CHAPTER 16 – S CORPORATIONS: OVERVIEW

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16-1. As long as H and W are married, they are treated as one shareholder, but if they divorce, and both retain S Corp. stock, they will be treated as two shareholders.. *See* §1361(c)(1). Thus, if they divorce, retaining their stock, S Corp. will have 101 shareholders, exceeding the 100-shareholder limit set by §1361(b)(1)(A). (This analysis assumes that no shareholders are otherwise members of the same family. *Cf.* §1361(c)(1).) To avoid this problem, H or W could get all the stock in the divorce, or they could sell all of their stock to one individual. Because the divorce of H and W could impact the other shareholders of S Corp., it would be appropriate for the shareholders to have an agreement providing that all of the stock of S Corp. held by a married couple must go to one of the spouses upon divorce (or, perhaps, the agreement could provide that the stock of the divorced couple had to be offered to S Corp. for redemption, which would allow the S corporation more control in the execution of the agreement).

16-2 If the owners of either entity elected to treat the entity as a corporation for federal income tax purposes, they could also elect to treat it as an S corporation if the entity was otherwise a small business corporation. Among other things, a small business corporation must have one class of stock. It seems likely that the general and limited partnership interests would be considered multiple classes of stock, if they entitle owners to different rights in current and liquidating distributions. Interests in a limited liability company more likely are uniform, although state statutes differ.

16-3 As long as C is not an ineligible corporation (*i.e.*, not an insurance company, a financial institution that uses the reserve method for accounting for bad debts, §936 corporation, or DISC or former DISC), it will be a small business corporation. It has fewer than 100 shareholders, no shareholder is a non-resident alien, each is an individual, and the corporation is a domestic corporation with just one class of stock. This answer assumes that C does not have debt characterized as another class of stock for this purpose.

If an S corporation election is filed during the first 2½ months of the corporation's taxable year, the election may be effective for the current year or for the subsequent year, whichever the corporation prefers. §1362(b)(2). Despite the corporation's preference, the election is treated as made for the subsequent taxable year if (i) the corporation did not qualify as a small business corporation during the taxable year before the election is made or (ii) one or more persons who were shareholders during the taxable year but before the election date did not consent to the election. *Id*. If the election is filed more than 2½ months into a taxable year, it automatically becomes effective for the subsequent year. §1362(b)(3). Thus, if an election is made on March 31 for a calendar-year S corporation (*i.e.*, more than 2½ months into a taxable year), it can be effective no earlier than the subsequent year. Further, even if the election is made on February 1 (or within the 2½ month window), it is not effective as of the beginning of the year unless all shareholders who were shareholders during the year and before the election is filed join in the election.

Because Fred did not join in the election, it is not effective until January 1 of the subsequent year

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16-4. If X, Y, and Z are members of a transferor group, the contributions are tax-free under §351 because the group "controls" XYZ Corp. immediately after the transfers. *See* Treas. Reg. §1.351-1(a)(1) (defining a transferor group). *See also* pages 11 and 17-19 of the text. X and Y recognize no gain or loss. Z has $900 of income on the services because services are not "property" within the meaning of §351(a). See §351(d)(1). X, Y, and Z have bases of $600, $2,000 (assuming no election is made under §362(e)(2)(C)), and $1,000 in the XYZ stock. The corporation takes a $600 basis in Blackacre and, assuming no election is made under §362(e)(2)(C), a $1,000 basis in the inventory. See §362(a) and (e)(2). If payment to Z for the services would have been deductible under §162, the corporation is entitled to a deduction. If payment for the services would have been capitalized, the corporation adds $900 to the basis of an asset. In the problems that follow, it will be assumed that the corporation is not entitled to a deduction for Z's services.

