Chapter 5: Entity Issues

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Corrections were made to this workbook through January of 2005. No subsequent modifications were made.

C CORPORATION TAXATION AFTER JGTRRA 2003

The Jobs Growth and Tax Relief Reconciliation Act of 2003 (JGTRRA) was enacted on May 28, 2003.[1] It created one of the largest tax cuts in U.S. history; approximated at $350 billion. The Act reduces income tax rates and capital gains rates for individuals. In addition, dividends received by individuals and trusts from U.S. domestic corporations are generally taxed to individuals at a 15% maximum income tax rate.

This chapter explores various aspects of C corporations as compared to S corporations. It also describes strategies that are useful to avoid some of the typical tax traps related to C corporations. In particular, this chapter addresses a number of questions that have arisen in the aftermath of JGTRRA:

- What are the tax planning implications of JGTRRA for clients?
- Is a C or S corporation more advantageous after JGTRRA?
- How is reasonable compensation versus dividends affected?
- What opportunities exist for planning with multiple corporations?
- What should be done with existing personal holding companies?
- How does the Act impact planning for the accumulated earnings penalty tax?
- How can appreciated assets be removed from corporations with minimal tax consequences?

GENERAL CONCEPTS

Subchapter C of the IRC is devoted to corporate distributions and adjustments and covers IRC §§301–385. In the most traditional sense, a C corporation is a business entity that must pay income tax on its earnings at corporate income tax rates set forth in IRC §11. C corporations have a number of distinct advantages and disadvantages compared to other business entities.

FISCAL YEAR

C corporations can elect to use any fiscal year end. Partnerships and S corporations generally must use a calendar year. Since the income tax filings for business entities are due within three (for corporations) to four (for partnerships, LLC, and sole proprietors) months after the end of the tax year, the workload of tax compliance professionals is a consideration. The freedom that C corporations have in being able to select any fiscal year end makes them attractive.

[1] PL 108-27

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TAX RATES

IRC §1 lists the rates at which income is taxed for individuals operating as sole proprietors, or as the owners of pass-through entities such as partnerships, limited liability companies, and S corporations. The individual income tax rates under §1 are graduated, and therefore increase as the taxpayer's level of taxable income increases. In 2004, the rates range from 10% on the lowest earned income up to 35% on the highest earned income. IRC §11 lists the rates at which income is taxed for C corporations. The corporation income tax rates under §11 are similarly graduated, increasing as the corporation's taxable income rises. As seen in the following table, C corporations have the benefit of lower rates on the first $75,000 of taxable income.

Tax Rate Schedule
Corporate
For Tax Years Beginning After December 31, 1992

If Taxable Income Is			
Over	But Not Over	The Tax Is	Of the Amount Over
$ 0	$ 50,000	15.0%	$ 0
50,000	75,000	7,500.00 + 25.0%	50,000
75,000	100,000	13,750.00 + 34.0%	75,000
100,000	335,000	22,250.00 + 39.0%	100,000
335,000	10,000,000	113,900.00 + 34.0%	335,000
10,000,000	15,000,000	3,400,000.00 + 35.0%	10,000,000
15,000,000	18,333,333	5,150,000.00 + 38.0%	15,000,000
18,333,333		6,416,667.00 + 35.0%	18,333,333

Note. If an individual business owner's effective income tax rate exceeds the corporate income tax rate, then corporate rates can shelter business income by subjecting it to taxation at lower rates.

Example 1. Compare the tax treatment for three C corporations.

	C corporation #1	C corporation #2	C corporation #3
Income (A)	$150,000	$335,000	$1,000,000
Tax due			
First $100,000	22,250	22,250	22,500
Next $150,000	19,500	58,500	58,500
Over $250,000 to $335,000		33,150	33,150
Over $335,000			226,100
Total C corporation tax (B)	$ 41,750	$113,900	$ 340,000
Effective tax rate			
Line B ÷ Line A	27.8%	34%	34%

If an individual business owner is in a 35% tax bracket, C corporation status may be the preferred choice. This is especially true in the early years of the business. If an individual business owner is funding growth, he needs to conserve as many current dollars as possible, and reinvest those dollars in the business as increased inventory and receivables. As a C corporation, the immediate tax savings enhance that growth. However, as the business matures over many years, an S corporation may become the preferred entity form because of tax treatment.

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PERSONAL SERVICE CORPORATIONS

C corporations that perform at least 95% of their activities in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, and consulting are classified as personal service corporations (PSCs).[2] The PSC definition does not include sales and brokerage services, or businesses that are compensated on a commission or contingent basis where a product is sold, such as real estate, insurance, investments, etc.

PSCs have special rules that are applicable.

1. A flat 35% income tax bracket applies to every dollar of taxable income.
2. PSCs are permitted to use a cash-basis method of accounting, and they must generally file income tax returns on a calendar year.

> **Note.** A PSC can elect on Form 8716 to have a tax year other than a calendar year, however, it must make a required payment under IRC §444 to neutralize the tax benefits resulting from such an election.

3. PSCs can only deduct payments made to an owner-employee in the tax year in which she included the payment in gross income.
4. PSCs cannot carry back any net operating loss (NOL) to offset a prior years' income, if it has made a §444 election.

5

DOUBLE TAXATION

Earnings that accumulate in a C corporation are ultimately taxed at the time they are distributed to the shareholders. This tax on distributed earnings is referred to as a **second tax.** With current tax rates, high-bracket taxpayers should consider electing S status to avoid the second tax.

Example 2. Compare the tax treatment for a C and an S corporation. The corporation is 100% owned by Joe. It has a $300,000 profit for the year. Joe is in the 35% tax bracket.

	C corporation	S corporation
Corporate profit	$300,000	$300,000
Tax paid by:		
Corporation	100,250	
Joe @ 35% rate		105,000
Remaining cash after first tax	$199,750	$195,000
Second tax: Joe @ 15% rate*	(29,963)	0
Remaining cash after second tax	$169,787	$195,000

*If Joe liquidates the corporation prior to 2008. A dividend is taxed at 15% under JGTRRA. Assume that Joe cannot raise his salary because of unreasonable compensation problems.

Appreciated Assets

A C corporation with appreciated assets, such as a building, has another concern regarding double taxation when it sells them. Under C corporation status, the first tax is assessed when the corporation sells the building, and the second tax occurs when the individual shareholder withdraws the funds as a dividend or when the corporation liquidates. This scenario commonly occurs for business owners who are looking to transfer their business through a sale of their assets to a future owner.

2. IRC §448

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Personal Holding Company

Historically, when owners sell business assets, they seek to avoid the second tax on liquidation by continuing to operate the corporate shell, and by reinvesting the proceeds in financial assets. In this situation, the goal is to hold the stock of the corporation until the owner's death. Under IRC §1014, the stock of the corporation receives a "step up" in basis to fair market value (FMV) at date of death. If the corporation is liquidated at that time, there is no gain.

This solution to double taxation is imperfect for two reasons:

1. If the corporation invests solely in financial assets during the interim period after the sale and prior to the shareholder's death, then the corporation becomes a personal holding company (PHC) under IRC §531.
2. If the proceeds from the sale appreciate in value inside the PHC, there is an additional built-in gain that does not receive a basis adjustment at the shareholder's death.

S Election

An easy way to avoid double taxation is to elect S corporation status. S corporations pay only one level of tax. For C corporations electing S status after December 31, 1986, a corporate level tax is imposed on any gains that arise prior to S conversion and are recognized by the S corporation through sale of assets or distributions to shareholders within 10 years following the effective date of the S election. This is called the "**built-in gains**" (BIG) tax and it applies only to:

- C corporations that elected S status as of January 1, 1987 or later[3]
- S corporations that acquired assets from C corporations, or from former C corporations in tax-free reorganizations or liquidations; an S corporation is subject to tax on the C corporation assets acquired for 10 years following that transaction

When this tax applies, it is probably the most complicated problem that an S corporation may face. The built-in gains tax was enacted as a companion provision to the 1986 liquidation rules under which gains and losses are recognized on corporate liquidations. Its principal purpose was to prevent C corporations from avoiding the tax on liquidating distributions by becoming S corporations before they liquidated. The Tax Reform Act of 1986 gave the IRS broad powers, including several grants to issue legislative regulations.

During the 10-year period, a first tax on recognized built-in gains is applied to the S corporation at the highest C corporation rate. The shareholder pays a second tax, on the same gain. The built-in gains tax eliminates one advantage of converting to an S corporation.

Observation. Drs. Gray and Moore, Inc., a C corporation want to make an S election to avoid the PSC tax. They must be aware that the accounts receivable net of any accounts payable in the corporation will be subject to BIG tax.

Tax Planning

If a C corporation wishes to convert to S status, and it owns appreciating property that will eventually be sold, it is best to elect S status in order to start the 10-year time period. The S election freezes the value of the appreciated property, and limits the amount of the potential built-in gains tax. Any appreciation after the date of the election is not subject to the tax.

3. IRC §1374

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MULTIPLE CORPORATIONS

Prior to 1969, multiple corporations were frequently used to take advantage of the lower income tax brackets on the first $100,000 of corporation taxable income. This advantage was partially closed by the 1969 Revenue Act, which created the concept of "controlled groups" of corporations. The only disadvantage to this arrangement was the additional paperwork and bookkeeping. This disadvantage is offset by the following advantages.

ADVANTAGES

1. Each corporation insulates that segment of operations within a liability shield. The liability arising within that business unit does not affect the other aspects of the business when the corporation is properly maintained and respected.
2. Separating various aspects of a corporation into separate stand alone corporations allows the shareholder to sell one corporation (a specific aspect of the business) without disturbing the other aspects of the business. Each separate sale of stock is eligible for capital gain treatment.
3. Separate corporations allow a business to separate union and non union jobs, allowing the owner to be more price competitive.
4. Other business reasons:
    - Easier accounting
    - Better credit potential for some separate aspects of the business
    - Laws affecting different divisions of the same business
    - Different profit-sharing and pension plan, however, this advantage was substantially limited by ERISA

CONTROLLED GROUPS OF CORPORATIONS

Two or more corporations, under the meaning of IRC §1563(a)(2), are considered a controlled group of corporations.

