

## CHAPTER 14

### CHOICE OF BUSINESS ENTITY – OPERATIONS AND DISTRIBUTIONS

2017 Edition	Topic	Status
<b>Questions</b>		
1	Explain why a sole proprietor does not include all items of income and deduction in determining its business income	Unchanged
2	Explain why partnerships must separately report some income and deduction items	Unchanged
3	Discuss the limitations on a partnership deducting losses	Unchanged
4	Explain how a partner's basis and at-risk amount can be different	Unchanged
5	Explain how a partner and partnership can engage in an arm's length transaction	Unchanged
6	Explain the rationale for adjusting the basis of partners and S corporation shareholders	Unchanged
7	Explain the tax treatment of capital gains, charitable contributions, passive losses, and dividends received for different entities	Unchanged
8	How are passive losses treated by different entities	Unchanged
9	Explain how the tax treatment of Section 1250 recapture is different for a corporation than other entities	Unchanged
10	Explain the purpose of the dividends received deduction	Unchanged
11	Explain the similarities and differences between the tax treatment of a partnership and an S corporation	Unchanged
12	Compare the tax treatment of nonliquidating and liquidating distributions of cash and property under different organizational forms of business	Unchanged
13	The tax advantages of hiring children in a family owned business	Unchanged
<b>Problems</b>		
14	Calculate taxable income for an owner operating as a sole proprietorship	Unchanged
15	Calculate taxable income for an owner operating as a partnership (relates to #14)	Unchanged
16	Calculate taxable income for an owner operating as a corporation (relates to #14)	Unchanged

<b>2017 Edition</b>	<b>Topic</b>	<b>Status</b>
<b>17-COMM</b>	Calculate taxable income for an owner operating as an S corporation (relates to #14)	Unchanged
18	Calculate taxable income for an owner operating under different forms of business	Unchanged
19	Calculate the total tax liability for an owner operating under different forms of business (relates to #18)	Unchanged
20	Effect operating income (loss) have on a partner's basis	Unchanged
21	Effect operating income (loss) have on a partner's basis and taxable income - material participant	Unchanged
<b>22-COMM</b>	Effect operating income (loss) have on a partner's basis and taxable income - not a material participant (relates to #21)	Unchanged
23	Effect operating income (loss) has on an owner's taxable income under different forms of business	Unchanged
24	Effect operating income (loss) has on an owner's taxable income under different forms of business (relates to #23)	Unchanged
25	Tax treatment of a transaction between a partner and a partnership	Unchanged
26	Tax treatment of a transaction between a partner and a partnership (relates to #25)	Unchanged
27	Tax treatment of a distribution under different forms of business	Unchanged
<b>28-COMM</b>	Tax treatment of a distribution from an S corporation	Unchanged
29	Dividends-received deduction	Unchanged
30	Dividends-received deduction	Unchanged
31	Dividends-received deduction	Unchanged
32	Determine amount a closely-held corporation can deduct from a passive activity	Unchanged
33	Determine the taxable income and tax liability of a corporation and an S corporation	Unchanged
34	Determine gain on sale of building under different forms of business (1250 unrecaptured gain)	Unchanged
35	Determine gain on sale of building for a corporation (1250 recapture tax)	Unchanged

<b>2017 Edition</b>	<b>Topic</b>	<b>Status</b>
36	Determine gain on sale of building for an S corporation -1250 recapture tax- (relates to #35)	Unchanged
37	Charitable contribution deduction for a corporation	Unchanged
<b>38-COMM</b>	Charitable contribution deduction for a corporation	Unchanged
39	Charitable contribution of inventory	Unchanged
40	Charitable contribution of inventory	Unchanged
41	Charitable contribution of computer equipment to a high school	Unchanged
42	Compare the taxable income and tax liability of an owner-employee using a corporation versus an S corporation	Unchanged
<b>43-COMM</b>	Compare the taxable income and tax liability of an owner-employee using a corporation versus an S corporation	Unchanged
44	Liquidation of sole proprietorship	Unchanged
45	Nonliquidating cash distribution from a partnership	Unchanged
46	Nonliquidating property distribution from a partnership	Unchanged
<b>47-COMM</b>	Liquidating cash distribution from a partnership	Unchanged
48	Nonliquidating cash distribution from a corporation	Unchanged
49	Nonliquidating cash distribution in excess of basis from a corporation	Unchanged
50	Nonliquidating cash distribution from a corporation	Unchanged
51	Nonliquidating cash distribution from a corporation - two scenarios	Unchanged
52	Nonliquidating property distribution from a corporation - two scenarios	Unchanged
53	Liquidating cash distribution from a corporation - three scenarios	Unchanged
54	Liquidating property distribution from a corporation - three scenarios	Unchanged
55	Nonliquidating cash distribution from an S corporation - four scenarios	Unchanged
56	Liquidating cash distribution from an S corporation - four scenarios	Unchanged

<b>2017 Edition</b>	<b>Topic</b>	<b>Status</b>
57-IID	Arm's length transaction – expense between a partner and partnership	Unchanged
58-IID	Arm's length transaction –sale of property between a partner and partnership	Unchanged
59-IID	Partner's deductible share of loss	Unchanged
60-IID	Partner's basis and deductible share of loss	Unchanged
61-IID	Depreciation recapture for corporation	Unchanged
62-IID	Dividends-received-deduction	Unchanged
63-IID	Personal service corporation	Unchanged
64-IID	Shareholder of S corporation deductible loss	Unchanged
65-IID	Dividends-received-deduction and charitable contribution limitation	Unchanged
66-IID	Effect of debt on shareholder's basis in S corporation	Unchanged
67-IID	Nonliquidating property distribution from a partnership	Unchanged
68-IID	Distribution from corporation in excess of E&P	Unchanged
69	INTERNET Assignment	Unchanged
70	INTERNET Assignment	Unchanged
71	Research Problem	Unchanged
72	Research Problem	Unchanged
73-DC	Compare a sole proprietorship versus corporation	Unchanged
74-DC	Types of distributions of entities life-cycle	Unchanged
75-TPC	Choosing the best form of organization	Unchanged
76-TPC	Choosing the best form of organization	Unchanged
77-EDC	Tax preparer's responsibility when finding an error in prior years' tax return	Unchanged

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## CHAPTER 14

### CHOICE OF BUSINESS ENTITY -- OPERATIONS AND DISTRIBUTIONS

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#### DISCUSSION QUESTIONS

1. Why do sole proprietors not include all the items of income and deductions related to their business in the calculation of the business's operating income?

**A sole proprietorship is not an entity separate from its owner. Because the results of the sole proprietorship are reported on the owner's return, any item that receives special treatment by an individual must be accounted for separately by the sole proprietor. Items that are not included in a sole proprietor's operating income calculation include investment income and expenses, capital gains and losses, Section 1231 gains and losses, passive activity items, charitable contributions, and personal expenses.**

2. Why must a partnership separately state certain items in reporting its income to the partners?

**Income from a partnership is taxed at the partner level. Different types of entities may be members of a partnership (e.g., individuals, corporations), each of which is subject to different rules for certain types of income and deductions. In order to get the proper tax treatment by the partners, the items, which are subject to varying rules, must be separately stated.**

3. Partners can generally deduct losses from the partnership. What are the three limitations on the deduction of partnership losses?

**The capital recovery concept limits the amount of any deduction to the amount invested. This limits the deduction for partnership losses to the partner's basis. The at-risk rules limit any loss deduction to the amount the partner has at-risk in the activity. If the partnership interest is a passive activity, the amount of partnership loss that survives the basis and at-risk limitations is subject to the passive loss rules.**

4. Explain how a partner's basis in a partnership can differ from the partner's at-risk amount.

**The main difference in a partner's basis and her or his at-risk amount is due to the treatment of nonrecourse debt related to real estate. Partners' bases are adjusted for their share of all debts of the partnership. However, the at-risk amount is increased only for nonrecourse debt that is related to real estate. Therefore, if a partnership incurs nonrecourse debt that is not related to real estate, a partner's basis is increased for her or his respective share of the debt, but the at-risk amount is not increased by the share of the debt.**

5. Under what circumstances can a partner transact with a partnership at arm's length?

**A partner can transact at arm's length with a partnership as long as they are not related parties. A partner and a partnership are related parties if the partner directly or indirectly owns more than 50 percent of the partnership. A related party partner can also transact at arm's length with the partnership in loan and rental transactions. In addition, payments for services to a partner also are considered to be at arm's-length if the partner is not acting as a partner in providing the services.**

6. Explain the general rationale for adjusting the basis of partners and S corporation shareholders.

**Owners of conduit entities must make adjustments to their bases reflecting changes in their capital investment to prevent double taxation and excess capital recoveries. For example, when a partner or S corporation shareholder is taxed on income from the entity, basis must be increased so that the income is not taxed again when the ownership interest is sold. Similarly, because partners and S corporation shareholders are not taxed on cash distributions, basis must be reduced to reflect the tax-free recovery of capital. This ensures that the cash received does not reduce the gain on a subsequent sale of the ownership interest (providing an excess capital recovery).**

7. Explain the general difference in the treatment of each of the following items for a corporation:

- a. Capital gains and losses

**Corporations can only deduct capital gains against capital losses. Any net capital loss can be carried back 3 years and forward 5 years and used to offset capital gains in the carryback and carryforward years.**

- b. Passive losses

**Corporations are not generally subject to the passive activity loss rules. However, personal service corporations cannot deduct passive losses against income from personal services or portfolio income. Closely held corporations are allowed to deduct passive losses against active income of the business, but not against portfolio income.**

- c. Charitable contributions

**Charitable contributions are limited to 10 percent of taxable income computed without regard to the charitable contribution deduction, net operating loss carrybacks, capital loss carrybacks, and the dividends-received deduction.**

- d. Dividends received

**Corporations are allowed a deduction for dividends received. The dividends received deduction (DRD) is generally 70% (but can be 80% or 100% depending on the ownership percentage) of dividends received from U.S. taxable corporations. The 70% and 80% DRD is limited to 70% (80%) of taxable income computed without the DRD, net operating loss carryovers, and capital loss carrybacks. The limitation is disregarded if a net operating loss results after deducting the general rule DRD.**

8. Are passive losses treated the same for all types of entities?

**Generally, individual taxpayers are only allowed to offset passive losses against passive income sources. Any unused passive losses are suspended until passive income is generated. In the year of disposal any passive loss for the current year and any suspended losses may be deducted from ordinary income. Regular corporations are not subject to the passive activity loss rules. Partners are responsible for determining whether they are engaged in a passive activity. Any passive loss of the partnership is passed through to the individual partner and is treated the same as described above. Personal service corporations cannot deduct passive losses against income from personal services or portfolio income. Closely held corporations are allowed to deduct passive losses against active income of the business, but not against portfolio income.**

9. How does the recapture of depreciation on a Section 1250 property for a corporation differ from that of other entities?

**Corporations that sell Section 1250 property are subject to an additional depreciation recapture provision. This corporate depreciation recapture provision recaptures 20 percent of the difference between the amount that would be ordinary income if the property were Section 1245 property and the amount that would be ordinary income under Section 1250.**

10. What is the purpose of the dividends-received deduction?

**The purpose of the dividends-received deduction is to alleviate the triple taxation of dividends received by a corporation. Because a corporation is a taxable entity, any income distributed to shareholders as a dividend is subject to double taxation. Without the dividends received deduction, dividends received by a corporation that are distributed to shareholders would be subject to triple taxation.**

11. What are the similarities and differences in the income tax treatment of a partnership and an S corporation?

**The income tax treatment of most income and expense items is the same for both entities. Separate reporting of income and deduction items is required by both entities to insure proper treatment at the owner level. One area of difference is the corporate depreciation recapture provision. An S corporation is an election to be taxed as a conduit entity. The S corporation must follow any provisions relating to corporations unless exempted from a specific provision. S corporations are subject to the corporate depreciation recapture rule on Section 1250 property. Partnerships are not subject to this rule.**

**Another difference is in the limitation on the deduction of current net operating losses. This results from the basis adjustments that are made to partner's basis for their share of partnership debt. S corporation shareholders do not adjust basis for debts of the corporation. However, an S corporation shareholder can deduct losses to the extent of the basis in any loan that the shareholder made directly to the corporation. The three basic limitations on the deductions of losses apply to both partners and S corporation shareholders: basis, at-risk amount, and passive loss limitations. Although the same general limitations apply to both types of owners, the differences in basis calculation provide different deduction limits.**

12. Compare the tax treatment of a nonliquidating distribution of cash or property and a liquidating distribution of cash or property for each of the following entities

a. Sole proprietorship

**A nonliquidating distribution of cash or property from a sole proprietorship is tax free because the sole proprietor and the business are not considered separate taxable entities. Although a distribution of property is treated the same as cash, the sole proprietor recognizes a gain or loss on the sale when the distributed property is later sold. However, the sole proprietor's recognition of loss is limited to the business use of the property. The same tax treatment occurs if a sole proprietorship makes a liquidating distribution of cash or property. Because the proprietor and the sole proprietorship are one taxpaying entity, nonliquidating and liquidating distributions of cash or property have no tax consequences to the sole proprietorship.**

b. Partnership

**Generally, a partner does not recognize gain on a nonliquidating distribution of cash or property. Because a partnership is a conduit entity, a distribution to a partner is usually either a return of original investment or a distribution of previously taxed income. The partner recognizes gain only if the amount of cash received exceeds the partner's basis. A partner never recognizes a loss on a nonliquidating distribution of cash or property.**

**If property is distributed, the adjusted basis of the property distributed reduces a partner's basis in the partnership. When both cash and property are distributed, the partner's basis first is reduced by the cash received and then by the adjusted basis of the property. A partner's basis can never be reduced below zero. When the adjusted basis of property distributed exceeds the partner's remaining basis in the partnership, the partner's basis in the property received is reduced (but not below zero) by the amount the property's basis exceeds the partner's remaining basis in the partnership (i.e., after the reduction for the cash distribution).**

**With one exception, the tax treatment of a liquidating distribution of cash or property is the same as for a nonliquidating distribution. A partner can recognize a capital loss if cash is distributed and the amount distributed is less than the taxpayer's basis in the partnership.**

c. Corporation

**A nonliquidating cash distribution (i.e., dividend) from a corporation is taxable to the shareholder if the distribution comes from the corporation's current or accumulated earnings and profits. Any amount distributed in excess of the corporation's current and accumulated earnings and profits is a tax-free return of capital to the extent of the shareholder's basis in the stock. If the amount distributed exceeds the shareholder's basis, the excess is a capital gain. There are no tax consequences to the corporation for the distribution.**

**The amount of the dividend on a nonliquidating distribution of property is the fair market value of the property distributed. The tax treatment for the shareholder is the same as for a cash distribution. A corporation must recognize gain on a nonliquidating property distribution if the fair market value of the property distributed exceeds the adjusted basis of the property. However, it cannot recognize a loss on the distribution of property.**



When a corporation makes a liquidating distribution of cash, the shareholder is treated as having sold stock to the corporation for cash. The shareholder recognizes a capital gain to the extent the cash received exceeds the stockholder's basis in the stock. The shareholder recognizes a capital loss if the amount received is less than the shareholder's basis. Unlike a nonliquidating distribution, the corporation's earnings and profits have no effect on the tax treatment of the distribution. A liquidating distribution of cash has no tax consequences for the corporation. A shareholder treats a liquidating distribution of property the same as a liquidating distribution of cash. If the fair market value of the property received is greater than the shareholder's basis, the shareholder recognizes a capital gain. If the fair market value of the property received is less than the shareholder's basis, the shareholder recognizes a capital loss. With one exception, the tax consequences for a corporation on a liquidating distribution of property are the same as for a nonliquidating distribution. The exception is that a corporation is allowed to recognize a loss on a liquidating distribution of property.

d. S corporation

The tax treatment of distributions by an S corporation is a combination of the tax treatment afforded partnerships and partners and that for corporations and shareholders. This combination of treatments occurs because an S corporation has tax attributes of both a conduit entity and a corporation. For both nonliquidating and liquidating distributions of cash, the tax treatment is similar to a partnership. The distribution is tax free, and shareholders recognize gain only if the amount distributed exceeds the shareholders' basis in the stock. A loss is never recognized. As with a partnership, a cash distribution has no tax consequences for an S corporation.

For a nonliquidating or liquidating distribution of property the shareholder will recognize gain to the extent that the amount distributed exceeds the shareholder's basis. As with a corporation, the amount of the distribution is the fair market value of the property. Shareholders can recognize a loss on a liquidating distribution of property. For an S corporation, the tax treatment for liquidating and nonliquidating distribution mirrors that for a corporation. The S corporation can recognize gains on nonliquidating distributions of property, whereas it can recognize both a gain and a loss on a liquidating distribution of property.

13. Explain the advantages to taxpayers of hiring their children to work in their businesses.

A tax-planning strategy for reducing the taxable income of a sole proprietorship, partnership, S corporation, or a corporation is the valid employment of an owner-employee's children in the business. This strategy allows the entity to deduct the wages or salaries as expenses, lowering the net income, and it may permit the child to receive income tax free. That is, the child can earn up to the standard deduction amount for single individuals (\$6,300 in 2016) with no income tax liability. Therefore, employing children in a business can allow a transfer of cash from parents to children free of income tax.

