3 Corporations

Corporate Liquidations

The 1996 *Farm Income Tax School* contained a substantial discussion of corporate liquidations in the context of converting C and S corporations to limited liability companies. See the discussion in the 1996 Partnership chapter. The basic liquidation rules were discussed in the 1995 *Farm Income Tax School* in Chapter 12 and are reiterated as follows:

In general, the liquidation of a corporation is a completely taxable event, at both the corporation and shareholder levels.

The liquidating corporation recognizes all gains and losses on distribution of property in liquidation [§336]. In general, the property distributed to the shareholders is treated by the corporation **as if it were sold to the shareholders at fair market value on the date of liquidation.** There are some special rules to be observed.

1. In general, the related-party loss disallowance rules of §267 do not apply. Thus a corporation can distribute property to a person who actually or constructively owns more than 50% of the corporation's stock, in many cases. However, losses are disallowed if property is distributed to the controlling shareholder or a related party

- if the property was received as a contribution to capital or received in a §351 exchange within five years, or
- if the distribution of loss property is not pro rata [§336(d)(1)].

2. The special gain recharacterization rule of §1239 (Gain from Sale of Depreciable Property between Certain Related Taxpayers) applies to **property distributed to an actual or constructive majority shareholder.** Under this rule, any gain recognized by the corporation is ordinary income if the property is **depreciable by the receiving party.** Thus the corporation could not use gain on a building to offset capital losses.

3. Losses may be limited on recently acquired property if not related to the corporation's business [§336(d)(2)]. This disallowance rule applies to any property contributed to the corporation two years prior to adopting a plan of liquidation, if the corporation's basis exceeded the fair market value of the property at the time of contribution and the property is unrelated to the corporation's trade or business activities.

4. The shareholders report all gains and losses on the disposition of their shares in a complete liquidation [§331]. Different rules govern the treatment of a parent corporation and a subsidiary corporation [§§332, 337].

5. The basis of the property received in the liquidation is its fair market value at the date of the distribution [§334(a)].

6. The same general rules apply to both C and S corporations, although the incidence of tax may be quite different, due to the double tax on C corporation distributions and single tax on S corporation distributions. **The S corporation recognizes all gains and loss on the distribution of property in complete liquidation. The gains and losses, however, pass through to the shareholders and adjust their stock basis at the moment of liquidation.** See the 1996 *Farm Income Tax School* for demonstrations of the differing tax treatments of C and S corporations and their shareholders.

In this year's *Farm Income Tax School* the discussion turns to some different applications of the liquidation rules. First, the special problems faced by a loss corporation are discussed and demonstrated. The next part is concerned with special rules dealing with installment receivables and corporate liquidations.

Special Considerations in Liquidating a Loss Corporation

Corporate Rules, C Corporations

In general, both the corporation and the shareholders are allowed to recognize losses on complete liquidations of corporations, subject to some limits discussed above. The ability to recognize a loss, however, does not necessarily provide a tax benefit. For instance, if the corporation is a C corporation, it must be able to carry a net loss back to one of its last three taxable years (or two for tax years beginning after August 5, 1997 [Taxpayer Relief Act of 1997]) or it will receive no tax benefit.

Example 1. Downco has assets with aggregate adjusted basis $2,500,000 and fair market value of $2,000,000. If it liquidates, it will be allowed to recognize the loss, provided it does not fall into one of the loss disallowance rules of §336(d). Downco may still face some problems in getting any tax refund for its recognized losses, such as:

1. If the loss is capital, it could not be used against ordinary income in any year.
2. If the loss is ordinary, there must be income in the year of liquidation or one of the three (or two) preceding taxable years in order to claim a refund based on a carryback.

Shareholder Rules, C Corporations

The shareholders also have some important considerations for liquidating a loss corporation.

The shareholders also have some important considerations for liquidating a loss corporation. In general, the loss realized on the receipt of property in exchange for their shares will be capital, subject to all of the usual capital loss limitations, such as the $3,000 maximum deduction per year against ordinary income.

In general, a person who actually or constructively owns more than 50% of a corporation's stock is not allowed to recognize any loss on a sale of property to the corporation. However, this rule does not apply to stock transferred by a shareholder in complete liquidation of the corporation [§267(a)(1)]. Therefore, a shareholder who receives property in a complete liquidation recognizes a capital loss if his or her stock basis is more than the fair market value of the property received from the corporation.

However, if the stock is §1244 stock and the shareholder realizes a loss on the liquidation, the loss is an ordinary loss subject to the limitations of §1244. Section 1244 characterizes certain **losses** as **ordinary,** whether they are incurred on an actual sale of stock or when the stock becomes worthless. Section 1244 has no effect on any **gains** on the disposition of stock. **The principal benefit of §1244 is that it allows an investor to claim a loss deduction in excess of that normally allowed for capital losses.** The benefit of this characterization, however, has its own limits. An investor is limited to $50,000 ordinary loss deduction from §1244 in any taxable year; but the limit is doubled to $100,000 if the shareholder files a joint return.

The $100,000 limit for joint filers is not dependent upon the actual losses sustained by each of the spouses. If one of the spouses disposes of §1244 stock, and the stock is separate property, that person may claim the entire $100,000 limit on a joint return. The ordinary loss deduction of §1244 is allowable only to individual shareholders in S corporations. The term *individual* does not include any estate or trust, regardless of how the entity acquired the stock [Reg. §1.1244(a)-1(b)(2)]. Therefore, an estate of a deceased or bankrupt shareholder could not claim ordinary loss on the disposition of stock under §1244.