If each contributed asset is sold, the shareholders share gain and loss equally because they each have 100 shares of stock. On Blackacre, there is a gain of $400; on the inventory, there is no gain or loss (assuming that no §362(e)(2)(C) election is made). Gain and loss are apportioned pro rata based on how much stock a shareholder owns. Character passes through. Each shareholder increases the basis of his or her XYZ stock by $133.

If each shareholder sells his or her XYZ stock for $1,000 at the end of the year, X has a $267 gain, Y has a $1,133 loss, and Z has a $133 loss.

Assume instead that an election is made under §362(e)(2)(C). Then, the results are the same as described above, except as follows: Y will take a $1,000 basis in the XYZ stock, and XYZ will take a $2,000 basis in the contributed inventory. Further, on the inventory's sale, XYZ recognizes a $1,000 loss, one-third of which is allocated to each shareholder ($333). Overall, therefore, the shareholders will reduce their stock bases by $200 each. Thus, the benefit of the loss is eliminated, at least in part, on a shareholder's sale of the stock (but there may be a character advantage, since the $1,000 ordinary loss is preserved). Finally, if each shareholder sells his or her XYZ stock for $1,000 at the end of the year, X has a $600 gain, Y has a $200 gain, and Z has a $200 gain. X's $600 gain is attributable to the $267 gain (out of $400 on Blackacre) that was allocated to Y and Z and the $333 allocated loss on the inventory. Y and Z's $200 gain each is attributable to the $133 allocable gain from Blackacre and the $333 loss on the inventory. Overall, the shareholders report a $1,000 loss on the inventory, a $400 gain on Blackacre, and a $1,000 gain on the stock, for an overall gain of $400. Thus, the election and sale, in the aggregate, eliminated the benefit of the loss on the inventory, and resulted in a shift of benefits away from Y (who had a net $1,000 ordinary loss in the inventory converted into a $200 capital gain).

The remaining problems generally assume that no §362(e)(2)(C) election was made.

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16-5. If no § 362(e)(2)(C) election was made, there was an entity-level income for the year of \$400. (Note that in adjusting shareholder basis, the character of the corporate-level income and loss is irrelevant.) The tax consequences of the distribution are determined at the close of the corporation's taxable year, after adjustments to stock basis under §1367. See Reg. §1.1368- 1(e)(1). Note that only positive adjustments to stock basis are taken into account before accounting for the distribution, while negative basis adjustments are taken into account after accounting for the distribution. Note as well that adjustments for non-separately stated items (*i.e.*, bottom-line income) are netted as net income or net loss. XYZ had capital gain on the sale of Blackacre (a separately stated item) plus \$0 or \$1,000 of loss on the inventory (a bottom-line item) depending on whether a § 362(e)(2)(C) election was made.

Whether or not the election was made, for each shareholder, the distribution is tax-free under §1368(b)(1). X, Y, and Z's bases in the XYZ stock after taking into account the \$133 allocable share of gain on Blackacre are \$733, \$2,133 (or \$1,133 if the § 362(e)(2)(C) election were made), and \$1,133. (See problem 16-4.) Each shareholder reduces her basis in that stock by \$600 (\$6 times \$100) to \$133, \$1,533 (or \$533 if the § 362(e)(2)(C) election were made), and \$533. If the election was made, XYZ has a \$1,000 loss on the inventory, allocated \$333 to each shareholder. Y and Z can take the entire loss into account, reducing their XYZ stock bases to \$200. X can take only \$133 of that loss into account, reducing her stock basis to \$0 and suspending \$200 of the loss. Note that if she sells the stock at the end of the year, the suspended loss disappears.

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16-6. This problem raises some very difficult issues. Before actually working this problem, you may consider using the following simpler variation that raises the central issue:

> Individual B is the sole shareholder of X Corp., an S corporation using the calendar year as its taxable year. X Corp. has 2 shares outstanding, each owned by B with an adjusted basis of \$0.00 (zero) per share. On April 1, 2013, B sells 1 of the 2 shares to unrelated individual P for its fair market value of \$17.00. Prior to that sale, the corporation distributed \$10.00 per share (\$20.00 total) to B. For the entire year, X Corp. has taxable income of \$32.00. What are the tax consequences of the distribution and of the sale to B?