**PROBLEMS**

The following information is to be used for problems 14-17:

Wrigley Juice has the following income, expense, and loss items for the current year:

Sales	\$850,000
Tax-exempt interest	40,000
Long-term capital gain	85,000
Short-term capital loss	35,000
Passive activity loss	20,000
Cost of goods sold	480,000
Depreciation	40,000
Section 179 expense	25,000
Other operating expenses	200,000
Net operating loss (from preceding year)	24,000

14. Assume that Wrigley Juice is owned by Calvin as a sole proprietorship. Explain the effect of Wrigley's results on Calvin's tax return.

**A sole proprietorship is not an entity separate from its owner. Because the results of the sole proprietorship are reported on the owner's return, any item that receives special treatment by an individual must be accounted for separately by the sole proprietor. Items that are not included in Calvin's operating income calculation are the tax-exempt interest, the capital gains and losses, the passive activity loss, and the net operating loss. Wrigley's operating income is \$105,000:**

Sales	\$ 850,000
Cost of goods sold	(480,000)
Depreciation	(40,000)
Section 179 expense	(25,000)
Other operating expenses	(200,000)
Operating income	<u>\$ 105,000</u>

Calvin will include the \$105,000 of operating income from the sole proprietorship on his individual return. The capital gains and losses must be netted with any other capital gains and losses Calvin has for the year. The passive activity loss is subject to the passive loss rules (losses deductible to the extent of passive income). The net operating loss carryforward is deductible for adjusted gross income to the extent of Calvin's business income for the year. The tax-exempt interest is reported on his individual return, but is excluded from gross income.

15. Assume that Wrigley Juice is a partnership owned equally by Vinnie and Chandra. Explain the effect of Wrigley's results on Vinnie's and Chandra's tax returns.

**Income from a partnership is taxed at the partner level. To get the proper tax treatment by the partners, the items that are subject to varying rules must be separately stated. Items that are not included in the partnership's operating income calculation are the tax-exempt interest, the capital gains and losses, the Section 179 deduction, and the passive activity loss. The net operating loss carryforward would have been distributed to the partners in the preceding year. The partnership's operating income is \$130,000:**

Sales	\$ 850,000
Cost of goods sold	(480,000)
Depreciation	(40,000)
Other operating expenses	(200,000)
Operating income	<u>\$ 130,000</u>

**Vinnie and Chandra will each report one-half of the partnership's operating income and separately stated items on their individual returns:**

	<u>Vinnie</u>	<u>Chandra</u>
Operating income (\$130,000 x 1/2)	\$ 65,000	\$ 65,000
Tax-exempt interest (\$40,000 x 1/2)	\$ 20,000	\$ 20,000
Long-term capital gain (\$85,000 x 1/2)	\$ 42,500	\$ 42,500
Short-term capital loss (\$35,000 x 1/2)	\$(17,500)	\$(17,500)
Passive activity loss (\$20,000 x 1/2)	\$(10,000)	\$(10,000)
Section 179 expense (\$25,000 x 1/2)	\$(12,500)	\$(12,500)

**Each partner will include their \$65,000 share of the partnership operating income on their individual returns. The share of the capital gains and losses must be netted with any other capital gains and losses Vinnie and Chandra have for the year. If they have no other capital gains and losses, the \$25,000 (\$42,500 - \$17,500) of net long-term capital gain is taxed at 15%. The share of the passive activity loss is subject to the passive loss rules (the loss is deductible to the extent of passive income). Each partner can deduct their share of the Section 179 expense, subject to the \$500,000 annual limitation. If either partner has a section 179 expense from other sources, the total deduction cannot exceed the annual limit. The tax-exempt interest is reported on each partner's individual return, but is excluded from gross income.**

16. Assume that Wrigley Juice is a corporation owned by Cora. Explain the effect of Wrigley's results on Cora's tax return.

**A corporation is a taxable entity and pays tax on its taxable income. Shareholders are taxed on dividends received from the corporation. Because Wrigley Juice did not distribute any dividends, Cora does not have any taxable income. Note: If Cora was paid a salary that is included in the operating expenses, she will be taxed on the salary she received.**

**The corporation's taxable income is \$111,000:**

Sales	\$ 850,000
Cost of goods sold	(480,000)
Depreciation	(40,000)
Section 179 expense	(25,000)
Other operating expenses	(200,000)
Net operating loss	(24,000)
Active business income	\$ 81,000
Passive activity loss	(20,000)
Net long-term capital gain (\$85,000 - \$35,000)	50,000
Taxable income	<u>\$ 111,000</u>

**Because Cora is the sole shareholder, Wrigley Juice is a closely held corporation. Closely held corporation's can only deduct passive losses to the extent of active business income. Wrigley's active business income is sufficient to absorb the entire passive activity loss. Corporate capital losses can only be deducted against capital gains. The long-term capital gain is sufficient to absorb the short-term capital loss.**

17. Assume that Wrigley Juice is an S corporation owned equally by Henry, Iris, and Jasmine. Prepare a memo explaining the effect of Wrigley's results on Henry's, Iris's, and Jasmine's tax returns.

**Income from an S corporation is taxed at the shareholder level. In order to get the proper tax treatment by the shareholders, the items which are subject to special rules must be separately stated. Items that are not included in the S corporation's operating income calculation are the tax-exempt interest, the capital gains and losses, the Section 179 deduction, and the passive activity loss. The net operating loss carryforward would have been distributed to the shareholders in the preceding year. The S corporation's operating income is \$130,000:**

Sales	\$ 850,000
Cost of goods sold	(480,000)
Depreciation	(40,000)
Other operating expenses	(200,000)
Operating income	<u>\$ 130,000</u>

**Henry, Iris, and Jamine will each report one-third of the S corporation's operating income and separately stated items on their individual returns:**

	Henry	Iris	Jasmine
Operating income (\$130,000 x 1/3)	\$ 43,334	\$ 43,333	\$ 43,333
Tax-exempt interest (\$40,000 x 1/3)	\$ 13,333	\$ 13,334	\$ 13,333
Long-term capital gain (\$85,000 x 1/3)	\$ 28,333	\$ 28,333	\$ 28,334
Short-term capital loss (\$35,000 x 1/3)	\$ (11,667)	\$ (11,666)	\$ (11,666)
Passive activity loss (\$20,000 x 1/3)	\$ (6,666)	\$ (6,667)	\$ (6,666)
Section 179 expense (\$25,000 x 1/3)	\$ (8,333)	\$ (8,334)	\$ (8,333)

**Each shareholder will include their \$43,333 share of the S corporation operating income on their individual returns. The share of the capital gains and losses must be netted with any other capital gains and losses the shareholders have for the year. If they have no other capital gains and losses, the \$16,667 (\$28,333 - \$11,666) of net long-term capital gain is taxed at 15%. The share of the passive activity loss is subject to the passive loss rules (the loss is deductible to the extent of passive income). Each shareholder can deduct their \$16,667 share of the Section 179 expense, subject to the \$500,000 annual limitation. If Henry, Iris, or Jasmine has a section 179 expense from other sources, the total deduction cannot exceed the annual limit. The tax-exempt interest is reported on each shareholder's individual return, but is excluded from gross income.**

## 18. EndLand Company reports the following results for the current year:

Gross profit from sales	\$350,000
Dividends received (less than 20% ownership)	40,000
Long-term capital loss	60,000
Salaries paid to employees	70,000
Salaries paid to owners	130,000
Investment expenses	10,000
Depreciation (including \$10,000 expensed under Section 179)	60,000
Charitable contributions	30,000

- a. Assume that EndLand is a partnership owned by Kira (60%) and Justin (40%). Kira receives a salary of \$70,000, and Justin receives a salary of \$60,000. The salaries are not guaranteed payments. Determine the tax treatment of EndLand's operating results and the effect of the results on Kira and Justin.

**Income from a partnership is taxed at the partner level. Partner's cannot be employees and the salaries are not deductible by the partnership or taxable to the partners. To get the proper tax treatment by the partners, the items which are subject to special rules must be separately stated. Items that are not included in the partnership's operating income calculation are the dividends received, the capital loss, the Section 179 deduction, the investment expenses, and the charitable contributions. The partnership's operating income is \$230,000:**

Gross profit from sales	\$ 350,000
Salaries paid to employees	(70,000)
Depreciation (\$60,000 - \$10,000)	(50,000)
Operating income	<u>\$ 230,000</u>

**Kira and Justin will each report their proportionate shares of the partnership's operating income and separately stated items on their individual returns:**

	60% Kira	40% Justin
Operating income	\$138,000	\$ 92,000
Dividends	\$ 24,000	\$ 16,000
Investment expenses	\$ (6,000)	\$ (4,000)
Long-term capital loss	\$ (36,000)	\$ (24,000)
Section 179 expense	\$ (6,000)	\$ (4,000)
Charitable contributions	\$ (18,000)	\$ (12,000)

- b. Assume the same facts as in part a, except that EndLand is a corporation. Determine the tax treatment of EndLand's operating results and the effect of the results on Kira and Justin.

**A corporation is a taxable entity and pays tax on its taxable income. Shareholders are taxed on dividends received from the corporation. Shareholders can be employees of the corporation. The salaries paid to Kira and Justin are taxable to them and deductible by the corporation. Because the corporation did not pay any dividends, Kira and Justin have gross income from the salaries paid of \$70,000 and \$60,000.**

**The corporation's taxable income is \$83,000:**

Gross profit from sales	\$ 350,000
Dividends received	40,000
Salaries paid to owners	(130,000)
Salaries paid to employees	(70,000)
Investment expenses	(10,000)
Depreciation	(60,000)
Taxable income before special deductions	\$ 120,000
Dividends received deduction (\$40,000 x 70%)	(28,000)
Charitable contributions	(9,000)
Taxable income	<u>\$ 83,000</u>

**The corporation can deduct the \$10,000 Section 179 expense. The 70% dividends received deduction (DRD) is fully allowed because it is less than 70% of taxable income computed without the DRD (\$90,000 x 70% = \$63,000) and the charitable contributions deduction. The charitable contribution deduction is limited to 10% of taxable income before the DRD and charitable contributions deduction (\$90,000 x 10% = \$9,000). No deduction for the capital losses can be taken in the current year because corporation's can only deduct capital losses against capital gains. However, the corporation can carry back the loss 3 years and obtain a refund of taxes paid on capital gains for the \$60,000 of loss. If the loss is not fully used in the carryback years, any remaining loss can be carried forward for 5 years and used to reduce capital gains.**

- c. Assume the same facts as in part b, except that EndLand is an S corporation. Determine the tax treatment of EndLand's operating results and the effect of the results on Kira and Justin.

**Income from an S corporation is taxed at the shareholder level. S corporation owners can be employees of the corporation. The salaries paid to Kira and Justin are taxable to them and deductible by the corporation. To get the proper tax treatment by the shareholders, the items which are subject to special rules must be separately stated. Items that are not included in the S corporation's operating income calculation are the dividends received, the capital loss, the section 179 deduction, the investment expenses, and the charitable contributions. The S corporation's operating income is \$100,000:**

Gross profit from sales	\$ 350,000
Salaries paid to owners	(130,000)
Salaries paid to employees	(70,000)
Depreciation (\$60,000 - \$10,000)	(50,000)
Operating income	<u>\$ 100,000</u>

**In addition to their salaries, Kira and Justin will each report their proportionate shares of the S corporation's operating income and separately stated items on their individual returns:**

	<b>60% Kira</b>	<b>40% Justin</b>
Salary	\$ 70,000	\$ 60,000
Operating income	\$ 60,000	\$ 40,000
Dividends	\$ 24,000	\$ 16,000
Investment expenses	\$ (6,000)	\$ (4,000)
Long-term capital loss	\$ (36,000)	\$ (24,000)
Section 179 expense	\$ (6,000)	\$ (4,000)
Charitable contributions	\$ (18,000)	\$ (12,000)



19. Return to the facts of problem 18. Determine the total tax liability for EndLand, Kira, and Justin for parts a, b, and c. Assume that Kira has net taxable income from other sources of \$50,000, which includes a \$30,000 long-term capital gain. Justin's net taxable income from other sources is \$20,000. Assume Kira and Justin are both single and that both have income from other sources that offset their allowable deductions.

**Partnership:**

Each partner will include their share of the partnership operating income and dividend income on their individual returns. The investment expenses are deductible as miscellaneous itemized deductions, subject to the 2% of adjusted gross income limitation. The share of the capital loss must be netted with any other capital gains and losses Kira and Justin have for the year. Kira has a net capital loss of \$6,000 (\$30,000 - \$36,000), but only \$3,000 of the capital loss is deductible. Justin can deduct \$3,000 of his \$24,000 capital loss. Each partner can deduct their share of the Section 179 expense, subject to the \$500,000 annual limitation. The charitable contributions are deductible as itemized deductions. Assuming that both Kira and Justin have other miscellaneous itemized deductions in excess of 2% of their adjusted gross income, Kira's taxable income is \$149,000 and Justin's taxable income is \$99,000:

	<u>Kira</u>	<u>Justin</u>
Other net taxable income	\$ 20,000	\$ 20,000
Add: share of partnership income items		
Partnership income	138,000	92,000
Dividends	24,000	16,000
Taxable income before partnership deductions	<u>\$182,000</u>	<u>\$122,000</u>
Deduct: share of partnership deduction items		
Investment expenses	(6,000)	(4,000)
Long-term capital loss	(3,000)	(3,000)
Section 179 expense	(6,000)	(4,000)
Charitable contributions	(18,000)	(12,000)
Taxable income	<u><u>\$149,000</u></u>	<u><u>\$ 99,000</u></u>

The total income tax liability is \$50,558. Dividends are taxed at 15%. Kira pays ordinary income rates on \$125,000 (\$149,000 - \$24,000), while Justin's ordinary income is \$83,000 (\$99,000 - \$16,000).

**Kira:**

Tax on \$125,000 - \$18,558.75 + [28% x (\$125,000 - \$91,150)]	\$28,037
Tax on \$ 24,000 - \$24,000 x 15%	3,600

**Justin:**

Tax on \$ 83,000 - \$5,183.75 + [25% x (\$ 83,000 - \$37,650)]	\$16,521
Tax on \$ 16,000 - \$16,000 x 15%	2,400
Total tax liability	<u><u>\$50,558</u></u>

In addition to the income taxes that are paid under each scenario, Social Security taxes or self-employment taxes must also be considered as part of the total tax liability that is owed. The self-employment tax paid by Kira and Justin is \$29,311 (\$18,419 + \$11,162) and their total tax liability when organized as a partnership is \$79,869 (\$50,558 + \$29,311).

Kira	$[(\$149,000 - \$20,000) \times 92.35\%]$	=		\$119,132
	$\$118,500 \times 12.4\%$		14,694	
	$\$119,132 \times .029\%$		<u>3,455</u>	\$18,149
Justin	$[(\$99,000 - \$20,000) \times 92.35\%]$	=	\$ 72,957	
	$\$ 72,957 \times 15.3\%$			<u>11,162</u>
Total				<u>\$29,311</u>

### Corporation:

The corporation's taxable income is \$83,000. Kira's taxable income is \$120,000 (\$70,000 + \$50,000). Because she is in the 28% marginal tax rate bracket, her \$30,000 capital gain is taxed at 15%. Justin's taxable income is \$80,000 (\$60,000 + \$20,000). Because the corporation can deduct the Social security tax it pays on Kira and Justin's salaries, the Social security tax must be computed before computing the corporation's income tax liability:

Kira	$\$70,000 \times 7.65\%$	=	\$5,355
Justin	$\$60,000 \times 7.65\%$	=	\$4,590
Total			<u>\$9,945</u>

The corporation's taxable income is reduced to \$73,055 (\$83,000 - \$9,945) by the payment of the Social Security tax. In addition, a matching Social Security Tax must be paid individually by Kira and Justin. The total tax liability for the corporate form is: \$71,696:

Corporation -	$\$ 7,500 + (\$73,055 - \$50,000) \times 25\%$	\$13,264
Kira -	$\$ 5,183.75 + [25\% \times (\$90,000 - \$37,650)]$	18,271
Kira (cap. gain) -	$\$ 30,000 \times 15\%$	4,500
Justin -	$\$ 5,183.75 + [25\% \times (\$80,000 - \$37,650)]$	15,771
Social Security taxes	$\$ 9,945 + \$9,945$	19,890
Total tax liability		<u>\$71,696</u>

**S Corporation:**

Each owner will include their salary, their share of the S corporation operating income and their share of the dividend income on their individual returns. The other separately stated items are treated the same as for a partnership. Assuming that both Kira and Justin have other miscellaneous itemized deductions in excess of 2% of their adjusted gross income, Kira's taxable income is \$141,000 and Justin's taxable income is \$113,000:

	<u>Kira</u>	<u>Justin</u>
Other net taxable income	\$ 20,000	\$ 20,000
Salaries	70,000	60,000
Add: share of S corporation income items		
S corporation income	60,000	40,000
Dividends	24,000	16,000
Taxable income before S corporation deductions	<u>\$174,000</u>	<u>\$136,000</u>
Deduct: share of S corporation deduction items		
Investment expenses	(6,000)	(4,000)
Long-term capital loss	(3,000)	(3,000)
Section 179 expense	(6,000)	(4,000)
Charitable contributions	(18,000)	(12,000)
Taxable income	<u>\$141,000</u>	<u>\$113,000</u>

Owners of an S corporation do not pay self-employment tax on the income that flows through to them. However, the S corporation will have to pay Social Security taxes on the salaries paid to Kira and Justin. Dividends are taxed at 15%. Kira pays ordinary income rates on \$117,000 (\$141,000 - \$24,000), while Justin's ordinary income is \$97,000 (\$113,000 - \$16,000). The total income tax liability is \$71,884:

**Kira:**

Tax on \$ 99,000 - \$18,558.75 + [28% x (\$117,000 - \$91,150)]	\$25,797
Tax on \$ 24,000 - \$24,000 x 15%	3,600

**Justin:**

Tax on \$ 97,000 - \$18,558.75 + [28% x (\$97,000 - \$91,150)]	20,197
Tax on \$ 16,000 - \$16,000 x 15%	2,400
Social Security taxes \$9,945 + \$9,945	19,890
Total tax liability	<u>\$71,884</u>

20. Fawn contributes undeveloped land with a basis of \$15,000 and a fair market value of \$90,000 to the Deer Partnership for a 25% interest in the partnership. What is Fawn's share of the partnership's operating income or loss, and how does the share affect Fawn's basis in each of the following situations? Assume that Fawn is a material participant in the partnership.