The only person entitled to claim an ordinary loss deduction under §1244 is the original holder of the stock [Reg. §1.1244-(a)(1)(b)(2); also see ***Harwell,*** TC Memo 1974-153]. Therefore, it would appear that any transfer, **even a gift between husband and wife,** would cause the stock to lose its §1244 character. See ***Priznant,*** TC Memo 1971-176, where a partnership which had held §1244 stock had transferred its shares to a partner before the stock was disposed of. The partner could not claim §1244 loss treatment.

Section 1244 stock has three essential requirements, as articulated in §1244(c):

1. The issuing corporation must have been a small business corporation at the time the stock was issued;
2. The stock must have been issued directly to a holder in exchange for property; and
3. The corporation's gross receipts from certain passive sources must not have exceeded 50% of its total receipts for a five-year period ending with the corporation's taxable year immediately preceding the shareholder's loss.

At the time the stock is issued, the corporation must have received no more than $1,000,000 of property in exchange for stock, or as a contribution to capital [§1244(c)(3)(A)]. The test is made with respect to the **adjusted basis of the property to the corporation.** Accordingly, if property was received in a §351 exchange, the corporation would use the shareholder's basis, plus any gain recognized by the shareholder.

The corporation must meet an entirely different criterion as a small business corporation at the time the shareholder sustains a loss on the disposition of stock. At that time, the corporation must look to its gross receipts for its five taxable years preceding the loss. If the corporation has been in existence less than five years, the corporation tests for the entire period of its existence. Within that period of time, the corporation must have derived **no more than 50%** of its gross receipts from royalties, rents, dividends, interest, annuities, and sales or exchanges of stocks or securities [§1244(c)(1)(C)].

Payment of Corporate Liabilities

In most cases, debts of a closely held corporation are guaranteed by the shareholders. If there are insufficient assets in the corporation to pay the debts, the shareholders will need to pay theseobligations with personal funds. When the corporation to be liquidated is a C corporation, the shareholder will generally treat the payment of corporate liabilities as a capital loss, either directly or indirectly, depending upon the manner in which the debt is paid.

If the shareholder pays a debt on behalf of the corporation by contributing money to the corporation's capital immediately before the liquidation, the contribution adds to the shareholder's adjusted basis in his or her stock at the time of liquidation. **Such contribution to capital does not increase basis for §1244 ordinary loss purposes.**

A shareholder might attempt to treat a contribution to a dying corporation as a loan, with an attempt to gain a **business bad debt deduction.** This technique is not always successful. For example, in *Sutherland,* several shareholders had loaned money to an ailing S corporation. The shareholder-creditors had claimed a bad-debt deduction when the corporation failed. The Tax Court held that the purported debts were really contributions to capital, rather than valid debts. Therefore, the shareholders were limited to a capital loss on the worthlessness of stock, rather than an ordinary deduction for a bad debt (*Sutherland,* 58 T.C.M. 1117, TC Memo 1991-619).

In some cases, the amount realized may not be finally determined until some years after the liquidation occurs. For example, the corporation may have had a contingent liability, which the shareholder was obligated to pay at some later date. If the shareholder pays that contingent liability in a year**after** the liquidation, the amount of such payment is a capital loss since it relates back to the original transaction [*F. D. Arrowsmith,* 52-2 USTC 9527 (S.Ct.)].

Liquidating a Distressed S Corporation

There is possibly no transaction in which the distinction between the C corporation and the S corporation is more important than a liquidation. One of the principal differences arises when the S corporation has sustained heavy tax losses. These will generally be ordinary deductions to the shareholder, who can claim them against his or her other taxable income. Under the *Arrowsmith* rule, a shareholder who pays off debts of a corporation after the corporation has liquidated will be allowed a capital loss deduction [*F.*

off debts of a corporation after the corporation has liquidated will be allowed a capital loss deduction [*F. D. Arrowsmith*, 52-2 USTC 9527 (S.Ct.)]. In some cases, this rule may work extreme hardships.

Example 2. Brenda is the sole owner of Songco. She has personally guaranteed a $750,000 note from Songco to First Bank. After selling all of its assets, Songco has only $150,000 to pay the bank loan. The sum total of Songco's income and loss has been a net ordinary loss of $600,000.

Brenda has worked out a schedule whereby she will pay the remaining $600,000. Brenda plans to liquidate Songco. If Brenda liquidates Songco and pays the bank, she will be allowed a $600,000 capital loss deduction under the *Arrowsmith* rule. **The loss will be deductible to the extent of Brenda's capital gains plus $3,000 per year, with any nondeductible loss being carried forward.**

In this situation, there is very little that can be done to help a shareholder in a C corporation. There would be no possibility of claiming an ordinary loss of this magnitude under §1244. It is unlikely that any loss would be allowed under §1244 if the shareholder had purchased stock when the failure of the corporation was a foregone conclusion. Similarly, a shareholder would have little success claiming a business bad debt deduction for a loan to a moribund corporation.

An S election, however, could provide enormous tax savings.

Example 3. Refer to **Example 2.** If Songco is an S corporation, Brenda may be able to claim an ordinary loss deduction, although the situation requires careful planning. In this situation, Songco had probably suffered substantial ordinary losses, and Brenda's basis has already been reduced to zero. Therefore, it is likely that Brenda has not yet been able to deduct all of Songco's ordinary losses. If Brenda liquidates Songco, she will have no opportunity to use her suspended losses in a future year, since the corporation will no longer exist. She would be well advised to pursue one of the following courses of action.