Types of Controlled Groups

IRC §1563 describes four types of controlled group corporations:

1. Brother – sister corporations
2. Parent subsidiaries
3. Combination groups
4. Certain insurance companies

For controlled groups, each of the following tax attributes must be allocated among the members of the controlled group:

- Tax bracket allocation (surtax exemption)
- AMT exemption
- Accumulated earnings credit
- IRC §179 limit
- Qualified deferred compensation plan or plans[4]

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4. IRC §414(b)

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If the corporations are not members of a controlled group, then each corporation, under IRC §1561(a), benefits from its own set of tax attributes.

Planning Pointer. Successfully avoiding the controlled group rules is an important skill for tax practitioners. Avoiding the controlled group rules allows multiple corporations, owned by a small group of individuals, to produce significant income tax savings. The lower tax rates may give the corporation a competitive advantage in the marketplace. It is important to effectively shift stock ownership, as required, to avoid becoming a member of a controlled group.

Tax Allocations

If more than one corporation is a member of a controlled group, then the corporations must annually allocate the corporate tax brackets among members of the controlled group. A statement of consent is attached to Form 1120 for each member of the controlled group. The statement outlines the allocation of tax attributes among the members of the controlled group of corporations. Following are two sample statements of consent. The first allocates the corporate income tax brackets, and the second allocates the alternative minimum tax (AMT) exemption among the corporations.

Note. If an allocation is not made, the allocations will be made equally between all corporations.

Statement of Consent to Apportionment Plan Under IRC §1561(a)(1). As amended.

The undersigned corporations hereby consent to the following apportionment plan with respect to December 31, 2003, under IRC §1561(a)(1), as amended by PL 95-600, as it applies to tax years beginning after December 31, 1978.

Name and Address	FEIN	Taxable Year	Amount of Each Bracket Apportioned	
Corporation	12-3456789	01/01/2003–12/31/2003	1st	$ 40,000
			2nd	20,000
			3rd	10,000
			4th	235,000
			5th	9,655,000
Affiliated Corporation	98-7654321	01/01/2003–12/31/2003	1st	10,000
			2nd	5,000
			3rd	15,000
			4th	0
			5th	0

The original of this election is filed with the IRS at Kansas City, MO, together with the tax return of Corporation, which is the first corporation filing for a taxable year including December 31. All other corporations are including a copy of this consent in their returns.

Corporation

Name of Corporation By: Title:

Affiliated Corporation

Name of Corporation: By: Title:

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Statement of Consent to Apportionment Plan for the Exemption Amount Under IRC §1561(a)(3). As amended.

The undersigned corporations hereby consent to the following apportionment plan with respect to December 31, 2003, under IRC §1561(a)(3), as amended by PL 99-514, as it applies to tax years beginning after December 31, 1986.

Name and Address	FEIN	Taxable Year	Amount of Each Bracket Apportioned
Corporation	12-3456789	01/01/2003–12/31/2003	$ 5,000
Affiliated Corporation	98-7654321	01/01/2003–12/31/2003	35,000

The original of this election is filed with the IRS at Kansas City, MO, together with the tax return of Corporation, for a taxable year including December 31. All other corporations are including a copy of this consent in their returns.

Corporation

Name of Corporation By: Title:

Affiliated Corporation

Name of Corporation: By: Title:

Note. The address shown on the consent should be the address of the IRS processing center where the tax return containing the original election is filed.

Example 3. Compare the tax treatment for a single corporation versus multiple corporations with $100,000 of earnings when owned by the same business owner.

	One Corporation	Two Corporations X	Two Corporations Y
Earnings	$100,000	$50,000	$50,000
Taxes: If one @ 35%	22,250		
If two @ 15% each		7,500	7,500
Total taxes	$ 22,250	$15,000	
Annual savings	$7,250		

Example 4. Compare the tax treatment for a single corporation versus multiple corporations with $200,000 of earnings when owned by the same business owner.

	One Corporation	Two Corporations X	Two Corporations Y
Earnings	$200,000	$100,000	$100,000
Taxes: If one @ 39%	61,250		
If two @ 34% each		22,250	22,250
Total taxes	$ 61,250	$44,500	
Annual savings	$16,750		

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Brother-Sister Corporations

The term brother-sister controlled group is defined as two or more corporations that are composed of the same five or fewer individuals, estates or trusts, and who own, directly or indirectly through attribution,[5] stock that **meets both of the following tests.**

80% ownership test. In order for the controlled group to meet the 80% test, **at least 80%** of the voting stock, or the value of all classes of stock must be owned by five or fewer individuals.

More than 50% ownership test. In order for the controlled group to meet the **more than 50%** test, those stockholders must own more than 50% of the stock of each corporation identically. In computing the 50% test, only the least percentage of ownership in each corporation is taken into account.

> **Caution.** The attribution rules can completely change the results in a brother-sister situation. Study the impact of these rules before implementing any actual case.

Example 5. Odette Corp. and Denty Corp. are two corporations owned by Lucy and Serena, who are unrelated. The stockholders' ownership is described below. The corporations pass the 80% test, but fail the 50% test. They are not part of a brother-sister controlled group.

	Identical Ownership %		
Stockholders	**Odette Corp.**	**Denty Corp.**	**50% Test**
Lucy	90%	20%	20%
Serena	10%	80%	10%
Total for 50% test			**30%**

Example 6. Maxi Corp. and Lister Corp. are two corporations owned by Marlon and Greg, who are unrelated. The stockholders' ownership is described below. The corporations pass both the 80% test and the 50% test. The corporations are considered a brother-sister controlled group.

	Identical Ownership %		
Stockholders	**Odette Corp.**	**Denty Corp.**	**50% Test**
Marlon	30%	75%	30%
Greg	70%	25%	25%
Total for 50% test			**55%**

Example 7. Wilson is a stockholder in three corporations. Each of Wilson's two sons, Dennis and Howard, owns a portion of one of the three corporations. The corporations pass the 80% test and fail the more than 50% test. They are not considered a brother-sister controlled group.

	Corporation			
Stockholders	**A**	**B**	**C**	**50% Test**
Wilson	100%	50%	50%	50%
Dennis	0%	50%	0%	0%
Howard	0%	0%	50%	0%
Total for 50% test				**50%**

5. Treas. Reg. §1.1563-3

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Example 8. Dennis buys both Wilson's and Howard's stock in Corporation C. Dennis now owns 100% of the stock of Corporation C. The corporations pass the 80% test and fail the 50% test. They are not considered a brother-sister controlled group.

	Corporation			
Stockholders	**A**	**B**	**C**	**50% Test**
Wilson	100%	50%	0%	0%
Dennis	0%	50%	100%	0%
Total for 50% test				**0%**

Note. The authority for **Example 7 and 8** is IRC §1563(d)(6)(B). It can be used for adult children or grandchildren (who have attained age 21), parents, and grandparents.

Caution. The taxpayer must be aware of the shift in economic risk when changing corporate ownership, as shown in **Example 8.**

S CORPORATIONS

A subchapter S corporation is not a member of a controlled group[6] for the purpose of having income subject to the regular corporate tax. Often the controlled group rules can be avoided by combining the concepts in the prior examples.

Example 9. Samantha owns all, or a portion of, four corporations. She has two children. Her adult son, Lyle, owns a portion of two of the corporations. Her minor daughter, Susan, has ownership in one of the corporations. Wilma, who is not related to Samantha, owns a portion of one of the corporations, and eight other stockholders own less than 5% of one of the corporations. Mike, a manager of one of the corporations, also owns stock. The corporations pass the 80% test and fail the 50% test. They are not considered a brother-sister controlled group. While the combination of all 5 corporations does not meet the 50% controlled group test, corporations S and T are a controlled group.

	C Corporations					S Corporation
Stockholders	**R**	**S**	**T**	**Q**	**50% Test**	**P**
Samantha	100%	50%	45%	0%	0%	50%
Lyle	0%	50%	10%	0%	0%	0%
Susan	0%	0%	0%	0%	0%	50%
Corporation T	0%	0%	0%	79%	0%	0%
Wilma	0%	0%	7%	0%	0%	0%
Others (8)	0%	0%	38%	0%	0%	0%
Mike	0%	0%	0%	21%	0%	0%
Totals	100%	100%	100%	100%	0%	100%

6. Treas. Reg. §1.1563-1(b)(2)(ii)(c)

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PAYROLL TAXES

If the business owner chooses to operate multiple corporations, he needs to ensure payroll taxes aren't overpaid. In order to minimize labor costs, each of the businesses likely shares certain management and administrative employees who perform common services. If each of the "common" employees draws separate paychecks from more than one corporation, there can be large hidden payroll taxes and operating costs. Each "shared" employee is subject to double federal unemployment tax (FUTA), state unemployment tax (SUTA), and employer FICA tax on the combined amounts that exceeded the maximum social security (FICA) wage level ($87,900 in 2004). The result is overpayment of corporate payroll taxes.

> **Example 10.** Joe is the president of two corporations, which are operated as separate businesses. PumpCo sells tanks and pump equipment; InstallCo performs installation services. Joe is paid a total wage of $150,000, comprised of $100,000 from PumpCo and $50,000 from InstallCo. The corporations shared 14 employees, including five executives who earned more than $60,000 each. Each "shared" employee receives a paycheck every payday from each corporation. PumpCo employs 80 additional employees who only work for PumpCo. The "shared" payroll totaled nearly $1 million each year.
>
> For Joe's small business the overpayment equates to $12,500 of excess tax paid in 2004. Although both corporations are owned by Joe, they are considered separate employers under payroll tax laws. If the situation is not corrected, the overpayment repeats itself each year.

