EA Part 2
Study Unit 17

S CORPORATIONS

Gleim® EA Review

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Overview

An S corporation is generally not subject to a federal tax on its income

- Corporation's items of **income, loss, deduction, and credit** are passed through to its shareholders on a per-day and per-share basis.
- Each shareholder is taxed on their **share** of the S corporation's income as it is earned.
- **Distributions** of cash or property generally are not income to its shareholders.

Eligibility and Election

Classification

Eligibility depends on the nature of the corporation, its shareholders, and its stock.

- A corporation must be **domestic** and eligible.
- Ineligible corporations include insurance companies and financial institutions (such as banks that use the reserve method of bad debts).

Stock

An S corporation must have only one class of stock

- The outstanding shares of the corporation must be **identical** as to **the rights** of the holders in the **profits and assets** of the corporation on liquidation or distribution.
- Variation in voting rights of that one class of stock is permitted
- Debt may be treated as a disqualifying second class of stock.

Shareholders

The number of shareholders may not exceed 100.

- Related taxpayers and their estates are considered a single shareholder for this purpose.
- A husband and wife are considered a single shareholder for this purpose.
- Family members in a six-generation range are also considered one shareholder.
- A nonresident alien (NRA) may not own any shares.

Shareholders

Each shareholder must be either:

- **an individual (including an individual owner of a single-member LLC),**
- **an estate (including estates of individuals in bankruptcy),**
- **a qualified trust.**
  - Certain small business trusts and tax-exempt organizations can be shareholders.
  - Partnerships and corporations may not be shareholders.
  - Single-member LLCs are not partnerships or corporations. However, they may elect corporation status.
  - Charitable Remainder Unitrusts and Charitable Remainder Annuity Trusts are not eligible shareholders.

Having a partnership as a shareholder will prevent a corporation from making an S corporation election

Which of the following characteristics can disqualify a corporation from S corporation status?

A. Corporation Z has variation in voting rights in its one class of stock.

B. Corporation M has 101 shareholders, including a husband and wife.

C. Corporation B has voting and nonvoting stock.

D. Corporation T has as its shareholders an individual, an estate, and a partnership.

Answer (D) is **correct.**
An S corporation may not have more than 100 shareholders; shareholders who are not individuals, estates, or certain kinds of trusts and exempt organizations; a nonresident alien as a shareholder; or more than one class of stock [Sec. 1361(b)]. Having a partnership as a shareholder will prevent a corporation from making an S corporation election.

S Corporation Subsidiaries

S corporations can own C corporations or Qualified Subchapter S Subsidiaries.

- A Qualified Subchapter S Subsidiary is an electing domestic corporation that is 100% owned by an S corporation parent.
- IRS refers to a Qualified Subchapter S Subsidiary as a QSub.

Election

An eligible corporation must make the election to achieve S corporation status.

- An election made **within the first 2 1/2 months** of the beginning of the corporation's tax year is effective from the first day of that tax year.
- An election made after the first 2 1/2 months of the corporation's tax year will become effective on the first day of the following tax year.

Election

All shareholders at the time the election is made must file a consent.

- A shareholder's consent is binding and may not be withdrawn after a valid election is made by the corporation unless the shareholders vote to terminate the election.
- In addition, each person who was a shareholder at any time during the part of the tax year before the election is made must also consent.
- If any former shareholders do not consent, the election is considered made for the following year.

IRS Receipt and Acknowledgement

Late Filing With Reasonable Cause

IRS can treat a late-filed election as timely filed if a determination is made that reasonable cause existed for corporation's late filing

Waiver of Invalid Election

IRS can waive the effect of an invalid election resulting from a corporation's failing to qualify as an S Corporation and/or failing to obtain the necessary shareholder consents.

Termination

Upon the occurrence of a terminating event, an S corporation becomes a C corporation.

An S corporation election is terminated by any of the following:

- Shareholders holding more than 50% of the outstanding voting and nonvoting shares of stock on the day of the revocation consent.
- Any eligibility requirement is not being satisfied on any day.
- There is a passive investment income termination.

Termination

Termination (other than a passive investment income termination) is effective as of the date the disqualifying event occurs.

Passive investment income termination occurs when, for 3 consecutive tax years, the corporation has both

- ✓ Subchapter C earnings and profits on the last day and
- ✓ Passive investment income that is greater than 25% of gross receipts.

