Chapter 10: C Corporation Issues

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Corrections were made to this workbook through January of 2010. No subsequent modifications were made.

ISSUE 1: UNIQUE ASPECTS OF CORPORATE TAXATION

A C corporation is a separate taxable entity for federal income tax purposes. It selects its own taxable year and method of accounting, and it computes its taxable income in essentially the same manner as a taxable individual. A C corporation can elect any fiscal yearend (partnerships and S corporations are generally limited to a calendar yearend) with the tax return due 2½ months after the end of the tax year.

A personal service corporation (PSC) is limited to a calendar yearend unless a business purpose is shown for using a fiscal year.[1] More information concerning personal service corporations is found later in this chapter.

The taxable income of C corporations is subject to tax at graduated rates, much like the rates of individual taxpayers. The benefits of the graduated rates phase out after corporate taxable income exceeds a particular amount.[2]

The following table compares the current marginal income tax brackets for corporations and individuals.[3]

For Tax Years Beginning in 1993 and Later		MFJ for Tax Year 2009	
Corporate Taxable Income	Rate (%)	Individual Taxable Income	Rate (%)
$0–$50,000	15	$0–$16,700	10
$50,000–$75,000	25	$16,700–$67,900	15
$75,000–$100,000	34 [a]	$67,900–$137,050	25
$100,000–$335,000	39	$137,050–$208,850	28
$335,000–$10,000,000	34	$208,850–$372,950	33
$10,000,000–$15,000,000	35 [a]	Over $372,950	35
$15,000,000–$18,333,333	38		
Over $18,333,333	35		

[a] If corporate taxable income exceeds $100,000, the tax is increased by the lesser of 5% of the excess or $11,750. For corporate taxable income exceeding $15 million, the amount of tax is increased by the lesser of 3% of the excess or $100,000.

1. IRC §441(i)(1).
2. IRC §§301–385.
3. IRC §11 for corporate tax rates and IRC §1 for individual rates.

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The Obama administration has proposed increasing the top individual income tax rate to 39.6%. Even if Congress takes no action to increase the individual tax rate, it will automatically increase to 39.6% beginning in 2011 due to the sunset of the Economic Growth Tax Relief Reconciliation Act of 2001.

This increase may heighten interest in the use of the corporation as a tax minimization device for high-income taxpayers. In addition, through 2010, a reduction in tax rates applicable to C corporation dividends is in effect. That rate (either 5% or 15%) makes the **effective** federal tax rate for 2009 C corporate dividends 27.75%. This assumes the corporate profit is taxed at 15% and the remaining after-tax profit of 85% is taxed at the shareholders' 15% capital gain rate $(.15 + (.15 \times .85) = .2775)$. At a 25% corporate income-tax rate, the effective federal (double) tax rate on C corporation shareholders is 36.25%. This assumes the corporate profit is taxed at 25% and the remaining after-tax profit of 75% is taxed at the shareholders' 15% capital gain rate $(.25 + (.15 \times .75) = .3625)$. This is still lower than a 39.6% individual income tax rate.

Note. It is possible that in the near future, individual income tax rates could rise (especially for the top marginal income tax brackets) and the corporate tax rate could fall. The House Ways and Means Committee Chair publicly stated his support for a reduction in the corporate income tax rate.

DETERMINING TAXABLE INCOME

Corporate taxable income is defined as "gross income of the corporation minus the deductions allowed by chapter 1 of the Code."[4]

Differences between Corporate and Individual Taxation

In the context of a corporation, taxable income is determined differently than it is for an individual. Corporations have no personal expenses, cannot claim dependency exemptions, and are not entitled to a standard deduction. Therefore, there is no distinction between above-the-line deductions (allowed in reaching AGI) and below-the-line itemized deductions. There is also no concern about the application of the 2% of AGI income floor to miscellaneous itemized deductions,[5] or the overall limitation on itemized deductions.[6] Most individual personal deductions are not applicable in the corporate tax realm. However, virtually all ordinary and necessary expenses **incurred in the pursuit of profit** are deductible under IRC §162.

4. Treas. Reg. §1.11-1(b).

5. IRC §67.

6. IRC §68.

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The following is a list of some of the major differences between corporate and individual taxation:

- Corporate charitable contributions are subject to a limitation of 10% of taxable income (50% limit for individuals).[7] A 5-year carryforward applies to the excess.[8]

Note. Qualified farm corporations (nonpublicly traded) are not subject to a taxable-income limitation for qualified conservation contributions. The limit is 100% of taxable income less all other charitable contributions for farm-related qualified conservation contributions in 2009 and 2010.[9]

- Corporations must generally use the accrual method of accounting,[10] but exemptions exist for corporations engaged in farming, qualified personal service corporations, and any other corporation whose average annual gross receipts for the 3-year period preceding the taxable year do not exceed $5 million.[11]
- The at-risk rules[12] and passive-loss rules[13] generally do not apply to corporations; however, they do apply to individuals. They also apply to closely-held corporations in certain circumstances.
- Corporations can deduct capital losses only to the extent of capital gains. The excess cannot be applied against ordinary income, but can be carried back for three years and forward for five years. However, individuals can deduct capital losses to the extent of capital gains, and up to $3,000 of excess losses may be deducted against ordinary income. An individual can indefinitely carry forward unused capital losses.[14]
- The alternative minimum tax (AMT) exemption and rate of tax is different. The corporate AMT is payable only to the extent it exceeds a corporation's regular tax liability and is 20% of the amount by which a corporation's AMTI exceeds a $40,000 exemption. The amount of AMT is reduced by the AMT foreign tax credit, if applicable.[15] Certain small corporations are exempt from the corporate AMT. Corporations with annual gross receipts of $7.5 million or less for the preceding three taxable year periods (post-1993 and ending before the tax year at issue) are considered small corporations. The $7.5 million exception is reduced to $5 million for the first 3-year period.[16] In its first year of existence, a corporation is exempt from the AMT regardless of the level of gross receipts, with some exceptions.[17]
- It is likely that a higher percentage of corporations than individuals are eligible for the IRC §199 domestic production activities deduction.

7. IRC §170(b)(2).
8. IRC §170(d)(2).
9. IRC §170(b)(2)(B)(i)(II).
10. IRC §448(a).
11. IRC §448(b).
12. IRC §465.
13. IRC §469.
14. IRC §§1211 and 1212.
15. IRC §55(b)(4); rules related to corporations with qualified timber gains.
16. IRC §55(e)(1)(D).
17. IRC §§448(c)(2) and 448(c)(3)(D).

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Corporate Tax Returns and Filing Requirements

A corporation must file a tax return if it is in existence for any portion of a tax year.[18] If the only event that occurs during the tax year is the corporation receiving a charter, no return is required to be filed. In this situation, the corporation must provide a statement to the IRS indicating it did not conduct any business during the tax year and did not receive any income from any source.[19] However, if the corporation is otherwise required to file a return and does not do so, the IRS may generate a return for the corporation.[20]

Note. The corporate tax return must be signed by the president, vice president, treasurer, assistant treasurer, chief accounting officer (controller), or any other officer duly authorized to sign. If the return is made for the corporation by a fiduciary (trustee, receiver, or assignee), the fiduciary must sign the return.[21]

Corporations with less than $250,000 in gross receipts for the tax year and less than $250,000 in assets need not complete Form 1120, Schedules L (balance sheet), M-1 (reconciliation of income/loss per books with income per return), and M-2 (analysis of unappropriated retained earnings). Corporations with total assets of $10 million or more reported on Form 1120, Schedule L, must file Schedule M-3 (reconciliation) instead of M-1. These corporations must also file Schedule B, which reports information about allocations, transfers of interests, cost-sharing arrangements, and changes in methods of accounting.

Note. A corporation may not be required to file Schedule L, Balance Sheet, but a balance sheet is still required in order to maintain adequate records that clearly reflect income.

If a corporation files at least 250 returns (including information returns) of any kind (in the aggregate) during the calendar year ending with or within the corporation's tax year and has assets of $10 million or more, the corporation must electronically file its tax return. The only exceptions from the electronic filing requirement are for forms that cannot be electronically filed and when the IRS waives the requirement for undue hardship reasons. Unless an exception applies, failure to electronically file constitutes a failure to file the return.[22]

Form 1120 must be filed on or before the 15th day of the third month after the end of the tax year.[23] If a corporation liquidates or dissolves and distributes all its assets, the final corporate return is due by the 15th day of the third full month after the dissolution or liquidation.

Note. A corporation can receive an automatic 6-month extension by filing Form 7004, *Application for Automatic Extension of Time to File Certain Business Income Tax, Information, and Other Returns.* Form 7004 must be filed by the original due date of the return and show the corporation's estimated tax liability.[24] Although the time to file the return can be extended, the tax must be paid on time. In addition, the IRS can terminate the extension by providing a 10-day notice.[25]

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18. IRC §6012(a)(2); Treas. Reg. §1.6012-2(a).
19. Treas. Reg. §1.6012-2(a)(2).
20. IRC §6020.
21. IRC §6062.
22. Treas. Reg. §301.6011-5.
23. IRC §6072(b).
24. Treas. Reg. §1.6081-3.
25. IRC §6081(b).

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A corporation must make electronic deposits of taxes by using the electronic federal tax payment system (EFTPS) if the aggregate annual deposits of certain taxes exceed $200,000, or if the corporation was required to use EFTPS in the prior year. EFTPS deposits are only timely if the corporation begins the transaction at least one business day prior to the due date for the deposit.[26]

Note. EFTPS maintains a business' payment history for 16 months and can be viewed online after enrollment. As such, it may be wise for a business to go online after every payroll date to ensure that required taxes are remitted, particularly employment taxes.

Effective for the first 2009 payroll, a disregarded entity (such as a single-member LLC) must file its own payroll tax returns, including Forms 941 and W-2, under its own name and taxpayer identification number.[27] In essence, an LLC is treated as separate from its owner for purposes of employment tax liabilities for wages paid on or after January 1, 2009. Consequently, a disregarded entity is taxed as a corporation for employment tax purposes.

Generally, a C corporation must make installment payments of estimated tax if it expects its total tax for the year (less applicable credits) to be $500 or more. The installments are due by the 15th day of the 4th, 6th, 9th, and 12th months of the tax year.

A corporation that does not make estimated tax payments when due may be subject to an underpayment penalty for the period of the underpayment. Generally, a corporation is subject to the penalty if its tax liability is $500 or more and it did not timely pay the smaller of:

- Its tax liability for the current year; or
- Its prior-year tax, **if the prior-year tax is greater than $0.**

Form 2220, *Underpayment of Estimated Tax by Corporations,* is used to determine the amount of the penalty or to establish an exception to the penalty.

Corporate Penalty Taxes

C corporations are potentially subject to two penalty taxes that are added to a corporation's regular income tax. The **accumulated earnings tax** is designed to limit the accumulation of operating income inside a C corporation, and the **personal holding company tax** targets the use of a C corporation to hold personal service contracts and passive sources of income. Both penalty taxes require (within certain guidelines) that sufficient amounts of income at the corporate level be distributed.