1. Keep Songco's existence intact **until she has paid the bank loan.** Each payment will be treated as a contribution to capital and will give her additional stock basis. **The added stock basis will enable her to deduct suspended losses.** (Rev. Rul. 70-50, 1970-1 C.B. 178; Rev. Rul. 71-288, 1971-2 C.B. 319).
2. Brenda could arrange with the bank to substitute her personal note for the corporation's note, **before she liquidates** Songco. She should obtain competent legal advice on whether this action will cause subrogation under state law. **If subrogation occurs, she will be allowed full basis** (Rev. Rul. 75-144, 1975-1 C.B. 277). If subrogation does not occur, she may nevertheless be able to claim basis at the time she substitutes the note [*Gilday, Donald S.*, 43 T.C.M. 1295 (1982)]. This immediate increase to basis will allow her to deduct all previously suspended losses, to the extent she now has basis. She may then liquidate Songco.

Either of these options will allow Brenda to claim the $600,000 ordinary loss on her personal return.

Liquidating Distributions of Installment Receivables

A corporation may sell all, or substantially all, of its operating assets prior to liquidation. If the purchaser's consideration is all or primarily cash, there is little tax planning to be done. If, however, there have been substantial gains on the sale of the corporation's property, and a substantial portion of the consideration received is in the form of installment notes, there are significant tax planning opportunities.

Shareholder Considerations on Receipt of Installment Obligation

In general, a shareholder must take into account the fair market value of all property received in any distribution from any corporation [§301(b), §334(a)]. There is, however, a special rule for receipt of an installment obligation from a corporation when the corporation is completely liquidated. If the installment receivable was generated in a liquidating sale of assets by the corporation, the shareholder treats the receivable as if it were received for an installment sale of stock [§453(h)(1)]. The shareholder must allocate his or her stock basis between the installment receivable and any other property received from the corporation in proportion to the relative fair market values. [**Note:** There are a number of requirements and limitations under §483(h) that may apply.]

Example 4. At the time of liquidation in 1997, Carco, Inc., had two remaining assets—cash of $60,000 and a note receivable of $120,000 arising from the sale of land. The note was payable in six installments of $20,000 beginning on December 31, 1998. The land, which had a basis of $40,000, was sold shortly after the plan of liquidation had been adopted. On October 31, 1997, the corporation distributed the cash and note to its sole shareholder, Anne, in complete liquidation. Anne had a basis in her stock of $18,000.

Anne realizes a gain of $162,000 ($60,000 + $120,000 - $18,000). However, Anne is allowed to report the gain allocable to receipt of the note as the note is collected. To determine the gain allocable to receipt of the note, the shareholder's basis is allocated between the note and other amounts received based on relative fair market values.

Allocated to Cash:	
$\frac{\text{Cash}}{\text{Total receipts}} \quad \frac{\$60,000}{\$180,000} \times 18,000 = \$6,000 \text{ basis}$	
Allocated to Note:	
$\frac{\text{Note}}{\text{Total receipts}} \quad \frac{\$120,000}{\$180,000} \times 18,000 = \$12,000 \text{ basis}$	
Cash received in 1997	$60,000
Basis of cash	(6,000)
Gain recognized in 1997	$54,000

The balance of the gain, $108,000 ($162,000 - $54,000), is reported as the note is collected. The new basis in the note is $12,000, resulting in a new gross profit ratio of 90% ($120,000 - $12,000 = $108,000/$120,000). Therefore, Anne's gain recognized in 1998 and each of the next five years is $18,000 ($20,000 × 90%).

To qualify for the deferral, the corporation must have adopted a plan to liquidate before making the sale that generated the receivable. In addition, the installment receivable must have been generated by a sale of the liquidating corporation's assets within the 12-month period ending on the date of the liquidating distribution.

Example 5. In 1997, Donco, Inc. sold some land on the installment method. The sales price was $400,000, and Donco's basis in the land was $150,000. In 1998, Donco received an offer for all of its remaining assets, for which it had a basis of $700,000. Upon receipt of the offer, Donco adopted a plan to liquidate. It sold all of its remaining property to the purchaser and received an installment obligation for $2,400,000. After the sale of its remaining properties, Donco's only two assets were the two installment receivables, which it then distributed to its shareholders. The shareholders must take the installment receivable from the early sale into account at its fair market value, since it arose from a sale that was completed before Donco adopted its plan to liquidate [§453(h)(1)(A)]. The shareholders would take the other receivable, from the liquidating sale, into account as an installment sale for their stock, in the same manner as shown in **Example 4.**

Corporate Considerations on Distribution of Installment Obligations

In this scenario, it is again evident that the S corporation is far superior to the C corporation in possible tax treatments. In general, a distribution of an installment receivable is treated as a disposition of the receivable, and accelerates all previously unrecognized gain to the distributor [§453B(a)]. If the distributor is a C corporation, this rule will hold regardless of the context of the distribution. Thus the corporation would need to recognize gain on the distribution of an installment obligation in a dividend distribution, a redemption of stock, or a distribution in complete liquidation.

Example 6. Refer to **Example 5.** If Donco is a C corporation, it must recognize gains on the distribution of both of the installment obligations as if it had collected those obligations in full on the date of the liquidating distribution.

Under certain circumstances, an S corporation is not required to recognize gain on the distribution of an installment receivable to its shareholders in a liquidating distribution [§453B(h)]. To qualify for the nonrecognition, the installment receivable must meet the same definition as an obligation that qualifies for deferral at the shareholder level. It must have been generated by a sale of the S corporation's assets within the 12-month period ending on the date of the liquidating distribution. In addition, the S corporation must have adopted a plan to liquidate before making the sale that generated the receivable.

Example 7. Refer to **Example 5.** If Donco is an S corporation, it will recognize gain on the distribution of the obligation from the early sale, but it will not recognize any gain from distribution of the receivable from the sale after the plan to liquidate was adopted. The shareholders, in addition, will be allowed to defer the gain from the sale of their stock in complete liquidation, under the same rules discussed above.