Termination

If an election is terminated, a new election cannot be made for 5 tax years without consent of the IRS

- The IRS may waive termination.
- The terminating event must have been inadvertent and corrected within a reasonable time.

A resident alien is an individual who qualifies to be a shareholder of an S Corporation.

All of the following events would cause an S corporation to cease qualifying as an S corporation EXCEPT

A. Having more than 100 shareholders.

B. The transfer of its stock to a corporation.

C. The transfer of its stock to a resident alien.

D. The election is revoked with the consent of shareholders who, at the time the revocation is made, had 55% of the stock.

Answer (C) is **correct.**
A resident alien is an individual who qualifies to be a shareholder of an S corporation. Therefore, the transfer of stock to a resident alien does not disqualify a corporation from S corporation status.

Upon the occurrence of a terminating event, as S Corporation becomes a C Corporation.

Which of the following statements regarding the termination of an S corporation election is true?

A. The election may be revoked with the consent of shareholders who, at the time the revocation is made, hold more than 50% of the number of issued and outstanding shares.

B. The election may be revoked by the board of directors of the corporation only if they are not shareholders.

C. The election terminates automatically if the corporation derives more than 25% of its gross receipts from passive investment income during the year.

D. The election may be revoked by the Internal Revenue Service if there is a history of 10 years of operating losses.

Answer (A) is **correct.**
Upon the occurrence of a terminating event, an S corporation becomes a C corporation. An S corporation election is terminated if shareholders collectively holding more than 50% of the outstanding shares of stock on the day of the revocation (voting and nonvoting) consent, any eligibility requirement not being satisfied on any day, and/or a passive income investment income (PII) termination.

Accounting Method

An S corporation may use cash, accrual, or any other method of accounting authorized by the IRS.

- The accounting method and the tax treatment of items of income, loss, deduction, and credit are determined at the corporate level.
- Shareholders personally elect
  - Credit or a deduction for foreign income taxes
  - Percentage or cost depletion for oil and gas properties
  - Treatment of mining exploration expenditures

Tax Year

An S corporation generally must adopt a calendar tax year.

- With IRS consent, it may adopt a **fiscal year** (if it establishes a valid business purpose for doing so) that does not result in deferral of income to shareholders and coincides with a natural business year.
- A natural business year may end with, or after the end of, the peak period of a cyclical business.
- A natural business year also exists if greater than **25% of gross receipts occur in the last 2 months** of the proposed year over a 3-year period.

Tax Year

An S corporation that deposits the equivalent amount of the deferred tax may elect a fiscal year.

- A new S corporation is limited to no more than 3 months' deferral of income to its shareholders.
- An existing S corporation may continue to use the fiscal year previously adopted

Filing Returns

The S corporation files its tax return on Form 1120-S

Each shareholder must report his or her pro rata share of items on his or her return, similar t a partnership, and it should be consistent with the corporate return unless (s)he notifies the IRS of the inconsistency.

- Administrative and judicial proceedings to determine proper treatment of items are unified at the level of the S corporation.
- Shareholders are provided notice and opportunity to participate.

Which of the following characteristics can disqualify a corporation from S corporation status?

A. Corporation Z has variation in voting rights in its one class of stock.

B. Corporation M has 101 shareholders, including a husband and wife.

C. Corporation B has voting and nonvoting stock.

D. Corporation T has as its shareholders an individual, an estate, and a partnership.

Answer (D) is **correct**.
An S corporation may not have more than 100 shareholders; shareholders who are not individuals, estates, or certain kinds of trusts and exempt organizations; a nonresident alien as a shareholder; or more than one class of stock [Sec. 1361(b)]. Having a partnership as a shareholder will prevent a corporation from making an S corporation election.

EA Part 2

SUBUNIT 17.2

Operations

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Governance and Exemptions

Provisions that govern taxation of C corporations also govern the taxation of S corporations, unless a specific exception applies.

S corporations are expressly exempt from the

- Corporate income tax,
- Accumulated earnings tax (AET), and
- Personal holding company (PHC) tax.

Reporting

The items of income, deduction (including losses), and credit of an S corporation are reported by the corporation.

- A shareholder reports the pro rata share of items passed through in his or her personal taxable income in the tax year within which the tax year of the S corporation ended.

Reporting - Example

Super, Inc., an S corporation, properly reported non-separately stated net income from operations of $100,000 for its tax year ending November 30, Year 2023.