The Accumulated-Earnings Tax. The accumulated-earnings tax is imposed on a corporation that is formed (or used) to avoid income tax for its shareholders by permitting earnings and profits to accumulate instead of being divided or distributed.[28] The tax is presently levied at a rate of 15% on C corporation accumulated taxable income. Accumulated earnings are generally defined as taxable income with certain adjustments which reflect the true dividend-paying capacity of the corporation. The adjustments involve subtracting taxes and dividends paid and adding back the dividends received deduction. The 15% rate is effective for tax years beginning after December 31, 2002. Before 2003, the rate was 38.6%. The reduction to 15% coincided with the maximum tax rate for qualified dividends being reduced to 15% under the Jobs and Growth Tax Relief Reconciliation Act of 2003. Presumably, the accumulated-earnings penalty tax rate will increase if the maximum tax rate for qualified dividends increases in future years.[29]

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26. Treas. Reg. §31.6302-1(h)(2)(ii).
27. Treas. Reg. §301.7701-2(c)(iv).
28. IRC §532(a).
29. IRC §§531 and 535.

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Observation. While closely-held corporations are the primary target of the accumulated-earnings tax, IRC §532(c) provides that its application is determined without regard to the number of shareholders. Likewise, the Tax Court has held the tax can apply to a publicly-traded corporation even when ownership is not concentrated in a small group of shareholders.[30] In reality, however, the accumulated-earnings tax has little application to publicly-traded corporations because the IRS has difficulty proving the corporation was formed for tax-avoidance purposes.

A C corporation can accumulate earnings up to $250,000 by virtue of a credit.[31] Excess accumulations are subject to a reasonable-business-needs test. However, if the principal function of the corporation is performance of services in health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting, then accumulations in excess of $150,000 are subject to the reasonable-business-needs test.[32]

The IRS presumes that accumulations of corporate earnings and profits beyond the reasonable needs of the business establish a tax-avoidance purpose unless the corporation proves to the contrary.[33] Except for holding companies and investment companies (which constitute prima facie evidence of a tax-avoidance purpose), whether a tax-avoidance purpose exists is determined by all the facts and circumstances of the particular case.[34]

Whether accumulations exceed the reasonable needs of the business is a factual question. The regulations provide extensive guidance on reasonable and unreasonable corporate accumulations[35] and concede that some accumulations may be proper, including accumulations for things such as these:

- Business expansion (i.e., purchase of land, purchase or building of facilities, and acquisition of additional machinery or equipment)
- Repayment of indebtedness (nonshareholder loans)
- Working capital needs
- Redeeming stock of a deceased shareholder to pay federal estate tax under IRC §303[36]

Observation. Care should be taken in drafting corporate annual minutes to specify the various business purposes for which earnings are retained rather than being paid out as dividends. Treas. Reg. §1.537-1(b)(1) states that the corporation must have specific, definite, and feasible plans for the use of accumulated earnings and profits.

30. *Technalysis Corp. v. Comm'r,* 101 TC 397 (1993).
31. IRC §§535(a) and (c).
32. IRC §535(c)(2)(B).
33. IRC §§533(a) and (b).
34. Treas. Reg. §1.533-1(a)(2).
35. Treas. Reg. §§1.537-2(b) and (c).
36. IRC §§537(a)(2) and 537(b)(1).

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An illustrative case on what constitutes accumulations for reasonable business needs is *Gustafson's Dairy, Inc. v. Comm'r*.[37] In this case, the Tax Court held that the accumulated-earnings tax did not apply to a fourth-generation dairy operation that had one of the largest dairy herds in the United States at one location. The corporation had accumulated $4.6 million for herd expansion, $1.6 million for pollution control, $8.2 million to buy equipment and vehicles, $2 million to buy land, $3.3 million to retire a debenture, and $1.1 million to self-insure against loss of the dairy herd. The court said the accumulations were for the reasonable needs of the business and noted the corporation had specific, definite, and feasible plans to use the accumulations.

Note. The accumulated-earnings tax is assessed by the IRS at the time of an audit or desk review. It is **not** computed and paid with Form 1120. An underpayment of accumulated-earnings tax may be subject to negligence penalties.[38] Interest is imposed on an accumulated-earnings tax underpayment from the due date of the corporation's tax return, determined without regard to extensions.[39]

The Personal Holding Company Tax.[40] When more than 60% of a C corporation's adjusted ordinary gross income comes from personal holding company income and 50% of the corporate stock is owned by five or fewer shareholders at any time during the last half of the taxable year, a 15% penalty tax may be levied on undistributed personal holding company income, less any deficiency dividend that might be declared under IRC §547. Examples of personal holding company income are interest, dividends, and cash rentals.

Observation. Steps should be taken to avoid the personal holding company tax. For example, the mix of corporate income could be changed and/or the corporation could engage in an active trade or business which produces more than 40% of the gross income (e.g., by a custom farming operation or crop-share lease if the corporation is a farming business). As a last resort, the corporation could declare a deficiency dividend to avoid the tax, but such a declaration will not avoid interest or penalties.

Unlike the accumulated-earnings tax, which is subjective, the determination of whether a corporation is a personal holding company is a mechanical test that does not depend on whether there is a tax-avoidance motive. If a corporation is determined to be a personal holding company, Schedule PH must be attached to Form 1120.

Personal Service Corporations

In order to prevent individuals that provide personal services from taking advantage of lower marginal corporate rates, IRC §11(b)(2) denies those rates to any qualified personal service corporation (PSC) as defined in IRC §448(d)(2). A PSC is taxed at a 35% flat rate on **all** taxable income. There are two tests to determine PSC status of a C corporation:

- **Function Test.** IRC §448(d)(2) defines a qualified PSC as a corporation that performs services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting.
- **Ownership Test.** Ninety-five percent or more of the corporate stock must be owned by employees who perform those services.

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37. *Gustafson's Dairy, Inc. v. Comm'r*, TC Memo 1997-519 (Nov. 17, 1997).

38. Rev. Rul. 75-330, 1975-2 CB 496.

39. IRC §6601(b)(4).

40. IRC §541.

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In 2007, the U.S. Tax Court held that bookkeeping services are within the business of accounting.[41] In the court case, the taxpayer employed persons to provide tax return preparation and bookkeeping services. The taxpayer argued the tax return preparation and bookkeeping services did not constitute accounting services because under state law in Nevada, accounting services could only be performed by a CPA. The taxpayer argued that he was not a CPA firm, did not employ CPAs, and did not perform services which were restricted under Nevada law to CPAs. Therefore, his business should not be treated as performing accounting services. The court disagreed. It noted that IRC §448(d)(2) only required the services be in the field of accounting and is not limited to public accounting. In addition, the court noted that Temp. Treas. Reg. §1.448-1T(e)(5)(vii), Example 1(i), indicated that for purposes of §448(d)(2), tax return preparation services are treated as accounting services.

Note. A discussion of personal service corporations can be found in the 2007 *University of Illinois Federal Tax Workbook*, Chapter 11, Entity Issues, on page 401. This chapter can be found on the accompanying CD.

Some service-oriented businesses are not considered PSCs. The definition does not include sales and brokerage services, or businesses compensated on a commission or contingent basis when a product is sold, such as real estate, insurance, investments, and similar businesses.

Note. A PSC must file tax returns on the calendar-year basis, unless an election is in place under IRC §444. It must deduct payments made to an owner-employee only in the tax year in which the employee includes the payment in income, and cannot carry back any election-year NOL to offset a prior year's income.

A corporation can avoid being classified as a PSC by:

1. Electing S corporation status,

Caution. Consider the built-in gains tax.

2. Having enough other business activity conducted by the employees to fall below the 95% threshold, or
3. Minimizing corporate taxable income (i.e., bonuses, salaries, payment of rents, etc.).

ISSUE 2: CONTRIBUTION OF PROPERTY TO A CORPORATION

The general tax policy behind corporation formations is one of nontaxability. The general rule for transfer of property to a corporation is found in IRC §351:

(a) ***General rule.*** *No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c) of the corporation.*

(b) ***Receipt of property.*** *If subsection (a) would apply to an exchange but for the fact that there is received, in addition to the stock permitted to be received under subsection (a), other property or money, then —*

1. *gain (if any) to such recipient shall be recognized, but not in excess of —*
   a. *the amount of money received, plus*
   b. *the fair market value of such other property received; and*
2. *no loss to such recipient shall be recognized.*

41. *Rainbow Tax Service, Inc., v. Comm'r,* 128 TC 42 (2007).

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The transfer of property to a corporation in exchange for stock is generally viewed as a change of an investment form rather than a disposition (cashing out) of an investment. Therefore, under the general rule, such a transaction does not trigger taxable gain.

The basis of the stock received by the transferor is controlled by IRC §358 which states that the basis of the property in the hands of the acquirer is determined by the adjusted basis of the property in the hands of the other person. However, IRC §362 controls the basis of the acquired property by the corporation. It states the basis is the same as it would be in the hands of the transferor, increased for gain recognized to the transferor on the transfer. The assumption of liability by the corporation is controlled by §357.

Example 1. Maxwell K. Oss forms a corporation for his new business venture, Chaos, Inc., (Chaos) an international spy business. Maxwell transfers an appreciated building with a fair market value (FMV) of $500,000 and a basis of $300,000 to the corporation in exchange for stock having an FMV of $500,000. Maxwell **realizes** $200,000 of gain. However, under IRC §351, Maxwell **recognizes** no gain. The corporation recognizes no gain or loss on the transfer. The corporation's tax basis in the property is the same as Maxwell's tax basis prior to the transfer.

Straight Exchange (Stock Only)

Maxwell		Code Section	Chaos, Inc.		Code Section
FMV of building transferred	$500,000		Basis of building	$300,000	§362
Basis of building transferred	(300,000)		Appreciation over basis	200,000	
Gain realized	$200,000		Capital stock	$500,000	
Cash or other property received	0				
Gain recognized	0	§351			
FMV of stock received	500,000				
Basis of stock received	300,000	§358			

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TRANSFER MUST BE SOLELY FOR STOCK

Transfers of property to the corporation must be solely in exchange for corporate stock. Stock generally refers to an equity investment in the corporation (not stock rights or warrants).[42]

Any gain realized by a transferor, in an otherwise qualified §351 exchange, must be recognized to the extent of boot received. The gain is characterized by reference to the character of the assets transferred, taking into account the impact of the depreciation recapture provisions. No loss may be recognized.[43] If a transferor exchanges several assets in exchange for stock and boot, the boot must be allocated among the transferred assets. Similarly, allocations are required to determine the basis of the assets in the hands of the corporation.

IRC §358(a) determines the basis of the stock received by the transferor. It states that the basis of the property received is the same as the basis of the property transferred, decreased by:

- The FMV of any other property (except money) received,
- The amount of money received by the transferor, and
- The amount of loss to the transferor which was recognized on the exchange, and

Increased by:

- The amount which is treated as a dividend, and
- The amount of gain to the taxpayer, which is recognized on the exchange (not including the gain, which is treated as a dividend.)

Example 2. Use the same facts as **Example 1,** except Maxwell received stock with an FMV of $450,000 and cash of $50,000 in exchange for his contribution of the building. The contribution of the asset still qualifies under §351, but Maxwell's $200,000 realized gain ($500,000 FMV – $300,000 basis) is subject to federal income tax to the extent of the $50,000 boot received. In this situation, Chaos borrowed $50,000 to pay the boot to Maxwell.

