

Chapter C11

S Corporations

Problems

C11-31 a. King Corporation:

\$50,000 x 0.15 =	\$ 7,500
\$25,000 x 0.25 =	6,250
\$25,000 x 0.34 =	<u>8,500</u>
Total	<u>\$22,250</u>

Ken Munro: \$-0-

Total tax liability = \$22,250 + \$0 = \$22,250

b. King Corporation: \$22,250 (same as Part a). Ken Munro: (\$100,000 - \$22,250 taxes) gross income - \$4,400 standard deduction - \$2,800 personal exemption = \$70,550 taxable income; \$16,552 tax liability. Total tax liability: \$22,250 + \$16,552 = \$38,802.

c. King Corporation: \$100,000 - \$50,000 salary = \$50,000 taxable income; \$7,500 (\$50,000 x 0.15) tax liability. Ken Munro: \$50,000 gross income - \$4,400 standard deduction - \$2,800 personal exemption = \$42,800 taxable income; \$8,572 tax liability. Total tax liability: \$7,500 + \$8,572 = \$16,072.

The lowest liability is in Part c because no income is taxed twice and because the income is split between the two taxpayers. Thus, the lowest marginal tax rates are used for each taxpayer. The above calculations ignore any payroll taxes incurred with respect to the salary payment.

d. King Corporation: No tax liability for Parts a, b, and c. The shareholder's gross income for Parts a, b, and c equals \$100,000. In Part a, all \$100,000 of income passes through to Ken. In Part b, all \$100,000 passes through to Ken, and none of the distribution is taxable. In Part c, \$50,000 is taxed to Ken as salary, and \$50,000 passes through to Ken as ordinary income. This answer again ignores any payroll taxes imposed on the S corporation's salary payment. The tax liability for Ken Munro in all three cases is: \$100,000 gross income - \$4,400 standard deduction - \$2,800 personal exemption = \$92,800 taxable income and \$23,449 tax liability for Ken Munro. For all three parts the total corporate and individual tax liability is \$23,449 (\$0 + \$23,449). The S corporation is advantageous only when compared to the C corporation in Part b.

pp. C11-18 and C11-19.

C11-38 Receivables	\$200,000
Automobile (Sec. 1245 gain)	1,000 ^a

Land (Sec. 1231 gain)	20,000 ^b
Accounts payables	<u>(125,000)^c</u>
Recognized built-in gains	<u>\$ 96,000</u>
Limited to: smaller of: 2000 taxable income	\$400,000
Net unrealized built-in gain	295,000 ^d
Recognized built-in gains	96,000

^a\$2,500 [\$3,500 - (\$2,000 - \$1,000)] recognized gain. Limited to \$1,000 built-in gain on first day of first S corporation tax year (2000).

^b\$35,000 (\$60,000 - \$25,000) recognized gain. Limited to \$20,000 built-in gain on first day of first S corporation tax year (2000).

^cDeductible accounts payable only.

^d\$420,000 unrealized built-in gains - \$125,000 unrealized built-in losses = \$295,000 net unrealized built-in gain.

Neither special limitation (taxable income nor net unrealized built-in gain) applies because the total recognized built-in gains are less than either limitation.

The built-in gains tax liability equals \$33,600 (\$96,000 x 0.35). The built-in gains tax liability reduces the income pass-through for the receivables, the automobile gain (ordinary income), and the land gain (Sec. 1231 gain) on a ratable basis. pp. C11-16 and C11-17.

C11-39 a and b.

	Ordinary Income (Loss)	Separately Stated
Operating profit	\$284,000	
Dividend income - domestic corporation		\$12,000
- foreign corporation		6,000
Interest income - municipal bonds		7,000
- corporate bonds		3,000
Gains and losses on property sales		
Sec. 1231 gain		9,000
Net long-term capital gain		5,000
Short-term capital gain		8,000
Sec. 1245 gain (recapture)	10,000	
MACRS depreciation	(46,000)	
Charitable contribution deduction		25,000
Salary expense	(60,000)	
Rental expense	(30,000) ^a	
Repairs expense	(36,000)	
State and local taxes	(6,000)	
Interest expense on stock investment		10,000 ^b
Foreign taxes		1,200 ^c
Total	<u>\$116,000</u>	

^aThe \$6,000 unpaid amount at year-end is nondeductible under Sec. 267(c). The corporation owes the liability for the unpaid rents to a shareholder (Amelia), and the liability remains unpaid at year-end. It is deductible in the year in which it is paid and included in the shareholder's gross income.

^bThe interest expense is investment interest and subject to a special shareholder limitation.

^cForeign taxes withheld on dividend. pp. C11-13 and C11-14.

$$\text{John: } \$125,000 \times 100\% \times \frac{161^*}{365} = \$ 5,137$$

$$\text{-----} \$125,000 \times 90\% \times \frac{204}{365} = \underline{\underline{\$118,014}} \quad 62,877$$

*The donee is assigned the income for the gift date.

$$\text{Michael: } \$125,000 \times 10\% \times \frac{204}{365} = \underline{\underline{\$ 6,986}}$$

C11-40

pp. C11-18 and C11-19.

C11-45 a.