In addition to overpaying payroll taxes, there are other double expenses. These include increased paperwork for issuing two paychecks and counting employees twice for workers' compensation insurance purposes, which results in premium overpayments.

Solving Overpayment Problem

One way practitioners can recognize the overpaid payroll taxes problem is by reviewing Form 1040, Page 2, line 64. If a credit for excess social security tax is reported, and the individual works for businesses that are related, it is likely double taxes are being paid. Although the employee is recovering the overpayment, the corporation is still losing overpayment expenses for FUTA, SUTA, and the employer's portion of FICA.

	Line	Description		
Other Taxes		...dule SE		55
	56	Social security and Medicare tax on tip income not reported to employer. Attach Form 4137		56
	57	Tax on qualified plans, including IRAs, and other tax-favored accounts. Attach Form 5329 if required		57
	58	Advance earned income credit payments from Form(s) W-2		58
	59	Household employment taxes. Attach Schedule H		59
	60	Add lines 54 through 59. This is your **total tax** ▶		60
Payments	61	Federal income tax withheld from Forms W-2 and 1099	61	
	62	2003 estimated tax payments and amount applied from 2002 return	62	
If you have a qualifying child, attach Schedule EIC.	63	**Earned income credit (EIC)**	63	
	64	Excess social security and tier 1 RRTA tax withheld (see page 56)	64	
	65	Additional child tax credit. Attach Form 8812	65	
	66	Amount paid with request for extension to file (see page 56)	66	
	67	Other payments from: a ☐ Form 2439 b ☐ Form 4136 c ☐ Form 8885	67	
	68	Add lines 61 through 67. These are your **total payments** ▶		68
Refund	69	If line 68 is more than line 60, subtract line 60 from line 68. This is the amount you **overpaid**		69
	70a	Amount of line 69 you want **refunded to you** ▶		70a

To avoid overpayment of payroll taxes and expenses, business owners can designate one of their corporations as the "common paymaster." Treas. Reg. §31.2131(s) permits corporate employers that have either common ownership or common officers to combine the payroll of shared employees within a single accounting department and report the wages paid on a single paycheck and payroll system.

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The process for combining the shared employees is fairly easy. No special forms must be filed. One of three tests must be met in order for a common paymaster to be assigned. The related group of corporations must have at least:

1. 50% common ownership,
2. 50% of the officers work for both corporations, or
3. 30% of the employees are shared employees.

The board of directors must authorize the officers of each of the corporations to combine the wages of shared employees onto the payroll of one of the corporations.

The shared employees are paid by only one of the corporations, and that corporation is considered to be the only employer. The other corporation can pay a management fee or periodically reimburse the reporting company for the wages and its share of the payroll costs. By using a common paymaster, payroll taxes are due only once per employee.

C CORPORATION ADVANTAGES

IRC §170 CHARITABLE CONTRIBUTION DEDUCTIONS

The maximum allowed charitable contribution deduction for a C corporation is 10% of its taxable income computed without regard to (1) the charitable contribution deduction itself, (2) the dividends received deduction under IRC §§242–247, (3) net operating loss carrybacks under IRC §172, and (4) capital loss carrybacks under IRC §1212(a)(1). C corporations may carry forward unused charitable contributions for a period of five years. Unused contributions may not be carried back. A C corporation is entitled to an expanded deduction for qualified contributions of inventory and certain other property.

IRC §170 covers the income tax deductibility of various types of property given to charities. The general rules limit the income tax deductions available for tangible personal property. Gifts of tangible personal property (e.g., art, jewelry, furniture) that, if sold, would qualify as a capital gain can be deducted at market value if the receiving organization can put it to a "related use." Related use is generally where the gift is used or consumed by the organization in its original form. If the property is not put to a "related use" (i.e., it is sold within two years), then the donor's deduction is limited to its basis (i.e., its acquisition cost plus the cost of appraisal and transfer).

This rule often limits corporate donors to the cost basis, since the tangible property generally available for donation by a corporation is not a capital asset under IRC §1231. Inventory, furniture, and equipment are generally ordinary income property or subject to depreciation recapture that is taxed as ordinary income. Frequently, as a result of depreciation, the adjusted basis for many assets is $0.

IRC §170 grants three important exceptions for C corporations, but not for S corporations. It grants an enhanced deduction for contributions of ordinary income property in certain specific cases:

- Ordinary income property used for the care of the ill, needy, or infants[7]
- Scientific property used in research[8]
- Computer technology, software, and equipment for educational purposes[9]

The special deduction is the FMV of the property less one half of the ordinary income component inherent in the property at the time of contribution, but not to exceed twice the adjusted basis of the property.

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7. IRC §170(e)(3)
8. IRC §170(e)(4)
9. IRC §170(e)(6)

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Example 11. Success donates furniture meeting the requirements of IRC §170(e)(3). FMV = $1,000 adjusted basis is $100. One half of the depreciation recapture is $600. Although the initial portion of the formula suggests that the deduction might be $1,000 less $600, the deduction is limited to two times the adjusted basis, or $200.

Note. If the asset is fully depreciated, the deduction is $0.

As the example illustrates, depreciable assets are generally poor choices for income tax benefits via charitable contribution. Both recipients (since it is generally new) and the donor (by virtue of statute) prefer contributions of inventory, or appreciated property.

Note. S corporations do not receive this advantage available to donations of ordinary income property.

DIVIDENDS-RECEIVED DEDUCTIONS[10]

In general, a C corporation that owns less than 20% of another corporation receives a deduction of 70% of any dividends received from that corporation. Where the C corporation owns 20% or more of the stock, it can deduct 80% of its dividends received. The deduction is limited to 80% of the taxable income of the corporation.

C corporations generally prefer investing in dividend paying stocks. First, banks rarely pay interest on balances maintained by C corporations in demand accounts. Second, interest rates are extraordinarily low. Dividends on common stock and preferred stock are frequently higher today. The higher rates, coupled with the dividends-received deduction makes investing in equities a reasonable option for C corporations.

PARTIAL EXCLUSION FOR GAIN FROM CERTAIN SMALL BUSINESS STOCK[11]

IRC §1202 generally allows individual investors to exclude 50% of the gain on qualified small business stock (i.e., **original issue** C corporation stock acquired **after** the date of enactment of the Revenue Reconciliation Act of 1993 and held for five years). The remaining 50% is taxed at 28% for an effective rate of 14%. The AMT preference caused large gains to be taxed at 19.8% effective rate. JGTRRA 2003 adjusts the preference so that the effective rate for AMT becomes 14.98%. IRC §1045 was enacted at the same time as §1202. It allows individual investors to postpone capital gains realized on qualified small business stock, if they rollover the proceeds of the sale into other qualified small business stock.

Note. The .02% tax rate difference is a negligible advantage. The true benefit of the small business stock provisions lies in the ability to defer the tax and spread the tax consequences over years that may not be subject to the AMT.

10. IRC §§242-247

11. IRC §1202

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2004 Workbook

CORPORATE DISTRIBUTIONS

Whenever cash or property is distributed from a corporation, income tax considerations must be analyzed. Initially, the tax impact of the distribution on the distributor is determined and secondarily, the tax impact on the recipient is determined. The distributor will treat the distribution as either a deductible expense or as a dividend.

DEDUCTIBLE EXPENSES

Deductible Distributions

IRC §162 allows both individual and corporate taxpayers to claim an income tax deduction for all "ordinary and necessary expenses" paid or incurred during the taxable year within a trade or business.

DIVIDENDS

For many years, the receipt of qualified dividend income by C corporations was granted a special deduction under IRC §§242–247. In contrast, the receipt of dividend income by individual taxpayers has traditionally been subject to tax as part of the taxpayer's ordinary income.

Effective in 2003, JGTRRA lowered income tax rates for individuals (through calendar year 2008), and reduced the tax rate on dividend distributions received by an individual from a domestic corporation to a maximum tax rate of 15%. For low-income individuals (i.e., in or below the 15% individual income tax bracket) a new 5% rate applies to qualified dividends through 2007. In 2008, dividends received are tax-free for low-income individuals.

In order to be treated as a dividend, a distribution received by a shareholder must be paid out of earnings and profits (E&P) of the distributing corporation. The E&P must be accumulated after February 28, 1913, or out of E&P of the current tax year (computed as of the close of the tax year), without reduction by reason of any distributions made during the year. Computation E&P is predicated on IRC §312 and its associated regulations. The following worksheet is a summary of some of those rules.

