Chapter C:2

Corporate Formations and Capital Structure

Discussion Questions

C:2-1 Various. A new business can be conducted as a sole proprietorship, partnership, C corporation, S corporation, LLC, or LLP. Each form has tax and nontax advantages and disadvantages. See pages C:2-2 through C:2-8 for a listing of the tax advantages and disadvantages of each form. A comparison of the C corporation, S corporation, and partnership alternative business forms appears in Appendix F. pp. C:2-2 through C:2-8.

C:2-2 Alice and Bill should consider forming a corporation and making an S corporation election. An S corporation election will permit the losses incurred during the first few years to be passed through to Alice and Bill and be used to offset income from other sources. The corporate form affords them limited liability. As an alternative to incorporating, Alice and Bill might consider setting up a limited liability company that is taxed as a partnership and also has limited liability. pp. C:2-6 through C:2-8.

C:2-3 Yes, several alternative classifications. The only default tax classification for the LLC is a partnership. Because the LLC has two owners, it cannot be taxed as a sole proprietorship. The entity can elect to be taxed as a C corporation or an S corporation. If the entity makes such an election, Sec. 351 applies to the deemed corporate formation. The entity would have to make a separate election to be treated as an S corporation. pp. C:2-8 and C:2-9.

C:2-4 The default tax classification for White Corporation is a C corporation. However, White can be treated as an S corporation if it makes the necessary election. Following an S corporation election, the entity's income will be taxed to its owners, thereby avoiding double taxation. The S corporation election is made by filing Form 2553 within the first 2½ months of the corporation's existence (see Chapter C:11). pp. C:2-6 and C:2-7.

C:2-5 The only default tax classification for the LLC is a sole proprietorship. Because the LLC has only a single owner, it cannot be treated as a partnership. Thus, the default classification is a "disregarded entity" taxed as a sole proprietorship. The entity can elect to be taxed as a C corporation or an S corporation. If the entity makes such an election, Sec. 351 applies to the deemed corporate formation. pp. C:2-8 and C:2-9.

C:2-6 Possible arguments include:

PRO (Corporate formations should be taxable events):

1. A corporate formation is an exchange transaction; therefore, parties to the exchange should recognize gains and losses.
2. Making a corporate formation a taxable event increases tax revenues.
3. Simplification is achieved by eliminating one of the two options - whether a transaction is taxable or not. This change will make administration of the tax laws easier.

4. This change eliminates the need for taxpayers to structure transactions to avoid Sec. 351 to recognize gains and/or losses.

CON (No change should occur to current law):

1. A change in current law would hurt start-up corporations by reducing their capital through the income tax paid by transferors on an asset transfer.
2. No economic gains or losses are realized. Just a change in the form of ownership (direct vs. indirect) has occurred. Therefore, it is not appropriate to recognize gains and losses at this time.
3. With taxation, corporations will have to raise more capital because transferors of noncash property will have less capital to invest and because money must be diverted to pay taxes.
4. Taxpayers are prevented from recognizing losses under the current system, thereby increasing revenues to the government.
5. With taxation, businesses would be deterred from incorporating because of the tax consequences, and therefore economic growth in the U.S. would be adversely affected. pp. C:2-9 and C:2-10.

C:2-7 The following tax consequences, if Sec. 351 applies: Neither the transferor nor the transferee corporation recognizes gain or loss when property is exchanged for stock. Unless boot property (i.e., property other than qualified stock) is received, the transferor's realized gain or loss is deferred until he or she sells or exchanges the stock received. If boot property is received, the recognized gain is the lesser of (1) the amount of money plus the FMV of the nonmoney boot property received or (2) the realized gain. The transferor recognizes no losses even if boot property is received. The transferor's basis in the stock received references his or her basis in the property transferred and is increased by any gain recognized and is reduced by the amount of money plus the FMV of the nonmoney boot property received and the amount of any liabilities assumed by the transferee corporation. The basis of the boot property is its FMV. The transferee corporation recognizes no gain on the transfer. The transferee corporation's basis in the property received is the same basis that the transferor had in the property transferred increased by any gain recognized by the transferor. pp. C:2-12, C:2-16, and C:2-17.

C:2-8 For purposes of Sec. 351, the following items are considered to be property: Money and almost any other kind of tangible or intangible property, including installment obligations, accounts receivable, inventory, equipment, patents, trademarks, trade names, and computer software. Property does not include services, an indebtedness of the transferee corporation that is not evidenced by a security, or interest on an indebtedness that accrued on or after the beginning of the transferor's holding period for the debt. pp. C:2-12 and C:2-13.

C:2-9 "Control" is defined as follows: Transferrers as a group must own at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock. The nonvoting stock ownership is tested on a class-by-class basis. pp. C:2-13 through C:2-16.

C:2-10 The IRS has interpreted the phrase as follows: Sec. 351 requires the transferors to control the transferee corporation immediately after the exchange but does not specify how long this control must be maintained. The transferors, however, must not have a prearranged plan to dispose of their stock outside the control group. If they have such a plan, the IRS may not treat the transferors as in control immediately after the exchange. p. C:2-16.

C:2-11 No. The Sec. 351 requirements are not met because Peter is not considered a transferor of property. Even though he transferred $1,000 of money, this property is of nominal value--less than 10% of the value of the stock he received for services ($49,000). Therefore, only John and Mary are deemed to have transferred property and, since they own only 66-2/3% of the stock of New Corporation, they are not in control. The 10% minimum is specified in Rev. Proc. 77-37 and applies only for advance ruling purposes. The shareholders may choose to engage in the transaction without an advance ruling, report it as nontaxable, and run the risk of being audited, with the result that the IRS treats the transaction as taxable. Alternatively, they might restructure the transaction by having Peter provide a larger amount of cash to the corporation and take more shares of stock. Another option would be for Peter to provide fewer services with the increased amount of cash and still receive 100 shares of stock. pp. C:2-14 and C:2-15.

C:2-12 No. Section 351 does not require that the shareholders receive stock equal in value to the property transferred. Section 351 would apply to the transfer by Susan and Fred if all other requirements are met. However, Fred probably will be deemed to have made a gift of 25 shares of stock, paid compensation of $25,000, or repaid a $25,000 debt to Susan by transferring the Spade stock. pp. C:2-15 and C:2-16.

C:2-13 Yes. Section 351 applies to property transfers to an existing corporation. For the exchange to be tax-free, the transferors must be in control of the corporation immediately after the exchange. In this example, Carl is <u>not</u> in control since he owns only 75 out of 125 shares, or 60% of the North stock. Therefore, the Sec. 351 requirements are not met. To qualify under Sec. 351, Carl can transfer enough property to acquire a total of 200 shares out of 250 (200 shares held by Carl and 50 shares held by Lynn) outstanding shares. In this situation, Carl would own exactly 80% of North stock (250 shares x 0.80 = 200 shares). A less expensive alternative would be for Lynn to transfer property equal to or exceeding $10,000 (50 shares owned x $2,000 per share x 10% minimum) to be considered a transferor. pp. C:2-14 and C:2-15.

C:2-14 The transferor's basis in stock received in a Sec. 351 exchange is determined as follows (Sec. 358(a)):

Adjusted basis of property transferred to the corporation	
Plus:	Any gain recognized by the transferor
Minus:	FMV of boot received from the corporation
	Money received from the corporation
	The amount of any liabilities assumed by the transferee corporation
Adjusted basis of stock received	

For purposes of calculating stock basis, liabilities assumed by the transferee corporation are considered money and reduce the shareholder's basis in any stock received (Sec. 358(d)).

The shareholder's holding period for the stock includes the holding period of any capital assets or Sec. 1231 assets transferred. If the shareholder transfers any other property (e.g., inventory), the holding period for any stock received begins on the day after the exchange date. This rule can cause some shares of transferee corporation stock to have two different holding periods. The shareholder's basis for any boot property is its FMV, and the holding period begins on the day after the exchange date (Sec. 358(a)(2)). pp. C:2-18 and C:2-19.

C:2-15 Two sets of circumstances may require recognition of gain when liabilities are transferred.

- First, all liabilities assumed by a controlled corporation are considered boot if the principal purpose of the transfer of any portion of such liabilities is tax avoidance or if no bona fide business purpose exists for the transfer (Sec. 357(b)).
- Second, if the total amount of liabilities transferred to a controlled corporation exceeds the total adjusted basis of all property transferred by the transferor, the excess liability amount is treated as a gain taxable to the transferor without regard to whether the transferor had actually realized gain or loss (Sec. 357(c)).

Under the second set of circumstances, the transferor recognizes gain, but the excess liabilities are not considered to be boot. Section 357(c)(3) provides special rules for cash basis transferors who transfer excess liabilities to a corporation. pp. C:2-22 through C:2-25.

C:2-16 The IRS likely would consider the following two factors: (1) The transferor's reason for incurring the liability (e.g., did the liability relate to the transferor's trade or business). (2) The length of time from when the liability was incurred to the transfer date. If the transferor incurred the liability in connection with his or her trade or business, a Sec. 357(b) "problem" probably would not exist even if the transferor incurred the liability shortly before the transfer date. pp. C:2-12 through C:2-27.

C:2-17 If Mark receives no boot, depreciation is not recaptured (Secs. 1245(b)(3) and 1250(d)(3)). The recapture potential is transferred to Utah Corporation along with the property. If Mark <u>does</u> receive boot and must recognize gain, the recognized gain is treated as ordinary income but not in an amount exceeding the recapture potential. Any remaining recapture potential is transferred to Utah. If Utah sells the property at a gain, it must recapture depreciation deducted by Mark and not recaptured at the time of the transfer, as well as depreciation that it has claimed. Depreciation in the year of transfer must be allocated between the transferor and transferee according to the number of months each party has held the property. The transferee is considered to have held the property for the entire month in which the property was transferred. pp. C:2-25 through C:2-27.

C:2-18 The assignment of income doctrine could apply to a transfer of unearned income. However, the assignment of income doctrine does not apply to a transfer of accounts receivable by a cash method transferor in a Sec. 351 exchange if (1) the transferor transfers substantially all the assets and liabilities of a business and (2) a business purpose exists for the transfer. (See Rev. Rul. 80-198, 1980-2 C.B. 113.) p. C:2-27.

C:2-19 In enacting Sec. 385, Congress mandated that the following factors be taken into account in determining whether an amount advanced to a corporation should be characterized as debt or equity capital:

- Whether there is a written unconditional promise to pay on demand or on a specified date a sum certain in money in return for an adequate consideration in money or money's worth, and to pay a fixed rate of interest,
- Whether the debt is subordinate to or preferred over other indebtedness of the corporation,
- The ratio of debt to equity of the corporation,
- Whether the debt is convertible into the stock of the corporation, and
- The relationship between holdings of stock in the corporation and holdings of the interest in question.

Although Congress enacted Sec. 385 in an attempt to provide statutory guidelines for the debt/equity question, the lack of a subsequent set of interpretative regulations has required taxpayers, the IRS, and the courts to continue to use these statutory factors and other factors identified by the courts in ascertaining whether an instrument is debt or equity. Amendment of Sec. 385 in 1989 to permit part-debt and part-equity corporate instruments has lead to the issuance of administrative pronouncements (e.g., Notice 94-97, 1947-1 C.B. 357) that interpret the Sec. 385 statutory guidelines. See also O.H. Kruse Grain & Milling v. CIR, 5 AFTR 2d 1544, 60-2 USTC ¶9490 (9th Cir., 1960) cited in footnote 47 of the text, which lists additional factors the courts might consider. pp. C:2-27 and C:2-28.

C:2-20 Advantages of using debt include: Interest is deductible by the payor while a dividend payment is not deductible, and the repayment of an indebtedness generally is treated as a return of capital while a stock redemption often is treated as a dividend. Disadvantages of using debt include that dividend payments are eligible for a dividends-received deduction when received by a corporate shareholder; stock can be received tax-free as part of a corporate formation and/or reorganization while the receipt of debt usually is treated as boot; a distribution of stock to shareholders can be a nontaxable stock dividend while a distribution of a debt usually results in dividend income; and worthless stock results in an ordinary loss under Sec. 1244 while a worthless debt instrument generally results in a capital loss. pp. C:2-29 and C:2-30.

C:2-21 Ordinary loss treatment. The principal advantage of satisfying the Sec. 1244 small business stock requirements is the ordinary loss treatment available for individual shareholders and certain partnerships reporting up to $50,000 (or $100,000 if married and filing jointly) of losses incurred on a sale or exchange of the stock. Ordinary loss treatment is available only if the loss is incurred by a qualifying shareholder who acquired the stock from the small business corporation; the corporation was a small business corporation at the time it issued the stock (i.e., a corporation whose aggregate money and other property received for stock is less than $1 million); the corporation issued the stock for money or property (other than stock or securities); and the issuing corporation derived more than 50% of its aggregate gross receipts from active sources during the most recent five tax years ending before the date when the stock was sold or exchanged. pp. C:2-32 and C:2-33.

C:2-22 The two advantages of business bad debt treatment are (1) a business bad debt deduction can be claimed for partial worthlessness and (2) a business bad debt can be deducted as an ordinary loss. A nonbusiness bad debt can be deducted only in the year in which total worthlessness occurs. No partial write-offs of nonbusiness bad debts are permitted. A nonbusiness bad debt can be deducted only as a short-term capital loss. These losses can offset capital gains or be deducted by individuals up to $3,000 in a tax year. No limit exists on business bad debt deductions and, if such losses exceed income, they can be carried back as part of a net operating loss. To claim a business bad debt deduction, the holder must show that the dominant motivation for the loan was related to the taxpayer's business and was not related to the taxpayer's investment activities. pp. C:2-33 and C:2-34.

C:2-23 To recognize gain or loss. Shareholders might avoid Sec. 351 treatment if, in transferring property, they realize a gain or loss that they want to recognize. They may be able to avoid Sec. 351 treatment by violating one or more of its requirements, for example, by selling the property to the corporation for cash, by selling the property to a third party who contributes it to the corporation, or by receiving sufficient boot to recognize the gain. pp. C:2-34 through C:2-36.

C:2-24 The reporting requirements are as follows: Every person who receives stock, securities, or other property in a Sec. 351 exchange must attach a statement to his or her tax return for the period that includes the date of the exchange. The statement must include all the facts pertinent to the exchange (see Reg. Sec. 1.351-3(a)). Similarly, the transferee corporation must attach a statement to its tax return for the year in which the exchange took place (see Reg. Sec. 1.351-3(b)). The transferee's statement requires a description of the property and liabilities received from the transferors and the stock and property transferred to the transferors in exchange for the property. p. C:2-36.

Issue Identification Questions

C:2-25 Mary and Peter should consider the following tax issues:

- Does the property transfer meet the Sec. 351 requirements?
    - Have Peter and Mary transferred property? Does Peter's controlling Trenton Corporation prior to the transfer change the tax result?
    - Are the transferors in control of the corporation immediately after the transfer?
    - Do the transferors receive transferee corporation stock?
- What is each shareholder's recognized gain?
- What is each shareholder's basis in his or her stock?
- What is each shareholder's holding period for his or her stock?
- Does Trenton recognize gain when it issues its stock?
- What is Trenton's basis in the property received from Mary?
- What is Trenton's holding period for the property received from Mary?

The property transfer meets all the Sec. 351 requirements. Peter and Mary are considered to own all 195 of the Trenton shares immediately after the exchange. Peter's contribution of cash for stock is not considered to be a nominal amount according to IRS rules relating to the issuance of private letter rulings (i.e., it equals or exceeds 10% of the value of Peter's prior stock holdings). Thus, his stock is counted towards the 80% minimum stock ownership for control. Mary recognizes no gain on the asset transfer and takes a $50,000 basis in the Trenton shares she receives. The holding period for the Trenton shares includes her holding period for the property transferred. Trenton recognizes no gain when it issues its stock and takes a $50,000 basis in the property. pp. C:2-12 through C:2-30.

C:2-26 Carl and his son should consider the following tax issues:

- Does the property transfer meet the Sec. 351 requirements?
  - Have Carl and his son transferred property?
  - Are the transferors in control of the corporation immediately after the transfer?
  - Do the transferors receive transferee corporation stock?
- Does the property contribution/receipt of stock as described in the facts reflect the true nature of the transaction? Or, has a deemed gift or other event occurred?
- What is each shareholder's recognized gain?
- What is each shareholder's basis in his stock?
- What is each shareholder's holding period in his stock?
- If a deemed gift has been made, is it a taxable gift from Carl to his son? (This question could be rewritten for events other than a gift (e.g., repayment of a loan.))
- What is Cook Corporation's basis in the property received from Carl?
- What is Cook's holding period for the property received from Carl?

The contribution is nontaxable because it meets all the Sec. 351 requirements, and Carl and Carl, Jr. own all the Cook stock. Carl, Jr. receives a disproportionate amount of stock relative to his $20,000 capital contribution. It appears that the transaction should be recast so that Carl is deemed to receive 80 shares of stock, each valued at $1,000. He then gifts 30 shares to Carl, Jr. The deemed gift leaves each shareholder with 50 shares of stock. Neither shareholder recognizes any gain, and Carl takes a $50,000 adjusted basis in the 80 shares he receives. He recognizes no gain on the transfer of 30 shares to Carl, Jr., and $18,750 [(30/80) x $50,000] of his basis accompanies the deemed gifted shares. Carl's basis in his remaining 50 shares is $31,250 ($50,000 - $18,750). Carl, Jr's basis in his 50 shares is $38,750 ($20,000 + $18,750). pp. C:2-9 through C:2-27.

C:2-27 Bill should consider the following tax issues:

- Was the stock sold to a related party (Sam), as defined by Sec. 267(b)? If so, Bill cannot recognize the loss, and the remaining issues need not be examined. If not, then...
- Is the stock a capital asset?
- Is Bold a qualifying small business corporation?
- If so, does the stock qualify for Sec. 1244 stock treatment?
- If Sec. 1244 stock, what is Bill's marital and filing status?
- Has Bill's basis in the stock changed relative to its initial acquisition cost?
- What is the amount and character of Bill's recognized loss?

Bill's stock sale results in the realization of a $65,000 ($100,000 - $35,000) long-term capital loss. If the purchaser is a related party, Sec. 267(a) precludes Bill from recognizing the loss. Because Bill is the original holder of the stock, the loss may be characterized as ordinary under Sec. 1244, assuming the various requirements of that provision are satisfied. pp. C:2-32 and C:2-33.

Problems

C:2-28 With the given facts, the C corporation option with the salary payment results in the lowest total tax, as determined in the following analysis:

	Sole Proprietorship	C Corporation With Salary	C Corporation With Dividend	S Corporation With Salary	S Corporation With Distribution
Entity Level:					
Income before salary	$50,000	$50,000	$50,000	$50,000	$50,000
Salary deduction	-0-	(20,000)	-0-	(20,000)	-0-
Taxable income	$50,000	$30,000	$50,000	$30,000	$50,000
Entity level tax	$ -0-	$ 4,500	$ 7,500	$ -0-	$ -0-
Lucia:					
Pass-through income	$50,000	$ -0-	$ -0-	$30,000	$50,000
Salary income	-0-	20,000	-0-	20,000	-0-
Dividend income	-0-	-0-	20,000	-0-	-0-
Total income to Lucia	$50,000	$20,000	$20,000	$50,000	$50,000
Lucia's tax	$12,500[a]	$ 5,000[b]	$ 3,000[c]	$12,500[d]	$12,500[e]
Total Tax	$12.500	$ 9,500	$10,500	$12.500	$12.500

[a]$50,000 x 0.25 = $12,500
[b]$20,000 x 0.25 = $5,000
[c]$20,000 x 0.15 = $3,000
[d]$50,000 x 0.25 = $12,500
[e]$50,000 x 0.25 = $12,500

Because corporate taxable income is low enough to be taxed at 15% and dividends are taxed at 15%, the C corporation options are better than the sole proprietor and S corporation options because, under the latter options, all income is taxed at Lucia's 25% ordinary tax rate. Within the C corporation options, the salary situation is better than the dividend situation because less income is subject to double taxation as a result of the salary deduction. These results apply only to the given factual circumstances. For example, if the corporation's income were taxed at higher marginal tax rates, such as 35% or 39%, the C corporation options would be less attractive than the sole proprietor and S corporation options. pp. C:2-2 through C:2-8.

C:2-29 a. None. Dick does not recognize his $10,000 realized loss.

b. $60,000 basis in Triton shares received. Dick's holding period is deemed to begin three years ago when Dick originally purchased the land.

c. None. Evan does not recognize his $15,000 realized loss.

d. $45,000 basis in Triton shares received. Evan's holding period is deemed to begin four years ago when Evan originally purchased the machinery.

e. Fran recognizes $20,000 of ordinary income.

f. $20,000 basis in Triton shares received. Fran's holding period begins the day after the exchange date in the current year.

g. Triton takes a $50,000 basis in the land and a $30,000 basis in the machinery. Because of the loss property limitation rule, the bases of these assets are reduced to their respective FMVs, assuming the parties do not elect to reduce stock basis. Thus, both assets have a holding period that begins the day after the transfer in the current year. The services, if capitalized, would have a $20,000 basis and a holding period starting in the current year. pp. C:2-9 through C:2-22.

C:2-30 a. $20,000 gain. The Sec. 351 requirements have not been met because 30% of the stock is issued for services. Therefore, Ed recognizes $20,000 ($35,000 - $15,000) of capital gain.

b. $35,000 basis in Jet shares received. Ed's holding period begins on the day after the exchange date.

c. Fran recognizes a $10,000 ($35,000 - $45,000) Sec. 1231 loss.

d. $35,000 basis in Jet shares received. Fran's holding period begins on the day after the exchange date.

e. George recognizes $30,000 of ordinary income.

f. $30,000 basis in Jet shares received. George's holding period begins the day after the exchange date.

g. Jet Corporation takes a $35,000 basis in the land and a $35,000 basis in the machinery. Its holding period for each asset begins the day after the exchange date. The services, if capitalized, would have a $30,000 basis.

h. Because the Sec. 351 requirements would now have been met, the answers change as follows:

- a. Ed recognizes no gain or loss.
- b. $15,000 basis in the Jet shares received. Ed's holding period is deemed to begin four years ago when he originally purchased the land.
- c. Fran recognizes no loss.
- d. $45,000 basis in the Jet shares received. Fran's holding period is deemed to begin four years ago when she originally purchased the machinery.
- e. George recognizes $25,000 of ordinary income.
- f. $30,000 ($5,000 cash + $25,000 FMV of services) basis in the Jet shares received. George's holding period begins the day after the exchange date.
- g. Jet's basis in the land and machinery are $15,000 and $35,000, respectively. The loss property limitation rule limits the corporation's basis in the machinery to its FMV. Jet's holding period for the land is deemed to begin four years ago when Dick originally purchased the land. The holding period for the machinery begins the day after the exchange date because, by having its basis reduced to FMV, it no longer has a basis that references the

transferor's basis before the exchange. The services, if capitalized, would have a $25,000 basis. pp. C:2-12 through C:2-22.

C:2-31 a. The control requirement is not met. Transferors of property receive only 75% and thus do not have 80% control.

b. The control requirement is met. Robert transferred more than a nominal amount of property. The 80% control requirement has been met since all of Robert's stock is counted for this purpose.

c. The control requirement is not met. Sam owns only 33-1/3% of the Vast stock immediately after the exchange. No stock ownership is attributed from Sam's parents to Sam.

d. The control requirement is met. Charles and Ruth own 100% of the Tiny stock. The transfers do not have to be simultaneous.

e. The control requirement is not met. Charles had a prearranged plan to sell a sufficient amount of shares to fail the control test. Only if Sam were considered to be a transferor (i.e., the sale took place as part of a public offering) would the transaction meet the requirements of Sec. 351. pp. C:2-13 through C:2-16.

C:2-32 a. The control requirement is met. The property transferred by Fred is not considered to be nominal relative to the value of stock received for services. Therefore, Fred and Greta are considered to own 100% of the New stock.

b. The control requirement is not met. For advance ruling purposes, Maureen's shares are not counted towards determining whether the control requirement has been met because the property she contributed was nominal (i.e., does not meet the 10% property minimum of Rev. Proc. 77-37) compared to the value of the stock received for services. The taxpayer may choose to enter into the transaction without an advance ruling, report it as nontaxable, and run the risk of being audited, with the result that the IRS treats the transaction as taxable. Alternatively, Maureen can contribute additional property so that the amount of property equals or exceeds the 10% minimum. The minimum property contribution is $4,545 [$4,545 = 0.1 x ($50,000 - $4,545)]. The $4,545 amount is found by solving the following equation for Property: Property = 0.1 x ($50,000 - Property), which solves to Property = (0.1 x $50,000)/1.1. pp. C:2-13 and C:2-14.

C:2-33 Veronica needs to receive 1,000 additional shares in exchange for $25,000 worth of silver bullion. The 200 shares currently held by Veronica equal 40% of the 500 shares outstanding. To avoid recognizing a gain, Veronica must be "in control" of Poly-Electron immediately after the exchange. Control implies ownership of at least 80% of the total number of Poly-Electron shares outstanding.

The number of additional shares that Veronica must acquire to achieve control can be calculated as follows, where A = additional shares needed:

$$(200 + A) / (500 + A) = 0.80$$
$$200 + A = 0.80 \times (500 + A)$$
$$200 + A = 400 + 0.80 A$$
$$0.20 A = 200$$
$$A = 1{,}000 \text{ additional shares}$$

Thus, with the additional 1,000 shares, Veronica will have 80% control after the exchange (i.e., 1,200 / 1,500 = 80%.) If each share is worth $25, the value of silver bullion that Veronica must contribute is $25,000 (1,000 shares x $25). Having achieved control, Veronica's exchange will qualify for nontaxable treatment under Sec. 351. pp. C:2-13 through C:2-15.

C:2-34 a. No. The exchange does not qualify as nontaxable under Sec. 351 because Al and Bob do not control West Corporation. (Al owns only 1,000/1,300 = 76.9% of the voting common stock while Bob owns 100% of the nonvoting preferred stock). Al recognizes $25,000 of gain on the transfer of the patent. His basis in his West stock is $25,000. Bob recognizes no gain or loss because he contributed cash. His basis in the preferred stock is $25,000. Carl recognizes $7,500 of ordinary income. His basis in his West stock is $7,500. West recognizes no gain or loss on the exchange. Its basis for the assets is: cash, $25,000; patent, $25,000; and services, $7,500.

b. Nontaxable. The exchange now qualifies as nontaxable under Sec. 351 because Al and Bob together own 1,200/1,500 = 80% of the voting common stock and 100% of the nonvoting preferred stock. Al recognizes no gain or loss, and his basis in his West stock is zero. Bob recognizes no gain or loss, and his basis in his West stock is $25,000. Carl recognizes $7,500 of ordinary income, and his basis in his West stock is $7,500. The consequences to West are the same as in Part a, except the basis for the patent is zero instead of $25,000.

c. Nontaxable. The exchange apparently would qualify under Sec. 351. Assuming the $800 of cash contributed is acceptable under Rev. Proc. 77-37 because it meets the 10% property minimum for advance ruling purposes, Al and Bob would recognize no gain or loss. Carl would recognize $6,700 of ordinary income. The consequences to West are the same as in Part b except the cash contributed by Carl takes an $800 basis and the services generate $6,700 of taxable income. pp. C:2-13 through C:2-16.