Steve, a calendar-year taxpayer who owns 5% of the shares of Super, Inc., must include $5,000 (5% x $100,000) of ordinary income in his tax return for 2023, which is due on or before April 15, 2024.

Separate Statement

Separately Stated Items

S corporation items of income, deduction, and credit, which could alter the tax liability of shareholders if they are taken into account on their personal returns, are required to be stated (and are passed through) separately

Non-separately Stated Items

Items not required to be separately stated are combined at the corporate level, and the net amount of ordinary income or loss is passed through to shareholders.

Separately Stated Items

- Section 1231 gains and losses
- Net short-term capital gains and losses
- Net long-term capital gains and losses
- Dividends
- Charitable contributions
- Taxes paid to a foreign country or to a U.S. possession
- Tax-exempt interest and related expense
- Investment income and related expense
- Amounts previously deducted, such as bad debts
- Real estate activities
- Section 179 deduction
- Credits
- Deductions disallowed in computing S corporation income

Gross sales less operating expenses are reported on Schedule K-1 as ordinary income.

Foster's RV Sales, Inc., is an S corporation with the following activity during 2023:

Gross sales of RVs and campers	$500,000
Operating expenses	300,000
Interest income	1,000
Charitable contributions	3,000
Sec. 179 expense	10,000

How much ordinary income from trade or business activities will be reported on Schedule K, *Shareholder's Pro Rata Items*?

A. $188,000

B. $190,000

C. $198,000

D. $200,000

Answer (D) is **correct.**

Items of income, gain, expense, loss, and credit must be separately stated if those items are specially treated for tax purposes at the shareholder level. These items include interest income, charitable contributions, and the Sec. 179 expense. Therefore, Foster will report $200,000 ($500,000 – $300,000) as ordinary income on Schedule K.

Separate Statement

A shareholder's Sec. 179 deduction is subject to limits

- The maximum Sec. 179 deduction is $1.16 million.
- If the cost of Sec. 179 property placed in service during the year exceeds $2.89 million, the maximum deduction limit must be reduced by the amount of cost that exceeds $2.89 million.
- The maximum deduction limit is applied to **each taxpayer**, not each separate business.

Charitable Contributions

S Corporation Contribution of Property to a Charity

Each shareholder reduces his or her basis in the stock of the S corporation by his or her pro rata share of the adjusted basis of the contributed property.

Pro Rata Shares

The shareholder characterizes each item (e.g., long-term capital gain) as the corporation would.

Charitable Contributions - Example

S Corporation contributed a long-term capital asset to a charity.

The basis of the asset was $12,000 and the fair market value was $20,000.

The sole shareholder has a $20,000 charitable contribution and reduces basis in the stock by $12,000.

Debt Discharge

Ordinarily, a taxpayer realizes income when indebtedness is forgiven or otherwise canceled.

- If the discharge of debt occurs in a bankruptcy case, when the taxpayer is insolvent, or when the discharge of indebtedness is with respect to qualified real property business indebtedness, the income realized upon discharge is excluded from income.
- The amount excluded is applied to reduce the tax attributes of the taxpayer.
- Income from an S corporation's discharge of indebtedness that is excluded from the S corporation's income is not considered an item of income by any shareholder.

Carryovers

Carryovers between S and C corporations, such as those for net operating losses, are not permitted.

- This rule applies to corporations that change their status from C to S or from S to C.

All of the following are true regarding cancellation of debt income for S corporations EXCEPT

A. The canceled amount is considered gross income on Form 1120-S.

B. The amount of canceled debt excluded from income will increase the basis of the shareholders' stock.

C. The pro rata share of the canceled debt income will pass through to the shareholders.

D. Canceled debt income may be excluded to the amount of insolvency of the S corporation.

Answer (B) is **correct**.
Income from the discharge of indebtedness of an S corporation that is excluded from the S corporation's income is not taken into account as an item of income by any shareholder. As a result, it does not increase the basis of any shareholder's stock in the corporation.

Cancellation of debt income for an S corporation

A. Flows to shareholder if income is excluded by the S corporation.

B. Is recognized as income to an S corporation regardless of the extent of corporate insolvency.

C. Is not excluded from gross income to the S corporation when granted in Chapter 11 reorganizations.

D. Gives rise to income, which flows to shareholders if income is not excluded by the S corporation.

Answer (D) is **correct.**
A taxpayer realizes income when indebtedness is forgiven or otherwise canceled. If income from the discharge of indebtedness of an S corporation is not excluded from the S corporation's income, it flows to the shareholders.

