CHAPTER 18 – TRANSITION ISSUES

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18-1. Under §1368(c)(1), assuming adequate stock basis, distributions from an S Corporation having Subchapter C earnings and profits are taxed first as a return of stock basis to the extent of (post-election) accumulated earnings, then as dividend to the extent of (pre-election) earnings and profits, then as return of stock basis. Recall that the tax consequences of distributions are determined after positive basis adjustments for pass-thru of income are made to stock basis. §1368(d).

The accumulated adjustment account equals $6,000 after the close of the taxable year (note that tax-exempt income does not contribute to AAA), and $10,000 of income passes-thru to the shareholders and increases stock basis under §1367. Therefore, P has an aggregate stock basis of $6,000 while Q has an aggregate stock basis of $10,000.

These numbers tell us that the $6,000 of the total $20,000 distributed will be taxed under §1368(c)(1), $8,000 will be taxed under §1368(c)(2), and $6,000 will be taxed under §1368(c)(3). Under Treas. Reg. §1.1368-2(b)(2), the available AAA is allocated among all distributions made during the year in proportion to the amounts distributed. Here, there were 4 equal distributions, so that $6,000 AAA is allocated equally among each of them, or $1,500 per distribution. Under Treas. Reg. §§1.1368-1(d)(1) and 1.316-2(b), accumulated earnings and profits are allocated to the earliest distributions first. See Treas. Reg. §1.316-2(c). (Note: there is a different allocation rule for current earnings and profits, but S Corporations cannot have current earnings and profits, only accumulated earnings and profits.) Therefore, the allocation of each distributions is as follows:

	D1	D2	D3	D4
§1368(c)(1)	1,500	1,500	1,500	1,500
§1368(c)(2)	3,500	3,500	1,000	0
§1368(c)(3)	0	0	2,500	3,500

The shareholders' stock basis is determined as follows:

P	Q	
1,000	5,000	Stock Basis
3,000	3,000	Taxable Income
2,000	2,000	Exempt Income
(3,000)	(3,000)	§1368(c)(1) amounts
(3,000)	(3,000)	§1368(c)(3) amounts
0	4,000	Totals

Thus, for the year of the distribution, each shareholder is allocated $3,000 of taxable income and $2,000 of tax-exempt income, and because of the §1368(c)(2) distributions, each shareholder reports $4,000 of dividend income.

18-2 They can. On Dec. 31 and Jan.1, in alternate years, X could make distributions to the family and the ESOP and make no other distributions. The distributions would be in cash to the family and in X stock to the ESOP. For the years in which the ESOP receives a distribution, the corporation could elect under §1368(e)(3) to distribute earnings and profits first. The distributions to the family would be in years when that election is not made (and presumably paid out of the accumulated adjustments account). Note that the stock distribution to the ESOP would be a §1368 and §301 distribution because of §305(b)(2) (providing that if some shareholders receive stock and others non-stock property, the stock distribution is not excluded from gross income). Further, merely because the stock and cash distributions are separated by one day does not make X have two classes of stock. *See* Treas. Reg. §1.1361-1(l)(2) (stating that a corporation is not treated as having more than one class of stock as long as the governing instruments provide for identical distribution and liquidation rights but that differences in timing are given appropriate tax effect under the facts and circumstances).

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18-3. Y Corp.'s net unrealized built-in gain is the amount by which the aggregate value of Y Corp.'s assets exceeds their aggregate basis, both determined when the S election becomes effective. That excess is $2,000 (or $22,000 less $20,000). How much net recognized built-in gain does Y Corp. recognize each year? For year 1, Y Corp. recognizes no net recognized built-in gain, because the $1,000 recognized built-in gain on asset 1 is less than the $2,000 recognized built-in loss on asset 2. For year 2, Y Corp. again recognizes no net recognized built-in gain, because on its sale of asset 3, it recognizes a loss, not a gain. For year 3, Corp. Y recognizes a $5,000 gain on its sale of asset 4, $4,000 of which is built-in (the excess of

the value of asset 4 over its adjusted basis, both determined when the S election became effective). However, because the recognized built-in gain taxed under §1374 is limited to the net unrealized built-in gain (§1374(c)(2)), only $2,000 of that amount is taxed under §1374, meaning that Y Corp. has a $420 tax (21% of $2,000). See §1374(b)(1). See also Treas. Reg. §1.1374-6(c) (*ex. 1)* and §1.1374-8(e) (*ex. 1*) (both using a 35% rate).

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18-4 Because M Corp. has accumulated earnings and profits, it is subject to the §1375 tax if it has "excess" passive investment income. M Corp.'s "excess" passive investment income equals the amount, if any, by which its passive investment income (*i.e.,* $80,000, its royalty income) exceeds 25% of its gross receipts ($160,000). That excess equals $40,000 ($80,000 minus 25% of $160,000). Thus, M Corp. has "excess" passive investment income, and it is subject to tax under §1375. The tax equals 21% of the excess net passive income, which is determined under a formula (at page 589 of the text) which includes as factors "excess" passive investment income ($40,000), passive investment income ($80,000), and net passive income (or $60,000 [passive investment income ($80,000) less allocable deductions ($20,000)]). Note that this formula has the effect of reducing the excess passive investment income by its proportionate share of the expenses taken into account in computing net passive income.

Under the formula, excess passive income is determined as follows:

$$\frac{\$40{,}000 \times \$60{,}000}{\$80{,}000} = \$30{,}000$$

Thus, M Corp.'s tax liability is $6,300 (21% of $30,000). Note that if M Corp. had distributed out its earnings and profits (which could be distributed first under a §1368(e)(3) election), M Corp. would not be subject to this tax.