C:2-35

	Cash	Equipment	Building	Land	Total
FMV of assets	$ 5,000	$90,000	$40,000	$30,000	$165,000
Fraction of total value	0.030303	0.545455	0.242424	0.181818	1.0000
FMV of stock received	$ 3,788	$68,182	$30,303	$22,727	$125,000
Plus: Boot property	1,212	21,818	9,697	7,273	40,000
Total proceeds	$ 5,000	$90,000	$40,000	$30,000	$165,000
Minus: Adj. basis of assets	(5,000)	(60,000)	(51,000)	(24,000)	(140,000)
Gain (loss) realized	$ -0-	$30,000	($11,000)	$ 6,000	$ 25,000
Allocation of boot	$ 1,212	$21,818	$ 9,697	$ 7,273	$ 40,000
Gain recognized	$ -0-	$21,818	$ -0-	$ 6,000	$ 27,818

a. $27,818 gain recognized:

Gain on equipment, ordinary income (recapture on Sec. 1245 property)	$21,818
Gain on land, Sec. 1231 gain	6,000
Total gain recognized	$27,818

b. $40,000 basis in stock:

Adj. basis of property transferred	$140,000
Minus: FMV of boot received	(40,000)
Plus: Gain recognized by transferor	27,818
Basis in stock	$127,818
Basis in interest-bearing notes ($10,000 each):	$ 40,000

c. $165,000 total basis in the property received:

	Tom's Basis	Recog. Gain	Reduction*	Total
Cash	$ 5,000	$ -0-	$ -0-	$ 5,000
Equipment	60,000	21,818	-0-	81,818
Building	51,000	-0-	(2,818)	48,182
Land	24,000	6,000	-0-	30,000
Total	$140,000	$27,818	$(2,818)	$165,000

*Total adjusted basis = $167,818 ($140,000 + $27,818); total FMV = $165,000. Thus, the reduction under Sec. 362(e)(2) = $2,818 ($167,818 - $165,000). Reg. Sec. 1.362-4(g)(2)(ii), adjusted basis includes the increase for gain recognized by the shareholder.

pp. C:2-16 through C:2-22.

C:2-36 $15,000. Ann must recognize $15,000 ($25,000 - $10,000) of gain on the exchange. To comply with the advance ruling requirements of Rev. Proc. 77-37, Fred must receive more than a nominal amount of stock in exchange for his property. If Fred obtained additional stock worth at least 10% of the value of the stock he already owned (i.e., at least five shares of stock in exchange for $5,000), his stock likely would be counted for control purposes, and the Sec. 351 requirements would be met. Ann may choose to enter into the transaction without increasing her property contribution so as to acquire at least 80% of Zero's stock or without having Fred increase his contribution to at least $5,000, proceed without an advance ruling, and report the transaction as being nontaxable. Ann and Fred then run the risk of being audited and the IRS's arguing the transaction is taxable. pp. C:2-14 and C:2-15.

C:2-37 $4,000. Lucy recognizes $4,000 ($12,000 - $8,000) gain on the exchange because she owns less than 80% of the stock immediately after the exchange [(50+10)/110=54.5%]. To qualify under Sec. 351:
(1) Lucy could contribute additional property for enough additional stock to obtain 80% control. To meet the 80% control requirement, she would have to purchase an additional 150 shares to own 200 shares (of the 250 shares outstanding).
(2) Marvin could exchange enough property as part of the same transaction to qualify as a transferor under Sec. 351. For advance ruling purposes under Rev. Proc. 77-37, Marvin would have to contribute at least $6,000 for an additional five shares of stock to be considered a transferor of property. The taxpayers may choose to engage in the transaction without Lucy's and Marvin's increasing their property contributions, proceed without an advance ruling, and report it as being

nontaxable. However, they would run the risk of being audited and the IRS's arguing the transaction is taxable. pp. C:2-14 and C:2-15.

C:2-38 a. None. Neither Jerry nor Frank recognizes any gain or loss on the exchange because the Sec. 351 requirements have been met.

b. $44,000. Because the exchange is disproportionate, Frank probably could be deemed to have made a gift of 25 shares of Texas stock to Jerry. Jerry's basis in his 75 shares is $44,000 ($28,000 basis in property transferred by Jerry + $16,000 basis in the 25 shares received from Frank). This calculation presumes that no gift taxes are paid on the transfer. If gift taxes are paid, a second basis adjustment may be needed for the portion of the gift tax attributable to the appreciation.

c. $16,000. Frank's basis in his 25 Texas shares is $16,000 [$32,000 basis in property transferred x (25/50)]. pp. C:2-15 and C:2-16.

C:2-39 a. $20,000 capital gain:

Amount realized	$170,000
Minus: Basis in land	(30,000)
Realized gain	$140,000
Boot received (note)	$ 20,000
Gain recognized (capital in character)	$ 20,000

b. $30,000. Basis of common stock and preferred stock: $30,000 + $20,000 - $20,000 = $30,000. This basis must be allocated to the common and preferred stock based on their relative fair market values.

Basis of common stock: $\frac{\$100{,}000}{\$150{,}000}$ x $30,000 = $20,000

Basis of preferred stock: $\frac{\$50{,}000}{\$150{,}000}$ x $30,000 = $10,000

Basis of short-term note: $20,000 (FMV).

c. Basis of land to Temple Corporation: $50,000 = $30,000 + $20,000

pp. C:2-16 through C:2-22.

C:2-40 a. None for Karen and Larry; $7,000 capital gain to Joe. Karen and Larry recognize no gain or loss under Sec. 351 because they receive only stock. Joe recognizes a $7,000 ($15,000 - $8,000) capital gain because he receives only notes and therefore does not qualify for Sec. 351 treatment.

b. Joe's basis in the notes is $15,000. Karen's basis in the stock is $18,000. Larry's basis in the stock is $25,000.

c. Gray Corporation's basis in the land is $15,000. Gray's basis in the equipment is $18,000. The $10,000 of depreciation recapture potential is inherited by Gray because Karen does not recognize a gain on the asset transfer. pp. C:2-16 through C:2-19.

C:2-41 a. $4,000 gain. Nora realizes a $7,000 gain [($18,000 + $4,000) - $15,000] and must recognize a gain of $4,000, the amount of the boot (note) received. Of the $4,000 gain, $3,000 is ordinary income recaptured under Sec. 1245. The remaining $1,000 is a Sec. 1231 gain.

b. $4,000 and $15,000. Nora's basis in the note is $4,000, its FMV. Nora's basis in the stock is $15,000 ($15,000 + $4,000 gain - $4,000 FMV of note).

c. $19,000. Needle Corporation's basis in the machinery is $19,000 ($15,000 + $4,000 gain recognized). pp. C:2-16 through C:2-22 and C:2-25 through C:2-27.

C:2-42 a. $3,000 of ordinary income: Jim realizes a $3,500 [($5,000 + $1,000 + $2,000) - $4,500] gain and recognizes a $3,000 gain. Because the $2,000 education loan assumed by Gold Corporation has no apparent business purpose, all liabilities transferred to Gold are treated as boot under Sec. 357(b). All of Jim's gain is ordinary income recaptured under Sec. 1245.

b. $4,500. Jim's basis in his stock is $4,500 ($4,500 + $3,000 - $3,000).

c. Jim's holding period for the additional shares includes his holding period for the automobile.

d. $7,500. Gold's basis in the automobile is $7,500 ($4,500 + $3,000). pp. C:2-22 and C:2-23.

C:2-43 a. $3,000 of ordinary income, determined as follows:

Stock (FMV) received		$17,000
Release from liability		28,000
Amount realized		$45,000
Minus: Basis of property transferred		
Machinery	$15,000	
Money	10,000	(25,000)
Realized gain		$20,000
Liability assumed		$28,000
Minus: Basis of all property transferred		(25,000)
Recognized gain (Sec. 357(c))		$ 3,000

The gain is treated as ordinary income under Sec. 1245 recapture rules.

b. Zero basis:

Property transferred	$25,000
Minus: Boot received (including liability)	(28,000)
Plus: Gain recognized	3,000
Basis in Moore stock	$ -0-

c. $18,000 basis:

Barbara's basis in the machine	$15,000
Plus: Barbara's recognized gain	3,000
Moore corporation's total basis in machinery	$18,000

d. Sam recognizes no gain or loss.

e. $17,000 basis, the amount of money he contributed to Moore for the stock.

f. Barbara's holding period for her stock includes her holding period for the machinery. Sam's holding period starts on the day after the exchange date.

g. Sec. 351 would not apply, so the answers would change as follows:

   a. $20,000 ordinary income. Barbara would recognize $20,000 of ordinary income recaptured under Sec. 1245.

   b. $17,000 basis. Barbara's basis in the stock would be $17,000, its FMV.

   c. $35,000 basis. Moore's basis in the machinery would be $35,000, its FMV.

d. $17,000 ordinary income. Sam would recognize $17,000 of ordinary income from compensation.
e. $17,000 basis. Sam's basis in the Moore stock would be $17,000, its FMV.
f. Sam's holding period for his stock would start on the day after the exchange date. Barbara's stock would have a split holding period because she contributed both Sec. 1231 property and cash.

pp. C:2-24 and C:2-25.

C:2-44 a. $3,000 gain recognized. Jerry realizes an $18,000 [($15,000 + $35,000) - $32,000] gain and recognizes a $3,000 ($35,000 - $32,000) gain because the liabilities exceed the property's basis (Sec. 357(c)).

b. Zero basis. Jerry's basis in his Emerald stock is zero ($32,000 + $3,000 - $35,000).

c. $35,000 basis. Emerald's basis in the property is $35,000 ($32,000 + $3,000).

d. a. No gain or loss. Jerry recognizes no gain or loss because the liabilities are not considered boot and do not exceed the basis of property contributed.

b. $17,000 basis. Jerry's basis in his Emerald stock is $17,000 ($32,000 - $15,000).

c. $32,000 basis. Emerald's basis in the property is $32,000.

pp. C:2-22 through C:2-25.

C:2-45 a. No gain or loss recognized. Ted realizes a $70,000 ([$60,000 + $35,000 + $15,000] - [$5,000 + $35,000]) gain, but Ted recognizes no gain or loss. Section 357(c)(3) precludes Ted from recognizing a gain because of his "excess" liability situation (i.e., liabilities that total $50,000 exceeding the $40,000 total bases of the assets).

b. $25,000 basis. Ted's basis in the stock received is $25,000 ($40,000 - $15,000). No reduction in basis is required for liabilities assumed by the transferee corporation under Sec. 357(c)(3) or under Sec. 358(d)(2).

c. $40,000 basis. The corporation's basis in the assets is the same $40,000 basis that Ted had ($5,000 in the cash, zero in the accounts receivable, and $35,000 in the equipment).

d. The corporation. The corporation must recognize the income from the receivables when it collects on them. The corporation also can deduct the current liabilities when it pays them (Rev. Rul. 80-198, 1980-2 C.B. 13). pp. C:2-24 and C:2-25.

C:2-46 a. $10,000 of ordinary income. Mary realizes a $50,000 ($110,000 - $60,000) gain but recognizes a $10,000 gain (amount of boot received). The gain is treated as ordinary income under the Sec. 1245 recapture rules.

b. $60,000 basis. Mary's basis in the Green stock is $60,000 ($60,000 + $10,000 - $10,000). Her holding period for the stock is deemed to begin three years ago when she purchased the machine. Mary's basis in the two-year note (boot) is $10,000, its FMV. Her holding period for the note begins on the day after the exchange date.

c. Green recognizes no gain or loss.

d. $70,000 basis. Green's basis in the machine is $70,000 ($60,000 basis to Mary + $10,000 gain recognized by Mary). Green's holding period is deemed to begin three years ago when Mary purchased the machine. pp. C:2-17 through C:2-21, C:2-25, and C:2-26.

C:2-47 a. None. Ace Corporation reports no income.
b. Ace takes a zero basis in the land.
c. Ace reports no income when it receives the cash. The basis of the equipment purchased with the $100,000 contribution is its $250,000 purchase price minus the $100,000 of contributed funds, or $150,000. p. C:2-31.

C:2-48 a. Kobe recognizes a $70,000 dividend, which is taxed at the applicable capital gains tax rate, and Bryant Corporation reports taxable income of $120,000. Bryant may not deduct the dividend paid to Kobe.
b. Kobe recognizes interest income of $20,000, which is taxed at his ordinary tax rate. The principal repayment is not taxable to Kobe. Bryant reports taxable income of $100,000 because it gets a $20,000 deduction for the interest paid to Kobe. pp. C:2-27 through C:2-30.

C:2-49 a. $75,000 capital loss to each shareholder. The $75,000 loss with respect to the stock investments is capital in character for both Tom and Vicki because they did not purchase the stock from the corporation. Because the $25,000 debts are secured by bonds, the worthless security rules of Sec. 165(g)(1) apply and their losses will be capital in character.
b. STCL to Vicki; ordinary loss to Tom. If the liability were not secured by bonds, Vicki's loan would be related solely to her stock investment and should be treated as a nonbusiness bad debt that is deductible as a short-term capital loss (up to $3,000 a year after netting capital losses against capital gains). An argument can be made that Tom's loss would relate to an attempt to maintain his employment with Guest Corporation and, therefore, has a substantial business purpose. Such a loss would be deductible as an ordinary loss if the dominant motive for making the loan were related to his employment activities.
c. Limited ordinary loss on stock; capital loss on bonds. The loss with respect to the stock investment would be ordinary in character under Sec. 1244 for both Tom and Vicki up to the $100,000 annual limit for the couple because they purchased the stock directly from Guest. The $50,000 loss exceeding the $100,000 Sec. 1244 limit would be capital in character. The worthless security rules of Sec. 165(g)(1) still would apply to the $25,000 losses on the bond investments. These losses would be capital in character. pp. C:2-32 through C:2-34.

C:2-50 Harry: Ordinary loss of $50,000 under Sec. 1244 and LTCL of $75,000.
Susan: LTCL of $175,000.
Big Corporation: $125,000 LTCL. pp. C:2-32 through C:2-34.

C:2-51 a. $50,000 ordinary loss and $2,000 LTCL. Lois's loss is $52,000 ($28,000 - $80,000 basis), of which $50,000 (the limit for a single taxpayer) is ordinary under Sec. 1244. The remaining $2,000 is a long-term capital loss.
b. $42,000 ordinary loss and $10,000 LTCL. Lois's loss still would be $52,000 ($28,000 - $80,000 basis). However, for purposes of computing the Sec. 1244 loss, Lois's basis in the stock would be $70,000. Therefore, the ordinary loss under Sec. 1244 would be $42,000 ($28,000 - $70,000). The remaining $10,000 would be a long-term capital loss. pp. C:2-32 through C:2-34.

C:2-52 $52,000 LTCL. The entire loss is capital in character because Sue was not the original owner of the stock; therefore, the stock is no longer Sec. 1244 stock. pp. C:2-32 through C:2-34.

C:2-53 a. Donna recognizes no gain when she transfers the land to Development Corporation. Development's basis in the land will be $150,000. All gain on the subsequent sale will be ordinary income to Development. This alternative results in the pre-contribution gain that accrued prior to Donna's transfer and the post-contribution profit earned from subdividing the land being taxed at a 34% marginal tax rate.

b. Donna could transfer the land to Development in exchange for stock and $330,000 of debt instruments. In this case, Donna would recognize $330,000 of long-term capital gain and Development's basis in the land would be $480,000. The $330,000 of pre-contribution capital gain (net of any capital losses that Donna has recognized) is taxed at the applicable capital gains tax rate (in this case, 23.8%, including the 3.8% net investment tax). The step-up in basis permits Development to use the additional basis to offset income earned from subdividing the land that otherwise would be taxed at a 34% marginal tax rate. Author's Note: The basic scenario apparently would permit Donna's gain to be reported using the installment method. However, sale of the land by a related person (a corporation controlled by Donna) within two years of the transfer date precludes deferral of the installment gain (Sec. 453(e)). pp. C:2-34 through C:2-36.

Comprehensive Problems

C:2-54 a. Yes. The transaction meets the requirements of Sec. 351. Transferors of property (Alice, Bob, and Carla) own 88.2% (750/850 = 0.882) of the Bear stock.

b. Alice recognizes a $10,000 gain, the amount by which the $60,000 mortgage assumed by Bear Corporation exceeds the $50,000 basis ($12,000 + $38,000) of all the assets transferred by Alice. The character is Sec. 1231 gain, of which some would be Sec. 1250 gain because of depreciation claimed on the building. Bob recognizes $10,000 of gain (the lesser of his realized gain of $15,000 or the boot received of $10,000). The gain is treated as ordinary income recaptured under Sec. 1245. Carla recognizes no gain or loss even though she received cash because she realized a $5,000 loss. Dick recognizes $10,000 of ordinary income as compensation for his services. Bear recognizes no gain or loss on issuing its stock or the note.

c. Alice's basis in her stock is zero ($12,000 + $38,000 - $60,000 liabilities + $10,000 gain). Her holding period for the stock includes her holding period for the land and building. Each share of stock, therefore, has a split holding period. Bob's stock basis is $25,000 ($25,000 + $10,000 gain - $10,000 boot). His holding period for his stock includes his holding period for the equipment. Carla's basis for her stock is $10,000 ($15,000 - $5,000 boot). Her holding period for the stock includes her holding period for the van. Dick's basis in his stock is $10,000. His holding period begins on the day after the exchange date.

d. Bear's basis in the assets received is: land $15,000 [$12,000 + (0.30 x $10,000)] and building $45,000 [$38,000 + (0.70 x $10,000)]. (The gain is allocated between the land and building according to the two assets' relative FMVs as prescribed by the Sec. 357 Treasury Regulations.) The holding period for the land and building includes the time Alice held these properties. Equipment basis is $35,000 ($25,000 + $10,000). Holding period includes the time that Bob owned the properties. Van basis is $10,000, limited to the van's FMV. If Bear and Carla elect, Bear can take a $15,000 basis in the van, but Carla's basis in her stock would be limited to $5,000, its FMV. Holding period begins the day after the exchange date because the van takes a FMV basis. The accounting services are deductible by Bear if incurred after operations have begun. If the expenses are pre-operating expenses, they should be amortizable under Sec. 248. pp. C:2-12 through C:2-27.

C:2-55 a. No. The transaction does not meet the requirements of Sec. 351. Transferors of property, Eric and Florence, own only 75% (750/1,000 = .75) of the Wildcat stock, which fails the 80% test.

b. Eric recognizes a $150,000 capital loss on the land ($50,000 FMV - $200,000 basis). Florence recognizes a $25,000 gain ($25,000 FMV - $0 basis) on the equipment. The gain is treated as ordinary income under Sec. 1245 recapture rules. George recognizes $25,000 of ordinary income as compensation for his services. Wildcat Corporation recognizes no gain or loss on issuing its stock for property or services.

c. Eric's basis in his stock is $50,000, its FMV. Florence's basis in her stock is $25,000, its FMV. George's basis in his stock is $25,000, its FMV. They each have a holding period that begins the day after the exchange date.

d. Wildcat's bases in the assets received are as follows: land $50,000 (FMV) and equipment $25,000 (FMV). The holding period for the land and equipment begins the day after the exchange date. The legal services may be deductible by Wildcat if incurred after operations have begun. They might have to be amortized over a period of time depending on when they were incurred and for what they were incurred. Also, if George has not yet performed the services, deduction may be deferred until economic performance occurs. pp. C:2-12 through C:2-27.

Tax Strategy Problems

C:2-56 a. The circumstances vary for the shareholders, who may or may not be pleased with this result. They have avoided the requirements of Sec. 351, which allows Eric to recognize a $150,000 capital loss. Although Florence has to recognize $25,000 of ordinary income, Wildcat can depreciate the machinery's FMV of $25,000. If Eric can use the $150,000 loss to offset capital gains from other sources, he may be happy with this result. If Florence is in a low tax bracket, she might not mind that she has to recognize $25,000 of ordinary income. However, if Eric has no capital gains and cannot use the $150,000 capital loss, avoiding Sec. 351 may not be a desirable result. This is especially true if Wildcat plans to subdivide the land and sell it, thereby generating ordinary income in the near future. If Sec. 351 applied, Wildcat's basis in the land would be limited under the Sec. 362(e)(2) reduction rules to $50,000, its FMV. However, Eric and Wildcat Corporation could make an election under Sec. 362(e)(2)(C) so that the land would have a $200,000 carryover basis to Wildcat and, therefore, much less income for Wildcat to report in future years. In such case, Eric's basis would be limited to his stock's FMV of $50,000 rather than the $200,000 basis in the property contributed. If he is not planning to sell his stock anytime soon, this reduction might not matter. Also, Florence could avoid recognizing $25,000 of ordinary income on the machinery. On the other hand, the machinery would have a zero basis to Wildcat, and therefore Wildcat would not be allowed any depreciation on the machinery. As far as George is concerned, it makes no difference to him whether Sec. 351 applies or not. The result to him is the same either way. pp. C:2-21 and C:2-22.

b. If the shareholders decide that meeting the Sec. 351 requirements would produce a greater tax benefit, they can proceed in several ways. For example:

1. The corporation could give George 150 shares of stock worth $15,000 and $10,000 of bonds. In such case Eric and Florence would own more than 80% (750/900 = 0.83) of the stock.

2. Florence and Eric each could contribute an additional $15,000 for 150 shares of stock. In such case, Eric and Florence would own more than 80% (1,050/1,300 = 0.808) of the stock.
3. George could contribute $2,500 of cash in addition to his services for 25 more shares. Thus, he would be a property contributor allowing all his shares to count in the 80% test. In such case, Eric, Florence, and George would own 100% of the stock.

C:2-57 a. Advantages of Alternative a:

1. Simplicity. Each person gets stock equal to her contribution to capital and will share in any appreciation in value in proportion to her contribution.
2. Paula recognizes no gain on the transaction because she received no boot.
3. The stock will be Sec. 1244 stock so, if Paula or Mary sells the stock at a loss or the business becomes bankrupt, at least some of the loss will be an ordinary loss.
4. The corporation, with the shareholders' consent, can elect S corporation status for the first two years, so the losses flow through to the shareholders to offset income from other sources. Later, the corporation, with the shareholders' consent, can revoke the S corporation election to become a regular C corporation.

Disadvantages of Alternative a:

1. All distributions to Paula and Mary (above reasonable salaries) will be taxed as dividends to the shareholders and are not deductible by the corporation.
2. Mary may want additional assurance that she will have preference in getting her investment back before the corporation pays any dividends. Since Paula has a majority ownership, she can decide when and if the corporation pays any dividends.
3. Paula may not want to share ownership with Mary. She might prefer that Mary's investment be treated as a loan so that all future appreciation accrues to her (Paula).

b. Advantages of Alternative b:

1. Paula recognizes no gain on the transaction.
2. Mary is assured of a return of her investment on whatever terms are specified in the debt instrument, plus a return of 8% for ten years (provided the corporation does not go bankrupt).
3. Even if the corporation becomes bankrupt, Mary will have first call on any assets before Paula since Mary is a creditor.
4. Paula owns all the stock and benefits from the company's appreciation in value.
5. Paula's stock is Sec. 1244 stock.
6. The corporation, with Paula's consent, can elect S corporation status for the first two years, which allows Paula to use losses to offset income from other sources.
7. The corporation gets a deduction for the interest paid to Mary.
8. Mary's income is limited to the note interest. She is not taxed on the return of her principal.

Disadvantages of Alternative b:

1. Mary may want to participate in the anticipated growth of the company. She might prefer some stock in addition to some notes.
2. All distributions to Paula (above salary) are taxed as dividends and are not deductible by the corporation.
3. In the event of bankruptcy, Mary's loss is capital in character.

c. Advantages of Alternative c:

1. Both Paula and Mary share in any stock appreciation.
2. The interest paid to Paula and Mary is deductible by the corporation. Their income does not include any principal payments.
3. The stock is Sec. 1244 stock, so Mary and Paula each would have an ordinary loss for at least part of their investment.
4. The corporation, with the shareholders' consent, can elect S corporation status and pass through losses during the first two years. Later, the corporation, with the shareholders' consent, can revoke the S corporation election.

Disadvantages of Alternative c:

1. For Paula, receipt of the note would be considered the receipt of boot, and she would have to recognize gain to the extent of $100,000 FMV of the note received, possibly over the ten-year period under the installment method.
2. Paula might not want to share ownership with Mary.
3. Mary might prefer a more secure return of her investment as in Alternative b even if she cannot participate in future growth of the corporation.
4. The IRS might try to reclassify the debt as equity, thereby changing its tax characteristics and possibly jeopardizing the S corporation election, if one has been made.

d. Advantages of Alternative d:

1. Paula recognizes no gain on the exchange.
2. All stock is Sec. 1244 stock.
3. Paula owns all the common stock and is entitled to the company's appreciation in value. If she is willing to share some of this appreciation, the preferred stock could be made participating preferred stock.

Disadvantages of Alternative d:

1. Mary has no assured return because the corporation might not pay dividends. However, she is more assured of payment than with common stock since the stock is cumulative.
2. Mary does not participate in the growth of the corporation. However, if they agree, the preferred stock can be participating.
3. The corporation cannot elect S corporation status because it has issued more than one class of stock.
4. All distributions to Paula and Mary (above any salaries) are taxable to them as dividends and not deductible by the corporation.

In general, no one plan is ideal. Paula and Mary must take into consideration the following factors:

1. How much of the future appreciation in growth is Paula willing to share with Mary?
2. How much assurance does Mary want that she will have first claim on assets to repay her investment? How willing is she to be a minority shareholder or would she rather be a creditor?
3. How large a risk exists that the corporation will go bankrupt so that Paula and Mary want their ownership stakes to be Sec. 1244 stock?
4. How willing is Paula to recognize gain on the corporate formation?

C:2-58 a. A "pass-through" entity. In light of the nursery's projected losses over the next two years, Paula and Mary might consider organizing the business as an S corporation, a general partnership, a limited partnership, or a limited liability company. With respect to all these forms, losses generated at the entity level would pass through to Paula's and Mary's separate returns. As a result, Paula and Mary could use a pro rata share of the entity's loss to offset income they earn over the next two years. In the case of a C corporation, losses generated at the entity level would carry back or forward to offset the corporation's income in other years. Paula and Mary could not use such losses to offset income they earn over the next two years.

b. As a type of partnership. To achieve their various business and investment objectives, and in light of their proposed use of debt and equity, Paula and Mary might structure the partnership as either a limited partnership or as a general partnership that makes a special allocation.

A limited partnership would give either investor the opportunity to trade her general partnership right to manage the business (analogous to common stock ownership) for a limited partnership right to a fixed rate of return (analogous to preferred stock ownership). A limited partnership also would give either investor the opportunity to become a general creditor of the partnership (analogous to a corporate bondholder).

In the case of a general partnership, so long as the special allocation has substantial economic effect (see Chapter C:9) this business form would give either investor the opportunity to trade her general partnership right to residual profits (analogous to common stock ownership) for a more limited right to a fixed rate of return (analogous to preferred stock ownership). It also would give either investor the opportunity to become a general creditor of the partnership (analogous to a corporate bondholder).

Although the general partner in either partnership form would have unlimited liability, a limited liability company taxed by default as a general partnership would afford all its members limited liability.

Case Study Problems

C:2-59 Listed below are the major points that should be covered in the memorandum to Bob. The student should incorporate those points into a properly structured memorandum using good form with proper grammar and punctuation.

In the client memorandum, before discussing the tax advantages and disadvantages of incorporating, the student might discuss the nontax advantages of incorporating (e.g., limited liability, ease of transferring ownership interest, etc.).

With the popularity of limited liability companies (LLCs), some consideration should be given to this business form. All states have adopted LLC legislation. Because most of Bob's business will be done within a single state, interstate activities and the lack of a common body of LLC rules among states will not be an issue.

The adoption of the final check-the-box regulations means that C corporation tax treatment is not limited to incorporated entities. Some discussion of the tax implications of the check-the-box regulations for an existing entity (a proprietorship) should be mentioned in the memorandum.

Incorporation

1. A corporate formation in which Bob receives only stock is nontaxable. Bob will recognize no gain or loss on the asset transfer. The transfer of property by either of the new investors should be properly timed since nontaxable transfers to existing corporations are difficult to accomplish because of the 80% control requirement. Timing is less important if the new investors are contributing cash and their contributions are to be made after Bob's contribution.