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Earnings and Profits (E&P) Worksheet

	Item	Reference	Amount
1.	Taxable income (loss)		________
2.	Increases in E&P		
	Federal income tax refunds	Rev. Ruls. 75 153, 1975 1 CB 106 and 79 69, 1979 1 CB 134	________
	Life insurance proceeds in excess of aggregate sum of premiums paid	Rev. Ruls. 54 230, 1954 1 CB 114	________
	Dividends-received deduction	*R.M. Weyerhaeuser*, 33 BTA 594 (1935)	________
	NOL carryovers, capital loss carryovers, and charitable contribution carryovers used in the current year	*R.M. Weyerhaeuser*, 33 BTA 594 (1935)	________
	E&P gains on depreciable property over regular tax gains	IRC §312(f)	________
	Excess of accelerated depreciation over straight-line depreciation	IRC §312(k)(1)	________
	80% of the current year's IRC §179 deduction	IRC §312(k)(3)(B)	________
	Construction period carrying charges	IRC §312(n)(1)(A)	________
	Certain intangible drilling costs deducted under IRC §312(n)(2)(A)	IRC §263(c)	________
	Certain mineral exploration and development costs deducted under IRC §§616(a) or 617	IRC §312(n)(2)(B)	________
	Circulation and organizational expenditures deducted under IRC §§173 and 248	IRC §312(n)(3)	________
	Increases in LIFO recapture amount	IRC §312(n)(4)(A)	________
	Excess of realized gains on installment sales over currently recognized gains	IRC §312(n)(5)	________
	Excess of percentage of completion profits over completed contract profits	IRC §312(n)(6)	________
	Tax exempt income	Treas. Reg. §1.312 6(b)	________
	Excess of statutory (percentage) depletion over cost depletion	Treas. Reg. §1.312-6(c)(1)	________
	Other increases		________
	Total increases in E&P: carry to line 2		________

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Earnings and Profits (E&P) Worksheet (continued)

	Item	Reference	Amount
3.	Decreases in E&P		________
	Federal income tax payments	Rev. Rul. 79 69, 1979 1 CB 134; *R.M. Weyerhaeuser,* 33 BTA 594 (1935)	________
	Nondeductible interest paid to carry tax exempt bonds	Rev. Rul. 75 515, 1975 2 CB 117	________
	Penalties	Rev. Rul. 75 515, 1975 2 CB 117	________
	Charitable contributions in the year paid in excess of the 10% limit	Rev. Rul. 75 515, 1975 2 CB 117	________
	Illegal bribes and kickbacks except in the case of foreign-controlled corporations	Rev. Rul. 77 442, 1977 2 CB 264; IRC §964(a)	________
	Life insurance premiums paid in excess of current increase in cash surrender value for coverage for corporate officers	*Sidney Stark,* 29 TC 122 (1957), nonacq. 1961 2 CB 6; Ltr. Rul. 7839030 (June 27, 1978)	________
	Nondeductible travel and entertainment expenses	Rev. Rul. 75 515, 1975 2 CB 117	________
	Distributions to shareholders	IRC §312(a)	________
	Excess of regular tax gains on depreciable and depletable property over E&P gains	IRC §312(f)	________
	Excess of E&P depreciation over tax depreciation	IRC §312(k)(1)	________
	20% of prior year's IRC §179 deductions	IRC §312(k)(3)(B)	________
	12-months' amortization for certain intangible drilling costs incurred in a prior year	IRC §312(n)(2)(A)	________
	12-months' amortization for certain mineral exploration and development costs incurred in a prior year	IRC §312(n)(2)(B)	________
	Decrease in LIFO recapture amount	IRC §312(n)(4)(A)	________
	Recognized gain on prior years' installment sales	IRC §312(n)(5)	________
	Excess of completed contract profits over percentage of completion profits	IRC §312(n)(6)	________

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Earnings and Profits (E&P) Worksheet (continued)

	Item	Reference	Amount
	Amounts distributed in redemption of stock to which IRC §§302(a) or 303 applies	IRC §312(n)(7)	______
	Excess of cost depletion over percentage depletion	Treas. Reg. §1.312 6(c)	______
	Losses in transactions with related taxpayers not allowed for regular tax purposes under IRC §267	Treas. Reg. §1.312 7(b)(1)	______
	Net capital loss for the current year not allowed for regular tax purposes under IRC §1211	Treas. Reg. §1.312 7(b)(1)	______
	Other decreases		______
	Total decreases in E&P, carry to line 3		______
4.	Current E&P (line 1 + line 2 − line 3)		______
5.	Distributions constituting dividends, limited to the amount of positive E&P in line 4 (dividends cannot reduce current E&P below zero)		______
6.	Current E&P net of dividends (line 4 − line 5)		______
7.	Accumulated E&P at the beginning of the year		______
8.	Adjustments to beginning accumulated E&P (positive or negative)		______
9.	Adjusted beginning accumulated E&P (line 7 + line 8)		______
10.	Distributions constituting dividends that could not be subtracted on line 5 (i.e., excess of distributions over the line 4 amount) but not in excess of the line 9 amount (distributions cannot cause a deficit in E&P)		______
11.	Ending accumulated E&P		______

Example 12. Flint Corporation operates as a calendar year, cash basis C corporation. During 2003, it has a taxable loss of $1,000 for regular income tax purposes. As of the beginning of its calendar year, Flint had accumulated E&P of $8,000. During 2003, it distributed $7,500 of cash to its sole shareholder.

Flint Corp. had nondeductible charitable contributions of $500; nondeductible meals and entertainment (M&E) expenses of $1,000; nondeductible premiums on officer life insurance (OLI) of $2,000; accelerated depreciation in excess of straight-line depreciation of $5,000; and current year amortization of organizational costs of $100.

Using the prior worksheet, Flint calculates its current and accumulated E&P at year-end, prior to the $7,500 distribution to the sole shareholder, as follows:

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Taxable Income (line 1)		($1,000)
Increases in E&P (line 2)		
Excess of Accum. Depr. over straight-line	$5,000	
Amortization of organization costs	100	
Total increases in E&P		5,100
Decreases in E&P (line 3)		
Non-deductible charitable contributions	500	
Non-deductible M&E	1,000	
Non-deductible OLI	2,000	
Total Decreases in E&P		(3,500)
Current E&P (line 4)		$ 600
Accumulated E&P, January 1, 2003 (line 7)		8,000
Total accumulated E&P (prior to distribution) (line 11)		$8,600

Distribution of cash results in no gain or loss to the corporation.[12] However, the entire $7,500 distribution to the shareholder is taxable to the shareholder as a dividend under IRC §301(b)(1).

Example 13. Use the same facts as **Example 12** except, Flint Corp. distributes land worth $7,500. The basis of the land on Flint's books is $1,000.

Flint must recognize a gain, but not loss, of $6,500 on the distribution of the appreciated land. Its E&P increases by the gain recognized ($6,500) and decreases by the value of the distributed property ($7,500), for a net decrease in E&P of $1,000. Had the distribution resulted in a loss, the loss would not be deductible. However, E&P would still be adjusted.

Note. There may be a tax on the gain as a result of the dividend, resulting in another adjustment to E&P.

When property, subject to a liability, is distributed, the shareholder assumes the liability. The corporation benefits because it is relieved of liability.

Example 14. Use the same facts as **Example 13** except, that the appreciated land is subject to a mortgage of $2,500. The assumption of the mortgage increases E&P by the amount of the debt that is assumed by the shareholder. The net impact on E&P is an increase of $1,500. This is due to the elimination on the books of the debt ($2,500) and the corresponding elimination of the basis of the land ($1,000).

Note. While most dividends are the result of distributions of cash or property, it is possible that the IRS might attempt to reclassify a transaction deemed to be for the personal benefit of the shareholder, rather than for the benefit of the corporation as a constructive or disguised dividend. Constructive dividends are commonly found in the following areas: excessive compensation, excessive rents, loans, personal use of corporate property, and bargain purchases.

DEBT VERSUS EQUITY[13]

Historically, there has been substantial incentive to treat amounts received from shareholders as "debt to be repaid" rather than "equity to be retained by the corporation indefinitely." This reliance on debt tends to result in thinly capitalized corporations. Although interest rates are currently low, Congress is concerned that corporations relying on debt financing will be negatively impacted if interest rates rise in the future. Thinly capitalized corporations have a harder time securing additional financing. It was the belief of Congress that thinly capitalized corporations had a higher failure (bankruptcy) rate.

12. IRC §311(a)

13. IRC §385

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JGTRRA seeks to remove some of the negative aspects of equity and thus encourage small investors to accept it. Under JGTRRA, the new 5% and 15% tax rates for dividends are an advantage over the marginal tax rate for interest payments which can be as high as 35%. After 2008, the income tax rates on dividends return to their pre-JGTRRA levels. Private investors and corporations need to investigate the value of the interest deduction versus the lower tax rates available to individuals for dividend income.

INTEREST VERSUS DIVIDEND

Closely held corporations have generally been reluctant to pay dividends to shareholders. The common tax planning focus was to avoid double taxation by providing loans rather than making equity contributions. Interest paid is deductible to the corporation and taxable to the individual at ordinary marginal tax rates. Dividends are nondeductible to the corporation and taxable to the individual at preferred tax rates through tax years 2008 under current law.

The following tables are a comparison of tax liability for paying $1,000 in interest to an individual as opposed to a dividend. The example shows various results depending on the corporate tax bracket. The example assumes a 5% state corporate tax rate and no individual state tax.

High-Income Taxpayer Comparison

	$1,000 Interest	$1,000 Dividends			
		15% Rate	25% Rate	34% Rate	39% Rate
Additional corporate federal tax		$150	$250	$340	$390
Additional corporate state tax		50	50	50	50
Individual income tax	$350	150	150	150	150
Total	$350	$350	$450	$540	$590

The result appears to prefer debt (and the corresponding deductible interest payments) to equity at all levels for high tax bracket taxpayers regardless of the size of the corporation.

Low-Income Taxpayer Comparison

	$1,000 Interest	$1,000 Dividends			
		15% Rate	25% Rate	34% Rate	39% Rate
Additional corporate federal tax		$150	$250	$340	$390
Additional corporate state tax		50	50	50	50
Individual income tax	$150	150	150	150	150
Total	$150	$350	$450	$540	$590

Again, clearly the result appears to prefer debt (and the corresponding deductible interest payments) to equity at all levels for low tax bracket taxpayers as well regardless of the size of the corporation.

REASONABLE COMPENSATION

The Tax Court in a 2001 Memorandum Decision held that the reasonable compensation for an owner-employee of a PSC was limited to the net collections that the corporation received from the work of the shareholder-employee less his share of the corporation's overhead.