Planning Strategies. When there are gains to be realized in the liquidation of a corporation, a last-minute S election may provide only reduced tax savings, due to the built-in gains tax imposed by I.R.C. §1374.

That provision imposes a corporate level tax at the flat rate of 35% on gains recognized by the corporation on property held at the time of conversion to S status, but does not apply to corporations that have been S corporations from inception. The tax applies to all gains recognized on such property for 10 years following the conversion to S status. Therefore, the best time to make an S election is the corporation's first year, so that it will never face the built-in gains tax. A C corporation that is already in existence may also benefit from an S election, even though there might be a built-in gains tax for the following reasons:

1. The corporation might not liquidate, or otherwise sell a substantial portion of its assets, for 10 years after the election takes effect. It would outlive the 10-year statutory period of the built-in gains tax, and it would receive the full advantage of S corporation status at the 10-year mark.
2. The built-in gains tax applies only to assets held at the time of conversion to S status. Therefore, assets acquired subsequent to that date would not be subject to the tax when sold or distributed in liquidation.

Caution. There are special rules dealing with installment sales of built-in gain property. First, the built-in gains tax will apply if these receivables are distributed to the shareholders in liquidation of the corporation. Second, if the corporation does not liquidate, and continues to collect the receivables, the gains will be subject to the built-in gains tax. This tax will continue to apply even after the normal 10-year built-in gain recognition period has expired.

Stock Redemptions

This topic was discussed in the 1995 *Farm Income Tax School*. The basic rules are restated herein. A "stock redemption" is simply a purchase by the corporation of its own stock from its shareholders [§317(b)]. From the shareholder's view, a redemption of his or her stock is simply a sale of the corporation's own stock back to the corporation. When the shareholder desires to dispose of part or all of his or her interest in the business, the redemption may be useful as a financing technique.

For example, if a buyer wishes to acquire the business but has insufficient funds, the corporation could use some of its cash to buy the shareholder's stock while the buyer purchases the shareholder's remaining stock. For many years, commentators simply called this arrangement a bootstrap acquisition. More recently, it has been reshaped and in its more sophisticated form is referred to as a leveraged buyout (LBO).

While a redemption appears to be simply a sale, it may in fact be a disguised dividend. Consequently, before sale treatment is granted, the redemption portion of the transaction must pass the test of §302. Failure of these tests normally condemns the transaction to dividend treatment.

Statutory Authority: Code Section 302(a) & (d)

(a)General Rule—If a corporation redeems its stock [within the meaning of §317(b)], and if paragraph (1), (2), (3), or (4) of subsection (b) applies, such redemption shall be treated as a distribution in part or full payment in exchange for the stock.***

(d)Redemptions Treated as Distributions of Property—Except as otherwise provided in this subchapter, if a corporation redeems its stock [within the meaning of §317(b)], and if subsection (a) of this section does not apply, such redemption shall be treated as a distribution of property to which §301 applies.

There are four tests listed in §302. If a redemption passes **any one of these tests,** it is treated as an exchange. Otherwise, it will be a dividend to the extent of the corporation's current earnings and profits and accumulated earnings and profits, as of the close of the tax year of the redemption. The four tests are

1. Not essentially equivalent to a dividend [§302(b)(1)]
2. Substantially disproportionate (non–pro rata) [§302(b)(2)]
3. Complete termination of the shareholder's interest in the corporation [§302(b)(3)]
4. Redemption from noncorporate shareholder in distribution qualifying as a partial liquidation [§302(b)(4)]

Another test that is sometimes useful is found in §303. This provision applies only to stock that has been received through a deceased shareholder's estate. The estate or other holder can have enough stock redeemed to pay the federal and state estate taxes attributable to the decedent's stock in the business. In this situation the redemption need not pass any of the other redemption tests listed above.

Effects on the Corporation

If a corporation uses cash or its own notes to fund a redemption, the corporation will recognize no gain or loss. It must reduce accumulated earnings and profits by the proportion of shares redeemed. Similarly, if the corporation is an S corporation, it must post a proportionate reduction to its accumulated adjustments account. If an S corporation uses noncash property to fund the redemption, it is subject to the same rules that apply if it distributes property as a dividend. If the fair market value of the property exceeds its predistribution basis, the corporation must recognize gain [§311(b)]. If the fair market value is less than the predistribution basis, the corporation **may not recognize any loss** [§311 (a)].

Note: The same tests apply to shareholders in both C corporations and S corporations, although the nature of the two types of entities is such that the tax results may be markedly different. In brief, the redemption technique may be used for bootstrap acquisitions and for retirement of shareholders' interests. Any of these redemption techniques may require some additional analysis to determine whether it is treated as a dividend or as an exchange.

Possibility of a Second Class of Stock. If the redeeming corporation is an S corporation, it must be careful to avoid creating a second class of stock, which would be a violation of the Subchapter S eligibility requirements [§1361(b)(1)(D)]. A redemption of one shareholder's stock means that a person receives a distribution from the corporation that is different from any distribution received by continuing shareholders. **Treatment of a redemption as a sale or an exchange should prevent the IRS from asserting that a second class of stock exists, because such a redemption is not considered a distribution. Regulations §1.1361-1 provides that redemptions do not create a second class of stock unless the redemption price varies significantly from the fair market value of the stock.** The Regulation also provides a safe harbor for book value [Reg. §1.1361-1(l)(2)(iii)]. Under the Regulation, the treatment of a redemption as an exchange or a distribution is immaterial (PLR 9404020).