Exchange with Boot or Other Property

Maxwell		Code Section	Chaos, Inc.		Code Section
FMV of building transferred	$500,000		Basis of building	$350,000	§362
Basis of building transferred	(300,000)		Appreciation over basis	100,000	
Gain realized	$200,000		Capital stock	$450,000	
Cash or other property received	50,000				
Gain recognized	50,000	§351			
FMV of stock received	450,000				
Basis of stock received	300,000	§358			

42. Treas. Reg. §1.351-1(a)(1).

43. IRC §351(b).

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TIMING OF THE GAIN

When the boot is in the form of cash or other assets, the transferor recognizes gain immediately upon receipt of the boot.

Example 3. Use the same facts as **Example 1,** except Maxwell transfers his building (FMV of $500,000 and basis of $300,000) to Chaos in exchange for Chaos stock (FMV of $425,000) and a $75,000 note from Chaos. Maxwell realizes $200,000 ($500,000 – $300,000) of gain, but only recognizes $75,000 of the gain (to the extent of the boot received).

Exchange with Note as Boot/Other Property

Maxwell		Chaos, Inc.	
FMV of building transferred	$500,000	Basis of building	$375,000
Basis of building transferred	(300,000)	Appreciation over basis	125,000
Gain realized	$200,000	Note payable to Maxwell	(75,000)
Note receivable from Chaos, Inc.	75,000	Capital stock	425,000
Gain recognized	75,000		
FMV of stock received	425,000		
Basis of stock received	300,000		

For timing purposes, Prop. Treas. Regs. §§1.453-1(f)(1)(iii) through 1(f)(3)(ii) divide Maxwell's exchange into two separate transactions:

1. Nonrecognition treatment to the extent of the stock that Maxwell receives, and
2. An installment sale to the extent of the boot received.

The tax implications of Maxwell's asset transfer to Chaos are as follows:

- Maxwell's basis in the transferred property ($300,000) is first allocated to the stock he receives in the exchange in an amount up to the FMV of the transferred property ($500,000). Consequently, the full $300,000 basis is allocated to the stock Maxwell receives in the exchange.
- Next, to the extent Maxwell's basis in the transferred property ($300,000) exceeds the FMV of the nonrecognition property that he receives in the exchange ($425,000), the excess (if any) is allocated to the installment portion of the exchange. In this instance, there is no excess basis to allocate.
- Maxwell then applies IRC §453 to the installment portion of the exchange. The selling price equals the sum of the face value of the installment obligation ($75,000) and the FMV of any other boot ($0). Because **Example 3** does not involve the assumption of any liabilities, the total contract price is the same as the selling price ($75,000). The gross profit equals the selling price less any excess basis allocated to the installment obligation ($75,000 – $0 = $75,000). Therefore, Maxwell's gross profit ratio is 100%. Consequently, 100% of any payment received in the year of exchange is recognized gain, as are payments as they are received in future years under the note.
- Maxwell does not recognize any gain at the time of the exchange. However, the entire $75,000 of gain is recognized as the note is paid off. As for the stock's income tax basis, the regulations treat Maxwell as electing out of the installment method, so his basis in Chaos stock under IRC §358 is $300,000 ($300,000 basis – $75,000 boot + $75,000 gain). The corporation's basis in the transferred property is the same as Maxwell's basis increased by any amount of gain that is actually recognized.

Note. If Maxwell had transferred §1245 property with depreciation recapture, the entire gain up to the amount of the depreciation recapture would be recognized in the year of transfer.

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ASSUMPTION OF LIABILITIES

Many corporate formations involve the transfer of encumbered property or the assumption of liabilities by the transferee corporation. Normally, when a taxpayer is relieved of indebtedness related to the disposition of property, the debt relief amount is realized income for the taxpayer, even if it is nonrecourse debt. However, a different rule applies in the context of a corporate formation. Under IRC §357(a), the assumption of a liability by a transferee corporation in a tax-free (§351) exchange does not constitute boot and does not prevent the exchange from qualifying under §351. Instead, what otherwise would be recognized gain attributable to the transferred liabilities is postponed under IRC §358(d). Under that provision, the basis of stock received in the exchange is reduced by treating the relieved liabilities as money received by the transferor for purposes of determining the shareholder's basis.

There are two exceptions to §357:

1. IRC §357(b) sets forth a tax avoidance exception. The assumption of a liability is treated as boot if the taxpayer's principal purpose in transferring the liability was the avoidance of federal taxes or was not for a bona fide business purpose.
2. IRC §357(c) provides that if the sum of the liabilities assumed by the corporation exceed the aggregate adjusted bases of the properties transferred by a particular transferor, the excess is treated as gain from the sale or exchange of the property. For this purpose, assumed liabilities do not include any obligation that would give rise to a deduction if paid for by the transferor. In most instances, this is the more important exception. In order to maintain tax-free exchange status, the assumption of liabilities by the corporation must not exceed the contributed property's tax basis.

Example 4. Use the same facts as **Examples 1** and **3,** except Chaos assumes a $425,000 debt on the contributed asset. Maxwell receives Chaos stock with an FMV of $75,000. The contribution of the asset to Chaos qualifies under §351, and Maxwell is subject to federal income tax to the extent the liabilities transferred exceed the basis of the property transferred.

Exchange with Existing Loan Assumed

Maxwell		Chaos, Inc.	
FMV of building transferred	$500,000	Basis of building	$425,000
Basis of building transferred	(300,000)	Appreciation over basis	75,000
Gain realized	$200,000	Note payable to bank	(425,000)
Bank note transferred to Chaos	425,000	Capital stock	$ 75,000
Gain recognized	125,000		
FMV of stock received	75,000		
Basis of stock received	0		

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Example 5. Maxwell transfers the $500,000 building with a $300,000 basis to Chaos. In addition, Maxwell has a $225,000 note to the bank on the building and just prior to the transfer borrows an additional $70,000 using the building as collateral. Both loans are transferred to Chaos. along with the building. If Chaos assumes both the $225,000 debt on the contributed asset and Maxwell's $70,000 personal loan, it will be difficult to make a good argument that Maxwell had a bona fide business reason for Chaos, Inc., to assume the personal loan. Thus, Chaos's assumption of the personal loan may be viewed as the equivalent of Chaos borrowing the $70,000, then passing it to Maxwell as boot in the §351 exchange. In this situation, Treas. Reg. §1.357-1(c) subjects Maxwell to tax on $70,000 of realized gain (i.e., the amount of the tainted note assumed is treated as boot).

Exchange with Tainted Debt

Maxwell		Chaos, Inc.	
FMV of building transferred	$500,000	Basis of building	$370,000
Basis of building transferred	(300,000)	Appreciation over basis	130,000
Gain realized	$200,000	Note payable to bank	(225,000)
Bank note transferred to Chaos	225,000	Tainted bank note	(70,000)
Tainted note transferred to Chaos	70,000	Capital stock	$205,000
Gain recognized	200,000		
FMV of stock received	205,000		
Basis of stock received	205,000		

As an exception to the general rule of section 357(a), section 357(b)(1) treats the assumption or acquisition of a liability as ***money received by the transferor*** *(i.e., as boot under section 351(b)) "[i]f, taking into consideration the nature of the liability and the circumstances in the light of which the arrangement for the assumption or acquisition was made, it appears that the principal purpose of the taxpayer . . . was to avoid Federal income tax on the exchange, or . . . if not such purpose, was not a bona fide business purpose." Under this provision, the entire amount of all liabilities assumed or acquired (not merely a particular liability for which a tax avoidance purpose exists) is tainted.*[44]

Note. A taxpayer might be able to argue that only the taint is taxable.

Observation. When planning an incorporation (particularly incorporations involving cash-method taxpayers), it is important to carefully compare the amount of liabilities that will be transferred to the corporation with the adjusted tax basis of the assets transferred by each incorporator. Accelerated methods of depreciation often produce low-basis assets, which may be secured by substantial operating debt and equipment loans.

44. FSA 2000-11011 (July 30, 1999).

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Avoiding Gain Recognition

One possible method of avoiding gain recognition due to liabilities in excess of basis on contributed assets is for the transferor to contribute additional cash to the corporation in an amount equal to the excess of assumed liabilities over the aggregate adjusted basis of the other contributed assets. If cash is not available to be contributed, a transferor may be tempted to either remain personally liable on the assumed debts or transfer a personal note to the corporation for the excess.

Whether these techniques will accomplish the intended result has created a great deal of confusion among the courts. Following is a summary of how the IRS views the matter and how the courts have handled these cases:

- In Rev. Rul. 68-629,[45] the IRS ruled that gain is recognized under §357(c) when a promissory note is issued for the excess of liabilities over the adjusted basis of assets transferred by a sole proprietorship to a controlled corporation. The IRS pointed out that under IRC §1012, the basis of property is its cost, except as otherwise provided in the Code. Because the taxpayer had not incurred any cost in making the note, the taxpayer's basis in the note was zero. Consequently, the transfer of the note to the corporation did not increase the basis of assets transferred to the corporation in the exchange, and the liabilities assumed by the corporation exceeded the taxpayer's basis in the assets transferred. This resulted in the excess being taxable gain.
- Rev. Rul. 80-235[46] addresses the liability created by an interest-bearing nonrecourse note given by a limited partnership as the total purchase price for a synthetic oil converter and paid out of the partnership's net cash flow. The IRS ruled the liability may not be included in the partnership's basis in the converter for purposes of investment tax credits. The IRS also ruled a liability created by a written obligation given as part of the purchase price for a partnership interest is not included in the basis of the partnership interest. In so ruling, the IRS noted "a payment which is so speculative as to create a contingent liability cannot be included in the basis of property." In this instance, the IRS indicated there had to be adequate cash flow before the limited partnership was required to make a payment of principal on the note. Likewise, the IRS ruled that contribution of a partner's personal note did not increase basis under IRC §722 because the partner had a zero basis in the written obligation. However, payments on the note are added to the partner's basis in the partnership as the payments are made.

Note. While the revenue ruling pertains to a partnership, it shows the relevance the IRS gives to the debt/basis issue.

45. Rev. Rul. 68-629, 1968-2 CB 154.

46. Rev. Rul. 80-235, 1980-2 CB 229.

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The following court decisions indicate the importance of distinguishing who has liability for debt after taking into account the impact that a §351 exchange has on the transfer.

- In *Jackson v. Comm'r,*[47] the taxpayers claimed on appeal that the Tax Court erred when it ruled they realized taxable income on the transfer of a joint-venture interest to their wholly-owned corporation. The taxpayer owned a 50% interest in an apartment complex joint venture and was obligated to repay loans on the project personally and via his corporation. Later, he severed his personal involvement in the project. The Ninth Circuit reversed the Tax Court. It held that because the taxpayer remained personally liable on the indebtedness, he did not recognize taxable income on the transfer of the indebtedness to the corporation.
- In *Smith v. Comm'r,*[48] the Tax Court ruled a taxpayer had to recognize gain upon the transfer of a partnership interest for corporate stock. Smith held an interest in a partnership that purchased real estate. A note held by the seller and secured by a deed of trust evidenced the debt for the purchase of the real estate. Smith signed an assumption-of-liability agreement in which he personally assumed the debt evidenced by the note. The partnership also took a second loan on the property. The loan on which Smith was personally liable became subordinate to the new loan. Thereafter, the partners formed a corporation and, in exchange for their partnership interests, they received stock. The corporation assumed the partnership's debt (second loan). However, Smith personally made all interest payments on the note he had assumed. The court held that Smith could not deduct the interest payments on the note and had to recognize gain on the transfer of his partnership interest for the stock under IRC §357(c).