As to the share sold, its adjusted basis is increased for pass-thru of income and then reduced for the distribution. There is income of \$4.00 per share per quarter, which means that we increase the adjusted basis of the share sold from \$0.00 to \$4.00. The distribution then reduces that adjusted basis to \$0.00 and requires B to report income of \$6.00. Sale of the share for \$17.00 produces a realized and recognized gain of \$17.00.

As to the share retained throughout the year, basis is increased to $16.00 for the pass-thru income and then reduced to $6.00 for the distribution; the $10.00 distribution on this share is tax-free.

This analysis is most likely correct, but note what happened: B received a total distribution of $20.00 and reported pass-thru income of $20.00, so we would expect that the distribution would be entirely tax-free as a return of capital. Yet, under this analysis B reports income of $6.00 and has a $6.00 basis in the retained share.

Is there an alternate analysis? We could allocate the distribution on a per share, per day basis. To do so, note that B owned 5 share-quarters (where one share-quarter equals 1 share held for one-quarter of the year). Thus, the $20.00 distributed to B should be allocated $4.00 to each share-quarter. This allocation of the distribution just offsets the allocation of income, so B has no income and owns one share at the end of the year with an adjusted basis of $0.00.

Any other possibilities? Of course: recall that basis is computed per share except that if a share cannot absorb all of a negative adjustment, it can take basis from other shares. Reg. §1.1367-1(c)(3). We can follow the initial analysis but avoid recognition of income on the distribution made with respect to the first share by taking basis from the second share. This approach will also produce no income and a final stock basis of $0.00. Are these alternatives always the same? No: if a shareholder has unequal basis in the shares, the third alternative will allow the shareholder to make maximum use of her stock basis. Note the one problem with the third alternative: the year closes with respect to the sold share on the date of sale, and *at that time the remaining share has no basis to give*.

Turning now to the actual, more complex problem in the book, this is the complete answer:

If X sells 70 of her shares one-quarter of the way into the year for $12.00 per share, X will recognize gain or loss on the sale under §1001(a) depending on X's adjusted basis in the shares. The adjustments to stock basis under §1367, normally made at year end, are made immediately prior to disposition with respect to shares disposed of during the taxable year. Reg. §1.1367-1(d)(1).

As of the beginning of the taxable year, X's stock basis was $6.00 per share. How will X account for the distribution? Based on the discussion of sole shareholder B above, there are at least 3 possibilities. First, because the shares were sold prior to the distribution, it might be correct (and is most likely correct) to say that no distribution is properly allocable to these shares. Second, we could allocate the total amount distributed to X during the year among all shares held by X on a per-share, per day basis. Third, we could apply the first approach but permit shares to take basis from other shares, if needed.

Applying the first approach, there is no basis reduction for the distribution with respect to the shares sold (because the distribution follows the sale), so their basis remains at $6.00 per share. We next adjust the stock basis upward for X's share of pass-thru gain properly allocable to the shares sold. Since the gain for the year was $1.33 per share ($400/300), the proper allocation to the shares sold is $0.33 per share ($1.33/4), because the shares were sold one-quarter of the way into the year. Thus, the 70 shares were sold for $12.00 per share with an adjusted basis of $6.33 per share, for a taxable gain of $5.67 per share, or $396.90 total.

As of the close of the taxable year and prior to making the §1367(a) adjustments (except as to the shares sold by X), X owns 30 shares with adjusted basis of $6.00 per share, Y owns 100 shares with adjusted basis of $20.00 per share and 35 shares with a cost basis of $12.00 per share, and Z owns 100 shares with adjusted basis of $10.00 per share and 35 shares with a cost basis of $12.00 per share. Because the corporation reported a $400 gain for the year, we determine the tax consequences of the distribution after passing through the gain. §1368(d). Except for the stock purchased or sold during the year, each shareholder increases his or her basis in each share by $1.33 before accounting for the distribution. For the stock purchased during the year, Y and Z increase their basis in each of those shares by $1.00 (1.33 minus .33).