**A partnership is a conduit entity. Fawn's share of the partnership income (loss) flows-through the partnership and is reported on her return. Net operating loss deductions from partnerships are limited to the partner's basis and at-risk amount in the activity. Because the partnership has no liabilities, Fawn's at-risk amount is equal to her basis.**

- a. Deer Partnership reports an operating loss of \$40,000 for the current year.

**Fawn's share of the partnership loss is \$10,000 ( $25\% \times \$40,000$ ). Because she is a material participant in the partnership and she has adequate basis to absorb the loss, she can deduct the \$10,000 loss. Her initial basis of \$15,000 decreases by the \$10,000 loss and her ending basis is \$5,000 ( $\$15,000 - \$10,000$ ).**

- b. Deer Partnership reports operating income of \$25,000 for the current year.

**Fawn recognizes \$6,250 ( $25\% \times \$25,000$ ) of the partnership income. Her initial basis of \$15,000 increases by the \$6,250 of income recognized and her ending basis is \$21,250 ( $\$15,000 + \$6,250$ ).**

- c. Deer Partnership reports an operating loss of \$80,000 for the current year.

**Fawn's share of the partnership loss is \$20,000 ( $\$80,000 \times 25\%$ ). Fawn's deductible loss is limited to her \$15,000 basis. The \$5,000 ( $\$20,000 - \$15,000$ ) excess loss from the partnership is suspended and carried forward until a future tax year when Fawn's basis in the partnership has increased enough to absorb the loss. Fawn's basis in the partnership interest is reduced to zero by the loss recognition.**

21. Binh has a 50% interest in the Lamonica Partnership with a basis of \$10,000 at the end of the year before accounting for his share of the current year's losses. The partnership suffers ordinary losses of \$60,000. Assume that Binh is a material participant in the partnership.
- a. How much of the partnership's losses may Binh deduct? What is Binh's adjusted basis at the end of the year?

**Binh's share of the losses is \$30,000 (\$60,000 x 50%). The amount of the loss Binh can deduct is limited to his \$10,000 basis in the partnership. The \$20,000 (\$30,000 - \$10,000) excess loss is suspended and carried forward to a future year when his basis in the partnership has increased enough to absorb the loss. Binh's basis in the partnership at the end of the year is zero.**

Basis before loss recognition	\$ 10,000
Loss flow-through	(30,000)
Excess loss -- suspended under basis rules	<u>\$(20,000)</u>
Loss recognition	<u>\$(10,000)</u>
Year-end basis of partnership interest	<u>\$ -0-</u>

- b. Assume that next year, Binh makes additional capital contributions to Lamonica Partnership of \$16,000, the partnership incurs \$9,000 in additional debt, and the partnership realizes operating income of \$2,000. How do these items affect Binh's adjusted basis?

**Binh's basis is increased by his capital contribution, his share of the partnership's new debt, and his share of partnership income**

Beginning of the year basis	\$ - 0 -
Capital contribution	16,000
Share of partnership debt (\$9,000 x 50%)	4,500
Share of partnership income (\$2,000 x 50%)	1,000
Basis before loss carryforward	<u>\$21,500</u>
Recognition of suspended loss from prior year	<u>(20,000)</u>
Ending basis	<u>\$ 1,500</u>

**Binh has sufficient basis to recognize all of the prior year's loss carryforward. Therefore, Binh will report a loss from the partnership of \$19,000 in the current year.**

Income from partnership	\$ 1,000
Suspended loss carryforward	(20,000)
Reported loss for the year	<u>\$(19,000)</u>

22. Return to the facts of problem 21. How would your answers change if Binh is not a material participant in the Lamonica Partnership? Assume that Binh has no other passive income in either year. Write a memo to Binh explaining what he has to do to achieve material participation.

**Because he is not a material participant in the Lamonica Partnership, Binh is subject to two limitations: the basis limitation and the passive loss limitations. The \$10,000 of the loss is not recognized in the previous year due to the passive activity loss limitations. He also has \$20,000 suspended loss under the basis rules. The \$20,000 of suspended loss that becomes deductible under the basis limitation next year is subject to the passive activity loss rules. Binh has \$1,000 of passive income from the partnership. Therefore, he can deduct only \$1,000 of the \$30,000 (\$10,000 + \$20,000) suspended loss in the current year. The remaining \$29,000 of loss is suspended under the passive activity loss rules.**

**Generally, for Binh to meet the material participation standard, he must participate in the operations of the partnership for more than 500 hours per year. The regulations also provide for six other tests that allow lower levels of participation based on the particular facts of the situation.**

23. AnnaBell and Eva own and manage Purity Forms Development. Annabell's and Eva's bases in Purity at the beginning of the year are \$18,000 and \$24,000, respectively. During the current year, Purity suffers a \$90,000 net operating loss. Purity's only debt is a \$45,000 nonrecourse debt on its office building (incurred during the current year). Determine the deductibility of the net operating loss under each of the following assumptions:
- a. Purity is a partnership. Annabell owns a 1/3 interest, and Eva owns a 2/3 interest in the partnership.

**AnnaBell's share of the partnership loss is \$30,000 ( $\$90,000 \times 1/3$ ) and Eva's share of the loss is \$60,000 ( $\$90,000 \times 2/3$ ). The capital recovery concept limits the amount of any deduction to the amount invested. This limits the deduction for partnership losses to the partner's basis. Because partners are liable for debts of the partnership, individual partners have a risk of loss from any debts that the partnership incurs. Due to this liability feature, a partner's share of the partnership's debt is deemed to be the equivalent of a cash contribution to the partnership and basis is increased by each partner's proportionate share of the partnership debt. AnnaBell's basis increases by \$15,000 ( $\$45,000 \times 1/3$ ) to \$33,000 for the partnership debt. Eva's basis increases by \$30,000 ( $\$45,000 \times 2/3$ ) to \$54,000 for the partnership debt. AnnaBell has sufficient basis to deduct her \$30,000 loss, leaving her with a basis of \$3,000. Eva can only deduct \$54,000 of the loss, with \$6,000 suspended until her basis increases:**

	<b>AnnaBell</b>	<b>Eva</b>
Beginning basis	\$ 18,000	\$ 24,000
Share of partnership debt	15,000	30,000
Basis for deducting losses	\$ 33,000	\$ 54,000
Loss deduction	(30,000)	(54,000)
Ending basis	<u>\$ 3,000</u>	<u>\$ -0-</u>

**The at risk rules limit any loss deduction to the amount the partner has at-risk in the activity. A partner's at-risk amount parallels her or his basis. Only nonrecourse debt attributable to real property is considered to be at-risk. The partnership debt is at risk and the partner's at-risk amounts are equal to their bases. Because the partners participate in the management of the partnership, they are material participants in the activity and the passive activity loss rules do not apply. Therefore, they can deduct the \$30,000 and \$54,000 in losses calculated under the basis and at-risk limitations.**

- b. Purity is a corporation. Annabell owns 1/3 of the stock, and Eva owns 2/3 of the Purity stock.

**A corporation is a separate taxable entity. A corporation pays tax on its taxable income. Purity can carry back the net operating loss for 2 years and forward for 20 years and use the loss to offset taxable income in those years. Shareholders are taxed on dividends received from the corporation. AnnaBell and Eva received no dividends and have no income, nor can they deduct any of the corporation's loss.**

- c. Purity is an S corporation. Annabell owns 1/3 of the stock, and Eva owns 2/3 of the Purity stock.

**AnnaBell and Eva's shares of the S corporation loss are \$30,000 and \$60,000, respectively. The capital recovery concept limits the amount of any deduction to the amount invested. This limits the deduction for S corporation losses to the shareholder's basis. Because of the limited liability feature of a corporation. S corporation shareholders cannot adjust their basis for debts of the corporation. Therefore, AnnaBell's loss deduction is limited to her \$18,000 basis and Eva's loss deduction is limited to her \$24,000 basis. Both partner's basis are reduced to zero. Annabell has a \$12,000 (\$30,000 - \$18,000) suspended loss and Eva has a \$36,000 (\$60,000 - \$24,000) suspended loss.**

**The at risk rules limit any loss deduction to the amount the taxpayer has at-risk in the activity. An S corporation shareholder's at-risk amount parallels her or his basis. Nonrecourse debt attributable to real property is considered to be at-risk. The S corporation debt is at risk and the shareholder's pro rata share of the debt is added to their at-risk amounts. Annabell's at-risk amount is \$33,000 (\$18,000 + \$15,000) and Eva's at-risk amount is \$54,000 (\$24,000 + \$30,000). The \$18,000 and \$24,000 losses are deductible under the at risk rules and Annabell and Eva's at-risk amounts are reduced to \$15,000 and \$30,000 by the deduction. Because the shareholders participate in the management of the S corporation, they are material participants in the activity and the passive activity loss rules do not apply. Therefore, they can deduct the \$18,000 and \$24,000 in losses calculated under the basis and at-risk limitations.**



24. Assume the same facts as in problem 23, except that the \$45,000 debt is a loan that Annabell made to Purity. How would your answers to parts a and c change? Assume that the beginning basis numbers do not reflect the debt to Annabell.

***Partnership:***

AnnaBell and Eva's deductions are limited to \$30,000 and \$54,000 by the basis limitation. However, only nonrecourse debt attributable to real property is considered to be at-risk. The partnership debt is not at risk and the partners' at-risk amounts are equal to their beginning bases. The at risk rules limit Annabell's loss deduction to \$18,000 and Eva's loss deduction to \$24,000. The remaining loss is suspended until the partner's at-risk amounts increase.

***S Corporation:***

AnnaBell and Eva's deductions are limited to \$18,000 and \$24,000 by the basis limitation. The nonrecourse debt is not at risk and Eva cannot increase her at-risk amount for the debt. Because AnnaBell made the loan to the corporation, she is at-risk with respect to the loan and her at-risk amount is increased by the \$45,000 loan to \$63,000.

An S corporation shareholder is allowed to deduct losses in excess of basis to the extent of their basis in any loan to the corporation. This provision allows Annabell to deduct the \$12,000 in loss that was suspended under the basis limitation. The deduction reduces her basis in the loan to \$33,000 (\$45,000 - \$12,000) and her at-risk amount to \$33,000 (\$63,000 - \$18,000 - \$12,000).

25. Lanny is an owner of the Chasteen Partnership. He sells land to the partnership for \$40,000 for which he had paid \$52,000. Discuss the treatment of the sale under the following assumptions:

**Partners can transact at arm's-length with a partnership as long as they are not related parties. A partner and a partnership are related parties if the partner directly or indirectly owns more than 50 percent of the partnership.**

- a. Lanny owns a 30% interest in the partnership.

**Lanny and the partnership are not related parties. Therefore, Lanny can deduct the \$12,000 (\$40,000 - \$52,000) loss on the sale of the land (subject to the capital gain and loss netting rules).**

- b. Lanny owns a 60% interest in the partnership.

**Lanny owns more than 50% of the partnership and they are related parties. Lanny cannot deduct the loss on the sale of the land to the partnership.**

- c. Assume the same facts as in part b. Several years later Chasteen sells the land for \$60,000. What is Chasteen's recognized gain on the sale?

**Chasteen realizes a \$20,000 gain on the sale. The related party rules allow the gain on a subsequent sale of property to an unrelated party to be reduced (but not below zero) by the disallowed loss on the related party sale. In this case, Chasteen's \$20,000 realized gain is reduced to \$8,000:**

Amount realized	\$ 60,000
Adjusted basis	(40,000)
Realized gain	\$ 20,000
Disallowed loss on related party	(12,000)
Recognized gain on sale	<u>\$ 8,000</u>

26. Assume the same facts as in problem 25, except that Lanny sells the land to the partnership for \$60,000. He held the land for investment. Chasteen is a real estate company. How would your answers to parts a and b change?

**Lanny realizes a gain of \$8,000 (\$60,000 - \$52,000) on the sale. Gains on sales between related parties are not subject to any general restrictions. However, any gain realized on a related party sale between a partner and a partnership must be recognized as ordinary income unless the property is a capital asset for both the partner and the partnership.**

**Part a is not a related party sale and Lanny recognizes the gain as a capital gain.**

**Part b is a related party sale. The land is a capital asset for Lanny and is inventory (which is not a capital asset) for the partnership. Therefore, Lanny's \$8,000 gain is ordinary income.**

27. Louis is the president and 40% owner of Adams Company. His basis in Adams at the beginning of the year is \$8,000. Adams suffers a net operating loss of \$15,000 during the current year. Louis receives a \$5,000 cash distribution from Adams during the year. Determine the effect of the company's results on Louis under each of the following assumptions:

- a. Adams Company is a partnership.

**A partnership is a conduit entity; it does not pay tax on its income. The income of the partnership flows through to the owners of the partnership and each partner is taxed on their share of the entity's income. Partners are not taxed on withdrawals from the partnership; withdrawals are nontaxable returns of capital.**

**Louis's share of Adam's loss is \$6,000 ( $\$15,000 \times 40\%$ ). The capital recovery concept limits the amount of any deduction to the amount invested. This limits the deduction for partnership losses to the partner's basis. For purposes of deducting losses, basis is determined at the end of the tax year after determining the effect of additional contributions, other income items, and withdrawals on the partner's basis. Louis's basis before deducting the loss is \$3,000 ( $\$8,000 - \$5,000$ ). Therefore, the basis limitation will allow a deduction of only \$3,000 of the current year's loss. Louis's basis is reduced to zero and the additional \$3,000 of loss is suspended until he has adequate basis to deduct the loss.**

**The at risk rules limit any loss deduction to the amount the partner has at-risk in the activity. A partner's at-risk amount parallels her or his basis. Therefore, the \$3,000 loss from the basis limitation would be at-risk and deductible under the at risk rules. Louis's at-risk amount is reduced to zero and the additional \$3,000 of loss is suspended until he has an adequate at-risk amount to deduct the loss.**

**If the partnership interest is a passive activity, the amount of loss that survives the basis and at-risk limitations is subject to the passive activity loss rules. Assuming that Louis materially participates in the operation of Adam's Company, he can deduct the \$3,000 loss. If he is not a material participant in Adams, he can only deduct the loss to the extent that he has passive income from other sources.**

- b. Adams Company is a corporation.

**A corporation is a separate taxable entity. A corporation pays tax on its taxable income. Shareholders are taxed on dividends received from the corporation. Louis is taxed on the \$5,000 in dividends he receives from Adams Company.**

c. Adams Company is an S corporation.

**An S corporation is a conduit entity; it does not pay tax on its income. The income of the S corporation flows through to the shareholders and each shareholder is taxed on her/his share of the entity's income. Shareholders are not taxed on dividends received from an S corporation; dividends are nontaxable returns of capital.**

**Louis's share of Adam's loss is \$6,000 ( $\$15,000 \times 40\%$ ). The capital recovery concept limits the amount of any deduction to the amount invested. This limits the deduction for S corporation losses to the shareholder's basis. For purposes of deducting losses, basis is determined at the end of the tax year after determining the effect of additional contributions, other income items, and dividends on the shareholder's basis. Louis's basis before deducting the loss is \$3,000 ( $\$8,000 - \$5,000$ ). Therefore, the basis limitation will allow a deduction of only \$3,000 of the current year's loss. Louis's basis is reduced to zero and the additional \$3,000 of loss is suspended until he has adequate basis to deduct the loss.**

**The at risk rules limit any loss deduction to the amount the taxpayer has at-risk in the activity. An S corporation shareholder's at-risk amount parallels her or his basis. Therefore, the \$3,000 loss from the basis limitation would be at-risk and deductible under the at risk rules. Louis's at-risk amount is reduced to zero and the additional \$3,000 of loss is suspended until he has an adequate at-risk amount to deduct the loss.**

**If the S corporation interest is a passive activity, the amount of loss that survives the basis and at-risk limitations is subject to the passive activity loss rules. Assuming that Louis materially participates in the operation of Adam's Company, he can deduct the \$3,000 loss. If he is not a material participant in Adams, he can only deduct the loss to the extent that he has passive income from other sources.**

28. Natrone pays \$35,000 for stock in an S corporation and receives shares equal to a 20% interest in the corporation in the current year. At the same time he pays \$35,000 for a 20% interest in a general partnership. Both entities incur mortgage debt of \$60,000 during the current year, and both report ordinary taxable income of \$20,000. What is the maximum cash distribution each entity can make to Natrone this year without causing him to recognize income? Write a memo to Natrone explaining your answers in terms of the underlying concepts and facts that support your calculations.

