -	$ -	($30,000)
Ending basis – Year 2	$ -	$ -	$50,000

NOTE – Jack will be able to deduct the entire $30,000 trade or business loss since he has enough debt basis. However, since the loan repayment on Debt #1 in Year 2 exceeds the basis (i.e., zero) by $50,000, Jack will have to recognize ordinary income.

Case 8 - Sale of S Corporation Stock

1. Amy will have a $1,000,000 long-term capital gain on the sale of her stock calculated as follows:

Selling price	$1,200,000
Stock basis	(200,000)
Long-term capital gain	$1,000,000

2. Per §1.1(h)-1: when an interest in a S corporation held for more than one year is sold or exchanged in a transaction in which all realized gain is recognized, the transferor shall recognize as collectibles gain the amount of net gain (but not net loss) that would be allocated to that shareholder if the S corporation transferred all of its collectibles for cash equal to the fair market value of the assets in a fully taxable transaction immediately before the transfer of the interest in the S corporation. When Amy sold her interest in the S corporation, the collectibles had a FMV of $250,000 and cost basis $50,000 (i.e. unrealized gain of $200,000). Amy is deemed to have sold her 100% share of the collectibles to Beetlejuice (i.e. a deemed gain of $200,000). As a result, Amy's $1,000,000 long-term capital gain is taxed as follows:

	Gain	**Rate**	**Tax**
Collectibles	$200,000	28%	$ 56,000
Remaining gain	800,000	20%	160,000
Totals	$1,000,000		$216,000

3. Amy's would have a total loss of $200,000. Her initial $70,000 investment would be treated as a §1244 stock loss and the remaining $130,000 would be treated as a capital loss. Under §1244, If she is married filing a joint return should could deduct all $70,000 (up to $100,000) of the §1244 stock loss as an ordinary loss on the Form 4797, Part II. A single taxpayer is limited to $50,000 of ordinary losses under §1244.

Case 9 – Schedule M-2, Distributions & Basis Calculation

1. Wildcat's ending schedule M-2 balances (i.e., AAA, OAA, PTI & E&P) are calculated as follows:

	AAA	OAA	PTI	E&P
Beginning balance	$ 20,000	$5,000	N/A	$40,000
Business income	8,000			
Tax-free income	0	13,000	N/A	0
	28,000	18,000	N/A	40,000
Short-term capital loss	(2,000)			
Life insurance premiums	0	(3,000)		0
	26,000	15,000		40,000
Distribution	(26,000)	0	N/A	(24,000)
Ending balance	$ 0	$15,000	N/A	$16,000

2. The first $26,000 of the distribution will come out of the AAA tax-free up to the shareholder's stock basis (any excess is a capital gain). Since there is no PTI, the remaining $24,000 of the distribution will come out of the E&P as a taxable dividend.

3. Lou's ending stock basis is calculated as follows:

Initial basis	$26,000
Trade or business income	8,000
Tax-free interest income	13,000
	47,000
Less: tax-free distribution	(26,000)
	21,000
Non-deductible expenses	(3,000)
	18,000
Short-term capital loss	(2,000)
Ending stock basis	$16,000

Case 10 – Schedule M-2, Distributions & Basis Calculation

1. The ending schedule M-2 balances (i.e., AAA, OAA, PTI & E&P) are calculated as follows:

	AAA	OAA	PTI	E&P
Beginning balance	$10,000	$8,000	N/A	$90,000
Short-term capital gain	3,000		N/A	
Life insurance proceeds		100,000	N/A	
Business loss to extent of increases to AAA	(3,000)	0	N/A	0
Balance before distribution	10,000	108,000	N/A	90,000
Distributions	(10,000)	0	N/A	(65,000)
	0	108,000	N/A	25,000
Business loss in excess of increases to AAA above	(5,000)	0	N/A	0
Ending balance	($5,000)	$108,000	N/A	25,000

2. Under the distribution ordering rules, the first $10,000 of the distribution will come out of the S corporation's AAA and flow through to Sparky tax-free up to his stock basis. Since there is no PTI, the remaining $65,000 of the distribution will be taxed as a dividend to Sparky and reported on a Form 1099-DIV.

3. Sparky's ending stock basis is calculated as follows:

Initial basis	$19,000
Short-term capital gain	3,000
Life insurance proceeds	100,000
	122,000
Less: tax-free distribution	(10,000)
	112,000
Business loss	(8,000)
Ending stock basis	$104,000

Case 11 – Schedule M-2, Distributions & Basis Calculation

1. The schedule M-2 **through December 31, 2XO2** is calculated as follows:

	AAA	OAA	PTI	E&P
Beg. Balance	$	$	N/A	$900,000
2X01	100,000	10,000	N/A	0
12-31-2X01	100,000	10,000	N/A	900,000
§1231 gain	20,000			
T or B Loss	(20,000)			
	100,000			
Distribution	(100,000)		N/A	(10,000)
Loss	(400,000)	0	N/A	0
12-31-2X02	($400,000)	$10,000	N/A	$890,000

Because 2X02 is a net negative adjustment year, distributions affect the AAA prior to any other items. Following the regulation ordering rules, AAA is increase by $20,000 for the §1231 gain and then reduced by only $20,000 for the trade or business loss. The excess $400,000 trade or business loss is taken into account after any distributions. Thus, the first $100,000 of the distribution will come out of the AAA tax-free up to the shareholder's stock basis (any excess is a capital gain). Since there is no PTI, the remaining $10,000 of the distribution will come out of the E&P as a taxable dividend.