Qualified Business Income Deduction (QBID)

QBID is determined at the shareholder level.

- To allow shareholders to correctly figure the deduction on the shareholder's Form 1040 return, the S corporation must report on the shareholder's Schedule K-1.

Stock Basis

Generally, if a shareholder purchases stock, the shareholder's original basis in the stock is its cost.

- If a shareholder receives stock in exchange for property, the basis is the same as the property's basis.
- If a shareholder lends money to an S corporation, the basis is usually the amount of the loan, and a separately tracked type of basis called debt basis is created.

Stock Basis

- If a shareholder guarantees a third-party loan to an S corporation, the loan does not increase the shareholder's basis
- If the shareholder makes payments on the loan, the payments increase the shareholder's basis.
- The shareholder receives basis if the shareholder is the primary signer on the note and the S corporation is the guarantor.
- The FMV of the stock exchanged for services is gross income to the shareholder.
- The shareholder's basis in the stock exchanged for services is its FMV.

Stock Basis -- Increases

Almost every transaction of an S corporation affects shareholder basis.

The adjusted basis of the shareholder's stock is calculated at year-end, with increases for the shareholder's pro rata share of the following:

- All income items of the S corporation, both separately and non-separately stated.
- The amount of the deduction for depletion (other than oil and gas) that is greater than the basis of the property being depleted.

Stock Basis -- Increases

Example

The Taxpayer's basis in the S Corporation is $12,000 at the beginning of the year. The corporation has:

- ordinary income of $6,000,
- tax-exempt interest of $2,000
- a long –term capital gain of $1,500.

What is the taxpayer's basis?

Taxpayer's basis will be increased by $9,500 ($6,000 + $2,000 + $1,500) to $21,500 at the end of the year.

Stock Basis -- Decreases

The adjusted basis of the shareholder's stock must also be decreased by the shareholder's pro rata share of the following:

- S corporation **distributions t**hat were not included in income
- All **separately stated** loss and deduction items
- Any **non-separately stated** loss of the S corporation
- Any **expenses** of the S corporation that are not deductible in figuring its taxable income or are not properly capitalized
- The shareholder's deduction for **depletion** of oil and gas property held by the S corporation (to the extent it is not more than his or her share of the adjusted basis of the property)

Stock Basis -- Decreases

The taxpayer's basis at the beginning of the year is $22,000. The taxpayer withdraws $16,000 during the year, and the corporation has an ordinary loss of $9,000.

How much of the loss can be deducted and how much is carried forward?

$22,000 – basis, beginning of the year

- $16,000 – distribution

$6,000 – shareholder's deduction is limited by its basis

- $9,000 – ordinary loss

$3,000 – remaining loss is carried forward

Stock Basis

Basis is not reduced below zero.

- After basis in the shareholder's S corporation stock has been reduced to zero, the shareholder's basis in debt of the S corporation to that shareholder is reduced (but not below zero) by his or her share of items of loss and deduction.
- In a subsequent tax year, items passed through must restore the basis in the debt before basis in the stock.
- A shareholder's share of loss and deduction items in excess of basis in the debt is not deductible.
- The excess is suspended and carried over indefinitely.
- It may be deducted in a subsequent tax year when basis is restored to debt or stock.

Stock Basis

Example

The taxpayer's basis at the beginning of the year is $22,000. The basis consists of $19,500 stock basis and $2,500 debt basis. The taxpayer withdraws $16,000 during the year, and the corporation has an ordinary loss of $9,000.

$19,500 – stock basis

- $16,000 – distribution

$ 3,500 – adjusted basis of the stock

- $ 9,000 – loss pass-through

- $ 0 – basis, $3,000 loss carried forward ($9,000 - $3,500 - $2,500)

If a shareholder paid capital gains in deposing of the stock, this tax does not increase the basis of the shareholder’s remaining stock.

Which of the following would NOT increase the basis of a shareholder’s stock in an S corporation?

A. All separately stated income items of the S corporation, including tax-exempt income.

B. Any non-separately stated income of the S corporation.

C. Capital gains tax paid by the shareholder.

D. The amount of deductions for depletion that is more than the basis of the property being depleted.

Answer (C) is **correct.**
If the shareholder paid capital gains in disposing of the stock, this tax does not increase the basis of the shareholder’s remaining stock.