	Monte	Allie
Allocation to shareholders		
Ordinary loss	\$87,500	\$ 87,500
Tax-exempt interest income	10,000	10,000
Long-term capital loss	16,000	16,000
Loss limitation:		
Stock basis	\$80,000	\$ 90,000
Tax-exempt interest	10,000	10,000
Debt basis	-0-	10,000
	<u>\$90,000</u>	<u>\$110,000</u>
Loss deduction:		
Ordinary loss	\$76,087 ^a	\$ 87,500 ^b
Capital loss	\$13,913 ^c	\$ 16,000 ^b

^a $[\$87,500/(\$87,500 + \$16,000)] \times \$90,000 = \$76,087$

^b No limitation applies because the total loss of \$103,500 ($\$87,500 + \$16,000$) is less than the Allie's \$110,000 limitation.

^c $[\$16,000/(\$87,500 + \$16,000)] \times \$90,000 = \$13,913$

b. Monte's stock $(\$80,000 + \$10,000) - \$90,000 = \0

c. Allie's stock: $(\$90,000 + \$10,000) - \$100,000 = \0
 Allie's note: $\$10,000 - \$3,500 = \$6,500$

d. Monte has an \$11,413 ($\$87,500 - \$76,087$) ordinary loss carryover and a \$2,087 ($\$16,000 - \$13,913$) capital loss carryover to the next year. Allie has no loss carryovers.

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	Monte	Allie
Allocation to partners		
Ordinary loss	\$ 87,500	\$ 87,500
Tax-exempt interest income	10,000	10,000
Long-term capital loss	16,000	16,000
Loss limitation:		
Capital investment basis	\$ 80,000	\$ 90,000
Tax-exempt interest	10,000	10,000
Note payable to Allie	-0-	10,000*
Accounts payable	45,000	45,000
Mortgage payable	<u>15,000</u>	<u>15,000</u>
Total	<u>\$150,000</u>	<u>\$170,000</u>
Deduction:		
Ordinary loss	\$ 87,500	
Capital loss	\$ 16,000	\$ 87,500
		\$ 16,000

*Under Reg. Sec. 1.752(c)(1), a partner who lends money to the partnership bears the economic loss and hence is allocated that liability.

The larger basis under the partnership interest basis rules allow the individuals to deduct the ordinary and capital losses in full.

pp. C11-19 through C11-22.

C11-47 a. \$150,000 (\$100,000 basis for stock + \$50,000 basis for note).
b. Stock: -0- Note: -0-
c. Next year's activities: ordinary income, \$60,000; loss carryover from prior year, \$25,000 ordinary loss; note repayment, \$15,000 [$\$50,000 - (-0- + \$60,000 - \$25,000) = \$15,000$] long-term capital gain. Even though the note was repaid before the year-end, its basis was increased for the restoration at the time of the repayment. The stock basis at year-end remains at zero. pp. C11-19 through C11-25.

C11-51

		Ordinary Income/Loss	AAA	Stock Basis
a.	Operating profit	+	+	+
b.	Dividend income from stocks		+	+
c.	Interest income from bonds		+	+
d.	Life insurance proceeds			+
e.	Long-term capital gain		+	+
f.	Sec. 1231 loss		-	-
g.	Sec. 1245 gain (recapture)	+	+	+
h.	Charitable contributions		-	-
i.	Fines paid for overweight trucks		-	-
j.	Depreciation	-	-	-
k.	Employee pension plan contributions	-	-	-
l.	Salary paid to owner	-	-	-
m.	Life insurance premiums on policy in d			-
n.	Money distribution		-	-

Items b, c, d, e, f, h, i, and m are separately stated items.

Items d and m, the life insurance policy and the premiums paid on the policy, are taken into account when determining the other adjustments account balance.

The salary payment (item l) reduces ordinary income (loss) and is separately reported to the shareholder-employee on a Form W-2. Salary payments made to a shareholder-employee are subject to social security tax and income tax withholding. Such treatment is different from the treatment for a guaranteed payment made to a partner which is reported on Schedules K and K-1 of Form 1065 and which is treated as self-employment income.

pp. C11-13, C11-14, and C11-23 through C11-30.

C0-1 a. None. The corporation recognizes no gain because it is an S corporation and does not distribute appreciated property. The shareholder recognizes no gain because the distribution does not exceed stock basis.

b. $\$40,000 + \$36,000 - \$5,000 - \$10,000 = \$61,000$

c. The basis for the stock is \$76,000 immediately after positive basis adjustments. Thus, \$76,000 is tax-free as a return of capital, and \$4,000 is taxed to Tammy as a capital gain. Tammy's stock basis is zero immediately after the distribution. Thus, Tammy cannot deduct the short-term capital loss in the current year. pp. C11-26 and C11-27.

C0-2 a. No income, gain, or loss is recognized because the corporation distributed cash instead of appreciated property and because the cash distribution did not exceed Hal's stock basis.

b. $\text{Basis} = \$120,000 + \$30,000 + \$15,000 - \$20,000 - \$65,000 = \$80,000$

c. $\text{AAA: } \$85,000 + \$30,000 - \$20,000 - \$65,000 = \$30,000$

Accumulated E&P: \$20,000

Other adjustment account: $-0- + \$15,000 = \$15,000$

Authors' Note: The basis and AAA portions of the solution might be shown to the students by using T accounts.

d. Part a. \$95,000 of the distribution is tax-free because it comes from AAA. The remaining \$20,000 is taxable from accumulated E&P.

Part b. $\$120,000 + \$30,000 + \$15,000 - \$20,000 - \$95,000 \text{ from AAA} = \$50,000.$

Part c. $\text{AAA: } \$85,000 + \$30,000 - \$20,000 - \$95,000 = -0-$

Accumulated E&P: $\$20,000 - \$20,000 = -0-$

Other adjustment account: $-0- + \$15,000 = \$15,000$

pp. C11-26 through C11-30.