**Taxation of S Corporations – T518**

**Question 1**

Lana Cool and Luke Warm are U.S. citizens. On May 1, Year 1, they decide to work together and operate the business as a corporation, named L2. On May 1, Year 1, 50 shares of voting stock are issued to Lana and Luke that convey identical rights in all respects, and they each lend $15,000 to L2. The corporation will have a December 31st yearend. They anticipate the business losing money – i.e., operating at a loss in Year 1 – but making profit / income starting in Year 2.

1. Lana and Luke ask you to explain what eligibility and election filing requirements must be met / satisfied for L2 to operate in Year 1 as an S corporation for federal income tax purposes under the subchapter S provisions **(9 points**).

If L2 makes a valid S election for Year 1, advise it and the shareholders of the effect on L2’s S election / status under each of the following alternative occurrences:

1. On September 1, Year 1, L2 issues 50 shares of nonvoting stock to Lana’s son and Luke’s daughter – i.e., they each receive 50 shares of nonvoting stock. The stock is identical rights in all other respects to the sharesheld by Lana and Luke except it is nonvoting stock; alternatively, the stock only entitles the children to one vote per share for the Board of Director members and Lana and Luke’s shares entitle them to 10 votes per share for the Board of Director members **(3 points)**;

1. On October 1, Year 1, Lana sells 25 shares of her L2 stock to Tom Peters, a regional heating and cooling distributor, who refuses to consent to the S election **(2 points)**;
2. On October 15, Year 1, Lana dies and her L2 stock is temporarily transferred / held by her estate prior to being distributed to her son pursuant to her will **(2 points)**;
3. On November 1, Year 1, L2 issues 50 shares of voting stock to Larry Alien, a resident alien. Larry’s spouse is a nonresident alien and they were married and live in a community property state **(3 points)**; and
4. On January 1, Year 2, Luke sells his L2 stock to SW Heating & Cooling Company, an S Corporation **(3 points)**.

Considering your conclusions in part b) through f), what might you suggest as appropriate provisions to be included in the shareholders’ agreement related to/pertaining to maintenance / continuance of L2’s S corporation election / status **(3 points)**?

**Question 2**

On January 1, Year 2, U.S. citizens A owns 40 shares and individual B owns 60 shares of Corporation X, a valid calendar-year S corporation, and the shares of stock convey identical rights in all respects. A’s stock basis in X is $20,000 and B's stock basis in X is $30,000. For Year 2, X generates ordinary gross receipts and income from operations of $60,000, has deductible operating expenses of $20,000, earns $10,000 of tax-exempt interest, and has a short-term capital gain of $10,000. A and B’s only source of income and deductions is from their ownership in Corporation X.

1. What are the tax consequences to X, A, and B in Year 2?
2. Same facts, except that on July 1, Year 2, X also distributes $60,000 to A and $90,000 to B. What are the tax consequences of the distributions to A and B in Year 2?
3. How, if at all, would your answers in (a) and (b) change if X had been a C corporation in Year 1, Year 2 is X’s first year as an S corporation, and X has accumulated earnings and profits (E&P) of $150,000?

**Question 3**

A, an individual, is the sole owner of Corporation X, a calendar-year S corporation. It has always been an S corporation. On January 1, Year 5, A has a basis of $100 in her X stock. On December 31, Year 5, X distributes to A appreciated land, Blackacre, with a basis of $100 and fair market value of $1,000. X had no other activity for Year 5.

What are the tax consequences to X and A in Year 5 with respect to the distribution?

**Question 4**

Same facts as in Question 3, except that X converted to an S corporation effective January 1, Year 2. As of December 31, Year 1, the fair market value of Blackacre was $600 and X had one other asset, Whiteacre, with a basis of $500 and a fair market value of $400.

What are the additional tax consequences, if any, to X and A in Year 5 with respect to the distribution?

**Question 5**

Corporation X is a calendar-year C corporation with accumulated earnings & profits (E&P) of $50,000 and is owned equally by individuals A and B. A's stock basis in X is $10,000 and B's stock basis in X is $100,000. On January 1, Year 2, X converts from a C corporation to an S corporation. In Year 2, X realizes and recognizes a short-term capital gain of $10,000 (asset acquired on February 1, Year 2 and sold on June 1, Year 2) and has ordinary net operating income of $40,000. On December 31, Year 2, X distributes $80,000 ($40,000 each) to A and B.

What are the tax consequences to X, A and B for Year 2?

**Question 6**

In Year 1, A, an individual, contributes $20,000 to Corporation X, a calendar-year S corporation, in exchange for all its stock, and simultaneously lends $15,000 to X. A materially participates in the operation of X. In Year 1, X has an ordinary operating loss of $25,000. In Year 2, X has ordinary net operating income of $4,000. In Year 3, X has ordinary net operating income of $10,000 and distributes $9,000 to A.

What are the tax consequences to A in each of Years 1, 2 and 3?

**Question 7**

In Year 1, A, an individual, contributes $20,000 to Corporation X, a calendar-year S corporation, in exchange for all its stock. A materially participates in the operation of X.

X borrowed $15,000 from a bank and A guaranteed the loan. In Year 1, X has an ordinary operating loss of $25,000.

1. What are the tax consequences to A in Year 1?

1. How, if at all, would your analysis change if A (instead of X) borrowed $15,000 from the bank on a nonrecourse basis and A used the bank loan proceeds to loan $15,000 to X?
2. How, if at all, would your analysis change, if A borrowed $15,000 on a recourse basis from her wholly owned corporation S1 and used the loan proceeds to loan $15,000 to X?

**Question 8**

A, an individual, is the sole owner of Corporation X, a calendar-year S corporation. At the beginning of Year 2, A owns 100 shares of X with a $5,000 basis – i.e., per-share basis of $50. On July 1, Year 2, A sells 40 of her 100 shares to B for $8,000 – per share sales price of $200. During Year 2, X has ordinary net operating income of $6,000.

Assuming no election is made to close X’s books, what are the tax consequences to A and B in Year 2, including but not limited to the tax consequences to A and B on the stock sale?