Note. The Tax Court has consistently rejected the notion that transferred liabilities are excluded from the §357(c) calculation if the transferring shareholder remains personally liable for the debt.[49]

- In *Lessinger v. Comm'r,*[50] the taxpayers consolidated a proprietorship (which had a negative net worth) into a corporation. The taxpayers retained a personal loan for the proprietorship's debt, part of which was repaid to the corporation and part of which was refinanced by a new creditor. The IRS claimed the discharge of the proprietorship's debt was taxable under §357. The Tax Court affirmed the IRS's claim because the corporation's account receivable, attributed to the taxpayer, lacked a due date, interest, security, or other features of true debt. As such, the debt was merely artificial. However, the appellate court reversed the decision. The appellate court believed a true debt was involved as evidenced by a promissory note to a creditor. As such, the value of the note to the corporation meant that it could not be considered gain.
- In *Peracchi v. Comm'r,*[51] the court held that a personal promissory note contributed to a corporation had an income tax basis equivalent to its face value. Therefore, the aggregate liabilities of the property that the taxpayer contributed to his closely-held corporation did not exceed his income tax basis in the contributed assets. As a result, there was no taxable gain on the exchange.

  The taxpayer contributed two tracts of real estate to the corporation in order to comply with Nevada's minimum premium-to-asset ratio for insurance companies. The tracts were encumbered with liabilities exceeding the taxpayer's basis in the tracts. Therefore, the taxpayer executed a promissory note as part of the exchange. The note had a face amount that more than covered the shortfall of basis as compared to liabilities on the contributed tracts. The court held that the taxpayer could claim a basis equal to the face amount of the note, pointing out the note was an ordinary, negotiable, recourse obligation that was a genuine debt for tax purposes. In a footnote, the court stated "we confine our holding to a case such as this where the note is contributed to an operating business which is subject to a non-trivial amount of risk of bankruptcy or receivership."

47. *Jackson v. Comm'r,* 708 F.2d 1402 (9th Cir. 1983).
48. *Smith v. Comm'r,* 84 TC 889 (1985).
49. *Rosen v. Comm'r,* 62 TC 11 (1974).
50. *Lessinger v. Comm'r,* 872 F.2d 519 (2nd Cir. 1989).
51. *Peracchi v. Comm'r,* 143 F.3d 487 (9th Cir. 1998).

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- In *Seggerman Farms, Inc. v. Comm'r,*[52] the taxpayers, a farming family, incorporated the family farm. In exchange for stock in the newly-formed corporation, the family transferred assets to the corporation subject to indebtedness. The amount of the aggregate debt on the contributed properties exceeded the taxpayers' adjusted basis in the assets. The IRS asserted the transfer was taxable as to the excess, and the Tax Court agreed. On appeal, the court affirmed the decision because the taxpayers remained liable as guarantors on the indebtedness. The taxpayers claimed that *Peracchi* and *Lessinger* created an exception to a strict application of §357(c), but the court disagreed. Instead, the court reasoned that a personal guarantee is not an economic outlay (not actually incurring debt), but only a promise to pay in the future if certain events should occur.

Note. In 1999, Congress amended §357(c), effective for transactions after October 18, 1998. The amendment struck the words "plus the amount of liabilities to which the property is subject" from the statute. Thus, the amended statute provides relief for taxpayers transferring assets subject to liabilities when the transferor remains personally liable on the debt but for which the corporation does not assume liability. The amendment occurred after the transaction at issue in *Seggerman* and, in any event, the Tax Court took the position that the Seggerman family debt obligations were assumed by the corporation.

Caution Concerning Shareholder Loans. As noted above, a shareholder may loan funds to the corporation in order to boost basis to a level exceeding liabilities to avoid gain recognition on corporate formation. The cases point out the desired result may or may not be achieved. It is also a fairly common practice for a shareholder to loan money to a corporation after the initial formation or for a corporation to loan money to a shareholder. Because corporate distributions must be based on ownership percentages, loaning money to the corporation or vice versa may seem to serve as a convenient method for returning cash to a shareholder. Therefore, the shareholder would not have to worry about maintaining ownership percentages amongst the shareholder group as required with actual distributions. However, when a corporation loans money to a shareholder (or vice-versa), the below-market (imputed interest) loan rules of IRC §§7872(c) and (e) apply unless the aggregate amount of the loans are $10,000 or less,[53] **or** the loan reflects an interest rate (i.e., a rate at least equal to the applicable federal rate (AFR)).[54]

Observation. Given the present low-interest-rate environment, it may be worth considering whether to reissue any presently existing demand loans for a fixed term at current (presumably lower) AFR interest rates in order to lock lower interest rates for the term of the note. Consideration should also be given to whether new corporate-shareholder loans are made to take advantage of current low interest rates.

Note. For more information on below-market loans, see Chapter 8, Related Parties.

52. *Seggerman Farms, Inc. v. Comm'r,* 308 F.3d 803 (7th Cir. 2002).

53. IRC §7872(c)(2).

54. IRC §7872(e).

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"CONTROL" IMMEDIATELY AFTER THE EXCHANGE

As a group, the transferors of property to the corporation must control the corporation immediately after the exchange. Control is defined by IRC §368(c), and requires the following:

1. The transferor group owns at least 80% of the total combined voting power of all classes of stock that are entitled to vote, and
2. The transferor group owns at least 80% of the total number of shares of all other classes of stock.

Observation. In the formation of many corporations, only one class of voting common stock is involved, so the transferor group winds up owning 100% of all classes of voting stock. However, if the corporation issues more than one class of stock, the transferor group must own at least 80% of each class.[55]

Particular Control Issues

The transferors of property must act in concert under a single integrated plan. The transfers do not necessarily have to be simultaneous. The regulations state that transfers must be consistent with orderly procedure.[56] Basically, transfers are mutually interdependent steps in the formation and carrying on of the business. Therefore, transfers separated by only a short time period can be considered separately for purposes of the control requirement, and transfers that are several years apart can be treated as part of an integrated plan.

The transferors must be in control (defined by the 80% test) immediately after the exchange. Momentary control is not enough if dropping below the 80% threshold is a result of a disposition of stock in a taxable transaction under a binding agreement or prearranged plan. Consequently, care should be taken to avoid shareholder agreements that require stock to be sold upon transfer of property to a corporation.[57] However, a voluntary disposition of stock (such as by gift) is allowable even if the original transferor parts with the stock shortly after the exchange, as long as **it is not part of a prearranged plan.** Obviously, such transactions can easily destroy tax-free exchange status if the IRS is convinced that a particular transaction **is** part of a prearranged plan.

BUSINESS PURPOSE FOR TRANSFERS

As noted above, a requirement of a tax-free exchange is that property must be transferred to the corporation. The transfer of property to the corporation must have a business purpose. This is usually an easy test to pass. However, if personal liabilities or business liabilities that were used to fund personal expenses are transferred to the corporation, questions may arise concerning the satisfaction of the business-purpose test.[58]

What constitutes property for tax-free exchange purposes? Property is not defined for purposes of IRC §351 but has generally been broadly construed. Following is a short summary of what does and does not constitute property.

Property includes the following:

- Cash
- Capital assets
- Inventory
- Accounts receivable
- Patents
- Nonexclusive licenses and industrial know-how

Property does not include services.

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55. Rev. Rul. 59-259, 1959-2 CB 115.
56. Treas. Reg. §1.351-1(a)(1).
57. Ltr. Rul. 9405007 (Oct. 19, 1993).
58. IRC §357(b) (tax-avoidance purpose).

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Note. A transferor that receives stock solely in exchange for services may cause other parties to the incorporation to recognize gain or loss. While a person that is only a service provider is not deemed to have transferred property and is not counted as part of the transferor group, a person that transfers **both** property and services to the corporation in exchange for stock is part of the transferor group. As such, all of this person's stock received in the exchange counts toward the 80% control requirement.

Example 6. Paul Promoter and Ira Investor form a corporation for their new business. Paul contributes his marketing and promotion services to the corporation and receives 25% of the corporation's stock. Ira contributes $500,000 of highly-appreciated property and receives 75% of the corporation's stock. Ira does not meet the 80% test and must recognize gain on the transfer.

Observation. An alternate solution would include issuing stock for services, which treats the transfer as compensation and allows a deduction for reasonable compensation. Paul could **not** become a member of the control group by transferring a small amount of cash to the corporation. Treas. Reg. §1.351-1(a)(1)(ii) provides that the stock is not treated as being issued for property if the primary purpose of the transfer is to qualify the exchanges of the other property transferors for nonrecognition and if the stock issued to the nominal transferor is of relatively small value in comparison to the value of the stock already owned or to be received for services by the transferor. Rev. Proc. 77-37 specifies that transferred property is not considered relatively small in value if the transferred property's FMV is equal to, or in excess of 10% of the FMV of the stock already owned (or to be received for services) by the transferor.

FILING AND RECORDKEEPING REQUIREMENTS

Treas. Reg. §1.351-3 requires every significant transferor to file a statement **with** the transferor's income tax return for the year in which a §351 exchange takes place. The statement must contain the following information:

- The name and employer identification number (if any) of the transferee corporation
- The date(s) of the transfer(s) of assets
- The aggregate FMV and basis, determined immediately before the exchange, of the property transferred by the transferor in the exchange
- The date and control number of any private letter ruling(s) issued by the IRS in connection with the exchange

Note. A significant transferor is either a 5% (by vote or value) shareholder of a public corporation or a 1% (by vote or value) shareholder of a private corporation immediately after the §351 exchange.

Transferee corporations must file similar transferee statements identifying every significant shareholder. A transferee corporation is not required to file a transferee statement provided all information that would have been included in the transferee statement is included in any significant transferor statement(s) attached to the same return for the same §351 exchange. It is not clear when and how this limited exception applies. Therefore, tax counsel should be consulted to determine if this exception is applicable to a particular situation.

Note. In addition to the filing requirements, taxpayers must keep, as part of their permanent records, pertinent facts regarding the §351 exchange, such as basis, FMV, and liabilities assumed (among other items).

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While the failure to file the required statement and keep related records will likely not result in penalties or disqualify a tax-free exchange (that would otherwise meets the requirements), the failure to file the required statement or keep records may have negative collateral effects. For example, to the extent an underpayment of tax is eventually sustained, such failures may factor into whether the IRS seeks civil penalties for negligence or disregard of rules or regulations.

Note. Similarly, transfer of property for stock in a foreign corporation may be subject to an entirely different set of reporting requirements under IRC §6043(c). Failures to report under §6043(c) are subject to significant penalties.

ISSUE 3: CONVERTING A C CORPORATION TO AN S CORPORATION[59]

Note. The 2008 *University of Illinois Federal Tax Workbook*, Chapter 4, Limited Liability Companies, has a discussion of conversions between entity types beginning on page 142. This can be found on the accompanying CD.