Effect on Earnings and Profits of a C Corporation

If a redemption is treated as a dividend-type distribution, there are no special rules for the corporation. It combines this distribution with its other distribution and makes the appropriate charge to earnings and profits (if it is a C corporation), or AAA (if it is an S corporation).

A C corporation must make a special calculation of its accumulated earnings and profits. The method for doing this calculation is laid out in Rev. Rul. 74-338 (1974-2 C.B. 101); and Rev. Rul. 74-339 (1974-2 C.B. 103), which describe the effects of a redemption on a C corporation's current and accumulated earnings and profits. These rulings provide that:

- Ordinary distributions for the entire year take precedence over redemption distributions.
- The current year's earnings and profits from corporate income or loss are pro-rated to the date of the redemption.
- Accumulated earnings and profits are chronologically assigned to both ordinary distributions and redemptions, to the extent that each of these distributions exceeds current earnings and profits.

Example 8. Mary owns 35% and Leon owns 65% of the stock in ML Corporation, a C corporation. The corporation uses the calendar year. On December 31, 1996, ML's accumulated earnings and profits balance is $25,000. On May 27, 1997 (40% of the year had elapsed), ML redeems all of Mary's shares, and the redemption qualifies as a complete termination of Mary's interest under §302(b)(3). ML made no ordinary distributions in 1997. ML's current earnings and profits for the entire year of 1997 were $50,000. The corporation's earnings and profits calculations for 1997 are

Beginning balance	$25,000
Current earnings and profits through May 26 (40% of $50,000)	20,000
Balance at the end of May 26	45,000
Portion attributable to shares redeemed (35%)	(15,750)
Balance after redemption	$29,250

Effect on AAA for an S Corporation

A redemption distribution that does not meet one of the exchange tests is treated in the same manner as a nonredemption distribution. Rev. Rul. 95-14, 1995-6 IRB 29, clarifies that this is the appropriate treatment. If the redemption passes one of the exchange tests of §302 or §303, the corporation must reduce its AAA, after all of the activity for the entire year.

Example. Walt and Anne each own 50 shares (50%) in WACKO, an S corporation. In the current year, WACKO's AAA would have been $100,000, without regard to any distributions. WACKO distributed $40,000 to each shareholder during the current year. In addition, WACKO redeemed 25 of Walt's shares for $60,000. There are two possible treatments of the AAA to reflect the redemption.

If the redemption qualifies as an exchange under §302 or §303, the results will be

AAA, before distributions and redemption	$100,000
Less ordinary distributions	(80,000)
AAA, before redemption	20,000
Percent of shares redeemed (25) times pre-redemption balance	(5,000)
Final AAA balance	$ 15,000

If the redemption does not qualify as an exchange, the treatment of the AAA would be

	Amount	Percent
Ordinary distributions	$80,000	57
Redemption distribution	60,000	43

Thus the ordinary distributions would absorb $57,000 of the AAA, whereas the redemption distribution would consume $43,000. The remainder of each distribution could come from AEP, if the AEP balance were at least $40,000.

Treatment of Redemption Expenses

In general, the expenses incurred by a corporation pursuant to a redemption of its stock are nondeductible [§162(k)(1)]. The expenses, such as legal and accounting fees incurred by the corporation, are capitalized as part of the stock acquisition cost. Therefore, they should be treated as a reduction in paid-in capital. Such expenses should not flow through to the shareholders and do not reduce the corporation's AAA [Reg. §1.1368-2(a)(3)(i)(C)].

If the corporation borrows money to finance the redemption, the interest paid on the loan generally will be deductible. The corporation may obtain its financing from an outside lender or from the redeemed shareholder. The IRS has said that interest paid in connection with the purchase of S corporation stock is treated as interest paid on a loan to purchase the assets of the corporation (Notice 88-20, 1988-1 C.B. 487; Notice 89-35, 1989-1 C.B. 917).

Personal Holding Company Tax Problems

To prevent taxpayers from using a corporation as a "pocketbook" in which to accumulate income that is taxed at the corporate rate, Congress imposes a personal holding company (PHC) tax on undistributed personal holding company income. The PHC tax rate is equal to the highest individual income tax rate, 39.6% (I.R.C. §541). **This tax is imposed on the corporation in addition to the income tax,** and it does not relieve the shareholders of the burden of tax on dividends when earnings are actually distributed.

This tax is so onerous that it should be avoided at almost any cost. A rare exception might exist for some nontax business purpose. Similarly, if the status of a corporation as a personal holding company is only temporary, there might be reasons for paying the tax for one, or very few, years, in order to facilitate some long-term business objectives.

Prior editions of the *Farm Income Tax School* have discussed the specific rules governing the computation of this tax. This year's edition restates some of the basic problems and alerts the reader to some possible corrective actions.

The PHC tax can become a problem for closely owned C corporations that discontinue a trade or business. At that point there may be few assets left inside the corporation. They may include cash or notes from a purchaser of the corporation's operating assets, or they may include real estate that was not wanted by the purchaser. When this situation becomes a realistic possibility, the tax advisor must be on the lookout for personal holding company problems. Thus a restatement of the two basic tests is in order:

1. The income test
2. The ownership test

Income Test

This test is met if at least 60% of the corporation's adjusted ordinary gross income (AOGI) for the tax year is personal holding company income. AOGI is calculated by starting with the ordinary gross income of the corporation and reducing it by certain expenses. For example, rental income that is included in ordinary gross income is reduced by deductions for depreciation, property taxes, interest, and rent that is allocable to that income.

Observation. Capital gains are not included in AOGI since the starting point includes only ordinary gross income. Therefore, the sale of capital assets and assets used in the trade or business that trigger capital gains do not add to either the numerator or the denominator for purposes of the 60% test.