**The adjusted basis represents the unrecovered capital investment. Therefore, following the capital recovery concept, no gain (income) is recognized until all capital (adjusted basis) is recovered. Cash distributions from conduit entities are not taxable; they are returns of capital investment that reduce the owner's basis. If a partner or S corporation shareholder receives a distribution in excess of their basis, the excess capital recovery is taxed as a capital gain.**

**A partner in a partnership is allowed to increase their basis in the partnership by their pro rata share of the partnership debt. This occurs because the partners are liable for the debts of a partnership and are treated as deemed cash contributions by the partners. Natrone's basis in the partnership is \$51,000 after the adjustments for his shares of the partnership debt and partnership income. Therefore, he can receive a cash distribution of \$51,000 without recognizing any income:**

<b>Original basis</b>	<b>\$35,000</b>
<b>Share of partnership debt (20% x \$60,000)</b>	<b>12,000</b>
<b>Share of entity income (20% x \$20,000)</b>	<b>4,000</b>
<b>Adjusted basis/Maximum tax-free cash distribution amount</b>	<b><u>\$51,000</u></b>

**An S corporation shareholder does not adjust basis for debts of the corporation. Because of the limited liability feature of a corporation, shareholders are not liable for debts of the corporation and an adjustment to basis is not required to reflect any potential loss from the liability. Natrone's basis in the S corporation after adjustment for his share of the income is \$39,000. Therefore, he can receive a cash distribution of \$39,000 without recognizing any income:**

<b>Original basis</b>	<b>\$35,000</b>
<b>Share of entity income (20% x \$20,000)</b>	<b>4,000</b>
<b>Adjusted basis/Maximum tax-free cash distribution amount</b>	<b><u>\$39,000</u></b>

29. The Boo-Ball Corporation receives dividend income of \$200,000 from Flew-Ball, a domestic corporation. Boo-Ball owns 70% of Flew-Ball. Boo-Ball's net income from operations is \$50,000. What is Boo-Ball's dividends-received deduction?

**Because Boo-Ball owns more than 20% but less than 80% of the distributing corporation (Flew-Ball), the 80% deduction percentage applies. Under the general rule, the DRD is \$160,000 (80% x \$200,000 dividends). The taxable income limitation is \$200,000 (80% x \$250,000 taxable income before DRD). Because \$160,000 is less than \$200,000, the full 80% DRD is permitted.**

**General rule DRD:  $\$200,000 \times 80\% = 160,000$**

**Taxable income limitation:  $(\$200,000 + \$50,000) \times 80\% = \$200,000$**

30. The John Corporation suffers a \$22,000 net loss from operations for the current year but receives \$150,000 in dividend income from corporations in which it owns 50% of the stock. What is the dividends-received deduction and the corporation's actual taxable income for the current year?

**If the ownership percentage is 20 percent or greater but less than 80 percent, the DRD percentage is 80 percent of the dividend income. The divided-received deduction (DRD) under the general rule is \$120,000 (80% x \$150,000). The taxable income limitation is \$102,400 (80% x \$128,000 in taxable income calculated without the DRD). A loss does not result after deducting the DRD under the general rule, so the taxable income limitation applies:**

**General rule DRD :  $\$150,000 \times 80\% = \$120,000$**

**Taxable income limitation:  $(\$150,000 - \$22,000) \times 80\% = \$102,400$**

**Computation to check for loss after deducting general rule DRD:**

Net loss from operations	\$ (22,000)
Dividend income	150,000
General rule DRD (80% x 150,000)	(120,000)
Taxable income (general rule)	<u>\$ 8,000</u>

**Therefore, the DRD is limited to \$102,400 (80% x \$128,000), and the actual amount of taxable income for the current year is \$25,600 (\$150,000 - \$22,000 - \$102,400).**

31. The Bat-Ball Corporation incurs a net loss from operations of \$62,000 for the current year. Bat-Ball receives \$175,000 in cash dividends from 30%-owned domestic corporations. What is the dividends-received deduction and the actual taxable income for the current tax year?

If the ownership percentage is 20 percent or greater but less than 80 percent, the DRD percentage is 80 percent of the dividend income. The DRD under the general rule is \$140,000 (80% x \$175,000). The taxable income limitation is \$90,400 (80% x \$113,000 in taxable income calculated without the DRD). The taxable limitation does not apply in this case because an NOL would result after deducting the general rule DRD:

**General rule DRD : \$175,000 x 80% = \$140,000**

**Taxable income limitation: (\$175,000 - \$62,000) x 80% = \$90,400**

**Computation to check for loss after deducting general rule DRD:**

Net loss from operations	\$ (62,000)
Dividend income	175,000
General rule DRD (80% x \$175,000)	(140,000)
NOL calculated under the general rule	<u>\$ (27,000)</u>

**Therefore, the full \$140,000 DRD is allowed. Bat-Ball corporation has a net operating loss of \$27,000.**

32. Adele owns 60% of Trouble, Inc., a corporation. During the current annual accounting period, Trouble has an operating income of \$19,000, dividend income from investments in stock of other corporations of \$2,800, interest income from First National of \$2,200, and a loss from an investment in a limited partnership of \$24,000. How much of the passive activity loss can Trouble use to offset other income?

**Trouble, Inc. is a closely held corporation because Adele owns more than 50% of the stock. Closely held corporations are allowed to deduct passive activity losses against active income, but may not deduct them against portfolio income. Therefore, \$19,000 of the \$24,000 passive loss is used to offset the \$19,000 in operating (active) income. The \$5,000 of loss remaining may not be used to offset the dividend or interest income. The \$5,000 is suspended and carried over to a subsequent year to offset any passive or active income in that year.**



33. Elvira owns 100% of the stock of Midnite Corporation, a manufacturer of galobnotites. During the current year, Midnite has operating income of \$50,000, dividend income of \$16,000 from investments in other corporations, and losses from investments in limited partnerships of \$46,000. It pays \$20,000 in dividends.
- a. What are the amounts of taxable income and tax liability reported by Midnite for the current year?

**Midnite is a closely held corporation because Elvira owns more than 50% of the stock. A loss from a limited partnership is a passive loss. Closely held corporations are allowed to deduct passive activity losses against active income, but may not deduct them against portfolio income. Therefore, the \$46,000 passive loss may be used to offset the \$50,000 in operating (active) income. Midnite's operating income is reduced to \$4,000 by the deduction of the passive loss.**

**The \$16,000 of dividend income is recognized by the corporation, but Midnite is allowed the 70% dividends received deduction resulting in a net taxable dividend of \$4,800 [ $\$16,000 - (\$16,000 \times 70\%)$ ]. Midnite's taxable income is \$8,800 and it pays a tax of \$1,320 ( $15\% \times \$8,800$ ). Elvira is taxed on the \$20,000 in dividends she receives from the corporation.**

Operating income	\$ 50,000
Passive losses	(46,000)
Dividends received	16,000
Dividends received deduction (70% x \$16,000)	(11,200)
Taxable income	<u>\$ 8,800</u>

- b. Assume that Midnite Corporation is operated as an S corporation. Explain why the amount of taxable income resulting from the items reported by both Midnite Corporation and Elvira are different from your answers in part a.

**The S corporation is a conduit. Therefore, all income items flow through the entity to Elvira. All income items retain their attributes or characteristics. Elvira has \$50,000 of active income, \$16,000 of dividend income, and \$46,000 of passive activity losses. The dividend received deduction does not apply to an S corporation. The passive losses can only be used to offset passive income. However, Elvira has no passive income and the \$46,000 loss is suspended and carried forward. Elvira is taxed on the \$66,000 ( $\$50,000 + \$16,000$ ) of income that flows-through to her from the S corporation. The dividends distributed to Elvira are nontaxable returns of investment and reduce her basis in Midnite by \$20,000.**

34. Lulu Enterprises sells a building with an adjusted basis of \$40,000 for \$85,000. Lulu paid \$60,000 for the building five years ago. What is the treatment of the gain on the sale of the building if
- Lulu is a sole proprietorship owned by Horace
  - Lulu is a partnership owned equally by Doreen and Fatima

**A building is Section 1250 property. Section 1250 recaptures the excess depreciation taken on the property as ordinary income. Because the property was purchased after 1986, straight-line MACRS was used to depreciate the property and there is no excess depreciation to recapture. However, the portion of the gain attributable to depreciation \$20,000 (\$60,000 - \$40,000) is classified as unrecaptured Section 1250 gain and taxed at a maximum tax rate of 25%. The remaining \$25,000 (\$45,000 - \$20,000) of gain is a Section 1231 gain.**

Amount realized	\$ 85,000
Adjusted basis (\$60,000 - \$20,000)	40,000
Gain on sale	<u>\$ 45,000</u>
Unrecaptured Section 1250 gain	(20,000)
Section 1231 gain	<u><u>\$ 25,000</u></u>

- Lulu is a corporation owned equally by Doreen and Fatima?
- Lulu is an S corporation owned equally by Doreen and Fatima?

**Corporations (and S corporations) are subject to an additional recapture provision on Section 1250 property. This corporate depreciation recapture provision recaptures as ordinary income 20 percent of the difference between the amount that would have been ordinary income if the property had been Section 1245 property and the ordinary income from Section 1250. Section 1245 recaptures all depreciation taken on the property as ordinary income. The Section 1245 recapture on the building would have been \$20,000 (\$60,000 - \$40,000) and the corporate depreciation recapture is \$4,000 (\$20,000 x 20%):**

Ordinary income if Section 1245 property (\$60,000 - \$40,000)	\$ 20,000
Less: Ordinary income under Section 1250	-0-
Excess	<u>\$ 20,000</u>
Recapture percentage	x 20%
Equals: Ordinary income	<u><u>\$ 4,000</u></u>

**A corporation (and S corporation) reports the \$45,000 gain on the sale as \$4,000 in ordinary income and a \$41,000 Section 1231 gain.**

35. Lacy Corporation sells equipment and a building during the current year. The equipment, which cost \$14,000 in 2013, is sold for \$9,000. The equipment was expensed using the Section 179 election in 2013. The building, purchased in 2008 for \$130,000, is sold for \$180,000. The adjusted basis of the building at the date of sale is \$95,000. How should Lacy report the gains on the sale of the equipment and the building?

**Equipment is Section 1245 property. Section 1245 recaptures all depreciation taken on the property as ordinary income. Because the \$14,000 in depreciation is greater than the \$9,000 gain on the sale, the entire gain is ordinary income:**

Amount realized	\$ 9,000
Adjusted basis (\$14,000 - \$14,000)	-0-
Gain on sale	\$ 9,000
Section 1245 ordinary income	(9,000)
Section 1231 gain	<u>-0-</u>

**A building is Section 1250 property. Section 1250 recaptures the excess depreciation taken on the property as ordinary income. Because the property was purchased after 1986, straight-line MACRS was used to depreciate the property and there is no excess depreciation to recapture. Therefore, the \$85,000 (\$180,000 - \$95,000) is a Section 1231 gain after the application of Section 1250.**

**Corporations are subject to an additional recapture provision on Section 1250 property. This corporate depreciation recapture provision recaptures as ordinary income 20 percent of the difference between the amount that would have been ordinary income if the property had been Section 1245 property and the ordinary income from Section 1250. Section 1245 recaptures all depreciation taken on the property as ordinary income. The Section 1245 recapture on the building would have been \$35,000 (\$130,000 - \$95,000) and the corporate depreciation recapture is \$7,000 (\$35,000 x 20%):**

Ordinary income if Section 1245 property (\$130,000 - \$95,000)	\$ 35,000
Less: Ordinary income under Section 1250	-0-
Excess	\$ 35,000
Recapture percentage	x 20%
Equals: Ordinary income	<u>\$ 7,000</u>

**Lacy Corporation reports the \$85,000 gain on the sale as \$7,000 in ordinary income and an \$78,000 Section 1231 gain.**

36. Assume the same facts as in problem 35, except that Lacy is an S corporation equally owned by Jorge and Gloria. How should Lacy report the gains on the sale of the equipment and the building?

**An S corporation is subject to the corporate depreciation recapture provisions. Therefore, Lacy corporation will have \$7,000 in ordinary income and an \$78,000 Section 1231 gain on the sale.**

**An S corporation is a conduit entity; the owners are taxed on the corporation's income. To get the proper tax treatment by the owners, items which are subject to special rules must be separately stated. Because net Section 1231 gains are treated as long-term capital gains, which must be included in the capital gain and loss netting, Lacy must separately report each owner's share of the Section 1231 gain. The \$7,000 in ordinary income is added to the operating income of the S corporation. Jorge and Gloria will each receive \$39,000 of the Section 1231 gain.**

37. The Baker Corporation has the following entries on its books for the current tax year:

Net income from operations	\$120,000
Dividends received (70% rules)	14,000
Charitable contributions made in current year	13,000
Charitable contribution carryover from the previous year	1,900

What is the maximum charitable contribution deduction for the current year?  
What is Baker's taxable income for the current year?

**Corporate charitable deductions are limited to 10 percent of taxable income computed without regard to the charitable contribution deduction, NOL carrybacks, capital loss carrybacks, and the dividend-received deduction. Current-year contributions must be deducted against the limit before any carryover contributions may be deducted.**

**The contribution deduction is limited to \$13,400:**

Net income from operations	\$ 120,000
Dividend income	14,000
Taxable income before DRD and charitable deduction	<u>\$ 134,000</u>
Percentage limitation	x 10%
Maximum amount of charitable deduction	<u>\$ 13,400</u>

**The current year's excess charitable contribution of \$1,500 (\$1,900 + \$13,000 - \$13,400) is carried over to the next tax year. The excess charitable contribution is solely from the previous year because current-year contributions are deducted against the limit before any carryover contributions may be deducted. Carryovers of excess charitable contributions are limited to 5 years subsequent to the year of contribution. Any excess contribution not deducted after 5 years is lost forever. Therefore, the \$1,500 charitable deduction carryover has exhausted one year and has four years left before the carryover is lost forever.**

**Taxable income for the year is \$110,800:**

Net income from operations	\$ 120,000
Dividend income	14,000
Taxable income before DRD and charitable deduction	<u>\$ 134,000</u>
Dividends received deduction	(9,800)
Charitable deduction	(13,400)
Taxable income	<u>\$ 110,800</u>

38. Fairplay Corporation has gross income of \$150,000 and taxable income of \$50,000. The company includes no special deductions in the calculation of its taxable income. While reviewing the tax return, Fairplay's accountant finds \$20,000 in charitable contributions improperly classified as advertising and promotion expense. He sends the return back to the tax department for correction. Write a letter to Fairplay's accountant explaining why a correction to taxable income must be made.

**Fairplay's taxable income without a charitable contribution is \$70,000 (\$50,000 + \$20,000). Corporate charitable contribution deductions are limited to 10 percent of taxable income computed without regard to the charitable deduction, NOL carrybacks, capital loss carrybacks, and the dividends-received deduction. Current-year deductions must be deducted against the limit before any carryover contributions may be deducted. Fairplay's maximum charitable deduction is \$7,000 (taxable income of \$70,000 x 10% limitation). Therefore, the corrected taxable income for Fairplay is \$63,000 (\$70,000 - \$7,000). The remaining charitable contribution deduction of \$13,000 (\$20,000 - \$7,000) is carried forward. The charitable contribution carryover of \$13,000 is limited to 5 years from the year of the contribution. Any excess contribution not deducted after 5 years is lost forever.**

Taxable income as previously reported	\$ 50,000
Add: Incorrect charitable deduction	20,000
Taxable income before charitable deduction	<u>\$ 70,000</u>
Percentage limitation	x 10%
Allowable charitable deduction	<u>\$ 7,000</u>
 Taxable income before charitable deduction	 \$ 70,000
Less: Charitable contribution deduction	(7,000)
Taxable income	<u>\$ 63,000</u>
 Charitable contribution carryover	 <u>\$ 13,000</u>

39. The New Tech Corporation contributes some of its inventory of scientific equipment to the computer department of Great University during the current year. At the date of the contribution, the equipment has a fair market value of \$38,000. New Tech's basis in the equipment is \$12,000.

a. How much can New Tech deduct as a charitable contribution?

**Generally, the value of donated inventory is the adjusted basis of the inventory. An exception is provided for a corporate taxpayer that donates inventory that: (1) is given solely for the care of the ill, needy, or infants; or (2) is donated to a university or qualified research organization to be used for research, experimentation, or research training in the biological or physical sciences. The amount of deduction under this exception is the inventory's fair market value less 50 percent of the income that would be recognized if the inventory were sold at its fair market value. However, there is a ceiling or maximum amount of deduction, of twice the basis of the donated inventory items.**

**New Tech's charitable contribution deduction is \$24,000:**

Fair market value of donated inventory		\$ 38,000
Less:		
Fair market value of donated inventory	\$ 38,000	
Less: Basis of the donated inventory	(12,000)	
Percentage limitation	<u>x 50%</u>	(13,000)
New Tech's charitable deduction		<u>\$ 25,000</u>

**Because the calculated amount of the charitable contribution (\$25,000) is greater than the maximum allowable deduction of \$24,000 (2 x \$12,000 basis), New Tech's charitable contribution is limited to \$24,000.**

- b. Would your answer change if New Tech's basis in the equipment were \$16,000?

**New Tech's charitable contribution is \$27,000:**

Fair market value of donated inventory		\$ 38,000
Less:		
Fair market value of donated inventory	\$ 38,000	
Less: Basis of the donated inventory	(16,000)	
Gain if sold	<u>\$ 22,000</u>	
Percentage limitation	<u>x 50%</u>	(11,000)
New Tech's charitable deduction		<u>\$ 27,000</u>

**Because this amount is less than twice the adjusted basis \$32,000 (2 x \$16,000), New Tech's deductible charitable contribution is \$27,000.**

40. Mel's Super Groceries, Inc., donates \$70,000-worth of canned food with a basis of \$50,000 to St. Rebecca's Homeless Shelter, a qualified charitable organization. How much may Mel's deduct for the charitable contribution of the canned food?