For various reasons, taxpayers may wish to extract assets from a C corporation by converting it to an S corporation. The corporation may have been formed many years ago for tax and estate planning reasons, and/or to limit liability. The shareholders may currently desire to remove assets from the corporation to facilitate current estate-planning goals. This type of situation involves several important problems that are usually complicated, time-consuming, and fraught with pitfalls for the unwary.

The 1986 Tax Reform Act substantially changed corporate tax law in the area of corporate liquidations by adding §311(b). Generally, the liquidation of a C corporation results in double taxation (corporate and shareholder level) as the result of appreciation in value of corporate assets from the corporation's inception through liquidation. To prevent C corporations from avoiding §311(b) gain by converting to S corporations prior to liquidation, Congress enacted §1374. This appreciation in value is known as built-in gain (BIG) and it triggers a BIG tax.

The BIG tax is a corporate-level tax imposed by IRC §1374 on any net recognized built-in gain occurring in any taxable year during a 10-year recognition period. The BIG tax is **in addition to regular taxation** that occurs upon sale of the asset. The BIG tax is equal to the highest corporate rate (currently 35%). It also applies to any asset carried over from a C corporation that is disposed of within the 10-year recognition period.

Note. For tax years beginning in 2009 and 2010, the American Recovery and Reinvestment Act of 2009[60] reduces the 10-year period to seven years for BIG **recognized** in these years. To qualify for the reduced 7-year period, the seventh taxable year in the recognition period must precede either 2009 or 2010. Consequently, any immediate impact of the provision is limited to C corporations with BIG property that elected S status in 2000–2002. **The recognition period is not reduced for S corporation elections made in 2009 or 2010.**[61]

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59. This section is drawn heavily from Section J of *2008 Tax Manual,* prepared by Orville W. Bloethe, A. David Bibler, and Lee E. Wilmarth, for use at the 69th Annual Bloethe Tax School, with portions republished verbatim. We are grateful for the authors' permission to utilize this material in the 2009 workbook.

60. H.R. 1, P.L. No. 111-5.

61. Act, Sec. 1261, *amending* IRC §1374(d)(7).

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If an S corporation sells BIG property within the recognition period and the sale qualifies for the installment method, the recognition period for that sale continues until the last installment is collected, even if the collection period extends beyond the corporation's normal 10-year recognition period.[62] The built-in gain for each liquidated asset is limited to its net unrealized gain (FMV – adjusted tax basis) as measured on the date that the S election takes effect. Any BIG tax liability is treated as a reduction in the S corporation's taxable income for the year of recognition.[63] Clearly, the BIG tax is a serious concern for assets that are "trapped" in a C corporation when the owners want to liquidate the business and free the assets from inside the corporation.[64]

Conversion Scenario. Gene and Kathy are the majority shareholders of a cash-basis C corporation (farm) with retained earnings of $236,000. They both want to retire and they have no on-farm heirs to take over the farming operation. They anticipate that the corporation, which includes low-basis farmland, will be liquidated at their deaths. Following retirement, they wish to rent all corporate farmland on a cash-rental basis to simplify their involvement in the business. According to their current wills, at the death of the first spouse, a portion of the corporate stock transfers to a bypass trust which is a qualified subchapter S trust (QSST). The trust provides for the remainder of trust assets to pass equally to Gene and Kathy's children upon the surviving spouse's death.

There are several options that can be implemented which can extract assets from a C corporation as a means of avoiding the BIG tax on corporate assets.

S Corporation Election

Due to the double taxation effect of liquidating an existing C corporation, Gene and Kathy might consider electing S status. This action can lock in and limit the total amount of gain that would be realized upon an eventual liquidation of the corporation.

The S election freezes the corporate BIG at a level that does not exceed the difference between the cost basis in the farm real estate/improvements and the FMV on the effective date of the S election. Following this election, the corporation and shareholders avoid double taxation (corporate and shareholder level) on any additional FMV appreciation of the assets if the corporation continues its corporate existence for a period of 10 years following the S election. However, if the corporation does not continue for at least 10 years after conversion to S status, BIG is triggered.[65]

It may be possible to minimize the impact of the BIG tax by liquidating particular assets before the S election is made.

Conversion Scenario Continued. Gene and Kathy have zero-basis grain on hand with an FMV of $200,000 that was not liquidated prior to electing a change to S corporate status. Upon sale of the grain, the S corporation is required to pay $70,000 of BIG tax ($200,000 × 35%). The shareholders pay federal and state income taxes on the remaining $130,000 of sale price ($200,000 – $70,000 BIG tax). If Gene and Kathy are in the 25% federal marginal income tax bracket and an 8% state income tax bracket, the combined tax rate pertaining to the liquidation of the corporation's grain is 56.45% ($112,900 of the $200,000 sale price). Clearly, Gene and Kathy should sell the grain **before** converting the C corporation to an S corporation. If they do this, the grain sale is only subject to a single tax at the corporate level (assuming that no dividends are paid).

> **Note.** Recognized built-in gains may be offset by C corporation NOL carryovers or capital loss carryovers which had not been used as of the S election date, subject to normal carryover timeframe limitations (i.e. current 20-year carryover for NOLs).[66] However, upon conversion, unused operating losses of the C corporation cannot be used by the newly-formed S corporation to offset future income of the S corporation.

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62. Treas. Reg. §1.1374-10(b)(4).
63. IRC §1366(f)(2); Treas. Reg. §1.1366-4(b).
64. This is a particular problem for farm corporations created before 1986 that now contain low-basis farmland.
65. IRC §1374.
66. IRC §1374(b)(2).

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Alternatives to Selling Assets within the Recognition Period

If shareholders convert an existing C corporation to an S corporation and it becomes necessary to liquidate some or all of the corporation's property within the 10-year recognition period, they should consider the following alternatives:

1. **Sell corporate stock instead of liquidating assets.** A sale of corporate stock in lieu of liquidation of assets does not trigger the BIG tax. However, the assets of the corporation continue to be subject to BIG tax rules for the remainder of the 10-year recognition period and the new purchaser of the stock is responsible for any built-in gains taxation.

> **Note.** A buyer of corporate stock subject to a BIG recognition period will likely require a significant discount from FMV in negotiating the purchase price of the stock.

2. **Utilize a like-kind exchange of property.** If BIG property is used in a like-kind exchange, the basis of the relinquished property becomes the basis of the replacement property. The replacement property is still subject to the BIG tax.[67] If cash or unlike-kind property is received as a part of the exchange, the BIG tax is applied to the cash or value of the unlike-kind property received. Thus, assets subject to the 10-year BIG recognition rule can be exchanged for like-kind assets without triggering the BIG tax (e.g., farm real estate exchanged for apartment building or other urban rental real estate; farm equipment exchanged for like-kind farm equipment). The exchanged asset continues to be subject to BIG tax for the remainder of the 10-year recognition period.

3. **Enter into a long-term lease.** Shareholders may be able to enter into a long-term lease of corporate assets with the lessee having an option to purchase the assets after the expiration of the 10-year BIG recognition period. If this alternative is considered, care should be taken when drafting the lease agreement to ensure the transaction does not constitute a sale for federal income tax purposes and that it avoids exposure to various passive income tax problems.

4. **Liquidate assets when the S corporation's taxable income can be reduced to zero.** The BIG tax is limited to the S corporation's taxable income.[68] Under this provision, net recognized BIG for any tax year is the lowest of the following three amounts:

   - Total remaining net unrealized BIG resulting from the S corporation conversion;
   - Amount of recognized BIG during the tax year; or
   - S corporation taxable income for the tax year.

If shareholders must liquidate some or all of the corporation's assets within the 10-year BIG recognition period, the corporation may be able to avoid payment of the BIG tax if the S corporation's taxable income can be reduced to zero. Any net recognized BIG upon which tax is not paid during a taxable year carries forward to each subsequent taxable year during the 10-year recognition period. Consequently, the net recognized BIG tax is assessed in a subsequent year unless the S corporation taxable income can also be lowered to zero for those tax years.

> **Note.** If the S corporation has net recognized BIG during a taxable year, steps should be taken to reduce the S corporate taxable income to zero in order to defer payment of the BIG tax (e.g., deferral of income, salary increases or bonuses, accelerated expenses). If an S corporation's taxable income can be reduced to zero for each taxable year during the 10-year recognition period, the BIG tax is eliminated forever.

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67. IRC §1374(d)(6).

68. IRC §1374(d)(2)(A)(ii).

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Other Issues That Arise upon Conversion

C Corporation Has Retained Earnings and Profits. An S corporation that was previously a C corporation **and** has C corporation earnings and profits can only remain an S corporation for three years if more than 25% of its gross receipts are from passive sources (cash rent, interest, etc.).[69] S corporation status is lost immediately at the end of the third taxable year in which this condition exists following the S election. Rents do not constitute passive investment income if the S corporation provides significant services or incurs substantial costs in conjunction with rental activities. Whether significant services are performed or substantial costs are incurred is a facts and circumstances determination.[70] The significant services test can be met by entering into a lease format that requires significant involvement in decision-making by the corporate officers.

If the corporation has accumulated earnings and profits at the close of its tax year, has passive investment income for the tax year that is in excess of 25% of gross receipts, and has taxable income at yearend, the corporation must pay a tax on the excess net passive income.

Observation. Since Gene and Kathy's corporation has C corporate earnings and profits, if they wish to cash-rent corporate farmland after the S election is made, they can only avoid the "sting" tax in one of the following ways:

- Avoid reporting any excess net passive income. This can be accomplished only if the corporation is able to prepay sufficient farm expenses to offset all passive investment income (as defined by IRC §1362(d)(3)(C)) and/or create negative net passive income.
- Distribute all accumulated C corporate earnings and profits to shareholders before the first yearend of the S corporation.[71] In order to make a distribution of accumulated C corporation earnings and profits, the S corporation must elect to treat these distributions to the corporation's shareholders as taxable dividends.[72]

Deemed Dividend Election. If the corporation does not have sufficient cash to distribute the entire accumulated C corporation earnings and profits, it may make a deemed dividend election under Treas. Reg. §1.1368-1(f)(3). Under this election, the corporation can be treated as having distributed all its accumulated C corporate earnings and profits to the shareholders as of the last day of its taxable year. The shareholders, in turn, are deemed to have contributed the amount back to the corporation in a manner that increases stock basis. With the increased stock basis, the shareholders can extract these proceeds in future years without additional taxation, as S corporation cash flow permits. The consent of all affected shareholders is required to make this election. The election for a deemed dividend is made by attaching a statement to the S corporation's timely-filed original or amended Form 1120S. The election must state that the corporation is electing to make a deemed dividend under Treas. Reg. §1.1368-1(f)(3). The election must include the amount of the deemed dividend that is distributed to each shareholder.[73] It is also important to note that deemed dividends issued proportionately to all shareholders are not subject to one-class-of-stock issues and do not require payments of principal or interest.

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69. IRC §1362(d)(3).
70. Treas. Reg. §1.1362-2(c)(5)(ii)(B)(2) .
71. IRC §1375(a)(1).
72. IRC §1368(e)(3).
73. Treas. Reg. §1.1368-1(f)(5).