X received a distribution on the 30 shares held throughout the year of $6.00 per share. The distribution is tax-free, §1368(b)(1), and reduces X's stock basis from $7.33 to $1.33, §1367(a)(2)(A). In summary, X reported a taxable gain of $396.90 from the sale of the shares, reported a pass-thru gain of $63.00, and now holds 30 shares with a basis of $1.33 or 39.90 total.

As to Y and Z, each received a distribution of $6.00 per share. This is tax-free to each shareholder, §1368(b)(1), Y reduces her stock basis from $21.33 to $15.33 per share for the original 100 shares and from $13.00 to $7.00 per share for the purchased 35 shares, and Z reduces her stock basis from $11.33 to $5.33 per share for the original 100 shares and from $13.00 to $7.00 for the purchased 35 shares. As for the entity-level gain, Y and Z each pass-thru $1.33 per share for their 100 original shares and $1.00 for their purchased shares.

Applying the second approach to X, because the 70 shares were sold after one quarter, X increases his basis in each share sold by $0.33 from $6.00 to $6.33 to account for allocable gain on those shares. Further, X received an aggregate distribution for the year of $180.00. Since X owned 30 shares for the entire year and 70 other shares for one quarter, X had 190 share-quarters of ownership, so that the distribution works out to about $0.95 per share-quarter. Thus, the proper allocable share of the distributed amount equals $0.95 per share, reducing the adjusted basis of each share from $6.33 to $5.38. Accordingly, sale of these shares for $12.00 each produces a gain of $6.62 per share, or $463.40 total.

As to the retained shares, each share's allocable portion of the distribution to X is $3.80 ($0.95 per quarter times 4 quarters in a year), so adjusted basis declines from $7.33 to $3.53.

In summary, X reported a taxable gain of $463.40, X claimed a pass-thru gain of $63.00 ($23.10 from the shares sold and $39.90 from the shares retained), and now holds 30 shares with a basis of $3.53 per share, or $105.90 total. (The aggregate difference of $0.50 between the first and second approaches is due to rounding.)

The third approach should reach the same result as the first approach, because there is adequate stock basis to account for the distribution on each share.

If X sells the 70 shares three-quarters of the way into the year, we must adjust X's basis in these shares for the corporate-level gain and for the distribution. The gain is accounted for first and then the distribution. §1368(d).

For the 70 shares sold, X would be allocated three-quarters of the gain (or $1.00) on each share or a total of $70.00. X would increase his basis in each of those shares from $6.00 to $7.00. Thus, for the shares Y and Z purchased, each would be allocated one-quarter of the gain (or $0.33) and increase his or her basis in those shares by $0.33 from $12.00 to $12.33. For the stock that each shareholder owned for the entire year, each shareholder would be allocated gain of $1.33 and increase the basis of each of those shares by the same amount (or to $7.33 for 30 shares for X, $21.33 for 100 shares for Y, and $11.33 for 100 shares for Z). See §1367(a).

Applying the first approach, the distribution equaled $6.00 per share, reducing X's basis in the shares sold from $7.00 per share to $1.00. §1367(a)(2)(A). On the sale of these 70 shares, X recognizes a gain of $11.00 per share times 70 shares, or $770.00.

X received a distribution on the 30 shares held throughout the year of $6.00 per share. (X also received a distribution on the 70 shares sold, but that distribution has already been accounted for.) The distribution is tax-free, §1368(b)(1), and reduces X's stock basis from $7.33 to $1.33, §1367(a)(2)(A). In summary, X recognizes a gain of $770.00 on the sale of the 70 shares, is allocated a gain of $109.90 ($70 on the shares sold plus $39.90 on the shares retained) and has a final basis of $1.33 in each share retained.