2. Bob likely will desire to continue to use the calendar year as the corporation's tax year because there appears to be little advantage of changing to a fiscal year.

3. Bob likely will desire to continue the cash method of accounting as the corporation's overall method of accounting because of its simplicity, assuming the small business exception under Sec. 448 applies if he operates the business as a C corporation.

4. Bob will continue to use the same depreciation method and convention once he transfers the building and equipment to the corporation. The depreciation recapture potential carries over from the proprietorship to the corporation. Depreciation for the year of transfer should be divided between Bob and the corporation.

5. The income from collecting the accounts receivable and accounts payable items that represent deductible expenses are reported by the corporation. The income is recognized when the corporation collects the receivables. The expenses are deducted when the corporation pays the liability.

6. Consideration should be given to an S corporation election. A C corporation will permit a tax savings for the first $75,000 of corporate taxable income but may trigger double taxation if the earnings are distributed as a dividend, although the dividends will be taxed at the applicable capital gains rate. The S corporation election will permit all the earnings to be taxed at the individual tax rates (which may be lower than the corporate tax rates) and avoid the possibility of double taxation.

7. By retaining C corporation status Bob would be permitted to exclude 50%, 75%, or 100% (depending on the acquisition date) of the gain recognized on the sale or exchange of qualified small business corporation stock that has been held for more than five years. The included gain is taxed at 28%, making the effective rate on the entire gain 14%, 7.84%, or 0%. Even if the stock were held less than five years, but more than one year, Bob's gain

would be taxed at the applicable capital gains rate. This advantage is not available to an S corporation whose shareholders instead increase the basis of their stock by the amount of any earnings retained in the business.

8. The salary paid to Bob should be reviewed to make sure it is reasonable. The employment taxes paid on the salary are about the same as the self-employment tax liability incurred with the sole proprietorship.

9. Consideration should be given to the availability of fringe benefits for Bob from either the C or S corporation business form. In general, the treatment of these fringe benefits—accident and health benefit premiums, etc.—are treated like guaranteed payments or salary for partners and 2%-or-more-shareholders of an S corporation. (See Chapter C:11.)

10. Consideration should be given to a retirement plan for Bob. He can make deductible contributions to an IRA, or perhaps establish a qualified plan if he makes the S corporation election.

Capital Structure

1. The simplest capital structure is to have solely common stock issued to Bob and/or either of the other individuals who are interested in investing in the business. Common stock may be attractive to the individual who desires to be active in the business. Bob may prefer to issue preferred stock or debt to the individual who is interested only in investing in the business. The preferred stock could provide a guaranteed dividend payment for the investor. Preferred stock, however, may prevent an S corporation election.

2. The preferred or common stock should qualify for Sec. 1244 treatment. Section 1244 permits an ordinary loss to be claimed on the sale, exchange, or worthlessness of the stock.

3. The use of debt will permit the payment of a deductible interest payment to the debt holder. The receipt of debt as part of the incorporation transaction will trigger the recognition of part or all of the transferor's realized gain.

4. The use of debt will permit the repayment to be partially or totally nontaxable. Unlike stock, which need not be retired, debt usually is retired at a designated maturity date.

5. Bob should consider whether he should transfer the building and equipment to the corporation as part of the incorporation transaction. Some tax advantages may exist with Bob retaining title to the property and leasing it to the corporation. Keeping the property outside the business and leasing it to the corporation also prevents the possible taking of the property by the corporation's creditors if financial difficulties arise.

Although the above discussion has been couched in terms of using a corporation or an LLC primarily to obtain tax advantages, one probably also should explain that LLCs and partnerships can be taxed as a C corporation under the check-the-box regulations. This change will provide greater flexibility for selecting the business entity form.

Depending on the length of the assignment, the student might compare the partnership, corporation, and LLC forms of doing business because it is not entirely obvious from the facts that the corporate form is superior to the partnership form.

C:2-60 Among the information that the transferor must provide the IRS are statements about the property transferred and its adjusted basis to the transferor. In addition, a statement about the liabilities transferred to the corporation including the nature of the liabilities, when and why they were created, and the corporate business reason for the transfer must be attached to the transferor's return for the year of the transfer (see Reg. Sec. 1.351-3(a). Similar information must be attached to the transferee corporation's tax return for the year of transfer (see Reg. Sec. 1.351-3(b).

From the facts of the problem, the funds obtained from placing the mortgage on the building and land apparently has been used for personal purposes. Withdrawals from a sole proprietorship, however, are not a taxable event for Eric Wright. The transfer of the mortgage to the corporation, however, may be a taxable event if the IRS can prove that the acquisition or assumption of the liability by the corporation had a tax avoidance motive or lacked the necessary business purpose. In such a situation, all the liabilities assumed and acquired by the corporation would be boot property. On the other hand, a factor in favor of the taxpayer not being subject to Sec. 357(b) is that one year has passed between the time the mortgage was taken out and the time it was transferred to the corporation.

The tax practitioner should thoroughly research the issue before reaching a conclusion. Should he or she find Sec. 357(b) is applicable, he or she should not agree to the client's position since the AICPA's Statements on Standards for Tax Services (SSTS) No. 1, Tax Return Positions, Para. 5a (reproduced in Appendix E) holds that a CPA should not recommend to a client that a position be taken with respect to the tax treatment of any item on a return unless the CPA has a good faith belief that the position has a realistic possibility of being sustained administratively or judicially on its merits if challenged. Eric's situation may lie in a gray area but, if sufficient authority exists for saying the necessary business purpose is present, the CPA may prepare Eric's return and not report any gain under Sec. 357(b). If the position does not have a reasonable basis, SSTS No. 1, Paragraph 5b, also would prevent the CPA from signing either Eric's personal return or the corporate return unless the liability is appropriately disclosed on the two returns. Thus, even if the position is disclosed, the CPA may not sign the return if the position does not have a reasonable basis.

Tax Research Problems

C:2-61 The memorandum should explain why the transaction meets the requirements of Sec. 351. Under Reg. Sec. 1.351-1(a)(3), stock underwriters may be disregarded for purposes of Sec. 351 if the underwriter is an agent of the corporation or the underwriter's ownership of the stock is transitory. If a person acquires stock from an underwriter in exchange for cash in a qualified underwriting transaction, the person who acquires the stock is treated as transferring cash directly to the corporation in exchange for the stock and the underwriter is disregarded.

C:2-62 The memorandum should point out that the transfers of property to a controlled corporation are nontaxable only if the transferors control the transferee corporation immediately after the exchange (Sec. 351(a)). Section 368(c) defines control in terms of two 80% tests. Regulation Sec. 1.351-1(a) outlines some of the requirements of the control test but does not directly address the question of a prearranged binding agreement whereby one transferor sells one-half of his stock to someone who is not a transferor. Example (1) of Reg. Sec. 1.351-1(b) permits a transfer to qualify under Sec. 351 where transferee corporation stock is transferred by gift from a controlling transferor to his son, who also is a transferor, immediately after the exchange. Regulation Sec. 1.351-1(a)(1)(ii) permits a shareholder to be ignored as a transferor when the amount of stock issued directly for property is of relatively small value in comparison to the value of the stock already owned or to be received by the person who transferred the property.

Under Rev. Rul. 79-194, 1979-1 C.B. 145, the control requirement of Sec. 351(a) is to be determined after any sales or transfers occur. In Situation 1 of this ruling, the control requirement is satisfied when part of the 80% stock interest in a newly created corporation that was acquired by a transferor corporation was sold to a group of investors who had acquired the other 20% stock interest in the original transaction. In this situation, the shift in ownership occurred among individuals who were transferors, and the recipients owned a substantial amount of the corporation's stock.

In a second situation, described in Rev. Rul. 79-194, the control requirement was not met upon completion of a sale under a similar agreement, whereby a transferor who originally had acquired 99% of the stock sold one-half the stock of the new corporation to a second transferor who had originally acquired only 1% of the stock. The IRS held that the control requirement was not met because the 1% shareholder received stock of small value in the original transfer relative to the amount received in total and, therefore, was not considered to be a transferor.

In the current case, it must be determined whether Bob has received a substantial part of the Stone Corporation stock or not. Revenue Procedure 77-37, 1977-2 C.B. 568, Sec. 3.07, indicates that ownership of 10% of the stock to be owned is not "of small value" and therefore should be considered a substantial part of the stock. Under this authority, the control requirement should be met and the transaction should be permitted to qualify under Sec. 351.

C:2-63 The memorandum should explain that, as long as the additional 25 shares to be received by Greta do not have any other rights attaching to them, they are considered to be stock for purposes of Sec. 351. Thus, Greta will not have to recognize any income when she receives her contingent shares.

Revenue Ruling 57-586, 1957-2 C.B. 249, addressed negotiable certificates issued to a shareholder in connection with a nontaxable reorganization representing a contingent interest in additional shares of the acquiring corporation's stock that would be issued along with cash dividends if certain occurrences took place. The ruling held that the certificates were "other" property and fell under the boot rules.

Two later court cases and several revenue rulings have changed this position substantially. First, in June M. Carlberg v. U.S., 6 AFTR 2d 5316, 60-2 USTC ¶9647 (8th Cir., 1960), the Eighth Circuit Court of Appeals held that certificates of contingent interest issued to the taxpayer-stockholder in a corporate reorganization permitting her to obtain reserved shares, which were not to be issued pending the determination of liabilities of one of the merging corporations, were stock rather than other property.

In James C. Hamrick, 43 T.C. 21 (1964), the Tax Court held that a taxpayer's contractual right to receive additional stock, contingent upon the earnings of the corporation exceeding a specified amount, is the equivalent of stock within the meaning of Sec. 351. The receipt of additional shares in later years pursuant to the original incorporation agreement was held not to result in the recognition of gain by the transferor.

The IRS held in Rev. Rul. 66-112, 1966-2 C.B. 68, that, because the contingent contractual rights were not specifically marketable and could give rise only to the receipt of additional stock by a transferor, both the stock and the control tests of Sec. 351 were satisfied. The IRS has acquiesced to the Hamrick decision (1966-2 C.B. 2). Revenue Ruling 66-112 also distinguished the facts at hand from those in Rev. Rul. 57-586.

Revenue Ruling 67-90, 1967-1 C.B. 79, provides that a contingent contractual right to receive only additional voting stock provided for in a plan of reorganization satisfies the "solely for voting stock" requirement for a Type B reorganization where the number of additional shares of stock to be issued is determined by a formula based upon the future market price of the shares of the acquiring corporation.

Revenue Procedure 77-37, 1977-2 C.B. 568, places certain restrictions on contingent stock that will be issued as part of a reorganization when a taxpayer is requesting a private letter ruling on the transaction. These restrictions do not apply to a Sec. 351 transaction. Revenue Procedure 83-59, 1983-2 C.B. 575, as modified by Rev. Proc. 2013-32, 2013-28 I.R.B. 55, requires a representation be made about contingent shares that are to be issued as part of a request for a private letter ruling on a Sec. 351 transaction, but it does not place any limit on the portion of the stock that can be considered to be contingent.

C:2-64 The memorandum should point out that, for tax purposes, Lisa and Matthew recognize no gain or loss (Sec. 351(a)). Lisa's basis in her stock is $50,000. Matthew's basis in his stock is $35,000 (Sec. 358(a)). Lima Corporation recognizes no gain on issuing the stock (Sec. 1032). Lima's basis in the land is $35,000 (Sec. 362(a)).

For financial accounting purposes, Lima records the land on its books at its $50,000 FMV and credits the capital account as follows: Common stock, $50,000 (ASC 845, formerly APB No. 29).

Lima's balance sheet immediately after the corporate information is as follows:

Assets		**Capital**	
Cash	$ 50,000	Common Stock	$100,000
Land	50,000		
Total	$100,000	Total	$100,000

For financial accounting purposes, the transferor will recognize gains and losses on the asset transfer. In this case, it is unlikely that either Lisa or Matthew would be maintaining GAAP financial accounting records.

C:2-65 Yes. John can avoid recognizing the $175,000 gain according to Ninth Circuit and Second Circuit holdings. In Peracchi v. CIR, 81 AFTR 2d 98-1754, 98-1 USTC ¶50, 150 (9th Cir., 1998), the Ninth Circuit reversed the decision of the Tax Court and held that an unsecured promissory note contributed to a corporation by its sole shareholder had a basis equal to its face amount. A similar result was reached in Lessinger v. CIR, 63 AFTR 2d 89-1055, 89-1 USTC ¶9254 (2nd Cir., 1989).

Therefore, if John contributes a $175,000 promissory note to Newco in addition to the assets, the basis of assets contributed includes the face value of the note and is $475,000 ($250,000 + $175,000). Because the liabilities do not exceed the basis of assets contributed, John recognizes no gain.

C:2-66 The client letter should address two questions. First, if Leticia, Monica, and Nathaniel advance funds to Lemona Corporation, will the advance be recharacterized as equity instead of debt? Second, will the unavailability of alternative financing at "reasonable rates" be significant in any decision to recharacterize?

If the IRS and/or the courts recharacterize the advance as equity, the IRS and/or the courts would treat any "interest" paid to the three investors as "dividends," nondeductible by Lemona. Furthermore, the IRS and/or the courts might treat the advance as nonbusiness related, i.e., as intended to safeguard the investors' initial equity investment. In the latter event, if Lemona later became insolvent, and the three investors were unable to recoup the full amount of the advance, their loss would be treated as nonbusiness bad debt. Because the loss would be capital in character, it would be deductible only to the extent of $3,000 (per year) in excess of any capital gains. No relief for partial losses would be afforded the investors.

The key statutory authority that governs the characterization of an investor advance to a corporation is Sec. 385. Under Sec. 385, the Treasury Secretary is authorized to issue regulations for determining whether an interest in a corporation should be treated as equity or indebtedness. Factors to be considered in the determination include,

- Whether there is a written, unconditional promise to pay a sum certain in money
- Whether the interest is subordinate to any corporate indebtedness
- The corporation's debt to equity ratio
- Convertibility of the interest into corporate stock
- The relationship between stockholdings and the interest in question

Based on Factors 2, 3, and 5, the three investors' interest in Lemona resembles equity more than debt. The interest is subordinate to other Lemona obligations; the corporation's debt to equity ratio is extraordinarily high (25:1 before the note issuance); and the relationship between the interest in question and the investors' pre-existing stockholdings is proportionate.

On the other hand, based on Factors 1 and 4, the three investors' interest resembles debt more than equity. The interest is evidenced by a note (i.e., a written, unconditional promise to pay a sum certain in money), and it is not convertible into Lemona stock.

Under the authority granted by Sec. 385, the Treasury Secretary issued regulations in 1980 but withdrew them in 1983. In the absence of regulatory authority, court cases provided guidance.

In Rudolph A. Hardman, 60AFTR 2d 87-5651, 82-7 USTC ¶9523 (9th Cir., 1987), the Ninth Circuit Court of Appeals cited 11 factors for distinguishing debt from equity for purposes of Sec. 385:

- The names given to certificates evidencing indebtedness
- The presence or absence of a maturity date
- The source of repayments
- The right to enforce payment of principal and interest
- Participation in management
- The investor's status relative to corporate creditors
- The intent of the parties
- Thin capitalization
- Identity of interest between creditor and stockholder
- Payment of interest out of "dividend" funds
- The ability of the corporation to obtain funds from outside lenders

In the client letter, and to the extent possible, the student should evaluate the three investors' corporate interest in terms of each of these factors.

In Tomlinson v. The 1661 Corporation, 19 AFTR 2d 1413, 67-1 USTC ¶9438 (5th Cir., 1967), a closely held corporation attempted to procure financing from outside lenders, but because of prohibitive interest rates, instead issued 7%, 15-year notes to its existing shareholders in exchange for cash advances of $138,400. The debt was subordinate to other corporate obligations. The corporation was not entitled to pay dividends on its stock until it had paid all past accrued interest on the notes. The corporation issued the notes on a pro rata basis and was thinly capitalized. On its tax return, the corporation deducted "interest" payments on the notes, but the IRS disputed this tax treatment. The IRS argued that based on all the facts and circumstances, the capital advanced by the shareholders was equity, not debt. Therefore, payments on the securities were dividends and nondeductible.

In the client letter, the student should draw an analogy between the facts and issues of the Tomlinson case and those of the case in question. The student also should cite factual dissimilarities that might undermine application of the Tomlinson holding to the present case. From the analysis, he or she should derive a cogent conclusion that addresses the two central issues.

"What Would You Do In This Situation?" Solution

Ch. C:2, p. C:2-31. The Case of the 100-Year Bonds.

The IRS is likely to carefully scrutinize any issuance of debt to determine whether it should be treated as debt or equity or some combination of each.

The Treasury Department has been given the authority under Sec. 385 to write regulations to distinguish between debt and equity, and also to allow an issue to be treated partly as debt and partly as equity. Thus far, the Treasury Department has not issued final Sec. 385 regulations. As a result, taxpayers must rely on judicial decisions as an indication of how a particular issue will be treated.

Section 385 suggests factors that should be considered in determining whether amount advanced to a corporation should be treated as debt or equity (See page C:2-31). In addition, O.H. Kruse Grain and Milling v. CIR, 5 AFTR 2d 1544, 60-2 USTC ¶9490 (9th Cir., 1960), lists additional factors the courts might consider. The Treasury Department indicated in Notice 94-47, 1994-1 C.B. 357, that it will carefully scrutinize instruments that combine tax treatment for debt with significant equity characteristics. Eight factors were listed that may be considered.

As a CPA, you should inform your client of the risk that the proposed debt issue may be challenged by the IRS and partly or totally reclassified as equity. The fact that many large corporations already have issued debt instruments with extremely long maturities is a point in your client's favor. If the corporation decides to go ahead with the issue, you would be justified in recommending the interest deductions if there exists a realistic possibility of the deductions being sustained upon examination. You also may recommend the deductions if a reasonable basis exists, and the taxpayer makes adequate disclosures. See Statement on Standards for Tax Services No. 1, Tax Return Positions in Appendix E.

Form **1120S**

Department of the Treasury
Internal Revenue Service

U.S. Income Tax Return for an S Corporation

▶ **Do not file this form unless the corporation has filed or is attaching Form 2553 to elect to be an S corporation.**
▶ **Information about Form 1120S and its separate instructions is at *www.irs.gov/form1120s*.**

OMB No. 1545-0123

2015

For calendar year 2015 or tax year beginning , 2015, ending , 20

A S election effective date: 1/24/2005	Name: Bottle-Up, Inc.	D Employer identification number: XX-XXXXXXX
B Business activity code number (see instructions): 327210	Number, street, and room or suite no. If a P.O. box, see instructions.: 1234 Hill Street	E Date incorporated: 1/08/2005
C Check if Sch. M-3 attached ☐	City or town, state or province, country, and ZIP or foreign postal code: City, ST 33333	F Total assets (see instructions): $ 750,028

TYPE OR PRINT

G Is the corporation electing to be an S corporation beginning with this tax year? ☐ Yes ☐ No If "Yes," attach Form 2553 if not already filed

H Check if: **(1)** ☐ Final return **(2)** ☐ Name change **(3)** ☐ Address change **(4)** ☐ Amended return **(5)** ☐ S election termination or revocation

I Enter the number of shareholders who were shareholders during any part of the tax year . . . ▶ 2

Caution. Include **only** trade or business income and expenses on lines 1a through 21. See the instructions for more information.

Income	1a	Gross receipts or sales	1a	2,500,000		
	b	Returns and allowances	1b	15,000		
	c	Balance. Subtract line 1b from line 1a			1c	2,485,000
	2	Cost of goods sold (attach Form 1125-A)			2	1,474,000
	3	Gross profit. Subtract line 2 from line 1c			3	1,011,000
	4	Net gain (loss) from Form 4797, line 17 (attach Form 4797)			4	
	5	Other income (loss) (see instructions—attach statement)			5	
	6	**Total income (loss).** Add lines 3 through 5 ▶			6	1,011,000
Deductions (see instructions for limitations)	7	Compensation of officers (see instructions—attach Form 1125-E)			7	120,000
	8	Salaries and wages (less employment credits)			8	331,020
	9	Repairs and maintenance			9	38,000
	10	Bad debts			10	620
	11	Rents			11	30,000
	12	Taxes and licenses			12	39,480
	13	Interest			13	1,000
	14	Depreciation not claimed on Form 1125-A or elsewhere on return (attach Form 4562)			14	36,311
	15	Depletion **(Do not deduct oil and gas depletion.)**			15	
	16	Advertising			16	105,000
	17	Pension, profit-sharing, etc., plans			17	
	18	Employee benefit programs			18	11,000
	19	Other deductions (attach statement)			19	226,102
	20	**Total deductions.** Add lines 7 through 19 ▶			20	938,533
	21	**Ordinary business income (loss).** Subtract line 20 from line 6			21	72,467
Tax and Payments	22a	Excess net passive income or LIFO recapture tax (see instructions)	22a			
	b	Tax from Schedule D (Form 1120S)	22b			
	c	Add lines 22a and 22b (see instructions for additional taxes)			22c	
	23a	2015 estimated tax payments and 2014 overpayment credited to 2015	23a			
	b	Tax deposited with Form 7004	23b			
	c	Credit for federal tax paid on fuels (attach Form 4136)	23c			
	d	Add lines 23a through 23c			23d	
	24	Estimated tax penalty (see instructions). Check if Form 2220 is attached ▶ ☐			24	
	25	**Amount owed.** If line 23d is smaller than the total of lines 22c and 24, enter amount owed			25	
	26	**Overpayment.** If line 23d is larger than the total of lines 22c and 24, enter amount overpaid			26	
	27	Enter amount from line 26 **Credited to 2016 estimated tax** ▶		**Refunded** ▶	27	

Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Heuman Hiebert | 4/14/16 |
Signature of officer | Date | Title

May the IRS discuss this return with the preparer shown below (see instructions)? ☐ Yes ☐ No

Paid Preparer Use Only

Print/Type preparer's name	Preparer's signature	Date	Check ☐ if self-employed	PTIN
Firm's name ▶			Firm's EIN ▶	
Firm's address ▶			Phone no.	

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11510H Form **1120S** (2015)

Schedule B Other Information (see instructions)

		Yes	No
1	Check accounting method: a ☐ Cash b ☑ Accrual c ☐ Other (specify) ▶		
2	See the instructions and enter the: a Business activity ▶ Manufacturing b Product or service ▶ Glass bottles		
3	At any time during the tax year, was any shareholder of the corporation a disregarded entity, a trust, an estate, or a nominee or similar person? If "Yes," attach Schedule B-1, Information on Certain Shareholders of an S Corporation		✓
4	At the end of the tax year, did the corporation:		
a	Own directly 20% or more, or own, directly or indirectly, 50% or more of the total stock issued and outstanding of any foreign or domestic corporation? For rules of constructive ownership, see instructions. If "Yes," complete (i) through (v) below		✓

(i) Name of Corporation	(ii) Employer Identification Number (if any)	(iii) Country of Incorporation	(iv) Percentage of Stock Owned	(v) If Percentage in (iv) is 100%, Enter the Date (if any) a Qualified Subchapter S Subsidiary Election Was Made

		Yes	No
b	Own directly an interest of 20% or more, or own, directly or indirectly, an interest of 50% or more in the profit, loss, or capital in any foreign or domestic partnership (including an entity treated as a partnership) or in the beneficial interest of a trust? For rules of constructive ownership, see instructions. If "Yes," complete (i) through (v) below		✓

(i) Name of Entity	(ii) Employer Identification Number (if any)	(iii) Type of Entity	(iv) Country of Organization	(v) Maximum Percentage Owned in Profit, Loss, or Capital

		Yes	No
5 a	At the end of the tax year, did the corporation have any outstanding shares of restricted stock?		✓
	If "Yes," complete lines (i) and (ii) below.		
	(i) Total shares of restricted stock ▶		
	(ii) Total shares of non-restricted stock ▶		
b	At the end of the tax year, did the corporation have any outstanding stock options, warrants, or similar instruments?		✓
	If "Yes," complete lines (i) and (ii) below.		
	(i) Total shares of stock outstanding at the end of the tax year ▶		
	(ii) Total shares of stock outstanding if all instruments were executed ▶		
6	Has this corporation filed, or is it required to file, **Form 8918,** Material Advisor Disclosure Statement, to provide information on any reportable transaction?		✓
7	Check this box if the corporation issued publicly offered debt instruments with original issue discount ▶ ☐ If checked, the corporation may have to file **Form 8281,** Information Return for Publicly Offered Original Issue Discount Instruments.		
8	If the corporation: **(a)** was a C corporation before it elected to be an S corporation **or** the corporation acquired an asset with a basis determined by reference to the basis of the asset (or the basis of any other property) in the hands of a C corporation **and (b)** has net unrealized built-in gain in excess of the net recognized built-in gain from prior years, enter the net unrealized built-in gain reduced by net recognized built-in gain from prior years (see instructions) ▶ $		
9	Enter the accumulated earnings and profits of the corporation at the end of the tax year. $		
10	Does the corporation satisfy **both** of the following conditions?		
a	The corporation's total receipts (see instructions) for the tax year were less than $250,000		
b	The corporation's total assets at the end of the tax year were less than $250,000		✓
	If "Yes," the corporation is not required to complete Schedules L and M-1.		
11	During the tax year, did the corporation have any non-shareholder debt that was canceled, was forgiven, or had the terms modified so as to reduce the principal amount of the debt?		✓
	If "Yes," enter the amount of principal reduction $		
12	During the tax year, was a qualified subchapter S subsidiary election terminated or revoked? If "Yes," see instructions		✓
13 a	Did the corporation make any payments in 2015 that would require it to file Form(s) 1099?		✓
b	If "Yes," did the corporation file or will it file required Forms 1099?		