Generally, the value of donated inventory is the adjusted basis of the inventory. An exception is provided for a corporate taxpayer that donates inventory for the purpose of aiding the ill, needy, or infants. Mel's contribution to St. Rebecca's Homeless Shelter qualifies under this exception. Therefore, the amount of Mel's deduction is the inventory's fair market value, less 50% of the income that would be recognized if the inventory were sold at its fair market value. The maximum amount of the deduction is twice the basis of the donated inventory items.

**Mel's charitable contribution deduction is \$60,000:**

Fair market value of donated inventory		\$ 70,000
Less:		
Fair market value of donated inventory	\$ 70,000	
Less: Basis of donated inventory	(50,000)	
Gain if sold	\$ 20,000	
Percentage limitation	x 50%	(10,000)
Mel's charitable deduction		<u>\$ 60,000</u>

Because this amount is less than twice the adjusted basis \$100,000 (2 x \$50,000), Mel's deductible charitable contribution is \$60,000.

41. Tarhari Enterprises, Inc., donates \$70,000 worth of computer equipment and related software to Northwest Gifford High School. The property's basis is \$30,000. How much may Tarhari deduct for the charitable contribution of the computer equipment and related software?

A charitable deduction can be taken for gifts of computer technology, equipment, and software that are made to schools (grades K through 12). Generally, the value of the gift will be treated similarly to gifts of donated inventory which is limited to the inventory's fair market value, less 50% of the income that would have been recognized if the inventory were sold at its FMV. This amount is limited to no more than twice the basis of the donated property. Tarhari's charitable contribution is \$50,000.

Fair market value of donated inventory		\$ 70,000
Less:		
Fair market value of donated inventory	\$ 70,000	
Less: Basis of donated inventory	(30,000)	
Gain if sold	\$ 40,000	
Percentage limitation	x 50%	(20,000)
Tarhari's charitable deduction		<u>\$ 50,000</u>

Because this amount is less than twice the adjusted basis of the \$60,000 (2 x \$30,000), Tarhari's deductible charitable contribution is \$50,000.



42. The Viking Corporation has the following items of income for 2016:

Operating income	\$350,000
Dividend income (12%-owned corporations)	15,000
Long-term capital gains	9,000
Short-term capital gains	3,000
Capital loss carryover from 2015	8,000
Charitable cash contributions	12,000
Net operating loss carryover from 2015	35,000

a. Calculate the corporation's 2016 taxable income and its tax liability.

**The taxable income is \$311,500. Netting the current year's capital gains with the 2015 carryover results in a net capital gain of \$4,000 (\$9,000 + \$3,000 - \$8,000). The charitable contributions are fully deductible because the contributions are less than 10% of taxable income before special deductions but reduced by the NOL carryforward { \$12,000 < \$33,400 [10% x (\$369,000 - \$35,000)]}. Because Viking owns less than 20 percent of the corporations paying the dividends, the dividend-received deduction (DRD) is 70 percent of the dividend income. The DRD under the general rule is \$10,500 (70% x \$15,000). The taxable income limitation is \$258,300 (70% x \$369,000 taxable income before DRD). Because \$10,500 is less than \$258,300, the full 70 percent DRD is permitted. Viking's taxable income is \$311,500 and its tax liability is \$104,735:**

Operating income	\$ 350,000
Net capital gains	4,000
Dividend income	15,000
Taxable income before special deductions	<u>\$ 369,000</u>
Less: Special deductions	
Dividends received	(10,500)
Charitable Contribution	(12,000)
NOL carryover from 2015	(35,000)
Taxable income	<u><u>\$ 311,500</u></u>

**Tax liability - \$22,250 + [39% x (\$311,500 - \$100,000)] = \$104,735**

- b. Assume that Viking is, and always has been, an S corporation wholly owned by Fran, a single taxpayer with no other income or deductions. Will either Viking Corporation or Fran realize any tax savings, given the income and liability determined in part a? Explain.

**Because an S corporation is a conduit entity, all income and expense items from Viking flow through to Fran, the sole shareholder. As a conduit entity, Viking has no tax liability.**

**Fran has an AGI of \$369,000 (\$350,000 + \$15,000 + \$9,000 + \$3,000 - \$8,000) from Viking. The NOL does not apply because the loss would have flowed-through to her in the year of occurrence. The charitable contribution flows through separately and retains its character in the hands of Fran. The charitable contribution is an itemized deduction and will allow Fran to itemize her deductions (\$12,000 > \$6,300). Fran's taxable income is \$352,950. Because her marginal tax rate is 33%, the \$4,000 capital gain and the \$15,000 of dividend income are taxed at 15% and \$333,950 is taxed at the individual rates and her liability is \$96,583.**

<b>AGI</b>	<b>\$ 369,000</b>
<b>Charitable contribution</b>	<b>(12,000)</b>
<b>Exemption</b>	<b>(4,050)</b>
<b>Taxable Income</b>	<b>\$ 352,950</b>
<b>Net LTCG and dividend income taxed @ 15%</b>	<b>(19,000)</b>
<b>Income taxed at ordinary rates</b>	<b><u>\$ 333,950</u></b>

**Tax on \$333,950:**

<b>\$46,278.75 + [33% x (\$333,950 - \$190,150)]</b>	<b>\$ 93,733</b>
<b>Tax on dividend income - \$15,000 x 15%</b>	<b>2,250</b>
<b>Tax on net long-term capital gain - \$4,000 x 15%</b>	<b>600</b>
<b>Tax liability</b>	<b><u>\$ 96,583</u></b>

**As long as no dividends are distributed to Fran in part a (i.e., Viking Corporation operates as a regular corporation), the tax savings are \$8,152 (\$104,735 - \$96,583) greater than as an S corporation.**

43. Charger, Inc., has the following items for the current year:

Net operating income	\$130,000
Dividend income (50%-owned corporation)	40,000
Charitable cash contributions	20,000
Net operating loss carryover	10,000

a. What are the corporation's taxable income and tax liability?

**Charger's taxable income is \$112,000 and its base for calculating the charitable contribution limitation is \$160,000 (\$130,000 + \$40,000 - \$10,000). Therefore, the charitable contribution deduction is limited to \$16,000 (\$160,000 x 10%). Because Charger owns 50% of another corporation which provided Charger with dividend income, the dividend-received deduction (DRD) is 80% of the dividend income, \$32,000 (80% x \$40,000).**

Operating income	\$ 130,000
Dividends	40,000
Charitable deduction	(16,000)
Taxable income before special deductions	<u>\$ 154,000</u>
Less: special deductions	
Dividends received deduction	(32,000)
NOL carryover from prior year	(10,000)
Taxable income	<u><u>\$ 112,000</u></u>
<b>Tax Liability \$22,250 + 39% (\$112,000 - \$100,000)</b>	<b><u><u>\$ 26,930</u></u></b>

b. Assume that Charger is, and always has been, an S corporation wholly owned by Suzanne, a married individual with no dependents and no other income or deductions. What are the tax liabilities of Charger and Suzanne?

**Suzanne has income of \$170,000 (\$130,000 + \$40,000) from Charger. The NOL is not used in the calculation because the loss flowed-through to Suzanne in the year it occurred. The charitable contribution flows through separately and retains its character in the hands of Suzanne. The charitable contribution is an itemized deduction and will allow Suzanne to itemize her deductions (\$20,000 > \$12,600). Their taxable income is \$141,900. However, the dividend income is taxed at 15%, leaving \$101,900 taxed at ordinary income rates. Their tax liability is \$23,018:**

AGI	\$ 170,000
Charitable contribution	(20,000)
Exemptions (2 x \$4,050)	(8,100)
Taxable income	<u>\$ 141,900</u>
Dividend Income	40,000
Income taxed at ordinary rates	<u><u>\$ 101,900</u></u>

Tax on \$101,900 - \$10,367.50 + [25% x (\$101,900 - \$75,300)]	\$17,018
Tax on \$ 40,000 - \$40,000 x 15%	6,000
Total tax liability	<u><u>\$23,018</u></u>

- c. Write a memo explaining why the answers in part a and b are different.

**As an S corporation, Charger is a conduit entity and all income and expense items flow through to Suzanne, the sole shareholder. The differences in the taxable incomes are caused by differences in treatment of items by a corporation versus an individual.**

**One difference in the taxable incomes is the deductibility of the NOL by the corporation. Suzanne has already deducted the NOL in a previous year(s), so it causes a difference in the current year. Therefore, she gets the same deduction sooner when the business is operated as an S corporation. The charitable contribution deduction of the corporation is limited to \$16,000, while Suzanne can deduct \$20,000 of the charitable contribution. In addition, the dividends are fully taxable to Suzanne at the long-term capital gains rate, while the corporation is taxed on only 20% of the dividends after the dividends received deduction. Also, the individual tax rates are lower at Suzanne's current income level than the corporate rates.**

44. Myrna operates a plumbing business as a sole proprietorship. During the year she sells the business to Tonya for \$175,000. The assets sold and the allocation of the purchase price are as follows:

	<u>Adjusted Basis</u>	<u>Purchase Price</u>
Plumbing parts	\$ 6,000	\$ 8,000
Building	42,500	93,900
Land	10,000	15,100
Equipment	6,500	30,600
Goodwill	-0-	27,400
Total assets	<u>\$ 65,000</u>	<u>\$175,000</u>

Myrna acquired the building 10 years ago for \$70,000. She acquired the equipment on various dates, paying a total of \$30,000 for it. What are the tax consequences of the liquidation for Myrna?

**Because a sole proprietorship is not a separate entity, the liquidation or termination of the business is not viewed as the sale of one asset but rather a sale of the individual assets of the business. Therefore, the gain or loss and its character (i.e., ordinary, capital) depends on the assets sold.**

**Myrna will recognize a Section 1231 gain of \$56,500  $[(\$93,900 + \$15,100) - (\$42,500 + \$10,000)]$  on the sale of the building and land. Because the building was acquired after 1986, there is no Section 1250 recapture. However, the portion of the gain attributable to depreciation is considered unrecaptured Section 1250 gain and taxed at a maximum rate of 25%. The portion of the gain that reflects appreciation (sales price > original cost) is a Section 1231 gain. The sale of the equipment results in a gain of \$24,100  $(\$30,600 - \$6,500)$ . Because the sales price of the equipment exceeds its original cost by \$600  $(\$30,600 - \$30,000)$ , \$600 of the gain is a Section 1231 gain and the remaining \$23,500  $(\$24,100 - \$600)$  is ordinary income -- Section 1245 recapture. Because the amount of the purchase price allocated to inventory (i.e., plumbing parts) is greater than its cost, Myrna has an ordinary gain of \$2,000  $(\$8,000 - \$6,000)$ . The \$27,400 representing goodwill is treated as a capital gain.**

45. Maurice, Lawrence and Kerwin own and operate a chain of sandwich shops as a partnership. Maurice owns 40% and his basis in the partnership is \$80,000. Lawrence, a 35% owner, has a basis of \$50,000 and Kerwin who owns 25% has a basis in the partnership of \$15,000. What are the tax consequences and basis effects for each partner if the partnership's ordinary income is \$70,000 and each receives a cash distribution of \$30,000?

**Partners must include their pro rata share of the partnership's income or loss on their individual tax return. In addition, the amount of the income or loss increases (decreases) their basis in the partnership. Consistent with the capital recovery concept, as long as a partner's basis in the partnership before the distribution is greater than the amount distributed, the amount received is treated as a return of capital and no gain is recognized. If the amount received exceeds the partner's basis the difference is a capital gain.**

**Maurice, Lawrence and Kerwin must increase their basis in the partnership by their pro rata share of the partnership income. Because their basis in the partnership before the distribution is greater than the amount distributed, the amount is treated as a return of capital and no gain is recognized. Maurice, Lawrence, and Kerwin's bases in the partnership at the end of the year is as follows:**

	40% Maurice	35% Lawrence	25% Kerwin
Initial basis	\$ 80,000	\$ 50,000	\$ 15,000
Share of partnership income	28,000	24,500	17,500
Cash distribution	(30,000)	(30,000)	(30,000)
Remaining basis	<u>\$ 78,000</u>	<u>\$ 44,500</u>	<u>\$ 2,500</u>

46. The Boyle Brothers own and operate a microbrewery. The partnership has two equal partners, Ed and John. At the close of the current year John's basis in the partnership is \$42,000, and Ed's basis is \$31,000. What are the tax and basis effects if at year end, the partnership distributes to Ed

- a. Property with a basis of \$15,000 and a fair market value of \$18,000?

**If a partner receives a nonliquidating distribution of property, the partner's basis in the partnership is reduced by the adjusted basis of the property distributed, but the partner's basis cannot be reduced below zero. If the basis of the property distributed is greater than the partner's basis in the partnership, the partner must reduce his basis in the distributed property by the excess.**

**Ed does not recognize a gain or loss on the distribution of property. The property distribution of \$15,000 reduces his basis in the partnership to \$16,000 (\$31,000 - \$15,000).**

- b. Property with a basis of \$12,000 and a fair market value of \$35,000 along with \$10,000 in cash?

**If a partner receives a nonliquidating distribution of cash and property, the partner's basis in the partnership is first reduced by the cash distributed and then by the adjusted basis of the property distributed, but the partner's basis cannot be reduced below zero. If the basis of the property distributed is greater than the partners' basis in the partnership, the partner must reduce their basis in the distributed property by the excess.**

**Ed does not recognize a gain or loss on the distribution of the cash and property. The cash distribution of \$10,000 reduces his basis in the partnership to \$21,000 (\$31,000 - \$10,000). Ed then reduces his basis in the partnership by the adjusted basis of the property distributed. The property distribution of \$12,000 reduces his basis in the partnership to \$9,000 (\$21,000 - \$12,000).**

47. The Hartford Group is a partnership owned and operated by June and Joyce. June owns a 60% interest and her basis in the partnership is \$33,000. Joyce owns a 40% interest, and her basis is \$18,000. At the end of the year, both June and Joyce decide to retire and liquidate the business. Write a memo discussing the tax consequences for each partner if June and Joyce receive cash distributions of \$45,000 and \$28,000 respectively.

**A distribution of cash and/or property in complete liquidation of the partnership can result in the partners recognizing a gain or loss. A gain is recognized only to the extent that the amount of cash distributed exceeds the partner's basis in the partnership. A loss can be recognized on the complete liquidation of a partner's interest but only if cash is the only asset distributed.**

**Because the cash distribution to June and Joyce exceeds their basis in the partnership, under the capital recovery concept they will report a capital gain of \$12,000 and \$10,000, respectively.**

**Whether the gain is long term or short term depends on how long (i.e., less or more than one year) June and Joyce held their partnership interest.**

	<u>June</u>	<u>Joyce</u>
Liquidating cash distribution	\$ 45,000	\$ 28,000
Initial basis	(33,000)	(18,000)
Capital gain	<u>\$ 12,000</u>	<u>\$ 10,000</u>



48. Machela, a single individual, owns all the stock in the Gordon Corporation, which reports taxable income of \$55,000. The corporation distributes the \$55,000 in earnings as a dividend. Machela also receives a salary from the company of \$67,000. She has itemized deductions for the year of \$16,400. What are Machela's and Gordon Corporation's tax liabilities for the year?

**A cash distribution to a noncorporate shareholder is generally taxable to the shareholder and is not deductible by the distributing corporation. As a result, the dividend is subject to double taxation. As a separate taxable entity, the Gordon Corporation must pay tax on its taxable income of \$67,000. Gordon's tax liability is \$8,750 { $\$7,500 + [25\% \times (\$55,000 - \$50,000)]$ }.**

**Machella must report as income her salary of \$67,000 and the \$55,000 in dividends she receives from Gordon Corporation. She can reduce her income of \$122,000 ( $\$55,000 + \$67,000$ ) by her itemized deductions of \$16,400 and her \$4,050 personal exemption. Her taxable income is \$101,550:**

Salary	\$ 67,000
Dividend	55,000
Adjusted gross income	<u>\$ 122,000</u>
Itemized deductions	(16,400)
Personal exemption	(4,050)
Taxable income	<u>\$ 101,550</u>

**The dividend income is taxed at 15%, leaving \$46,550 ( $\$101,550 - \$55,000$ ) taxed at ordinary income rates. Her tax liability is \$15,659:**

Tax on \$ 46,550 - $\$5,183.75 + [25\% \times (\$46,550 - \$37,650)]$	\$ 7,409
Tax on \$ 55,000 - $\$55,000 \times 15\%$	8,250
Total tax liability	<u>\$15,659</u>

49. Dance Corporation distributes \$150,000 in cash to its shareholders during the current year. Accumulated earnings and profits are \$25,000 at the beginning of the year. Current earnings and profits are \$75,000. Jack, the sole shareholder of Dance Corporation, has a basis of \$40,000 in the stock. What is the tax effect of this distribution for Jack?