As to Y and Z, each received a distribution of $6.00 per share on the original 100 shares. This is tax-free to each shareholder, §1368(b)(1), Y reduces her stock basis from $21.33 to $15.33 per share for the original 100 shares, and Z reduces her stock basis from $11.33 to $5.33 per share for the original 100 shares.

Applying the second approach to X, the total amount distributed equaled $600.00, and X owned 330 share-quarters of stock, so that the distribution is allocated about $1.82 per share quarter). As to the 70 shares sold, this allocation of the distribution reduces adjusted basis from $7.00 to $1.54. On the sale of these shares for $12.00, there is a taxable gain of $10.46 per share, or $732.20 total.

As to the 30 shares retained, their allocable share of the distribution is $7.28 per share. Accordingly, X has a $0.05 adjusted basis in the shares retained or in total a $1.50 basis.

In summary, X recognizes a gain of $732.20 on the sale, is allocated $109.90 of gain, and has a basis in the retained shares of $1.50. (With a rounding error of $0.60, this is consistent with the first approach.)

The third approach should reach the same result as the first approach because there is adequate stock basis to account for the distribution on each share.

16-7a. Before the year-end basis adjustments under §1367, I has a stock basis of $10 per share, or $1,000 total. The corporation recognizes gain on the distribution of $12,000, and this gain (as well as the corporation's other taxable income of $3,000) increases I's stock basis pursuant to §1367(a)(1)(A), increasing aggregate stock basis to $16,000. Under §1368(b), the distribution of property having a fair market value of $17,000 will then be taxable to I to the extent of $1,000 and will reduce I's stock basis to $0.

16-7b. Assuming that the gain on Blackacre is included in bottom-line income, the aggregate §1367 adjustment is $10,000, increasing I's stock basis to $11,000. Thus, distribution of property to I having a fair market value of $17,000 produces income to I of $6,000 under §1368(b)(2).

If, however, the gain on Blackacre is capital gain and excluded from bottom-line income, I takes the gain into account, adjusts stock basis for that gain, next takes the distribution into account, and finally takes the loss into account. Thus, I's stock basis is increased by $12,000, from $1,000 to $13,000. The distribution of Blackacre, worth $17,000, produces a basis recovery of $13,000 to I and gain of $4,000. I is allocated $2,000 of bottom-line loss but can take none of that loss income account (assuming that I has no available debt basis). §1366(d). That loss is suspended and the corporation treats it as a loss allocable to I in the next year.

16-7c. Because I owns 100% of the corporation's stock both before and after the redemption, the redemption will be taxed as a distribution pursuant to §302(d). Accordingly, this problem is the same as part (a) except that I will receive distributions totaling $17,750, so that I must recognize income of $1,750 under §1368(b)(2).

16-8. The corporation cannot recognize a loss on a nonliquidating distribution. §311(a). Thus, I's basis increases by only $3,000 under §1367, so that there is a gain to I on the distribution of $13,000 under §1368(b)(2). Note that I takes a $17,000 basis in Blackacre under §301(d), so that the $3,000 built-in loss disappears as a result of the distribution.

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16-9 The ESOP is not taxed on the income allocated from the S corporation, so that it will be indifferent about the order of the distributions. Since an S corporation shareholder takes into account tax items for an S corporation only during a year in which he is a shareholder, Fred should receive a liquidating distribution in a year in which S sells the land, resulting in capital gain, half of which would be allocated to Fred. On the liquidating distribution, Fred would recognize the remaining gain on his stock, and all of his gain would be capital gain. Note that if Fred receives a liquidating distribution on Dec. 30, it appears that the corporation could close its books at that time, so that Fred would be allocated none of the gain arising on a subsequent sale of the inventory.