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Distribution of Earnings and Profits. Another issue that shareholders must deal with is the problem of income tax liability upon the distribution of C corporate earnings and profits. Generally, earnings and profits should be distributed at a time when income taxation to the shareholders can be minimized. Given the current reduction in tax rates applied to C corporate dividends (5% and 15%), there may never be a better time during which accumulated C corporate earnings and profits can be distributed while minimizing shareholder tax rates. Retired shareholders should consider the effect, if any, that distribution of earnings and profits have upon the taxability of social security benefits.

Observation. Gene and Kathy in the above scenarios may also want to consider gifts of stock to children or grandchildren. Such a technique may provide distributions to persons in lower tax brackets. However, tax benefits may be negated if children and grandchildren up to the ages of 18–23 (for 2008 and after) receive sufficient dividends to trigger the kiddie-tax rules.

Shareholder Death. The death of shareholders during the existence of the S corporation raises another issue. Once S status is elected, the corporation must maintain appropriate shareholders. When one shareholder dies and leaves his property in two packages to his spouse (the typical marital and bypass trust), the portion of corporate stock held by the bypass trust could only qualify as an acceptable S corporate shareholder if the trust meets the definition of a qualified subchapter S trust (QSST). A QSST is one in which:

1. All of the trust's income is either distributed or required to be distributed currently to only one beneficiary who is a citizen or resident of the United States;
2. During the life of the current income beneficiary, there is only one income beneficiary;
3. Corpus distributions during the current income beneficiary's life can only be made to that beneficiary;
4. The current income beneficiary's income interest must terminate on the earliest of the current beneficiary's death or the termination of the trust; and
5. If the trust terminates during the current income beneficiary's life, the trust assets are all distributed to the current income beneficiary.[74]

Upon satisfying those conditions, a QSST beneficiary's election can be made under IRC §1361(d)(2).

Liquidating the S Corporation

Except for the C corporate earnings and profits issue, shareholders can minimize tax by waiting to liquidate until the later of the death of the shareholder(s) or the expiration of the 10-year built-in gain rule. At death, a decedent's stock ownership interest receives a step up in basis to FMV. This basis adjustment is coupled with the basis increase that results from gain recognition upon liquidation of corporate assets that is passed through to the shareholder on Schedule K-1. This results in taxation being incurred on liquidation at only the shareholder level. Because stock basis increases at death and income is passed through, **no gain recognition results when cash or property is distributed to the decedent's estate/heirs (in exchange for stock) as a result of complete liquidation**. The pass-through gain (Schedule K-1) to the estate/heirs is offset by a matching loss from liquidation of the stock.

Observation. Any undistributed C corporate earnings and profits remaining on the liquidation date must still be accounted for. These earnings and profits are treated as distributed qualified dividends, and are taxed at individual income tax rates.

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[74] IRC §§1361(d)(3) and (4).

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For distributions of property in liquidation of a deceased shareholder's S corporation stock when the corporation has multiple shareholders, distributions of property (other than cash) are treated as though the corporation sold the property to the shareholder for its FMV.[75] The corporation recognizes gain to the extent the property's FMV exceeds its adjusted basis. When appreciated property is distributed to an S corporate shareholder in exchange for stock, the gain recognized at the corporate level passes through to all shareholders (via Schedule K-1) based on their percentage ownership in the corporation. If the S corporation only had one shareholder and his interest is liquidated at death, gain recognition does not cause taxation problems due to a matching loss offset resulting from the stock basis adjustments discussed above. However, if the S corporation has more than one shareholder, a distribution of property to a single shareholder (deceased or otherwise) in liquidation of a stock interest results in a taxation event for all corporate shareholders.

For property distributed to a shareholder, the shareholder's income tax basis is the property's FMV at the date of distribution. Unfortunately, the distributee shareholder's holding period begins when the shareholder actually or constructively receives the property, because the distribution is treated as if the property were sold to the shareholder at its FMV on that date. Since the shareholder's basis in the property is its FMV (rather than a carryover of the corporation's basis), the corporation's holding period is not added to the shareholder's holding period. Consequently, the redeeming shareholder must hold distributed property for one year after distribution before selling it in order to achieve capital gain income tax treatment on the sale.

An alternative to liquidating the S corporation at the death of the surviving spouse is a divisive reorganization under IRC §355. In a divisive reorganization, a portion of the assets of a parent corporation are split off to one or more (former) shareholders through a new corporation.

A corporation must be liquidated in the same tax year as the sale/distribution of assets to produce the desired tax result. If a sale/distribution of assets was accomplished in one tax year and the liquidation of the corporation in the following year, the capital loss produced upon liquidation would not offset the capital gain generated by the sale of assets. In such a case, the capital loss produced upon liquidation would only offset other long-term capital gains for the tax year of the liquidation, plus $3,000 of ordinary income. The remaining long-term capital loss would be carried forward to subsequent tax years.

Reporting Requirements upon Corporate Liquidation. Form 966, *Corporate Dissolution or Liquidation*, must be filed within 30 days after adoption of a resolution or plan to dissolve a corporation or to liquidate part or all of a corporation's stock.[76] The return is filed with the district director for the district in which the corporate income tax return is filed. If the resolution or plan is amended, an additional Form 966 must be filed within 30 days after adoption of the amendment or supplement. A Form 966 must be filed whether or not any part of the gain or loss to the shareholders is recognized.

A certified copy of the resolution or plan must be attached to Form 966. Additionally, Form 966 must also contain:

1. The name and address of the corporation,
2. The place and date of incorporation,
3. The date of the adoption of the resolution or plan and the dates of any amendments or supplements, and
4. The Internal Revenue District in which the last corporate income tax return was filed and the taxable year covered by the last return.[77]

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75. IRC §311(b).

76. IRC §6043(a)(1).

77. Treas. Reg. §1.6043-1(b)(1).

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Failure to file does not affect the reporting of income tax consequences resulting from the liquidation. The willful failure to file Form 966 could result in criminal penalties.[78] As noted above, when a corporation stops conducting business, liquidates, and dissolves, a return must be filed for the fractional part of the year during which the corporation was in existence **if the corporation retains no assets.** Simply retaining a nominal amount of cash negates the filing requirement until the time all the remaining cash is either distributed or used to pay remaining expenses.[79]

Observation. Costs incurred in connection with a corporate liquidation (e.g., filing fees, attorney/accountant fees, etc.) are deductible for the year of dissolution. Expenses incurred after liquidation cannot be deducted on the corporate income tax return for the year of liquidation.

CONVERTING A C CORPORATION TO AN LLC

Note. Many strategies are being developed for asset protection that have appeal to clients beyond tax results. These asset protection strategies usually involve co-ownership of interest in entities as corporation and partnership, instead of the monolithic ownership model of corporation and shareholders. These asset protection models utilize the differences in law as applied to corporations, partnerships, and LLCs (particularly with respect to charging orders contained in state LLC statutes).

This asset protection strategy is often made more complex by the ability of LLCs to choose taxation as a partnership or as a corporation. Eventually, any asset protection strategy will involve tax issues and an attempt to achieve favorable advantages in tax planning. The appeal of the partnership form of taxation is its allowance of nonrecognition treatment when owners change, the avoidance of double taxation of corporate income, the accumulated-earnings tax, and the personal holding company tax.

Alternatives

One alternative to a C corporate liquidation may be to convert an existing C corporation to an LLC. While an LLC that is treated for tax purposes as a partnership is not subject to a double layer of taxation, the tax consequences of converting an existing C corporation to an LLC must be considered. There are different ways to ultimately achieve a conversion of a C corportion to an LLC.

A second approach is to have the C corporation shareholders contribute their C corporate stock to a newly-formed LLC, followed by a liquidation of the corporation. The LLC would receive all of the corporation's assets.

The shareholders would then transfer additional funds to the LLC in exchange for an interest in the LLC. The part of the LLC owned by the corporation remains in the corporate format, and the corporation will have to report its share of the entity's income. Under this approach, it is important that the corporation and the shareholders receive an interest in the LLC equal to the FMV of assets they transferred to the LLC. The shareholders should contribute sufficient funds or property to the LLC. If insufficient funds or property is contributed in an attempt to give the corporation as small an interest as possible, the IRS could take the position that the excess value was transferred to the corporation's shareholders who then contributed it to the LLC. This could be considered a dividend to the corporate shareholders. Thus, the corporation should have the corporate assets that will be transferred to the LLC valued.

78. Rev. Rul. 65-80, 1965-1 CB 154.

79. Treas. Reg. §1.6012-2(a)(2).

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Additionally, if the existing assets that are transferred to the LLC from the corporation are subject to debt, care must be exercised in the treatment of the corporate partner's liabilities assumed by the partnership.[80]

Note. The IRS has authority to reallocate income and expense among commonly-owned or controlled entities. The IRS could also utilize other strategies, such as the substance-over-form argument, assignment of income doctrine, or partnership anti-abuse regulations to allocate income away from the LLC to the corporation. The result is taxing the income within the corporation and subjecting the shareholders to deemed dividend treatment.

When the C corporation is liquidated, tax at the corporate level would be triggered to the extent of appreciation on the corporate assets, and the LLC members would incur tax on the gain inherent in the corporate stock. This strategy usually involves adding new assets to the LLC and a slow combination of businesses by winding down affairs of the corporation.

A third approach involves liquidating the corporation into the hands of the shareholders followed by a contribution of the corporate assets to a newly formed LLC. Under this approach, the corporate shareholders have exposure to corporate liabilities while holding the assets, as well as recognition of gains. However, they also achieve an asset step-up.

Care should be taken to determine whether the treatment of realized gain is capital gain or ordinary gain for depreciable assets.[81]

A fourth approach involves an LLC formed with an unrelated third-party investor by transferring the corporate assets and liabilities to it in exchange for an ownership interest in the LLC. Under IRC §721(a), neither the C corporation nor its shareholders recognize gain or loss on the contribution of property to the LLC. The corporation assumes a carryover basis in its ownership interest, matching the basis of the assets contributed. If the C corporation transfers intangibles (such as goodwill) to the LLC, it must recognize gain based on the difference between the FMV of the intangibles and their basis under IRC §721(d). It is treated like a deemed corporate liquidation.

Note. Courts have ruled that goodwill and other customer-based intangibles in a closely-held C corporation may attach to the ultimate shareholders, as opposed to the C corporation.[82] Thus, an entity may be able to liquidate without including the FMV of goodwill among its assets if it can prove that the ownership of the goodwill is attributable to the shareholders, not to the corporation. Likewise, the Tax Court has ruled that goodwill does not pass from a liquidating corporation to shareholders if the goodwill was solely attributable to the shareholders' personal attributes.

The C corporation's basis in the new LLC decreases under IRC §752(b) for any contributed liabilities that the LLC assumed (debt relief is a deemed cash distribution for tax purposes). Simultaneously, the C corporation's tax basis increases for its allocable share of LLC debt, which is a deemed cash contribution for tax purposes.[83] If the debt assumed by the LLC does not result in a negative tax basis, the C corporation does not recognize gain on contributing assets to the LLC. However, if the C corporation is left with a negative capital account, it must recognize capital gain under IRC §731(a) to restore the negative capital account to zero.