60% Test

For purposes of the 60% test, there are specific types of adjusted ordinary income that make up personal holding company income [I.R.C. §543(a)]:

1. Dividends, etc. Dividends, interest, royalties (other than mineral, oil, or gas royalties or copyright royalties), and annuities***
2. Rents***
3. Mineral, oil, and gas royalties.***
4. Copyright royalties.***
5. Produced film rents.***
6. Use of corporate property by shareholder.***
7. Personal service contracts.***

One of the types is rental income; however, there is an exception. If rents constitute 50% or more of the AOGI and if other PHC income does not exceed 10% of the (unadjusted) ordinary gross income, then the rents are not included in PHC income.

Therefore, if rents make up most of the corporation's income (so that the 50% test is met) and there is very little other PHC income, such as dividends, interest, and royalties (so that the 10% test is met), the rents will not be included in PHC income, and the 60% test is not likely to be met. If the 60% test is not met, the corporation is not subject to the PHC tax.

Not all rent is PHC rental income. If the corporation is sufficiently involved in the business that is "renting" its assets, the payments it receives for use of the assets will not be treated as rent for purposes of the 60% test. For example, in ***White's Ferry, Inc. v. Commissioner,*** 66 T.C.M. 1855, T.C. Memo 1993-639, the taxpayer corporation had an agreement with another corporation under which White's Ferry, Inc. leased property to the other corporation. However, since one of the shareholders of White's Ferry, Inc. participated in all management decisions pertaining to the operation of the business, the court ruled that the lease payments were not rent for purposes of the PHC tax. Similarly, in ***Webster Corporation v. Commissioner,*** 25 T.C. 55; aff'd per curiam, 240 F.2d 164, the court held that income derived from farms owned by the corporate taxpayers and managed through a supervising agent who engaged farmers to operate the farms under a crop-sharing arrangement was not "rent" for purposes of the PHC tax. In Rev. Rul. 67-423, 1967 C.B. 221, the IRS ruled that a landowner corporation's share of Soil Bank payments was not "rent" for purposes of the PHC tax since the corporation materially participated in the management of the farm production.

Since the tax applies only to income that is not distributed, one way to avoid the PHC tax is to distribute the corporate income to shareholders. If that is done in the form of dividends, the shareholders must pay taxes on the dividends at their individual rate, but in most cases they would have paid taxes on the distributions at some time in any event. By distributing the income in the year it is earned, the individual income taxes are accelerated, but the PHC tax is avoided.

Observation. Undistributed personal holding company income is computed by making adjustments to the corporation's taxable income—not just its personal holding company income. Therefore, once a corporation has enough personal holding company income to be subject to the tax (see the discussion of the AOGI test below), all of the corporation's income is used as the starting point for calculating the PHC tax (I.R.C. §545).

The following is a comprehensive example of a corporation that has primarily rental income, and might or might not be a personal holding company. It is representative of a corporation that has sold most of its operating assets, but has retained real estate. It has invested funds in marketable securities. It has also sold some property during the year.

Example 9. Rentco has the following income and deductions for the current year:

Gross income from interest	$20,150
Gross income from rents	67,250
Capital gains	14,000
§1231 gains	7,500
Depreciation recapture	12,750
Total	121,650
Depreciation, taxes, and interest on rental property	(24,250)
Other expenses	(17,375)
Taxable income	$80,025

Rentco's ordinary gross income is

Gross income from interest	$20,150
Gross income from rents	67,250
Depreciation recapture	12,750
OGI	$100,150

Rentco's adjusted ordinary gross income is

Gross income from interest	$20,150
Gross income from rents	67,250
Depreciation, taxes and interest on rental property	(24,250)
Depreciation recapture	12,750
AOGI	$75,900

The adjusted income from rent is

Gross income from rents	$67,250
Depreciation, taxes, and interest on rental property	(24,250)
Adjusted income from rents	$43,000

As a percent of AOGI, the rents are 56.6535% ($43,000/$75,900).

If Rentco pays out no dividend, or an insufficient dividend, its rents will be treated as personal holding company income. If the corporation does not pay the dividend, personal holding company income will be as follows:

as follows:

	PHCI	Not PHCI	Total
Gross income from interest	$20,150		$20,150
Gross income from rents		67,250	67,250
Depreciation, taxes, and interest on rental property		(24,250)	(24,250)
Depreciation recapture		12,750	12,750
Total	$63,150	$12,750	$75,900
Percent of total	83.2	16.8	100

If the corporation does pay the dividend, personal holding company income will be as follows:

	PHCI	Not PHCI	Total
Gross income from interest	$20,150		$20,150
Gross income from rents	67,250		67,250
Depreciation, taxes, and interest on rental property	(24,250)		(24,250)
Depreciation recapture		12,750	12,750
Total	$63,150	$12,750	$75,900
Percent of total	83.20	16.80	100

Thus the payment of the dividend will determine whether or not Persco is a personal holding company for the year. The minimum dividend is calculated as follows:

PHCI	$20,150
Less 10% OGI	(10,015)
Minimum dividend	$10,135

Ownership Test

This test is met if 50% in value of the outstanding stock of the corporation is owned directly or indirectly by five or fewer individuals at any time during the last half of the tax year (§542). Ownership by family members (brothers, sisters, spouse, ancestors, and lineal descendants) is attributed to the shareholder for purposes of this test, as is ownership through entities and partners (§544). Therefore, ownership of more than 50% must be disbursed among more than five unrelated taxpayers to avoid satisfying this test. For many closely held corporations, such disbursement is not practical.