When appreciated property is distributed, gain is recognized in the same manner as if the property was sold at its FMV.

On December 31, Year 1, Walter had a $2,000 basis in Oak, Inc., an S corporation. Walter owns 50% of all outstanding Oak stock. At the beginning of Year 2, Walter contributed a patent that he had acquired for $1,000 to Oak. During Year 2, Oak received $5,000 in royalty income from that patent. Oak also received $2,500 in ordinary income and had $500 in Internal Revenue Code Sec. 179 deductions. At the end of Year 2, Oak returned ownership of the patent, which now had a fair market value of $5,000, back to Walter. What is Walter's basis in Oak, Inc., at the end of Year 2?

A. $1,000

B. $1,500

C. $2,500

D. $3,500

Answer (D) is **correct.**

Walter's original basis of $2,000 is increased to $6,500 ($1,000 basis in the contributed patent plus $2,500 royalty income plus $1,250 ordinary income less $250 from the Sec. 179 deduction). When appreciated property is distributed, gain is recognized in the same manner as if the property was sold at its FMV. The distribution of the patent results in a $4,000 ($5,000 FMV – $1,000 basis) gain to Oak and an increase of $2,000 ($4,000 × 50%) to Walter's basis. Upon distribution of the patent, Walter's basis is decreased by the $5,000 FMV of the patent. Therefore, Walter's basis in Oak at the end of Year 2 is $3,500 ($6,500 + $2,000 – $5,000).

A shareholder of an S corporation may include a pro rata share of loss in income, limited to the shareholder's basis in the stock. A shareholder loan to an S Corporation does not increase it's basis. Loan payments increase it's basis.

Magnolia Corporation, a calendar-year S corporation, was formed on January 1, Year 1. Kathy owns 25% of Magnolia's outstanding stock, which she purchased for $20,000. In Year 1, Kathy guaranteed a corporate loan for $40,000. In Year 2, Kathy made payments on the loan totaling $10,000. Magnolia had losses of $90,000 and $60,000 in Year 1 and Year 2, respectively. What is the amount of the unallowed loss that Kathy can carry over to Year 3?

A. $0

B. $7,500

C. $10,000

D. $17,500

Answer (B) is **correct**.
A shareholder of an S corporation may include a pro rata share of loss in income, limited to the shareholder's basis in the stock. Generally, the shareholder's original basis is its cost. If a shareholder guarantees a loan to an S corporation, the loan does not increase the shareholder's basis. If, however, the shareholder makes payments on the loan, the payments increase the shareholder's basis. Kathy's basis in the stock was $20,000, the cost. Kathy may deduct only $20,000 of her $22,500 loss in Year 1 ($90,000 × 25%). After deducting the loss, her basis is $0. In Year 2, Kathy makes loan payments of $10,000. This makes her basis $10,000 for Year 1. Kathy may deduct the remaining loss of $2,500 from Year 1 in Year 2 ($22,500 – $20,000). Therefore, Kathy may deduct up to $7,500 ($10,000 – $2,500) of her $15,000 loss from Year 2 ($60,000 × 25%). She may, however, carry the remaining $7,500 loss over to Year 3.

At-Risk Rules

At-risk rules are applied at the shareholder level.

- Any excess of each shareholder’s pro rata share of passed-through losses for the tax year over his or her amount at risk at the close of his or her tax year is not deductible in the current tax year.
- It is suspended and carried forward indefinitely until the shareholder’s amount at risk, with regard to the particular activity, has increased.
- The shareholder’s basis in his or her stock and debt of the corporation is reduced (subject to prior application of the basis loss limitation) even if current deductibility of the loss is prohibited by the at-risk rules.

At-Risk Amount

Each shareholder’s at-risk amount

Equals the sum of:

1. Money and the adjusted basis of property contributed to the corporation
2. Amounts borrowed and lent to the corporation

   However, it does not include other debts of the corporation to third parties, even if repayment is guaranteed by the shareholder.

Changes to Shareholder’s amount at Risk

Shareholder’s amount at risk is increased or decreased by the shareholder’s pro rata share of passed-through income and deduction and by distributions to the shareholder.

Passive Activity Loss Rules

Rental Activity or no material Participation

- If the S corporation engages in rental activity or if a shareholder does not materially participate in the trade or business conducted by the corporation (even if the S corporation materially participates), current deductibility of any losses passed through is limited at the shareholder level to passive activity income.
- A shareholder's amount at risk must be reduced by the full amount allowable as a current deduction after application of the at-risk rules, even if part of it must be suspended by the passive loss rules.