Precontribution gain will be allocable as income to the corporate partner's contribution resulting in income allocable under §704(c). Further, any distribution or sale of a corporation's contributed assets could be completely allocable to the corporate partner without a proportionate allocation of cash proceeds to pay the tax.[84]

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80. IRC §752(b).

81. IRC §1239.

82. *Martin Ice Cream Co. v. Comm'r,* 110 TC 189 (1998).

83. IRC §752(a).

84. IRC §737.

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Liquidation Distribution to Shareholders

The C corporation liquidates after its contribution of assets and liabilities to the LLC. Gain or loss is recognized under IRC §336(a) on the distribution of property in complete liquidation as if such property was sold to the shareholders at its FMV (including the value of any intangibles). The C corporation distributes the LLC ownership interests to its shareholders in complete liquidation, which is treated by IRC §331(a) as full payment in exchange for the stock. The gain or loss a shareholder recognizes under IRC §1001 is determined by comparing the distribution amount to the shareholder's stock basis. Consequently, the shareholders report either a return of capital or capital gain income subject to a 15% tax rate.

Benefit of Conversion

The former C corporation shareholders no longer are subject to tax on any distributions from the newly-formed LLC, unless cash distributions exceed basis.[85] Because an LLC member's allocable share of LLC liabilities is treated as a deemed cash contribution to the LLC for federal tax purposes, the LLC members are given additional protection against tax. However, the members (assuming the newly-formed LLC is taxed as a partnership) are subject to the passive loss rules of IRC §469.[86] Redemption of partner interest can lead to tax deductibility under §754 as a result of the basis step-up procedure.

Note. Any C corporation shareholders that are passive investors in multiple flow-through vehicles could have suspended losses resulting from the passive-activity loss-limitation rules. Any passive-activity losses that were suspended for nonmaterially-participating investors can be used to offset any IRC §731 gain that could be recognized by members on LLC distributions that exceed basis. Any IRC §731(a) gain that nonmaterial participants recognize is treated as passive-activity gross income and netted against their passive-activity suspended losses.[87]

Observation. If the corporation begins the LLC conversion process **before** the corporation's assets have appreciated significantly, any gain that the corporation and the shareholders must recognize on the deemed liquidation is minimized.

ISSUE 4: C CORPORATION COMPENSATION ISSUES

The Code allows a corporate-level deduction for reasonable salaries and compensation paid to employees for their personal services. As a consequence of the dual-level taxation associated with C corporations (on corporate income when earned and again when paid as dividends), C corporations have an incentive to pay larger than normal salaries to reduce their taxable income and get corporate earnings to owners with only one level of tax. The IRS can challenge what they deem to be excessive salaries as disguised dividends resulting in a loss of a corporate deduction from taxable income and the addition of the excessive amount to the corporation's net taxable income. Conversely, in certain situations, corporate employees may receive only a nominal salary in an attempt to minimize FICA and Medicare taxes. Upon audit, the IRS may increase the salaries, which results in FICA and Medicare tax due, plus interest and penalties.

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85. IRC §731.

86. But see *Garnett v. Comm'r,* 132 T.C. No. 19 (2009) (heightened standard for material participation applicable to limited partner in a limited partnership does not apply to non-managing member of LLC); *Thompson v. United States,* No. 1:06-cv-00211 (Fed. Cl. Jul. 20, 2009) (same; no additional analysis necessary concerning whether passive loss rules applied to taxpayer under the general tests for material participation because the taxpayer did not hold a limited partnership interest).

87. Rev. Rul. 95-5, 1995-1 CB 100.

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> **Note.** Another problem associated with setting salaries too low is that the corporation could be assessed for payroll taxes on the unreported compensation. The penalties and interest associated with unreported compensation are often greater than an income tax deficiency assessment. The quarterly payroll deposit rules typically have been violated, resulting in cascading penalties that include the failure to timely deposit and failure to properly report.

Corporate salaries must be reasonable in light of the personal services that are actually rendered.[88] However, "reasonable" is not defined in the Code, and the Regulations indicate that reasonable compensation is an amount paid for like services by like enterprises under like circumstances.[89] Hence, the facts and circumstances of each particular situation are determinative of the outcome. The courts, in numerous cases, have set forth several factors used in determining the reasonableness of salaries, including the following:

- The level of the salary in light of the employee's qualifications
- The compensation paid in light of the nature and extent of the employee's work, with consideration paid to the role that the shareholder plays in the corporation (e.g., the employee's position, number of hours worked and duties performed)
- How the compensation compares to compensation paid for similar services by similar entities
- Whether the compensation is reasonable in relation to the salary history of the corporation
- Whether the compensation is reasonable in light of the character and financial condition of the corporation
- Whether a hypothetical, independent investor would conclude that there is an adequate return on investment after considering the shareholder's compensation
- The size and complexity of the business
- How the amount of salaries paid compares to corporate sales and net income
- General economic conditions
- How the amount of salaries compare to shareholder distributions and retained earnings
- The corporation's dividend history
- Whether the employee and employer dealt at arm's length
- Whether the employee guaranteed the employer's debt
- Whether there is a catch-up element involved in situations in which the corporation is making up for years when the employee was underpaid
- Whether the corporation has developed compensation policy for employees allowing them to participate in the company's success

The Internal Revenue Manual utilizes the same factors. In addition, the IRS issued a Fact Sheet in late 2008 detailing salary requirements for S corporation officers.[90] In the Fact Sheet, the IRS indicates that corporate officers must take a reasonable salary from the corporation. The Fact Sheet also describes the IRS's concern when too much corporate income flows through the corporation to a shareholder on a K-1 (where it is not subject to FICA and Medicare tax) rather than as wages on Form W-2.

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88. IRC §162(a)(1).

89. Treas. Regs. §§1.162-7(b)(3) and 1.1366-3(a).

90. FS-2008-25.

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The court cases confirm that no single factor controls. Instead, a combination of factors must be considered. In addition, the factors are not all inclusive and may not carry equal weight. Many or a few factors may be appropriate, depending on the specific facts and circumstances.

Note. As a tax planning strategy, the compensation for each shareholder/employee should be reviewed for reasonableness and increased by payment of a bonus, if needed before yearend. While reasonableness is based on the facts and circumstances, in many situations, compensation can be placed at the low end of a wide salary range that is both reasonable and supportable. Thorough documentation that explains why wages and bonuses are appropriate is more likely to withstand IRS scrutiny.

Example 7. Joe establishes an accounting practice, and employs Ray and Charlene. Joe operates as a PSC. The firm has a successful first year, generating $300,000 in corporate net income. Joe declares a bonus for himself in the amount of $300,000, which eliminates the corporation's taxable income. However, $200,000 of the $300,000 in income was generated by the efforts of Ray and Charlene. The IRS will likely take the position that the extra time and effort expended by Joe in managing the accounting practice is, at best, a nominal factor to be taken into account when a large portion of the income is based on the services rendered by other employees. Therefore, the IRS will likely conclude that $200,000 of net income paid to Joe is actually a nondeductible dividend. The resulting additional corporate income is taxed at the 35% rate applicable to PSCs. This results in additional tax liability of $70,000.

Joe could elect to have the company taxed as an S corporation. In this situation, Joe does not declare and pay himself the $300,000 bonus. Instead, he takes the $300,000 as an S corporation distribution which is taxed to the shareholders on a pro-rata basis. If this occurs, the IRS may examine the $300,000 S corporation distribution to determine whether it actually should be treated as compensation to Joe. If all or a portion of the $300,000 is deemed to be compensation, FICA and Medicare tax will be assessed on the deemed compensation amount.

Joe could establish his compensation at the maximum amount for funding a qualified retirement plan, with the balance of corporate net income structured as an S corporation distribution. In this situation, he avoids Medicare tax on the S corporation distribution amount. However, the IRS may examine that scenario to determine whether compensation is too low.

The following is a list of the more prominent cases and rulings on the reasonable compensation issue with a brief note associated with each case or ruling concerning the pertinent issue or issues involved:

- ***Menard, Inc. v. Comm'r*, 560 F.3d 620 (7th Cir. 2009).** The IRS challenged as unreasonable the $20 million salary of a corporate CEO (who worked full-time and owned all of the voting stock and 56% of the nonvoting stock). Of that amount, over $17 million was paid in accordance with a plan that had been in place since 1973 which set bonuses at 5% of the corporation's net income before taxes. The Tax Court disallowed all but $7 million of the salary, after comparisons to CEO salaries of competing businesses such as Home Depot and Lowes. The case was reversed on appeal. Under the CEO's management, the corporation's revenue grew from $788 million in 1991 to $3.4 billion in 1998 (the year at issue), and the corporation's taxable income increased from $59 million to $315 million during the same period. The corporation's rate of return on shareholder's equity in 1998 was higher than that of either company the Tax Court used for comparison purposes. Thus, 5% of net corporate income did not look like a dividend and the Tax Court committed clear error in holding that the salary was excessive. The appeals court said the Tax Court had established itself as the "super-personnel department for closely-held corporations."

Note. For more detail on this case, see Chapter 13, Rulings and Cases.

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- ***Nu-Look Design, Inc. v. Comm'r*, 356 F.3d 290 (3d Cir. 2004), *cert. den.*, 2004 U.S. LEXIS 5680 (U.S. Oct. 4, 2004).** The IRS classified an officer as an employee with the result that the corporation was found liable for employment taxes. The appeals court, affirming the Tax Court, held the Tax Court appropriately focused on the nature of the services the officer rendered to the corporation and whether the distributions from the corporation were remuneration for those services. The court also determined the corporation was not entitled to §530 relief provided by the Revenue Act of 1978.

- ***Joseph M. Grey Public Accountant, P.C. v. Comm'r,* 119 TC 121 (2002).** The Tax Court held that a shareholder (who was the sole owner and shareholder) was an employee for FICA and FUTA purposes. All receivables were deposited into the corporation's checking account, and the shareholder was the only person with signature authority over the account. The corporation did not make regular payments at fixed times to the shareholder for his services and did not distribute any dividend to the shareholder. The corporation issued the shareholder a Form 1099-MISC reporting nonemployee compensation. The Tax Court also held that the corporation had no reasonable basis for not treating the shareholder as an employee and that the corporation was not entitled to §530 relief.

- ***Veterinary Surgical Consultants, P.C. v. Comm'r,* 117 TC 141 (2001).** The S corporation had a single shareholder, a veterinarian who served as the corporation's president and only officer. All of the shareholder's income came from the services rendered by the individual. The corporation claimed that the shareholder was not its employee, but the court disagreed. The shareholder had performed substantial services for the corporation, including consulting and surgical services. As such, the monies paid to the shareholder were wages subject to employment taxes.

- ***Joly v. Comm'r*, U.S. Court of Appeals, 6th Circuit, 99-1414, (Mar. 20, 2000), 2000 U.S. App. LEXIS 4998, *affirming the Tax Court,* 76 TCM 633, 52,907(M), TC Memo 1998-361 (Dec. 1998).** The taxpayer was the sole shareholder of an S corporation. The court determined the taxpayer was an employee and had not properly reported income he received from the corporation. An accuracy-related penalty was justified because the taxpayer did not maintain sufficient records to substantiate the position taken on the return.