Using S corporation status to avoid personal holding company problems

An S corporation is exempt from all normal taxes and surtaxes imposed by Chapter 1 (income tax chapter) of the Internal Revenue Code [§1363(a)]. **This definition includes the personal holding company tax as well as the more commonplace income tax and alternative minimum tax.** Thus a closely held corporation may avoid the entire personal holding company problem by being an S corporation. **There are, however, some cautions to be observed.**

1. An S corporation may have problems if it has accumulated earnings and profits from years in which it was a C corporation, if its passive investment income exceeds 25% of its gross receipts [§1362(d)(3, §1375]. The term *passive investment income* includes most types of personal holding company income, such as rents, interest, annuities, and dividends.
2. If an S corporation has no such earnings and profits, it has no passive investment income problems. Thus a corporation that has always been an S corporation will not face any serious consequences of meeting both the personal holding company income test and the ownership test, because it is exempt from the personal holding company tax. A corporation that has such earnings and profits, however, must be much more careful.
3. If an S corporation violates the passive investment income limit of 25% of gross receipts in any one year, it is liable for a corporate level tax **on its excess net passive income.** The tax is imposed on the corporation at the rate of 45%, although it reduces the flow-through of taxable income to the shareholders.
4. This tax, in and of itself, is not nearly as burdensome as the personal holding company tax. The most severe problem occurs when the S corporation has violated the passive investment income test for three consecutive years. At that point the corporation loses its S election and becomes a C corporation. It is likely that the corporation will then be a personal holding company.

Election to distribute earnings and profits

In general, the distributions from an S corporation are from its Accumulated Adjustments Account (AAA) until that account is exhausted [§1368(b) and (c)]. Those distributions are generally reductions of shareholder basis. **In rare instances, if a distribution does exceed the AAA, and exceeds the shareholder's basis, the excess of the distribution over the shareholder's basis is treated as a gain from the sale of the stock.** The AAA is the accumulation of all taxable income, less deductions and distributions to shareholders, since the S election has been in effect.

If a distribution exceeds the corporation's AAA, the next source is the corporation's accumulated earnings and profits from years in which it was a C corporation. **This distribution is treated as a dividend, in the same manner as if it had been distributed before the S election took effect.** This dividend will reduce earnings and profits. If the corporation distributes out all of its earnings and profits, it will no longer be subject to the passive investment income problems.

An S corporation may elect to distribute its accumulated earnings and profits before its AAA [§1368(e)(3)]. By doing so, the shareholders will all report taxable dividend income rather than tax-free reductions of basis, to the extent of the distribution or the earnings and profits before the distribution, whichever is less. Thus, this election is not to be taken lightly, nor should it be done in the absence of a careful study of the corporation's accumulated earnings and profits. It may, however, save a corporation from losing its S status and becoming a personal holding company.

Example 10. Formerco, an S corporation, was an operating company that has sold most of its operating assets. It retains some rental property that it used in its principal business. It has secured a tenant with a net lease on the property. It anticipates that virtually all of its sources of income will be interest, dividends, and passive rents. It is closely held and has no plans to diversify its ownership. The rental property has a basis of $1,500,000 and fair market value of $3,000,000. Formerco expects about $350,000 per year in net rental income, and another $50,000 in interest and dividend income from blue-chip securities.

The fair market value of all Formerco's assets is $5,000,000. Its total debts are $450,000. It has one shareholder, who has a basis of $1,250,000 in her stock. Formerco's AAA is $1,250,000, and its accumulated earnings and profits are $550,000. At this point, Formerco has three options:

1. It can continue in existence without taking any special action.
2. It can liquidate.
3. It can continue in existence and make an election to distribute its earnings and profits.

Each of these courses of action has its costs:

1. If the corporation continues in existence without taking any action, it will be subject to the passive investment income tax for three years. After that time it will lose its S election and become a personal holding company.
2. If the corporation liquidates immediately, it will recognize all gains and losses on the distribution of its property. It will need to be cognizant of any special character of gain, such as ordinary income under §1239. It will need to determine how much, if any, of the gains are subject to the corporate level built-in gains tax (45%) under §1374. Finally, the shareholder must recognize gain on the receipt of property in exchange for her stock.
3. If the corporation distributes out all of its earnings and profits, by electing to bypass AAA, the shareholder will recognize dividend income of $550,000. The corporation may continue as an S corporation, without danger of the passive investment income tax or losing its S election. This course of action is probably the best.

In summary, the personal holding company tax may be a serious problem for a closely held corporation that has significant investment income. One of the best strategies is to plan ahead, and make sure that every closely held corporation has an S election in effect from its inception, unless there are overwhelming reasons for being a C corporation.

Disallowance of Corporate Expenses under §262 and §162

Prior editions of the *Farm Income Tax School* have contained numerous discussions and examples of loss and deduction disallowance rules. There have also been comprehensive discussions of compensation and fringe benefits to shareholders. Disallowances and compensation are both present in many dealings between closely held corporations and their shareholders. For example, constructive dividends are used as disallowance provisions. In these situations, a shareholder-employee has been charged by the IRS with receiving a tax benefit from the corporation in which he or she is a shareholder.

The usual tax treatment sought by the IRS is to disallow the deduction at the corporate level. Usually, in this scenario, the cost to the corporation is directly related to the benefit to the shareholder. The most common example is unreasonable compensation, whereby the corporation pays an excessive salary to the shareholder-employee. The disallowance mechanics are quite simple. The corporation is simply not allowed to deduct any more than the reasonable amount of compensation.