The stock basis is increased for the portion of the municipal interest in order for that income to never be subject to taxation.

Beech Corp., an accrual-basis, calendar-year S corporation, has been an S corporation since its inception. At the beginning of the current year, Gold owned 50% of the 100 issued shares of Beech stock, and had a $3,000 tax basis in the Beech stock. During the current year, Beech had $200,000 in net business income and $4,000 in Oak County municipal bond interest income. Beech made no distributions to its shareholders. What was Gold's tax basis in Beech stock at year end?

A. $102,000

B. $103,000

C. $104,000

D. $105,000

Answer (D) is **correct**.
The shareholder's stock basis would be $105,000 [$3,000 beginning basis + $100,000 income allocation ($200,000 × 50% ownership interest) + $2,000 municipal interest ($4,000 × 50% ownership interest)]. The stock basis is increased for the portion of the municipal interest in order for that income to never be subject to taxation. If the basis was not increased, when the interest was later sold, gain would be realized on the portion of the business attributable to that income.

Failure to File Penalty

Penalty Base Amount

The penalty base amount (regardless of any tax amount owed) is imposed in the amount of the number of persons who were shareholders during any part of the year, multiplied by $235 for each of up to 12 months (including a portion of one) that the return was late or incomplete.

Failure to File Penalty

Example

An S corporation has 5 shareholders and the tax return is filed 1 ¼ months late. What is the penalty?

5 shareholders

x $ 235

$1,175

x 2 months – rounded up

$2,350 - Penalty

Failure to File Penalty

If Tax is Due

The penalty amount is increased by 5% of the unpaid tax for each month or part of a month the return is late, up to a maximum of 25% of the unpaid tax. The minimum penalty for a return that is more than 60 days late is the smaller of the tax due or $485.

Failure to File Penalty – Tax Due

Example

An S corporation has 5 shareholders and the tax return is filed 1 ¼ months late. Thereis also a $10,000 tax liability. What is the penalty?

$10,000 – tax liability
x 10% = 5% x 2 months

$1,000
+ $ 2,350 – Failure to pay penalty

$3,350 – Total Penalty

EA Part 2

SUBUNIT 17.3

Distributions

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Distributions

Distributions include nonliquidating and liquidating distributions of money or other property, but not the S corporation's own stock or obligations.

- The amount of a particular distribution is the sum of any money plus the fair market value of property distributed.

Adjustment Accounts

S corporations maintain two types of records for each shareholder:

- Accumulated adjustments account (AAA)
- Other adjustments account (OAA)

Determining Tax Treatment of Distributions

The AAA and OAA, together with a shareholder's basis in their stock and any Subchapter C E&P in the corporation, are used to determine the shareholder's tax treatment of distributions.

Adjustment Accounts

Distributions from an S corporation

are funded in the following source order:

- AAA
- AE&P
- OAA
- Stock basis

Note that AAA and OAA records and information are needed by S corporations only for purposes of helping shareholders determine taxability of distributions when the S corporation has Subchapter C E&P.

Accumulated Adjustments Account

The AAA represents the current cumulative balance of all the separately and non-separately stated items of the S corporation.

- The adjustments in this account parallel those made to basis for separately and non-separately stated items.
- The balance is calculated without regard to any net negative adjustments (excess of losses and deductions over income and gains).
- The AAA is not affected by any transactions related to when it was a C corporation.
- Expenditures that are not deductible by the S corporation decrease basis in stock and the AAA.

Accumulated Adjustments Account

- Adjustment is not made to the accumulated adjustments account (AAA) for tax-exempt income (which increases basis) or related nondeductible expenses (which reduce basis).
- The adjustments are made to the other adjustments account.
- The AAA balance can be reduced below zero, but basis may not.
- Distributions do not reduce AAA below zero.

Other Adjustments Account

OAA represents a cumulative balance of tax-exempt interest earned and life insurance proceeds, reduced by the expenses incurred in earning it.

Subchapter C E&P

S Corporation E & P

- An S corporation does not have earnings and profits unless it was formerly a C corporation or acquired earnings and profits in a tax-free reorganization, like a merger.
- Subchapter C earnings and profits are not adjusted for any S corporation items of income (or loss, deduction, or credit) passed through to shareholders.