**Cash or other property distributed to a shareholder is generally taxable to the shareholder. The distribution is a dividend which must come from a corporation's earnings and profits. Earnings and profits (E&P) generally represent undistributed, previously taxed corporate profits. If a corporate distribution exceeds both the current and accumulated E&P, the capital recovery concept dictates that the distribution is tax-free to shareholders. Therefore, the basis in the stock held by shareholders is reduced by the amount of the tax-free return of capital. If a shareholder receives a distribution in excess of the basis of the stock (excess capital recovery), the shareholder recognizes a capital gain.**

**The corporation has current and accumulated earnings and profits of \$100,000 (\$75,000 + \$25,000). Therefore, \$100,000 of the distribution is taxable to Jack as ordinary dividend income. Because Jack's basis in the stock is \$40,000 before the distribution, \$40,000 of the \$50,000 excess distribution (\$150,000 - \$100,000) is a tax-free recovery of capital. The amount of the distribution in excess of his basis, \$10,000 (\$40,000 - \$30,000), is treated as a capital gain.**

**Ordinary dividend income**

Current E & P	\$ 75,000	
Accumulated E & P	<u>25,000</u>	\$ 100,000
Tax-free, recovery of capital (amount of basis)		40,000
Capital gain - nondividend distribution in excess of basis		<u>10,000</u>
Total distribution		<u>\$ 150,000</u>

50. Toy Corporation distributes \$175,000 in cash (\$1.75 per share) when its current and accumulated earnings and profits are \$40,000. What is the effect of the distribution for Bernice, who owns 500 shares of Toy stock for which she paid \$8,000? Write a letter to Bernice explaining the tax results using the income tax concepts discussed in the text.

**Cash or other property distributed to a shareholder is generally taxable to the shareholder based on the all-inclusive income concept. The distribution is classified as a dividend coming from the taxable entity's earnings and profits. Earnings and profits (E&P) generally represent undistributed, previously taxed corporate profits. If a corporate distribution exceeds both the current and accumulated E&P, the capital recovery concept dictates that the distribution is tax-free to shareholders. Therefore, the basis in the stock held by shareholders is reduced by the amount of the tax-free return of capital. If a shareholder receives a distribution in excess of the basis of the stock (recovery in excess of capital), the shareholder recognizes a capital gain.**

**Bernice received \$875 (\$1.75 per share x 500 shares). The first 22.86% (\$40,000 ÷ \$175,000) of the distribution is a taxable dividend for Bernice, \$200 [22.86% x (\$1.75 x 500 shares)]. Because Toy Corporation has only \$40,000 in E&P (distributions are only taxable as dividend income if the distribution is from E&P), the remaining distribution of \$675 (\$875 - \$200) is deemed a recovery of capital to the extent of the basis in her stock. Because Bernice's basis is \$8,000, the remaining \$675 of the dividend (\$875 - \$200) reduces the basis of her stock to \$7,325 (\$8,000 - \$675).**

Ordinary dividend income	<u>\$ 200</u>
Tax-free return of capital	<u>\$ 675</u>
<b><u>Bernice's stock basis:</u></b>	
Initial stock basis	\$8,000
Capital recovery (\$875 - \$200)	(675)
Ending basis	<u>\$7,325</u>

**Instructor's Note: If Bernice's basis had been less than \$675, the distribution in excess of the basis is a capital gain and her basis in the stock is zero.**

51. During the current year, Snowden Corporation distributes \$600,000 in cash (\$2 per share) to its shareholders. Yong owns 300 shares of Snowden stock with a basis of \$9,000. What are the tax consequences for Yong if Snowden's current and accumulated earnings and profits are

**Cash or other property distributed to a shareholder is generally taxable to the shareholder based on the all-inclusive income concept. The distribution is classified as a dividend coming from the taxable entity's earnings and profits. Earnings and profits (E&P) generally represent undistributed, previously taxed corporate profits. If a corporate distribution exceeds both the current and accumulated E&P, the capital recovery concept dictates that the distribution is tax-free to shareholders. Therefore, the basis in the stock held by shareholders is reduced by the amount of the tax-free return of capital. If a shareholder receives a distribution in excess of the basis of the stock (recovery in excess of capital), the shareholder recognizes a capital gain.**

- a. \$300,000?

Yong received \$600 (\$2.00 per share x 300 shares). Because Snowden has only \$300,000 in E&P (distributions are only taxable as dividend income if the distribution is from E&P), only 50% ( $\$300,000 \div \$600,000$ ) of the distribution is a taxable dividend for Yong. . Therefore, Yong must report \$300 [ $50\% \times (\$2.00 \times 300 \text{ shares})$ ] as income. The remaining distribution of \$300 ( $\$600 - \$300$ ) is deemed a recovery of capital to the extent of his basis in the shares of stock. The \$300 reduces Yong's basis in the stock to \$8,700 ( $\$9,000 - \$300$ ).

Ordinary dividend income	<u>\$ 300</u>
Tax-free return of capital	<u>\$ 300</u>
<b>Yong's stock basis:</b>	
Initial stock basis	\$9,000
Capital recovery (\$600 - \$300)	(300)
Ending basis	<u>\$8,700</u>

**Instructor's Note:** If Yong's basis had been less than \$300, the distribution in excess of his basis is a capital gain and his basis in the stock is zero.

- b. \$720,000?

Yong will report \$600 as dividend income. Because Snowden's current earnings and profits exceed the amount distributed, the \$600 (\$2.00 per share x 300 shares) Yong receives is fully taxable.

52. In the current year, Penelope receives a nonliquidating distribution of land from the Royal Corporation. The corporation has earnings and profits of \$300,000. What is the tax effect of the distribution for Royal and for Penelope if

**A property distribution from a corporation has the same tax consequences to the shareholder as a cash dividend. If the corporation makes the distribution from current or accumulated earnings and profits, the shareholder recognizes income equal to the fair market value of the property.**

**A corporation making a nonliquidating distribution of property will recognize gain to the extent the fair market value of the property distributed exceeds its basis. However, if the fair market value of the property distributed is less than the property's basis, the corporation cannot recognize a loss.**

- a. The land has a fair market value of \$30,000 and a basis of \$18,000?

**Penelope will report dividend income of \$30,000 on the receipt of the land and the Royal Corporation must recognize a gain of \$12,000 (\$30,000 - \$18,000) on the distribution.**

- b. The land has a fair market value of \$25,000 and a basis of \$35,000?

**Penelope will report dividend income of \$25,000. However, because the land distributed is part of a nonliquidating distribution, Royal cannot recognize a loss.**

53. In the current year, Simon receives a liquidating cash distribution of \$32,000 from Torborg Corporation. What is the tax effect of the distribution for Torborg and for Simon if

**The tax law treats a shareholder who receives a distribution of cash in complete liquidation as having sold their stock to the corporation for the amount of cash received. Therefore, to the extent the distribution is greater than the shareholder's basis in the stock, the stockholder recognizes gain. Conversely, if the shareholder's basis is less than the amount received, the shareholder recognizes a loss. The corporation does not recognize income on the distribution of cash in a complete liquidation.**

- a. Simon has a basis in his stock of \$42,000?

**Simon will recognize a capital loss of \$10,000 (\$32,000 - \$42,000). Whether the gain is long term or short term depends on how long Simon has owned the stock. The Torborg Corporation does not recognize a gain or loss on the liquidating distribution.**

- b. Simon has a basis in his stock of \$19,000?

**Simon will recognize a capital gain of \$13,000 (\$32,000 - \$19,000). Whether the gain is long term or short term depends on how long Simon has owned the stock. The Torborg Corporation does not recognize a gain or loss on the liquidating distribution.**

- c. Assume the same facts as in parts a and b, except that Torborg is an S corporation. What is the tax effect for Torborg and Simon?

**A shareholder who receives a cash distribution in complete liquidation of their interest in an S corporation will recognize a gain or loss depending on whether the distribution is more or less than their basis in the stock. The gain or loss is either short term or long term depending on how long the shareholder has held the stock.**

**The tax treatment to Simon and Torborg is the same as in part a and b. That is, in part a Simon will recognize a capital loss of \$10,000 and in part b, he will recognize a capital gain of \$13,000. In both cases, Torborg does not recognize a gain or loss on the liquidating distribution.**

54. In the current year, Jose receives a liquidating property distribution from Valenzuela Corporation. The basis of the property distributed is \$25,000. What is the tax effect of the distribution for Valenzuela and for Jose if

**A corporation that distributes property in a complete liquidation must recognize gain to the extent that the fair market value of the property exceeds the basis of the property. Unlike a nonliquidating distribution of property, the corporation is allowed to recognize loss if the fair market value of the property is less than its basis.**

- a. The property distributed has a fair market value of \$30,000, and Jose has a basis in his stock of \$38,000?

**Because the fair market value of the property distributed is less than Jose's basis in the stock, he will recognize a capital loss of \$8,000 (\$30,000 - \$38,000). Valenzuela will recognize a gain of \$5,000 (\$30,000 - \$25,000). For Valenzuela whether the gain is long term or short term depends on how long it held the property.**

- b. The property distributed has a fair market value of \$20,000, and Jose has basis in his stock of \$18,000?

**Because the fair market value of the property distributed exceeds Jose's basis in the stock, he will recognize a capital gain of \$2,000 (\$20,000 - \$18,000). Valenzuela will recognize a loss of \$5,000 (\$20,000 - \$25,000).**

- c. Assume the same facts as in parts a and b, except that Valenzuela is an S corporation and Jose owns 20% of the stock. What is the tax effect of the distribution for Valenzuela and for Jose?

**A shareholder who receives a property distribution in complete liquidation of their interest in an S corporation will recognize a gain or loss depending on whether the distribution is more or less than their basis in the stock. The gain or loss is either short term or long term depending on how long the shareholder has held the stock. The S corporation distributing the property will recognize either a gain or loss on the distribution. The tax treatment for the S corporation is identical to that for a corporation.**

**Therefore, in part a, Jose will recognize a loss of \$8,000 and in part b, he will recognize a gain of \$2,000. Valenzuela recognizes a gain of \$5,000 in part a and a loss of \$5,000 in part b.**

55. Marco owns all the shares of Craig Corporation which operates as an S corporation. Its basis in the stock is \$47,000. What are the tax consequences for Marco and the Craig Corporation if

**Nonliquidating cash distributions from an S corporation to its shareholders are generally tax free and reduce the shareholders' basis in the corporate stock. If the distribution exceeds a shareholder's basis, the excess amount is treated as a capital gain. The cash distribution has no tax consequences to the S corporation. A nonliquidating distribution of property to shareholders of an S corporation is treated the same as a cash dividend. The shareholder's basis is reduced by the fair market value received. The shareholders does not recognize income to the extent that the distribution is less than their basis in the corporation. The S corporation will recognize gain if the fair market value of the property distributed exceeds its basis. An S corporation cannot recognize a loss on the distribution of property.**

- a. Marco receives a nonliquidating cash distribution of \$18,000 from the S corporation?

**The \$18,000 is a recovery of capital to the extent of Marco's basis. His basis is reduced by the amount of the cash distribution. After the tax-free receipt of the \$18,000 Marco's adjusted basis is \$29,000 (\$47,000 - \$18,000). There are no tax consequences to the Craig Corporation.**

- b. Marco receives a nonliquidating cash distribution of \$50,000 from the S corporation?

**Applying the capital recovery concept, the first \$47,000 (Marco's basis) of the distribution is tax free. The excess \$3,000 (\$50,000 - \$47,000) is a capital gain. Marco's basis in the S corporation is zero. There are no tax consequences to the Craig Corporation.**

- c. Marco receives a nonliquidating property distribution from the S corporation? The property distributed has a fair market value of \$24,000 and a basis of \$14,000.

**The property distribution is a recovery of capital and reduces Marco's basis by the fair market value of the property received. His basis in the S corporation is \$23,000 (\$47,000 - \$24,000). The Craig Corporation must recognize a gain of \$10,000 (\$24,000 - \$14,000) on the distribution. Because Marco is the sole owner of Craig, the recognition of gain increases his basis in the S corporation to \$33,000 (\$23,000 + \$10,000).**

- d. Marco receives a nonliquidating property distribution from the S corporation? The property distributed has a fair market value of \$14,000 and a basis of \$22,000.

**The property distribution is a recovery of capital and reduces Marco's basis by the fair market value of the property received. His basis in the S corporation is \$33,000 (\$47,000 - \$14,000). The Craig Corporation cannot recognize a loss (\$14,000 fair market value < \$22,000 basis) on a nonliquidating distribution of property.**



56. Michelle owns all the shares of Lockett Corporation which operates as an S corporation. Her basis in the stock is \$41,000. What are the tax consequences for Michelle and Lockett Corporation if

**A shareholder who receives a cash distribution in complete liquidation of their interest in an S corporation will recognize a gain or loss depending on whether the distribution is more or less than their basis in the stock. The gain or loss is either short term or long term depending on how long the shareholder has held the stock. A shareholder who receives a property distribution in complete liquidation of their interest in an S corporation will recognize a gain or loss depending on whether the distribution is more or less than their basis in the stock. The gain or loss is either short term or long term depending on how long the shareholder has held the stock. The S corporation distributing the property will recognize either a gain or loss on the distribution of property. The tax treatment for the S corporation is identical to that for a corporation.**

- a. Michelle receives a liquidating cash distribution of \$24,500 from the S corporation?

**Michelle will recognize a capital loss of \$16,500 (\$24,500 - \$41,000). Whether the gain is long term or short term depends on how long she has owned the stock. The Lockett Corporation does not recognize a gain or loss on the liquidating cash distribution.**

- b. Michelle receives a liquidating cash distribution of \$41,200 from the S corporation?

**Michelle will recognize a capital gain of \$200 (\$41,200 - \$41,000). Whether the gain is long term or short term depends on how long she has owned the stock. The Lockett Corporation does not recognize a gain or loss on the liquidating cash distribution.**

- c. Michelle receives a liquidating property distribution from the S corporation? The property distributed has a fair market value of \$16,400 and a basis of \$4,400.

**The distribution of the property by Lockett to Michelle is treated as if Lockett sold the property to Michelle. The corporation must recognize a gain of \$12,000 (\$16,400 - \$4,400) on the distribution of the property to Michelle. Because she is the sole owner of the corporation, the \$12,000 gain increases her basis in Lockett to \$53,000 (\$41,000 + \$12,000). The property distributed to Michelle is tax free and reduces her basis in Lockett to \$36,600 (\$53,000 - \$16,400). Under the capital recovery concept, because she will not recover her basis in the S corporation, she has a capital loss of \$36,600. Assuming Michelle has no other capital gains or losses, she can deduct \$3,000 of the loss in the current year.**

- d. Michelle receives a liquidating property distribution from the S corporation? The property distributed has a fair market value of \$9,500 and a basis of \$17,200.

**The distribution of the property by Lockett to Michelle is treated as if Lockett sold the property to Michelle. The corporation must recognize a loss of \$7,700 (\$9,500 - \$17,200) on the distribution of the property to Michelle. Because she is the sole owner of the corporation, the \$7,700 loss reduces her basis in Lockett to \$33,300 (\$41,000 - \$7,700). The property is distributed to Michelle tax free and reduces her basis in Lockett to \$23,800 (\$33,300 - \$9,500). Under the capital recovery concept, because Michelle does not recovery her basis in the S corporation, she has a capital loss of \$23,800. Assuming Michelle has no other capital gains or losses, she can deduct \$3,000 of the loss in the current year.**

**ISSUE IDENTIFICATION PROBLEMS**

In each of the following problems, identify the tax issue(s) posed by the facts presented. Determine the possible tax consequences of each issue that you identify.

57. Lydia owns 75% of Flower Farms, a partnership. She also owns land that she leases to Flower Farms for \$6,000 per month.

**The issue is whether the partnership can transact with a partner. Partners can transact at arm's-length with a partnership as long as they are not related parties. A partner and a partnership are related parties if the partner directly or indirectly owns more than 50 percent of the partnership.**

**A related party partner can also transact at arm's-length with the partnership in loan and rental transactions. In addition, payments for services to a partner are also considered arm's length if the partner is not acting as a partner in providing the services. Therefore, Flower Farm can deduct the \$6,000 monthly rental payment it makes to Lydia.**

**NOTE: The deduction is subject to the reasonableness requirement (see Chapter 5). Flower Farm can only deduct the amount of the rental payment to Lydia that is reasonable in amount. Therefore, if comparable land rented for only \$2,000 per month. Flower Farm could only deduct \$2,000, the reasonable rental for the land.**

58. Michael buys a piece of property from JFK Partnership for \$60,000 that has a \$70,000 basis. Michael owns 80% of JFK partnership.

**The issue is whether the partnership can sell the property to Michael and deduct the loss. The related party rules apply to sales between a partnership and a partner, if the partner owns more than a 50% interest in the partnership. Therefore, the partnership will not be able to deduct the \$10,000 loss and Michael will have a \$60,000 basis in the property. If Michael subsequently sells the property for more than \$60,000, he can offset the amount of his gain up to the partnership's disallowed loss of \$10,000.**

59. Irene contributes land to Micro Development Partnership for a 30% interest. The land's basis is \$20,000, and it has a fair market value of \$80,000. Micro reports a net operating loss of \$100,000 for the year. Irene devotes at least 12 hours a week to managing the partnership operations.

**The issue is whether Irene can deduct her pro rata share of the loss. Three sets of rules govern limitations on the amount of the loss deduction: the basis rules, the at-risk rules, and the passive activity loss rules. The passive activity rules are only applicable if Irene does not materially participate in the activity. Based on the facts, it is difficult to determine whether Irene would be treated as a material participant.**

**If Irene is considered a material participant, she will be allowed to deduct her ratable share of the partnership loss to the extent of her basis (\$20,000) in the partnership. This is also the amount that she is at-risk. The remaining \$10,000 loss is not deductible until her basis in the partnership is increased. If she is not a material participant, then she cannot deduct any of the loss. The loss is treated as a suspended passive loss and is deductible only when Irene has other passive income to offset loss or when she disposes of the passive activity.**

60. Powell owns a 20% interest in Cooke Partnership. At the beginning of 2015, Powell's basis is \$22,000. Cooke reports a \$90,000 operating loss in 2015, and Powell withdraws \$10,000 from the partnership. Cooke's 2016 operating income is \$70,000, and Powell withdraws \$10,000 from the partnership.