Pediatric Surgical, a PSC, provided pediatric surgical services in Fort Worth, Texas. The corporation employed 20 individuals, including six surgeons. During the years at issue, only four of the six surgeons were shareholders of the PSC. The Tax Court held that the earnings of the corporation in excess of the profits created by the nonshareholders

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salaries were an asset of the corporation, and therefore, a nondeductible dividend was paid to the shareholder-employees. In addition, the Tax Court imposed a negligence penalty on the shareholder-employees because they were aware that these payments were attributable to the efforts of the nonshareholders.[14]

Pediatric Surgical is a particularly alarming decision for all PSCs. Although this corporation did not earn any significant revenue from nonprofessional staff, it opens the door for such arguments in other PSCs such as law firms and accounting firms, where junior professionals who are not shareholders may provide significant profits to the firm through leveraged work assignments.

> **Planning Tip.** Clearly the easiest way to avoid the issue of unreasonable compensation for PSCs is to convert to S corporation status. As an S corporation, the income is taxed at effectively the same rate whether or not it is salary. The IRS may collect greater revenue (via FICA and Medicare taxes) if payments are categorized as compensation rather than distributions of AAA.

Background of the Compensation Controversy

IRC §162(a)(1) allows a corporation to deduct "a reasonable allowance for salaries or other compensation for personal services rendered as a business expense."

Whether the compensation is reasonable is a factual question that must be decided considering all the facts and circumstances. The taxpayer bears the burden to show that it is entitled to a compensation deduction larger than that allowed by the IRS. In deciding if compensation is reasonable, the following factors are considered:

1. **Employee's role in the company.** Focus is on the employee's importance to the success of the business (position, hours worked, duties performed, general importance as an employee). If there was a large salary increase, look at past and present duties and payment to determine if the increase is an attempt to rectify past underpayments.
2. **A comparison of the compensation paid to the employee with the compensation paid to similarly situated employees in similar companies.** Robert Morris Annual Statement Studies provides guidelines for industry norms.
3. **Character and condition of the company.** Focus is on company's size measured by its sales, net income, capital, the complexity of the business, and general economic conditions.
4. **Whether a conflict of interest exists that might permit the company to disguise dividend payments as deductible compensation.** Many courts have adopted the perspective of an independent investor, which is whether the investor would be satisfied with the company's return on equity after compensation at issue is paid. The mere fact that the corporation is controlled by the compensated employees coupled with an absence of dividend payments does not necessarily lead to the conclusion that the compensation is unreasonable.
5. **Whether compensation was paid according to a structured, formal, and consistently applied program.**

Unreasonably Low Salary — S Corporations

Often, when the closely-held corporation is an S corporation, there can be serious tax consequences to setting the owner's salary too low.

Income Shifting. If a member of the shareholder's family provides a service or capital to the corporation without receiving reasonable compensation, the IRS may make adjustments. These adjustments will be taken into account for both the individual and the corporation in order to reflect the value of the services or capital.

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14. *Pediatric Surgical Associates, P.C. v. Commr.*, TC Memo 2001-81, April 2, 2001

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Frequently this strategy is used to shift corporate income from a higher-bracket owner to a lower-bracket taxpayer, typically children.

Example 15. Gravel Pit Corporation is an S corporation. It has three shareholders. Mr. Rock and his two daughters own the corporation in the following ratio: 50%:25%:25%. The corporate profits, after deducting Mr. Rock's salary of $15,000, are $100,000. Consequently, $50,000 is allocated to the father, with $25,000 allocated to each lower-bracket daughter.

The IRS may decide that Mr. Rock's salary is unreasonably low and it may adjust his salary higher.

Example 16. Patio Stuff, Inc. is owned 55% by Gustaf and 45% by his children. Patio Stuff elected S status in 2004. Gustaf turns 65 years old in 2004 and has been receiving a salary of $150,000 from the corporation for several years.

Under Gustaf's direction, the corporation reduced his salary to $4,000 in 2004. Upon examination, Gustaf's salary could be deemed unreasonably low and the salary could be adjusted upward.

Payroll Tax Issues. If salary is low in comparison to industry standards or work performed and distribution from the S corporation are high by comparison, the IRS generally presumes there was intent by the taxpayer to circumvent payroll tax liability. Social security and Medicare tax liability are a potential issue. The Social Security Administration also wants to know if the S corporation owner is collecting social security benefits and is under normal retirement age. State revenue departments are interested in payroll issues related to state unemployment and workers' compensation liability.

The IRS is extremely successful in asserting the "unreasonably low compensation" issue in non-family situations. The following are a few recent cases relevant to this issue.

1. Rev. Proc. 74-44, 1974-1 CB 287;
2. *Joseph M. Grey Public Accountant, P.C. v. Commr.,* 119 TC 5, No. 4789-00, September 16, 2002;
3. *Veterinary Surgical Consultants, P.C. v. Commr.,* CA-3, *Veterinary Surgical Consultants P.C. v. Commr.,* Docket No. No. 02-1214, December 18, 2002;
4. *Yeagle Drywall Company, Inc. v. Commr.,* CA-3, *Yeagle Drywall Co, Inc. v. Commr.,* Docket No. 02-1132; December 18, 2002;
5. *Mike J. Graham Trucking, Inc. v. Commr.,* TC Memo 2003-49, February 26, 2003;
6. *Superior Proside, Inc. v. Commr.,* TC Memo 2003-50, February 26, 2003;
7. *Specialty Transport & Deliver Services, Inc. v. Commr.,* TC Memo 2003-51, February 26, 2003;
8. *Nu-Look Design, Inc. v. Commr.,* TC Memo 2003-52, February 26, 2003;
9. *Water-Pure Systems, Inc. v. Commr.,* TC Memo 2003-53, February 26, 2003.

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If an S corporation has income, makes distributions to shareholder-employees and has not adequately compensated these shareholder-employees in wages, the IRS will determine what amount of the shareholder distribution is under-compensated wages.

Example 17. Galore Marketing, Inc. is an S corporation. It is owned 70% by Maddy Galore and 10% by each of her three children. Maddy is the only employee of Galore Marketing and she works in excess of 2,000 hours each year.

A competent replacement for Maddy would cost Galore Marketing approximately $100,000 per year. Maddy's wages in 2003 were $25,000.

The corporation's net trade or business income for the year was $140,000 and it made pro-rata distributions to all shareholders with Maddy receiving a distribution of $80,000. Upon audit, an IRS agent could increase Maddy's wages to provide her adequate compensation. In addition, appropriate payroll taxes, interest and penalties would be levied.

Bonuses

If bonuses are paid at year-end to shareholder-employees, the transaction can fall under the IRS's scrutiny. The IRS could deem bonuses as corporate dividends, causing the corporation to lose its deduction and creating dividend income at the shareholder level. To avoid the IRS disallowance, the corporation:

- Should have a written formula for calculating bonuses at the beginning of the year before profits are known, and it should not be based upon corporate profits.
- Non-shareholder-employees should also be paid bonuses.
- Bonuses should not be paid in exact proportion to shareholdings.

Contingent Compensation

Contingent compensation to shareholder-employees should have a formula that reflects employee productivity rather than shareholdings. The formula should be established at the beginning of the year before profits are known.

No single factor controls. Most courts use the same or very similar tests to determine reasonableness.[15]

We have seen a steady increase in the number of cases dealing with unreasonable compensation in C corporations since the 1986 IRC was enacted.[16]

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15. *Leonard Pipeline Contractors, Ltd. v. Commr.,* TC Memo 1996-316, 72 TCM 83, July 15, 1996

16. *Alpha Medical, Inc. v. Commr.,* 99-1 USTC ¶50,461 (6th Cir. 1999) April 19, 1999; *Dexsil Corporation*, TC Memo 1999-155 (On remand from 2nd Cir, 1998) May 5, 1999; *Leonard Pipeline Contractors*, TC Memo 1998-315 (On remand of 9th Cir, 1998), September 1, 1998; *Modernage Developers, Inc.,* 95-1 USTC ¶50,196 (2d Cir. 1995), March 8, 1995; *Donald Palmer Company, Inc.,* TC Memo 1995-65*,* February 7, 1995; and *Rapco, Inc.,* TC Memo 1995-128*,* March 27, 1995

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Fringe Benefits

In general, employee fringe benefits are deductible for C corporations either as part of the compensation paid to the employees or as an ordinary and necessary business expense. In an S corporation the rules are slightly different. Only those fringe benefits received by employees and shareholders-employees owning 2% or less of the S corporation stock are deductible by the corporation as a business expense, and are not taxable to the employee.

As a result, a C corporation can fully deduct payments made under a nondiscriminatory Medical Reimbursement Plan (or an IRC §125 cafeteria plan), even though a portion may benefit the sole shareholder of the corporation. An S corporation can maintain a similar plan, but it cannot deduct payments made to a 2% or greater shareholder of the S corporation.

Note. C corporations may fully deduct insurance premiums for long-term care and health insurance. Amounts paid on any employee's behalf are not taxable to the employee.

For non-shareholder employees, or less than 2% shareholders of an S corporation, tax treatment is the same as for a C corporation. For more than 2% shareholder-employees of an S corporation, the premiums are deducted as wages. Wages are reported on the more than 2% shareholder-employee's Form W-2. This compensation is subject to income tax withholding but is not subject to FICA. The shareholder-employee may be allowed a 100% deduction for health insurance and some deduction for long-term care insurance on Form 1040, Page 1.

Payments that are nondeductible run the risk of being classified as dividends. A nondeductible payment will cause the corporation to pay a first tax at the corporate level, and a second tax at the individual level if the payment is deemed taxable to the recipient. The second tax that is paid may not outweigh the time value of having accumulated the dollars inside the corporation at the initial lower income tax bracket.

The following lists possible ways to remove dollars from the corporation, on a deductible basis. Some of the items are not deductible or available to all corporations. Each item should be considered on a facts and circumstances basis for each corporate client as applied by §162 or other applicable Code sections.