Schedule K Shareholders' Pro Rata Share Items

					Total amount
Income (Loss)	1	Ordinary business income (loss) (page 1, line 21)		1	72,467
	2	Net rental real estate income (loss) (attach Form 8825)		2	
	3a	Other gross rental income (loss)	3a		
	b	Expenses from other rental activities (attach statement)	3b		
	c	Other net rental income (loss). Subtract line 3b from line 3a		3c	
	4	Interest income		4	1,200
	5	Dividends: a Ordinary dividends		5a	11,600
		b Qualified dividends	5b 11,600		
	6	Royalties		6	
	7	Net short-term capital gain (loss) (attach Schedule D (Form 1120S))		7	
	8a	Net long-term capital gain (loss) (attach Schedule D (Form 1120S))		8a	48,666
	b	Collectibles (28%) gain (loss)	8b		
	c	Unrecaptured section 1250 gain (attach statement)	8c		
	9	Net section 1231 gain (loss) (attach Form 4797)		9	(1,100)
	10	Other income (loss) (see instructions) Type ▶		10	
Deductions	11	Section 179 deduction (attach Form 4562)		11	
	12a	Charitable contributions		12a	9,000
	b	Investment interest expense		12b	500
	c	Section 59(e)(2) expenditures (1) Type ▶ (2) Amount ▶		12c(2)	
	d	Other deductions (see instructions) Type ▶ Investment expenses		12d	600
Credits	13a	Low-income housing credit (section 42(j)(5))		13a	
	b	Low-income housing credit (other)		13b	
	c	Qualified rehabilitation expenditures (rental real estate) (attach Form 3468)		13c	
	d	Other rental real estate credits (see instructions) Type ▶		13d	
	e	Other rental credits (see instructions) Type ▶		13e	
	f	Biofuel producer credit (attach Form 6478)		13f	
	g	Other credits (see instructions) Type ▶		13g	
Foreign Transactions	14a	Name of country or U.S. possession ▶			
	b	Gross income from all sources		14b	
	c	Gross income sourced at shareholder level		14c	
		Foreign gross income sourced at corporate level			
	d	Passive category		14d	
	e	General category		14e	
	f	Other (attach statement)		14f	
		Deductions allocated and apportioned at shareholder level			
	g	Interest expense		14g	
	h	Other		14h	
		Deductions allocated and apportioned at corporate level to foreign source income			
	i	Passive category		14i	
	j	General category		14j	
	k	Other (attach statement)		14k	
		Other information			
	l	Total foreign taxes (check one): ▶ ☐ Paid ☐ Accrued		14l	
	m	Reduction in taxes available for credit (attach statement)		14m	
	n	Other foreign tax information (attach statement)			
Alternative Minimum Tax (AMT) Items	15a	Post-1986 depreciation adjustment		15a	9,000
	b	Adjusted gain or loss		15b	
	c	Depletion (other than oil and gas)		15c	
	d	Oil, gas, and geothermal properties—gross income		15d	
	e	Oil, gas, and geothermal properties—deductions		15e	
	f	Other AMT items (attach statement)		15f	
Items Affecting Shareholder Basis	16a	Tax-exempt interest income		16a	600
	b	Other tax-exempt income		16b	
	c	Nondeductible expenses		16c	14,500
	d	Distributions (attach statement if required) (see instructions)		16d	70,000
	e	Repayment of loans from shareholders		16e	

Form **1120S** (2015)

Form 1120S (2015) Page **4**

Schedule K **Shareholders' Pro Rata Share Items** (continued)

				Total amount
Other Information	17a	Investment income	17a	*12,800
	b	Investment expenses	17b	600
	c	Dividend distributions paid from accumulated earnings and profits	17c	
	d	Other items and amounts (attach statement)		
Reconciliation	18	**Income/loss reconciliation.** Combine the amounts on lines 1 through 10 in the far right column. From the result, subtract the sum of the amounts on lines 11 through 12d and 14l	18	122,733

Schedule L **Balance Sheets per Books**

	Beginning of tax year (a)	Beginning of tax year (b)	End of tax year (c)	End of tax year (d)
Assets				
1 Cash		15,000		116,948
2a Trade notes and accounts receivable	41,500		45,180	
b Less allowance for bad debts	( )	41,500	( )	45,180
3 Inventories		102,000		96,000
4 U.S. government obligations		15,000		16,000
5 Tax-exempt securities (see instructions)		10,000		10,000
6 Other current assets (attach statement)				
7 Loans to shareholders				
8 Mortgage and real estate loans				
9 Other investments (attach statement)		103,000		74,000
10a Buildings and other depreciable assets	374,600		375,000	
b Less accumulated depreciation	(160,484)	214,116	(173,100)	201,900
11a Depletable assets				
b Less accumulated depletion	( )		( )	
12 Land (net of any amortization)		160,000		190,000
13a Intangible assets (amortizable only)				
b Less accumulated amortization	( )		( )	
14 Other assets (attach statement)				
15 Total assets		600,616		750,028
Liabilities and Shareholders' Equity				
16 Accounts payable		36,000		10,000
17 Mortgages, notes, bonds payable in less than 1 year		44,000		52,000
18 Other current liabilities (attach statement)		20,616		19,666
19 Loans from shareholders		10,000		5,000
20 Mortgages, notes, bonds payable in 1 year or more		210,000		260,000
21 Other liabilities (attach statement)				
22 Capital stock		10,000		10,000
23 Additional paid-in capital				
24 Retained earnings		330,000		393,362
25 Adjustments to shareholders' equity (attach statement)				
26 Less cost of treasury stock		( )		( )
27 Total liabilities and shareholders' equity		660,616		750,028

Form **1120S** (2015)

*$1,200 interest + $11,600 dividends if shareholders elect to tax dividends at ordinary rates under Sec.163(d)(4)(B).

Form 1120S (2015) Page **5**

Schedule M-1 **Reconciliation of Income (Loss) per Books With Income (Loss) per Return**

Note. Schedule M-3 required instead of Schedule M-1 if total assets are $10 million or more—see instructions

1	Net income (loss) per books	133,362	5	Income recorded on books this year not included on Schedule K, lines 1 through 10 (itemize): a Tax-exempt interest $ 600	600
2	Income included on Schedule K, lines 1, 2, 3c, 4, 5a, 6, 7, 8a, 9, and 10, not recorded on books this year (itemize)				
3	Expenses recorded on books this year not included on Schedule K, lines 1 through 12 and 14l (itemize): a Depreciation $ b Travel and entertainment $ 10,500 Penalties 1,000 / Keyperson Life 3,000	14,500	6	Deductions included on Schedule K, lines 1 through 12 and 14l, not charged against book income this year (itemize): a Depreciation $ 24,529	24,529
			7	Add lines 5 and 6	25,129
4	Add lines 1 through 3	147,862	8	Income (loss) (Schedule K, line 18). Line 4 less line 7	122,733

Schedule M-2 **Analysis of Accumulated Adjustments Account, Other Adjustments Account, and Shareholders' Undistributed Taxable Income Previously Taxed** (see instructions)

		(a) Accumulated adjustments account	**(b)** Other adjustments account	**(c)** Shareholders' undistributed taxable income previously taxed
1	Balance at beginning of tax year	274,300	0	
2	Ordinary income from page 1, line 21	72,467		
3	Other additions	61,466	600	
4	Loss from page 1, line 21	( )		
5	Other reductions	(25,700)	( )	
6	Combine lines 1 through 5	382,533	600	
7	Distributions other than dividend distributions	70,000		
8	Balance at end of tax year. Subtract line 7 from line 6	312,533	600	

Form **1120S** (2015)

Bottle-Up, Inc.
XX-XXXXXXX 2015 Form 1120S

Page 1, Line 12 - Taxes and licenses:

Payroll taxes	$ 36,980
Other taxes	2,500
Total	$ 39,480

Page 1, Line 19 - Other deductions:

Utilities expense	$ 54,000
Automobile and truck expense	26,000
Office supplies expense	9,602
Meals and entertainment expense (net of nondeductible 50%)	10,500
Selling expense	100,000
Accounting and legal expense	4,500
Insurance expense	21,500
Total	$226,102

Page 3, Schedule K, Line 16c - Nondeductible expenses:

Keyperson life insurance premium	$ 3,000
Penalties	1,000
Travel and entertainment expenses	10,500
Total	$ 14,500

Form 1125-A, Line 5 - Other costs:

Supplies	$ 80,000
Utilities	100,000
Depreciation	38,000
Other manufacturing costs	150,000
Total	$368,000

Bottle-Up, Inc.
XX-XXXXXXX 2015 Form 1120S

Page 4, Schedule L, Line 18 - Other current liabilities:	**Beginning of Tax Year**	**End of Tax Year**
Accrued salaries payable	$12,000	$ 6,000
Payroll taxes payable	3,416	7,106
Sales taxes payable	5,200	6,560
Total	$20,616	$19,666

Page 4, Schedule L, Line 24 - Retained earnings reconciliation:

Retained earnings, beginning of tax year	$330,000
Net income per books	133,362
Distributions, other than dividends	(70,000)
Retained earnings, end of tax year	$393,362

Page 5, Schedule M-2, Line 3 - Other additions:

Interest income	$ 1,200
Dividend income	11,600
LTCG	48,666
Total	$61,466

Page 5, Schedule M-2, Line 5 - Other reductions:

Sec. 1231 loss	$ 1,100
Charitable contributions	9,000
Investment expenses	600
Investment interest	500
Nondeductible expenses (See Sch. M-1, Line 3b)	14,500
Total	$25,700

SCHEDULE D (Form 1120S)

Department of the Treasury
Internal Revenue Service

Capital Gains and Losses and Built-in Gains

► Attach to Form 1120S.
► Use Form 8949 to list your transactions for lines 1b, 2, 3, 8b, 9, and 10.
► Information about Schedule D and its separate instructions is at *www.irs.gov/form1120s*.

OMB No. 1545-0123

2015

Name: Bottle-Up, Inc.

Employer identification number: XX-XXXXXXX

Part I Short-Term Capital Gains and Losses—Assets Held One Year or Less

See instructions for how to figure the amounts to enter on the lines below. This form may be easier to complete if you round off the cents to whole dollars.	(d) Proceeds (sales price)	(e) Cost (or other basis)	(g) Adjustments to gain or loss from Form(s) 8949, Part I, line 2, column (g)	(h) Gain or (loss). Subtract column (e) from column (d) and combine the result with column (g)
1a Totals for all short-term transactions reported on Form 1099-B for which basis was reported to the IRS and for which you have no adjustments (see instructions). However, if you choose to report all these transactions on Form 8949, leave this line blank and go to line 1b . .				
1b Totals for all transactions reported on Form(s) 8949 with **Box A** checked				
2 Totals for all transactions reported on Form(s) 8949 with **Box B** checked				
3 Totals for all transactions reported on Form(s) 8949 with **Box C** checked				

4	Short-term capital gain from installment sales from Form 6252, line 26 or 37	4	
5	Short-term capital gain or (loss) from like-kind exchanges from Form 8824	5	
6	Tax on short-term capital gain included on line 23 below	6	( )
7	**Net short-term capital gain or (loss).** Combine lines 1a through 6 in column (h). Enter here and on Form 1120S, Schedule K, line 7 or 10	7	

Part II Long-Term Capital Gains and Losses—Assets Held More Than One Year

See instructions for how to figure the amounts to enter on the lines below. This form may be easier to complete if you round off the cents to whole dollars.	(d) Proceeds (sales price)	(e) Cost (or other basis)	(g) Adjustments to gain or loss from Form(s) 8949, Part II, line 2, column (g)	(h) Gain or (loss). Subtract column (e) from column (d) and combine the result with column (g)
8a Totals for all long-term transactions reported on Form 1099-B for which basis was reported to the IRS and for which you have no adjustments (see instructions). However, if you choose to report all these transactions on Form 8949, leave this line blank and go to line 8b . .				
8b Totals for all transactions reported on Form(s) 8949 with **Box D** checked				
9 Totals for all transactions reported on Form(s) 8949 with **Box E** checked				
10 Totals for all transactions reported on Form(s) 8949 with **Box F** checked	* 148,666	100,000		48,666

11	Long-term capital gain from installment sales from Form 6252, line 26 or 37	11	
12	Long-term capital gain or (loss) from like-kind exchanges from Form 8824	12	
13	Capital gain distributions (see instructions)	13	
14	Tax on long-term capital gain included on line 23 below	14	( )
15	**Net long-term capital gain or (loss).** Combine lines 8a through 14 in column (h). Enter here and on Form 1120S, Schedule K, line 8a or 10	15	48,666

For Paperwork Reduction Act Notice, see the Instructions for Form 1120S. Cat. No. 11516V **Schedule D (Form 1120S) 2015**

Note: Page 2 and Form 8949 not attached.

*Capital assets; acquired 3/3/13; sold 9/15/15.

Form **1125-A**
(Rev. December 2012)
Department of the Treasury
Internal Revenue Service

Cost of Goods Sold

▶ Attach to Form 1120, 1120-C, 1120-F, 1120S, 1065, or 1065-B.
▶ Information about Form 1125-A and its instructions is at *www.irs.gov/form1125a.*

OMB No. 1545-2225

Name	Employer identification number
Bottle-Up, Inc.	XX-XXXXXXX

1	Inventory at beginning of year	1	102,000
2	Purchases	2	200,000
3	Cost of labor	3	200,000
4	Additional section 263A costs (attach schedule)	4	
5	Other costs (attach schedule)	5	368,000
6	**Total.** Add lines 1 through 5	6	1,570,000
7	Inventory at end of year	7	96,000
8	**Cost of goods sold.** Subtract line 7 from line 6. Enter here and on Form 1120, page 1, line 2 or the appropriate line of your tax return (see instructions)	8	1,474,000

9a Check all methods used for valuing closing inventory:

(i) ☐ Cost
(ii) ☑ Lower of cost or market
(iii) ☐ Other (Specify method used and attach explanation.) ▶

b Check if there was a writedown of subnormal goods ▶ ☐

c Check if the LIFO inventory method was adopted this tax year for any goods (if checked, attach Form 970) ▶ ☐

d If the LIFO inventory method was used for this tax year, enter amount of closing inventory computed under LIFO | 9d |

e If property is produced or acquired for resale, do the rules of section 263A apply to the entity (see instructions)? ☐ Yes ☑ No

f Was there any change in determining quantities, cost, or valuations between opening and closing inventory? If "Yes," attach explanation ☐ Yes ☑ No

Section references are to the Internal Revenue Code unless otherwise noted.

General Instructions

Purpose of Form

Use Form 1125-A to calculate and deduct cost of goods sold for certain entities.

Who Must File

Filers of Form 1120, 1120-C, 1120-F, 1120S, 1065, or 1065-B, must complete and attach Form 1125-A if the applicable entity reports a deduction for cost of goods sold.

Inventories

Generally, inventories are required at the beginning and end of each tax year if the production, purchase, or sale of merchandise is an income-producing factor. See Regulations section 1.471-1. If inventories are required, you generally must use an accrual method of accounting for sales and purchases of inventory items.

Exception for certain taxpayers. If you are a qualifying taxpayer or a qualifying small business taxpayer (defined below), you can adopt or change your accounting method to account for inventoriable items in the same manner as materials and supplies that are not incidental.

Under this accounting method, inventory costs for raw materials purchased for use in producing finished goods and merchandise purchased for resale are deductible in the year the finished goods or merchandise are sold (but not before the year you paid for the raw materials or merchandise, if you are also using the cash method).

If you account for inventoriable items in the same manner as materials and supplies that are not incidental, you can currently deduct expenditures for direct labor and all indirect costs that would otherwise be included in inventory costs. See the instructions for lines 2 and 7.

For additional guidance on this method of accounting, see Pub. 538, Accounting Periods and Methods. For guidance on adopting or changing to this method of accounting, see Form 3115, Application for Change in Accounting Method, and its instructions.

Qualifying taxpayer. A qualifying taxpayer is a taxpayer that, (a) for each prior tax year ending after December 16, 1998, has average annual gross receipts of $1 million or less for the 3 prior tax years and (b) its business is not a tax shelter (as defined in section 448(d)(3)). See Rev. Proc. 2001-10, 2001-2 I.R.B. 272.

Qualifying small business taxpayer. A qualifying small business taxpayer is a taxpayer that, (a) for each prior tax year ending on or after December 31, 2000, has average annual gross receipts of $10 million or less for the 3 prior tax years, (b) whose principal business activity is not an ineligible activity, and (c) whose business is not a tax shelter (as defined in section 448 (d)(3)). See Rev. Proc. 2002-28, 2002-18 I.R.B. 815.

Uniform capitalization rules. The uniform capitalization rules of section 263A generally require you to capitalize, or include in inventory, certain costs incurred in connection with the following.

- The production of real property and tangible personal property held in inventory or held for sale in the ordinary course of business.
- Real property or personal property (tangible and intangible) acquired for resale.
- The production of real property and tangible personal property by a corporation for use in its trade or business or in an activity engaged in for profit.

See the discussion on section 263A uniform capitalization rules in the instructions for your tax return before completing Form 1125-A. Also see Regulations sections 1.263A-1 through 1.263A-3. See Regulations section 1.263A-4 for rules for property produced in a farming business.

Form **4797**

Department of the Treasury
Internal Revenue Service

Sales of Business Property

(Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2))

► Attach to your tax return.
► Information about Form 4797 and its separate instructions is at *www.irs.gov/form4797.*

OMB No. 1545-0184

2015

Attachment Sequence No. 27

Name(s) shown on return: Bottle-Up, Inc.

Identifying number: XX-XXXXXXX

1 Enter the gross proceeds from sales or exchanges reported to you for 2015 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20 (see instructions) 1

Part I Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Than Casualty or Theft—Most Property Held More Than 1 Year (see instructions)

2 (a) Description of property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition	(f) Cost or other basis, plus improvements and expense of sale	(g) Gain or (loss) Subtract (f) from the sum of (d) and (e)
1231 Property	6/5/14	12/21/15	8,900		10,000	(1,100)

3	Gain, if any, from Form 4684, line 39	3	
4	Section 1231 gain from installment sales from Form 6252, line 26 or 37	4	
5	Section 1231 gain or (loss) from like-kind exchanges from Form 8824	5	
6	Gain, if any, from line 32, from other than casualty or theft.	6	
7	Combine lines 2 through 6. Enter the gain or (loss) here and on the appropriate line as follows:	7	(1,100)

Partnerships (except electing large partnerships) and S corporations. Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 10, or Form 1120S, Schedule K, line 9. Skip lines 8, 9, 11, and 12 below.

Individuals, partners, S corporation shareholders, and all others. If line 7 is zero or a loss, enter the amount from line 7 on line 11 below and skip lines 8 and 9. If line 7 is a gain and you did not have any prior year section 1231 losses, or they were recaptured in an earlier year, enter the gain from line 7 as a long-term capital gain on the Schedule D filed with your return and skip lines 8, 9, 11, and 12 below.

8	Nonrecaptured net section 1231 losses from prior years (see instructions)	8	
9	Subtract line 8 from line 7. If zero or less, enter -0-. If line 9 is zero, enter the gain from line 7 on line 12 below. If line 9 is more than zero, enter the amount from line 8 on line 12 below and enter the gain from line 9 as a long-term capital gain on the Schedule D filed with your return (see instructions)	9	

Part II Ordinary Gains and Losses (see instructions)

10 Ordinary gains and losses not included on lines 11 through 16 (include property held 1 year or less):

11	Loss, if any, from line 7	11	( )
12	Gain, if any, from line 7 or amount from line 8, if applicable	12	
13	Gain, if any, from line 31	13	
14	Net gain or (loss) from Form 4684, lines 31 and 38a	14	
15	Ordinary gain from installment sales from Form 6252, line 25 or 36	15	
16	Ordinary gain or (loss) from like-kind exchanges from Form 8824.	16	
17	Combine lines 10 through 16	17	
18	For all except individual returns, enter the amount from line 17 on the appropriate line of your return and skip lines a and b below. For individual returns, complete lines a and b below:		
a	If the loss on line 11 includes a loss from Form 4684, line 35, column (b)(ii), enter that part of the loss here. Enter the part of the loss from income-producing property on Schedule A (Form 1040), line 28, and the part of the loss from property used as an employee on Schedule A (Form 1040), line 23. Identify as from "Form 4797, line 18a." See instructions	18a	
b	Redetermine the gain or (loss) on line 17 excluding the loss, if any, on line 18a. Enter here and on Form 1040, line 14	18b	

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 13086I Form **4797** (2015)

671113

☐ Final K-1 ☐ Amended K-1 OMB No. 1545-0123

Schedule K-1 (Form 1120S) **2015**
Department of the Treasury
Internal Revenue Service

For calendar year 2015, or tax year beginning ____________, 2015 ending ____________, 20 ______

Shareholder's Share of Income, Deductions, Credits, etc.

► See back of form and separate instructions.

Part I Information About the Corporation

A Corporation's employer identification number
XX-XXXXXXX

B Corporation's name, address, city, state, and ZIP code
Bottle-Up, Inc.
1234 Hill Street
City, ST 33333

C IRS Center where corporation filed return
Center City, ST

Part II Information About the Shareholder

D Shareholder's identifying number
XXX-XX-XXXX

E Shareholder's name, address, city, state, and ZIP code
Herman Hiebert

F Shareholder's percentage of stock ownership for tax year . . . . 50 %

For IRS Use Only

Part III Shareholder's Share of Current Year Income, Deductions, Credits, and Other Items

1	Ordinary business income (loss)		36,234
2	Net rental real estate income (loss)		
3	Other net rental income (loss)		
4	Interest income		600
5a	Ordinary dividends		5,800
5b	Qualified dividends		5,800
6	Royalties		
7	Net short-term capital gain (loss)		
8a	Net long-term capital gain (loss)		24,333
8b	Collectibles (28%) gain (loss)		
8c	Unrecaptured section 1250 gain		
9	Net section 1231 gain (loss)		(550)
10	Other income (loss)		
11	Section 179 deduction		
12	Other deductions	A	4,500
		K	300
		H	250
		Q	45,000
		R	225,510
13	Credits		
14	Foreign transactions		
15	Alternative minimum tax (AMT) items	A	4,500
16	Items affecting shareholder basis	A	300
		C	7,250
		D	35,000
17	Other information	A	600
		A	*5,800
		B	300
		T	**5,000

* See attached statement for additional information.

For Paperwork Reduction Act Notice, see Instructions for Form 1120S. IRS.gov/form1120s Cat. No. 11520D **Schedule K-1 (Form 1120S) 2015**

*Investment income if shareholder elects to tax dividends at ordinary rates under Sec. 163(d)(4)(B).
**Loan repayment to Mr. Hiebert.

671113

☐ Final K-1 ☐ Amended K-1 OMB No. 1545-0123

Schedule K-1 (Form 1120S) **2015**
Department of the Treasury
Internal Revenue Service

For calendar year 2015, or tax year beginning ____________, 2015 ending ____________, 20 ______

Shareholder's Share of Income, Deductions, Credits, etc.

► See back of form and separate instructions.

Part I Information About the Corporation

A Corporation's employer identification number
XX-XXXXXXX

B Corporation's name, address, city, state, and ZIP code
Bottle-Up, Inc.
1234 Hill Street
City, ST 33333

C IRS Center where corporation filed return
Center City, ST

Part II Information About the Shareholder

D Shareholder's identifying number
XXX-XX-XXXX

E Shareholder's name, address, city, state, and ZIP code
Melvin Jones

F Shareholder's percentage of stock ownership for tax year . . . . 50 %

For IRS Use Only

Part III Shareholder's Share of Current Year Income, Deductions, Credits, and Other Items

1	Ordinary business income (loss)	36,233
2	Net rental real estate income (loss)	
3	Other net rental income (loss)	
4	Interest income	600
5a	Ordinary dividends	5,800
5b	Qualified dividends	5,800
6	Royalties	
7	Net short-term capital gain (loss)	
8a	Net long-term capital gain (loss)	24,333
8b	Collectibles (28%) gain (loss)	
8c	Unrecaptured section 1250 gain	
9	Net section 1231 gain (loss)	(550)
10	Other income (loss)	
11	Section 179 deduction	
12	Other deductions	
A		4,500
K		300
H		250
Q		45,000
R		225,510

13	Credits	
14	Foreign transactions	
15	Alternative minimum tax (AMT) items	
A		4,500
16	Items affecting shareholder basis	
A		300
C		7,250
D		35,000
17	Other information	
A		600
A		*5,800
B		300

* See attached statement for additional information.

*Investment income if shareholder elects to tax dividends at ordinary rates under Sec. 163(d)(4)(B).

This list identifies the codes used on Schedule K-1 for all shareholders and provides summarized reporting information for shareholders who file Form 1040. For detailed reporting and filing information, see the separate Shareholder's Instructions for Schedule K-1 and the instructions for your income tax return.

1. Ordinary business income (loss). Determine whether the income (loss) is passive or nonpassive and enter on your return as follows:

	Report on
Passive loss	See the Shareholder's Instructions
Passive income	Schedule E, line 28, column (g)
Nonpassive loss	Schedule E, line 28, column (h)
Nonpassive income	Schedule E, line 28, column (j)
2. Net rental real estate income (loss)	See the Shareholder's Instructions
3. Other net rental income (loss)	
Net income	Schedule E, line 28, column (g)
Net loss	See the Shareholder's Instructions
4. Interest income	Form 1040, line 8a
5a. Ordinary dividends	Form 1040, line 9a
5b. Qualified dividends	Form 1040, line 9b
6. Royalties	Schedule E, line 4
7. Net short-term capital gain (loss)	Schedule D, line 5
8a. Net long-term capital gain (loss)	Schedule D, line 12
8b. Collectibles (28%) gain (loss)	28% Rate Gain Worksheet, line 4 (Schedule D instructions)
8c. Unrecaptured section 1250 gain	See the Shareholder's Instructions
9. Net section 1231 gain (loss)	See the Shareholder's Instructions

10. Other income (loss)

Code		
A	Other portfolio income (loss)	See the Shareholder's Instructions
B	Involuntary conversions	See the Shareholder's Instructions
C	Sec. 1256 contracts & straddles	Form 6781, line 1
D	Mining exploration costs recapture	See Pub. 535
E	Other income (loss)	See the Shareholder's Instructions

11. Section 179 deduction — See the Shareholder's Instructions

12. Other deductions

A	Cash contributions (50%)	See the Shareholder's Instructions
B	Cash contributions (30%)	See the Shareholder's Instructions
C	Noncash contributions (50%)	See the Shareholder's Instructions
D	Noncash contributions (30%)	See the Shareholder's Instructions
E	Capital gain property to a 50% organization (30%)	See the Shareholder's Instructions
F	Capital gain property (20%)	See the Shareholder's Instructions
G	Contributions (100%)	See the Shareholder's Instructions
H	Investment interest expense	Form 4952, line 1
I	Deductions—royalty income	Schedule E, line 19
J	Section 59(e)(2) expenditures	See the Shareholder's Instructions
K	Deductions—portfolio (2% floor)	Schedule A, line 23
L	Deductions—portfolio (other)	Schedule A, line 28
M	Preproductive period expenses	See the Shareholder's Instructions
N	Commercial revitalization deduction from rental real estate activities	See Form 8582 instructions
O	Reforestation expense deduction	See the Shareholder's Instructions
P	Domestic production activities information	See Form 8903 instructions
Q	Qualified production activities income	Form 8903, line 7b
R	Employer's Form W-2 wages	Form 8903, line 17
S	Other deductions	See the Shareholder's Instructions

13. Credits

A	Low-income housing credit (section 42(j)(5)) from pre-2008 buildings	See the Shareholder's Instructions
B	Low-income housing credit (other) from pre-2008 buildings	See the Shareholder's Instructions
C	Low-income housing credit (section 42(j)(5)) from post-2007 buildings	See the Shareholder's Instructions
D	Low-income housing credit (other) from post-2007 buildings	See the Shareholder's Instructions
E	Qualified rehabilitation expenditures (rental real estate)	See the Shareholder's Instructions
F	Other rental real estate credits	See the Shareholder's Instructions
G	Other rental credits	See the Shareholder's Instructions
H	Undistributed capital gains credit	Form 1040, line 71, box a
I	Biofuel producer credit	See the Shareholder's Instructions
J	Work opportunity credit	See the Shareholder's Instructions
K	Disabled access credit	See the Shareholder's Instructions
L	Empowerment zone employment credit	See the Shareholder's Instructions
M	Credit for increasing research activities	See the Shareholder's Instructions
N	Credit for employer social security and Medicare taxes	See the Shareholder's Instructions
O	Backup withholding	See the Shareholder's Instructions
P	Other credits	See the Shareholder's Instructions

14. Foreign transactions

Code		*Report on*
A	Name of country or U.S. possession	Form 1116, Part I
B	Gross income from all sources	Form 1116, Part I
C	Gross income sourced at shareholder level	Form 1116, Part I
	Foreign gross income sourced at corporate level	
D	Passive category	Form 1116, Part I
E	General category	Form 1116, Part I
F	Other	Form 1116, Part I
	Deductions allocated and apportioned at shareholder level	
G	Interest expense	Form 1116, Part I
H	Other	Form 1116, Part I
	Deductions allocated and apportioned at corporate level to foreign source income	
I	Passive category	Form 1116, Part I
J	General category	Form 1116, Part I
K	Other	Form 1116, Part I
	Other information	
L	Total foreign taxes paid	Form 1116, Part II
M	Total foreign taxes accrued	Form 1116, Part II
N	Reduction in taxes available for credit	Form 1116, line 12
O	Foreign trading gross receipts	Form 8873
P	Extraterritorial income exclusion	Form 8873
Q	Other foreign transactions	See the Shareholder's Instructions

15. Alternative minimum tax (AMT) items

A	Post-1986 depreciation adjustment	See the Shareholder's Instructions and the Instructions for Form 6251
B	Adjusted gain or loss	See the Shareholder's Instructions and the Instructions for Form 6251
C	Depletion (other than oil & gas)	See the Shareholder's Instructions and the Instructions for Form 6251
D	Oil, gas, & geothermal—gross income	See the Shareholder's Instructions and the Instructions for Form 6251
E	Oil, gas, & geothermal—deductions	See the Shareholder's Instructions and the Instructions for Form 6251
F	Other AMT items	See the Shareholder's Instructions and the Instructions for Form 6251

16. Items affecting shareholder basis

A	Tax-exempt interest income	Form 1040, line 8b
B	Other tax-exempt income	See the Shareholder's Instructions
C	Nondeductible expenses	See the Shareholder's Instructions
D	Distributions	See the Shareholder's Instructions
E	Repayment of loans from shareholders	See the Shareholder's Instructions

17. Other information

A	Investment income	Form 4952, line 4a
B	Investment expenses	Form 4952, line 5
C	Qualified rehabilitation expenditures (other than rental real estate)	See the Shareholder's Instructions
D	Basis of energy property	See the Shareholder's Instructions
E	Recapture of low-income housing credit (section 42(j)(5))	Form 8611, line 8
F	Recapture of low-income housing credit (other)	Form 8611, line 8
G	Recapture of investment credit	See Form 4255
H	Recapture of other credits	See the Shareholder's Instructions
I	Look-back interest—completed long-term contracts	See Form 8697
J	Look-back interest—income forecast method	See Form 8866
K	Dispositions of property with section 179 deductions	See the Shareholder's Instructions
L	Recapture of section 179 deduction	See the Shareholder's Instructions
M	Section 453(l)(3) information	See the Shareholder's Instructions
N	Section 453A(c) information	See the Shareholder's Instructions
O	Section 1260(b) information	See the Shareholder's Instructions
P	Interest allocable to production expenditures	See the Shareholder's Instructions
Q	CCF nonqualified withdrawals	See the Shareholder's Instructions
R	Depletion information—oil and gas	See the Shareholder's Instructions
S	Amortization of reforestation costs	See the Shareholder's Instructions
T	Section 108(i) information	See the Shareholder's Instructions
U	Net investment income	See the Shareholder's Instructions
V	Other information	See the Shareholder's Instructions

Form **1120S** | Department of the Treasury Internal Revenue Service

U.S. Income Tax Return for an S Corporation

▶ **Do not file this form unless the corporation has filed or is attaching Form 2553 to elect to be an S corporation.**
▶ **Information about Form 1120S and its separate instructions is at *www.irs.gov/form1120s*.**

OMB No. 1545-0123 | **2015**

For calendar year 2015 or tax year beginning , 2015, ending , 20

A S election effective date: 1/1/14	Name: Healthwise Medical Supplies Company	**D Employer identification number**: XX-2017015
B Business activity code number (see instructions): 339110	TYPE OR PRINT — Number, street, and room or suite no. If a P.O. box, see instructions.: 2400 Second Street	**E** Date incorporated: 1/1/14
C Check if Sch. M-3 attached ☐	City or town, state or province, country, and ZIP or foreign postal code: City, ST 12345	**F** Total assets (see instructions): $ 3,466,740

G Is the corporation electing to be an S corporation beginning with this tax year? ☐ Yes ☒ No If "Yes," attach Form 2553 if not already filed

H Check if: **(1)** ☐ Final return **(2)** ☐ Name change **(3)** ☐ Address change **(4)** ☐ Amended return **(5)** ☐ S election termination or revocation

I Enter the number of shareholders who were shareholders during any part of the tax year ▶ 2

Caution. Include **only** trade or business income and expenses on lines 1a through 21. See the instructions for more information.