**The issue is whether Powell can deduct his pro rata share of the loss. Three sets of rules govern limitations on the amount of the loss deduction: the basis rules, the at-risk rules, and the passive activity loss rules. The passive activity rules are only applicable if Powell does not materially participate in the activity. Based on the facts, it appears that Powell would be treated as a material participant.**

**Powell needs to determine his basis in the partnership and how his partnership income and loss over the two years will affect his basis in the partnership. In addition, he also must determine how withdrawals affect his basis in the partnership.**

**A partner must include their pro rata share of partnership income or loss on their individual tax return. A partner's share of income increases basis while a loss reduces their basis. Withdrawals are treated as a return of capital and thus have no income tax effect, but reduce a partner's basis in the partnership. A partner's basis is first reduced by any withdrawals made during the year. At the beginning of 2015, Powell's basis in Cooke is \$22,000. He first must reduce his basis by the \$10,000 withdrawal made during the year. This leaves him with a basis of \$12,000 (\$22,000 - \$10,000). His share of the 2015 loss is \$18,000 (\$90,000 x 20%). However, he can only deduct \$12,000 of loss since that is his remaining basis in the partnership. Powell's basis at the end of 2015 is zero. The remaining \$6,000 of Powell's loss is suspended until Powell increases his basis in Cooke. In 2016, Powell's share of the partnership income is \$14,000 (\$70,000 x 20%). The income increases his basis in the partnership to \$14,000. Powell then reduces his basis by the \$10,000 withdrawal to \$4,000. He now can deduct the \$4,000 of the loss from 2015 that was suspended because his basis was zero. In doing so, his basis at the end of 2016 is zero. The remaining \$2,000 (\$6,000 - \$4,000) of suspended loss can be deducted when Powell increases his basis in Cooke.**

61. Ramrod, Inc., sells a warehouse for \$350,000. It purchased the warehouse 10 years ago for \$250,000 and had taken \$75,000 in depreciation on the building to the date of sale.

**The issue is how the gain on the sale of the warehouse will be treated for tax purposes. Ramrod must determine how much of the \$175,000 [\$350,000 - (\$250,000 - \$75,000)] gain is taxed as ordinary income and how much of the gain is Section 1231 gain. In this case, no Section 1250 recapture is required (the property was placed in service after 1986). However, corporations are subject to a special 20% recapture provision. This provision requires a corporation to treat as ordinary gain the difference between what would be ordinary income if the property were classified as Section 1245 property (\$75,000) and the amount that would be ordinary income (\$0) if classified as Section 1250 property. Therefore, \$75,000 of the depreciation is subject to the special corporate recapture provision. Ramrod must report \$15,000 (\$75,000 x 20%) of the \$175,000 gain as ordinary income and \$160,000 (\$175,000 - \$15,000) as Section 1231 gain.**

62. Myrtle Coast Corporation has a \$35,000 operating loss during the current year. Not included in the loss is a \$40,000 dividend it received from a corporation in which it owns a 15% interest.

**The issue is the amount Myrtle Coast Corporation is entitled to as a dividends-received deduction. The dividends-received deduction is based on the relative ownership interest in the dividend paying company. The deduction is further limited (either 70% or 80% depending on the percentage of ownership) of taxable income before considering the DRD, and net operating loss carryover and any capital loss carrybacks to the current year.**

**Because Myrtle Coast only owns 15%, it is only entitled to a 70% DRD. If Myrtle had owned more than 20% it would be entitled to an 80% DRD subject to the taxable income limitations. In this case, Myrtle has \$5,000 of gross income after considering the dividend income. The DRD before considering the taxable income limitation is \$28,000. However, the taxable income limitation is 70% of \$5,000 or \$3,500. There is a special rule that allows a full deduction if the DRD creates an NOL or increases an existing NOL before considering the DRD. In this case because the special rule applies, Myrtle is allowed the full deduction of \$5,000.**

63. LMC, Inc., is equally owned by Larry, Maurice, and Charles. The owners are sports agents. LMC's income consists solely of fees from the owners' clients. During the current year, LMC's net income from operations is \$380,000, and it receives \$20,000 in interest income. The corporation owns an interest in a limited partnership that generates a \$24,000 loss in the current year.

**The first issue is determining whether LMC, Inc. is a personal services company (PSC). A second issue is whether LMC may deduct its share of the loss from the limited partnership. The purpose of the personal service corporation rules is to deny the benefit of the graduated corporate income tax rates to individuals who attempt to lower their tax on personal service income by using a corporation. The income from a PSC is subject to a flat 35% tax rate. LMC, Inc. is considered a PSC because it meets the three tests: its principal activity is a service; more than 50% of its stock is owned by the owner-employees; and the owner-employees perform the services to its clients. Since LMC is a PSC it will be able to deduct its share of the loss from the limited partnership, but will not be able to offset any of the loss against portfolio income. Thus, LMC's taxable income is \$376,000 (\$380,000 + \$20,000 - \$24,000) and is taxed at 35%. Note that this treatment for the passive losses allows closely held companies to avoid the passive activity loss rules applicable to flow-through owners and individuals.**

64. Assume the same facts as in problem 63, except that LMC, Inc., is an electing S corporation.

**If LMC, Inc. is an S corporation, similar issues arise but different treatment occurs. Because LMC is an S corporation the income flows through to each of the owners. Larry, Maurice, and Charles will be allocated a pro rata share (1/3) of the S corporation's operating income, interest income, and limited partnership loss. The deductibility of the passive loss is determined on an individual basis. Each owner must determine whether they materially participated in the activity.**

65. Kummell Corporation reports a \$200,000 taxable income in the current year. Included in the taxable income calculation are \$20,000 in dividends received from less-than-20%-owned corporations, and \$30,000 in charitable contributions.

**The issue is to determine the amount of Kummell's dividends-received deduction and charitable contribution deduction. Both a corporation's dividends-received deduction (DRD) and charitable contribution deduction are subject to certain limitations. Kummell's charitable contribution deduction is limited to 10% of taxable income before the charitable contribution and dividend received deduction. Therefore, Kummell's gross income is \$220,000 (\$200,000 + \$20,000) and its charitable contribution is limited to \$22,000. Kummell will have a carryover of \$8,000 to the following year. Kummell's DRD is limited to 80% of taxable income after the charitable contribution deduction but before the DRD. Kummell's taxable income after the charitable contribution deduction but before the DRD is \$198,000 and its DRD is \$16,000 (\$20,000 x 80%). Kummell's taxable income is \$182,000 (\$198,000 - \$16,000).**

66. Milena owns a 25% interest in Davis Company, an S corporation. Her basis in the Davis stock is \$40,000. Davis reports an operating loss of \$200,000 in the current year. Davis owes Milena \$25,000 on a loan she made to the company several years ago.

**The first issue is whether Milena has sufficient basis in her stock to deduct her pro rata share of the Davis Company loss. A second issue is how does the debt effect her basis in Davis. Because Davis is an S corporation, Milena's ability to deduct losses is limited to her basis in the Davis stock. Unlike a partnership her basis is not increased by any debt of the S corporation. However, she can increase her basis by any amount the corporation owes her. Therefore, she can increase her basis by the \$25,000 debt. Milena's basis is \$65,000 (\$40,000 + \$25,000) and she can deduct her share of the loss (\$50,000).**

67. Charlene owns a 70% interest in Maupin Mopeds, which is organized as a partnership. She wants to open another business and needs office space for it. She has Maupin distribute a building worth \$150,000 to her in lieu of her normal cash distribution. Maupin's basis in the building is \$55,000. Charlene's basis in Maupin is \$80,000.

**The issue is the tax treatment of a nonliquidating distribution to a more than 50% partner and the impact the distribution has on the partner and the partnership. Generally, partnership distributions of property are not a taxable event. Neither the partner nor the partnership recognizes gain or loss on such distribution. This treatment is consistent with the capital recovery concept. The partner's basis in the partnership interest must be reduced by the amount of the property's basis but not below zero. After the distribution Charlene's basis in Maupin is \$25,000 (\$80,000 - \$55,000).**

68. Ballou Corporation distributes \$200,000 in cash to its shareholders during the current year. Accumulated earnings and profits at the beginning of the year are \$45,000, and current year earnings and profits are \$105,000. Buddy owns 80% of Ballou and has a basis of \$60,000 at the beginning of the year.

**The issue is how Buddy should treat the distribution for tax purposes. Because this is a corporation and not a flow through entity, Buddy will only be taxed on the amount actually distributed to him and not his percentage share of the income. Buddy will be taxed if the distribution is deemed to come from earnings and profits. Earnings and profits consist of two parts, accumulated earnings and profits - earnings accumulated in prior years, and current earnings and profits. Dividends are deemed to be paid out of current earnings and profits first and then from accumulated earnings and profits on a chronological basis. To the extent the distribution amount is greater than the sum of both of these amounts, the excess will be first considered a tax-free return of capital and will reduce the shareholder's basis in the stock to zero but not below zero. To the extent the distribution amount exceeds the basis in stock, the excess will be taxed as capital gain. Buddy will receive \$160,000 (\$200,000 x 80%) of dividends and his pro rata share of the earnings and profits is \$120,000 (\$150,000 x 80%). Buddy will report dividend income of \$120,000 (the extent of his share of the current and accumulated earnings and profits), and a tax-free return of capital of \$40,000. His remaining basis in the stock is \$20,000 (\$60,000 - \$40,000).**

69. **INTERNET ASSIGNMENT** A limited liability company is becoming a common business form, with most states having passed legislation allowing this entity form. Use the Internet to find out more information about LLCs. Use several search engines and find at least two articles and three Web sites discussing LLCs. Summarize the information found in the articles and list the information found at the Web sites.

Using the Google ([www.google.com](http://www.google.com)) search engine complete this assignment by typing in the keywords “limited liability companies and tax”. This will yield over 320,000 articles and links to other websites that have information on limited liability companies with a tax focus. One such article is entitled: “Tax Aspects of Limited Liability Companies” and can be found at [www.nysscpa.org/cpajournal/old/14469483.htm](http://www.nysscpa.org/cpajournal/old/14469483.htm)

**INSTRUCTOR'S NOTE:** Information on the Internet is developing at a rapid pace. Therefore, this solution may become outdated. We suggest that you do the assignment prior to assigning it to your students. This will allow you to provide students with any additional information they may need to complete the assignment.

70. **INTERNET ASSIGNMENT** In addition to the federal income tax, a corporation is subject to the laws of the state in which it is incorporated, including state income tax. Use the Internet to locate sources of tax law that govern the taxation of corporations for your state. List of the web addresses that pertain to your search. Write a brief description of the contents of the sites you find that pertain directly to corporate income tax.

One place to search for this type of information is [www.taxsites.com/](http://www.taxsites.com/). Click on “State and Local Tax” and then click on “State Links”. From this page, you can link to your home state to see what information is available concerning corporate income taxes. For instance, the Oklahoma Tax Commission (<http://www.oktax.state.ok.us>) has a link to a page of FAQs (Frequently Asked Questions) about the corporate income tax.

**INSTRUCTOR'S NOTE:** Information on the Internet is developing at a rapid pace. Therefore, this solution may become outdated. We suggest that you do the assignment prior to assigning it to your students. This will allow you to provide students with any additional information they may need to complete the assignment.



71. **RESEARCH PROBLEM** Tim and his daughter, Mary, own and operate Tamar Corporation. Tim is nearing retirement and would like to transfer ownership of the corporation to Mary but would like to stay on as a paid consultant providing retirement planning for the corporation's other employees. Tamar redeems all of Tim's common stock and gives him a contract to provide employee retirement counseling. The contract states that Tim is to be paid a flat \$60,000 for his services. Tamar will provide an office in the plant where he can interact with employees who take advantage of his services. Prepare a memo to Tim and Mary outlining the likely tax outcomes associated with the redemption of Tim's stock and subsequent contractual services.

**The redemption of Tim's stock might qualify for capital gain treatment if the conditions under Sec. 302(b) and Reg. Sec. 1.302-4 for the waiver of the attribution rules are properly met. The subsequent contractual arrangement must be construed as a bona-fide debtor/creditor relationship in order for the redemption to be effective. The fact that there is a contract price that is fixed, and that there will be an office on site brings into question whether Tim is really in a creditor relationship with Tamar Corporation or whether he is still considered an employee. The attribution rules may be waived for family members if the redeeming shareholder agrees not to have any financial relationship with the redeeming corporation other than one as a creditor. The facts in this case suggest that Tim may not have such a relationship.**

**The facts in this case are similar to the facts in Rev. Rul. 70-104, 1970-1 C.B. 66, where a father was ruled to have a prohibitive relationship when he entered into a long-term contract to provide consulting services for his former firm. *M. Lennard v. Comm.*, 61 T.C. 554, (1974) is also a case with a similar fact pattern.**

72. **RESEARCH PROBLEM** ADC, Inc., is a corporation that was formerly a three-person partnership. It is in the business of acquiring software and distributing it to accounting firms that need specialized software in their operations. ADC, Inc., is still owned and operated by the original three owners, who own 100% of its stock. ADC decides to invest in a limited partnership that buys old office buildings and converts them into condominiums. ADC reports net income from its business of \$400,000 and interest on investments of \$12,000. ADC's share of the limited partnership's loss for the year is \$100,000. Prepare a memo to ADC's president discussing the proper tax treatment of the loss from the limited partnership investment and the impact on the closely held business.

**A closely held corporation is one if it has five or fewer shareholders who own more than 50% of its stock during the last half of the year. ADC fits this description. Because ADC is a closely held corporation, under Sec. 469(a)(2)(B) and (C), it will not be able to deduct any of the loss due to the investment in the limited partnership against ADC's portfolio income. However, according to Sec. 469(e)(2)(A)(i), it will be able to deduct the loss against its active (operating) income. Based on the facts, ADC will be able to deduct the passive loss of \$100,000 against its operating income of \$400,000. ADC's taxable income will be \$312,000.**

**DISCUSSION CASES**

73. Astrid, who is single, is a sales representative for several sporting goods manufacturers. She operates her enterprise as a sole proprietorship. Astrid has 1 employee, Melvin, who serves as office manager for the business. Gross revenues are \$250,000 annually. Annual operating expenses are

Astrid's \$50,000 term life insurance policy	\$ 3,000
Melvin's salary	30,000
Payroll taxes and fees	3,000
Utilities	1,200
Rent	4,800
Selling expenses	8,000
Premiums paid for Melvin:	
\$50,000 term life insurance policy	3,000
Health insurance policy	2,700

Astrid takes an annual draw of \$2,700 to pay for health insurance coverage equal to Melvin's. Assume Astrid is paid a salary of \$100,000 and has income from other sources that offset her allowable deductions. Astrid is considering incorporating her business. Discuss the benefits that will accrue to Astrid by incorporating. Recommend any alternative courses of action. [Hint: Don't forget Social Security/self-employment tax.]

***Individual/Sole Proprietorship:***

**A sole proprietorship is not an entity separate from its owner. A sole proprietor cannot be an employee of the business. Therefore, sole proprietors cannot receive deductible salaries or fringe benefits from the business. Astrid includes the \$197,300 in operating income from the business on her individual tax return:**

<b>Gross income</b>	<b>\$ 250,000</b>
<b>Less: Business expenses</b>	
Melvin's salary	(30,000)
Payroll taxes and fees	(3,000)
Utilities	(1,200)
Rent	(4,800)
Selling expenses	(8,000)
Premiums paid for Melvin:	
\$50,000 term life insurance policy	(3,000)
Health insurance policy	(2,700)
<b>Operating income</b>	<b><u>\$ 197,300</u></b>

As a sole proprietor, Astrid is subject to the self-employment tax on her net self-employment income. Net self-employment income is equal to 92.35% of self-employment income. In 2016, the self-employment tax is 12.4% on \$118,500 of self-employment income and 2.9% on all self-employment income. Astrid can deduct one-half of her self-employment tax for adjusted gross income. Astrid's net self-employment income is \$182,207 (\$197,300 x 92.35%). Her self-employment tax is \$19,978 and her deduction for adjusted gross income is \$9,989 (\$19,978 x 1/2):

OASDI: \$ 118,500 - (\$118,500 x 12.4%)	\$ 14,694
MHI: \$182,207 - (\$182,207 x 2.9%)	5,284
Self-employment tax	<u>\$ 19,978</u>

Astrid can deduct the \$2,700 she spends on her health insurance for adjusted gross income. Assuming that she does not itemize her deductions, her taxable income is \$174,261:

Operating income	\$ 197,300
Deductions for adjusted gross income	
Self-employment tax	(9,989)
Health insurance	<u>(2,700)</u>
Adjusted gross income	\$ 184,611
Deductions from adjusted gross income	
Standard deduction	(6,300)
Personal exemption	<u>(4,050)</u>
Taxable income	<u>\$ 174,261</u>

Astrid's income tax liability is \$41,830 and her total tax liability when operating the business as a sole proprietorship is \$61,808:

Income tax - \$18,558.75 + [28% x (\$174,261 - \$91,150)]	\$ 41,830
Self-employment tax	19,978
Total tax liability	<u>\$ 61,808</u>

### **Corporation:**

A corporation is a separate taxable entity. Corporations are taxed at lower marginal tax rates than individuals through taxable incomes of \$75,000. Astrid is treated as an employee of the corporation and her salary and nontaxable fringe benefits are deductible by the corporation. Therefore, the corporation should pay Astrid's health insurance. This will lower the corporate taxable income and be nontaxable for Astrid. The operating income of \$197,300 can be reduced by Astrid's salary of \$100,000, the \$3,000 payment of Astrid's group-term life insurance, and the health insurance of \$2,700.

