Business Tax
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Problem Set 1

Problem 1.1. Individuals A and B both are and will continue to be in the highest marginal individual tax bracket. They are forming a business that they expect will generate deductible losses of about $300,000 over the next three years and then will turn around and generate income of about $100,000 per year indefinitely. A and B each will "materially participate" in the operation of the business. What form(s) of business organization will produce the most favorable tax results for A and B?

Problem 1.2. Three individuals, R, S, and T, form a limited liability company. Each of the three are equal members of the LLC. How will the LLC be classified for federal income tax purposes, with and without available tax elections?

Problem 1.3. Unless otherwise indicated, Z Corporation ("Z") is a domestic corporation that has 115 shares of voting common stock outstanding. In each of the following alternative situations, determine whether Z is eligible to elect S corporation status:

(a) Z has 99 unrelated individual shareholders, each of whom owns one share of Z stock. The remaining 16 shares are owned by A and his brother, B, as joint tenants with right of survivorship.

(b) Same as (a), above, except that A and B are married to each other and own 10 of the 16 shares as community property. The remaining 6 shares are owned 3 by A as her separate property and 3 by B as his separate property.

(c) In (b) above, assume that the shareholders of Z elected S corporation status. What will be the effect on Z's election if one year later A dies and bequeaths her interest in Z stock to her unrelated butler, X?

(d) Same as (a), above, except that the remaining 16 shares are held by a nonprofit corporation that operates a private high school.

(e) Same as (a), above, except that the remaining 16 shares are held by an irrevocable inter vivos trust that has three related beneficiaries. The trustee is given the power to decide which of the beneficiaries receive the income from the trust. All of the beneficiaries are individuals, and the grantor of the trust retains no interest in it whatsoever. What if the beneficiaries were unrelated to each other and to any of the other shareholders?

(f) Same as (a), above, except that the remaining 16 shares are owned by a revocable trust created by an individual, the income of which is taxed to the grantor under I.R.C. § 671.

(g) Same as (a), above, except that the remaining 16 shares are owned by a testamentary trust under which the surviving spouse has the right to income for her life, with the remainder passing to her children. The trust is a "qualified terminable interest trust" (see IRC § 2056(b)(7)).

(h) One of Z's 115 outstanding shares is owned by a C corporation.

(i) Ninety of Z's 115 outstanding shares are owned by an S corporation.

(j) All of Z's 115 outstanding shares are owned by an S corporation.

(k) All of Z's 115 outstanding shares are owned by a partnership.

(l) Z has 100 shares of Class A voting common stock and 50 shares of Class B nonvoting common stock outstanding. Apart from the differences in voting rights, the two classes of common stock have equal rights with regard to dividends and liquidation distributions. Z also has an authorized but unissued class of nonvoting stock that would be limited and preferred as to dividends. The Class A common stock is owned by four individuals, and the Class B common stock is owned by E and F (a married couple) as tenants-in-common.

(m) All of Z's outstanding shares are held by an individual. Among other things, Z owns a .001% stock interest in Microsoft, a publicly traded corporation; 80% of the stock of a privately held corporation, Privco; and 100% of the stock of another corporation, Subco. Can Privco elect to be an S corporation? Can Subco?

Problem 1.4. X is a "small business corporation" that has been operating for several years as a C corporation. X uses the calendar year for its taxable year. When is its S election effective if it is duly filed –

(a) On March 2, 2026?

(b) On March 22, 2026?

Problem 1.5. Y, a "small business corporation," is formed, and begins its first taxable year, on September 1, 2025. Its taxable year is the calendar year. When is its S election effective if it is duly filed –

(a) On September 1, 2025?

(b) On November 10, 2025?

(c) On November 22, 2025?

(d) On March 2, 2026?

(e) On March 22, 2026?

Problem 1.6. How is a corporation's status as an S corporation terminated? When is a termination of S status effective? Can S status be retroactively reinstated after a termination?

Study Materials for Problem Set 1

IRC §§ 11, 199A, 701, 1361, 1362, 1363, 1366, 7701(a)(3), 7704.

Treas. Regs. §§ 1.1362-6, 301.7701-1, 301.7701-2, 301.7701-3.

Readings in Burke & Friel Casebook

Chapter 1.

Readings in Schwarz & Lathrope Black Letter Outlines

Corporate Tax

Problems 1.1 and 1.2: Chapter II.

Problems 1.3 to 1.6: Chapter XV, Parts A to C.

Partnership Tax (redundant with Corporate Tax for this problem set)

Problems 1.1 and 1.2: Chapter II.

Problems 1.3 to 1.6: Chapter XV, Parts A to C.