- ***Jeffrey B. Fleck Co. v. U.S.*, U.S. District Court, Northern Dist. Ohio, 4:99CV1587 (July 2000).** The corporation prepaid its sole owner one year of wages. At the time of the prepayment, the owner loaned the corporation a larger amount of money to be repaid periodically throughout the year and part of the next year. However, on the tax return, the corporation did not report any FICA or FUTA tax. The court held the principal objective of the corporation was to avoid FICA and FUTA tax and disallowed the transaction due to lack of economic substance.

- ***Donald Palmer Co., Inc. v. Comm'r,* TC Memo 1995-65 (Feb. 7, 1995).** Half of the compensation paid to the president, sole officer, and sole shareholder of the corporation was determined to be deductible by the corporation. The bonus and salary were consistent with evidence about contracts with other employees, but the bonus payment resulted in negative returns, which made it reasonable to conclude that funds were being siphoned out of the company disguised as salary.

- ***Ghosn v. Comm'r,* TC Memo 1995-192 (Apr. 27, 1995).** The taxpayer was the sole shareholder of the corporation, which operated as a restaurant. The shareholder was the cook, janitor, driver, and corporate CEO. The corporation paid management expenses but did not claim any deduction for salaries. The court held that the shareholder received constructive dividends.

- ***Dunn & Clark, P.A. v. Comm'r,* U.S. Circuit Court of Appeals, 9th Circuit, 94-35562 (June 6, 1995), *affirming a District Court decision,* 853 F.Supp 365.** A corporation operating as a law firm did not make any payments that were designated as wages or salary to the attorneys. However, it did make payments that were characterized as dividends. The court held that the payments were remuneration for employment services.

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- ***Langer v. Comm'r,* TC Memo 1990-268 (May 30, 1990).** The corporation was a home-based greeting card business run by three sisters. The court found the amount the corporation paid two of the sisters in rent was excessive, but the extra amount could be deducted as employee compensation.
- ***Spicer Accounting v. U.S.*, 918 F.2d 90 (9th Cir. 1990).** Because the corporation's shareholder performed substantial services that were essential to the corporation, payments to the shareholder were wages. The shareholder was also not a common-law independent contractor.
- ***Esser, P.C. v. U.S.,* 750 F.Supp. 421 (DC Ariz. 1990).** An attorney provided legal services for the corporation but did not receive a salary. The corporation loaned the attorney money on a weekly basis. At year's end, the corporation declared a dividend in the amount equal to the corporation's net taxable income, but the dividends were left in the corporation to repay the loans the attorney received during the year. FICA and FUTA taxes were not paid. The court held that the attorney was an employee due to the substantial legal services rendered to the corporation.
- ***Joseph Radtke, S.C. v. U.S.,* 895 F.2d 1196 (7th Cir. 1990).** Payments to shareholder were remuneration for services performed and were, therefore, wages.
- ***C.D. Ulrich, Ltd. v. U.S.,* 692 F.Supp. 1053 (1988).** The Code expressly includes corporate officers within the definition of employee.
- ***Gale W. Greenlee, Inc. v. U.S.,* 661 F.Supp. 642 (1985).** A corporation made loans to sole stockholders. The IRS characterized the loans as wages and assessed FICA and FUTA tax. The court held the loans were wages because the loans were unsecured demand notes which bore no interest and did not specify the conditions under which the loans had been made. The stockholder regularly performed substantial, valuable services for the corporation.
- **Rev. Rul. 74-44, 1974-1 CB 287.** Dividends were determined to be in lieu of reasonable compensation.
- **Rev. Rul. 73-361, 1973-2 CB 331.** A corporate employee performing substantial services as a corporate officer, for which he is paid a salary, is an employee of the corporation for FICA and FUTA purposes and income tax withholding.
- **Rev. Rul. 71-86, 1971-1 CB 285.** The corporation's president and sole shareholder is found to be an employee.
- ***Electric & Neon, Inc. v. Comm'r,* 56 TC 1324 (1971), *aff'd* 496 F.2d 876 (5th Cir. 1974).** Excess withdrawals by the corporate president should have been treated as dividends.
- ***Haber v. Comm'r,* 52 TC 255 (1969).** Amounts paid to a shareholder were not loans but were taxable compensation for services.

Other pertinent cases and rulings:

- *Elliotts, Inc.,* TC Memo 1980-2282, *rev'd in part*, 217 F.2d 1241 (9th Cir. 1983)
- *Bramlette Building Corp., Inc. v. Comm'r,* 52 TC 200 (1969), *aff'd,* 424 F.2d 751 (5th Cir. 1970)
- *Krahenbuhl v Comm'r,* TC Memo 1968-34
- *Peter H. Jacobs v. Comm'r,* TC Memo 1993-570
- Rev. Rul. 82-83, 1982-1 CB 151
- *Townsend*, 40 TCM 706, TC Memo 1980-264

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ISSUE 6: TAX CONSEQUENCES OF CORPORATE LIQUIDATION[91]

The previous issue examined the step-by-step process of extracting assets from a C corporation in a manner that avoids the BIG tax that would be incurred upon liquidation. The following discussion compares the tax cost difference between the current liquidation of a C corporation versus current liquidation of an S corporation upon a shareholder's death.

Note. The following examples, for purposes of simplicity, disregard the tax that is triggered upon liquidation of a C corporation with retained earnings and profits. Those are treated as distributed qualified dividends upon liquidation and are taxed at prevailing individual income tax rates.

It is important to remember that a corporate liquidation is a taxable event at both the corporation and shareholder levels. This is true whether the corporation is a C corporation or an S corporation. However, the incidence of the tax may be quite different due to double taxation on C corporation distributions and single taxation on S corporation distributions.

COMPLETE LIQUIDATION OF C CORPORATION

Example 8. Siblings, Inc., has two equal shareholders, John and Ann. The FMV of the corporation's assets (all unimproved real estate) is $2 million with an adjusted basis of $1 million. John and Ann each have $200,000 basis in their stock. The shareholders want to liquidate the corporation and distribute its assets equally.

Tax on Corporation	
FMV of assets	$2,000,000
Adjusted basis of assets	(1,000,000)
Gain on liquidating distribution (all gain taxed at ordinary income rates)	1,000,000
Corporation tax on gain (assuming flat 34%)	340,000
Distributions to Shareholders	
Corporation's assets (pretax)	$2,000,000
Less: corporation's tax liability	(340,000)
Amount distributed to shareholders (total)	$1,660,000
Amount distributed per shareholder	830,000
Less: shareholder basis (each)	(200,000)
Gain recognized per shareholder	$ 630,000
Tax per shareholder (fed/state (15%/8%), or 23%)	144,900
Total Tax Liability	
Tax on corporation	$ 340,000
Tax on John	144,900
Tax on Ann	144,900
Total tax	$ 629,800

Each shareholder's basis in the assets received above will be the FMV of the assets at the time of distribution.

[91] This material is adapted, with permission, from material prepared for the 69th Annual Bloethe Tax School, Iowa Bar Association, by A. David Bibler, Lee Wilmarth, and James Goodman.

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The liquidating corporation recognizes all gains and losses on the distribution of property in liquidation:[92]

- Losses may be limited on recently acquired property if not related to the corporation's business.[93]
- Losses are disallowed if property:
  1. Is distributed to the controlling shareholder or a related party,
  2. Was received as a contribution to capital or received in a §351 exchange within five years, or
  3. The distribution of loss property is not pro rata.[94]

Shareholders report all gains and losses on the disposition of their shares in a complete liquidation.[95] Different rules may govern if a shareholder was a corporation that owned at least 80% of the shares in the liquidated corporation.[96]

The shareholder's basis of the property received in a liquidation is its FMV at the date of the distribution.[97]

COMPLETE LIQUIDATION OF S CORPORATION

The same general liquidation rules apply to an S corporation as to a C corporation. However, the tax cost is significantly smaller **unless** the S corporation is subject to the BIG tax.

Example 9. Use the same facts as **Example 8,** except that Siblings, Inc., has always been an S corporation. Therefore, it is exempt from the BIG tax. **If the S corporation completely liquidates, there will be no tax at the corporate level.** The shareholders are required to recognize the corporation's pass-through gains and losses on the liquidating distribution.

Tax on S Corporation		
FMV of assets	$2,000,000	
Adjusted basis of assets	(1,000,000)	
Gain on liquidating distribution	$1,000,000	
Gain passed through to shareholders	1,000,000	
Tax at S corporation level		$ 0
Tax to Shareholders		
Pass-through gain on liquidating distribution	$1,000,000	
Tax on pass-through gain (fed/state (15%/8%), or 23%)		230,000
Distribution to Shareholders		
FMV of assets	$2,000,000	
Beginning shareholders' basis	(400,000) [a]	
Pass-through gain	(1,000,000)	
Gain to shareholders from distribution	$ 600,000	
Tax on distribution gain (fed/state (15%/8%), or 23%)		138,000
Total tax		$368,000
Combined Corporate and Shareholder Tax		
Total tax if C corporation	$ 629,800	
Total tax if S corporation	(368,000)	
S corporation savings	$ 261,800	

[a] If shares are retained until death, a step-up to FMV will be obtained. This will materially reduce any tax consequences.

92. IRC §336.
93. IRC §336(d)(2).
94. IRC §336(d)(1).
95. IRC §331.
96. IRC §§332 and 337.
97. IRC §334(a).

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2009 Workbook

COMPLETE S CORPORATION LIQUIDATION UPON SHAREHOLDER DEATH

The tax benefits of retaining stock until the shareholder's death are illustrated in the following example.

Example 10. Landco, Inc., was incorporated in 1983 as a C corporation. This corporation elected S status in 1987. Landco, Inc., has one shareholder, Albert.

Albert died in 2008 at a time when the FMV of the corporation's assets was $2 million with an adjusted basis of $1 million.

Prior to Albert's death, his basis in Landco's stock was zero. At his death, Albert's basis in the Landco stock receives a step-up to FMV. Therefore, the heir's basis in Albert's Landco, Inc., stock is $2 million. The corporation is liquidated following Albert's death.

Tax on Corporation			
FMV of assets		$2,000,000	
Adjusted basis of assets		(1,000,000)	
Gain on liquidating distribution (passed through to Albert's heirs)		$1,000,000	$1,000,000
Distributions to Shareholders			
S corporation's assets		$2,000,000	
Basis before liquidating distribution	$2,000,000 [a]		
Gain passed through from corporation	1,000,000		
Shareholder's basis	$3,000,000	(3,000,000)	
Loss recognized (Albert's heirs on liquidation)		($1,000,000)	(1,000,000)
Total Gain/Loss on Liquidation			**$ 0**

[a] Step-up in basis at date of death

Caution. As previously mentioned, a corporation **must be liquidated** in the same tax year as the sale/distribution of assets to produce the desired tax result. If a sale/distribution of assets is completed in one tax year and the liquidation of the corporation in the following year, the capital loss produced upon liquidation will not offset the capital gain generated by the sale of assets.

In this case, the capital loss produced upon liquidation will only offset other long-term capital gains for the tax year of the liquidation, plus $3,000 of ordinary income. The remaining long-term capital loss will be carried forward to subsequent tax years.

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