The AAA and OAA accounts, together with the shareholder's basis in their stock and any subchapter C earnings and profits in the corporation, are used to determine the shareholder tax treatment of distributions.

An S corporation without prior C corporation earnings and profits must maintain the accumulated adjustments account in order to

A. Determine the tax effect of any cash distributions.

B. Determine the tax effect of possible future postmerger distributions.

C. Determine the tax effect of distributions of property.

D. All of the answers are correct.

Answer (D) is **correct.**
S corporations maintain two types of records for each shareholder: adjustment accounts (AAA) and other adjustments accounts (OAA). These records, together with a shareholder's basis in his or her stock and any Subchapter C earnings and profits (E&P) in the corporation, are used to determine the shareholder tax treatment of distributions.

If an S corporation has no accumulated earnings and profits from prior operations as a C corporation, any amount distributed to a shareholder

A. Must be returned to the S corporation.

B. Increases the shareholder's basis in the stock.

C. Decreases the shareholder's basis in the stock.

D. Has no effect on the shareholder's basis in the stock.

Answer (C) is **correct.**
Section 1368(d) provides that if there are no accumulated earnings and profits, the S corporation treats distributions as a reduction in the shareholder's basis and therefore a nontaxable return of capital. If the entire basis is exhausted, any additional distribution is treated as a gain on the sale or exchange of property [Reg. 1.1368-1(c)].

Distributions of Property

Recognition of Gain

An S corporation recognizes gain realized on the distribution of appreciated property.

Amount and character of the gain and its treatment

Determined as if the distributed property were sold to the shareholder at its fair market value.

- Ordinary income results if the property is depreciable in the hands of a more-than-50% shareholder.

Distributions of Property -- Gain

Treatment of Gain

- The gain is passed through pro rata to each shareholder, and the shareholder's basis in his or her stock and the accumulated adjustments account are increased as if the S corporation had sold the property.
- The distributee shareholder must determine the proper treatment of the distribution.

Distributions of Property -- Gain

Example

The S Corporation sells an investment asset with a basis of $15,000 for $23,000.

The Corporation reports an $8,000 gain, which flows through to the shareholders

Distributions of Property -- Loss

When loss property is distributed, no loss may be recognized by the S corporation.

- The loss is passed through to the shareholders and is nondeductible.
- Each shareholder must reduce the basis in his or her stock in the S corporation and take a fair market value basis in the property distributed.
- The distributee shareholder must determine the proper treatment of the distribution.
- Sale to a non-related party instead of distribution results in pass-through of loss.

Distributions of Property -- Loss

Example

The S Corporation has a capital asset with a basis of $7,000 and a FMV of $5,000, which it distributes to the sole shareholder. The Corporation has a nondeductible loss of $2,000.

The shareholder reduces basis by $7,000 and has a $5,000 basis in the asset. If the Corporation sold the asset and distributed the proceeds, the shareholder would have a $2,000 deductible loss.

Distributions of Property -- Installment Obligations

Gain Non-Recognition

- An S corporation is not required to recognize gain on the liquidating distributions of certain installment obligations.
- The shareholder treats each payment as a passed-through item from the S corporation.

Which of the following is true regarding distributions from an S corporation?

A. Distributions do not include cash, only property.

B. Distributions of appreciated property are valued at the fair market value on original date of purchase.

C. Dividends paid to shareholders from accumulated earnings and profits are reported on Schedule K-1.

D. Property distributions (except for cash) require a statement attached to the Form 1120-S reporting the date the property was acquired, the distribution date, the property's fair market value on the distribution date, and the basis in the property distributed.

Answer (D) is **correct**.
Property distributions (except for cash) require a statement attached to the Form 1120-S reporting the date the property was acquired, the distribution date, the property's fair market value on the distribution date, and the basis in the property distributed (Form 1120-S Instructions).

Previous years' cash distributions to a shareholder have reduced his or her stock basis to zero in an S corporation. How will any further cash distributions be treated for tax purposes if the company continues to have losses?

A. It will be treated as a deemed sale of the shareholder's stock.

B. It will be treated as a capital contribution to the corporation.

C. It will receive passive activity loss treatment, subject to any limitations.

D. It will be carried over indefinitely to be offset with future earnings.

Answer (A) is **correct.**
Publication 550 states, "Generally, S corporation distributions, except dividend distributions, are considered a return of capital and reduce your basis in the stock of the corporation. The part of any distribution that is more than your basis is treated as a gain from the sale or exchange of property. The corporation's distributions may be in the form of cash or property."