This checklist should be reviewed at least every two years.

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"Key Employee" Benefits Available			Does Company Offer?
A.	**Direct pay**		
	1.	Salary based upon responsibility, geographical location, and company	Yes ( ) No ( )
B.	**Indirect pay: extra compensation**		
	1.	Moving and relocation costs	Yes ( ) No ( )
	2.	Placement fees	Yes ( ) No ( )
	3.	Company-provided or subsidized travel	Yes ( ) No ( )
	4.	Paid attendance at business, professional, and other meetings	Yes ( ) No ( )
	5.	Legal assistance	Yes ( ) No ( )
	6.	Tax assistance	Yes ( ) No ( )
C.	**Special perks**		
	7.	Matching charitable donations	Yes ( ) No ( )
	8.	Recreation and gym facilities	Yes ( ) No ( )
	9.	Professional dues and memberships	Yes ( ) No ( )
	10.	Low-interest loans	Yes ( ) No ( )
	11.	Company medical department	Yes ( ) No ( )
	12.	Outside medical services	Yes ( ) No ( )
	13.	Psychiatric services	Yes ( ) No ( )
	14.	Physical examinations	Yes ( ) No ( )
	15.	Medical reimbursement plan	Yes ( ) No ( )
	16.	Company-provided automobile	Yes ( ) No ( )
	17.	Company-provided plane	Yes ( ) No ( )
	18.	Company-provided boat	Yes ( ) No ( )
	19.	Company-provided apartment	Yes ( ) No ( )
	20.	Tickets for theater and sporting events	Yes ( ) No ( )
	21.	Home entertainment allowance	Yes ( ) No ( )
	22.	Social and recreational club memberships	Yes ( ) No ( )
	23.	Financial counseling, retirement planning	Yes ( ) No ( )
	24.	Chauffeur	Yes ( ) No ( )
	25.	IRC §132 Benefits:	
		a) No-additional-cost service	Yes ( ) No ( )
		b) Employee discounts	Yes ( ) No ( )
		c) Working condition fringes	Yes ( ) No ( )
		d) De minimis fringes	Yes ( ) No ( )
		e) Executive dining room	Yes ( ) No ( )
		f) Job-related educational assistance	Yes ( ) No ( )
	26.	Personal hotel and travel reservations	Yes ( ) No ( )
	27.	Qualified parking	Yes ( ) No ( )
	28.	Commuter transportation	Yes ( ) No ( )
	29.	Qualified transit pass	Yes ( ) No ( )
	30.	Educational assistance plans (IRC §127)	Yes ( ) No ( )
	31.	Qualified tuition waivers for dependents (IRC §117)	Yes ( ) No ( )
	32.	Scholarships for dependents of employees (IRC §117)	Yes ( ) No ( )
	33.	Dependent care assistance	Yes ( ) No ( )
	34.	Adoption assistance plan (IRC §137)	Yes ( ) No ( )

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"Key Employee" Benefits Available		Does Company Offer?
D.	**Financial protection**	
35.	Pension plan	Yes ( ) No ( )
36.	Profit-sharing plan	Yes ( ) No ( )
37.	Employee stock ownership plan (ESOP)	Yes ( ) No ( )
38.	401(k) Plan	Yes ( ) No ( )
39.	412(i) Plan	Yes ( ) No ( )
40.	Voluntary employee benefit association	Yes ( ) No ( )
41.	Thrift plan or other qualified deferred compensation plan	Yes ( ) No ( )
42.	Nonqualified deferred compensation plan	Yes ( ) No ( )
43.	Sickness or accident insurance (IRC §105)	Yes ( ) No ( )
44.	Long-term disability benefit (IRC §106)	Yes ( ) No ( )
45.	Personal accident insurance	Yes ( ) No ( )
46.	Accidental death, dismemberment insurance	Yes ( ) No ( )
47.	Severance pay	Yes ( ) No ( )
48.	Group life insurance (IRC §79)	Yes ( ) No ( )
49.	Survivor's (death) benefits	Yes ( ) No ( )
50.	Hospital-surgical-medical insurance (IRC §106)	Yes ( ) No ( )
51.	Dental and eye-care insurance (IRC §106)	Yes ( ) No ( )
52.	Health-maintenance organization fees (IRC §106)	Yes ( ) No ( )
53.	Home health care	Yes ( ) No ( )
54.	Nursing home care	Yes ( ) No ( )
55.	Deferred salary plan	Yes ( ) No ( )
56.	Deferred bonus	Yes ( ) No ( )
57.	Stock bonus plan	Yes ( ) No ( )
58.	Stock purchase plan	Yes ( ) No ( )
59.	Incentive stock options	Yes ( ) No ( )
60.	Long-term sick pay	Yes ( ) No ( )
61.	Cafeteria plan (IRC §125)	Yes ( ) No ( )
62.	Long-term care insurance	Yes ( ) No ( )

Reasonable Compensation to Shareholders

After JGTRRA 2003, the question of what amount of reasonable compensation should be paid to a shareholder of a C corporation takes on new relevance. Reasonable compensation continues to be deductible to the corporation, and taxable to the individual at his marginal income tax rate, plus payroll taxes. However, the individual's highest marginal rate is reduced to 35%. Dividends are nondeductible to the corporation and taxable to the individual at a maximum rate of 15% for most taxpayers and a rate of 5% for taxpayers in the 10% or 15% regular brackets. Payroll taxes (particularly FICA and Medicare) continue to be a significant consideration. Many taxpayers pay more in payroll taxes each year than they do in income taxes.

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Compensation Versus Dividend

The net result per $1,000 of **compensation** for a shareholder who is already over the FICA limit (currently $87,900 in 2004) is:

High-Income Taxpayer Comparison

	$1,000 Compensation	$1,000 Dividends	
		15% Rate	25% Rate
Additional corporate federal tax	$ 0	$150	$250
Additional corporate state tax	0	50*	50*
Payroll tax 1.45%	29	0	0
Individual income tax	350	150	150
Total	$379	$350	$450

*Net of federal deduction

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At first glance, paying dividends instead of compensation appears to be a reasonable approach. It saves the taxpayer taxes at the lowest levels of C corporation income and the highest levels of individual income. However, the result rapidly changes as the personal and corporation income tax rates fluctuate in the example. The net result per $1,000 of dividends in the second corporate bracket is as follows.

	$1,000 Compensation	$1,000 Dividends	
		34% Rate	39% Rate
Additional corporate federal tax	$ 0	$340	$390
Additional corporate state tax	0	50*	50*
Payroll tax 1.45%	29**	0	0
Individual income tax	350	150	150
Total	$379	$540	$590

*Net of federal deduction
**Plus FUTA and SUTA

For high-income taxpayers, already drawing salary in excess of the FICA limits, paying a dividend in lieu of salary makes sense when the dollars can be taxed at the lowest corporate tax bracket. Conversely, where a high-income individual does not otherwise receive salary over the FICA limit (currently $87,900 in 2004), or is at low salary level to avoid interference with social security benefits, the decision to pay dividends is better than paying the initial salary up to the FICA limit.

The net result per $1,000 of compensation for a high-income shareholder who is **not** otherwise over the FICA limit is $427 [($1,000 × .0765) + ($1,000 × .35)]. The amount of payroll tax adds so significantly to the cost that dividends are preferred to compensation at even high levels of corporate taxation. The net result per $1,000 of dividends in the third corporate bracket is $540.

For low-income taxpayers who do not otherwise receive salary over the FICA limit (currently $87,900 in 2004) the advantage of paying dividends as opposed to paying the initial salary up to the FICA limit is mixed.

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The net result per $1,000 of compensation for a low-income shareholder who is not otherwise over the FICA limit is as follows:

Low-Income Taxpayer Comparison

	$1,000 Compensation	$1,000 Dividends	
		15% Rate	25% Rate
Additional corporate federal tax	$ 0	$150	$250
Additional corporate state tax	0	50*	50*
Payroll tax 7.65%	153**	0	0
Individual income tax	150	50	50
Total	$303	$250	$350

*Net of federal deduction
**Plus FUTA and SUTA

The results are mixed and therefore confusing:

1. Paying dividends appears to be preferred to paying compensation for small corporations in the 15% corporation income tax bracket.
2. The payroll tax burden on the first $87,900 of wages in 2004 drives the cost of compensation above a dividend for high individual income tax bracket taxpayers at all level of corporate income. As a result, wealthy shareholders would be better off drawing dividends than receiving a low salary.
3. Once a high individual income tax bracket shareholder is over the FICA threshold, dividends are only preferred to salary in the lowest corporation income tax bracket. Once the FICA limit is exceeded, large corporations would be better served to pay more compensation.
4. The payroll tax burden on the first $87,900 of wages in 2004 drives the cost of compensation above a dividend for low individual income tax bracket taxpayer only at the lowest corporation tax level.

STRATEGIES AFTER JGTRRA 2003

As a result of the changes to dividends under JGTRRA for 2003 through 2008, it is reasonable to look at the potential opportunities that may exist to get rid of some undesirable issues that exist in tax preparation files.

LARGE SHAREHOLDER LOANS

In order to avoid dividend treatment in the past, distributions were reclassified as shareholder loans. As interest accrues and adds to the loan balance, the liability grows. The interest is taxed at ordinary income tax rates. Consider reducing the indebtedness through systematic dividends.

PREFERRED STOCK DIVIDENDS

Preferred stock dividends allow the owner to take tax-paid dollars out of the corporation and transfer them to low-tax-bracket family members, usually children, grandchildren, or retired parents. Under IRC §305, stock dividends are tax free if declared proportionally to each stockholder.