Income	1a	Gross receipts or sales	1a	6,000,000		
	b	Returns and allowances	1b	300,000		
	c	Balance. Subtract line 1b from line 1a			1c	5,700,000
	2	Cost of goods sold (attach Form 1125-A)			2	2,160,000
	3	Gross profit. Subtract line 2 from line 1c			3	3,540,000
	4	Net gain (loss) from Form 4797, line 17 (attach Form 4797)			4	
	5	Other income (loss) (see instructions—attach statement)			5	
	6	**Total income (loss).** Add lines 3 through 5 ▶			6	3,540,000
Deductions (see instructions for limitations)	7	Compensation of officers (see instructions—attach Form 1125-E)			7	150,000
	8	Salaries and wages (less employment credits)			8	840,000
	9	Repairs and maintenance			9	39,000
	10	Bad debts			10	
	11	Rents			11	180,000
	12	Taxes and licenses			12	84,000
	13	Interest			13	28,800
	14	Depreciation not claimed on Form 1125-A or elsewhere on return (attach Form 4562)			14	293,880
	15	Depletion **(Do not deduct oil and gas depletion.)**			15	
	16	Advertising			16	36,000
	17	Pension, profit-sharing, etc., plans			17	
	18	Employee benefit programs			18	
	19	Other deductions (attach statement)			19	207,000
	20	**Total deductions.** Add lines 7 through 19 ▶			20	1,858,680
	21	**Ordinary business income (loss).** Subtract line 20 from line 6			21	1,681,320
Tax and Payments	22a	Excess net passive income or LIFO recapture tax (see instructions)	22a			
	b	Tax from Schedule D (Form 1120S)	22b			
	c	Add lines 22a and 22b (see instructions for additional taxes)			22c	
	23a	2015 estimated tax payments and 2014 overpayment credited to 2015	23a			
	b	Tax deposited with Form 7004	23b			
	c	Credit for federal tax paid on fuels (attach Form 4136)	23c			
	d	Add lines 23a through 23c			23d	
	24	Estimated tax penalty (see instructions). Check if Form 2220 is attached ▶ ☐			24	
	25	**Amount owed.** If line 23d is smaller than the total of lines 22c and 24, enter amount owed			25	
	26	**Overpayment.** If line 23d is larger than the total of lines 22c and 24, enter amount overpaid			26	
	27	Enter amount from line 26 **Credited to 2016 estimated tax** ▶		**Refunded** ▶	27	

Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Signature of officer	Date	Title
Leisa H. Bailey	4/14/16	President

May the IRS discuss this return with the preparer shown below (see instructions)? ☐ Yes ☐ No

Paid Preparer Use Only

Print/Type preparer's name	Preparer's signature	Date	Check ☐ if self-employed	PTIN
Firm's name ▶			Firm's EIN ▶	
Firm's address ▶			Phone no.	

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11510H Form **1120S** (2015)

Schedule B **Other Information** (see instructions)

		Yes	No
1	Check accounting method: a ☐ Cash b ☑ Accrual c ☐ Other (specify) ▶		
2	See the instructions and enter the: a Business activity ▶ Manufacturing and sales b Product or service ▶ Medical equipment		
3	At any time during the tax year, was any shareholder of the corporation a disregarded entity, a trust, an estate, or a nominee or similar person? If "Yes," attach Schedule B-1, Information on Certain Shareholders of an S Corporation . .		✓
4	At the end of the tax year, did the corporation:		
a	Own directly 20% or more, or own, directly or indirectly, 50% or more of the total stock issued and outstanding of any foreign or domestic corporation? For rules of constructive ownership, see instructions. If "Yes," complete (i) through (v) below . . .		✓

(i) Name of Corporation	(ii) Employer Identification Number (if any)	(iii) Country of Incorporation	(iv) Percentage of Stock Owned	(v) If Percentage in (iv) is 100%, Enter the Date (if any) a Qualified Subchapter S Subsidiary Election Was Made

		Yes	No
b	Own directly an interest of 20% or more, or own, directly or indirectly, an interest of 50% or more in the profit, loss, or capital in any foreign or domestic partnership (including an entity treated as a partnership) or in the beneficial interest of a trust? For rules of constructive ownership, see instructions. If "Yes," complete (i) through (v) below . . .		

(i) Name of Entity	(ii) Employer Identification Number (if any)	(iii) Type of Entity	(iv) Country of Organization	(v) Maximum Percentage Owned in Profit, Loss, or Capital

		Yes	No
5 a	At the end of the tax year, did the corporation have any outstanding shares of restricted stock? . . .		✓
	If "Yes," complete lines (i) and (ii) below. (i) Total shares of restricted stock . . . ▶ (ii) Total shares of non-restricted stock . . . ▶		
b	At the end of the tax year, did the corporation have any outstanding stock options, warrants, or similar instruments? .		✓
	If "Yes," complete lines (i) and (ii) below. (i) Total shares of stock outstanding at the end of the tax year ▶ (ii) Total shares of stock outstanding if all instruments were executed ▶		
6	Has this corporation filed, or is it required to file, **Form 8918,** Material Advisor Disclosure Statement, to provide information on any reportable transaction? . . .		✓
7	Check this box if the corporation issued publicly offered debt instruments with original issue discount . . . . ▶ ☐ If checked, the corporation may have to file **Form 8281,** Information Return for Publicly Offered Original Issue Discount Instruments.		
8	If the corporation: **(a)** was a C corporation before it elected to be an S corporation **or** the corporation acquired an asset with a basis determined by reference to the basis of the asset (or the basis of any other property) in the hands of a C corporation **and (b)** has net unrealized built-in gain in excess of the net recognized built-in gain from prior years, enter the net unrealized built-in gain reduced by net recognized built-in gain from prior years (see instructions) . . . ▶ $		
9	Enter the accumulated earnings and profits of the corporation at the end of the tax year. $		
10	Does the corporation satisfy **both** of the following conditions?		
a	The corporation's total receipts (see instructions) for the tax year were less than $250,000 . . .		
b	The corporation's total assets at the end of the tax year were less than $250,000 . . .		✓
	If "Yes," the corporation is not required to complete Schedules L and M-1.		
11	During the tax year, did the corporation have any non-shareholder debt that was canceled, was forgiven, or had the terms modified so as to reduce the principal amount of the debt? . . .		✓
	If "Yes," enter the amount of principal reduction $		
12	During the tax year, was a qualified subchapter S subsidiary election terminated or revoked? If "Yes," see instructions .		✓
13 a	Did the corporation make any payments in 2015 that would require it to file Form(s) 1099? . . .		✓
b	If "Yes," did the corporation file or will it file required Forms 1099? . . .		

Form 1120S (2015) Page **3**

Schedule K **Shareholders' Pro Rata Share Items**

					Total amount
Income (Loss)	1	Ordinary business income (loss) (page 1, line 21)		1	1,681,320
	2	Net rental real estate income (loss) (attach Form 8825)		2	
	3a	Other gross rental income (loss)	3a		
	b	Expenses from other rental activities (attach statement)	3b		
	c	Other net rental income (loss). Subtract line 3b from line 3a		3c	
	4	Interest income		4	
	5	Dividends: **a** Ordinary dividends		5a	19,800
		b Qualified dividends	5b 19,800		
	6	Royalties		6	
	7	Net short-term capital gain (loss) (attach Schedule D (Form 1120S))		7	
	8a	Net long-term capital gain (loss) (attach Schedule D (Form 1120S))		8a	1,008,000
	b	Collectibles (28%) gain (loss)	8b		
	c	Unrecaptured section 1250 gain (attach statement)	8c		
	9	Net section 1231 gain (loss) (attach Form 4797)		9	
	10	Other income (loss) (see instructions) Type ▶		10	
Deductions	11	Section 179 deduction (attach Form 4562)		11	500,000
	12a	Charitable contributions		12a	48,000
	b	Investment interest expense		12b	3,600
	c	Section 59(e)(2) expenditures **(1)** Type ▶	**(2)** Amount ▶	12c(2)	
	d	Other deductions (see instructions) Type ▶ Investment expenses		12d	5,400
Credits	13a	Low-income housing credit (section 42(j)(5))		13a	
	b	Low-income housing credit (other)		13b	
	c	Qualified rehabilitation expenditures (rental real estate) (attach Form 3468, if applicable)		13c	
	d	Other rental real estate credits (see instructions) Type ▶		13d	
	e	Other rental credits (see instructions) Type ▶		13e	
	f	Biofuel producer credit (attach Form 6478)		13f	
	g	Other credits (see instructions) Type ▶		13g	
Foreign Transactions	14a	Name of country or U.S. possession ▶			
	b	Gross income from all sources		14b	
	c	Gross income sourced at shareholder level		14c	
		Foreign gross income sourced at corporate level			
	d	Passive category		14d	
	e	General category		14e	
	f	Other (attach statement)		14f	
		Deductions allocated and apportioned at shareholder level			
	g	Interest expense		14g	
	h	Other		14h	
		Deductions allocated and apportioned at corporate level to foreign source income			
	i	Passive category		14i	
	j	General category		14j	
	k	Other (attach statement)		14k	
		Other information			
	l	Total foreign taxes (check one): ▶ ☐ Paid ☐ Accrued		14l	
	m	Reduction in taxes available for credit (attach statement)		14m	
	n	Other foreign tax information (attach statement)			
Alternative Minimum Tax (AMT) Items	15a	Post-1986 depreciation adjustment (293,880 – 229,560)		15a	64,320
	b	Adjusted gain or loss		15b	
	c	Depletion (other than oil and gas)		15c	
	d	Oil, gas, and geothermal properties—gross income		15d	
	e	Oil, gas, and geothermal properties—deductions		15e	
	f	Other AMT items (attach statement)		15f	
Items Affecting Shareholder Basis	16a	Tax-exempt interest income		16a	800
	b	Other tax-exempt income		16b	
	c	Nondeductible expenses		16c	9,000
	d	Distributions (attach statement if required) (see instructions)		16d	1,800,000
	e	Repayment of loans from shareholders		16e	

Form **1120S** (2015)

Form 1120S (2015) Page 4

Schedule K **Shareholders' Pro Rata Share Items** (continued)

				Total amount
Other Information	17a	Investment income	17a	19,800*
	b	Investment expenses	17b	5,400
	c	Dividend distributions paid from accumulated earnings and profits	17c	
	d	Other items and amounts (attach statement)		
Reconciliation	18	**Income/loss reconciliation.** Combine the amounts on lines 1 through 10 in the far right column. From the result, subtract the sum of the amounts on lines 11 through 12d and 14l	18	2,152,120

Schedule L **Balance Sheets per Books**

		Beginning of tax year		End of tax year	
	Assets	(a)	(b)	(c)	(d)
1	Cash		596,200		552,100
2a	Trade notes and accounts receivable	648,000		720,000	
b	Less allowance for bad debts	(0)	648,000	(0)	720,000
3	Inventories		1,200,000		1,440,000
4	U.S. government obligations				
5	Tax-exempt securities (see instructions)		20,000		20,000
6	Other current assets (attach statement)				
7	Loans to shareholders				
8	Mortgage and real estate loans				
9	Other investments (attach statement)		360,000		0
10a	Buildings and other depreciable assets	1,200,000		1,700,000	
b	Less accumulated depreciation	(171,480)	1,028,520	(965,360)	734,640
11a	Depletable assets				
b	Less accumulated depletion	( )		( )	
12	Land (net of any amortization)				
13a	Intangible assets (amortizable only)				
b	Less accumulated amortization	( )		( )	
14	Other assets (attach statement)				
15	Total assets		3,852,720		3,466,740
	Liabilities and Shareholders' Equity				
16	Accounts payable		120,000		156,000
17	Mortgages, notes, bonds payable in less than 1 year		600,000		120,000
18	Other current liabilities (attach statement)		4,200		6,300
19	Loans from shareholders				
20	Mortgages, notes, bonds payable in 1 year or more				
21	Other liabilities (attach statement)				
22	Capital stock		3,000,000		3,000,000
23	Additional paid-in capital				
24	Retained earnings		128,520		184,440
25	Adjustments to shareholders' equity (attach statement)				
26	Less cost of treasury stock		( )		( )
27	Total liabilities and shareholders' equity		3,852,720		3,466,740

*Investment income if shareholders elect to tax dividends at ordinary rates under Sec. 163(d)(4)(B).

Form **1120S** (2015)

Schedule M-1 Reconciliation of Income (Loss) per Books With Income (Loss) per Return

Note. Schedule M-3 required instead of Schedule M-1 if total assets are $10 million or more—see instructions

1	Net income (loss) per books	1,855,920	5	Income recorded on books this year not included on Schedule K, lines 1 through 10 (itemize):	
2	Income included on Schedule K, lines 1, 2, 3c, 4, 5a, 6, 7, 8a, 9, and 10, not recorded on books this year (itemize) Gain on stock sale	288,000	a	Tax-exempt interest $ 800	800
3	Expenses recorded on books this year not included on Schedule K, lines 1 through 12 and 14l (itemize):		6	Deductions included on Schedule K, lines 1 through 12 and 14l, not charged against book income this year (itemize):	
a	Depreciation $		a	Depreciation $	
b	Travel and entertainment $ 9,000	9,000	7	Add lines 5 and 6	800
4	Add lines 1 through 3	2,152,920	8	Income (loss) (Schedule K, line 18). Line 4 less line 7	2,152,120

Schedule M-2 Analysis of Accumulated Adjustments Account, Other Adjustments Account, and Shareholders' Undistributed Taxable Income Previously Taxed (see instructions)

		(a) Accumulated adjustments account	(b) Other adjustments account	(c) Shareholders' undistributed taxable income previously taxed
1	Balance at beginning of tax year	128,520[a]	0	
2	Ordinary income from page 1, line 21	1,681,320		
3	Other additions	1,027,800[b]	800	
4	Loss from page 1, line 21	( )		
5	Other reductions	(566,000[b])	( )	
6	Combine lines 1 through 5	2,271,640	800	
7	Distributions other than dividend distributions	1,800,000		
8	Balance at end of tax year. Subtract line 7 from line 6	471,640	800	

Form **1120S** (2015)

[a]Given in problem facts.

[b]See schedule on next page.

Healthwise Medical Supplies Company
XX-2017015 2015 Form 1120S

Page 1, Line 20 - Other deductions:

General insurance	$ 42,000
Travel	24,000
Utilities	72,000
Professional fees	60,000
Meals and entertainment ($18,000 x 0.50)	9,000
Total	$207,000

Page 4, Schedule M-2, Line 3 - Other additions:

Dividend income	$ 19,800
Long-term capital gain	1,008,000
Total	$1,027,800

Page 4, Schedule M-2, Line 5 - Other reductions:

Sec. 179 expense	$500,000
Nondeductible M&E expenses	9,000
Cash contributions	48,000
Investment interest expense	3,600
Investment expenses	5,400
Total	$566,000

SCHEDULE D (Form 1120S)

Department of the Treasury
Internal Revenue Service

Capital Gains and Losses and Built-in Gains

▶ Attach to Form 1120S.
▶ Use Form 8949 to list your transactions for lines 1b, 2, 3, 8b, 9, and 10.
▶ Information about Schedule D and its separate instructions is at *www.irs.gov/form1120s*.

OMB No. 1545-0123

2015

Name: Healthwise Medical Supplies Company

Employer identification number: XX-2017015

Part I Short-Term Capital Gains and Losses—Assets Held One Year or Less

See instructions for how to figure the amounts to enter on the lines below. This form may be easier to complete if you round off the cents to whole dollars.	(d) Proceeds (sales price)	(e) Cost (or other basis)	(g) Adjustments to gain or loss from Form(s) 8949, Part I, line 2, column (g)	(h) Gain or (loss). Subtract column (e) from column (d) and combine the result with column (g)
1a Totals for all short-term transactions reported on Form 1099-B for which basis was reported to the IRS and for which you have no adjustments (see instructions). However, if you choose to report all these transactions on Form 8949, leave this line blank and go to line 1b				
1b Totals for all transactions reported on Form(s) 8949 with **Box A** checked				
2 Totals for all transactions reported on Form(s) 8949 with **Box B** checked				
3 Totals for all transactions reported on Form(s) 8949 with **Box C** checked				

4	Short-term capital gain from installment sales from Form 6252, line 26 or 37	4	
5	Short-term capital gain or (loss) from like-kind exchanges from Form 8824	5	
6	Tax on short-term capital gain included on line 23 below	6	( )
7	**Net short-term capital gain or (loss).** Combine lines 1a through 6 in column (h). Enter here and on Form 1120S, Schedule K, line 7 or 10	7	

Part II Long-Term Capital Gains and Losses—Assets Held More Than One Year

See instructions for how to figure the amounts to enter on the lines below. This form may be easier to complete if you round off the cents to whole dollars.	(d) Proceeds (sales price)	(e) Cost (or other basis)	(g) Adjustments to gain or loss from Form(s) 8949, Part II, line 2, column (g)	(h) Gain or (loss). Subtract column (e) from column (d) and combine the result with column (g)
8a Totals for all long-term transactions reported on Form 1099-B for which basis was reported to the IRS and for which you have no adjustments (see instructions). However, if you choose to report all these transactions on Form 8949, leave this line blank and go to line 8b				
8b Totals for all transactions reported on Form(s) 8949 with **Box D** checked				
9 Totals for all transactions reported on Form(s) 8949 with **Box E** checked				
10 Totals for all transactions reported on Form(s) 8949 with **Box F** checked	*1,080,000	72,000		1,008,000

11	Long-term capital gain from installment sales from Form 6252, line 26 or 37	11	
12	Long-term capital gain or (loss) from like-kind exchanges from Form 8824	12	
13	Capital gain distributions (see instructions)	13	
14	Tax on long-term capital gain included on line 23 below	14	( )
15	**Net long-term capital gain or (loss).** Combine lines 8a through 14 in column (h). Enter here and on Form 1120S, Schedule K, line 8a or 10	15	1,008,000

For Paperwork Reduction Act Notice, see the Instructions for Form 1120S. Cat. No. 11516V **Schedule D (Form 1120S) 2015**

Note: Page 2 and Form 8949 not attached.

*1,000 shares Fastgrowth, Inc.: acquired 1/2/12; sold 7/2/15.

Form **1125-A** (Rev. December 2012) Department of the Treasury Internal Revenue Service

Cost of Goods Sold

► Attach to Form 1120, 1120-C, 1120-F, 1120S, 1065, or 1065-B.
► Information about Form 1125-A and its instructions is at *www.irs.gov/form1125a.*

OMB No. 1545-2225

Name	Employer identification number
Healthwise Medical Supplies Company	XX-2017015

1	Inventory at beginning of year	1	1,200,000
2	Purchases	2	2,400,000
3	Cost of labor	3	
4	Additional section 263A costs (attach schedule)	4	
5	Other costs (attach schedule)	5	
6	**Total.** Add lines 1 through 5	6	3,600,000
7	Inventory at end of year	7	1,440,000
8	**Cost of goods sold.** Subtract line 7 from line 6. Enter here and on Form 1120, page 1, line 2 or the appropriate line of your tax return (see instructions)	8	2,160,000

9a Check all methods used for valuing closing inventory:
- (i) ☐ Cost
- (ii) ☑ Lower of cost or market
- (iii) ☐ Other (Specify method used and attach explanation.) ►

b Check if there was a writedown of subnormal goods ► ☐

c Check if the LIFO inventory method was adopted this tax year for any goods (if checked, attach Form 970) ► ☐

d If the LIFO inventory method was used for this tax year, enter amount of closing inventory computed under LIFO — 9d

e If property is produced or acquired for resale, do the rules of section 263A apply to the entity (see instructions)? ☐ Yes ☑ No

f Was there any change in determining quantities, cost, or valuations between opening and closing inventory? If "Yes," attach explanation ☐ Yes ☑ No

Section references are to the Internal Revenue Code unless otherwise noted.

General Instructions

Purpose of Form

Use Form 1125-A to calculate and deduct cost of goods sold for certain entities.

Who Must File

Filers of Form 1120, 1120-C, 1120-F, 1120S, 1065, or 1065-B, must complete and attach Form 1125-A if the applicable entity reports a deduction for cost of goods sold.

Inventories

Generally, inventories are required at the beginning and end of each tax year if the production, purchase, or sale of merchandise is an income-producing factor. See Regulations section 1.471-1. If inventories are required, you generally must use an accrual method of accounting for sales and purchases of inventory items.

Exception for certain taxpayers. If you are a qualifying taxpayer or a qualifying small business taxpayer (defined below), you can adopt or change your accounting method to account for inventoriable items in the same manner as materials and supplies that are not incidental.

Under this accounting method, inventory costs for raw materials purchased for use in producing finished goods and merchandise purchased for resale are deductible in the year the finished goods or merchandise are sold (but not before the year you paid for the raw materials or merchandise, if you are also using the cash method).

If you account for inventoriable items in the same manner as materials and supplies that are not incidental, you can currently deduct expenditures for direct labor and all indirect costs that would otherwise be included in inventory costs. See the instructions for lines 2 and 7.

For additional guidance on this method of accounting, see Pub. 538, Accounting Periods and Methods. For guidance on adopting or changing to this method of accounting, see Form 3115, Application for Change in Accounting Method, and its instructions.

Qualifying taxpayer. A qualifying taxpayer is a taxpayer that, (a) for each prior tax year ending after December 16, 1998, has average annual gross receipts of $1 million or less for the 3 prior tax years and (b) its business is not a tax shelter (as defined in section 448(d)(3)). See Rev. Proc. 2001-10, 2001-2 I.R.B. 272.

Qualifying small business taxpayer. A qualifying small business taxpayer is a taxpayer that, (a) for each prior tax year ending on or after December 31, 2000, has average annual gross receipts of $10 million or less for the 3 prior tax years, (b) whose principal business activity is not an ineligible activity, and (c) whose business is not a tax shelter (as defined in section 448 (d)(3)). See Rev. Proc. 2002-28, 2002-18 I.R.B. 815.

Uniform capitalization rules. The uniform capitalization rules of section 263A generally require you to capitalize, or include in inventory, certain costs incurred in connection with the following.

- The production of real property and tangible personal property held in inventory or held for sale in the ordinary course of business.
- Real property or personal property (tangible and intangible) acquired for resale.
- The production of real property and tangible personal property by a corporation for use in its trade or business or in an activity engaged in for profit.

See the discussion on section 263A uniform capitalization rules in the instructions for your tax return before completing Form 1125-A. Also see Regulations sections 1.263A-1 through 1.263A-3. See Regulations section 1.263A-4 for rules for property produced in a farming business.

Form **4562** — Department of the Treasury, Internal Revenue Service (99)

Depreciation and Amortization

(Including Information on Listed Property)

▶ Attach to your tax return.

▶ Information about Form 4562 and its separate instructions is at *www.irs.gov/form4562.*

OMB No. 1545-0172 — 2015 — Attachment Sequence No. 179

Name(s) shown on return	Business or activity to which this form relates	Identifying number
Healthwise Medical Supplies Company	Medical Equipment Manufacturing	XX-2017015

Part I Election To Expense Certain Property Under Section 179

Note: *If you have any listed property, complete Part V before you complete Part I.*

1	Maximum amount (see instructions)	1	500,000
2	Total cost of section 179 property placed in service (see instructions)	2	500,000
3	Threshold cost of section 179 property before reduction in limitation (see instructions)	3	2,000,000
4	Reduction in limitation. Subtract line 3 from line 2. If zero or less, enter -0-	4	0
5	Dollar limitation for tax year. Subtract line 4 from line 1. If zero or less, enter -0-. If married filing separately, see instructions	5	

6	(a) Description of property	(b) Cost (business use only)	(c) Elected cost
	Equipment	500,000	500,000

7	Listed property. Enter the amount from line 29	7	
8	Total elected cost of section 179 property. Add amounts in column (c), lines 6 and 7	8	500,000
9	Tentative deduction. Enter the **smaller** of line 5 or line 8	9	500,000
10	Carryover of disallowed deduction from line 13 of your 2014 Form 4562	10	
11	Business income limitation. Enter the smaller of business income (not less than zero) or line 5 (see instructions)	11	500,000
12	Section 179 expense deduction. Add lines 9 and 10, but do not enter more than line 11	12	500,000
13	Carryover of disallowed deduction to 2016. Add lines 9 and 10, less line 12 ▶	13	

Note: *Do not use Part II or Part III below for listed property. Instead, use Part V.*

Part II Special Depreciation Allowance and Other Depreciation (Do not include listed property.) (See instructions.)