Shareholder Treatment

Shareholder treatment of distributions from the S corporation is determined at the end of the S corporation's tax year.

The AAA, OAA, basis in shareholders' stock, and basis in corporate-shareholder debt must be adjusted for the S corporation's items of income, deduction, etc., for the entire tax year before determining the proper treatment by the shareholders for the distributions.

Shareholder Treatment

Shareholder treatment of distributions is straightforward when the S corporation has no Subchapter C E&P.

Portion Not exceeding Basis

That portion of distributions that does not exceed the basis in the shareholder’s stock in the S corporation is treated as tax-free return of capital.

Portion Exceeding Basis

Excess over basis is treated as gain on sale of the stock.

Shareholder Treatment

If there are Subchapter C E&P, the distribution is first treated as return of capital (tax-free) to the extent of the shareholder's AAA balance (up to any basis in the shareholder's stock).

- **Excess distribution beyond the AAA** - dividend income to the extent of Subchapter C E&P.
- **Excess distribution beyond Subchapter C E&P** - return of capital to the extent of the OAA.
- **Excess distributions beyond the OAA** - return of capital to the extent of any remaining basis in the stock.
- **Any excess distribution over basis** - treated as gain from the sale of the stock.

Any part of a distribution from either current or accumulated earnings and profits is reported to the shareholder as dividend income.

If an S corporation, which has accumulated earnings and profits (AE&P), is allowed to treat shareholder distributions as being made from the AE&P account, how will those distributions be taxed, if at all?

A. They will be taxed as dividend income.

B. They will be taxed as ordinary earned income.

C. They will be taxed as capital gain income.

D. They will not be taxed, as it would be deemed a return of shareholder capital.

Answer (A) is **correct.**
Any part of a distribution from either current or accumulated earnings and profits is reported to the shareholder as dividend income.

Shareholder Treatment

S Corporation without Subchapter C E&P

Shareholder Distribution	Tax Result
To extent of basis in stock	Not subject to tax; reduces basis in stock
In excess of basis of stock	Taxed as capital gain

S Corporation with Subchapter C E&P

Shareholder Distribution	Tax Result
To extent of AAA	Not subject to tax; reduces AAA and basis in stock
To extent of C corporation E&P	Taxed as a dividend; reduces E&P, but not basis in stock
To extent of OAA	Not subject to tax; reduces OAA and basis in stock
To extent of basis in stock	Not subject to tax; reduces basis in stock
In excess of basis	Taxed as capital gain

For Year 1, VBN, an S corporation, has accumulated earnings and profits (E&P) of $50,000 and a zero balance in its accumulated adjustment account. VBN distributes $230,000 to its sole shareholder, Raymond. His basis in the stock is $140,000. How should Raymond handle the distribution?

A. $230,000 as a taxable distribution.

B. $50,000 as a taxable dividend, $90,000 as return of capital, and $90,000 as capital gain.

C. $50,000 as a taxable dividend, $140,000 as return of capital, and $40,000 as capital gain.

D. $90,000 as dividend, $50,000 as return of capital, and $90,000 as nontaxable.

Answer (C) is **correct.**

Since the S corporation does not have an accumulated adjustment account balance, any distribution is first treated as a dividend to the extent of accumulated E&P. After the accumulated E&P balance is reduced to zero, any distribution remaining will reduce any remaining basis of the shareholder's stock, and then any remainder will be treated as a capital gain from the sale of property. Therefore, Raymond will handle the distribution by treating $50,000 as a taxable dividend, $140,000 as a return of capital, and $40,000 as capital gain.

Example

A single-owner S corporation has an AAA of $12,000 and E&P of $8,000. The shareholder's basis is $25,000.

The first $12,000 of any distribution reduces AAA to $0 ($12,000 AAA – $12,000 of distribution) and shareholder basis by $12,000 to $13,000 ($25,000 basis – $12,000 of distribution) and is nontaxable.

The next $8,000 of distributions is classified as dividend income and reduces E&P to $0 ($8,000 E&P – $8,000 of distribution).

The next $13,000 (i.e., the balance of basis calculated previously) of distributions is a tax-free reduction of basis and is classified as return of capital.

Any distributions above $33,000 ($25,000 basis + $8,000 E&P) will be taxed as capital gain income.