Planning strategy. Any corporation that perceives a risk of excessive compensation should enter into an agreement with its employees that the employee must return any compensation found to be excessive. This provision is known as an ***Oswald clause,*** from a well-known Tax Court case (***Vincent E. Oswald,*** 49 T.C. 645 (1968)). In ***Oswald,*** the corporation's by-laws required employees to repay excessive compensation. The Court allowed the employee a deduction upon repayment.

An appropriate strategy for dealing with reasonable compensation problems is for the corporation to make an S election. By doing so, it assures the shareholders that the earnings of the corporation will be taxed just once, either as compensation or as pass-through income. **This strategy is not entirely foolproof, and there have been some egregious examples of expenses disallowed to S corporations involving payments for shareholder benefit.** For example, in a recent case, excessive compensation to family member of sole shareholders was disallowed [***Westbrook,*** T.C. Memo 1993-634, 66 T.C.M. 1823, aff'd ***Westbrook v. CIR,*** 68 F.3d 868, 76 AFTR2d 95-7397, 95-2 USTC ¶50,587 (5th Cir.)].

When an S corporation is involved, the law also subjects corporate outlays to the hobby loss rules of §183. There have been several cases upholding the IRS denial of deductions on this basis. [See ***Upton,*** 59 T.C.M. 653 (1990); ***Westbrook,*** T.C. Memo 1993-634, 66 T.C.M. 1823, aff'd ***Westbrook v. CIR,*** 68 F.3d 868, 76 AFTR2d 95-7397, 95-2 USTC ¶50,587 (5th Cir.); ***Ballard,*** T.C. Memo 1996-68; and ***Hilliard,*** T.C. Memo 1995-473, 70 T.C.M. (CCH) 898. **Expenses have also been disallowed when an S corporation pays personal expenses on behalf of its shareholders;** see ***Handke,*** T.C. Memo 1990-273, 59 (CCH) T.C.M. 766.

There are some additional problems when the shareholder receives benefits, but the cost to the corporation is not readily measured in cash. An example is use of a corporation's automobile or other property. The shareholder may be held as receiving a benefit, but the cost of the benefit to the shareholder is not immediately measurable.

The Tax Reform Act of 1984 provided a partial answer to this problem with the enactment of the special rules applicable to automobiles and other listed property. In general, those rules contain a twofold thrust. First, the recordkeeping requirements with respect to the business use of the property are stringent. Second, if the business use of the property does not exceed 50%, the owner of the property must use slower depreciation rates than those normally permitted by MACRS. In addition, if the property in question is a passenger automobile, the owner is subject to stringent limitations on the depreciation deductions.

None of these rules, however, deal with the indirect costs of owning the property, such as interest, maintenance, and insurance. The IRS has another method of dealing with such costs, using a combination of two code sections. First, §162 allows deductions for the ordinary and necessary costs of carrying on a **trade or business.** Thus, if a cost does not meet this definition, there is grounds for disallowance.

Second, §262 specifically disallows deductions for personal expenses. The section is brief, and has not been cited extensively in the context of corporations. Most of the rulings under this section have dealt with personal travel expenses, education expenses, etc. Section 262 has, however, been applied to corporations in their capacity as employers, and has been used to disallow certain expenses. These expenses are primarily those related to corporate property that is used by shareholder-employees, such as automobiles and airplanes.

The IRS has been successful in invoking §262 when the corporation was not involved in a trade or business except for provision of property to shareholders (***Ray Clymer & Denison Poultry,*** 47 T.C.M. 1576, T.C. Memo 1984-203, ***International Trading Co. v. Comm.,*** 5 AFTR2d 970, 275 F.2d 578, 1960-2 C.B. 435, 60-1 USTC 9335 (7th. Cir.)). Similarly, the IRS has prevailed in disallowing expenses relating to a company car, when the use of the car was a constructive dividend to a shareholder-employee (***Egan,*** 43 T.C.M. 1284, T.C. Memo 1982-237).

However, when the corporation rents the property to the shareholder-employee, or provides use of the property as compensation, the IRS has not been successful (***Levy,*** T.C. Memo 1984-306, 48 T.C.M. 293). The rationale of this case was that the compensation to the shareholder-employee was an ordinary and necessary business expense of the corporation. The corporation had reported the value of the personal use of the corporation's airplane as compensation on the president's W-2. Therefore, the cost of that portion of the compensation was a deductible expense to the corporation. The IRS did not raise the issue of excessive compensation in this case.

Thus, it could be of critical importance to make certain that employees, especially shareholder-employees, are charged for personal use of corporate property, in one manner or another. If the corporation charges a fair rent to the employee, the cost of maintaining and owning the property would be deductible by the corporation as an income-producing expense under §212. If the corporation reports the personal use of the corporate property as compensation to the executive, the cost of owning and operating the property would be allowable as a trade or business expenses under §162.

Example 11. Algco is a closely held corporation. Linda is the controlling shareholder. The corporation has an airplane. The maintenance, insurance, interest, and other costs, exclusive of depreciation, total $50,000 for the current year. The flight logs demonstrate that 60% of the use for the current year was for bona fide business purposes, and the remainder was Linda's personal use. If the corporation charges Linda for use of the airplane or, alternatively, reports the fair market value of her personal use of the aircraft on her form W-2, the corporation should be allowed to deduct the entire $50,000. If the corporation merely allowed her to use the airplane without any formal arrangements, the IRS could disallow the cost of the 40% personal use, or $20,000.

This treatment should not differ whether Algco is a C corporation or an S corporation. In addition, if Algco is a C corporation, the fair market value of the use of the airplane could be charged to Linda as a constructive dividend. In that instance, Linda would have income for the value of her personal use of the airplane, and the corporation would have no deduction for the cost of providing the airplane to Linda for