14	Special depreciation allowance for qualified property (other than listed property) placed in service during the tax year (see instructions)	14	
15	Property subject to section 168(f)(1) election	15	
16	Other depreciation (including ACRS)	16	

Part III MACRS Depreciation (Do not include listed property.) (See instructions.)

Section A

17	MACRS deductions for assets placed in service in tax years beginning before 2015	17	293,880
18	If you are electing to group any assets placed in service during the tax year into one or more general asset accounts, check here ▶ ☐		

Section B—Assets Placed in Service During 2015 Tax Year Using the General Depreciation System

(a) Classification of property	(b) Month and year placed in service	(c) Basis for depreciation (business/investment use only—see instructions)	(d) Recovery period	(e) Convention	(f) Method	(g) Depreciation deduction
19a 3-year property						
b 5-year property						
c 7-year property						
d 10-year property						
e 15-year property						
f 20-year property						
g 25-year property			25 yrs.		S/L	
h Residential rental property			27.5 yrs.	MM	S/L	
			27.5 yrs.	MM	S/L	
i Nonresidential real property			39 yrs.	MM	S/L	
				MM	S/L	

Section C—Assets Placed in Service During 2014 Tax Year Using the Alternative Depreciation System

20a Class life					S/L	
b 12-year			12 yrs.		S/L	
c 40-year			40 yrs.	MM	S/L	

Part IV Summary (See instructions.)

21	Listed property. Enter amount from line 28	21	
22	**Total.** Add amounts from line 12, lines 14 through 17, lines 19 and 20 in column (g), and line 21. Enter here and on the appropriate lines of your return. Partnerships and S corporations—see instructions	22	293,880*
23	For assets shown above and placed in service during the current year, enter the portion of the basis attributable to section 263A costs	23	

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 12906N Form **4562** (2015)

* Form 4562 instructions say to omit Sec. 179 deduction from this line for S corporations.

671113

☐ Final K-1 ☐ Amended K-1 OMB No. 1545-0123

Schedule K-1 (Form 1120S) **2015**
Department of the Treasury
Internal Revenue Service

For calendar year 2015, or tax year beginning ____________, 2015 ending ____________, 20 ______

Shareholder's Share of Income, Deductions, Credits, etc.

▶ See back of form and separate instructions.

Part I Information About the Corporation

A Corporation's employer identification number
XX-2017015

B Corporation's name, address, city, state, and ZIP code
Healthwise Medical Supplies Company
2400 Second Street
City, ST 12345

C IRS Center where corporation filed return
Center City, ST

Part II Information About the Shareholder

D Shareholder's identifying number
XXX-XX-XXXX

E Shareholder's name, address, city, state, and ZIP code
Leisa H. Bailey
1200 First Pike
City, ST 12345

F Shareholder's percentage of stock ownership for tax year . . . . 30 %

For IRS Use Only

Part III Shareholder's Share of Current Year Income, Deductions, Credits, and Other Items

1	Ordinary business income (loss)	504,396
2	Net rental real estate income (loss)	
3	Other net rental income (loss)	
4	Interest income	
5a	Ordinary dividends	5,940
5b	Qualified dividends	5,940
6	Royalties	
7	Net short-term capital gain (loss)	
8a	Net long-term capital gain (loss)	302,400
8b	Collectibles (28%) gain (loss)	
8c	Unrecaptured section 1250 gain	
9	Net section 1231 gain (loss)	
10	Other income (loss)	
11	Section 179 deduction	150,000
12	Other deductions	
	A	14,400
	H	1,080
	K	1,620
	Q	576,000
	R	297,000
13	Credits	
14	Foreign transactions	
15	Alternative minimum tax (AMT) items	
	A	19,296
16	Items affecting shareholder basis	
	A	240
	C	2,700
	D	540,000
17	Other information	
	A	5,940*
	B	1,620

* See attached statement for additional information.

For Paperwork Reduction Act Notice, see Instructions for Form 1120S. IRS.gov/form1120s Cat. No. 11520D **Schedule K-1 (Form 1120S) 2015**

*Dividends are investment income to extent shareholder elects to tax them at ordinary rates under Sec. 163(d)(4)(B).

671113

☐ Final K-1 ☐ Amended K-1 OMB No. 1545-0123

Schedule K-1 (Form 1120S) **2015**

Department of the Treasury
Internal Revenue Service

For calendar year 2015, or tax year beginning ____________, 2015 ending ____________, 20 ______

Shareholder's Share of Income, Deductions, Credits, etc.

▶ See back of form and separate instructions.

Part I Information About the Corporation

A Corporation's employer identification number
XX-2017015

B Corporation's name, address, city, state, and ZIP code
Healthwise Medical Supplies Company
2400 Second Street
City, ST 12345

C IRS Center where corporation filed return
Center City, ST

Part II Information About the Shareholder

D Shareholder's identifying number
XXX-XX-XXXX

E Shareholder's name, address, city, state, and ZIP code
Thomas J. Firth
3600 Third Blvd.
City, ST 54321

F Shareholder's percentage of stock ownership for tax year . . . . 70 %

For IRS Use Only

Part III Shareholder's Share of Current Year Income, Deductions, Credits, and Other Items

1	Ordinary business income (loss)	1,176,924
2	Net rental real estate income (loss)	
3	Other net rental income (loss)	
4	Interest income	
5a	Ordinary dividends	13,860
5b	Qualified dividends	13,860
6	Royalties	
7	Net short-term capital gain (loss)	
8a	Net long-term capital gain (loss)	705,600
8b	Collectibles (28%) gain (loss)	
8c	Unrecaptured section 1250 gain	
9	Net section 1231 gain (loss)	
10	Other income (loss)	
11	Section 179 deduction	350,000
12	Other deductions	
	A	33,600
	H	2,520
	K	3,780
	Q	1,344,000
	R	693,000

13	Credits	
14	Foreign transactions	
15	Alternative minimum tax (AMT) items	
	A	45,024
16	Items affecting shareholder basis	
	A	560
	C	6,300
	D	1,260,000
17	Other information	
	A	13,860*
	B	3,780*

* See attached statement for additional information.

For Paperwork Reduction Act Notice, see Instructions for Form 1120S. IRS.gov/form1120s Cat. No. 11520D Schedule K-1 (Form 1120S) 2015

*Dividends are investment income to extent shareholder elects to tax them at ordinary rates under Sec. 163(d)(4)(B).

This list identifies the codes used on Schedule K-1 for all shareholders and provides summarized reporting information for shareholders who file Form 1040. For detailed reporting and filing information, see the separate Shareholder's Instructions for Schedule K-1 and the instructions for your income tax return.

1. Ordinary business income (loss). Determine whether the income (loss) is passive or nonpassive and enter on your return as follows:

	Report on
Passive loss	See the Shareholder's Instructions
Passive income	Schedule E, line 28, column (g)
Nonpassive loss	Schedule E, line 28, column (h)
Nonpassive income	Schedule E, line 28, column (j)

2. Net rental real estate income (loss)	See the Shareholder's Instructions
3. Other net rental income (loss)	
Net income	Schedule E, line 28, column (g)
Net loss	See the Shareholder's Instructions
4. Interest income	Form 1040, line 8a
5a. Ordinary dividends	Form 1040, line 9a
5b. Qualified dividends	Form 1040, line 9b
6. Royalties	Schedule E, line 4
7. Net short-term capital gain (loss)	Schedule D, line 5
8a. Net long-term capital gain (loss)	Schedule D, line 12
8b. Collectibles (28%) gain (loss)	28% Rate Gain Worksheet, line 4 (Schedule D instructions)
8c. Unrecaptured section 1250 gain	See the Shareholder's Instructions
9. Net section 1231 gain (loss)	See the Shareholder's Instructions

10. Other income (loss)

Code		
A	Other portfolio income (loss)	See the Shareholder's Instructions
B	Involuntary conversions	See the Shareholder's Instructions
C	Sec. 1256 contracts & straddles	Form 6781, line 1
D	Mining exploration costs recapture	See Pub. 535
E	Other income (loss)	See the Shareholder's Instructions

11. Section 179 deduction	See the Shareholder's Instructions

12. Other deductions

A	Cash contributions (50%)	See the Shareholder's Instructions (A–G)
B	Cash contributions (30%)	
C	Noncash contributions (50%)	
D	Noncash contributions (30%)	
E	Capital gain property to a 50% organization (30%)	
F	Capital gain property (20%)	
G	Contributions (100%)	
H	Investment interest expense	Form 4952, line 1
I	Deductions—royalty income	Schedule E, line 19
J	Section 59(e)(2) expenditures	See the Shareholder's Instructions
K	Deductions—portfolio (2% floor)	Schedule A, line 23
L	Deductions—portfolio (other)	Schedule A, line 28
M	Preproductive period expenses	See the Shareholder's Instructions
N	Commercial revitalization deduction from rental real estate activities	See Form 8582 instructions
O	Reforestation expense deduction	See the Shareholder's Instructions
P	Domestic production activities information	See Form 8903 instructions
Q	Qualified production activities income	Form 8903, line 7b
R	Employer's Form W-2 wages	Form 8903, line 17
S	Other deductions	See the Shareholder's Instructions

13. Credits

Code		*Report on*
A	Low-income housing credit (section 42(j)(5)) from pre-2008 buildings	See the Shareholder's Instructions (A–G)
B	Low-income housing credit (other) from pre-2008 buildings	
C	Low-income housing credit (section 42(j)(5)) from post-2007 buildings	
D	Low-income housing credit (other) from post-2007 buildings	
E	Qualified rehabilitation expenditures (rental real estate)	
F	Other rental real estate credits	
G	Other rental credits	
H	Undistributed capital gains credit	Form 1040, line 71, box a
I	Biofuel producer credit	See the Shareholder's Instructions (I–M)
J	Work opportunity credit	
K	Disabled access credit	
L	Empowerment zone employment credit	
M	Credit for increasing research activities	
N	Credit for employer social security and Medicare taxes	See the Shareholder's Instructions (N–P)
O	Backup withholding	
P	Other credits	

14. Foreign transactions

A	Name of country or U.S. possession	Form 1116, Part I (A–C)
B	Gross income from all sources	
C	Gross income sourced at shareholder level	
	Foreign gross income sourced at corporate level	
D	Passive category	Form 1116, Part I (D–F)
E	General category	
F	Other	
	Deductions allocated and apportioned at shareholder level	
G	Interest expense	Form 1116, Part I
H	Other	Form 1116, Part I
	Deductions allocated and apportioned at corporate level to foreign source income	
I	Passive category	Form 1116, Part I (I–K)
J	General category	
K	Other	
	Other information	
L	Total foreign taxes paid	Form 1116, Part II
M	Total foreign taxes accrued	Form 1116, Part II
N	Reduction in taxes available for credit	Form 1116, line 12
O	Foreign trading gross receipts	Form 8873
P	Extraterritorial income exclusion	Form 8873
Q	Other foreign transactions	See the Shareholder's Instructions

15. Alternative minimum tax (AMT) items

A	Post-1986 depreciation adjustment	See the Shareholder's Instructions and the Instructions for Form 6251 (A–F)
B	Adjusted gain or loss	
C	Depletion (other than oil & gas)	
D	Oil, gas, & geothermal—gross income	
E	Oil, gas, & geothermal—deductions	
F	Other AMT items	

16. Items affecting shareholder basis

A	Tax-exempt interest income	Form 1040, line 8b
B	Other tax-exempt income	See the Shareholder's Instructions (B–E)
C	Nondeductible expenses	
D	Distributions	
E	Repayment of loans from shareholders	

17. Other information

A	Investment income	Form 4952, line 4a
B	Investment expenses	Form 4952, line 5
C	Qualified rehabilitation expenditures (other than rental real estate)	See the Shareholder's Instructions
D	Basis of energy property	See the Shareholder's Instructions
E	Recapture of low-income housing credit (section 42(j)(5))	Form 8611, line 8
F	Recapture of low-income housing credit (other)	Form 8611, line 8
G	Recapture of investment credit	See Form 4255
H	Recapture of other credits	See the Shareholder's Instructions
I	Look-back interest—completed long-term contracts	See Form 8697
J	Look-back interest—income forecast method	See Form 8866
K	Dispositions of property with section 179 deductions	See the Shareholder's Instructions (K–V)
L	Recapture of section 179 deduction	
M	Section 453(l)(3) information	
N	Section 453A(c) information	
O	Section 1260(b) information	
P	Interest allocable to production expenditures	
Q	CCF nonqualified withdrawals	
R	Depletion information—oil and gas	
S	Amortization of reforestation costs	
T	Section 108(i) information	
U	Net investment income	
V	Other information	

Healthwise Medical Supplies Company
XX-2017015 2015 Form 1120S

Basis in S corporation stock:

Item	**Bailey**	**Firth**
Basis at 1/1/15	$ 938,556	$1,901,964
S corporation ordinary income	504,396	1,176,924
Dividend income	5,940	13,860
Long-term capital gain	302,400	705,600
Tax-exempt interest	240	560
Distributions	(540,000)	(1,260,000)
Sec. 179 expense	(150,000)	(350,000)
Nondeductible M&E expenses	(2,700)	(6,300)
Charitable contributions (cash)	(14,400)	(33,600)
Investment interest expense	(1,080)	(2,520)
Investment expenses	(1,620)	(3,780)
Basis at 12/31/15	$1,041,732	$2,142,708

Chapter C:2

Corporate Formations and Capital Structure

Learning Objectives

After studying this chapter, the student should be able to:

1. Discuss the tax advantages and disadvantages of alternative business forms.

2. Apply the check-the-box regulations to partnerships, corporations, and trusts.

3. Recognize the legal requirements and tax considerations related to forming a corporation.

4. Discuss the requirements for deferring gain or loss upon incorporation.

5. Explain the tax implications of alternative capital structures.

6. Determine the tax consequences of worthless stock or debt obligations.

7. Identify tax planning opportunities in corporate formations.

8. Comply with procedural rules for corporate formations.

Areas of Greater Significance

It is important for the student to understand the tax consequences of forming a corporation, including the impact on both corporation and shareholder. The tax advantages and disadvantages of alternative forms of doing business should also be stressed.

Areas of Lesser Significance

In the interest of time, the instructor may determine that the following areas are best covered by student reading, rather than by class discussion:

1. Capital contributions.

2. Compliance and procedural considerations (Reporting requirements under Sec. 351).

3. Choice of capital structure.

Problem Areas for Students

The following areas may prove especially difficult for students:

1. Allocating basis in a partially tax-free incorporation.

2. Characterization of an instrument as debt or equity.

3. Understanding that the tax basis for property contributed to a corporation is different from the basis that is used for financial accounting purposes.

Highlights of Recent Tax Law Changes

After 2012, the capital gains rate for noncorporate shareholders can be 0% for taxpayers in tax brackets of 15% and below, 15% for taxpayers in the 25% through 35% tax brackets, and 20% for taxpayers in the 39.6% tax bracket. An additional 3.8% capital gains rate applies for taxpayers whose modified AGI exceeds $200,000 ($250,000 for married filing jointly).

In 2011 and 2012, the employee's half of Social Security taxes was reduced from 6.2% to 4.2%. In 2013, the employee's share returned to 6.2% and continued at this rate in 2014 up to earnings of $117,000, and $118,500 in 2015 and 2016.

Teaching Tips

Limited liability companies (LLCs) and limited liability partnerships (LLPs) have become more prevalent forms of doing business. Some discussion of LLCs and LLPs should take place here with particular emphasis on (1) the treatment of LLCs in the state where your school is located; and (2) the use of LLPs by the Big 4 accounting firms. More discussion on LLCs and LLPs takes place in Chapters C:9 and C:10.

Use Examples C:2-11 and C:2-12 to illustrate the rationale behind treating a Sec. 351 transaction as a nontaxable exchange. pp. C:2-12 and C:2-13. Some discussion might be incorporated about the fact that a corporate liquidation is not a tax-free transaction. As a result, it is inexpensive to create a corporation, but may be expensive to liquidate a corporation.

Table C:2-1 may be used as a format for presenting the tax consequences of a Sec. 351 transaction. p. C:2-11.

Use Example C:2-23 as an illustration of a prearranged disposition of stock that disqualifies a Sec. 351 transaction. p. C:2-16.

Tables C:2-2 and C:2-3 can be used as a format for presenting the advantages and disadvantages of issuing equity vs. debt. Point out that cash flow consideration may make equity more attractive than debt. pp. C:2-29 and C:2-30.

Lecture Outline

I. Organization Forms Available.

Businesses can be conducted in one of several forms. A brief summary of these forms will provide the students with an overview of some of the factors that enter into the business form decision.

A. **Sole Proprietorships.** A sole proprietorship is a business owned by one individual and often is selected by individuals who are beginning a new business. The income and expenses are reported on a Schedule C of Form 1040 since a sole proprietorship is not a separate tax entity. All of the business assets are owned by the proprietor. Examples C:2-1 and C:2-2 illustrate the effect this will have on the amount of tax that will be paid on business income. A completed Schedule C and the related facts are included in Appendix B. These facts are used (with minor modifications) to illustrate the similarities and differences in the tax reporting process for a sole proprietorship, C corporation, partnership, and S corporation.

1. **Tax Advantages.** The tax advantages of doing business as a sole proprietorship are listed beginning on p. C:2-3.

2. **Tax Disadvantages.** The tax disadvantages of operating as a sole proprietorship are listed beginning on p. C:2-3.

B. **Partnerships.** A partnership is an unincorporated business carried on by two or more individuals or other entities. A partnership is a tax reporting, non-taxpaying entity, which acts as a conduit. All items of income, expense, gain, loss, and credit flow through to the partners' tax returns. A partnership must file a Form 1065 annually. Each partner receives a Schedule K-1 (Form 1065), which provides the information that must be reported on the partner's tax return. Examples C:2-3 and C:2-4, p. C:2-4, illustrate the effect of partnership income and loss on an individual partner's tax liability. Only those partnerships maintaining a fiscal year under the Sec. 444 reporting period rules must make tax payments based on the amount of income deferral. A completed Form 1065 and the related facts are included in Appendix B.

A partnership can be either a general partnership or a limited partnership. In a general partnership, each partner has unlimited liability for partnership debts. In a limited partnership, at least one partner must be a general partner, and at least one partner must be a limited partner. Limited partners are liable only to the extent of their investment plus any amount that they commit to contribute to the partnership if called upon.

1. **Tax Advantages.** A partnership is exempt from taxation. Marginal tax rates of the individual partners may be lower than the marginal corporate tax rate on the same income. p. C: 2-4.

No double taxation is inherent in the use of the partnership form. Profits are taxed only when earned. Generally, additional taxes are not imposed on withdrawals.

Losses generally can be used to offset income from other sources. A positive basis adjustment is made when income is earned by the partnership and taxed to the partners. This reduces the gain recognized when a sale or exchange of the partnership interest occurs. No such basis adjustment occurs with a C corporation.

2. **Tax Disadvantages.** All profits are taxed when earned even though reinvested in the business. Marginal tax rates of the partners may be greater than the applicable marginal tax rate if the income is taxed to a corporation.

   A partner is not an employee. Employment taxes must be paid on a partner's self-employment income from the partnership.

   Some tax-exempt fringe benefits are not available to partners.

   The partnership's taxable year generally must conform to that of its partners or be a calendar year unless a special election is made to use a fiscal year. pp. C: 2-4 and C: 2-5.

C. **C Corporations.** A C corporation is a separate taxpaying entity that is taxed at rates ranging from 15% to 35%. A corporation must file a Form 1120 annually. Income may be taxed twice, once when earned by the corporation and either when it is paid out as a dividend or when the stock is sold or exchanged. Examples C:2-5 and C:2-6, p. C: 2-5, illustrate this point. A completed Form 1120 with related facts is included in Appendix B.

1. **Tax Advantages.** A corporation is taxed at marginal tax rates of 15% on the first $50,000 of taxable income and 25% on the next $25,000 of taxable income. These tax rates may be lower than the shareholder's marginal tax rate. As long as earnings are not distributed and taxed to both the shareholder and the corporation, a tax savings may result. Personal service corporations, personal holding companies and corporations accumulating earnings beyond the reasonable needs of the business have special taxing provisions. p. C: 2-5.

   Shareholders employed by the corporation are treated as employees for fringe benefit purposes. As employees they are eligible to receive deductible salary payments. This allows them to adjust their compensation (within limits) to cause the income to be taxed partly on the corporate return and partly on the shareholders' returns, to minimize their overall tax liability.

A C corporation is allowed to use a fiscal year. There are restrictions on using a fiscal year that apply to personal service corporations unless a special election is made under Sec. 444 by the corporation. p. C: 2-6.

2. **Tax Disadvantages.** Double taxation occurs when dividends are paid or the corporation's stock is sold or exchanged.

   Shareholders can generally not withdraw money from the corporation without tax consequences. Distributions are taxable as dividends to the extent of earnings and profits.

   Net operating losses can only be carried back or forward to offset income from other taxable years. Losses cannot be used to offset the shareholder's personal income.

   Capital losses provide no benefit in the year that they are incurred. They can only be used to offset capital gains. p. C: 2-6.

D. **S Corporations**. S corporations are corporations that elect to be taxed as a partnership. Generally no tax is paid by the corporation. Instead, all items of income, deduction, gain, loss, and credit flow through to the individual shareholders. Corporate rules apply unless overridden by the Subchapter S provisions. A completed Form 1120S (U.S. Income Tax Return for an S Corporation) is included in Appendix B.

1. **Tax Advantages.** S corporations are generally exempt from taxation. The shareholders pay tax at their marginal tax rates, which are generally lower than the C corporation's marginal tax rate. See the **Tax Strategy Tip** on p. C:2-7.

   Losses flow through to shareholders and generally can be used to offset income earned from other sources. Passive loss rules may limit loss deductions to shareholders. (See Chapter C:11.)

   Capital gains are taxed to individual shareholders as though they were earned by the individual. An individual may be able to offset these gains with capital losses from other sources or have them taxed at their own capital gains rates.

   Capital losses flow through separately to the shareholders and can be used to offset other capital gains and to a limited extent ordinary income.
   Shareholders can contribute or withdraw money from the S corporation without adverse tax consequence. Profits are taxed as earned. The earnings are generally not taxed a second time when distributed as dividends.

A positive basis adjustment is made when income is earned by the S corporation and taxed to the shareholders. This reduces the gain recognized when a sale or exchange of the S corporation stock occurs. No such basis adjustment occurs with a C corporation.

2. **Tax Disadvantages.** All the corporation's profits are taxed when earned, whether distributed or not. Distributions generally are made to at least cover the taxes paid by the shareholders on their share of the corporation's earnings.

   If the shareholders' marginal tax rates exceed those for a C corporation, the capital that remains for reinvestment may be reduced.

   Tax-free fringe benefits are generally not available to shareholders. When provided, they are deductible by the corporation and taxable to the shareholder as compensation. Shareholders are treated as employees for purposes of social security taxes.

   An S corporation generally must select a calendar year as its tax year unless a special election is made under Sec. 444 to use a fiscal year.

E. **Limited Liability Company.** A limited liability company (LLC) combines the best features of a partnership and corporation even though it is neither. It is taxed like a partnership while providing the limited liability of a corporation.

F. **Limited Liability Partnership.** Many states also have statutes that allow a business to operate as a limited liability partnership (LLP). This partnership form is particularly attractive to professional service partnerships, such as public accounting firms. Under state LLP laws, partners are liable for their own acts and the acts of individuals under their direction. LLP partners are not liable for the negligence or misconduct of other partners. p. C: 2-8.

G. A side-by-side comparison of the tax and nontax attributes of C corporations, partnerships, and S corporations is presented in Appendix F. It might be helpful to periodically refer to this comparison throughout Chapters C:2 through C:11.

II. Check-the-Box Regulations.

Unincorporated businesses are able to choose whether to be taxed as a partnership or corporation. The rules are commonly referred to as "check-the-box" regulations. Treasury Regulations provide that an unincorporated business with two or more owners is taxed as a partnership unless it elects to be taxed as a corporation. An unincorporated business with one owner may elect to be taxed as a corporation or be disregarded as a separate entity and be taxed directly to the owner on a Schedule C. This election is not available to corporations, trusts, or certain special entities such as Real Estate Investment Trusts, Real Estate Mortgage Investment Conduits, or Publicly Traded Partnerships.

An eligible entity may affirmatively elect its classification on Form 8832 [Entity Classification Election]. Examples C:2-8 and C:2-9, p. C2-8, illustrate the default rules. If an entity makes an election to change its classification, it cannot again change its classification by election during the 60 months following the effective date of the election. There are tax consequences to the changing of classifications. When applying check-the-box regulations, taxpayers must also check whether or not their state will treat an entity in a consistent manner for state tax purposes. p. C: 2-8.

III. Legal Requirements and Tax Considerations Related to Forming a Corporation.

The legal requirements for forming a corporation depend on the laws of the state in which the corporation is incorporated. These laws provide for legal capital minimums, incorporation fee, franchise tax, and corporate tax rules. Most corporations are incorporated in the state in which they commence business. Articles of incorporation must be filed. A fee is charged for incorporation and an annual franchise tax is collected. It is important to note that these fees and taxes can be substantial, and should be a consideration prior to formation.

IV. Tax Considerations in Forming a Corporation.

Property, money, or services are transferred to the corporation in exchange for a debt or equity interest. Tax consequences may occur for both the shareholder, debtholder, and the corporation. Example C:2-10 on p. C:2-10 illustrates these tax consequences for the corporation and its shareholders.

At this point you may wish to use Table C:2-1, Overview of Corporate Formation Rules. This summary is found on p. C:2-11 of the text and is a good tool to be used to explain each of the parts of the incorporation transaction. Book-tax accounting issues are discussed later in this chapter.

V. Section 351: Deferring Gain or Loss upon Incorporation.

No gain or loss is recognized when property is transferred to a corporation solely in exchange for stock provided that immediately after the exchange, the transferors are in control. Recognition of gain or loss is deferred through adjustment of the shareholder's basis in the stock. (See Example C:2-11 on p. C: 2-12.) The requirements for nonrecognition treatment are discussed below.

A. **The Property Requirement.** Property must be transferred to the corporation in an exchange transaction. Property includes money, and almost any other kind of property including installment obligations, accounts receivable, inventory, equipment, patents, and other intangibles representing "know-how," trademarks, trade names, and computer software.

Excluded from the property definition are services received in exchange for stock in a corporation, indebtedness of the transferee corporation that is not evidenced by a security, and interest on an indebtedness of the transferee corporation that accrued on or after the beginning of the transferor's holding period for the debt.

B. **The Control Requirement.** The transferors as a group must be in control immediately after the exchange. Control is ownership of at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock. Only stock received for property is counted when determining if control has been received. Stock received for services does not count for purposes of determining control unless property is also contributed.

A transfer of property to an existing corporation will be tax-free only if an 80% interest in the corporation is acquired, or existing shareholders also transfer enough additional property to the corporation to permit the 80% requirement to be satisfied by the transferors as a group.

Transferors must be in control of the corporation immediately after the exchange. The exchanges do not need to be simultaneous, but must be agreed to beforehand and executed in an expeditious and orderly manner.

C. **The Stock Requirement.** No gain or loss is recognized by transferors who exchange property solely for transferee corporation stock. Voting or nonvoting stock may be received by the transferors. However, nonqualified preferred stock is treated as boot. Preferred stock is nonqualified if: 1) the shareholder can require the corporation to redeem the stock; 2) the corporation is either required to redeem the stock or is likely to exercise a right to redeem the stock; or 3) the dividend rate on the stock varies with interest rates, commodity prices, or other similar indices. Stock rights or stock warrants are not considered stock for purposes of Sec. 351. p. C: 2-16.

At this point, you may wish to review with the students by referencing Topic Review C:2-1, which provides a concise overview of the requirements of Sec. 351. This review is found on p. C:2-17 in the text.