The schedule M-2 through **December 31, 2XO3** is calculated as follows:

	AAA	OAA	PTI	E&P
Beg. Balance	($400,000)	$10,000	N/A	$890,000
Life insurance	0	1,000,000	N/A	0
	(400,000)	1,010,000	N/A	890,000
Distribution	0	(110,000)	N/A	(890,000)
12-31-2X03	($400,000)	$900,000	N/A	$0

The $1,000,000 of tax-free life insurance will increase the OAA. Since Buckeye does not have any AAA or PTI, the $890,000 of the distribution will come out of E&P taxable as a dividend. The remaining $110,000 will come out of the OAA tax-free up to the Jughead's stock basis (any excess is a capital gain).

2. Archie's stock basis was zero at date of death calculated as follows:

Initial basis – capital contribution	$1,000
Trade or business income	100,000
Tax-free interest income	10,000
Ending basis – 12-31-2X01	111,000
§1231 gain	20,000
	131,000
Less: tax-free distribution	(100,000)
	31,000
Trade or business losses allowed up to basis	(31,000)
Ending stock basis – 12-31-2X02	$ 0

NOTE – The $389,000 of losses in excess of Archie's stock basis are lost after his death.

3. Jughead's stock basis as of December 31, 2X03 was $1,190,000 calculated as follows:

Jughead's initial basis is FMV date of death	$ 300,000
Plus tax-free life insurance proceeds	1,000,000
Basis prior to distribution	1,300,000
Less: tax-free distribution	(110,000)
Ending basis	$1,190,000

NOTE – Jughead received a taxable dividend distribution of $890,000.

Case 12 - Stock Redemptions

1. AAA is reduced for ordinary distributions prior to any redemption distributions. Since the redemption of Tom'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	$900,000	$100,000	N/A	$500,000
Ordinary Distr.	(200,000)	0	N/A	0
	700,000	100,000	N/A	500,000
Redemption	(350,000)	(50,000)	N/A	(250,000)
12-31-2X06	$350,000	$50,000	N/A	$250,000

The $100,000 ordinary distribution will not be taxed to Tom and will reduce his stock basis down to $400,000 (i.e., $500,000 - $100,000). 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., $700,000 - $400,000 stock basis) on his schedule D.

2. AAA is reduced for ordinary distributions prior to any redemption distributions. Since Tom and Sherri are related, the redemption of Tom'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	$900,000	$100,000	N/A	$500,000
Ordinary Distr.	(200,000)	0	N/A	0
	700,000	100,000	N/A	500,000
Redemption	(700,000)	0	N/A	0
12-31-2X06	$0	$100,000	N/A	$500,000

The $100,000 ordinary distribution will not be taxed to Tom and will reduce his stock basis down to $400,000 (i.e., $500,000 - $100,000). Since the redemption is treated as a distribution to Tom and the entire $700,000 was paid out of the S corporations AAA it will flow through to him on his schedule K-1 as a distribution. Thus, the $300,000 of the redemption distribution in excess of his $400,000 stock basis will be taxed as a long-term capital gain on his schedule D. Note - If the redemption distribution was more than $700,000, 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 13 – At-risk rules

1. Personal guarantees to not increase the shareholder's debt basis in an S corporation. The shareholder is not considered at-risk for this amount.

2. Under §465(b)(3)(A), even if you are personally liable for repayment of a borrowed amount or secure a borrowed amount with property other than property used in the activity, you are not considered at-risk with respect to an activity if such amounts are borrowed from any person who has an interest in such activity or from a related person to a person (other than the taxpayer) having such an interest. Barney has an interest in the business other than that as a creditor and also related to Fred, thus Fred is not considered at-risk for the amount borrowed.

3. The issue here is whether this would create a second class of stock. You would have to look at the governing provisions for the rights to distribution and liquidation proceeds. In addition, Fred would probably not be considered at-risk with respect to the capital contribution (see answer 2 above).

4. As long as the loan was made to Fred as the primary obligor and with Fred's personal assets being used as security with respect to the loan, he should be considered at risk.

Case 14 – Cancellation of Debt Income

NOTE – For detailed rules look at §1.108-7(d).

	Alfalfa	Buckwheat	Darla	Total
Allocation of excess NOL				
Prior year unallowed losses	$0	($200,000)	($400,000)	($600,000)
Current year losses	($200,000)	($200,000)	($200,000)	($600,000)
Deemed current year NOL	($200,000)	($400,000)	($600,000)	($1,200,000)
Excluded COD Income	$300,000	$300,000	$300,000	$900,000
Excess deemed NOL	$100,000	($100,000)	($300,000)	($300,000)
Allocation of Excess NOL	N/A	($75,000)	($225,000)	($300,000)

NOTE – Buckwheat's ($75,000) share is $100,000/$400,000 x ($300,000), C's ($225,000) share is $300,000/$400,000 x ($300,000).

Character of Buckwheat's excess NOL	NOL	$75,000 x	Allocation
Trade or business loss	($350,000)	87.5%	($65,625)
§1231 losses	($50,000)	12.5%	($9,375)
	($400,000)	100%	($75,000)

Character of Darla's excess NOL	NOL	$225,000 x	Allocation
Trade or business loss	($400,000)	66.67%	($150,000)
Capital	($100,000)	16.67%	($37,500)
§1231 losses	($100,000)	16.67%	($37,500)
	($600,000)	100%	($225,000)