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Example 18. Joe has five grandchildren and would like to use corporate funds to pay for their college educations. Joe owns 100% of Old Co., which declares a $50,000 preferred stock dividend. Joe gifts all the preferred shares to the five grandchildren ($10,000 each). With a 10% dividend rate, it earns $5,000 in total cash dividends. That dividend results in $1,000 per year in cash for each grandchild. The dividends only need to be paid on the preferred stock; they are not required to be paid on the common stock. Each grandchild could accumulate the $1,000 to provide for his college education. Such funds would be taxed no more than 15%.

1. Income tax consequences
   - **a.** $50,000 in value of the corporation (in the form of preferred stock) transferred to the grandchildren tax-free
   - **b.** $5,000 of after-tax corporate income taken out of the corporation in cash each year, with little or no tax
2. Gift tax consequences

   No gift tax (An individual can give up to $11,000 to each grandchild or any other person — each year — without gift tax consequences. The amount is doubled to $22,000 if the spouse consents to the gift on a joint gift tax return.)
3. Estate tax consequences

   Assume that the fair market value of the common stock is always equal to book value less $50,000 for the preferred stock. Then the estate tax consequences are:
   - **a.** $50,000 permanently removed from the estate at inception, plus
   - **b.** An additional $5,000 each year because of the cash dividends.

The same strategy works equally well with an elderly parent who is on a fixed income in a nursing home. The dividend income represents "cheap" corporate dollars.

ACCUMULATED EARNINGS PENALTY[17]

The penalty tax is reduced under JGTRRA. It may be wise to pay out a lot of the old C corporation retained earnings that tend to attract IRC §531 penalties. The decision to pay regular corporate dividends in the lowest tax bracket is not difficult; however, at higher rates it may be undesirable.

> **Planning Tip.** If paying a regular dividend makes sense consider a preferred stock dividend in order to restrict the payee and direct the dividend income where it is needed most.

PERSONAL HOLDING COMPANY TAX[18]

The PHC tax is reduced under JGTRRA. However, the benefits of retaining PHC status should be examined. What is the origin of the personal holding company? Did it result from the asset sale of an operating business? In the past, it made sense to keep the corporate shell alive and postpone the double taxation of a liquidation (second tax) until the death of the shareholder, because the estate would receive a stepped-up basis and the corporation could liquidate without a second tax.

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17. IRC §531
18. IRC §541

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The planner should ask the following questions:

- Does keeping the corporation intact, even though it is taxed as a PHC, limit the shareholder's ability to make annual exclusion gifts?
- If they keep the PHC going, how do they avoid the PHC tax?
- Does paying small salaries make sense in personal holding companies for the future?
- At 15% tax rate for a dividend or a capital gain, does it still make sense to retain the personal holding company?

Planning Tip. Consider paying out a dividend of all of the old C corporation earnings at 15% and electing S corporation status, taking into consideration the BIG tax and passive income rules.

The passive income rules are directed at regular corporations converting their operations into PHCs and electing S status to avoid paying a second level of income tax on the earnings.

UNDERSTANDING THE PASSIVE INCOME RULES[19]

IRC §1375 imposes a tax on S corporations whenever the "passive investment income" exceeds 25% of the S corporation's gross receipts. However, there must have been an old C corporation with accumulated earnings and profits. This tax is imposed at the highest corporate rate.

The corporation's S election is terminated where the "passive investment income" exceeds 25% of the S corporation's gross receipts for three consecutive years.[20] "Passive investment income" is generally defined to include gross receipts derived from "royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities" (at an actual gain).[21]

The term **gross receipts** is not specifically defined in either IRC §§1362(d)(2) or 1375. The term **gross receipts** generally means the total amount received or accrued under the method of accounting used by the corporation in computing its taxable income.[22] The receipts are not reduced by returns, allowances, costs of goods sold, or deductions. Furthermore, gross receipts include the amount received or accrued for the sale or exchange of any kind of property, including IRC §1231 property (but not capital assets, stock, and securities), and income on investment property and for services rendered by the corporation.

PASSIVE INVESTMENT INCOME PLANNING

1. Pay out all C corporation E&P before the close of the third taxable year. The IRC §1362 termination clause only takes effect when the S corporation has prior C corporation retained earnings and profits "at the close of each of three consecutive years." If all of the E&P is paid out as a dividend before the end of the third year, taxable to the shareholders, then the corporation may operate freely as an S corporation with unlimited passive income. The dividends may be spread out over the periods in order to minimize the income tax impact on the shareholders.

   Shareholders can elect to treat distributions made during the year as being made first out of accumulated E&P rather than AAA.[23] Generate gross receipts in one of the three years to dilute the passive investment income below 25% by disposing of any asset other than a capital asset.

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19. IRC §§1375 and 1362(c)(3)
20. IRC §1362(c)(3)
21. IRC §1362(d)(3)(C)
22. Treas. Reg. §1.1362-2(c)(4)(i)
23. IRC §1368(e)(3)

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Generate gross receipts by investing in a partnership or entering into a joint venture that carries on an active trade or business. Partnership gross receipts retain the same character in the hand of each partner. Each partner includes his pro-rata share of gross receipts in his computation under IRC §§1362 and 1375. PLR 8736052 provided two examples: one partnership that operated a hotel, another that leased retail and office space. Even if the investment vehicle is a limited partnership,[24] an LLC,[25] or a publicly traded partnership that invests in oil,[26] it must include its pro rata share of gross receipts in its computation.

Where the sole assets of the business are real estate, the corporation may need to add other activities in order to avoid having the rents constitute passive income. These may include the provision of significant services or incurrence of significant costs in the rental business.[27] A score of rulings provide examples.[28]

The IRC §1375 tax is calculated on the excess net passive income. The code limits the amount to the corporation taxable income without regard to the amortization of organizational expenses under IRC §248 and without regard to deductions for net operating losses under IRC §172.

2. Create 75% or more active income to counteract and override passive investment income concerns.

a. Provide significant services or incur significant costs in the rental business.[29]

b. Provide management services to another entity (i.e., FLP, LLC, or S corporation) This is good for relatively small amounts.

c. Create joint venture with tenant.[30]

d. Invest in a partnership. Partnership gross receipts retain the same character. Partner is allowed to include pro-rata share of gross receipts. PLR 8706052 provided two examples: one partnership that operated a hotel, another that leased retail and office space.

3. Merge C corporation or PHC with an active business and elect S status for the combined entity.

a. Wait 10 years before disposing of BIG,

b. Offset built-in gains (BIG) with deductions and other built-in losses in order to zero out the net BIG.

Remember that the test for BIG is generally a one-time-only test. If on the date of the election to S corporation status there is no net BIG, then there is no tax imposed under IRC §1374 at any time throughout the entire 10-year period.

24. Letter Ruling 8852021

25. Letter Ruling 200101024

26. Letter Ruling 200027037 and 200002012

27. Treas. Reg. §1.1362-2(c)(5)(ii)(B)(2)

28. Rev. Rul. 61-112 (farm-sharing); Rev. Rul. 64-232 (furniture and equipment); Letter Ruling 8926039 (office furniture); Rev. Rul. 65-40 (motor vehicles); Rev. Rul. 65-83 (personal property); Rev. Rul. 65-91 (grain storage); Rev. Rul. 76-48 (tennis courts); Rev. Rul. 81-97 (aircraft); Rev. Rul. 83-139 (Trailer Park); Letter Ruling 1999-17-017 (commercial warehouse and offices); Letter Ruling 1999-19-010 through –015 (apartment buildings). Provide management services to another entity (i.e., FLP, LLC, or S corporation) good for relatively small amount; create joint venture with tenant (*White Ferry, Inc. v. Commr.,* TC Memo 1993-639).

29. Treas. Reg. §1.1362-2(c)(5)(ii)(B)(2)

30. *White Ferry, Inc. v. Commr.,* TC Memo 1993-639, December 29, 1993

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REMOVING APPRECIATED ASSETS (REAL ESTATE)

ASSET FRACTIONALIZATIONS: VERTICAL AND HORIZONTAL DIVISIONS

The ownership of real estate can be divided both vertically and horizontally. Vertical divisions include tenancies in common and partnerships (e.g., the corporation could sell an undivided interest in the real estate prior to liquidation). Horizontal divisions include leasehold interests, life estates and remainder interests, and land-only sales and leasebacks.

Sell the Land, Keep the Building

When dealing with improved property, the planner should compare the relative values of the land and building. The buildings and improvements generally represent the majority of the value. While land and buildings are generally thought of together, they can be owned separately. In some areas (e.g., Hawaii) it is quite common for land to be rented under a long-term lease. The lessee will build the improvements on the land. Condominium owners generally own a portion of a building on either co-owned or third-party-owned land. The land and building need not be owned together. If the corporation sells the land and keeps the building, the tax exposure is limited.

The process is as follows:

1. Joe gets an appraisal for the land without the improvements.
2. Joe sells the land to his children and grandchildren, a trust for the benefit of his spouse, his children and grandchildren, or a partnership for the benefit of himself, his spouse, his children and grandchildren. It all depends on the desired level of control.
3. The corporation pays ordinary income tax on the sale of the land. The gain can be spread out over a long period using an installment sale.
4. The landlord (the new owner of the land) enters into a long-term lease with the corporation for the land. The longer the better (20, 30 or 40 years, with options, depending on the age and value of the building). The lease payment is relatively small, but large enough to handle the installment payments of interest and principal.
5. At the end of the lease term, the landlord owns all the improvements on the land, tax free.

> **Caution.** The substance of the lease is important to note, so the transaction is not treated as a sale of the building.

6. The landlord (now the owner of the land and building) enters into a lease with the corporation for the total land and building.

The landlord's basis in the land and building is only the cost of the land. Since the landlord did not depreciate the building, no portion of the gain on the sale of the building is subject to the 25% capital gains rate upon sale. The entire gain on the sale of the building is taxed to the landlord at a 15% capital gains rate. No portion of the gain is taxable to the corporation upon sale of the land and building.