D. **Effect of Sec. 351 on the Transferors.** If all the requirements of Sec. 351 are met, the transferors do not recognize any gain or loss on contribution of their property to the corporation. The receipt of property other than stock does not completely disqualify the transaction from coming under Sec. 351. However the receipt of property other than stock may cause the exchange to be partly taxable.

Property other than stock that is received is considered **boot**. Gain is recognized to the extent of the lesser of (1) the transferor's realized gain or (2) the amount of money plus FMV of the nonmoney boot property received. A loss is never recognized. The character of the gain depends upon the type of the property transferred. (See Example C:2-24.) Where several properties are transferred, a "separate properties approach" is used. (See Example C:2-25.)

E. **Basis of Stock Received.** The basis of the stock received in a Sec. 351 exchange is the adjusted basis of the property transferred plus any gain recognized by the transferor minus (1) any money received (including liabilities transferred to the corporation that are treated like money) and (2) the FMV of any nonmoney boot property that is received. (See Example C:2-26.)

F. **Tax Consequences to Transferee Corporation.** The transferee corporation needs to determine the amount of gain or loss (if any) it must recognize and the basis of property or services acquired. No gain or loss is recognized by a transferee corporation exchanging stock or debt instruments for property. A transferee corporation must **recognize** gain (but not loss) if it transfers appreciated property to a transferor as part of a Sec. 351 exchange. (See Example C:2-30.)

If the transaction is taxable to the transferor, the basis of the property acquired is its acquisition cost. If the transaction falls under Sec. 351, the basis of the property to the transferee corporation is the transferor's basis plus gain recognized by the transferor. The corporation's holding period includes the transferor's period in the case of a Sec. 351 transaction. (See Example C:2-31.)

Topic Review C:2-2 presents a summary of the tax consequences of a tax-free asset transfer to the transferor and the transferee corporation and may be referred to at this point to summarize the more important material relating to partially tax-free in corporations. This review is presented on p. C:2-20.

G. **Assumption of the Transferor's Liabilities.** The assumption of liabilities does not cause the transferor to recognize part or all of his realized gain unless (1) the transfer is made for a tax avoidance purpose or there is no bona fide business purpose for the acquisition and/or assumption of the debt, or (2) the liabilities assumed are in excess of the basis of the properties transferred.

The most important factor in determining whether a tax avoidance purpose is present is the length of time between the incurrence of the liability and the transfer of the liability to the corporation. Liabilities are considered to have a business purpose if the liabilities are incurred in the normal course of business or in the course of acquiring business property. If no business purpose is found, all of the liabilities assumed or acquired are considered boot.

If the total amount of liabilities transferred to a controlled corporation by a transferor exceeds the total adjusted basis of all properties transferred by the transferor, the excess liability is a gain that is taxable to the transferor. (See Example C:2-37.)

The term liabilities for a cash or hybrid method of accounting transferor does not include (1) any amount that would give rise to a deduction when paid or (2) any amount that is payable to a retired partner or to liquidate a deceased partner's interest. (See Example C:2-38.)

Topic Review C:2-3 presents a summary of the liability assumption and acquisition rules of Sec. 357 and may now be used to review this material with the students. This review is presented on p. C:2-25.

H. **Other Considerations in a Sec. 351 Exchange.**

1. **Recapture of Depreciation.** If a Sec. 351 exchange is nontaxable, no depreciation recapture is required. The transferor's recapture potential is transferred to the transferee corporation. (See Example C:2-39.)

2. **Computing Depreciation.** When a shareholder transfers depreciable property to a corporation in a Sec. 351 transaction, the corporation must continue to use the same depreciation method and recovery period with respect to the shareholder's basis in the property. An allocation of the depreciation for the year that includes the transfer date must be made between the transferor and transferee. If a basis adjustment occurs because the transferor recognizes a gain, a second depreciable asset is created which is generally depreciated as a new asset under the MACRS rules. (See Example C:2-40.)

3. **Assignment of Income Doctrine.** This doctrine is a judicial requirement that income be taxed to the person who earns it. This doctrine does not apply to a Sec. 351 exchange if the transferor transfers substantially all the business assets and liabilities to the corporation and a business purpose exists for the transfer. Accounts receivable take a zero basis in the corporation's hands and are included in income when collected. (See Example C:2-42.)

VI. Choice of Capital Structure.

A. **Characterization of Obligations as Debt or Equity Capital.** The tax laws provide an incentive for closely held corporations to use as much debt as possible. Where debt financing resembles equity obligations, the form of the transaction will be ignored and debt will be reclassified as common or preferred stock. No single factor is controlling in determining when reclassification will occur.

B. **Debt Capital.**

1. **Issuance of Debt.** If assets are exchanged for debt instruments, whether part of an otherwise tax-free transaction or not, the FMV of the debt received is treated as boot.

2. **When Interest Is Paid.** Interest paid on debt is deductible by the payor. Dividends paid on stock are not deductible by the corporation. Noncorporate investors who borrow funds in order to make an investment in a C corporation will find that the interest expense incurred to carry such an investment is generally subject to the investment interest limitation; unless the investment is a passive activity and the interest expense comes under the passive activity limitation rules.

3. **When an Indebtedness Is Satisfied.** Repayment of an indebtedness is not considered an exchange transaction. An obligation that is repaid by a corporation does not result in a gain or loss being recognized by the creditor. The satisfaction of a debt instrument (e.g., note, bond, or a debenture) is an exchange for the holder of a debt instrument and gain or loss will be recognized if the amount received is different from the asset's basis.

   Table C:2-2 presents the tax advantages and disadvantages of using debt in the capital structure. This table may be found on p. C:2-29. You may want to discuss the case presented in the box on p. C:2-31 concerning extremely long-term debt issued to raise capital by a corporation.

C. **Equity Capital.** The reasons for use of multiple classes of stock are found on p. C:2-29. Because of the many different types of equity issues that are possible, all tax and nontax advantages of each type cannot be listed. Table C:2-3, Tax Advantages and Disadvantages of Using Stock in the Capital Structure, is found on p. C:2-30.

D. **Capital Contributions by Shareholders.** A corporation does not recognize any income when it receives money or property as a capital contribution from a shareholder. If additional contributions are made without additional stock being issued, the payments are regarded as an additional price paid for the existing stock. (See Example C:2-44.)

E. **Capital Contributions by Nonshareholders.** The basis of property contributed by a nonshareholder is zero. If money is contributed, the basis of any property acquired with such money during a 12-month period beginning on the day the contribution was received is reduced by the amount of the contribution used toward the purchase. The amount of any monies contributed by nonshareholders that are not spent to purchase property during the 12-month period reduces first the basis of depreciable property, then amortizable property, depletable property, and all other property. Basis is not reduced below zero. (See Example C:2-45.)

VII. Worthlessness of Stock or Debt Obligations.

A. **Securities.** A debt or equity investment that is evidenced by a security and that becomes worthless results in a capital loss for the investor on the last day of the tax year in which the worthlessness occurs.

Ordinary loss can be reported in some situations. An example of this would be securities that are held by dealers as inventory. A domestic corporation is also permitted to claim an ordinary loss in connection with the worthlessness of a security of an affiliated corporation.

The Sec. 1244 rules permit an ordinary loss to be claimed for qualifying stock issued by a small business corporation that is sold, exchanged, or becomes worthless. Ordinary loss treatment is only allowed an individual who was originally issued the stock, or by a partner in a partnership that was originally issued the stock, and whose distributive share includes the losses for the corporate stock. If a shareholder contributes additional money or property to a corporation after acquiring Sec. 1244 stock, the amount of ordinary loss recognized upon the sale, exchange, or worthlessness of the Sec. 1244 stock is limited to the shareholder's capital contribution at the time the shares were issued. The ordinary loss is limited to $50,000 (or $100,000 if the taxpayer is married and files jointly). Losses in excess of the dollar ceiling are capital losses. The ordinary loss can be carried back or forward as part of a net operating loss. (See Example C:2-47.)

B. **Unsecured Debt Obligations.** Shareholders may make loans to corporations. The type of loss that can be claimed on these advances depends on the nature of the loan. If the advance is treated as paid-in capital, the amount of the loan increases the worthless securities loss on the stock.

A loan made to a corporation that is not evidenced by a security can be deducted under either the business or nonbusiness bad debt rules. Most unsecured advances are considered to be made outside the shareholder's trade or business. If a noncorporate shareholder makes the loan, it will generally be considered a nonbusiness bad debt that is a short-term capital loss, and is limited to a $3,000 deduction per year.

VIII. Tax Planning Considerations.

Sec. 351 treatment is mandatory, not elective, if the provisions are met. In some cases shareholders may wish to recognize gains or losses. In order to accomplish this, one of the provisions necessary for the application of Sec. 351 must be violated. (See Example C:2-50.)

IX. Compliance and Procedural Requirements.

Every person who receives stock, securities, or other property in an exchange qualifying under Sec. 351 must attach a statement to his tax return for the period that includes the date of the exchange. A list of the required information for the transferor is found on p. C:2-36. The transferee corporation must attach a statement to its tax return for the year in which the exchange takes place. A list of the transferee corporation's required information is found on p. C:2-36.

Court Case Briefs

Charles E. Wolfe* *v.* *U.S., 612 F. Supp 605 (DC Mont, 1985) aff'd. 798 F.2d 1241 (9th Cir., 1986).

The taxpayer, Charles E. Wolfe, was the sole shareholder and president of Wolfe & Company, a corporation which leased tractor-trailers. Mr. Wolfe also operated an "over-the-road" trucking business as a sole proprietorship. The corporation incurred a large federal tax bill which was paid by Mr. Wolfe personally when the corporation was unable to pay. Mr. Wolfe contended that he should not be held personally liable for the tax liability of the corporation.

The main issue was whether the corporation was the alter ego of Mr. Wolfe. If so, then the Internal Revenue Service could "pierce the corporate veil" and look to Mr. Wolfe's personal assets for satisfaction of the corporate tax liability. The court considered eleven factors, including level of ownership and control of the corporation, commingling of personal and corporate funds, common books and records, distribution of earnings and profits, and representation of corporate-personal relationship. In this case, the facts represented a classic case of a shareholder so dominating corporate affairs such that the corporation and the shareholder did not appear to have separate identities.

Therefore, the Service could pierce the corporate veil and look to the personal assets of the sole shareholder for payment of the taxes. Further, neither economic difficulties nor employee's illness constituted reasonable cause for failure to file or pay tax.

American Bantam Car Company* *v.* *CIR, 11 T.C. 397 (1948), aff'd. per curiam 177 F.2d 513 (3rd Cir., 1949).

This is a leading case in the determination of whether a transfer to a corporation is a tax-free transfer to a controlled corporation under the Code Sec. 351. This case is based on Section 112(b)(5) of the Revenue Act of 1936, the precursor of Code Sec. 351.

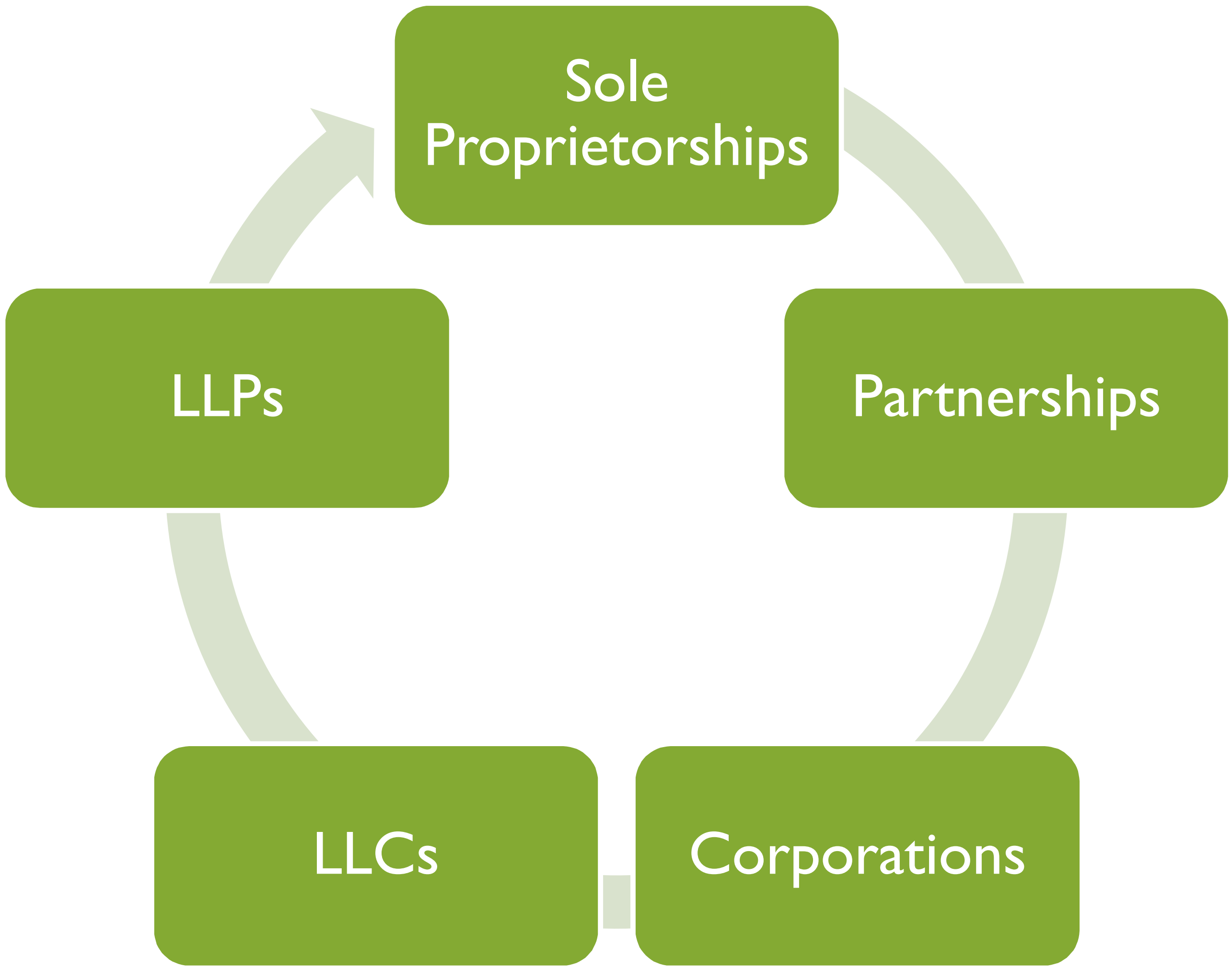
In this case, property was transferred to the newly formed American Bantam Car Company in exchange for stock of the corporation by three individuals, who immediately after the transfer owned greater than an 80% interest in the corporation. Subsequent to this transfer, the corporation entered into agreements with underwriters for the public offering of stock of the corporation, which if such offering had resulted in sufficient sales, would have reduced the interests of these three initial shareholders, based on the voting rights endowed upon the stock in the articles of incorporation.

The issue before the court was whether these transactions were all part of an integrated plan, thereby eliminating tax-free exchange treatment under Section 112(b)(5) or whether they were actually separate transactions. The court looked at four factors in making their decision: 1) intent of the parties, 2) mutual interdependence of steps, 3) time element, and 4) ultimate result. There is a detailed analysis of each factor and a summary of prior court cases in this case. The court held that the transactions were indeed separate and that the transfer of assets to the corporation should be treated as a tax-free exchange. Therefore, the basis of the assets for the corporation was their basis in the hands of the transferors on the date of the exchange.

Chapter 2: Corporate Formations and Capital Structure

Pearson's Federal Taxation 2017: Corporations, Partnerships, Estates & Trusts

Organizational Forms



Advantages of Sole Proprietorships

- Not subject to second layer of tax.
- Can withdraw cash w/o dividend treatment.
- Individual marginal rates < corporate rates.
- Business loss can offset owner's other non-passive income.

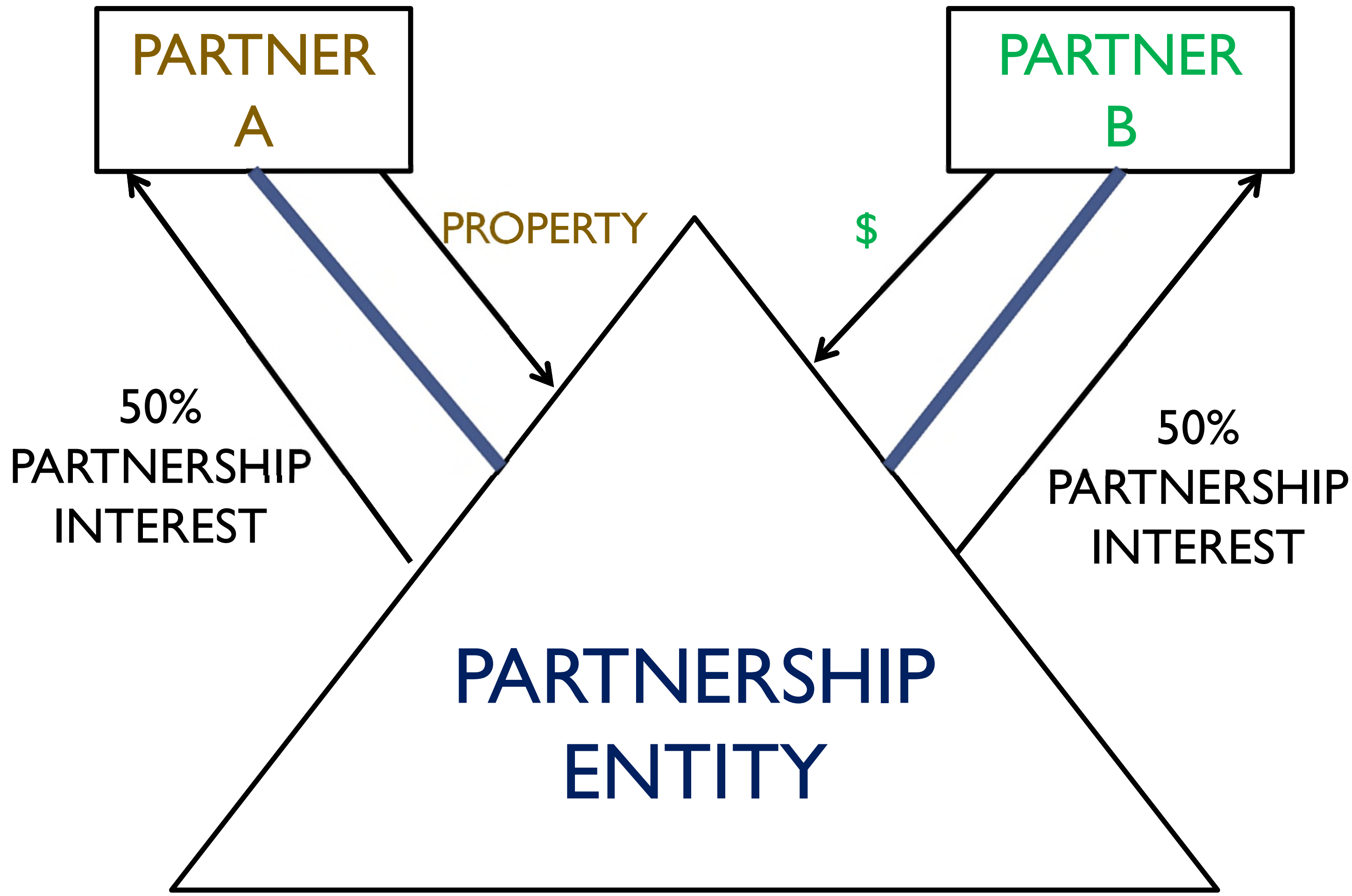
Disadvantages of Sole Proprietorships

Profits are currently taxed even if not withdrawn.

Certain fringe benefits may be taxable to owner.

Must use calendar year tax year.

Forming a Partnership



General v. Limited Partnerships

General Partnerships

- GPs have unlimited liability for p'ship debts.
- Liability can be greater than capital invested.

Limited Partnerships

- LPs are liable only up to capital invested + agreed-upon amounts.
- Must have at least one GP and one LP.

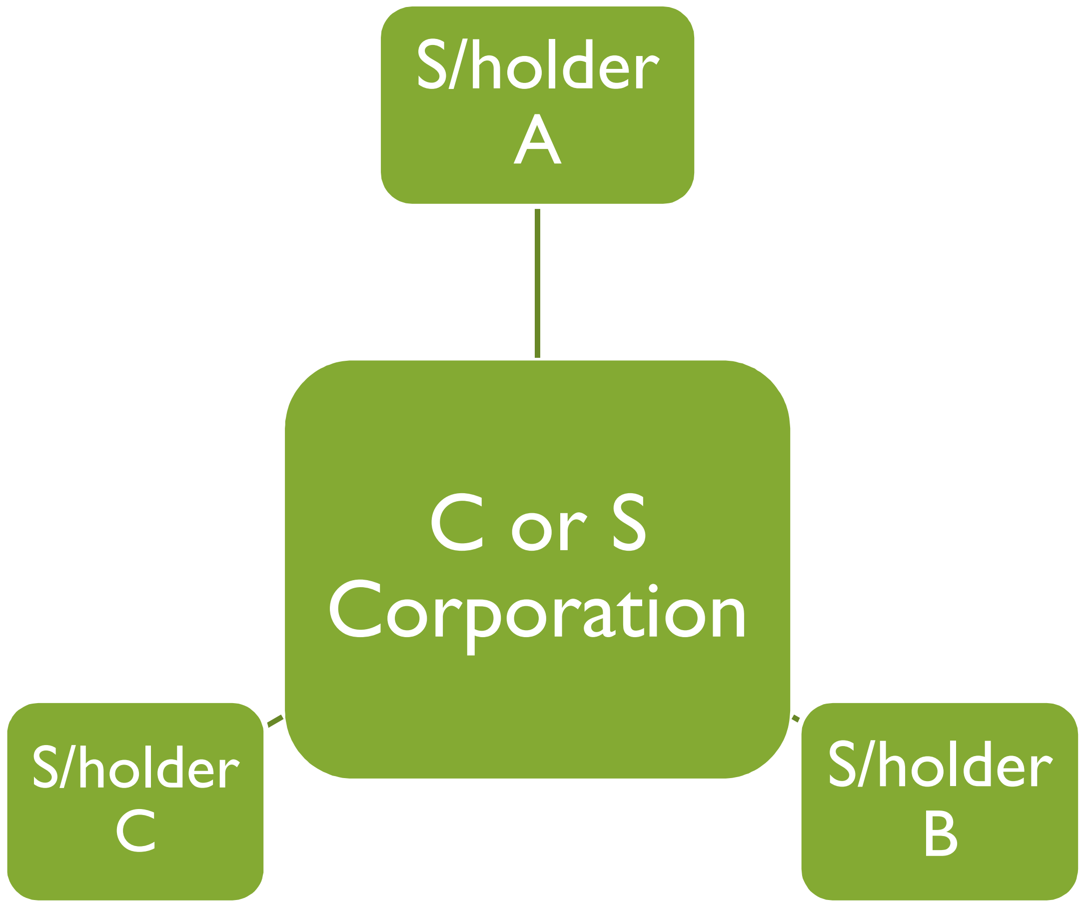
Advantages of Partnerships

- No entity level taxes – no double taxation.
- A partner's marginal rate may be < corporate rate.
- Contributions/distributions usually non-taxable.
- Pass-through income/losses can offset items on partner's Form 1040.

Disadvantages of Partnerships

- Profits currently taxed whether or not withdrawn.
- Partner's marginal rate could be > corporate marginal rate.
- No tax-free fringe benefits since not an employee.
- Must generally use calendar year tax year.

Corporate Structure



Advantages of C Corporations

Possible lower marginal rates on entity basis.

Shareholder-employees can have tax-free fringe benefits.

Corporation can use fiscal year tax year.

Disadvantages of C Corporations

Double taxation due to entity-level tax.

S/holder may have taxable dividend upon distribution of property.

NOLs and capital losses stay at the entity level and don't pass through to s/holder.

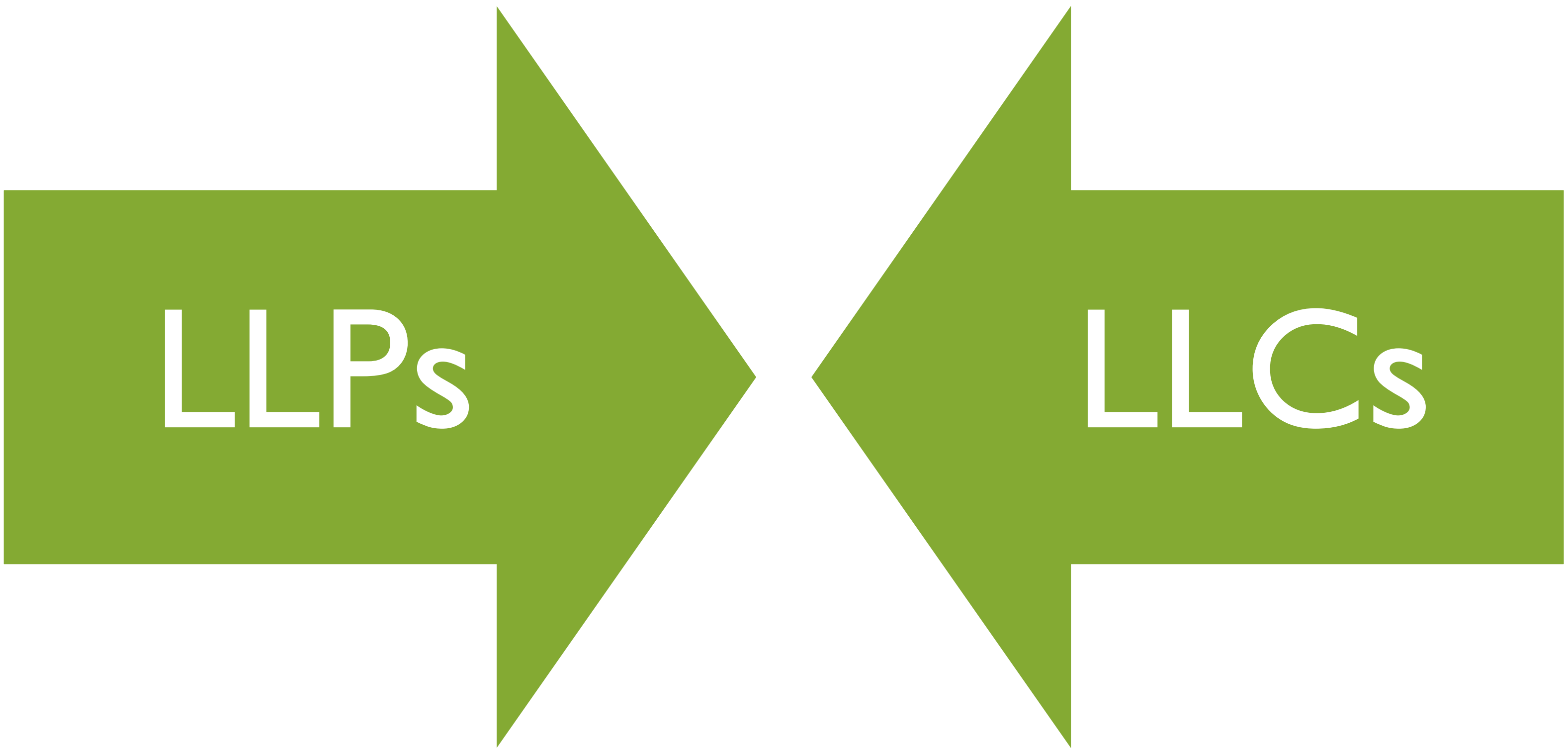
Advantages of S Corporations

- S Corps not subject to tax at an entity level. No double taxation.
- S/holder may have a lower marginal rate than a C Corporation.
- Non-passive losses can offset any income on s/holder's Form 1040.
- Income/deduction items retain their character.