In addition, Social Security taxes will have to be paid on any salary Astrid receives. The corporation can deduct its share of Social Security; Astrid cannot deduct the Social Security tax she pays. The Social Security tax paid by Astrid (and matched by the corporation) would be \$7,650  $[(\$100,000 \times 6.2\%) + (\$100,000 \times 1.45\%)]$ . Corporate taxable income is \$83,950 and the corporate income tax liability is \$16,793:

Operating income (from above)	\$ 197,300
Astrid's salary	(100,000)
Astrid's group-term life insurance	(3,000)
Social Security paid on salary	(7,650)
Astrid's health insurance	(2,700)
Corporate taxable income	<u>\$ 83,950</u>

Tax liability -  $\$13,750 + [34\% \times (\$83,950 - \$75,000)]$  \$ 16,793

Astrid's taxable income is \$89,650 and her income tax liability is \$18,184:

Salary	\$100,000
Standard deduction	(6,300)
Personal exemption	(4,050)
Taxable income	<u>\$ 89,650</u>

Tax liability -  $\$5,183.75 + [25\% \times (\$89,650 - \$37,650)]$  \$ 18,184

The total income tax liability is \$34,977 (\$16,793 + \$18,184). However, the additional \$15,300 (\$7,650 x 2) in Social Security taxes paid increases the total tax liability to \$50,277 (\$34,977 + \$15,300). This is \$11,531 (\$61,808 - \$50,277) less than the total tax liability for the sole proprietorship.

Other factors can affect the amount of savings from incorporating the business. For example, any dividends distributed to Astrid will decrease the amount of savings because of double taxation. Dividends do not decrease a corporation's taxable income (taxed once) and the dividend is included as income on Astrid's tax return (taxed again at the long-term capital gain rate of 15%). Also, varying the amount of Astrid's salary can have significant tax effects on both the corporation and Astrid individually.

74. Bert, founded Sambert Corporation a little over a year ago. He believes that his company, which sells specialized computer toys, will be very profitable over the next several years, as evidenced by its \$400,000 of earnings in the current year. Although Bert does not need the income, he is interested in getting the earnings out of the company while paying the least amount of tax possible. Bert intends to work actively in the company and be paid a reasonable salary for the next five years. At the end of that time, he expects his oldest son to take over the company after finishing college. Bert knows that the salary he draws will reduce the corporation's taxable income and that he will be taxed at ordinary rates on that income. However, he is interested in the tax implications of property distributions the company might make to him later either in redemption of his shares if something prevents his son from taking over the business, or in the liquidation of the corporation. Discuss the types of distributions that a shareholder might encounter over the life-cycle of the corporation and the tax implications of each type of distribution.

**Bert is correct in his assessment that his salary will be taxed as ordinary income as long as his salary is reasonable. The corporation will be allowed a deduction against taxable income which effectively negates a that income from double taxation. Dividends and redemptions are both nonliquidating distributions that Bert may encounter during the life-cycle of the corporation. Dividends will be taxed as ordinary income to Bert as long as Sambert Corporation has earnings and profits. No deduction is allowed the corporation for such distributions. Dividends are paid based on the proportionate number of shares owned by the stockholder. On the other hand, a redemption is a nonliquidating distribution that will require Bert to give up a significant portion of ownership in the firm. This may occur as his son takes on more responsibility with the firm. Such a distribution is taxed differently than a dividend and is accorded sale or exchange treatment. This type of distribution more clearly represents a capital recovery due to the significant reduction in ownership that occurs. If the redemption is properly planned, the difference between his basis in the stock and the fair market value of the distribution will be taxed as a capital gain.**

**Finally, if Bert's son does not take over the business and Bert decides to liquidate the business, he will receive liquidating distributions from the firm. This is also treated as a sale or exchange and the difference between his basis in the stock and the fair market value of the distribution is a capital gain. Unlike a nonliquidating distribution, a loss can be recognized on a liquidating distribution. With proper planning, Bert can minimize his tax burden on distributions over the life-cycle of the corporation.**

**TAX PLANNING CASES**

75. John and Joanne have 2 children, Joe, 16, and Jamie, 4. John is self-employed, and Joanne works as a swimming coach for Local University. John's business is manufacturing Jaugernauts. Through the years, JoJo's Jaugernauts has been fairly successful, providing a before-tax income of approximately \$100,000 per year. The business has several employees, including a secretary-receptionist, 2 sales people, 4 production workers, and 2 truck drivers.

Last year, Joanne entered a contest and won a sizable block of stock in a computer company. This stock is expected to produce approximately \$10,000 per year in taxable dividends. Other than this stock, their investment assets consist mainly of savings accounts and certificates of deposits. However, in 1981, John invested in a tax shelter that provided them with tax write-offs until the Tax Reform Act of 1986 curtailed the loss deduction from the shelter (i.e., the losses are considered passive losses).

John and Joanne have come to you for advice. They would like to rearrange their business and personal affairs to obtain a better tax situation. Discuss at least three actions (don't feel limited if you can think of more) that John and Joanne could take, and state the advantages and disadvantages of each. Specific numerical calculations are not required, but if you think such an example would help explain your point, please feel free to use it.

**John and Joanne's tax liability can be reduced by incorporating John's business. Sole proprietorships operate as conduits that tax the individual owner on the income of the business. Therefore, the \$100,000 of pre-tax income being generated by the business is being taxed at a minimum marginal tax rate of 28%. By incorporating, John can pay himself a salary (taxed at individual rates) which is deductible by the corporation. For example, assume John is paid a salary of \$50,000. This will reduce their total personal taxable income and most likely will result in the salary being taxed at a lower individual marginal tax rate than before (28% vs. 15%). The corporation has \$50,000 in taxable income after deducting John's salary, resulting in a tax of \$7,500 (\$50,000 x 15%). The amount of taxable income in the 15% marginal tax rate has increased from \$75,300 (married filing jointly limit) to \$125,300 (\$75,300 married filing jointly limit + \$50,000 corporate limit).**

**If the business is incorporated, there are other options to consider which may reduce John and Joanne's tax liability:**

***Fringe Benefits:***

**The cost of certain types of fringe benefits is deductible by a corporate employer. The value of the benefits is generally excludable from taxation for the owner-employee who receives them, and the corporation receives a tax deduction. The exclusion provisions are available only for employees. John could obtain his medical insurance, group-term life insurance, and any other allowable fringe benefits at a reduced cost through use of the corporate entity. However, most of the fringe benefits have discrimination clauses in them. This means that John would also have to provide the fringe benefits to his employees to receive them tax-free. If these are not already being provided, the additional cost of covering all employees may outweigh the benefit to John. Sole proprietors are not considered employees and cannot deduct the cost of any fringe**

benefits (other than medical insurance premiums) they provide to themselves. **Note:** This assumes that Joanne does not have health coverage at Local University.

***Employ Children:***

Another tax-planning strategy for reducing corporate taxable income is the valid employment of an owner/employee's children in the business. This strategy allows the corporation to deduct the wages or salaries as expenses, lowering taxable income, and it may permit the child to receive income tax-free. The child can earn as much as \$6,300 in 2016 with no income tax liability because of the standard deduction amount for single individuals. Any income in excess of \$6,300 is taxed at 10% (the child's tax rate), resulting in an additional split of income between the corporation and the family unit. In addition, the salary for children under 18 years of age is not subject to Social Security tax.

An expense must be reasonable in amount to be deductible. Related parties face scrutiny of their transactions for reasonableness. Therefore, wages paid to children who are employees of their parents' corporation must be comparable to wages paid to any other employee for comparable services.

**NOTE:** The employment of children does not rely on incorporation to be effective. That is, a sole proprietor can validly employ his/her children and deduct the reasonable salaries paid as business expenses.

***Transfer Stock:***

If Jaugernaut incorporates, Joanne should transfer the stock in the computer company to the corporation. If Joanne owns less than 20% of the computer company and transfers her ownership to Jaugernaut, then Jaugernaut will receive a dividends-received deduction of 70% of the dividend income received (or  $70\% \times \$10,000 = \$7,000$  deduction). Thus, only \$3,000 of the \$10,000 in annual dividends would be subject to tax within the corporate entity.

***Transfer Tax Shelter:***

John should transfer the tax shelter to Jaugernaut if he incorporates. Generally, regular corporate taxpayers are not subject to the passive loss limitations discussed in Chapter 7. Exceptions to this general rule are for closely held corporations (which the newly formed corporation would be). A closely held corporation that is not a personal service corporation can use passive activity losses to offset the corporation's active income, but not its portfolio income. This would allow John to deduct the losses from his passive activity against the corporate active income, further reducing the corporation's taxes.

An individual who owns a business as a sole proprietorship and also has passive activity losses cannot offset the operating (active) income with passive losses.

76. For a number of years, Nina was a mechanical engineer for a chemical company. She always enjoyed working around her home in her spare time, doing necessary repairs and maintenance. However, she was always frustrated by the multitude of tools she had to carry around to do her tasks. One evening she designed a gizmo that could do the work of 12 common home repair tools. At first, she made a few gizmos by hand and gave them to friends as gag gifts. Their reaction to the gizmo was so enthusiastic that Nina took out a patent on it, got a loan from a friend at Local Bank, quit her job, and began a small-scale manufacturing operation.

In setting up her business, Nina took most of her advice from her brother-in-law, an assistant district attorney. Accordingly, she organized the business as a corporation and pays salaries to herself, her husband, Stan, and their 3 children (ages 2, 9, and 13). In addition, she put her investment portfolio inside the corporation.

After the first year of business the corporate books show a loss of \$25,000 after paying salaries of \$30,000 to Nina, \$20,000 to Stan (who continues to earn \$18,000 from his full-time job), and \$5,000 to each child.

- a. What tax-related mistakes has Nina made regarding the business? Be specific. State any negative effects that could arise from this arrangement.

**The basic mistake is the use of a corporation during the initial start-up period when losses are expected. The \$25,000 of loss incurred in the first year is "locked into" the corporation and can only be used to reduce future corporate income. When losses are anticipated, the use of an S corporation will enable the losses to flow through to the owners for deduction against their other forms of income (assuming material participation in the S corporation, which Nina would appear to easily meet in this case).**

**Nina compounded the incorporation error by paying the salaries to her husband and her children. That is, without these payments, the corporation would have a taxable income of \$10,000:**

Reported tax loss	\$ (25,000)
Add: Salary to Stan	20,000
Salaries to children (\$5,000 x 3)	15,000
Taxable income without salaries	<u>\$ 10,000</u>

**Paying the salaries subjected them to tax (both income and Social Security), without the benefit of any loss flowing through from the corporation. In addition, it is likely that the IRS would disallow at least a portion of Stan's salary (is the \$20,000 reasonable in light of his full-time employment salary of \$18,000) and all of the children's salaries as unreasonable compensation. In the worst case, the \$35,000 in salary paid to Stan and the children would be found to be unreasonable and would be considered a non-deductible dividend payment (assuming adequate E&P) to Nina (subject to tax at their marginal tax rate). Thus, the corporation would pay tax on the \$10,000 and the entire \$35,000 would be subject to tax. Even if Stan's salary is found to be reasonable, it is highly unlikely that the salary payment to the children is reasonable.**



**Therefore, at a minimum, the \$15,000 in salary paid to the children is treated as a nondeductible dividend payment taxable to Nina and Stan. This leaves the corporation with an operating loss of \$10,000 that cannot be used to reduce taxes in the current period.**

- b. Is there anything Nina can do to rectify the problems you identified? Explain, and state how each solution you propose cures or mitigates the problem.

**Nina should cease making the salary payments to her children (although it may be possible to justify some payment to the 13 year old if valid employment within the corporation can be found). This will alleviate the double taxation of the payments as deemed dividends to Nina. She should also consider whether the amounts paid to Stan are reasonable, given his corporate responsibilities.**

**After considering the salary issues, Nina should make a projection of the corporate income for the next several years. If she projects positive incomes, the corporate form should be retained and the current year operating loss can be used to offset income in those years. However, if it appears that the corporation will continue to operate at a loss, she should consider making an S corporation election. This election will allow the operating losses to flow through to Nina and be used to reduce the tax on Nina and Stan's personal taxable income.**

**NOTE: If the S election is made, the net operating loss is effectively suspended and cannot be flowed through to the shareholders. However, when the corporation starts to show a profit, Nina can terminate the S election and return to corporate tax status. The net operating loss can then be used to offset the corporate taxable income. This is the result that will be obtained even if Nina doesn't elect S corporation status and the corporation continues to show operating losses.**

**ETHICS DISCUSSION CASE**

77. Waldo Corporation has recently retained your accounting firm to prepare its income tax return. Art, the partner in charge of the engagement, has assigned you the job of reviewing last year's return and making recommendations on the preparation of this year's return. The only item of concern on the return is a \$32,000 dividends received deduction that Waldo claimed on \$40,000 in dividends it received from a Swiss corporation in which it owns a 30% interest. Write a memorandum to Art with your recommendation on the course of action your firm should take regarding the dividends received deduction.

**The error that occurred is in taking a dividends-received deduction for a non-domestic owned corporation. A domestic corporation cannot take a dividends-received-deduction on dividends from a foreign owned corporation. Therefore, Art is now required to notify the client of the error and advise him of the underpayment of tax based on the improper deduction. In addition, Art is required to inform the taxpayer of the possibility of penalties and interest if the error resulted in a substantial understatement of income.**

**If the client does not want Art to disclose and correct the mistake, SSTS #6 states that he should consider whether to withdraw from the engagement. Specifically, paragraph .04 of the standard requires Art to reassess whether he should continue a professional relationship with the client.**

**In addition, a CPA is not allowed to disclose errors on prior year's tax returns to the IRS without the client's consent. It is important to remember that if the client refuses to disclose the error, Art cannot disclose this information to the Internal Revenue Service without potentially violating Rule 301 of the Code of Professional Conduct, dealing with a CPA's confidential client relationship.**

## Chapter 14

### Check Figures

14. Include \$105,000 of operating income
15. Vinnie: Income - \$65,000; TE interest - \$20,000; LTCG - \$42,500; STCL - \$17,500  
Passive - \$10,000 loss; Section 179 - \$12,500
16. Taxable income - \$111,000
17. Henry: Income - \$43,334; TE interest - \$13,333; LTCG - \$28,333; STCL - \$11,667  
Passive - \$6,666 loss; Section 179 - \$8,333
18. a. Kira: Income - \$138,000; Dividends - \$24,000; Investment expense - \$6,000  
LTCL - \$36,000; Section 179 - \$6,000; Charitable contribution - \$18,000  
b. \$83,000  
c. Kira: Salary - \$70,000; Income - \$60,000; Dividends - \$24,000; LTCL - \$36,000  
Investment expense - \$6,000; Section 179 - \$6,000; Charitable contribution - \$18,000
19. Partnership: Income tax - \$28,037 (K); \$16,521 (J);  
Social Security: \$18,149 (K); \$11,162 (J);  
S Corp.: Income tax - \$29,397 (K); \$22,597 (J) Social Security - \$19,890  
Corporation: Income Tax - \$13,264 (Corp.); \$22,771 (K); \$15,771 (J)  
Social Security - \$19,890
20. a. \$10,000 loss; \$5,000 basis                      b. \$6,250 income; \$21,250 basis  
c. \$20,000 loss limited to \$15,000; \$0 basis
21. a. \$10,000 loss; \$0 basis                                      b. \$19,000 loss; \$1,500 basis
22. Current year - \$10,000 suspended loss;  
Following year - \$1,000 loss allowed; \$29,000 suspended loss
23. a. \$30,000 (A); \$54,000 (E)                                      b. carryback 2 years or carryforward 20 years  
c. \$18,000 (A); \$24,000 (E)
24. Partnership: \$18,000 (A); \$24,000 (E); S Corporation: \$30,000 (A); \$24,000 (E)
25. a. \$12,000 deduction                                      b. No deduction  
c. \$ 8,000 gain
26. a. \$8,000 capital gain                                      b. \$8,000 ordinary income
27. a. Deduct \$3,000 loss                                      b. \$5,000 dividend income  
c. Deduct \$3,000 loss
28. Maximum tax-free distribution - \$51,000 (P); \$39,000 (S Corp.)
29. \$160,000 dividend received deduction (DRD)
30. DRD - \$102,400; Taxable income - \$25,600
31. DRD - \$140,000; Net operating loss - \$27,000



53. a. Simon - \$10,000 Capital loss  
Torborg - \$0  
c. Same as part a. and b.
- b. Simon - \$13,000 Capital gain  
Torborg - \$0
54. a. Jose - \$8,000 capital loss  
Valenzuela - \$5,000 gain  
c. Same as part a. and b.
- b. Jose \$2,000 capital gain  
Valenzuela - \$5,000 loss
55. a. Marco - \$0 income; \$29,000 basis; Craig – no tax consequences  
b. Marco - \$3,000 capital gain; \$0 basis; Craig – no tax consequences  
c. Marco - \$0 income; \$33,000 basis; Craig – \$10,000 gain  
d. Marco - \$0 income; \$33,000 basis; Craig – no tax consequences
56. a. Michelle - \$16,500 capital loss; Lockett – no tax consequences  
b. Michelle - \$200 capital gain; Lockett – no tax consequences  
c. Michelle - \$36,600 capital loss; Lockett – \$12,000 capital gain  
d. Michelle - \$23,800 capital gain; Lockett – \$7,700 capital loss