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Split Interest Purchase of Real Estate: The Ultimate §1031 Exchange

Similar to the previous strategy, when purchasing real estate, it is not necessary that the same person buy an entire fee simple interest in both the land and the building. Various buyers can come together to purchase. Here are some purchase variations:

1. One person could buy the land, a second person could acquire the building.
2. One person could buy a lease-term or a right to use for some period, and a second person could acquire the remainder interest in both land and building.

This strategy can be utilized in conjunction with the acquisition of new real estate or in conjunction with a §1031 exchange for old real estate. The key in qualifying for §1031 deferral is that the corporation selling the old "real estate" will need to acquire and interest in the new "real estate." The interests need not be identical, but they must both be real estate in order to qualify as like-kind under §1031.

Caution. These are possible solutions, but taxpayers and their tax preparer should proceed with care. Failure to meet all the provisions of the Code and Regulations can result in disallowance and additional tax and penalties. Unless the tax preparer has expertise in these areas, he is advised to seek competent advice.

CONVERTING TO S STATUS

S corporations are not subject to corporate income tax on gains. The exception is the **built-in gain** recognized within 10 years of a C corporation, with retained earnings, converting to an S corporation. The conversion may be subject to tax under IRC §1374.

Absent taxation under IRC §1374, the gain recognized on the sale of a capital asset is taxable to the S corporation shareholders pro rata. The gain to the shareholders receives the same treatment as if the shareholder had individually sold his pro rata share of the underlying assets. The gain is eligible for the applicable capital gains rates ranging from 5% to 28%.

Once taxed, the gain is added to the shareholder AAA pro rata. The S corporation shareholder's stock basis is increased (decreased) by changes in AAA. No additional income or capital gains tax (attributable to the disposition of the appreciated real estate) is due from the shareholder upon the subsequent liquidation of the S corporation.

BUILT-IN GAINS

The statement, "All gains recognized within 10 years of conversion to S status are taxable" is not correct, because some are not built-in gains.

1. Post election gains (appreciation) are not taxable under IRC §1374.

Note. It is important to get an appraisal of each asset likely to be sold within a 10-year period. The built-in gain on that asset is limited to the difference between FMV and the adjusted basis on the **date of election, not the date of sale.**

2. Only net unrealized built-in gain is taxable when collected. Net unrealized built-in gain is calculated by subtracting unrealized deductions from unrealized gains. Unrealized deductions include IRC §481 adjustments; losses not allowed under IRC §§382, 383, or 384; IRC §467 accruals; IRC §267 accruals to shareholder and related parties; and nonqualified deferred compensation plans.

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Tax practitioners often overlook the limitations under IRC §1374(c). First, §1374(c)(1) excludes corporations that were always S corporations. Secondly, "the total cap on net recognized built-in gains is the corporation's net unrealized built in gain."[31]

1. IRC §1374(c)(2) states: *"The amount of net recognized built in gain taken into account under this section for any taxable year shall not exceed the excess (if any) of – the net unrealized built-in gain, minus*
2. *The net recognized built-in gain for prior taxable years beginning in the recognition period."*

IRC §1374(d)(1) defines the term *net unrealized built-in gain* as "(A) the FMV of the assets of the S corporation as of the beginning of its 1st taxable year for which an election under IRC §1362(a) is in effect, exceeds (B) the aggregate adjusted bases of such assets at such time."

IRC §1374(d)(5)(C) provides: "The amount of the net unrealized built-in gain shall be properly adjusted for amounts which would be treated as recognized built-in gains or losses under this paragraph if such amounts were properly taken into account (or allowable as a deduction) during the recognition period."

As early as 1986, the IRS announced that it would adopt an antistuffing rule that would apply if shareholders contribute depreciated property to the corporation before the election is made.[32] Treas. Reg. §1374-9 in fact applies where a corporation acquires an asset before or during the recognition period with a "principal purpose" to avoid the tax.

PASSIVE INCOME TAX AND TERMINATION[33]

IRC §1375 imposes a tax whenever passive investment income of an S corporation with old C corporation accumulated earnings and profits exceeds 25% of the S corporation's gross receipts.

IRC §1362(c)(3) acts to terminate the corporation's S election where the passive investment income is in excess of 25% of the S corporation's gross receipts for three consecutive years.

Passive investment income is generally defined to include gross receipts derived from "royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities" (at an actual gain).[34]

S CORPORATION SOLUTION

If removing even a portion of the real estate is too expensive, and it must remain inside the corporation, then the best way to avoid double tax on the entire gain on the real estate may be to elect S corporation status. If the shareholders can effectively avoid the 10-year built-in gain rule, then the gain on the sale of the assets is taxed to the individual shareholders in proportion to their stock ownership in the S corporation. The gain is taxed to the shareholders using the benefit of the capital gains rules and rates that are available to individuals: 25% on recapture of depreciation and 15% on the true appreciation. The S corporation income (AAA) will add to the shareholders' basis and thus avoid a second level of tax upon liquidation and distribution of the corporation's assets to the shareholders.

If the shareholders cannot avoid selling the assets within the 10-year period, they will be subject to the BIG rules. However, depending on the S corporation profit, the tax may not be as high as expected.

> **Planning Tip.** Obtain an appraisal of the land and building at the time the S corporation is elected and limit the gain to the amount at that time of the election. All gain after the appraisal date will avoid double taxation.

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31. Eustice and Kuntz, *Federal Income Taxation of S Corporations*, Warren, Gorham & Lamont, 3rd Edition, 2001
32. IRS Announcement 86-128, 1986-51 IRB 22
33. IRC §1362(c)(3)
34. IRC §1362(d)(3)(C)

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SALE AND LIQUIDATION OF S CORPORATION

If 100% of the stock of the S corporation is held by a decedent at the time of death, income taxes are completely eliminated. This one requires careful planning and coordination.

Here are the steps to follow. Assume the only asset in the corporation is real estate worth $1 million with a basis of $200,000.

1. The S corporation stock receives a step-up in basis equal to its fair market value at the shareholder's date of death ($1,000,000).
2. The corporation realizes an $800,000 gain on the sale of the building and land. The gain flows through to the estate of the shareholder and is shown on his annual income tax return. A portion of the gain is 25% long-term capital gain (due to depreciation recapture) and a portion is 15% long-term capital gain (pure appreciation).
3. The gain that flows through to the estate of the shareholder also increases its income tax basis in the S corporation stock to $1,800,000 (the adjusted basis).
4. At liquidation, the proceeds of sale, $1,000,000, are less than the adjusted basis of the stock, $1,800,000. Therefore, the estate will recognize an $800,000 15% long-term capital loss on its income tax return.
5. If the sale and the liquidation occur in the sale taxable year, then the capital loss is netted against the capital gain and results in a zero net capital gain to the estate for income tax purposes. If the gain occurs in a prior taxable year, the estate is not able to carryback the long term capital loss occurring at liquidation and a malpractice claim is in order.

Deferral of Gain

Like-Kind Exchange. IRC §1031 allows taxpayers selling real estate to defer the income tax on the sale of real estate, if the seller engages in a like-kind exchange. The seller must follow specific rules laid out in Treas. Reg. §1.1031 regarding the handling of the proceeds and the identification and acquisition of the replacement property.

Private Installment Sale. The gain on installment sales is generally reported over the term of the installment note. Where the installment note is to a related party, IRC §453(e) requires that the installment buyer retain the real estate for at least two years. After two years the real estate may be resold without triggering a gain in the installment note. The note can stay in the corporation until shareholder’s death. Annual interest and capital gain in the corporation can be offset by operation expenses and benefits inside the corporation.

> **Caution.** Transfer of note will accelerate remaining gain on uncollected balance of note.

Reducing the Gain

Seller Pays Out Current and/or Accrued Deferred Compensation. An S corporation can also pay compensation and/or a bonus to its key employee for negotiating a successful sale of its business assets. Obviously, in order for compensation to be deductible, it must be reasonable. If the seller can anticipate a sale of its business by more than one year, then the seller may be able to accrue a larger amount of compensation deduction as an inducement to the key employees to stay.

Allocation of Purchase Price. Buyers of entrepreneurial businesses generally wish to acquire assets rather than the shareholder’s equity interest. The purchaser will generally wish to deduct its purchase price in the form of depreciation or business expenses. Purchasers will generally wish to allocate the price in the following order of priority:

1. Inventory which is recovered in the first business cycle (generally less than one year)
2. Equipment, furniture, etc. may be recoverable over 5–7 years
3. Convenant not to compete and goodwill over 15 years (IRC §197)

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4. Land improvements, parking lots, and so on, which are 15-year property
5. Real estate which is recoverable through depreciation deductions over 39 years
6. Land which is not depreciable

Allocations of the purchase price to assets owned by the business will result in built-in gains. Allocations to assets owned by the shareholders outside of the corporation will avoid the built-in gains tax. Seller will generally wish to allocate the price in the following order of priority:

1. Real estate outside the corporation
2. Personal goodwill of the shareholders; payments are taxable as capital gains
3. Personal covenant not to compete by the shareholders; payments are taxable as ordinary income

Note. This is a very simplistic overview. There are many planning opportunities for the buyer. However, Form 8594 must be completed by both the buyer and the seller in the year of sale.

Personal Goodwill. In *Martin Ice Cream Company*,[35] the Tax Court held that the customer relationships were the property of the shareholder who personally developed the business relationships and contacts. The shareholder never signed an employment agreement with the company, and he never transferred the relationships to the corporation. The relationships were the property of the shareholder, not the corporation. Since the payments never pass through the corporation, they are not subject to corporate taxation. The payments received by the individual qualify as the sale of an asset and thus qualify for capital gain treatment.

35. *Martin Ice Cream Company v. Commr.*, 110 TC 189, March 17, 1998

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