Disadvantages of S Corporations

- S/holders taxed on all profits even if undistributed.
- S/holders' marginal rate could be > if C Corp.
- No non-taxable fringe benefits for s/holder-owner.
- Must generally use calendar year accounting period.
- Limited number of shareholders.
- May have additional compliance requirements vs. sole proprietorship.

Advantages and Disadvantages



Check the Box Regulations

- Available to unincorporated businesses.
- Can elect to be treated as a partnership or a corporation.
- If two or more owners, default is partnership unless election to be treated as a corporation.
- If one owner, default is a disregarded entity and treated as a sole proprietorship unless election to be treated as a corporation.

Section 351

- No recognition of gain or loss (see also § 368(c)).
- Requirements:

1. Transfer of property.
2. Must be SOLELY in exchange for stock.
3. Transferors must be in control of the corporation immediately after the exchange.

- Rationale is that the transferors have not changed their situation economically so should not be taxed (they owned the property before, and they own it afterwards).

Section 351(cont'd)

- S/holder takes a carryover basis from the property to the stock.
- Alternative calculation:

FMV of trans property

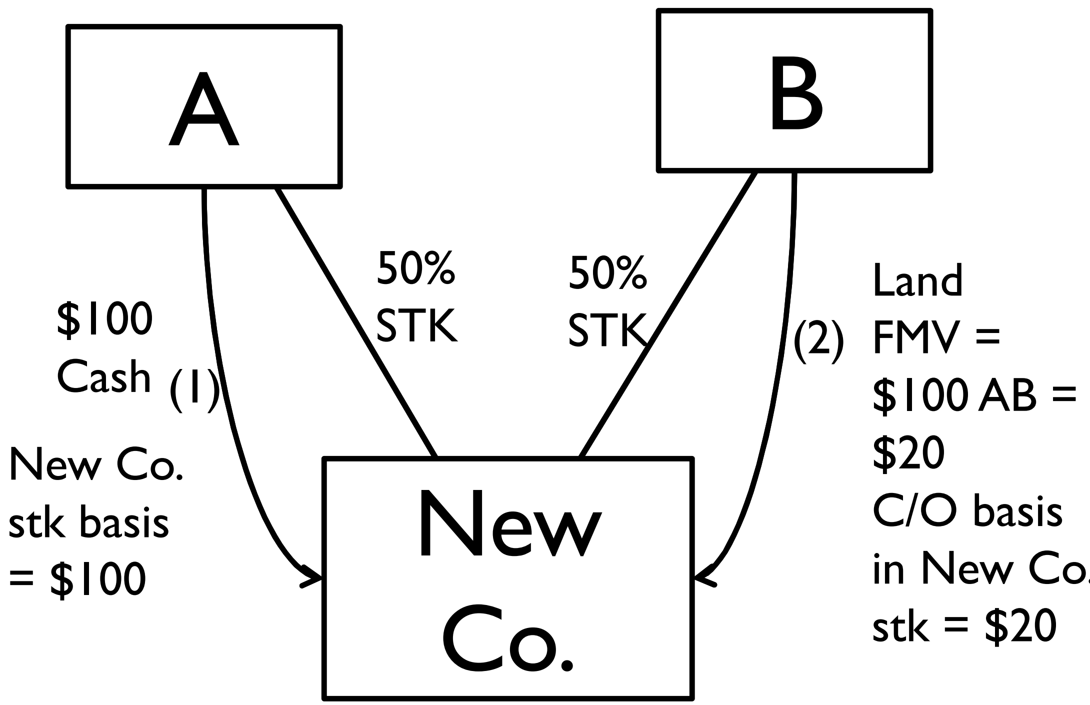
- deferred gain

or

+ deferred loss

Basis in new stock

§ 351 Property Transaction

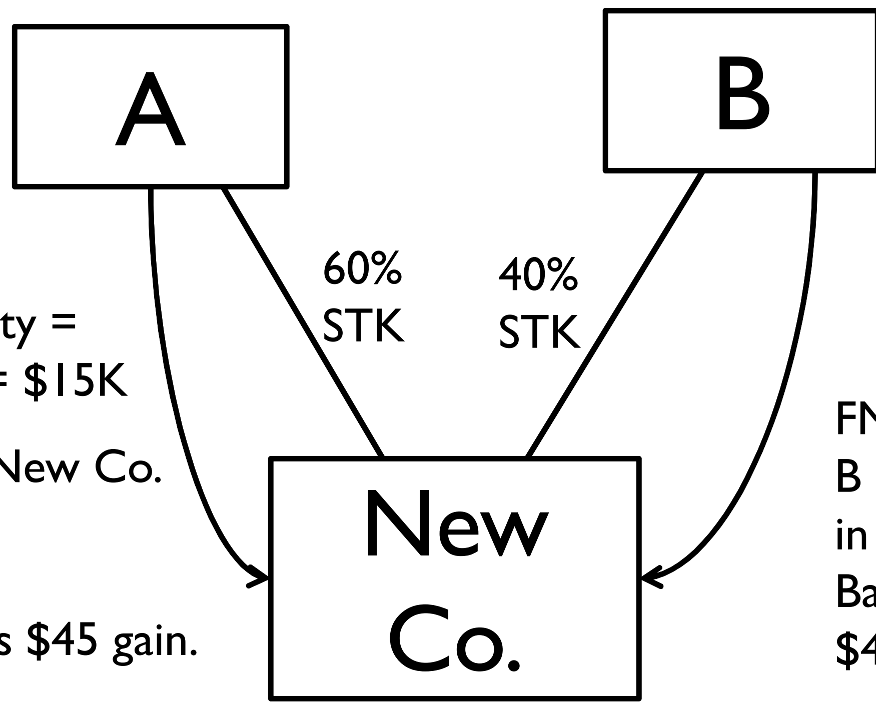


§ 351 Services Transaction

FMV property = $60K; A/B = $15K

A's basis in New Co. stk = $60K

A recognizes $45 gain.



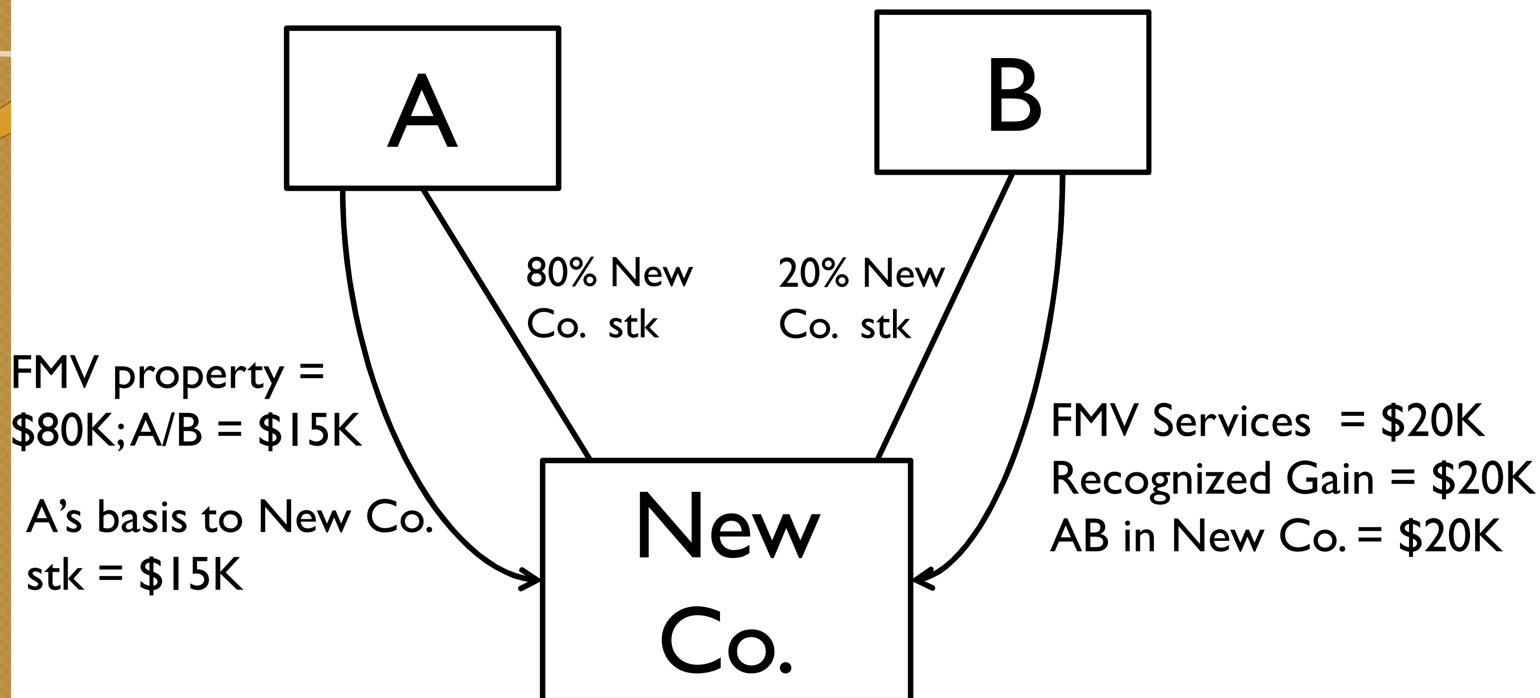
FMV Services = $40K
B Recognizes $40K in income
Basis in New Co. stk = $40K

§ 351 Control Requirement

- § 368(c) definition of "control:"
  1. 80% of total combined voting power of ALL classes of voting stock; AND
  2. 80% of the total number of shares of all other classes of stock, such as nonvoting preferred stock.

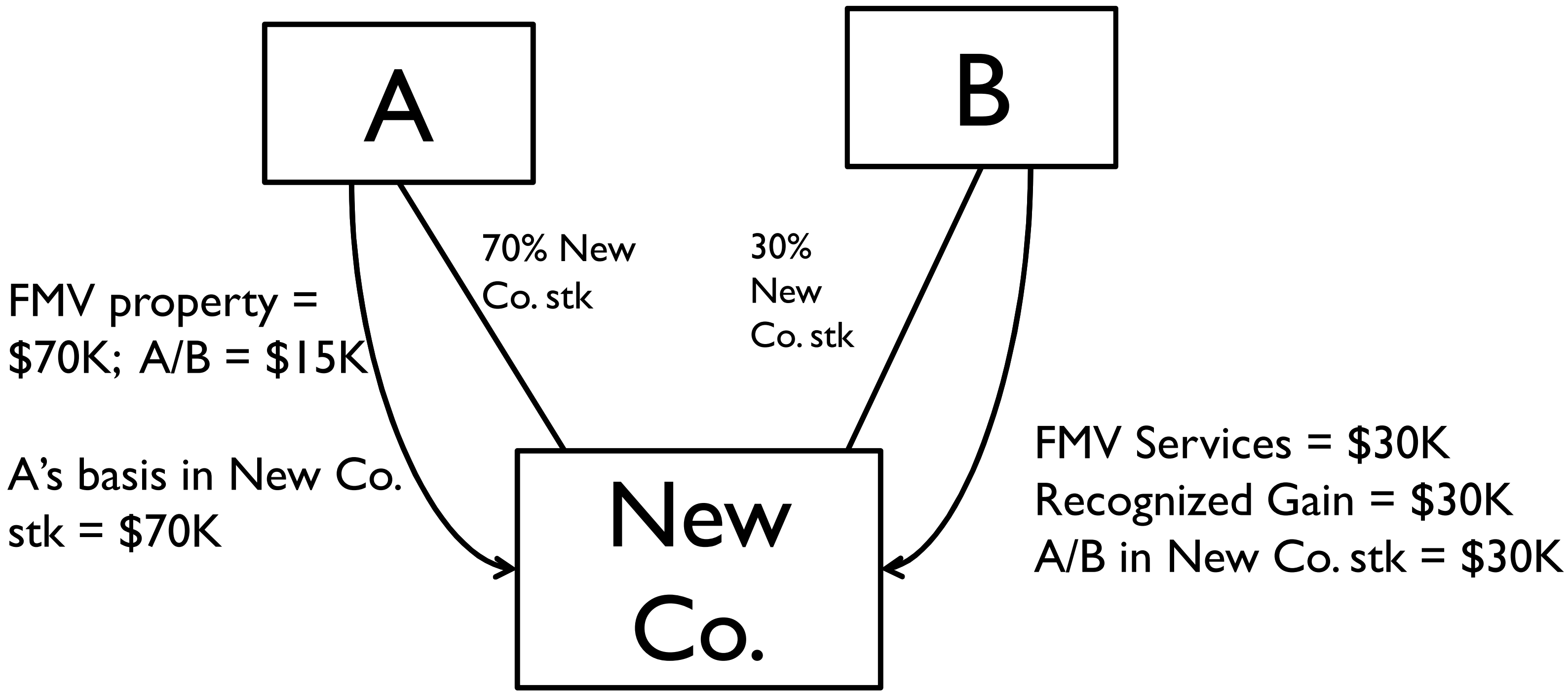
  NOTE: must meet 80% threshold for EACH class of stock, not just all nonvoting preferred as a whole.

§ 351 Services Transaction (20%)



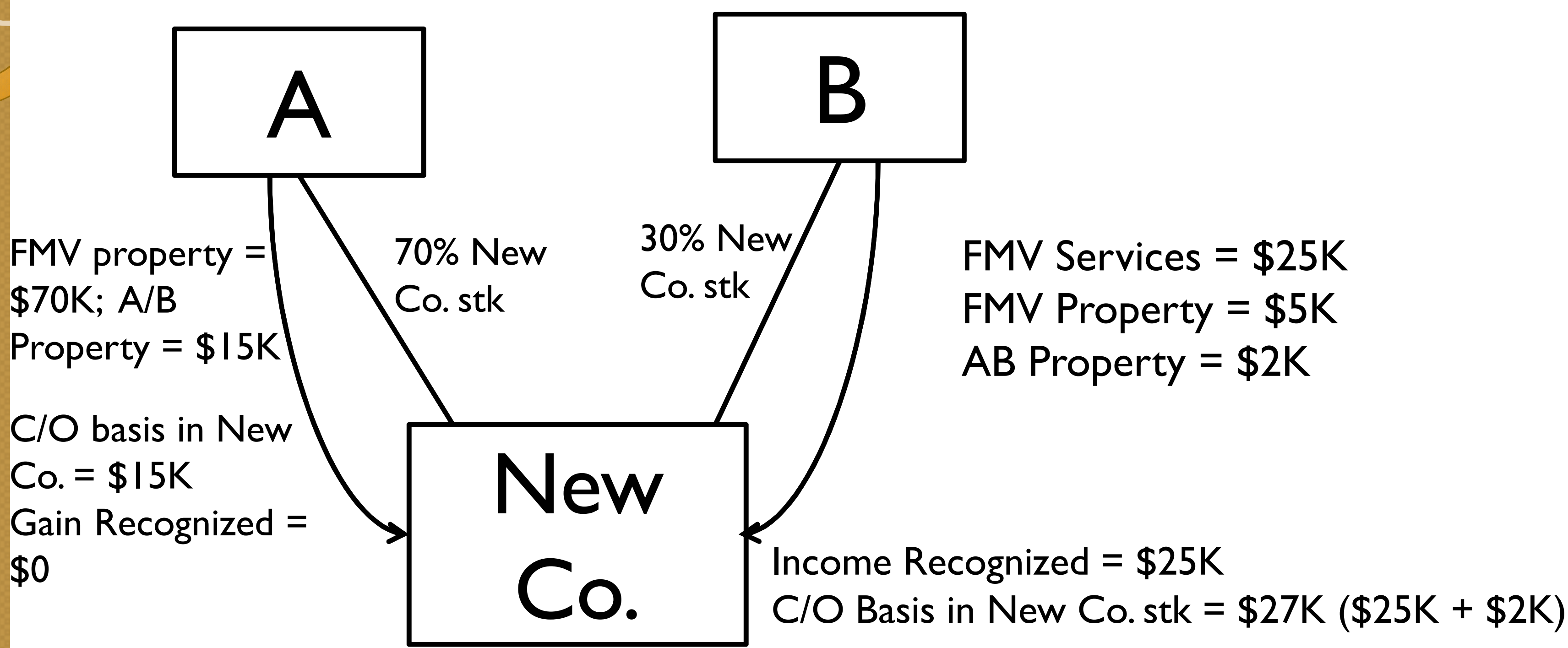
80% control requirement is met. A does not have to recognize $65K ($80K - $15K) in Built-In Gain ("BIG").

§ 351 Services Transaction (30%)



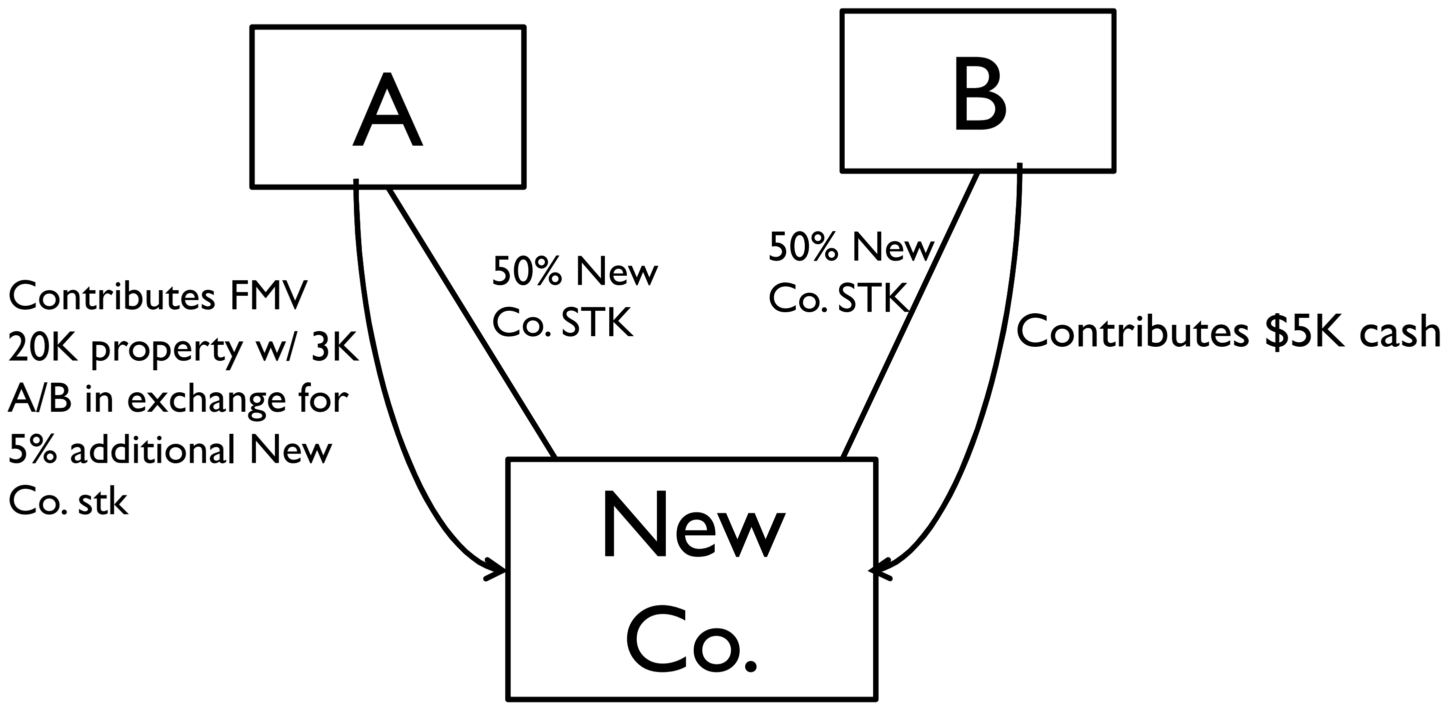
80% control requirement is not met.
A must recognize $55K ($70K - $15K) in BIG.

§ 351 Property/Svcs Transaction



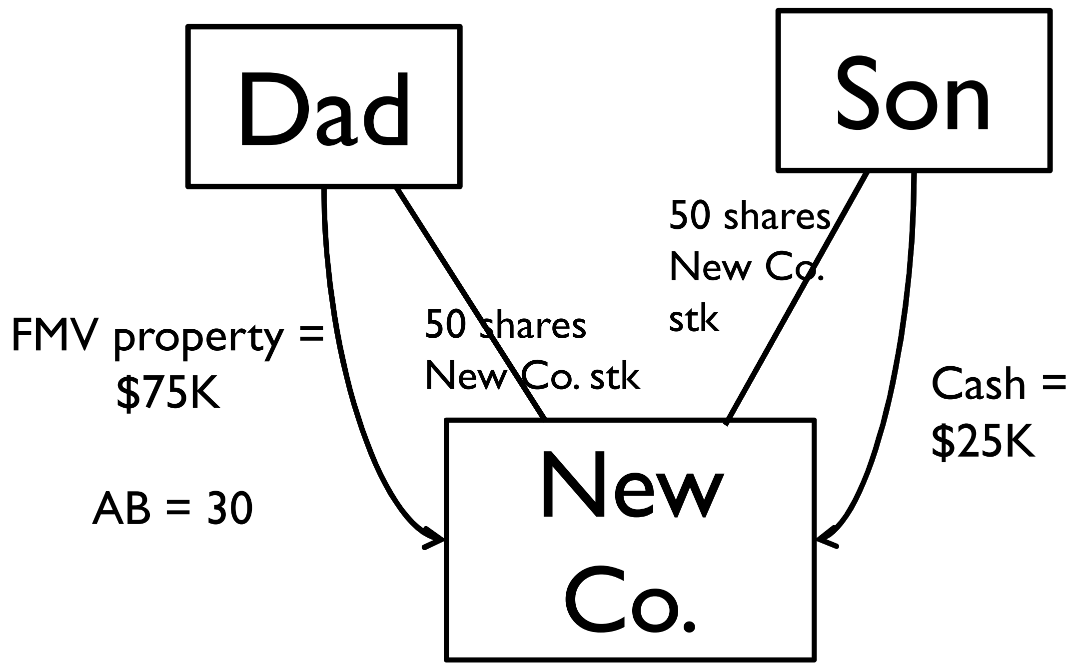
80% control requirement is met since FMV B's property contribution is over 10% the value of services ($25K x 10% = $2.5K; FMV property = $5K) Therefore, 10% threshold is met.

Prior to contribution, A & B's holdings in New Co. stock is worth $50K each.



§351 is satisfied because B contributes additional property worth at least 10% (50K x 10% = 5K) of the current holdings. A can defer recognizing $17K (20K – 3K) of BIG.

Disproportionate Exchanges



- Dad may owe gift taxes on extra 25 shares transferred to Son.
- §351 is met so Dad can defer $45 gain (75K – 30K)
- Dad deemed to have made gift of 25 shares to Son
- Dad's AB in his 50 shares is $20K ($\frac{50}{75}$ x 30)
- Son's AB is $35K ($25K cash + 10K basis from 25 shares gift by Dad)

Effect of § 351 on Transferors

Issues:

1. Is there realized gain or loss?
2. Is there recognized gain or loss?
3. What is the character of the recognized gain or loss?
4. What is the carryover basis to the New Co. stock?
5. What is the holding period?

What is Boot?

Cash	Notes
Property	Securities
Stock in another company	Boot is NOT stock in transferee co.

Computing Shareholder Basis

- Basis in Boot: Transferor's basis = FMV
- Basis in New Co. stock:

A/B Property transferred to New Co.

\+ Gain Recognized

\- FMV boot received

\- Cash boot received

\- Liabilities assumed by New Co.

A/B of Stock Received

Example: Allocation of Gain

	Equip.	Land
FMV	\$30K	\$70K
% of FMV	30%	70%
A/B	\$20K	\$20K
Realized Gain	\$10K	\$50K

Received: \$50K, 50 share New Co. (100%)

Allocated Boot	\$15K	\$35K
Gain Recog.	\$10K	\$35K

C/O Basis in New Co. = \$40K+\$45-\$50=\$35

Effect of § 351 to Transferees

Issues:

1. Is there realized gain or loss?
2. Is there recognized gain or loss?
3. What is the character of the recognized gain or loss?
4. What is the carryover basis to the assets received?
5. What is the holding period?

Effect of § 351 to Transferees – Realized/Recognized Gain/Loss

- Transfer of New Co. stock or debt issued by New Co. in exchange for services, property, or cash = no realized or recognized gain or loss.
- New Co.'s transfer of property to new shareholder = gain is recognized as if it had been sold.
- Losses are not recognized. Sell it first!

Effect of § 351 to Transferees – Basis in Property Received

Transferor's A/B in property being transferred to New Co.

+ Gain recognized by transferor

- <u>Any reduction for loss property</u>

New Co.'s basis in property received

Example 1

Bob transfers to New Co. a piece of land with FMV of $20K and A/B of $2K in exchange for 100% of New Co. stock. Bob has owned the land for 2 years.

Since § 351 applies, then New Co. will take an A/B in the land of $2K and will have the same holding period as Bob.

Example 2

Bob transfers to New Co. a piece of land with FMV of $20K and A/B of $2K in exchange for 50% of New Co. stock. Bob has owned the land for 2 years.

Since § 351 does NOT apply, then Bob recognizes $18K in gain. New Co. will take an A/B in the land of $20K and will start a new holding period.

Effect of § 351 to Transferees – Receipt of Loss Property

- If a s/holder transfers loss properties to a corporation, then the basis of the properties must be reduced to FMV.
- Prevents a "double deduction" – one at the shareholder level with a high basis, and a high basis at the corporate level if there were no reduction.
- Reduction in basis is allocated in proportion to the built-in losses on a shareholder by shareholder basis.

Effect of § 351 to Transferees – Receipt of Loss Property (cont'd)

- If A/B is not reduced to FMV, then holding period will tack.
- If total FMV of assets is > total A/B, then no reduction is required.
- If shareholders elect, the shareholders can take a reduction in basis instead of the corporation.

Assumption of Transferor's Liabilities

- For transfers NOT under like-kind exchange rules (§ 1031), the assumption of shareholder's indebtedness by New Co. is NOT the equivalent to receiving cash.
- Assumption of liability is in essence treated as a return of capital and reduces the transferor's A/B.

Assumption of Transferor's Liabilities (cont'd)

- Can use this treatment as long as:
  a) there was a proper business purpose for the debt; and
  b) liabilities assumed not > total A/B of property transferred.
- If the liabilities > basis, § 357(c), then transferor must recognize excess liability as gain.
- Transferor has zero basis in his/her New Co. stock.

Calculating Transferor's Basis

Assuming New Co. assumes Transferor's liabilities:

Basis in transferred asset

\+ Cash transferred

\+ Gain recognized (excess liab over basis)

\- Transferor's liab assumed by New Co.

Transferor's basis in New Co. stock

§ 118 Example

Stonebriar, Inc., wants Robby's Sporting Goods to locate in its new mall that it is developing in Denton. It offers Robby's a tract of land on the mall site upon which the sporting goods store can be built. The FMV of the land = $1 million. Stonebriar's A/B is $100K. Robby's does not have to recognize the $1m in income, but it must take a basis of $0 in the land.

Worthless Securities

- Examples of ordinary loss situations:
  - Securities that are non-capital.
  - Stock in affiliated corporations.
  - § 1244 stock.
- Worthless Unsecured debt
  - Non-business debts = short-term capital loss.
  - Business debts = ordinary losses.
- Ordinary losses = NOLs that can be carried back 2 years or forward 20.

Tax Planning Considerations

- § 351 is automatic, not elective.
- Loss property – should be disposed of before any § 351 transaction so any losses can be recognized.
- Can also avoid § 351 by busting 80% requirement. TP may have a reason for carrying a high basis in assets.
- However, § 267 may prevent loss recognition anyway if s/holder owns > 50%